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WOULD DELEGATION TO AN INDEPENDENT CARBON AUTHORITY FIX THE EU ETS?¹

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Summary

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Abstract

WOULD DELEGATION TO AN INDEPENDENT CARBON AUTHORITY FIX THE EU ETS?¹

As the permit price of the European Union Emissions Trading Scheme (EU ETS) crashed after 2008, dropping from over 25€ to 5€, so did the credibility in this market as the main pillar of the European climate policy. Some analysts argue that with such a low price the incentive for further abatement is practically nil and that the trading scheme should be either reformed or scrapped. To restore the well-functioning of the ETS, the European Commission proposed six different reform options, including a one-off reduction of the cap (annual maximum amount of permissible emissions), an extension of the scheme to other sectors (e.g. transport), or a price management mechanism (e.g. minimum price).

However, while these options could provide short- and medium-term solutions, they are not flexible enough to respond to “unknown unknowns” that could again destabilise the market in the future. To achieve such flexibility, some scholars have suggested that an independent management body for the carbon market should be created, making reference to the positive experience with such an institution in monetary policy. In fact, delegation of price-stability competencies to an independent central bank has emerged as an effective way to overcome the inherent trade-off between short-term gains from a generous supply of money and long-term losses from higher inflation. Similarly, in climate policy a trade-off between short-term growth and long-term gains from abatement might exist and thus motivate delegation to an independent carbon authority.

While the idea of applying delegation in the context of climate policy first emerged ten years ago, it has mainly been confined to academic circles. Only recently has the concept gained more traction, leading the European Commission to explicitly ask for further research on its feasibility. Although the theoretical rationale for delegation is rather uncontested, a definite prescription of this medicine to the EU ETS must be preceded by

a proper diagnosis of why the low price is problematic and whether it reflects a failure that delegation could correct.

What really is the problem with the current price?

The price of carbon in the EU ETS is without doubt lower than the level projected by the models which informed the process leading to the EU ETS directive. From a theoretical perspective, three different – and not mutually exclusive – drivers could have contributed to the sharp drop below the expected price level. First, unforeseen exogenous changes in demand or supply, namely the economic crisis and the supplementary climate policies for renewables and energy efficiency, reduced baseline emissions and hence the demand for permits. Second, the insufficient credibility of the announced European long-term commitment towards ambitious emission cuts might have undermined an inter-temporal smoothing of the price drop. Third, an inherent malfunctioning of the market due to market power or other economic ‘imperfections’, e.g. industry might have exaggerated the cost of compliance to obtain a (too) lenient cap.

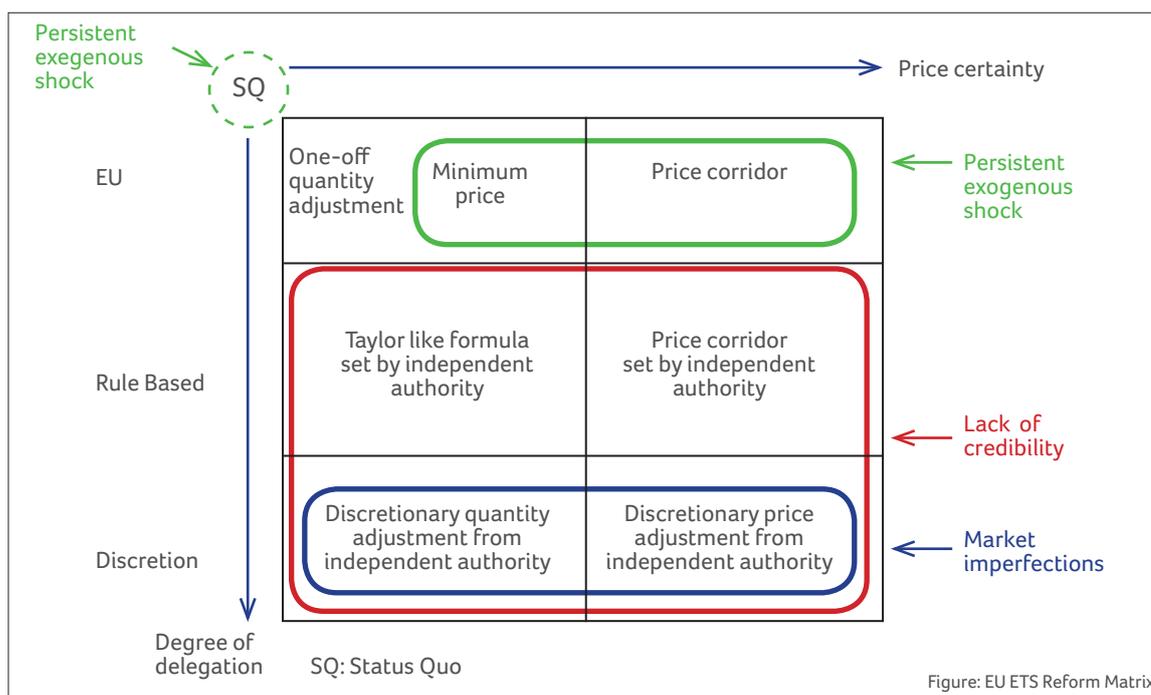
What to do about it: new instruments vs. new institutions

