

The emission trading scheme (ETS) is a market-based system as a

Emission rights securitisation, 22.5.2008

Critical memorandum about the emission trading scheme (ETS) / MEP Esko Seppänen 22.5.2008

The ETS is a market-based system, the alternative of which is taxation. Because of the neoliberalist hegemony in the EU, the market model was chosen to curb CO2 emissions. The European left forces should take a close look at the problems created by the market.

<!-- @page { size: 8.5in 11in; margin: 0.79in } P { margin-bottom: 0.08in } -

The main problematic elements of the scheme are 1) the allocation of allowances by auctioning, then through the secondary markets (Exchanges) and 2) its influence on the price of electricity.

Harmonisation and liberalisation

The European electricity market is under a process of liberalisation, which means that the price of electricity will be harmonised. The aim is that the wholesale price of electricity will be the same in all countries throughout the common market.

From the viewpoint of climate change it is understandable that the price of electricity should be high; the polluter should pay.

The problem is that the ETS increases the price of electricity by creating huge

extra profits for the big players and speculators in the financial market, and these profits will not be used to save the planet from green house gases (GHGs).

When the ETS comes into effect, the political left should act upon the problems caused by the market and financial speculation and being reflected in the price of electricity. The buyer of electricity is the payer of the in-built speculative elements of the system.

### Price of electricity

The place of the wholesale price formation of electricity in the harmonised EU market is in the wholesale spot market according to the model of the Nordic electricity Exchange Nord Pool, where electricity for every individual hour of the next day is traded. Each operator submits a bid that comprise of a price and the amount of electricity which can be supplied at that price. The Exchange then rewards the bidders with supply contracts, starting with the lowest bid, until the predicted demand is satisfied.

The problem of this pricing system is the next phase, wherein the bid of the last plant that receives a contract determines the price of all contracts. The price is the same for all electricity and thus becomes independent of its production cost. The power plants are not paid according to their own bid, but according to the bid of the marginal producer with the highest variable costs.

This price formation system favours hydro and nuclear power plants with their low variable costs. They get the same price for their electricity as those generating electricity by the more expensive oil and coal.

### ETS and electricity pricing

The hydro and nuclear power plants do not need emission allowances for

electricity production, the gas and coal plants do.

The emission generating plants must buy the allowances they need either in the auctions or from the secondary market. The system is not forgiving to power generation: from 2013 onwards full auctioning will be the rule for the power sector allowances. It is, because according to the Commission the power sector has the ability to pass through opportunity costs on to the consumers, and the final payers for the emission allowances will be industries and households through the price of electricity.

The price of the allowances will be automatically added onto the price of electricity independently of how it is produced. This then creates huge windfall profits especially to the hydro and nuclear producers and their shareholders. They are compensated for the allowances even though they do not need them.

This is how the ETS increases the price of electricity and makes the consumers pay for the unearned profits of the big electricity producers (who fully exploit the price formation system by using the special market information they have from each others' production capacities) and the financial speculators.

## Auctioning

Auctioning is the basic principle for the allocation of emission allowances.

There are not yet any rules for the EU-wide or national auctions, but the general knowledge is that the Commission has no plans to restrict any willing industrial or financial party from bidding. In the auctions, the emission rights are securitised, and they can later be traded in the secondary market in different Exchanges.

By auctioning and securitisation it is made possible to speculate with the allowances, and free international (even non-EU) speculation in the Exchanges

may increase the price of allowances - and through them the price of electricity - higher than what is needed for the proper functioning of electricity generation. If the allowances are - or are speculated to be - scarce, their price and the price of electricity increases for the benefit of those who do not need emission rights for power production.

The conclusion is that a new wealth distribution will come in the wake of auctioning benefiting non-producers, speculators, investors, pension and hedge funds, state funds etc.

The secondary market

Market laws and the relentless drive for profit rule in the Exchanges.

The secondary markets of emission allowances are electricity and other Exchanges, and the securitisation of the allowances turns them into normal financial products. They can be sold as such, or they can be wrapped in innovative financial packages - as was done to the sub-prime mortgages.

The reports and opinions of the European Parliament should be amended due to these kinds of warnings in the following ways:

- requests the Commission to react to the problems of the system of the wholesale pricing of electricity in the liberalised and harmonised market. In the ever-growing wholesale market of electricity and emission rights exchanges the pricing of electricity is based on the supply price at the margin, and that price includes, in most cases, the production of electricity with CO<sub>2</sub> emissions, and the use of emission rights. The problem (and the source of unearned windfall profits) is the biased system where the producers of hydro and nuclear electricity get the same wholesale market price even though they need not need emission rights for their energy production. The wholesale pricing system of electricity in the special exchanges needs to be modified to exclude the windfall profits of emission free producers.

- reminds that the ETS means securitisation of the emission rights and turns them into financial products. If the auctioning procedure and later the secondary markets in the emission rights exchanges are open to all bidders (including institutional investors, pension and hedge funds, state funds etc.) there is a danger of purely speculative price formation in the market. That is why it must be considered and not excluded that the access to the original auctioning procedure is open only to the bidders who need emission rights in their production processes.

- notes that the world's financial markets are extremely innovative in constantly creating new financial products with serious consequences, as happened lately with the sub-prime mortgage market in the USA, when the loans were packed into risky bundles with other securities. The ETS includes the securitisation of emission rights, which makes it possible for the financial markets to innovate new products in order to create scarcity and new profits. The participants in the speculative market will cause an increase in the price of emission rights for industrial producers. All these undue securitisation costs will be paid by the consumers, and therefore the risks of the securitisation must be analysed beforehand. The polluter shall pay, but the ETS makes the households and industries pay for financial speculation and not only for climate pollution