Could a Central Bank Rescue the European Emissions Trading Scheme?

The European Emissions Trading Scheme (EU ETS) is over supplied and prices are well below the level needed to promote abatement action by compliance entities. The price for Certified Emission Reductions (CERs) from Clean Development Mechanism (CDM) are so low that projects are not even bothering to claims credits they may be entitled to because verification costs exceed carbon value.

So what is the problem and what is the solution? The fundamental problem with the EU ETS is that there is no pressure release valve within the system. By this I mean there is no adjustment mechanism for supply and demand according to the economic cycle or technological advancement, such as shale gas discovery. Under the EU ETS, allocations are made on a declining straight line basis up to and beyond 2020 assuming straight line economic growth. This creates the current problem of significant oversupply due to significant economic contraction. This results in a price too low to promote actual emission reductions and indeed so low that most major financial players, a necessary part of any market (like it or not), are withdrawing from the market because there is simply no value remaining.

The inverse of this would be true if the economic conditions were reversed and we had excessively strong growth. Something of a dream in today's world but let your imagination run wild! The result would be excessively high carbon prices which on the one hand would deliver lots of domestic abatement but would also deliver compliance entities saying prices are too high and carbon markets don't work.

Both scenarios result in one party or another claiming carbon markets don't work. So should we throw the baby out with the bath water? No. The carbon markets are not perfect but they have come a very long way in the short time they have been in existence. My background is the insurance industry, a market that has been around for more than 300 years, and I can assure you, that is not a perfect market either. So what is the solution?

Some attempts are being made to create a pressure release valve though the back loading of allowance allocations. There are many questions about this as a strategy but the key issue here is that this retrospective meddling with the allocation system firstly undermines confidence in the policy, and secondly requires political will to be approved by the European Commissions. And therein lies the rub! When the economy is so weak people's agendas understandably change. Putting food on the table and keeping jobs move up the agenda; environmentalism moves down. This means that any pressure release mechanism that is dependent on political will is doomed to failure since that political will dries up just at the time it is most needed.

It is therefore time to remove the politics from carbon markets, in particular the EU ETS, by adopting a monetary policy approach to emissions with the establishment of an independent European Central Carbon Bank (ECCB).

The ECCB will be charged with targeting a price band for carbon (just as the Bank for England, ECB & Fed have been set an inflation target). The low point of this band should be high enough to promote domestic abatement, whilst the high point of this band should be below a point that would create a drag on economic production. Let's say €15-€35 for EU ETS.

The ECCB would then increase or decrease allowance (EUA) supply (as the Bank of England, ECB & Fed increase / decrease monetary supply by adjusting interest rates) in order to maintain a carbon price within the prescribed band.

The benefits are that emitters have certainty that there is always going to be a robust carbon price, something they don't today, and so will take action to reduce emissions. Yes they have to trade this for certainty about allocation levels, but carbon markets are here to deliver real emission reductions with some view on doing this at least cost, not to give emitters certainty of emission trajectories.

By having certainty of a robust carbon price emitters can be confident about taking their own abatement action. This in turn ensures that the carbon market delivers actual emission reductions.

Of course the proposed ECCB will have to earn its reputation for implementation of its task, just as Central Bankers have to around the world. But given a proper mandate and independence to deliver that mandate, the ECCB should be able to achieve this. A forerunner for this can be seen in the UK Committee on Climate Change which is an independent, statutory body established under the Climate Change Act 2008. Its purpose is to advise the UK Government and devolved administrations on emissions targets and report to Parliament on progress made in reducing greenhouse gas emissions and preparing for climate change.

If a similar body were created at the EU level and its mandate was amended so whilst it is still reports to the European Parliament, it also takes direct action to increase or decrease allowances in the EUETS, based on achieving climate related emission reduction targets.

California's cap and trade scheme started earlier this year has had the benefit of learning for the EU ETS and CDM. And this learning has prompted them to create a price containment mechanism, both on the up and down side of price fluctuations. The mechanisms used to deliver this (a floor price and price containment reserve), are not as dynamic as a central carbon bank proposal, but are very much a step in the right direction.

Key stakeholders in the carbon market should support the proposal for a central carbon bank for the following reasons:

- a robust carbon price (albeit within a range, which itself can be quite wide) is guaranteed which should please investors and emitters alike as this gives them certainty that it is now in their long term interests to take action.
- there is still trading and so least cost abatement opportunities are identified, again pleasing emitters.
- A robust carbon price should also please environmentalists since actual emission reductions will take place.
- Finally banks and other market participants can still participate in the market by offering risk management hedges such as swaps, just as they do for interest rates.

What's not to like?

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