

Cap and trade and financial markets

Suzi Kerr

CFTC – EEMAC

3 June, 2021

1. What drives cap-and-trade prices?

Government created property rights

Impacts of other climate policies

2. Cap-and-trade prices and clean investment

Volatility and politically driven system shifts

3. Environmental justice and equity concerns

How will it affect policy choice?

Avoiding risk of market manipulation

Protecting small actors

4. Fundamental changes coming to carbon markets

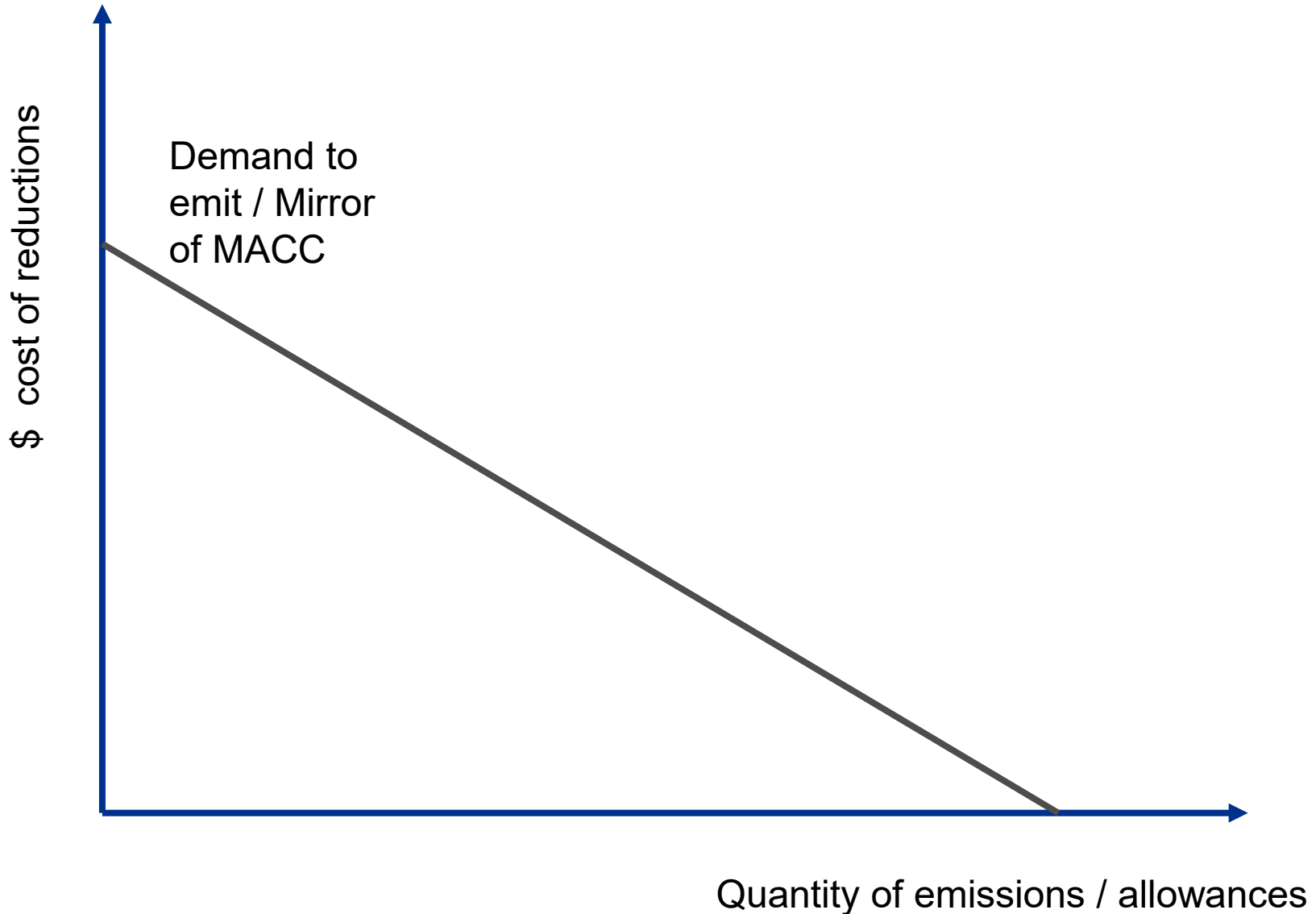
Ambition

Voluntary and compliance markets

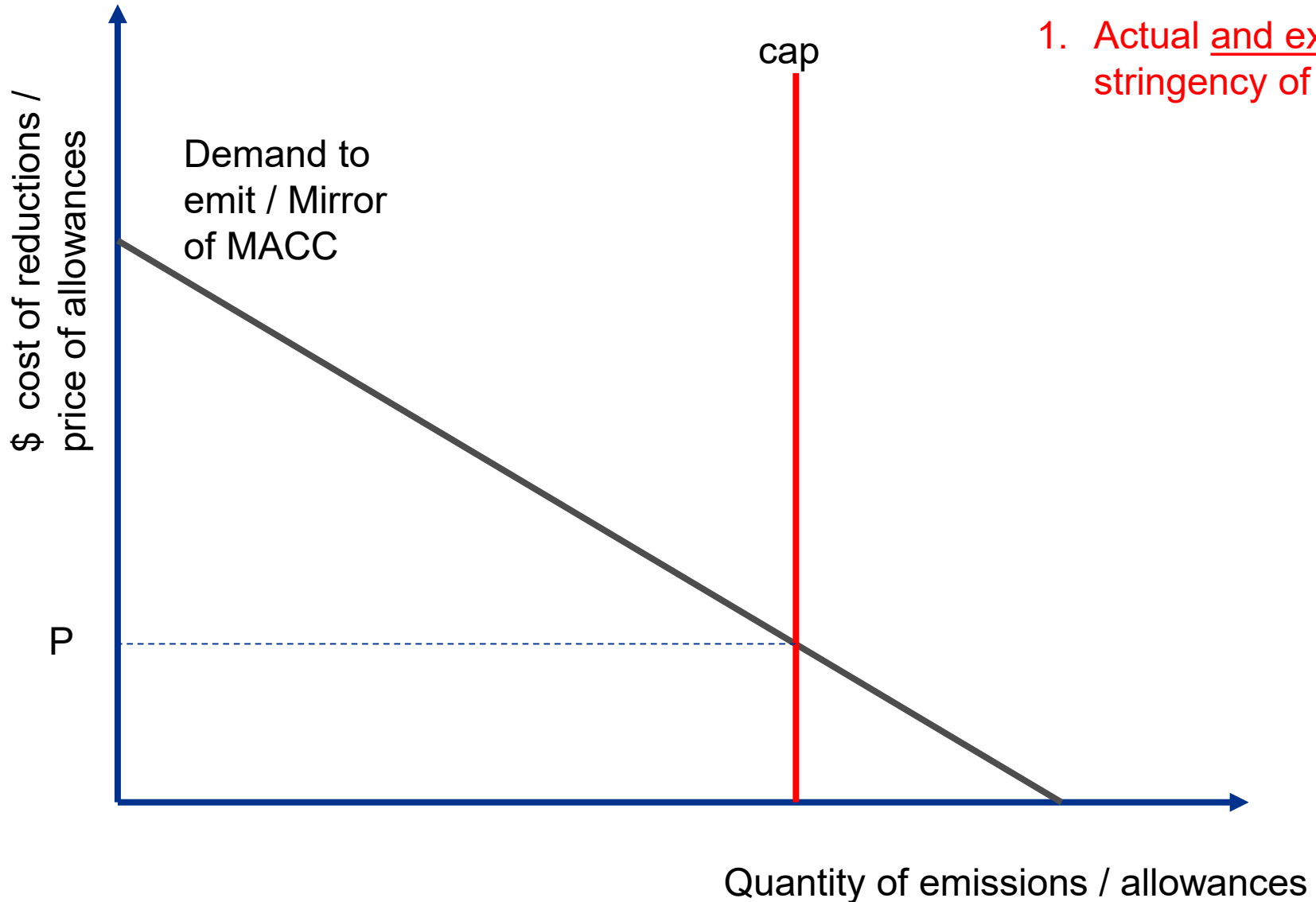
International trades



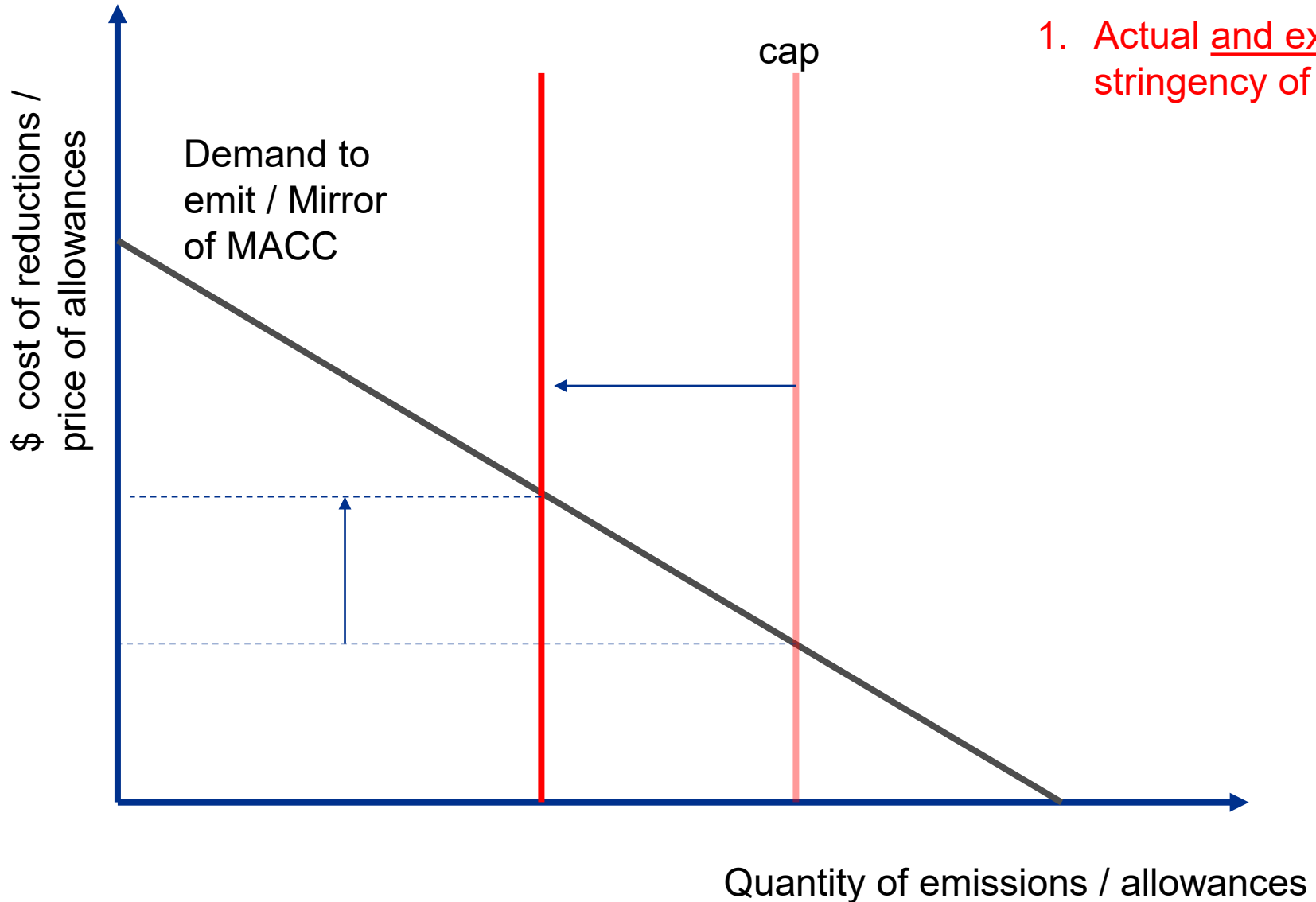
What drives cap-and-trade prices?



What drives cap-and-trade prices?

