As the European Union revises its carbon market to align with the bloc’s more ambitious climate objectives, calls are increasing to make the EU’s flagship climate policy tool future-proof and prevent wild price fluctuations.

In this Special Report, EURACTIV looks at options on the table to contain excessive price volatility on the EU’s Emissions Trading Scheme (EU ETS).

This report is available to read in French and German.
‘Politically-driven’ EU carbon market needs more transparency, analysts agree

Idea of carbon price ‘corridor’ resurfaces in France

Berlin pushes for a €60 minimum price on EU carbon markets

Analyst: Price collar would preserve ‘political stability’ of EU carbon market

Making EU ETS (and Europe) more resilient
‘Politically-driven’
EU carbon market needs more transparency, analysts agree

By Frédéric Simon | EURACTIV.com

Languages: Français | Deutsch

The European Union’s flagship climate policy instrument, the Emissions Trading Scheme (ETS), needs more monitoring and transparency in order to prevent “speculation about speculation” and restore political confidence in the market, analysts have said.

Carbon prices rose sharply last year, hitting €50 per tonne for the first time in May after languishing below €20 for more than a decade.

An all-time high of nearly €100 was reached in February this year on the back of new EU targets to halve emissions by 2030 and a gas supply crisis fuelled by Russia’s war in Ukraine.

This has sent alarm bells ringing in EU capitals, with Madrid calling for trading limits to be placed on the ETS in order to prevent CO2 prices from pushing up the cost of energy.
Those calls were later amplified by Polish Prime Minister Mateusz Morawiecki, who warned that carbon prices were “out of control” and needed to be contained in order to prevent “a drastic increase in energy bills” for ordinary households.

“We must cut through the speculative bubble that has built up around ETS trade,” Morawiecki wrote in an opinion piece published on EURACTIV in January.

**ESMA CALLS FOR MORE TRANSPARENCY AND MONITORING**

The European Commission has so far rejected suggestions that speculation was driving up the price of CO2, and referred to a March report by the European Securities and Markets Authority (ESMA) which concluded that the EU carbon market was functioning normally.

“Price movement and volatility are mainly driven by supply and demand dynamics, the structural decline in allowances and the rising in energy prices,” said Fabrizio Planta, head of markets and data reporting at ESMA.

And although investment funds have increased their presence on the EU carbon market, “traded volumes are still relatively small in comparison to other market participants,” he told a recent EURACTIV event, dismissing the notion that speculators had become dominant players on the ETS.

The official did acknowledge however that “transparency and monitoring” could be improved, and pointed to suggestions in the ESMA report for how this could be done.

This includes, for example, extending controls to emission allowance derivatives, amending positions reporting on emission allowances, improving the information content of weekly position reports, and improving transparency and reporting of Over-The-Counter (OTC) transactions, Planta said.

“So a lot of work in terms of transparency and monitoring is necessary,” he said.

**INCREASING TRUST**

Calls to increase transparency on the EU ETS are supported by Michael Pahle, a leading academic at the Potsdam Institute for Climate Research in Germany.

“The main problem, I believe, is actually ‘speculation about speculation,’” Pahle told EURACTIV in an interview, saying there is currently “no evidence” about speculation leading to an increase of the carbon price on the ETS.

That said, he agreed with Planta that stronger controls are needed to measure investment flows and allowance holdings, and define a point above which they can be considered excessive.

“One indicator is to measure how much liquidity is consumed – how many allowances are taken off the market that are not available to regulated entities anymore. If it’s just a very small share of overall market liquidity – currently a few million allowances – nobody will have to bother. But if at some point, it becomes a larger phenomenon, it risks distorting the market.”

“So we need to have a proper indicator and a threshold to determine when this becomes critical,” he said, adding that this requires new methods to measure the impact of trading as well as improving data along the lines ESMA suggested in its report.

**INFORMATION ‘MONOPOLY’**

More fundamentally, Pahle also pointed to a “monopoly on information” held by a handful of traders who have a disproportionate influence on the market. For instance, he pointed to a situation last year when prices rose sharply after an influential London-based hedge fund made vocal declarations about future ETS prices.

