

Guest commentary

Patience: the carbon market will deliver

By Alexandra Galin, policy and working groups manager, Carbon Markets and Investors Association (CMIA)

When policymakers created the EU emissions trading scheme (ETS), foremost in their minds was to construct a mechanism – to supplement other measures – to allow for an economically viable transition to a low-carbon economy. In creating a carbon market, they ensured progress toward specified emissions reduction targets is measurable at every juncture.

The 2020 targets were not designed to be easy, yet no policymaker could have foreseen the events of 2007-2008. The economic downturn proved deeper and longer than many predicted. CMIA does not take issue with those calling for tighter caps. We believe that an ambitious target resulting in a strong price signal is needed to spur investment and encourage behavioral change. However, we strongly disagree with claims that the integrity and purpose of the carbon market has been compromised.

We stress the transition to a low-carbon economy was designed to be gradual: an annual trajectory was mapped in advance to provide investment certainty. Whether or not the emissions caps are overly lax ignores the basic premise of the ETS design – the EU is on target to achieve the emissions reductions it has set. The downturn has, in fact, brought to the fore one of the key benefits of a market-based mechanism: price sensitivity. Yes – liable entities under the EU ETS discovered that as industrial output halved, they were in possession of surplus allowances. Yes – industry sold these surplus allowances, and this injection of supply without corresponding demand led to market depreciation. No – the events of the last six months do not indicate the EU ETS is not performing its function as a key mechanism to achieving emissions reductions.

Firms that used the capital from selling surplus EUAs did so in critical circumstances. A capital injection into a firm struggling to retain its workforce and maintain operations is vital, but became close to impossible as banks tightened lending in the credit crunch. These industries that have profited from monetising surplus EUAs may not have behaved rationally if one considers the long term. Caps will continue to narrow, and if fuel-substitution and carbon supply-chain management is not managed, firms will be required to put the capital forward at a later date, when prices are likely to be much higher. While it may appear contradictory that the EU ETS likely saved from effective bankruptcy the

very industries it seeks to reform, it is dangerously short-sighted to judge the market on the events of the last six months.

The type of retroactive intervention proposed, most recently by environmental group Sandbag, would cripple market integrity. Narrowing and expanding caps in response to economic circumstances rather than letting the markets respond organically would create a kind of ‘carbon casino’, in which participants merely bet capital on the next unpredictable regulation. Arbitrary and capricious rule-changes are an anaethema to an efficient and effective market. If regulators had retroactively decreased caps and forced large-scale EUA purchases, installations could have collapsed under the added financial liability. This outcome is in no citizen’s interest. As analysts noted, even in the midst of the current recession, the EU ETS was still short of allowances in 2008. Since caps will continue to narrow, EUA prices are poised to rise substantially. Firms are well aware of this fact, and are, no doubt preparing.

The EU ETS sets a limit of 50 per cent of the required reduction effort in phases 2 and 3 to be met by credits generated from Kyoto offset mechanisms. While we agree that difficulties do exist in the clean development mechanism (CDM), we would point to its multiple benefits in developing countries, as well as reform proposals under consideration. Those who argue that by “exporting emissions” developed countries make no progress ignore that emissions reductions are a global issue: where and how carbon is emitted is irrelevant to the atmospheric concentration of CO₂. The EU’s complementarity limits are set to allow developed countries to reduce global emissions at a lower cost, without precluding, once carbon prices rise to a certain level, to reduce them at home. It is important not to view markets through a short-term lens, but rather look toward how it achieves a long-term goal.

Patience, however, is a difficult concept to sell. We would not argue against more ambitious targets. We would only clarify that even with targets that the EU has set, the market is poised to bring Europe emissions reductions in a measurable and cost-effective manner. The recession may have made it easier, but only until the inevitable recovery.

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