

Publication

Price and market behavior in phase II of the EU ETS: a review of the literature

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Since 2005, the EU ETS has provided a market-based price signal for European carbon emissions, accompanied by increasing economic research related to this policy instrument. In this paper, we carry out a review of the empirical literature examining allowance price formation. A consensus has emerged that allowance prices are significantly related to fuel prices and to variables affecting the expected amount of necessary abatement, such as economic activity or changes in the cap. However, the relationship is not robust, probably because the relevant abatement technologies change with the economic conditions they operate in. There is evidence that models explicitly accounting for uncertainty about future demand and supply of abatement are better at explaining allowance price variation during certain periods. Yet, our understanding of the level of the allowance price remains poor. We cannot say with any degree of confidence whether the price is "right," in the sense that it reflects marginal abatement costs, or whether there is a price wedge caused by transaction costs, price manipulation, or other sources of inefficiency. Nevertheless, the market has matured compared to Phase I, and the banking provision has induced it to incorporate future scarcity of allowances and to smooth the effect of transient shocks as intended.

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