ANALYSIS: EU lawmakers unlikely to pull emergency supply handbrake over carbon price surge

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EU carbon allowances are surging to new 10-year highs almost daily, lifting power and gas prices across Europe to dizzying heights in the process, but experts say lawmakers are unlikely to intervene anytime soon by triggering a little-known emergency mechanism.

The benchmark EUA futures have gained around 15% since Monday to a fresh high of €23.35 on ICE on Friday, pulling everything from German power to UK gas up with them.

But with speculators including investment banks and hedge funds thought to be largely behind the recent rally, which has helped boost EUAs by some €9 or more than 60% since mid-June, some market participants are wondering if EU lawmakers could step in and attempt to control prices with a supply-side safety valve.

If they did, it would be through Article 29a of the ETS Directive, which was drafted back in Phase 2 (2008-2012) to offer some stability to the market "in the event of excessive price fluctuations".

The clause states that "if, for more than six consecutive months, the allowance price is more than three times the average price of allowances during the two preceding years", the European Commission shall immediately convene a meeting of the EU Climate Change Committee, which is made up of representatives from all 28 member states.

The article adds that if the price rise "does not correspond to changing market fundamentals", lawmakers, taking into account the degree of the increase, can opt to bring forward allowance sales from future dates or can decide to sell up to 25% of the remaining EUAs in the New Entrants Reserve – which contains almost 330 mln unallocated units.

"Any measure shall take utmost account of the reports submitted by the Commission to the European Parliament and to the Council pursuant to Article 29, as well as any other relevant information provided by member states," the directive adds.

A subsequent 2015 amendment states that if measures are adopted under Article 29a, and once the Market Stability Reserve (MSR) is launched in 2019, up to 100 million allowances withheld in the MSR would be released back into auction volumes.

“There is discretion on the outcome, but not on the process. They will have to hold the meeting if the target is met … but there is there is nothing that would force the Commission into any decision,” said Milan Elkerbout of the Centre for European Policy Studies (CEPS), a think-tank.

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TRIGGER POINT

There is some confusion in the market though regarding the wording, specifically whether the “preceding” two-year period includes the past six months or whether it is a rolling period that ended six months ago.

Regardless, in both cases recent prices are not high enough to meet the criteria. According to Carbon Pulse calculations, the front-year futures averaged around €15.50 in the past six months compared to €5.90 in the two years preceding that, which when tripled equates to €17.70 and a €2.20 shortfall.

In a scenario where the six-month period overlaps with the two years, that translates into averages of approximately €15.50 and €8.55, which equates to a much larger difference of €10.15.

Under the first case, prices would need to average €21.60 in the final six months of 2018, and €23.55 in the final four – some 20 cents above this year’s high touched on Friday.

“The trigger level will inevitably rise above this in the future, as the calculation will increasingly take into account [this year’s] price rally,” analysts at Thomson Reuters Point Carbon said in a note research published this week.

“There are several hurdles both to activate discussions under Article 29a and to implement concrete measures to counteract ‘excessive price fluctuation’, and [we] see very little risk of the provision being activated.”

Questions emailed to the European Commission on Friday had not been answered at the time of press.

A spokesperson for Austria – which currently holds the rotating EU presidency – told Carbon Pulse that the issue was not raised during a Friday Coreper meeting of officials from all EU member states on energy issues that included talks about upcoming electricity market reforms.

OPEN TO INTERPRETATION

“The likelihood is very low that Article 29a will ever be triggered,” said Marcus Ferdinand, an analyst with ICIS. “Even if prices hit those levels, you would need to define ‘changing market fundamentals’.”

Many analysts have said the quadrupling of prices in the past year appears detached from carbon’s current fundamentals, as utility profit margins are historically very low and any significant cuts in EUA supply are still years away.

“One could rightfully maintain that in the coming years, there will still be a substantial surplus in the market that should, in theory, dampen pressure on prices – ie. the fundamental market balance does not explain the steep price rise – which should hence not be seen to be due to ‘changing market fundamentals,” Point Carbon said.

But there is virtual consensus that the rally has been driven primarily by the finalisation of post-2020 reforms to the EU ETS, including agreement to cancel hundreds of millions of unused allowances from 2024 and a doubling of the MSR’s annual absorption rate to 24% in the years before that.

“The MSR as an underlying cause of the price rise would surely be considered a fundamental change,” Point Carbon added.

“The vast majority of buying by emitters right now is for compliance purposes, and the vast majority from speculators right now is due to the market’s new fundamentals,” a trader told Carbon Pulse.

As such, experts say it would be difficult to prove that the rally is not fundamentally driven.

“There is no hard definition here. They would need to attribute the price increase to other non-fundamentals factors, but how would they do that? There is no hard criteria for what’s fundamental and what’s not,” Ferdinand said.

“You would have to filter out some market actors’ behaviour, which I think would be almost impossible to do.”

THIRD TIME'S A CHARM

"I can't see why the EU would want to intervene again in the market, having already intervened twice this phase because prices were too low," the trader added, referring to the introduction of the MSR and the supply-curbing Backloading programme rolled out earlier this decade.

CEPS' Elkerbout said it would be "a strange situation" to have the MSR withdraw nearly 400 million allowances from the market next year, just to have lawmakers decide to add 100 million straight back in.

"The decision whether to implement counteractive measures is, in the end, a political one, and if there is political will to intervene in the market to soften a steep and consistent price rise, policymakers will find the right arguments to back up their decision," added Point Carbon.

*****Article 29a and rising EUA prices will be a central topic at our Carbon Forward 2018 conference in London on Oct. 16-18. Click here for more info or to order tickets. Limited quantities remain.*****

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