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Abstract

We propose a model for risk neutral futures price dynamics in the European Unions Emissions Trading Scheme (EU ETS). Historical price dynamics suggests that both allowance prices for different compliance periods and CER prices for different compliance periods are significantly related. To obtain a realistic price dynamics we take into account the specific details of the EU ETS compliance regulations, such as banking and the link to the Clean Development Mechanism (CDM), and exploit arbitrage relationships between futures on EU allowances and Certified Emission Reductions.