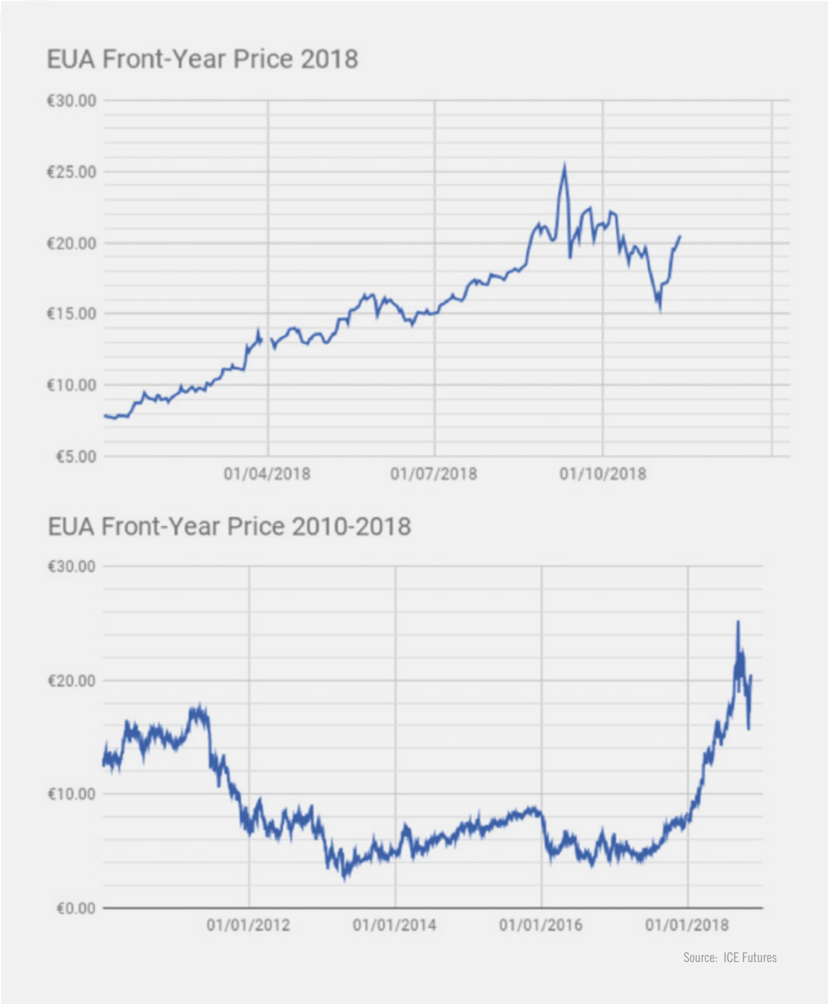
EU'S CARBON MARKET FACES

IT'S BEEN A TUMULTUOUS YEAR FOR THE EU EMISSIONS TRADING SYSTEM, IN WHICH PRICES HAVE SOARED TO LEVELS NOT SEEN IN A DECADE. THE OUTLOOK FOR 2019 IS NO LESS EXCITING: A MAJOR MARKET REFORM WILL BE IMPLEMENTED, WHILE THE SHAPE OF THE MARKET WILL CHANGE WITH THE EXPECTED DEPARTURE OF A KEY MEMBER STATE FROM THE UNION. ALESSANDRO VITELLI REPORTS

THE EU Emissions Trading System saw its busiest year ever in 2018, as prices rose non-stop for nine months, peaking at €25.79 on 10 September. As of 16 November, more than 3.6 billion front-year EUA futures had changed hands on ICE Futures, the most in any year since the market started.

Traders and compliance installations scrambled to beat the rising price trend by accumulating cheap EUAs, while speculators made a comeback to the market.

Below, several analysts set out what the world's largest cap-and-trade market should expect in 2019.



Source: ICE Futures

> Traders and compliance installations scrambled to beat the rising price trend by accumulating cheap EUAs

MARKET STABILITY RESERVE

Analysts are unanimous that the key development in 2019 will be the start of the Market Stability Reserve (MSR). The new measure will remove 24% of the market surplus every year from 2019 through 2023, before it reverts to a 12% withdrawal rate from 2024.

"MSR is by far the biggest thing that will happen next year," said Jahn Olsen of IETA member Bloomberg NEF. "It's the first time that there will be flexibility in EU Allowance supply."

The removal of the 1.6 billion EUA glut will be a gradual process, Olsen pointed out, but it's already changed market behaviour before it even starts.

When Phase 4 of the EU's market starts in 2021, free allocation to energy-intensive, export-oriented industries will shrink, meaning that more companies will find themselves short of EUAs. At the same

time, the annual cut in the total allocation will decrease at a faster rate. Some companies are already preparing for this.

"Industrial installations are no longer as willing to sell their surplus allocation as they once were - they need to bank this surplus for the next phase of the market," Olsen said.