“This certainly received a lot of attention from other, likely less informed traders, who may have followed suit,” Pahle explained, saying this underlines that information can play an important role in driving prices on the market.

To address this, Pahle recommends improving information-sharing and transparency among all market participants. “We need a better explanation of what actually drives prices,” he said. “And I think this is really the root problem of the current debate” on price stability, he told the EURACTIV event.

“In a politically-created market, we want a clear answer to this question” because everyone needs to be able to trust the market to deliver the political objectives for which it was created, he said. “So trust needs to come into the equation. And I think this is really what we should make a centrepiece of new proposals.”

Some European politicians are receptive to calls for greater transparency.

Peter Liese, a German MEP leading the ETS reform in the European Parliament, mentioned a recent example where carbon prices...
rose by 10% on the back of an article published by financial news agency Bloomberg.

For Liese, “that means there is speculation” happening on the ETS. That “nothing should happen is not a satisfactory answer to me,” he said.

COMPLAINTS ABOUT VOLATILITY

PGE, Poland’s largest energy utility, has complained loudly about volatility on the EU carbon market.

“The situation is absolutely unpredictable from our perspective,” said Wanda Buk, vice-president for regulatory affairs at PGE. “One day EU ETS allowances cost €90 per tonne, the next day it’s €60,” she told the EURACTIV event, recalling that the cost of CO2 had previously stayed at around €5 per tonne for many years.

“We are in a very, very difficult situation,” she said, complaining that the current high price of carbon credits “affects our daily liquidity” as a company. “In 2021 alone, we paid €2 billion” in EU ETS allowances, a sum equal to PGE’s earnings (EBITDA) for that year, she pointed out.

To investigate the impact of financial actors on the EU carbon market, PGE commissioned a study from a consultancy, Compass Lexecon, which published its report in April.

Fabien Roques, the consultant who oversaw the study, came to the same conclusion as ESMA and found “no hard evidence” that carbon price volatility can be attributed to financial players like investment funds.

However, he said, “some characteristics of the market itself can potentially favour speculation and have harmful consequences on price stability.”

For instance, even though a Market Stability Reserve (MSR) was introduced to prevent wild fluctuations in carbon prices, “there is in the short term an inelastic supply, and that obviously can increase price volatility”.

Roques also flagged “concerns” about the volume-based thresholds in the MSR, saying “this mechanism could actually have, in some circumstances, a destabilising effect on the market and actually favour speculation”.

More fundamentally, Roques said the ETS was “politically-driven” and based on the “credibility” of EU climate policies and commitments to reduce emissions. This long-term policy uncertainty, “in itself can enhance speculation on the market,” he pointed out.

In his view, it is essential to review the market design of the ETS and consider “some additional measures to enhance price predictability and stability” of carbon prices. Those include better monitoring and market oversight, as outlined by ESMA in a recent report.

“And we think that this is a no-regret option”.


Idea of carbon price ‘corridor’ resurfaces in France

By Nelly Moussu | EURACTIV France | translated by Daniel Eck

The recent surge in CO2 prices on the EU carbon market has revived the idea of introducing a “price corridor”, with a maximum and a minimum, in order to ensure greater market stability. EURACTIV France reports.

The EU emissions trading scheme, in place since 2005, applies to industrial companies across the bloc, of which 1,000 are in France.

For many years, prices remained below €10 per tonne of CO2 emitted. But in 2018, prices began increasing, on the back of more ambitious EU climate policies and a tightening cap on emissions.

By December last year, prices reached €80 per tonne before reaching a peak of nearly €100 in February.

Power utilities, who are major consumers of CO2 allowances, were quick to feel the pinch.

“Recently, a Polish electricity supplier explained to me that carbon allowances accounted for 60% of its costs,” said Sébastien Postic, head of the Public Finance, Development and Climate project at the Institute for Climate Economics.

