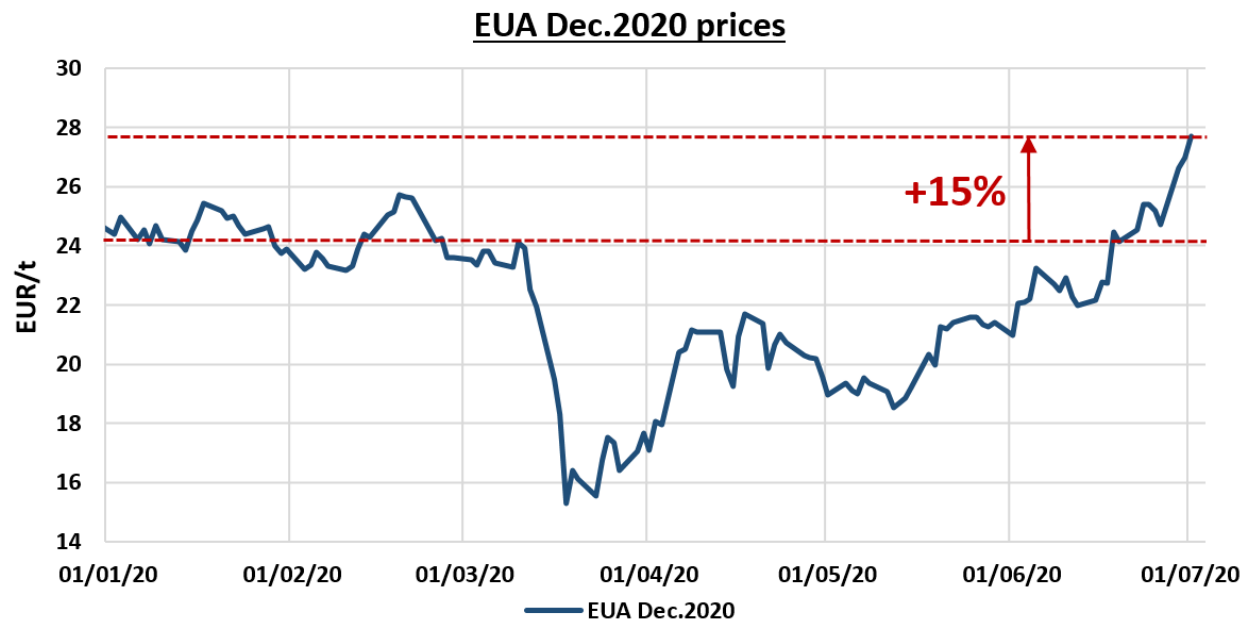


## EU ETS : An impromptu and questionable rally of emissions prices

Despite the expected drop in emissions induced by the covid-19 crisis, emissions prices have presented a strong bullish trend over the past few weeks, a rally that brought them above their pre-crisis level and at a 11-month high on July 1<sup>st</sup>.



Source 1 : Data from Intercontinental Exchange (ICE)

