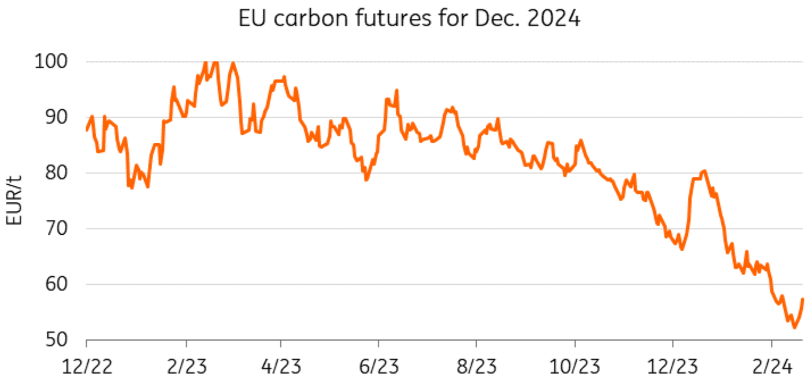
EU carbon prices likely to remain under pressure

EU emission allowance prices have been trading lower for much of this year, alongside gas and power. We believe this pressure is likely to persist

Emission allowance prices fell in February to the lowest level since July 2021

EU carbon price plunges on demand pressures



Source: ICE, ING Research

What's driving the EU's carbon prices lower?

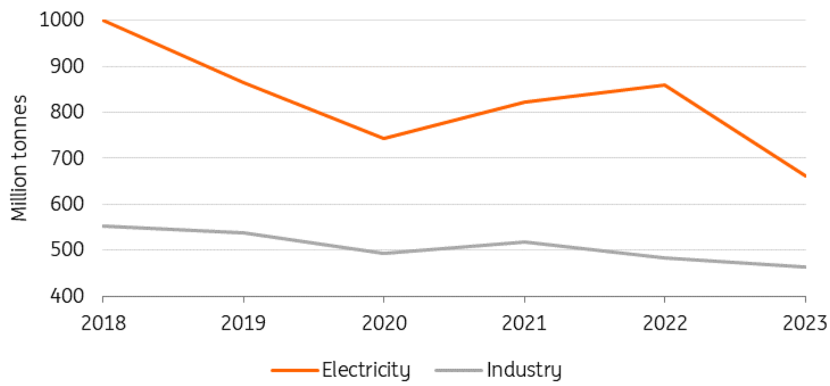
While the longer-term outlook for EU allowances (EUAs) remains constructive as allowances in the market are reduced, short-term dynamics are more bearish.

Emission allowance prices hit a low of EUR52.2 per metric tonne of CO2 equivalent in February, the lowest since July 2021. The market is down 26% year-to-date.

EUA prices have been weighed down by a combination of bearish factors, including a sluggish industrial recovery, strong renewables output and limited power demand from mild weather.

Almost half of the emissions under the EU's Emissions Trading System (ETS) come from the industrial sector. Meanwhile, the EU has seen reduced industrial activity as factories shut down following the surge in energy costs in 2022, which means lower emissions and fewer permits needed to account for the emissions. Overall, European CO2 emissions are down 28% since 2018.

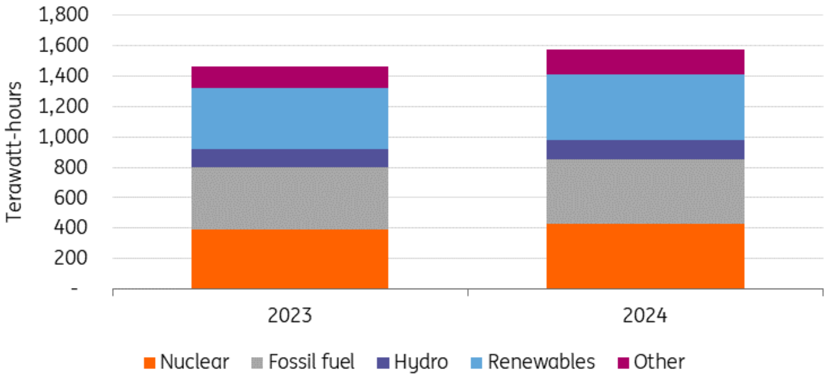
Emissions in the EU carbon market are shrinking



Source: Kayross Carbon Watch, ING Research

Most of the remaining emissions come from the power sector, where rapid expansion in renewables in Europe has also reduced the need for carbon permits. Higher energy costs following Russia's invasion of Ukraine have accelerated solar and wind deployment in the bloc. In France, nuclear output has also recovered. Meanwhile, generation from coal and natural gas has been under pressure.

EU renewables output grows



Note: Chart includes data for Germany, Great Britain, France, Italy and Belgium. "Other" includes oil, biomass, geothermal, uncategorized renewables and other fuels. Source: BNEF, ING Research

Looking ahead, this is not expected to change anytime soon. Both forward spark and dark spreads are in negative territory in the coming months, suggesting that power generation from natural gas and coal will remain under pressure. This all suggests that EUA prices are likely to remain subdued in the short term.

Supply to increase in 2024

On the supply side, the latest free allocation and auction numbers show the total supply of EUAs in 2024 will be at least 6% higher year-on-year, without taking into account the full extent of the Market Stability Reserve, thanks to the front-loading of allowance supply, new compliance entities receiving free permits and the addition of shipping, according to BNEF.

Some 86 million EUAs will have been auctioned through the European Energy Exchange (EEX) by the end of February. This includes 32.4 million auctioned for funds and REPowerEU, as well as 0.9 million aviation emission allowances. Some 49.9 million allowances are set to be auctioned in March, according to BNEF.

REPowerEU aims to end the EU's reliance on Russian fossil fuels by diversifying energy sources, energy savings and accelerating the roll-out of renewables. Part of the REPowerEU plan is set to be funded by the Recovery and Resilience Facility (RRF) through the sale of ETS allowances. The Commission's aim is to raise EUR20 billion from allowance sales. Some 40% of these funds are set to be met by bringing forward the auction of allowances scheduled to be auctioned between 2027-2030. These will now be brought forward to before 31 August 2026. Meanwhile, the remaining 60% will be met by sales of allowances from the Innovation Fund.

Longer-term picture still bullish

While the short-term outlook remains subdued and the medium-term outlook less bullish than originally envisaged, the longer-term picture remains bullish. Ambitious targets under Fit for 55 mean a more aggressive reduction factor will be used for allowances moving forward. A reduction factor of 4.3% per year will be used between 2024 and 2027 and 4.4% between 2028 and 2030. This compares to a previous linear reduction factor of 2.2%. In doing so, the Commission hopes to see emissions under the ETS fall 62% from 2005 levels by 2030 compared to a 43% reduction target previously. This is also slightly more aggressive than the proposed 61% reduction.

Furthermore, to help hit the target there will be two one-off reductions in the cap, effectively reducing it by 90m allowances in 2024 and a further 27m allowances in 2026.

Author

Ewa Manthey
Commodities Strategist
ewa.manthey@ing.com