French politicians have tended to complain about carbon prices being too low. “We need a carbon market that works at the European level (...). We need a European carbon price floor,” French President Emmanuel Macron said in March 2018. [European Union, 2017 Copyright]

We are witnessing “a turning point in the dynamics of the carbon price,” added Marc Baudry, head of the CO2 Price and Low-Carbon Innovation programme at the Climate Economics Chair of Paris Dauphine University.

According to him, this is due to several factors, such as the implementation of the Market Stability Reserve (MSR), “which has contributed to a tightening of the
supply of allowances and, as a result, to a price rise.”

“There is a proactive decarbonisation policy and, as a result, the price is going up,” said the expert, citing the European Green Deal and its Key objective of reaching net-zero emissions by 2050.

MACRON IN FAVOUR

In the past, French politicians have tended to complain about carbon prices being too low to incentivise investments in low-carbon technologies.

“We need a carbon market that works at the European level (...). We need a European carbon price floor,” French President Emmanuel Macron said in March 2018.

Paris again made the suggestion during the COVID crisis in 2020 when oil prices crashed at around $20 per barrel. “Extremely low fossil fuel prices” seen recently on world markets “do not reflect their true cost for climate,” the French said in a position paper sent to other EU member states.

To remedy this, Paris suggested “a carbon price floor” that could be implemented either through the EU’s emissions trading scheme or the energy taxation directive, which is currently up for review as part of the European Green Deal.

FRENCH SENATORS REVIVE THE IDEA

This idea is now being revived by Senators Guillaume Chevrollier and Denise Saint-Pé, who authored an information report titled “Reforming the carbon market to build a sovereign, sustainable and fair European economy”.

Published on 15 March, the document proposes a “tool to give economic actors more visibility on the evolution of the price of CO2, for example, by introducing a price corridor on the EU ETS.”

In addition to a carbon price floor, the two senators are therefore also calling for a price cap similar to the European “monetary snake” introduced in the 1970s to prepare for the single currency.

The idea of establishing a “price corridor” on CO2 is not new. It was notably defended in 2017 by the High-Level Commission on Carbon Prices, supported by the World Bank Group, the French environment agency ADEME and the country's ministry for ecological and solidarity transition.

In France, however, the issue is not much discussed at the national level. “The French view exists, but it is carried more by French lawmakers in the European Parliament. It is a debate that is very much played out at European level,” Postic observed.

Among the French MEPs who have spoken on the subject are Green MEP Marie Toussaint, who, together with her Belgian colleague Philippe Lamberts, authored a report on the EU carbon market in March this year.

According to the report’s foreword, “a strong and stable carbon price signal is essential for the ETS to be truly effective,” to which a carbon price floor would contribute.

However, it is not “the miracle solution,” warned MEP Aurore Lalucq (Socialists & Democrats), who also called for “regulation, standards”, planning and a change in lifestyle to reduce emissions.

“We need stability and vision” for the ecological transition, which is not compatible with volatile prices subject to market fluctuations, even if they are capped, she added.
Discounting allegations of speculation on the EU carbon market, Berlin is throwing its weight behind a minimum price of €60 per tonne of CO2, saying it will ensure this through national measures if the EU does not take action.

Among the critics, Poland is pushing for “a profound reform of the ETS system, which will take into account the current situation on the energy market.”

Polish Prime Minister Mateusz Morawiecki even spoke of a “speculative bubble,” a position supported by Spain, Hungary and other Eastern EU governments who fear a voter backlash in the face of rising prices.

MINIMUM PRICE

Undeterred by critics, the German government, on the other hand, wants to ensure prices are kept high enough to encourage private investments in low-carbon technologies.

“We certainly support the beefing up of the ETS system,” said Patrick Graichen, Germany’s climate state secretary, during a meeting of EU environment ministers in December.

To the German government, a price of around €60 per tonne appears as an optimal middle ground between ambitious climate action and social acceptance. Shortly after it came to power last year, the new German government made its position on this very clear.