### The fundamentals of the emissions market remain significantly bearish:

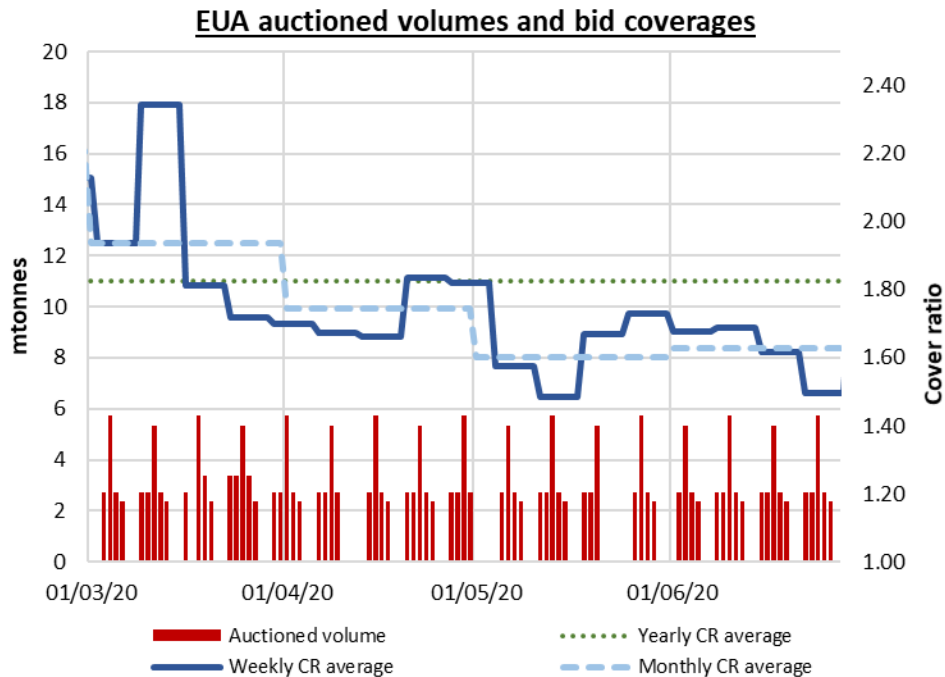
As a consequence of the lockdown and subsequent economic crisis across Europe, **emissions are estimated to fall between 15% and 25% in 2020**. By contrast, verified emissions dropped by 8.6% in 2019 from the year prior.

**The industrial activity and power consumption**, albeit presenting signs of recovery over the past weeks, **remain dampened** by the crisis which should further limit the demand for allowances. Last month, the French power demand was indeed 6% on average below June 2019's level and seems to be plateauing at this level.

Moreover, **the low gas prices and current levels of EUA prices are supporting the competitiveness of the less emitting gas based power plants** over the coal-fired ones.

**The Market Stability Reserve**, designed to support emissions prices in case of an oversupplied market, **will absorb the surplus generated during the covid-19 crisis only from May 2021**. The supply will hence remain important for the remaining of the year, especially with the 50mt of the Innovation Fund coming to market from July 16<sup>th</sup> (according to the European Commission publication on July 1<sup>st</sup>).

Furthermore, additional bearish signals are coming from the primary market. Despite auctions frequently clearing at a decent price, **the cover ratios** (ratio of total volume bided over the total volume auctioned, used as indicator of the compliance companies' buying interest) **have remained well below their yearly average**, illustrating the current lack of interest from the compliance companies for allowances at such level of prices. A bearish sentiment strengthened by the recent publication by the IMF of a pessimistic outlook for the economic growth implying a very slow recovery of the industrial sector.

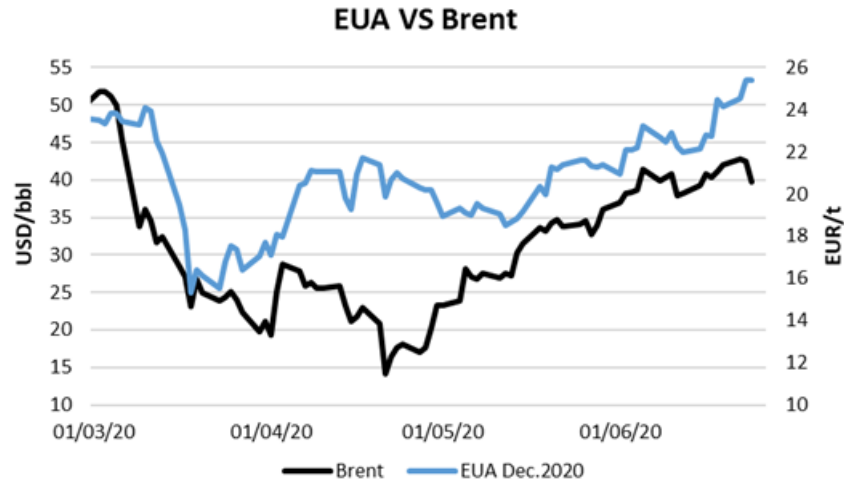


### A speculation-driven rebound:

Defying these bearish factors, **EUA prices have posted significant gains over the past few weeks and recently climbed back above their pre-crisis level.** Several factors can explain this surprising bullish trend.

