

Subdued carbon

EU allowances have been trending lower for much of this year. Weaker demand, increased renewables and the front loading of allowances have weighed on the market. Pressure is likely to persist as we enter 2024



France's nuclear power output has recovered this year, reducing the number of carbon allowances needed

EUAs fall on demand pressures

As we have approached year end, EU allowances (EUAs) have traded down to their lowest levels since November 2022, approaching EUR70/t. While the longer-term outlook for EUAs remains constructive as allowances in the market are reduced, short-term dynamics are more bearish. The EU has seen reduced industrial activity, which means lower emissions and the need for installations to surrender fewer allowances. Emissions over the first half of this year totalled 1.76b tonnes CO₂eq, down 4.2% year-on-year.

If we look at the power sector, in addition to overall power generation having fallen this year, we have also seen changes in the power mix. Renewables output has been strong, and in France nuclear power output has also recovered, therefore reducing the number of allowances needed. EU electricity generation has been in a YoY decline since March 2022. Meanwhile, generation from coal and natural gas has been under pressure throughout the year.

Looking ahead, this is not expected to change anytime soon. Both forward spark and dark spreads

are firmly in negative territory in the coming months, suggesting that power generation from natural gas and coal will remain under pressure through the 2023/24 winter. This all suggests that EUA prices are likely to remain subdued in the short term.

Front loading of allowances

Supply dynamics have also played a role in pressuring EUAs, dimming the short to medium outlook. This is partly due to REPowerEU, which 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 Emissions Trading System (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.

The EEX auction calendar shows an additional 35.3mn allowances are to be auctioned in 2023 for the RRF, whilst auction regulation from the Commission shows 86.7mn allowances to be auctioned in both 2024 and 2025 and 58mn allowances in 2026 for the RRF. This adds up to a total of 266.7mn allowances.

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 90mn allowances in 2024 and a further 27mn allowances in 2026.

Shipping falls under ETS from 2024

1 January 2024 will also see the shipping sector fall under the EU Emissions Trading System. Although, there have been calls from a number of member states to delay the inclusion of the shipping sector. These countries, including Spain and Italy, have cited concerns that the extra cost faced by shippers could drive traffic away from EU ports and that we could actually see increased emissions with some shippers taking longer routes to avoid stopping in EU ports.

Initially, carbon emissions from all large ships (above 5,000 gross tonnage) entering EU ports and transporting passengers or cargo for commercial purposes will fall under the ETS. There will be a phase-in period where shippers will only have to surrender allowances for 40% of their emissions for 2024, 70% for 2025 and 100% for 2026 emissions. Furthermore, only carbon emissions will be included from 2024, but from 2026, methane and nitrous oxide emissions will also be included.

100% of emissions will be covered for intra-EU trips and those that fall within an EU port, whilst 50% of emissions will be covered for extra-EU voyages that either start or end in an EU port.

The inclusion of the shipping sector in the EU ETS will see 78.4mn allowances added to the ETS,

which will be subject to the same reduction rate as the wider ETS. This compares to total ETS-applicable emissions from the maritime industry in 2022 of 83.4mtCO₂e.

Phase out of free allowances for the aviation sector

2024 will also start to see free allowances for the aviation sector phased out. Free allowances will be reduced by 25% in 2024 and 50% in 2025 while the industry will have to pay for 100% of their emissions from 2026. Given the difficulty in decarbonising the aviation sector and the continued recovery in air travel, demand for EUAs from the sector will continue to grow in 2024.

Author

Warren Patterson

Head of Commodities Strategy

Warren.Patterson@asia.ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.