Inform. Advise. Procure.

COVID-19: Implications for the EU ETS

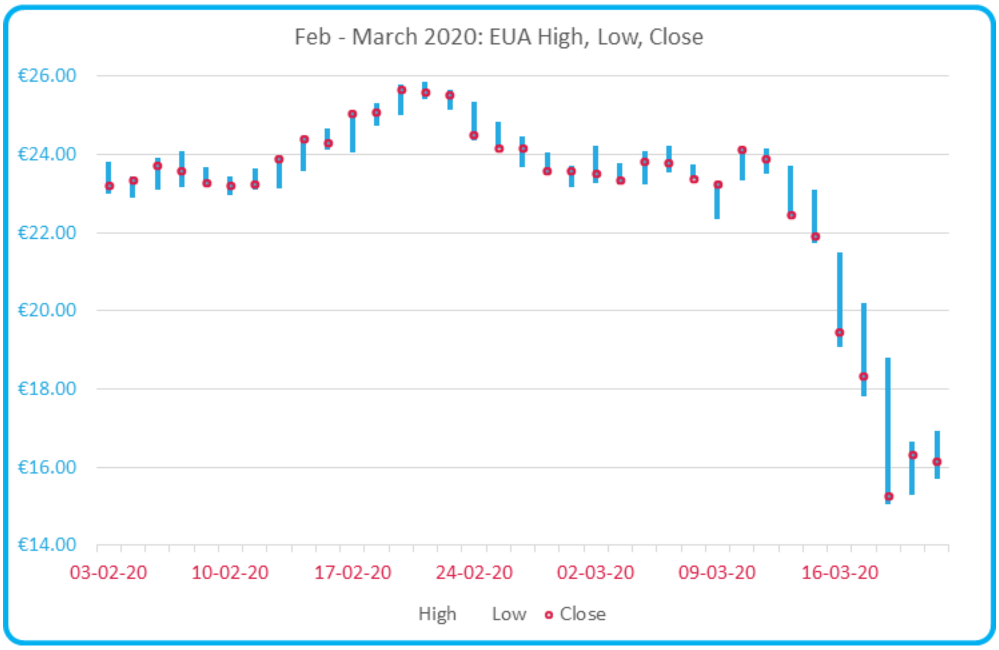
The new pandemic, even the resilient carbon markets have given ground.

The global spread of the COVID-19 virus has left global financial markets reeling, and after a resilient initial response, the EUA price dropped sharply last week, leaving interested parties wondering where the price slide stops and what comes next. The EUA price drop also presents an opportunity to buy a cheap asset that can be kept off-balance-sheet.

What happened to the EUA price?

After holding up well, due to the belief that carbon prices were uncorrelated with wider markets (thanks to existing aggressive supply curtailment measures), EUA prices dropped by €8 from their apparent floor at €23.00. This happened in just four days as speculators unloaded their holdings, power prices plummeted and general panic ensued that affected markets and commodity prices globally. At the time of writing EUAs (and other markets) appear to have found a (possibly temporary) bottom around €15. Thanks to legislation designed to boost prices, the EU ETS has not seen prices this low for nearly 2 years.

This is bad news for investors but good news for European industry, the cost of carbon is dropping when it most needs to.



What happens next?

Despite drastic actions by European governments to quell the spread of the virus, experts don't expect the infection rate to peak for another 6-7 weeks. The strategy to quell the speed of the spread of the virus and thereby minimise the impact on hospitals is designed to avoid worst-case morbidity scenarios. However, the strategy also raises the possibility of a second wave of infections.

Redshaw Advisors Ltd
279-283 Greenwich High Road, London, SE10 8NB, United Kingdom
Company Registration no. 8957133. VAT number: GB 185 2827 80
Tel: +44 20 3637 1055
Web: www.redshawadvisors.com

The strategy means we can expect a large short-term economic shock with the potential for a more drawn out decline. Some economists are comparing the problem with the 2009 global financial crisis. JP Morgan expect global GDP to contract by 1.1%, with the Eurozone's economy likely to contract by 22% in Q2 2020. In the UK's case, the researchers at Capital Economics are suggesting that GDP could shrink by as much as 20%. This much is seemingly obvious, the stock and oil markets, both bellwethers for the state of the economy, have plummeted, but according to the experts only by as much as would be expected for a relatively short-term impact. What is less clear is how long the negative effects will last and how deep those effects could be.

There are therefore three important questions for those with exposure to the EU ETS:

- How low can the EUA price go?
- How long will prices remain at lower levels?
- What sort of recovery in EUA price levels can we expect, if any?

How low can the EUA price go?

While prices around €15.00 were the recent floor and compliance buyers (buying for the 30th April EU ETS compliance deadline) are very happy to pick up EUAs at this unexpected discounted price, there is potential for further downside.

Our expectation is that the price drop was caused by a combination of long investors liquidating positions, call option sellers reducing their hedges and short-selling speculators selling EUAs to make money from a price drop. Arguably most, if not all, of these players got the trading they needed to do done in the first few days of the recent price rout. Therefore the short-term correction has already happened.

