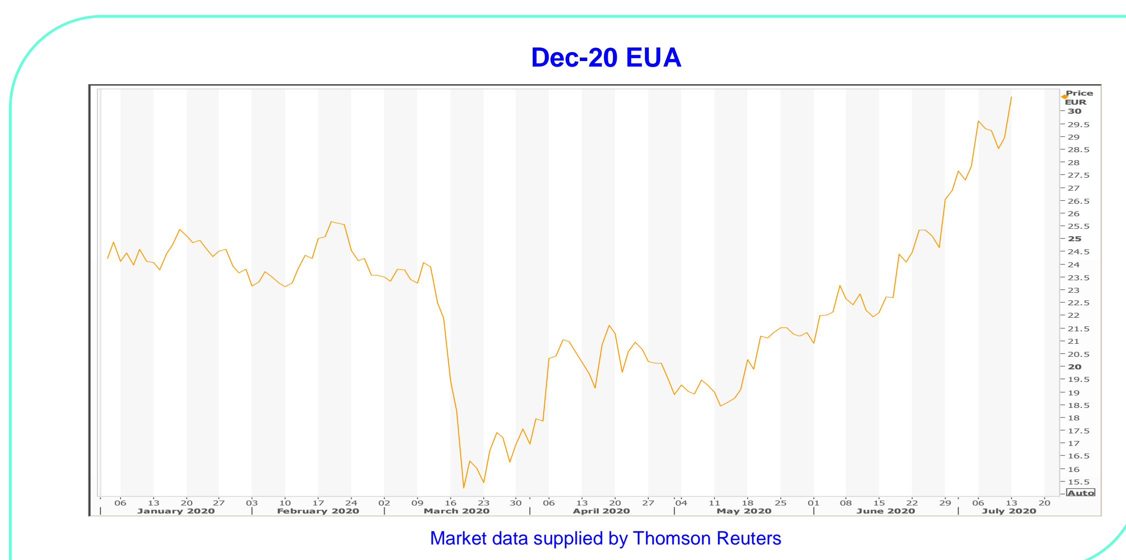
High Flying Carbon July 2020

In this article we examine the factors behind the incredible surge in carbon prices

Produced by Paul Harris, Senior Dealer Corporate & Institutional Sales
Bank of Ireland Markets & Treasury, 2 Burlington Plaza, Burlington Road, Dublin 4, Ireland. Tel: 076 624 4209 **corporate.bankofireland.com**

In March EU Allowance prices plunged to €14.34 as European economies grappled with the impact of the COVID-19 pandemic which saw industries shut down across the continent implying demand destruction for carbon permits.

Some three months later carbon prices have continued to surge, with the Dec-20 contract hitting a high of €30.56, an increase in value of over 50%. Market participants will be familiar with the dip in prices post the end of April compliance deadline, as traded volumes typically reduce over the summer months.



Market data supplied by Thomson Reuters

But what is behind the steep price rise in summer 2020, particularly as the return to business for many industries across Europe remains irregular?

The energy mix across the continent offers the first clue to price action. During the lockdown many countries reported a greater share of energy generation being attributable to renewable sources. The UK made much of (record) coal-free energy generation for an extended period and in Ireland Eirgrid report that since February's record 56% of demand being met by wind energy renewables continues to account for a large share of production.

However, in recent weeks across Europe lower wind and solar generation together with a reduction in French nuclear power production, has lent support to fossil fuel generation which in turn has underpinned the bid for carbon prices.

An additional source of support for the carbon complex has emerged as market players look ahead to the commencement of the EU Emissions Trading Scheme (EU ETS) Phase IV in 2021 and the change in rules governing the period. Whilst the annual reduction rate in annual free allocations has been well flagged – increasing to 2.2% from 1.74%[1] - which will tighten the market, perhaps the rules around surrender have been overlooked in some quarters. In Phase IV companies can only surrender allowances issued in the period to which the liability relates. This means that companies will not be able to use allowances delivered into their registry accounts in February 2021 to meet a shortfall for the 2020 period. As a consequence it is forecast that, notwithstanding the reduction in overall demand for EUAs resulting from lockdown-associated reduction in industrial output (estimated around 14%[2]), demand for EUAs will rise in Q420.

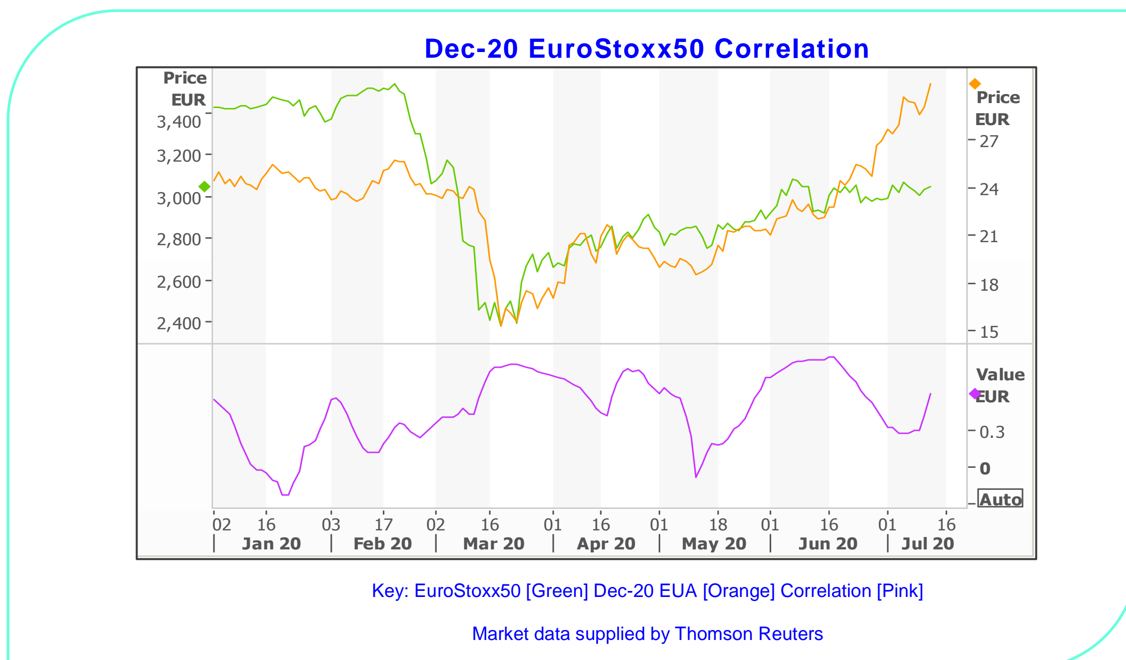
Furthermore a review of the Market Stability Reserve strategy[3] is predicted to tighten the market into Phase IV.

