



– Position paper –

Carbon Contracts for Difference (CCfDs) and their potentially distortive effects on emission markets: call for a comprehensive impact assessment

Brussels, 31 May 2021 | Carbon Contracts for Difference (CCfDs) have been broadly discussed as a potential instrument to support energy-intensive industries in developing and deploying low-carbon technologies. In its New Industrial Strategy, the Commission recently stated its interest in a European approach for CCfDs in the context of the upcoming revision of the EU ETS Directive.¹ Against this background, **Europex would like to draw attention to the potential unintended distortive effects that such a mechanism may cause to the European emissions market and advise that a thorough impact assessment is needed before determining whether or not to introduce CCfDs into the EU ETS.**

I. The introduction of subsidy instruments such as CCfDs into the EU ETS risks negative impacts on the carbon market

CCfDs have recently been touted as a ‘market-friendly’ mechanism that will support the uptake of low carbon technologies. **However, it must be noted that CCfDs remain socialised subsidies that may interfere with the free price formation in the EU ETS.**

For many years, the price level of European Emission Allowances (EUAs) has not been seen as sufficiently high or stable enough for low-carbon technologies with higher costs to be competitive compared to more polluting alternatives already available at scale. A CCfD offers assurance about the future trajectory of carbon prices in the form of a fixed price for certain emissions reductions. In particular, CCfDs cover the difference between a variable reference price (the price of EUAs) and a fixed competitive strike price. When the allowance price falls below the strike price, the CCfD is triggered, resulting in a payment from the contracting party (typically a national government) to the beneficiary. The ideal strike price differs between and within industrial sectors: a strike price of €80/tCO₂ was recently allocated to a large-scale CCS project in the Netherlands, whereas strike prices for green hydrogen are estimated between €55-90/tCO₂.²

¹ As part of the proposal for a revised ETS Directive, the Commission is considering proposing a European approach to carbon contracts for difference, using ETS revenues and complementing other forms of support under the Innovation Fund. Please see ‘Updating the 2020 New Industrial Strategy: Building a stronger Single Market for Europe’s recovery’, COM(2021) 350 final, pp.18, 20, [\[link\]](#).

² Port of Rotterdam [\[link\]](#), European Commission Hydrogen Strategy [\[link\]](#).

However, publicly backed CCfDs do not come without limitations: they raise particular problems for the emissions forward market, effectively reducing the need for market participants to hedge their risks leading to reduced overall liquidity and thus less efficient price-formation. This downward cannibalising pressure on EUA market volumes also raises questions on the impact it will have on the Market Stability Reserve (MSR) and the proposed Carbon Border Adjustment Mechanism (CBAM), as well as on the interaction with other EU ETS parameters such as the overall cap of emissions and/or the linear reduction factor, which might need readjusting to avoid waterbed effects in the EU ETS. Moreover, the cost of managing this risk is ultimately transferred to the public, rather than managed via the competitive energy and emissions market.³

Introducing CCfDs may also have an impact on the EU's trade policy, as this may create an unlevel playing field and grant advantages to those within the EU ETS. This is particularly important in the context of the EU-UK Trade and Cooperation Agreement and the ongoing negotiations for a potential future linkage of the EU ETS and the UK ETS.

In sum, such socialised subsidy schemes could lead to short- and long-term market distortions, reducing the effectiveness of the price signal as an operational and investment decisions driver. The paradox of CCfDs is that they require an already robust carbon price signal to be effective, yet CCfDs could potentially weaken the carbon market and its price signal.

II. Non-distortive alternatives are already widely available

In energy and emissions markets, market participants can already use the available short- and long-term trading products to efficiently manage their exposure to the carbon price signal, in parallel with other commodities. This market-based approach is the basis for the liquidity of the market, diversity and number of market participants in the system. The introduction of CCfDs, designed to guarantee carbon prices, ultimately risks undermining markets which are used to manage exposure to price risks.

