EU carbon market update: compliance deadline sees market move higher

EU carbon allowances have experienced a recovery from the recent lows seen in early March, with prices trading back at levels last seen in February. The upcoming compliance deadline to surrender allowances appears to have provided some support to prices, as has gas-to-coal switching

Coal power plant in Bełchatów, Poland

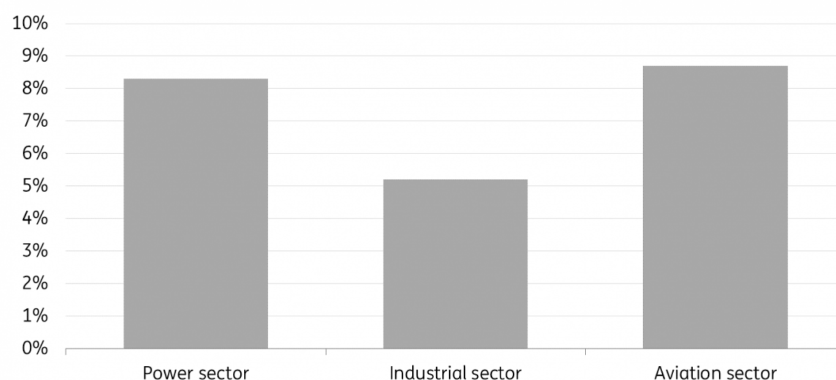
Compliance deadline provides some strength

Under the EU Emission Trading System (ETS), installations (power plants and industrial plants) and airlines have until 30 April to surrender the number of allowances equivalent to their emissions in the preceding year. Therefore, the potential for increased buying in order to meet obligations could be providing some support to the market. This is a year in which the EU would have seen an increase in carbon emissions. This would have been driven by the post-Covid recovery, along with increased consumption of coal in the power sector over 2021 due to strong gas prices.

The European Commission reported that greenhouse gas emissions from stationary installations covered by the EU ETS increased by 7.3% year-on-year in 2021 to a total 1.311 billion tonnes. Emissions from the power sector increased by 8.3%, the industrial sector saw a 5.2% increase in emissions, and aviation sector emissions grew by 8.7%. However, emissions for all three sectors

were still lower than 2019 levels.

2021 emissions for operators under EU ETS by sector (YoY % change)



Source: European Commission, ING Research

Gas-to-coal switching pushes demand for allowances higher

The strength that we have seen in the European natural gas market has provided a boost to coal demand from the power generation sector. Clean dark spreads have traded above clean spark spreads for quite some time now, supporting gas-to-coal switching. This continues to be the case currently and in fact, the forward curve suggests the dark spreads will remain above spark spreads for the remainder of the year. An increase in coal demand from the power sector should mean the need for further emission allowances which should be somewhat supportive of prices.

With allowances trading below the fuel-switching range, we would need to see stronger carbon prices in order to make gas-fired power generation more economically attractive than coal.

The clear downside risk for allowances is if high energy prices lead to significant demand destruction from the industrial sector. Since the fourth quarter of 2021, we have already seen a number of industrials reducing operating rates due to high energy prices, including electric arc furnace steel mills, and aluminium and zinc smelters. For example, EU steel output over 1Q22 is down almost 4% year-on-year, whilst 1Q22 aluminium output in Western and Central Europe declined more than 10% year-on-year.

The ongoing war also raises plenty of uncertainty over future Russian energy supply to Europe. Europe will find coal on the policy agenda to substitute for Russian gas, if Russia reduces gas flows to Europe or if Europe puts a ban on Russian gas (Poland and Bulgaria are already having to deal with Russia halting gas flows). For example, coal power plants in Germany, the Netherlands and Poland have spare capacity to substitute for gas used in the power sector. While Russian gas pipeline flows have held up well so far, it is likely that the market has still anticipated an increase in coal demand to some degree, adding to higher carbon prices.

Clearly right now the price action in allowances suggests the market expects gas-to-coal switching to be stronger than demand destruction from higher energy prices.

Progress in EU ETS reforms

Proposed reforms to the ETS in order to help meets the EU's Green Deal targets are a step closer to being legislated. The European Parliament's Committee on Industry, Research and Energy (ITRE) recently approved plans to increase the rate at which emissions are reduced each year from 2.2% currently to 4.2%. The committee also supported a one-off reduction in the cap, a strengthening in the market stability reserve, and the launching of another emission trading system for heating and road transport. However, there was a push from the committee to delay the phase-out of free allowances for companies where there is the largest risk of carbon leakage.

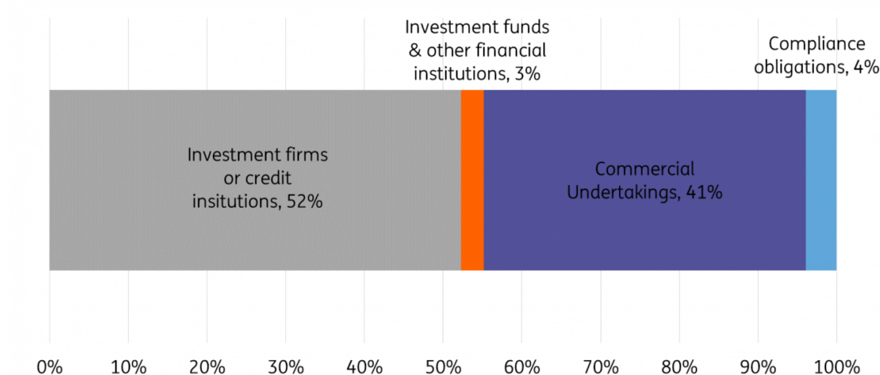
This was the first hurdle passed for the ETS reform. The next step would be for another committee to vote in May, which will then be followed by the EU Parliament in June.

The committee also narrowly voted in favour of a new amendment put forward to exclude financial institutions from carbon trading. This was put forward due to concerns that a large part of the strength in the ETS market has been driven by speculators. The proposal appears to exclude financial intermediaries that trade allowances on behalf of companies with an ETS compliance obligation. However, to be clear, this is a proposed amendment from the ITRE, and it will have to be supported by all member states if it has a chance of being included. This might be difficult, given the amendment scraped through the ITRE committee. Also, the European Securities and Market Authority (ESMA) in a recent report said that it found no *"current major deficiencies in the functioning of the EU carbon market…"* and that *"positions by investment funds remain limited"*. Although ESMA did recommend the implementation of position limits for derivatives.

Investment funds make up a small portion of the market

While there has been plenty of discussion around the impact of speculators on the EU ETS market, it is important to point out that investment funds hold a small share of open interest on ICE and EEX. Combined, investment funds hold around 3% of open positions at the moment (for comparison, investment funds and other financial institutions hold about 21% of open positions in ICE Brent under the MiFID II weekly COT report), whilst non-financials hold about 45% of open positions. The remaining 52% is held by investment firms and credit institutions, with the bulk of their open positions being short, and so helping to make the market. Without investment firms and credit institutions, there would be significantly less liquidity in the market.

Share of open positions in EUA futures by category



Source: ICE, EEX, ING Research

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