What should be done to correct the low price and what reforms are needed has recently been fiercely debated. A wide array of reform proposals has been launched, ranging from a one-off change of the cap to delegation to a new institutional body. In order to reduce the complexity of this puzzlingly rich menu of options, we propose mapping them onto an “EU ETS Reform Matrix” across two essential dimensions: the degree to which they increase control over the permit price and the degree to which they delegate the management of the carbon market to an independent authority. The first represents the instrumental change, the second – the institutional adjust-

¹ Preliminary title. Not that this text is also scheduled to appear as an entry of the EUROPP blog of the LSE.

ment embodied by the reform. Three levels of delegation are conceivable: (i) the status quo, with oversight and control of the carbon market remaining in the hands of EU institutions, (ii) delegation to an independent authority that applies rule-based mechanisms (e.g. a price corridor) to adjust the cap and (iii) delegation to a ‘carbon central bank’-like entity with a high level

degree of delegation should be considered. Higher levels of discretion might also decrease the risks associated with market imperfections. For instance, the flexibility given to the regulator might make it harder for firms to behave strategically and take advantage of asymmetric information. Within these two option sets (in red and blue in the matrix), the degree of orientation to-



el of discretion on how to achieve a predefined long-term goal (e.g. least cost decarbonisation of the European economy by 2050).

As can be seen in the Figure, the ‘EU ETS Reform Matrix’ can accommodate a variety of prominent reform proposals, and allows visualising their essential differences and similarities. Depending on what is perceived as the problem of the EU ETS, effective policy responses can be narrowed down to a certain area within the reform matrix. For example, if one views the EU ETS as a tool for achieving an emission target at least costs, no reform is necessary. If one perceives the current price drop to be an outcome of the economic crisis alone but also wants to achieve a minimum price of carbon to trigger innovation, then delegation is not necessary; the implementation by the EU of a price floor or corridor should suffice. However, if credibility of long-term commitment is the relevant issue, then only options with some

wards more or less price certainty is ultimately a political choice reflecting the objectives – which might be broad or rather narrow – of the EU ETS.

To sum up, many reform options for the EU ETS have been put forward over the past months and delegation is increasingly seen as a real reform option. However, before deciding on the preferred way to go, it is high time for policy-makers to be explicit in what they would like the EU ETS and EU climate policy in general to deliver. Is it to achieve a specific emissions target, or to transform the EU into a technology leader that can help other countries decrease their abatement costs, or both? The answer to these question cannot be given by academics alone but requires a wider public debate. As a next step, policy-makers should evaluate whether the real drivers of the low price are conflicting with their stated goals for the EU ETS and choose the appropriate response accordingly.