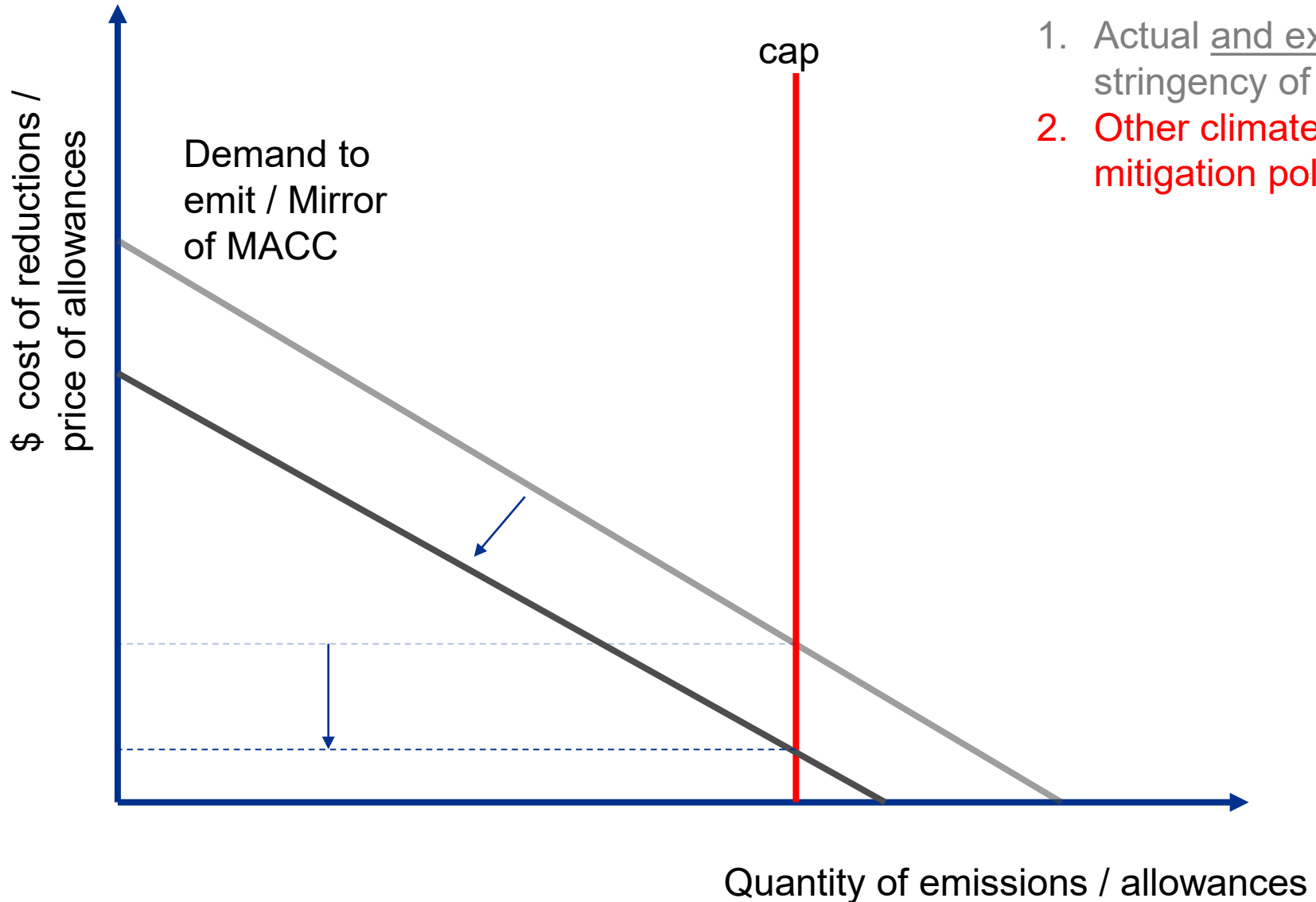


What drives cap-and-trade prices?