“We want a minimum carbon price across Europe,” Graichen said in December.

In comments to EURACTIV, the
ministry for economy and climate action now reiterated Germany's continued support for “an ambitious reform – including a minimum price” for EU emission allowances.

“If the European Union does not agree on a minimum price, the German government will decide on national measures to ensure that the CO2 price does not fall below €60/tCO2 in the long term,” a ministry spokesperson said.

For Berlin, the top priority is to ensure a minimum price signal to drive decarbonisation decisions by the private sector, a position supported by energy utilities and retail companies.

“For more investment security, Germany and the EU need immediate further development of emissions trading with accompanying measures for an investment-relevant CO2 price signal,” reads a 2017 letter by an industry coalition of 52 large companies, including Aldi, Puma and Siemens.

More recently 2021 survey conducted by VKU, the association of local utilities, found that 69.4% of local utilities saw a lack of planning and investment security as the biggest barrier to Germany's Energiewende. 56.3% of members cited a reform of carbon pricing as their top priority for the German government.

THE SPECULATION PROBLEM

Unlike Poland, Hungary or Spain, the German government did not voice concerns regarding alleged speculation on the ETS, reflecting the European Commission’s reluctance to intervene on the market.

After the European Securities and Markets Authority (ESMA) published its report in March, Berlin was ready to put the matter to rest.

“The European Securities and Markets Authority (ESMA) has investigated this and found no evidence of market manipulation,” the climate ministry said.

“However, it recommends increasing transparency in emissions trading. The Federal Government will carefully examine ESMA’s recommendations,” it added.

Not all German politicians are on the same page, though. Peter Liese, a Conservative MEP who is the lead rapporteur on the ETS review in the European Parliament, said the issue of speculation needs to be addressed.

Speaking to journalists last week, Liese cited a recent example where carbon prices rose by 10% on the back of an article published by financial news agency Bloomberg.

The price changed “without any fundamentals changing! That means there is some speculation here,” he told journalists on 11 May. That “nothing should happen is not a satisfactory answer to me,” he said, backing calls from other MEPs to rein in speculation on the ETS.

Liese is from Angela Merkel's CDU party, and his views do not reflect those of the current ruling coalition in Berlin, which comprises the left-leaning SPD, the Greens and the Liberals.
Analyst: Price collar would preserve ‘political stability’ of EU carbon market

By Frédéric Simon | EURACTIV.com

Some form of price regulation, like a price collar or position limits on market players, could address worries about high prices on the EU’s Emissions Trading Scheme (EU ETS) and help prevent “a political backlash”, climate and energy expert Michael Pahle told EURACTIV in an interview.

Dr Michael Pahle is a working group leader at the Potsdam Institute for Climate Impact Research in Germany.

INTERVIEW HIGHLIGHTS

- There is “no hard evidence” about speculation on the ETS which has a significant effect on the price of CO2 allowances.
- The notion that there are bad and good traders “is dangerously misguided” because speculation is also done by compliance traders acting on behalf of the regulated industry.
- That being said, allowing financials to operate without sufficient controls is “a recipe for turmoil and serious market disruption”.
- This is why indicators and thresholds are needed to measure trading patterns – to avoid a liquidity crunch for the regulated industries covered by the EU ETS.
- Carbon price volatility is also driven by a “monopoly on in-
formation” held by a handful of traders who can anticipate price movements. Greater transparency and information sharing would help prevent this.

- Other potential solutions include imposing “position limits” on market players or introducing a “price collar” to ensure price stability, like the US state of California has done with its own ETS.

**How much speculation is there on the ETS? Are the volumes significant? And what kind of problems can this generate?**

The main problem, I believe, is actually “speculation about speculation”. We cannot directly measure the volume of speculation, nor rigorously quantify its impact on prices so far. So if observers are stating with high confidence that speculation is a big problem or no problem at all in the ETS, they are in fact making claims for which there is no hard evidence.