Whilst these factors go some way to explain the support for carbon prices along the curve, they do not tell the whole story.

---

[1] https://ec.europa.eu/clima/sites/clima/files/docs/ets_handbook_en.pdf
[2] OECD.org
[3] https://ec.europa.eu/clima/policies/ets/reform_en

Interestingly the rise in carbon prices has mirrored that of equity markets with a strong correlation emerging. This is perhaps best illustrated with reference to the Dec-20 EUA and Euro STOXX indices.



Key: EuroStoxx50 [Green] Dec-20 EUA [Orange] Correlation [Pink]

Market data supplied by Thomson Reuters

This correlation points to the carbon complex increasingly being viewed by the financial markets as an asset in its own right, unconnected with compliance activities. Hedge funds and other investors are turning to carbon as a way of tapping into the returns associated with the paradigm shift to a low carbon economy.

As Europe emerges from the most restrictive elements of the COVID-19 lockdown there is a surge in support from businesses, legislators and broader society for the idea of a ‘green’ recovery that builds back economies with due regard for environmental considerations such as climate change and nature.

Central to this is the EU Green Deal that aims to reach carbon neutrality by 2050. That means updating the EU’s climate ambition for 2030, with a 50-55% cut in greenhouse gas emissions to replace the current 40% objective. In order to secure such targets policy instruments – including the EU ETS – will need to be strengthened to meet the new goals. Investors in carbon are banking on the fact that this will tighten carbon prices and thus yield healthy returns: the thinking is that, since the EUA is the prime market-based policy mechanism of the EU, success of the measures taken to secure the green transition will be reflected in the price of carbon.

The prospects for carbon prices between now and the end of the year would seem to be fundamentally strong with many analysts upgrading their forecasts with a consensus range of between €23-26t/CO2e for H220. Risks of a reintroduction of lockdowns associated with a resurgence of COVID-19 will inevitably dent prices and upcoming auctions will also add to downside risk as supply is increased over the next couple of weeks.

Brexit impacts will also influence price action. Under the terms of the withdrawal UK participants in the EU ETS will exit after the 31st March 2021 at the end of the 2020 compliance period. The UK has been a net contributor to supply so the inevitable impact of their departure will be to tighten prices. Plans for a linkage of the new UK ETS with the EU ETS are unclear, largely dependent upon whether the exit is soft or hard and the extent of the trade agreement: this may increase short term volatility in carbon prices until clarity emerges.

The US Presidential election may also have a bearing on carbon sentiment in Q420 – a victory for Biden and Democrats will likely see the US re-engage with the Paris Accord and breathe new impetus into the greening of the US economy. This will inevitably boost positivity around initiatives like the EU Green Deal and deliver bullish sentiment into the EU ETS.

In summary, the incredible rally in carbon prices from the lows in March to a market contemplating a test of record €30 highs, whilst based on normal pricing fundamentals in the near term, has at its core an increasing cohort of investors who view the asset value of carbon as an intelligent play as the European economy builds back with a heavy accent on environmental considerations. Notwithstanding the volatility associated with a second COVID-19 wave, Brexit and the US election, the trajectory for carbon looks to remain upwards until well into 2021.

Bank of Ireland

Produced by Bank of Ireland Global Markets ("GM"). Bank of Ireland incorporated in Ireland with limited liability. Bank of Ireland is regulated by the Central Bank of Ireland. In the UK, Bank of Ireland is authorised by the Central Bank of Ireland and the Prudential Regulation Authority and subject to limited regulation by the Financial Conduct Authority and Prudential Regulation Authority. Details about the extent of our authorisation and regulation by the Prudential Regulation Authority, and regulation by the Financial Conduct Authority are available from us on request. Registered Office – Head Office, 40 Mespil Road, Dublin 4, Ireland. Registered Number - C-1 This document is for information purposes only and GM is not soliciting any action based upon it. GM believes any information contained herein to be materially accurate but GM does not warrant its accuracy or completeness and this information should not be relied upon for any purpose. No prices or rates mentioned are bids or offers by GM to purchase or sell any currencies, securities or financial instruments. Except as otherwise may be specifically agreed, GM has not acted nor will act as a fiduciary, financial or investment adviser with respect to any derivative transaction that it has executed or will execute. Any investment, trading and hedging decision of a party will be based on its own judgement and not upon any view expressed by GM. This document does not address all risks related to the transactions described. You should obtain independent professional advice before making any investment decision. Any expressions of opinion reflect current opinions as 15 July 2020. This publication is based on information available before this date. For private circulation only. This document is property of GM. The content may not be reproduced, either in whole or in part, without the express written consent of a suitably authorised member of GM staff.