Considering the financial losses sustained by the industrial sector since March, it is unlikely that the compliance companies have some buying interests at such level of prices. **Speculators are more likely to be responsible** for the sharp bullish move and high volatility of EUAs.

**The carbon market is presenting a strong correlation with the oil and financial markets** as, for a lack of stronger drivers, speculators tends to track “more established” markets variations. Therefore, the OPEC+ cuts in crude oil production and the optimism seen in the financial markets following a quicker-than-expected economic recovery along with numerous stimulus measures announced by the EU (Recovery fund) and the central banks have provided support to carbon prices since the massive EUA sell-off mid-March.



*Source 3: Data from ICE*

In addition, the lack of compliance selling might come from cash-strapped companies retaining their allowances, despite their covid-fueled reduction of emissions, to be able to get government aid programs, hence delaying a potential downward correction of carbon prices.

According to most market participants, **the recent EUAs’ rally was supported by the current discussions of the EU about a potential reform of the EU ETS through the “Green Deal”**, including the implementation of a carbon floor price. However the European Commission has made no official declaration on the subject so far and is still currently assessing the impact of raising the EU 2030 emissions reduction target from 40% to 55% below 1990’s level, with the study’s results due next September. Beside a carbon price floor, a reform of the EU ETS could imply an increased MSR intake rate (currently at 24% of the Total Number of Allowances in Circulation it the 833mt threshold is exceed until 2023, then at 12%) or a strengthened Linear Reduction Factor, all factors resulting in a potential tightening of supply in the coming decade which might interest long-term investors waiting for higher prices amid zero storage costs.

The second main reason behind the EUAs’ steep rise would be a **combination of technical factors and strong algo trading**. The EUA benchmark Dec.2020 contract breaking through the 200-moving average resistance triggered stop losses and closed automatically short positions, lifting carbon prices further up. Several market participants agreed to say that speculators are “bullying” the market, bidding up small volumes to trigger stop losses from short-sellers trying to catch the rally’s end, resulting in EUA prices climbing further up.

Another support may have come from the **historically low French nuclear availability expected in the coming winter season**. EDF indeed announced early April the reduction of its nuclear output target for 2020 from 370-390TWh to 300TWh as a consequence of the lockdown and a complete revision of its maintenance schedule. Low nuclear generation would indeed strengthen the call for thermal power plants, increasing the demand for carbon allowances. However, a tension of the energy complex is likely only in the case of a fully recovered power demand and a combination of bullish factors such as low renewable production and cold temperatures.

Finally, a recent study on open interests carried out by ICIS HEREN suggests that **utilities may also have provided support to carbon prices by building long positions**, either by increasing significantly the pace of their hedging to secure margins (taking advantage of the low gas prices and subsequent positive clean spark spreads) and avoid credit rating issues, and/or to build a EUA strategic reserve ahead of the annual drop in auction supply coming in August and in anticipation of a potential review of the EU ETS, as they did in 2018 before the implementation of the MSR.

### Dec.2020 open interests



### EUA prices : an uncertain outlook

Considering all the elements listed above, **it is particularly difficult to have a clear view on the carbon market's outlook.**

With the significantly bearish fundamentals, we could expect a quick and sharp downward correction of carbon prices. However, the market seems to be ignoring completely the bearish signals coming from the expected drop in emissions and bleak economic outlook, and continue to be driven by speculative buying, technical factors, and possibly market players with a mid-to-long term view anticipating a potential tightness during the fourth phase of the EU ETS. The volatility should hence remain strong in the upcoming weeks and we could see emissions posting further gains, perhaps aiming at the 30€/t of even 40€/t resistance.

On the other hand, several traders and analyst recently pointed signs of weariness in the carbon's rally and, if the long-awaited downward correction finally occurs, EUAs could extend significant losses as compliance companies might be happy to sell their surplus at such level of prices. Numerous market participants are wondering which entities are behind the surge of EUAs considering the expected slow recovery of the economy and current prices in "overbought" territory, some attributing the bullish move to algorithms, others to investors attempting to "corner the market"

Finally, concerns about a second wave of virus have recently risen with the emergence of new covid cases in Germany, the US and China, and the carbon market might collapse once again if the outbreak is not quickly contained.