There are two main challenges when it comes to assessing speculation: First, it can be both beneficial and detrimental to market functioning. It is beneficial when it helps compliance traders to hedge, provides liquidity that reduces volatility, or supports price discovery when fundamentals change. If it does the opposite, it has a detrimental effect and is deemed excessive.

This is why I say speculation can only be meaningfully assessed with regard to its effects on prices, not with regard to the volumes held by, say, financials.

Second, speculation is not necessarily exclusive to financials – as our research suggests, compliance traders also engage in trading that goes beyond hedging purposes. To measure the effects of non-compliance traders like investment funds, one would therefore need to filter out their effects on the market and establish a counterfactual benchmark of how prices would have looked like without them.

In fact, there is a large body of literature on the financialisation of commodity markets, which has tried measuring the impact of so-called non-compliance traders. But the development of suitable scientific methods is still ongoing, and data availability and quality still need to be improved, as shown in ESMA’s report as well as ours.

Sorry for the lecture, but as an academic, I think it is important to clarify that hard evidence is still lacking, and proposals for how to deal – or not deal – with this topic should take this into account.

**So, to summarise the key distinction is between traders who are compliance players from the regulated industries, or those operating on their behalf, and traders who are not from regulated industries. Is this correct?**

Yes.

**How big is trading coming from non-compliance industries? Are the volumes significant and have they changed over time?**

Looking at the data in the ESMA report on the EU carbon market and in our own work, you can see that the lion’s share of trading volumes is by investment firms and credit institutions.

Mostly, these are banks acting on behalf of compliance traders who do so-called ‘carry trades’ – buying allowances on their behalf and selling them back to them – which is a very common form of trade for hedging.

Then, in much smaller volumes, there are trades by investment funds and other unclassified financials.

**These are the new players, right? These are the financials that have only been interested in the ETS until recently and are not acting on behalf of the regulated industries?**

Exactly.

**Are these people the speculators then?**

This is where terminology is important. Some would call them speculators because they solely trade to make money, while others would call them investors because they buy and hold allowances – in contrast to speculation, which is typically thought of as more short term, meaning profits are made within timescales ranging from seconds to months.

More interesting than wording though is what brought these firms into the market a few years ago. Until 2018, the EU’s climate targets were less stringent, there was an oversupply of emission allowances and CO2 prices were relatively low. And then, the ETS reform for phase IV was implemented to remove oversupply.

That made investment and hedge funds realise that the EU was being serious about climate change. Correspondingly, this was when these traders first started appearing, and as things stand they have come to stay.

**Ok, so there is more speculation than before. Can you now explain what kinds of problems this can generate? Is it just pushing up the price or are there other problems as well?**

Apparently, it affects the price of CO2 allowances, and it is important to understand how this happens.
These traders can both consume and provide liquidity to the market. But it’s not really clear when they buy or sell allowances, or how long they hold them. This very much depends on their trading strategies, which are hard to predict. In case they consume liquidity for a prolonged time, they may push prices up persistently above their fundamental value.

Related to this, the investment decision of retail investors may mostly be driven by the market and, in the case of impact investment, environmental sentiment. They may just buy allowances and decide to sell all of a sudden irrespective of market conditions, or even cancel to put price pressure on emitters.

This means you have higher uncertainty in terms of what drives trading, which generates noise in the market and impairs the environmental cost-effectiveness of the ETS.

So it’s really hard to tell because financial players follow other trading logic than compliance traders who need to buy allowance depending on their production.

In a recent paper, you warned about the participation of financial actors in the ETS, saying they risk triggering “excessive speculation” on the market. How is the behaviour of financial actors different from other players?

It is different in the way I just described, namely the trading strategies and the risk of a persistent reduction in liquidity.

However, we made clear that the potential negative effects of trading by new financials are more of a looming than a present threat. But as allowance supply is set to shrink over time and the ecosystem of market actors widens, allowing financials to operate without sufficient monitoring controls is a recipe for turmoil and serious market disruption.

Our conclusion, therefore, was that we need a way to measure investment flows and allowance holdings, and define a point above which they can be considered excessive.

