Market power, permit allocation and efficiency in emission permit markets

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Market power in permit markets has been examined in some detail following the seminal work of Hahn (1984), but the effect of free allocation on price manipulation with market power in both output and permit market has not been addressed.ă I show that in this case, the threshold of free allocation above which a dominant firm will increase the permit price is below its optimal emissions in a competitive market, and that by means of permit allocation alone, overall efficiency cannot be achieved.ă In addition to being of general economic interest, this issue is relevant in the context of the EUETS.ă I find that the largest German, UK and Nordpool power generators received free allowances in excess of the derived threshold.ă Conditional on having price-setting power in both the electricity and permit markets, these firms would have found it profitable to manipulate the permit price upwards despite being net permit buyers.
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