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IENE Comment

The Carbon Price Trap

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In December 2022, the European Union hailed a reform in its carbon emissions market that featured much more stringent reduction targets than before. Another prominent feature of the reform was the most ambitious carbon price in the world.

"No other continent in the world has such an ambitious carbon price," said the chairman of the EP's environmental committee, Pascal Canfin, at the time. The figure was 100 euro per tonne.

Earlier this month, the price of a tonne of carbon dioxide on the ETS fell to 53 euro – a low that nobody had predicted could be reached. In fact, no one had expected any declines in the price of CO2 in the observable future. The assumption was that big industrial emitters will simply swallow a constantly rising price for their CO2 emissions and keep generating them. It turned out to be a very wrong assumption.

News reports about businesses in Europe, especially Germany, shutting down or moving abroad have become increasingly frequent in the past few months. So have reports about whole industries struggling to survive in a high-energy-cost environment in the EU. Falling output, relocations, international expansion at the expense of domestic business—all this should have made the drop in carbon permit prices anything but surprising.

Yet, it's not just struggling businesses and their lower demand for permits that has contributed to the price drop that threatens a vital source of funding for the EU's transition plans. The EU's very transition plan was also a major contributor.

Wind and solar output in the bloc was hailed as record-high last year, as were significant declines in coal and gas generation. But lower coal and gas generation means lower emissions—and lower emissions mean less carbon permits purchased. Once again, we see the dangerous assumption that emitters will keep going as usual whatever else happens on the energy market deliver a blow to its authors.

The future seems bleak, too. In fact, one hedge fund manager said carbon permits are worth even less than 50 euro. According to Per Lekander, an industry veteran, a tonne of carbon dioxide is worth just 35 euro at this point.

This presents a problem for the transition ideologues in Brussels. It might turn into a big problem because carbon permits were devised as an essential tool of the transition. They were devised as a means of motivating industrial energy users to reduce their emissions but also, as mentioned above, a means of generating money for the transition to net zero.

That was the vision, however paradoxical, that also involved the assumption of a continued upward trajectory for the price of permits, even as emitters worked to reduce their emissions. That vision has failed to materialize, because of its paradoxical nature.

As things stand now, the decline in carbon permit prices will extend this year as more businesses are forced to curb their energy consumption—and, by extension, emissions. This, in turn, will see EU revenues from the ETS decline, too, shrinking the transition pot.

The expansion of the permit mechanism to maritime transport might mitigate the effect of the price drop but whether this mitigation will be meaningful remains to be seen.

Meanwhile, there is worry that lower carbon permit prices might lead to an increase in emission-heavy industrial activities. Those worrying about this seem to be forgetting that greater demand would stimulate higher prices—the same higher prices that the ETS authors see as necessary for a successful transition.

Yet the problem with constantly rising wind and solar output remains unsolved and quite ironic. The very solution to what the EU deems as the worst existential crisis in human history has become a problem. After all, the more wind and solar capacity you put into operation, the less generation—with their corresponding, hopefully expensive emissions—you need from coal and gas. It is difficult to believe nobody saw this development coming but this appears to be the case.

Carbon permit futures in the European Union declined by 44% over the past 12 months. The decline will likely continue, as suggested by a recent report that European business associations are pleading with Brussels to somehow lower energy prices, which are hurting businesses' competitiveness on the global stage.

Solar and wind capacity—and presumably output—will continue to grow, per plans. This means coal and gas plants would produce even less electricity going forward, their demand for permits declining with output. And this means that the EU's target for a price of 100 euro per tonne of carbon dioxide emissions is going to get a lot more distant.

This, in turn, means that EU transition architects would need to come up with a way to compensate for this lost revenue source. They don’t really have a lot of options there. We might soon see a more solid push for a per capita carbon tax, risky as such a move would be.

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