One indicator is to measure how much liquidity is consumed – how many allowances are taken off the market that are not available to regulated entities anymore. If it’s just a very small share of overall market liquidity – currently a few million allowances – nobody will have to bother. But if at some point, it becomes a larger phenomenon, it risks distorting the market.

So we need to have a proper indicator and a threshold to determine when this becomes critical. This is about finding new methods to measure the impact, but also about improving data along the lines ESMA suggested in its report.

Your paper recommends establishing a warning mechanism to guard against excessive speculation. How would this work? And where would you place the threshold?

The approach ESMA took to assess if the market is properly functioning is to look at ‘disorderly behaviour’. But it doesn’t provide a definition of it, it’s more an implicit notion based on volumes and aggregate market indicators, which are put in relation to what is deemed normal market behaviour.

What we suggested in the paper is to explicitly establish trading patterns that could reveal speculation. For instance, a substantial increase in front-year contracts’ open interest within a year, which would not be the case if trading in the futures market would be solely for hedging purposes.

This is not a bullet-proof approach, it is still more an informed heuristic. But it would be a major step forward to establish such trading patterns that are normal in the sense that they are characteristic of functioning compliance trading.

Then detecting a deviation from these patterns could be a clear warning signal that the market isn’t functioning correctly.

What about super-fast automated electronic trades, so-called high-frequency trades which are taking place in milliseconds? Could that be used as a metric as well?

You can indeed develop different metrics for trading on different time scales, such as high-frequency trading, measured in seconds or milliseconds. And you can also look at longer time scales, like years.

The latter is much more challenging because information and anticipation play a decisive role. For instance, at the beginning of 2021, a London hedge fund stated very vocally that the price of an allowance may well be around $100 per ton at the end of the year. This certainly received a lot of attention from other, likely less informed traders who may have followed suit – at least prices increased discernibly in the wake of this news.

This underlines that information can play an important role, not only in market uptake but also in market creation by key actors. That’s more like market manipulation, then.

Not really. Market manipulation is when you squeeze the market by withholding allowances to push prices up – it’s physical in the sense...
that the actual scarcity of the asset is increased.

In the case above, I would say this is more like creating contagious information. That is why our recommendations are actually aimed to improve information sharing and transparency among all actors in the market. It is to prevent a kind of monopoly on information that a handful of traders could capitalise on by anticipating price movements on the market and timing it to the disadvantage in particular of compliance traders.

This aligns well with the growing demand to improve transparency about market movements and make them understandable to a wider public.

Some lawmakers in the European Parliament have tabled an amendment to the ETS directive (Amendment 405) with the aim of limiting trading on the ETS to “operators with compliance obligations” or to financial intermediaries acting on behalf of them. What are your thoughts on this, would this help resolve the issue?

In general, I think it is very important to be clear about the role of financials in and for the market, and limit participation when it becomes detrimental.

But the notion that there are bad traders and good traders, and the latter can be excluded and all is well, is dangerously misguided. Doing so would be a substantial risk for market functioning in many ways.

First of all, the market could experience substantial liquidity problems, like it happened in South Korea, where financials were not allowed to participate until recently. This implies that the price signal becomes informationally inefficient. Furthermore, big compliance companies not excluded from trading could also engage in speculative trading, and likely already do so to some extent. Finally, there are also co-movements of financial products that mimic the ETS or are linked to it. So, there’s a number of good reasons not to exclude them.

A less intrusive option by far is to introduce position limits. I am generally supportive of this, also because it has a signalling function. We know this from the carbon market in California, where such limits are already implemented: market players know they are under surveillance, which can automatically contain potential disorderly behaviour.

But it is absolutely crucial to calibrate those position limits well, which is an issue both we and ESMA flagged in our respective reports. There are already position limits for agricultural commodity derivatives for example. But you can’t simply do the same with the carbon market – set a fixed level practically forever – since supply of carbon allowances is going down structurally. So, the limits need to be constantly adjusted to current market conditions, which makes it particularly tricky.