Further, besides the EU ETS as the primary instrument, investment grants outside of the carbon market can be used to promote investments in immature low-carbon and carbon removal technologies without interfering with the functioning of the market. **Additional support for low carbon technologies is already granted through several instruments aiming to mobilise funding** such as the Recovery and Resilience Plans, NextGenerationEU, InvestEU, as well as the Innovation and Modernisation Funds, among others.⁴

III. The policy context and price trajectory of the carbon market may render CCfDs unnecessary

First and foremost, the focus should be on aligning the EU ETS framework with the EU's 55% target for emission reductions by 2030. Strengthening the carbon price by setting an

³ The Europex response to the consultation on the EU offshore renewable strategy (24 September 2020) provides more detail on the potential negative market impacts of CfDs ([Link](#)).

⁴ Other forms of support and funding include the InnovFin Energy Demo Projects ([Link](#)); Connecting Europe Facility grants ([Link](#)); Horizon 2020 ([Link](#)), InvestEU Programme ([Link](#)); Modernisation Fund ([Link](#)); Just Transition Fund ([Link](#)); and Enhanced European Innovation Council (EIC) pilot ([Link](#)).

appropriate cap and linear reduction factor should be prioritised as it will ensure the EU ETS carbon price allows low carbon product technologies to be competitive against conventional production of the given product.

On top of the 55% target for emission reductions by 2030, the latest carbon price developments should be taken into account. Since its announcement, carbon prices have doubled to near 57 EUR⁵ and are estimated to double again by 2030.⁶ The Phase IV reforms reducing the volume of allowances in circulation and the upcoming EU ETS revision will strengthen the carbon price even further.

Against this background, Europex questions whether the introduction of CCfDs is truly justified. Concerns that the EU ETS carbon price is too low to allow low carbon product technologies to be competitive may be quickly outdated.

IV. Additional CCfDs drawbacks must be accounted for

Other CCfDs drawbacks include their inability to provide substantial improvements in sectoral innovation, their reliance on public funds and asymmetry of information. First, CCfDs are usually awarded via competitive auctions and while they can prevent leakage from the specific projects they cover, they do not offer any immediate benefits for the sector at large. This could also lead to a situation of double disadvantage where non-beneficiaries of CCfDs are financing state funding of CCfDs via the EU ETS. Second, relying on subsidies to the detriment of the end consumer when market solutions are available should not be the way forward to fund the energy transition, particularly during times of tight budgets. Last, information asymmetries can make it difficult for governments to gauge the true cost of bidding technologies and the required carbon strike price, something that competitive bidding processes can alleviate, but not eliminate. Given the rapidly changing price of EUAs and challenges in predicting the precise future level, it is exceedingly complex and nearly impossible to anticipate and reserve the exact amount of public budget needed, hence, rendering the overall budgeting process less efficient.

V. A comprehensive impact assessment considering the effects of CCfDs on the carbon market must be conducted before determining whether or not to introduce them in the EU ETS

All aspects considered, Europex calls upon the Commission to carefully deliberate the necessity of introducing potentially market distortive instruments, such as CCfDs, in the EU ETS. In case of a decision in favour of CCfDs, at the very least, we consider that the above concerns must be taken into account in a potential future European framework for CCfDs.

⁵https://carbon-pulse.com/128974/?utm_source=CP+Daily&utm_campaign=d2cd1367c6-CPdaily14052021&utm_medium=email&utm_term=0_a9d8834f72-d2cd1367c6-11031170/6

⁶ Some analysts suggest that carbon prices could increase by 50% over the next decade: <https://www.euractiv.com/section/energy-environment/news/eu-carbon-price-hits-record-e50-per-tonne-on-route-to-climate-target/>; <https://carbon-pulse.com/128974/>; <https://carbon-pulse.com/128335/>

In particular, we would like to stress the importance of conducting a comprehensive impact assessment that thoroughly assesses the consequences CCfDs may have on the market and how to avoid them. Importantly, any potential adoption of CCfDs in the EU ETS must be re-assessed against the current political context and most recent market developments, including the latest carbon price trends.

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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