

Allowance price formation in Environmental Trading Schemes

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Cap and Trade Systems have not least since the ratification of the Kyoto Protocol in 2004 become popular environmental instruments. However recent price development of carbon allowances in the EU Emission Trading Scheme and its impact on European electricity prices exhibits the importance of a clear understanding of such Trading Systems.

To this end we propose a stochastic equilibrium model for allowance price formation in the European Emission Trading Scheme and show how it is related to fundamental price drivers. Thereby particular focus is given on the influence of market design on allowance prices, overall social costs and the burden that is passed to the end consumer.