Generally speaking, carbon prices on the ETS have risen to almost €100 per tonne over the past months, levels that were not expected to be reached before 2030. Do you believe measures need to be taken to limit price volatility or levels on the ETS? For example, are you in favour of a price ceiling?

To begin with, at least in hindsight we shouldn’t be very surprised about high carbon prices: we have a European Green Deal ongoing, and a proposal on the table to substantially tighten the cap on emissions under the ETS.

According to the analysis we did at PIK one year ago looking at the ETS proposal, the price of carbon would reach €130 per tonne by 2030 under optimistic abatement costs assumptions. The pace at which prices rose may have been surprising, but certainly not the direction – it would have happened sooner or later.

In light of that, what financial players did was to actively anticipate this future. They were taking risks in doing so, not knowing how prices would actually develop. Sometimes, you are rewarded by taking risks and anticipating what the market will do next. And at other times you will get punished because you failed to make the right predictions. This is part of normal market functioning – price discovery during a transition to a new equilibrium.

However, we need to acknowledge the ETS is a politically created market, and there are arguably price levels that may trigger a political backlash when they hit regulated firms or countries too hard. To some extent, we are experiencing this at the moment in my view.

In order to safeguard political stability, a price collar would be very helpful to prevent discretionary intervention and clarify beforehand and for all stakeholders which range of price is politically acceptable. And we have a good example from which we could learn how to put this into action: the cap-and-trade program in California.
The EU is currently at the midst of a debate on its energy policy and translating the Fit for 55 packages into concrete legislation. The European Union Emission Trading System (EU ETS) is the cornerstone of European climate efforts and its changes will be crucial for the future of energy transition and energy security. The reforms of EU ETS are even more urgent due to Russia’s invasion on Ukraine. While the EU cannot quickly address the issue of energy dependency on Russia, a well-crafted ETS reform will protect the EU’s utilities against price shocks and support their energy transition.

Wojciech Dąbrowski is the CEO of the PGE Polska Grupa Energetyczna.

The European utilities and industry were recently hit by both the rising fuel prices and the carbon allowance price surge. While the EU cannot do much on the fuel supply side in the short term, it can effectively reform ETS, so it is more resilient to price shocks. A well-crafted reform of the EU ETS will also make the prices more predictable, allowing the emitters to focus on investments that advance energy transition.

WHY THE EU ETS REFORM IS ESSENTIAL?

There is a wide discussion about the causes of the rising European Union Allowance (EUAs) prices. Some experts and analysts claim that the rising prices are caused by the market fundamentals, while others point out at the speculative activities. The latter was analyzed by the European Securities and Markets Authority (ESMA), but its recent and final report doesn’t offer a definitive answers.
ESMA confirms there was high-frequency trading and activities by financial institutions (even originating in Cayman Islands), but on the other hand it did not have significant impact on the market. To make it even more complicated, ESMA supports better transparency and market data access. One might say that the glass is half full or half empty. But there’s more than that in ESMA report – the regulator offers some proposals to consider which might improve EU ETS functioning.

The list includes better transparency, market oversight and considering limiting the number of positions for financial transactions on EUA derivatives (ESMA invited the European Commission “to consider the arguments in favour and against the application of position limits”). There are also other voices, pointing out on ETS’s price volatility and uncertainty. Jos Debelke, former EC official in charge of EU ETS, warns against ETS price volatility; the Centre for Climate and Energy Analysis, points out that EU ETS design flaws allow the speculators to influence the prices.

On the other hand there are also some different opinions to simply increase the climate ambition. With such lively debate we are still convinced that finding a common ground is possible and that ESMA’s recommendations set a stage for the future discussion on ETS reform. We should focus on what can be done to improve the system and protect against volatility, whether it is caused by speculators or not, in order to achieve the climate targets.