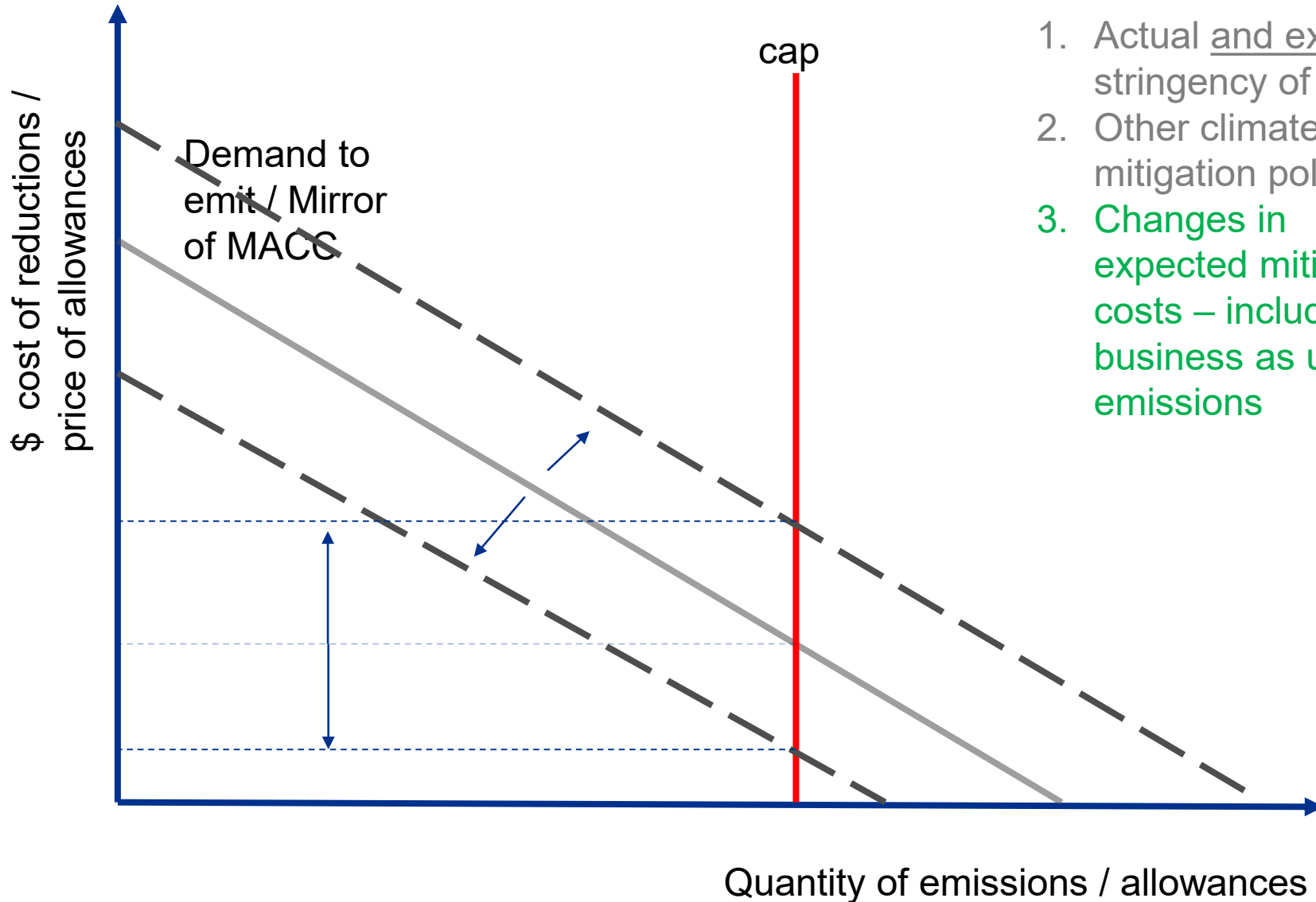
1. Actual and expected stringency of cap

What drives cap-and-trade prices?