The bigger problem, according to Trevor Sikorski of Energy Aspects, is how power generators will react to the changes in supply next year.

"We've already seen some one-off changes, such as RWE's bulk purchase of allowances in 2017 and 2018," Sikorski said, referring to the company's announcement earlier this year that it was "financially hedged" until 2023.

RWE is one of the most carbon-intensive utilities in Europe, and its early move demonstrated to shareholders that the company wouldn't be heavily impacted by higher EUA prices in the short term, Sikorski added.

The bigger problem is how power generators will react to the changes in supply next year

But for other generators, the issue is still very much in play. "Some utilities are using their coal plants less. And as coal consumption drops, so does the need to hedge," said Sikorski.

Germany is currently wrestling with the challenge of phasing out coal-burning power plants

This is a significant development, Sikorski said: "The change in how much utilities hedge, versus how much spot risk they're willing to take" by not buying carbon in advance, will affect the day-to-day market.

SPECULATORS

The other major development is the return to the market of speculative trading. Most EU ETS participants believe speculative buying was a major factor in pushing prices to a ten-year high, but with the expiry of the December 2018 futures contract fast approaching, there is little certainty as to what these investors will do next.

"Commodity markets behave differently from equity markets, in that the value of an equity reflects a future cash flow," explained Mark Lewis of Carbon Tracker. "Commodities reflect actual supply and demand: it's the physical flow that determines the value."

Lewis expects the operation of the MSR from January to generate a more proactive approach among the market. "We'll have a real impact on the supply-demand balance and that will change everything," he said.

Much will depend on whether investors have bought EUAs as a long-term play, or whether they are preparing to cash out their bullish bets, according to Marcus Ferdinand of ICIS.

"There's been a lot of front-running of the MSR, but the question is what will change in terms of price when supply is actually cut," he said. "Compliance buyers are risk-averse and don't like to anticipate price rises, so I don't expect much change from them."

BREXIT

The other major issue facing the market in 2019 is the UK's withdrawal from the European Union. As late as mid-November, it was still not clear whether the UK and EU would agree to a two-year transitional period that would allow UK installations to remain in the EU ETS until the end of Phase 3 in December 2020.

This uncertainty led the UK government to publish contingency plans for a "hard Brexit" in the autumn, advising UK-based companies on how to plan for a sudden Brexit in March 2019.

"There are basically two options for the UK," Sikorski said. "A managed withdrawal from the EU ETS by 2020, or a hard Brexit in March 2019."

And with the negotiated withdrawal deal attracting widespread criticism from within the UK as IETA Insights went to press, it's not at all clear that the managed withdrawal option is feasible.

Our panel of analysts agreed that a "no deal" Brexit would likely trigger widespread selling of older-vintage EUAs by UK installations that have surpluses, while utilities would unwind hedges for the period after March and sell off their EUAs as well.

Some analysts have estimated this liquidation of EUAs could temporarily overcome the impact of tighter supply due to the MSR, by pushing prices down by as much as €2.

"However, the UK wouldn't be auctioning EUAs in the event of a hard Brexit," said Lewis. "So a hard Brexit might be bullish after the short term sell-off."

Equally, a "no-deal" Brexit would require the Commission to "tag" UK-issued 2019 EUAs so that they could not enter the wider market, where they would have no monetary or compliance value. Earlier vintage EUAs would remain eligible.

OTHER FACTORS

There also remain a number of supply-related decisions which need to be made in 2019, said Ingvild Sorhus of Refinitiv.

Some member states have been given the choice to issue EUAs free of charge to power generators, rather than to auction them, Sorhus said. In a number of these countries such as Poland, there remain a large quantity of EUAs that have not been handed out to utilities, and must therefore be either auctioned, or transferred to the next compliance period (2021-30). These countries have until the end of 2019 to decide what to do.

Elections will also play a critical role in 2019, according to Ferdinand. Voters will choose a new European Parliament in May, while the chances are growing of a snap election in Germany as well.

Germany is currently wrestling with the challenge of phasing out coal-burning power plants, and an electoral victory for opponents of Chancellor Angela Merkel may delay progress in drawing up plans that balance the need for reliable power supply with the demands of EU climate policy.

While the reforms to the EU ETS for 2021-30 have been approved by the current EU chamber and member states, there remain some key aspects of the new rules that have yet to be completed, which could be affected by the outcomes of these polls.

This includes large funds to support the transition to clean energy, which are fed by revenue from EUA auctions, as well as free permit allocations to industrial installations.

While the reforms to the EU ETS for 2021-30 have been approved by the current EU chamber and member states, there remain some key aspects of the new rules that have yet to be completed

ANALYST FORECASTS FOR AVERAGE EUA PRICE IN 2019	
Refinitiv	€23.00
Carbon Tracker	€35.00
BNEF	€24.70
Energy Aspects	€28.00
ICIS	€23.53 (year-end price forecast)