WHAT'S HOT – EUA FUTURES KEEP ROCK N ROLLING

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As we enter the final weeks of the current compliance period for regulated entities in the Emissions Trading System (ETS), we see the price of EU Allowances reach new highs, above €73/tonne CO2 equivalent. This is a key time for regulated entities to take stock of the emissions they have produced during the year while closing hedges for the current year and opening them for next year. Economic strength and firm climate commitments are propelling the carbon market into 2022.

Emission clarity as we approach contract roll-period

As we approach the end of the year, commercial hedgers - who are the main users of EU Allowance (EUA) futures[1] - have a better sense of how much greenhouse gas emissions (GHG) they have put in the atmosphere during the year and thus are deciding whether to roll their futures positions or take delivery of underlying EUAs[2]. Regulated entities in the EU - primarily energy utilities, industrial emitters and intra-EU aviation companies - have the legal obligation to surrender EUAs commensurate with the amount of GHG they have produced in the year. Failure to surrender the appropriate number of EUAs results in a fine of €100/tonne CO2 equivalent for every excess tonne of carbon. Furthermore, the company needs to go into the market and purchase (and surrender) EUAs to make up for the shortfall. Not to mention the reputational risk from being named and shamed, companies have clear incentives to get the number right.

Front of December futures contract remains the most relevant

Our analysis shows that the front of December futures contract is the most liquid. ESMA has corroborated this finding. That outcome is largely rooted in the fact that commercial hedgers are the main users of EUA futures, and they prefer the December contract due to a better vision of emissions closer to the end of the year (as mentioned earlier). Investors in EUA futures also benefit from holding front December contracts rather than other contract maturities because this is where the bulk of trading liquidity sits. Strong liquidity enables efficient pricing and avoids the choppy trading we may find in illiquid futures contracts or in the spot market. The top panel of the chart below shows that the front December (2021) and next December (2022) contract prices are virtually the same (indicating very little by way of roll costs). The bottom panel shows that December 2021 has had more open interest through the course of the year, but now December 2022 has caught up, and soon December 2022 will be the new front December contract.

Source: WisdomTree, Bloomberg, Data from 24/11/2020 to 23/11/2022.

Historical performance is not an indication of future performance and any investments may go down in value.

Economic rebound and policy dynamics likely to have pushed up demand

Economic activity (and by extension, polluting activity) has picked up strongly in 2021 relative to 2020 when we were in the depths of a pandemic-stricken recession. The price of EUAs rose from €33/tonne CO2 equivalent on 31/12/2020 to €73/tonne CO2 equivalent on 24/11/2021 in part reflecting this pickup in economic activity but also proposed policy changes (see Fit for 55 legislation: Going harder, deeper, faster with the EU Emissions Trading System). The close to 25% increase in EUA prices in November so far (01/11/2021 to 24/11/2021), is likely a reflection of corporates taking stock of emissions as they approach the end of the compliance period (1st January to 31st December)[3] and the expiry of EUA futures contracts they are holding. It is also time to think about how many futures contracts they will need to hedge for next year's obligations. Even though Euro Area manufacturing purchasing managers indices (PMIs) have been slipping in recent months[4], the reading is way above 50 – indicating a period of expansionary activity. Indeed, most of the softness in the data reflects supply chain issues, which could be rectified during the course of 2022 and lead to PMIs gaining momentum again.

COP 26 reaffirms EU climate commitments

The messaging from the EU at the 2021 UN climate change conference (COP26), was to support the Paris Agreement strongly[5]. We believe the European Commission will pursue the implementation of the Fit for 55 legislative package in full. Any failure to implement at the Union level could be met by tougher actions at the national level. Germany's new government[6] said on Wednesday 24th November 2021 it would consider establishing a national long-term price floor of at least €60/tonne if carbon prices dropped below such levels in the next few years and the EU failed to agree on a similar measure.

Will we see fine inflation?

The €100/tonne CO2 equivalent fine for excess emissions seemed appropriate last year when EUAs were trading below €33/tonne CO2 equivalent (i.e. more than three times the EUA spot price). But now that EUAs are trading above €70/tonne CO2 equivalent, the fine is no longer as punitive. We expect to see the fine adjusted upwards. While the European Commission has not made any formal comments on this, the fine in nominal terms is not fixed for the duration of the whole of Phase 4 of the Emissions Training System[7], and so the next logical move is to raise the fine.

Sources

[1] Regulated entities have been identified as the main users of EUA futures by ESMA in their analysis of the EUA market, with relatively little involvement of investors, confirming our analysis:

[2] The ICE December 2021 EUA future expires on 20th December 2021, with the delivery starting on 21st December 2021.

[3] Although companies have more time for filing regulatory obligations: data for a given year must be verified by an accredited verifier by 31 March of the following year. Once verified, operators must surrender the equivalent number of allowances by 30 April of that year.

[4] http://www.markiteconomics.com/Public/Home/PressRelease/d1e6b09a9eea4993bb787845fb55233f

[5] i.e. to limit global warming to 1.5 degrees Celsius.

[6] On Wednesday 24th November 2021 Germany announced a new a center-left government led by Olaf Scholz, a Social Democrat, with partners from partners from the Greens and Free Democrats

[7] 2021 to 2030

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