



– Position paper –

Minimum carbon pricing is distortive and not needed – why free price formation should remain a cornerstone of the EU ETS' volume-based cap-and-trade mechanism

Brussels, 30 November 2020 | The EU Emissions Trading System (EU ETS) is a cornerstone of the EU's policy to combat climate change and the key carbon pricing instrument for reducing greenhouse gas emissions cost efficiently. While the main variant in terms of carbon pricing is a cap and trade system such as the EU ETS, other variants exist. The concept of a carbon price floor, for example, is regularly advertised as a way to improve investment certainty by reducing carbon price risk, decreasing the cost of capital and facilitating access to finance. Additionally, the price floor argument has been touted as a way of protecting against drops in fossil fuel prices and accelerating decarbonisation efforts by providing predictable long-term price signals. As such, a number of EU Member States have expressed their interest in considering the introduction of a carbon price floor, either by combining it with the EU ETS or in the form of a carbon tax.

The design of the volume-based EU ETS stands in stark contrast to these price-based approaches. Therefore, such a mechanism would seriously undermine the functioning of the EU ETS as a volume-based 'cap-and-trade' scheme, especially as regards the efficient and undistorted price formation and the interaction with the Market Stability Reserve (MSR).

In the following, we elaborate the main risks of implementing a carbon price floor and explain why the EU ETS must remain the EU's central climate policy instrument with undistorted price formation. The most efficient way to address well-functioning environmental and energy markets is the further development of the EU ETS as a volume-based system in which an emissions cap is set and prices are freely determined in the market. Any alternative design or artificial price management mechanisms would undermine efficient decarbonisation efforts, both in the 2030 timeframe and beyond towards 2050. This is also true for carbon taxation mechanisms introduced on a unilateral basis through different national systems which can have an impact on the internal market¹.

¹ Please see the impact assessment accompanying the document '*Stepping up Europe's 2030 Climate Ambition - Investing in a climate-neutral future for the benefit of our people*', as presented by the European Commission on 17 September 2020, states, at pg.110 ([link](#)).

1) Minimum carbon pricing would undermine free price formation in the volume-based EU ETS

As an abatement instrument, the EU ETS is a cap-and-trade scheme – i.e. it caps the emissions volume and facilitates the trading of allowances, resulting in a freely formed carbon price and efficient emissions reduction. Supply and demand together with the possibility to trade allowances sets the carbon price in the market for the short-, medium- and long-term. As a result, emissions are reduced where costs are lowest. Moreover, the price signal responds flexibly to external factors such as economic developments or policy changes. Any mechanism to manage the price will undermine the functioning of the emissions market and fundamentally alter the nature of this scheme. This is true for various price floor models going from a top-up payment above the EUA price to an auction price floor.

If a minimum carbon pricing mechanism was to be introduced, it would likely require a long and complex decision-making process on the actual floor price. The carbon price would then no longer be determined by supply and demand, but on the basis of a political decision. Determining the ‘right’ price level would be extremely challenging, requiring policymakers to balance the interests of investors and suppliers of low-carbon technologies (i.e. requiring price certainty) and ETS participants (i.e. avoiding excessive cost for participants and society). In addition, it would run against the fundamental economic principle that the market can most efficiently determine the price of an allowance.

For example, setting a carbon tax at the right level to incentivise efficiency in each individual sector would be an extremely complex task which a trading system can solve in an optimal way. Another often cited option is a price floor system for the EU ETS, eventually creating a hybrid price-volume scheme². However, this approach risks undermining the existing volume management and oversupply mechanism in the EU ETS, which is currently handled through the MSR. The MSR diverts allowances from auctions when the allowances in circulation exceed a defined range or releases allowances into auctions when they fall below this range. The MSR was explicitly designed as a volume-management tool to increase scarcity in the market and to strengthen the price signal while minimising market distortion. Alternatives to the MSR, including a discretionary price management mechanism, had been previously considered and rejected because of their incompatibility with the core ETS design, the political infeasibility and concerns from numerous stakeholders³.

The latest EU ETS reforms and the implementation of the MSR have been effective in increasing and stabilising prices while minimising the risk of the ‘waterbed effect’. Further, there are already a number of planned changes in the pipeline; for example, the scheduled increase of the Linear Reduction Factor (LRF) to 2.2% in 2021 will further reduce the surplus of allowances and strengthen the price signal as well as the effectiveness of the system. In addition, the likely increase of the EU climate targets to a 55% reduction (or more) in emissions by 2030 will require changes to the ETS and also impact EUA prices. Measures that would weaken this important price signal should be avoided.

² There are examples of price-base elements in different ETS schemes such as in the UK, California and China. In these cases, however, the governance contexts need to be considered.

³ See Commission SWD/2014/017 final: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52014SC0017>

2) Minimum pricing risks disrupting primary auctions and the regular, predictable supply of allowances to the market

Auctions are the default allocation method for allowances, providing a regular and predictable supply of allowances to the market. Adding a carbon price floor to the existing auction mechanism would not only increase its complexity but also risks interfering with the functioning of the MSR and upcoming reviews scheduled to take place in 2021 as part of the European Commission's 'Fit for 55 package'. In this context, carbon prices are estimated to double over the next decade following the likely increase of the EU climate targets to a proposed 55-60% reduction in emissions⁴. The market is already being strengthened during Phase IV and this will continue on the road to carbon neutrality by 2050. The carbon price floor discussion to address scarcity and a persistent fall in carbon prices has now become a debate of the past.