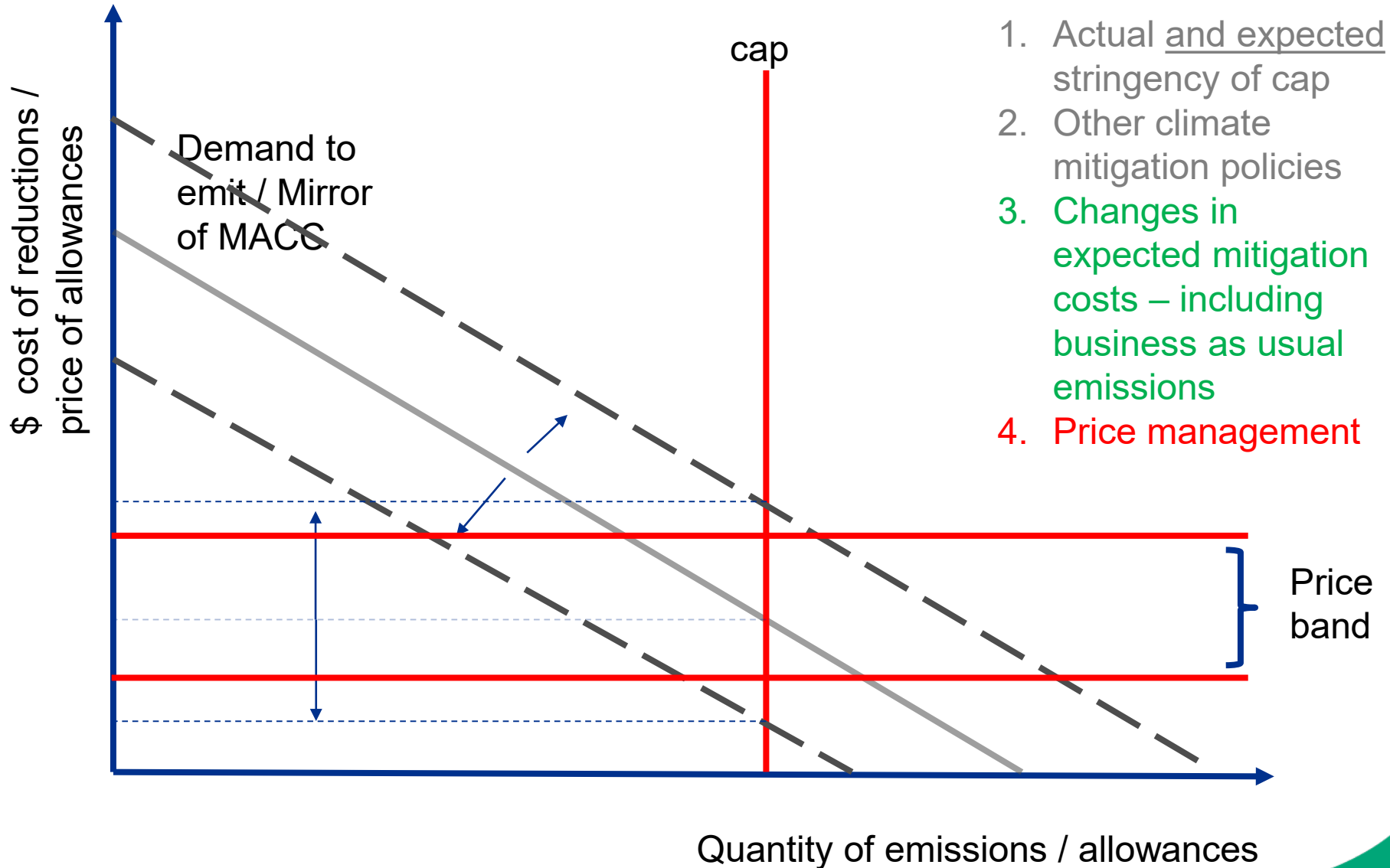
1. Actual and expected stringency of cap
2. Other climate mitigation policies

What drives cap-and-trade prices?