The recent report on the EU ETS reforms prepared by Compass Lexecon for PGE identifies the main weaknesses of the system’s design and explores the best options to reform it, so the ETS is more resilient to prices shock, whatever their cause might be. In order to address the issue, we must limit the access to the market for the speculators, while keeping the financial institutions which contribute to market liquidity on board. Without sorting this issue out we cannot move on with another important reforms, which are currently at the center of the debate: of Market Stability Reserve (MSR) and the Article 29a of the EU ETS directive.

MSR currently uses the Total Number of Allowances in Circulation (TNAC) mechanism. This solution is problematic: the allowances banked by financial institutions (bought and held to in a hope for financial gains in the future) are not available on the market.

With such design, MSR is vulnerable: the allowances banked by non-compliance entities are still calculated as TNAC; MSR responds by absorbing more allowances, thereby actually further increasing scarcity and driving the prices up. This is because the famous “surplus of allowances” is artificial as the two thirds of the TNAC is hold on account of financial actors accounts due to their buy-and-hold strategies. In fact these allowances are not available for compliance entities.

This demonstrates that the functioning of one of the tools which aims to stabilize market could be distorted by the speculative activities. The design of another mechanism – Article 29a – is also ineffective. According to the Article, it is triggered when for more than six consecutive months EUA prices need to be more than 300% the average price in the two preceding years. This make it anything but effective tool, it is not surprising that despite the rising prices the Article 29a has never been used so far.

**HOW TO CHANGE EU ETS?**

There are plenty of options, but they all come down to solving one general issue: making the market and prices more predictable. The European Commission assumed average prices of emission allowances equal to €50 per ton for the entire 2021-2030 period, while the current prices remain well above €80. The aim of the reform is not to directly control the prices, but rather to guarantee at least some certainty for companies, which make long-term investment to decarbonize their assets.

Preventing the speculations doesn’t necessarily mean getting rid of the financial institutions, that play an important role as the intermediaries and help i.a. in the price discovery and facilitates market liquidity. But the activities of those of them that do not act on behalf of the emitters should be limited.

The financials not acting on behalf of the emitters should be either excluded from the market or at least some limits on their activities should be imposed. A possible option is to set a limit on the EUA volumes they can buy. This can be done by imposing individual or general (applying to all financial institutions not acting on behalf of emitters) limits of positions. It must be pointed out that even if the issue of speculators is addressed, we must have the tools to prevent price volatility, which of course would still be possible.

The issue of the prices and excessive speculation was already raised by Spain and Poland. The debate is also gaining momentum in European Parliament, where Jerzy Buzek proposed to exclude the financials (not acting on behalf of emitters) from the market and the specific measures are now more widely discussed. To succeed, it is
crucial to reform The Market Stability Reserve and the Article 29a of the EU ETS directive.

MSR with its current TNAC-based trigger mechanism must be changed, so it reacts quickly to the market reality. The decision to release allowances from the reserve should be based on the certain threshold of the EUA price. The specific thresholds might reflect e.g. EC’s price projections or be based on them in some way. The Article 29a of the EU ETS directive must also become an effective price stabilization mechanism.

Similarly to MSR, it should be based on the specific price level, instead of price multipliers explained above – the current design made it impossible to invoke the article 29a. Furthermore, the recent compromise proposals from ENVI committee on the so called EU ETS 2 (ETS system for the transport and buildings) support introduction of the specific price limits, which would trigger MSR, as well as less strict price “multipliers” than those of art. 29a after which additional allowances would be released.

Similar measures should be introduced not only on the new, developing market (like EU ETS 2), but also on a mature one (like EU ETS), which faces price volatility challenges. Additionally, it is necessary to introduce a mechanism which would supply a set amount of allowances automatically to the auctions, without prior intermediary and politically-based steps.

**SUMMARY**

The above is just a few examples of the necessary reforms, but these are of crucial importance and should not be postponed. Meeting EU’s climate targets requires huge investments. The ETS market encourages to invest in energy transition, but at the same time the EUA surging prices should not drain money spent on the energy transition. The better market transparency will give us some answers about the main drivers behind the price volatility, but before it happens, we must urgently address the structural problems of EU ETS design.