THE
MESSAGE

A DOUBLE-EDGED SWORD

ETS

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Ideas are often born out of specific needs and with the best intentions. Sometimes, however, they turn out having unforeseen side effects that could prove counterproductive. Let's think for example to plastic, invented at the end of the 19th century to replace billiard balls (produced back then with the expensive and controversial ivory) and whose development and diffusion has produced the environmental effects that we all know today.

The ETS (*Emissions Trading System*) is the main mechanism used by the EU to reduce the continental CO2 emissions by 2050. It is also one of the new and most important financing sources to repay the portion of Eurobonds issued with the Next Generation EU program

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and used to subsidise member states.

The system is relatively simple (EU ETS for more details). The EU sets a cap for the annual CO_2 emissions that companies may emit in Europe, and issues one certificate for each tonne. As a result, every year the number of issued certificates will equal the emissions tonnes that companies are allowed to produce in aggregate. As CO_2 emissions cannot be avoided and the EU doesn't want to strangle its own companies, some of those certificates are allocated for free, while the others are auctioned. It should be pointed out that not all sectors are treated equally, because an IT company will definitely pollute less than a power plant and not all companies can avail of technologies to reduce their own emissions in the short-term: it's easier for a power plant to produce energy from solar and wind sources than for an airplane or a ship to travel with electricity. That's why the EU decides which sectors should fall within the ETS scheme and which should get a waiver (in the form of free allocation) for the time being. Every Apr 30th all companies of the sectors covered by the ETS have to calculate how many CO_2 tonnes they have emitted in the previous year and hold an equivalent number of certificates to return to the EU.

To reach the carbon neutrality target by 2050, the overall number of certificates is reduced every year and the free quota is reduced, too. The faster the EU wants to reach the target, the stronger will be the annual reduction. Indeed, to implement the Fit for 55 program's decision to increase CO_2 reduction from 40% to 55% within 2030, the EU will accelerate the annual certificates reduction from 1.74% to 2.2%.

This looks like a virtuous circle, whereby companies that have emitted less CO_2 will have more certificates than needed while the "bad guys" that polluted more will have to buy the missing certificates from the "good guys" or at the auction. Thus companies operating in the hydroelectric business or that produce electric cars may profit also from selling the excess certificates to the detriment of those that produce energy from fossil fuels or petrol-fuelled cars.

But... those certificates are also freely traded on the market: there's a future contract (MO1 Comdty is the Bloomberg ticker) that tracks its price, i.e. the price of one CO_2 tonne. As the EU accelerates on the certificates issuance reduction, hedge funds and other investment funds have started to bet on it, inflating its price. And it's not only funds, as there are financial instruments that allow also retail investors to attend the party. This is entirely admissible in a world where other commodities such as oil are affected by the same behaviour, but the side effects may be controversial. Today, 80% of the energy still comes from fossil fuels. If the price of CO_2 keeps rising, the companies that can't immediately become "virtuous" will have to spend more to buy the certificates they need and may pass the cost on to their customers. About 20% of the gas price increase seen in the last few months is estimated to derive from the increase in the CO2 price, which has trebled since the start of the year.

Poland has already lamented the presence of financial speculators in the CO2 market. In addition, high gas prices make it relatively cheaper to use carbon as energy source, which in turn requires the purchase of carbon certificates and contribute to its price rise. What started as a virtuous circle risks then becoming a vicious one.

In addition to the ETS there's also the CBAM (Carbon Border Adjustment Mechanism), a scheme by which the EU intends to "carbon tax" selected products imported from outside the Union. This is to fight the "carbon leakage", i.e. the import of products linked to CO2 emissions from countries that have not imposed sufficient carbon restrictions. Steel, aluminium, cement, electricity imported cheaply from abroad will see an increase in prices to protect the competitiveness of companies that produce only within the EU or in countries that participate to the EU ETS, such as Norway and Switzerland.

As a result of all this, companies operating in the covered sectors will have to pass on costs to their customers or tolerate a reduction of their profit margins: eventually someone will have to pay the 9 billion EUR due for the CBAM and the 10 billion EUR for the ETS. Or more, if the CO2 price keeps rising.

Although at least a couple of years will be needed to have efficient CO2 mechanisms, its effects may be felt well before then and, in a context where many talk about temporary inflation, these could stretch even more the time needed for a return to normality.

It is plausible that an increase of CO2 prices were a conscious objective of the creators of these schemes to push ahead in the energy transformation that is so much hoped for. However such a fast rise could prove to be the unintended consequence of a double-edged sword.