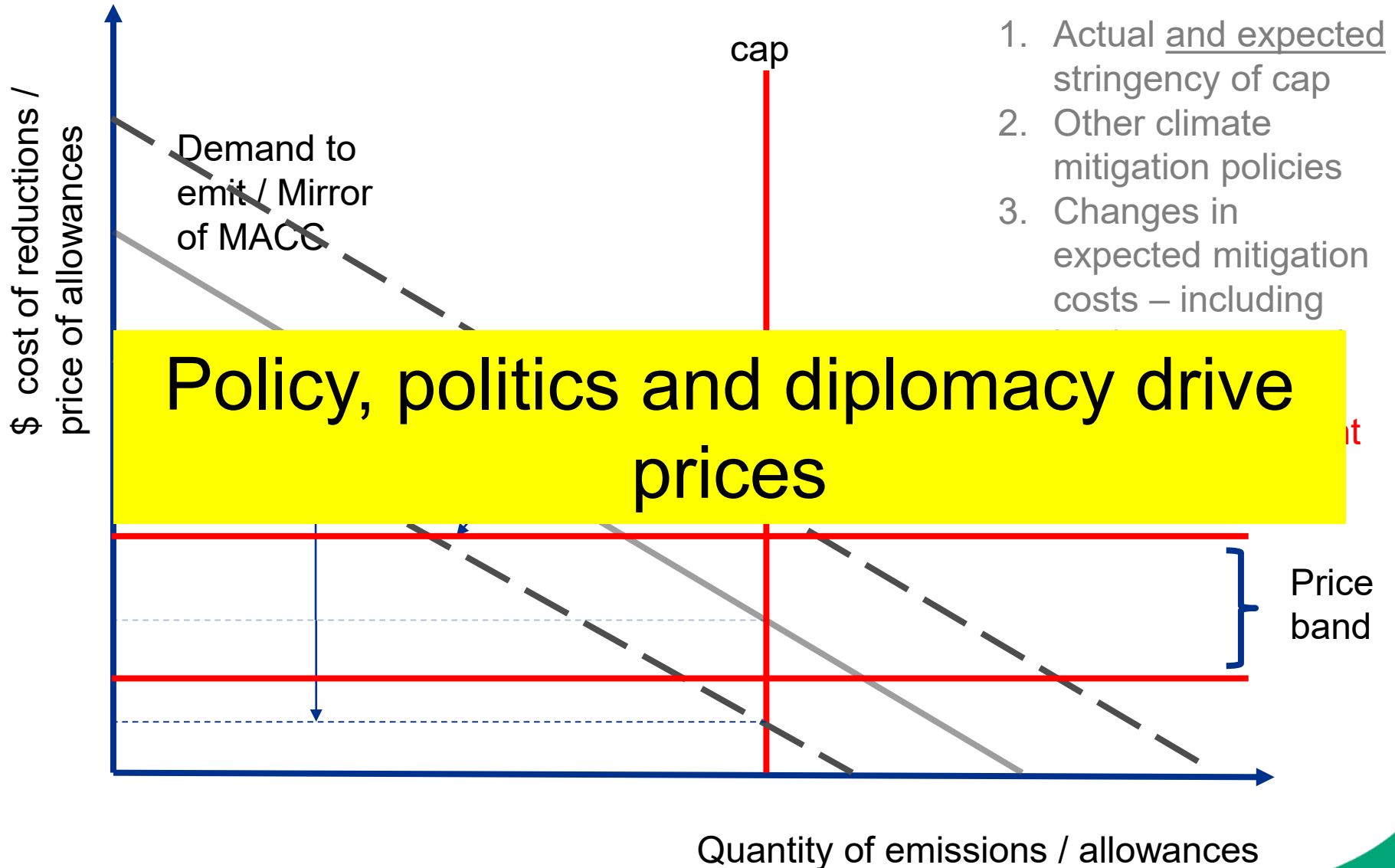


1. Actual and expected stringency of cap
2. Other climate mitigation policies
3. Changes in expected mitigation costs – including business as usual emissions

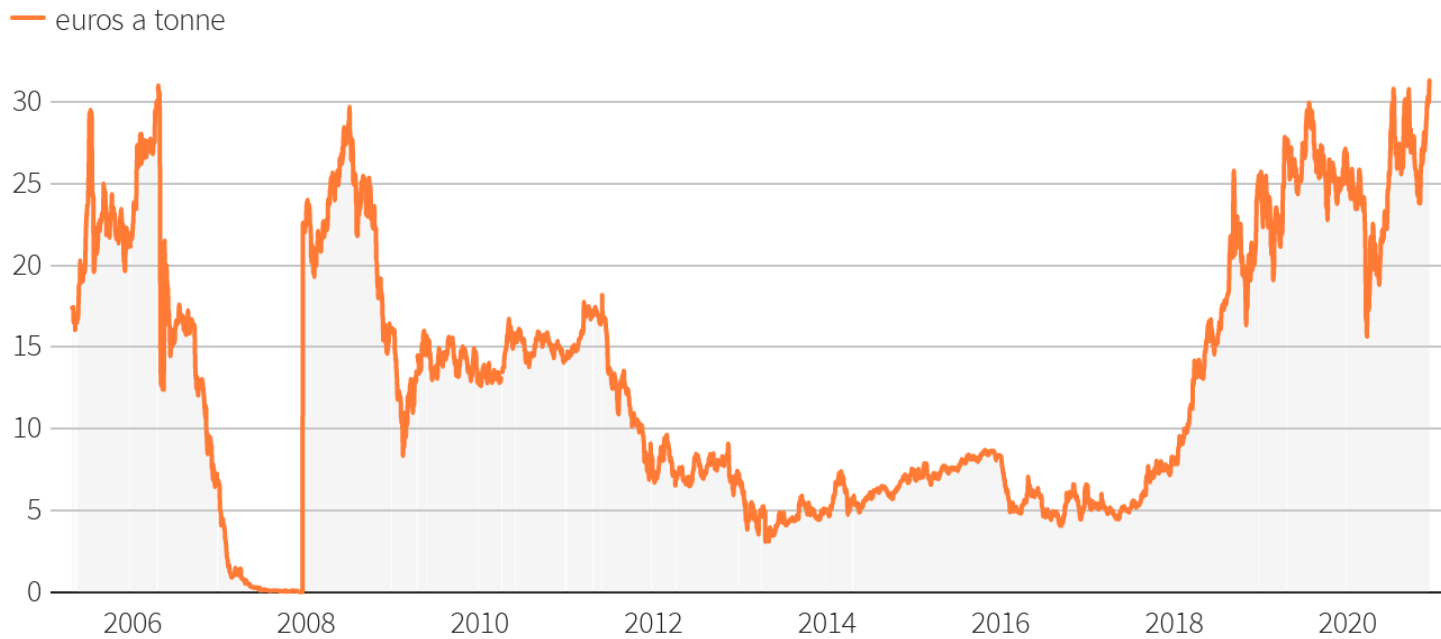
What drives cap-and-trade prices?