Setting an EU-wide minimum price floor below which permits would not be allocated in an auction could also impede the auction from clearing in case this minimum price is not met. Unsold permits could be set aside for use in future auctions or be cancelled, either immediately or at a later date. If unsold permits are not cancelled, no additional environmental benefit would follow. However, conversely, if unsold permits are cancelled this would again interfere with the functioning of the MSR and introduce uncertainty in the market about the amount of allowances in the European carbon budget. The introduction of a floor price leading to cancelled auctions, as well as the unpredictability created by potentially differing approaches to dealing with unsold permits, risks creating significant uncertainty for market participants.

Moreover, the EU ETS has measures in place to ensure access to primary auctions to all market participants, independent of their size. Hampered access to permits at primary auctions would harm small market participants in particular who are not always able to easily access the secondary markets, unlike larger players. In that way, smaller players may be prevented from accessing any type of emissions market altogether. Further, the fact that this auction price floor model would have a limited impact on the price formation in secondary markets puts its overall relevance into question.

3) Unilateral action on minimum pricing risks increased fragmentation without tangible environmental improvements

First and foremost, the EU ETS is the main tool in the EU's common approach on climate change policy. Emissions trading at European level assists in incentivising the cheapest reductions across member states, improving cost-efficiency in the sectors covered and counteracting potential internal distortions within the internal market. A unilateral price floor implementation by individual EU Member States, on the other hand, would reinforce political divergence in decarbonisation pathways across the EU and lead to economic inefficiencies⁵.

⁴ Some analysts suggest that carbon prices could increase by 50% over the next decade:

<https://www.reuters.com/article/us-climate-change-eu-carbon-idUSKBN2682ZQ>

<https://www.argusmedia.com/en/news/2142240-eu-ets-price-3265t-under-2030-scenarios>

<https://www.edie.net/news/6/Carbon-prices-set-to-climb-by-50--over-next-decade-following-raised-EU-climate-targets/>

⁵ Please see the impact assessment accompanying the document 'Stepping up Europe's 2030 Climate Ambition - Investing in a climate-neutral future for the benefit of our people', as presented by the European Commission on 17 September 2020,

The introduction of a top-up-payment in only some Member States creates additional costs for processing emissions, thereby risking to put their industries at an economic disadvantage⁶. It could even be argued that the introduction of the volume-based MSR has made a top-up-payment no longer required. An often cited example of a top-up-payment is the UK Carbon Price Floor. This was introduced by the UK government before the MSR was implemented in the EU ETS. At the time the UK government felt the EUA price ‘has not been stable, certain or high enough’⁷. These issues have been addressed by the MSR.

Second, the environmental outcome of a cap and trade system is guaranteed by its absolute limit on emissions, i.e. the cap. As evidenced in the European Commission’s impact assessment on stepping up Europe’s 2030 climate ambition, a carbon price floor such as one achieved by a national tax could potentially ensure revenues but does not guarantee a tangible environmental benefit. While emissions may decrease at national level, the overall cap will not. Saving emissions in one Member State or one sector will rather lead to freeing up EUAs, which will then be bought and used by other emitters in Europe. EU-wide emissions would therefore not decrease, a phenomenon often dubbed as ‘waterbed effect’.

In the context of a potential expansion of the EU ETS scope, it is important to ensure coherence between policies. Notably, the scenarios in the aforementioned impact assessment explain how the cost efficiency of the ETS at achieving emissions abatement might be limited by heterogeneity of the national fuel tax landscape. Setting EU wide explicit minimum carbon price levels by a revision of the EU energy taxation could mitigate internal market challenges, but then again offers no guarantee of emission reductions. To this end, Europex encourages efforts for coordination and harmonisation, to the greatest extent possible, of carbon pricing initiatives in line with the EU ETS.

4) Minimum carbon pricing policies may hinder efforts to link emission trading systems and cooperate globally on carbon pricing schemes

The EU speaks with one voice at international climate negotiations and this unified approach has proven successful. International climate policy and climate diplomacy have been strengthened as a result of coordination of European climate policy at the EU level; both of which are crucial in a world in which the EU accounts for only around 10% of global GHG emissions. Therefore, to reach the climate targets of the Paris Agreement, Europe should continue to actively support global cooperation in the fight against climate change and foster the establishment and linking of emissions trading systems around the world. Over the last few years, a rapid increase in carbon pricing globally could be observed, including in the form of new emissions trading schemes. While significant differences in climate policy exist among the 197 UNFCCC Parties, the policy landscape is gradually moving towards the vision of global carbon pricing. The EU ETS can serve as a benchmark in this process and underpin a shift towards a global emissions market. To this end, it is important that carbon price floors do not hinder efforts to link emission trading systems across regions, countries and continents.

which reads: “but also carbon taxation can come at an administrative costs and economic inefficiencies [...] through different national systems which impact the internal market.” At pg.110 ([link](#)).

⁶ E.g. PwC conducted a cross-sectoral level playing field study for the Dutch Ministry of Economic Affairs and Climate in the context of a CO2 tax proposal which concludes that the introduction of the proposed tax will negatively impact the financial situation of local industry ([link](#)).

⁷ DECC, Planning our electric future: a White Paper for secure, affordable and low-carbon electricity, July 2011 ([link](#)).

About

Europex is a not-for-profit association of European energy exchanges with 29 members. It represents the interests of exchange-based wholesale electricity, gas and environmental markets, focuses on developments of the European regulatory framework for wholesale energy trading and provides a discussion platform at European level.

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