So what next?

We compared notes with carbon analyst Trevor Sikorski of Energy Aspects and he noted that the key consideration for what happens next in Europe is studying what happened to electricity generation levels in Hubei Province in China. The COVID-19 shutdown saw a 35-40% drop in coal-fired power generation reflecting reduced demand. Extrapolating that to Europe (and adjusting for the power mix), he anticipates a drop in emissions of approximately 70-80 million tonnes of CO2 over the course of 2020 and as much as 100 million EUAs. Assuming most of this occurs in the next 2 months, the reduced demand and/or outright utility selling will put EUAs under continued downward pressure.

Anecdotal evidence tells us that some compliance buyers are happy to hold back on EUA purchases and to fall back on borrowing from 2020's free allocation in order to preserve cash. However, so far this approach seems to have been taken by a small minority and therefore is not expected to materially impact the supply/demand balance.

So in the short to medium term, the EUA price looks like it could oscillate in a €14-18 range with a higher probability of testing the downside at €14 than the upside of that range.

How long will EUA price remain at lower levels?

The COVID-19 pandemic came at a time when EUA markets were already under pressure. Low gas prices, a mild winter and the return of double-sized UK EUA auctions after a 15 month absence were already the main drivers. Our expectation is that with the worst of the pandemic is still to come in Europe so prices are likely to remain depressed for the next two months. Beyond that, the resulting malaise from an almost complete shutdown of European economies and the risk of a breakdown in supply chains is likely to last at least a further four or five months by our estimations. Any flare ups if the virus re-emerges in China and other countries will likely drag things out for much longer.

Aside from the spread of COVID-19, the underlying bearish influences were generally expected to start to subside in the second half of the year. If the pandemic were to also lift at the same time the prospects for a price rise late in 2020 seem inevitable.

Amidst a generally bearish outlook we identify a few bullish intervening factors that may make further price weakness a bit less certain:

- Economies will be propped up by European Central Bank / national central bank stimulus funding. If nothing else the inflow of money risks an inflationary outcome that could also affect EUA prices.
- Speculators – the 2018/19 EUA bull run began ahead of the Market Stability Reserve coming online, due to speculators buying ahead of the fact. A clear signal that economic impact of COVID-19 is lifting will be a prompt for investors to get long again, more so if the prices are viewed as cheap.
- Lower EUA prices may give limited room for coal fired generation to come back into the mix and thus increase demand for EUAs, albeit amidst weak fundamentals for coal power and likely weakened electricity demand across Europe.
- The European Commission favours higher prices rather than lower ones, regardless of the current economic turmoil. The fact that the EUA price dropped as the crisis unfolded will strengthen the argument that the EU's carbon market is functioning as it should and the chance of the EU ETS being dropped is arguably as remote as ever.

However:

- The European Commission has 50 million EUAs that it can sell to raise money for its Innovation Fund. Effectively the timing of this auction is in their control and they will choose to sell early if the market rallies too quickly.
- The longer-term impact of COVID-19 could be underestimated by the markets. If global supply chains were to collapse, manufacturing would drop like it did during the financial crisis. If power consumption were also to drop, we can expect EUA price to stay soft past year-end.

What sort of recovery in EUA price levels can we expect, if any?

Any large scale shutdowns will have an economic impact that lasts well beyond the peak of infections. Our current expectation is for the economic impact of COVID-19 to last around five months due to the development of vaccines, anti-retrovirals and more intelligent (and better resourced) testing and isolation techniques. However, the reality is that no-one can be sure and it may take 18 months or more for life to return to normal.

Trevor's view is that we can expect €20 on average during 2020, with €25 at year-end fairly likely. Our own view is that come 2021, this would be a lower estimate of EUA price. This view is based on 2021 already looking tight for the EU ETS due to UK EUA auctions coming to an end, the lack of easy emissions reductions by switching electricity generation from coal to gas, the Market Stability

Reserve (MSR) withdrawing an even larger number of EUAs in 2021/22 due to lower emissions in 2020 and the return of investors.

Creating an off-balance-sheet asset

If handled the right way, EUAs have long been known to create an off-balance-sheet asset holding opportunity for most companies. This is because most companies account for EUAs as a government grant and therefore they do not have to account for them in the usual way. If companies now buy EUAs at the current low prices and use those EUAs for compliance, the free EUAs can usually continue to be held off-balance-sheet.[1] Demonstrating which EUAs are which can be challenging and the use of a spare account to move free EUAs into is advised. If in doubt, please give us a shout.

Summary

While the impact of COVID-19 on carbon prices has been swift and sizeable it is too early to call the end of the price rout. Subject to developments, a price rise from current levels can reasonably be expected by year-end and the market will become very tight next year in most scenarios. The current price of €15.00 or less is likely to represent great value in a year's time.

Get in touch if you would like to know more: info@redshawadvisors.com or telephone: +44 20 3637 1055.

[1] Redshaw Advisors Ltd is not an accounting firm and we cannot advise on the suitability of such an approach for your company. Please contact your own accountant/auditor for advice that fits your circumstances.