What drives cap-and-trade prices?



EU prices: short-term volatility and longer-term shifts



Note:

Source: Refinitiv

Cap and trade prices and clean investment

Key role of pricing is to enable and drive clean investment – but that requires confidence about longer-term carbon prices.

Investors use financial market instruments to lay off and manage risk

Who has the best ability to share and manage cap-and-trade risks?

Are foreign exchange markets a good comparison?

Volatility versus policy uncertainty

Lots of focus in policy design on the former, but is that the biggest concern here?

Deeper challenges with long-term governance of the policies that drive prices

Environmental justice and equity concerns

Criticism of 'market' solutions – what impact could that have?

Procedural: Loss of local control

Distributional: Impacts on workers, consumers

Market manipulation

} Not clear that these challenges are unique to cap and trade

Some solutions

Inclusive governance

Simultaneous policies for local benefits: pollution monitoring, strategic use of auction revenues

Guardrails around cap-and-trade markets: Price protection, auction purchase limits, strong registries



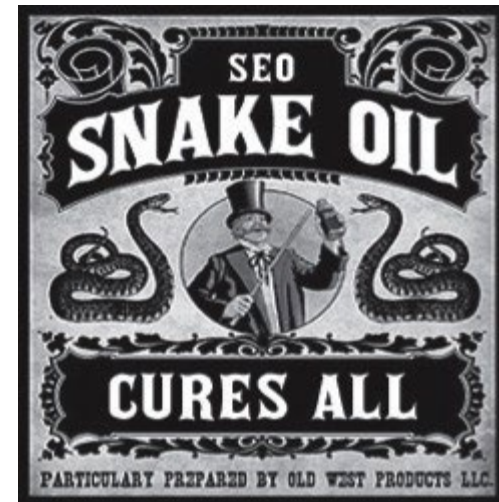
Environmental justice and equity concerns

Small sellers – can be exposed to unnecessary risk and ‘snake oil’ merchants

Nature-based solutions - players are small and liabilities can be created.

Solutions

Certify advisors; Develop alternative ways to engage and reward small actors.



Equity concerns still pose risks to the existence of and reliance on cap-and-trade markets particularly in the US.
Major source of potential price risk

Fundamental changes coming to carbon markets

1. Prices are likely to rise – or temperatures will!
2. International carbon markets are evolving
This will affect domestic cap and trade prices – not clear how
3. Voluntary markets
Their roles, and options, will change as ‘compliance markets’ have wider scope.
If compliance markets do well, voluntary ones are likely to shrink. Maybe rapidly.
Desire for standardization could invalidate many current credits

Risks will arise during the transitions from voluntary to compliance and from domestic only (or State only) to larger scale.

some types of credits might lose all value
prices may be driven by new political forces

Key messages

1. Cap-and-trade markets are created by regulation so politics creates price risk
 2. Supporting clean investment is a central goal so managing policy-driven risk is key
 3. Equity and avoidance of manipulation are possible but require attention
 4. Prices are likely to rise and markets are evolving fast – watch them
- 



Suzi Kerr
skerr@edf.org

