Market Functioning

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Market is not functioning

Fundamentals

*When asked how low EUA prices could drop, the first trader said:*

*“There is no floor. Zero is the only floor.”*

*Point Carbon*

- Decision-making on the ETS over the last two years has basically proceeded at two levels:
  - **High Level Political** discussions with mixed signals about the ETS remaining the cornerstone of European climate and energy policy, and hence causing confusion and uncertainty for the market about the long-term future of the ETS
  - **Technical discussions** have given a sense of continuity through the preparations for **Phase III** under the comitology process
- As a result the price has been affected...
- ...and it will continue to be so until Regulation is functioning (not just passed)
  - Best Case Scenario: July 2013
- Market is less entrepreneurial and more compliance functioning
- Too many policies affecting prices
- Renewable vs. coal
- Laissez Faire? Just not working... Man-made intervention is needed as per Money Markets, etc.
- Auctions low appetite, laughing stock, cancelations
The 2050 Low-Carbon Roadmap, included a recommended milestone of a 40% reduction in GHG emissions (compared with 1990 levels) envisages the ETS as a central pillar of European climate policy in terms of promoting carbon pricing as an incentive for low-carbon investment.

What will the European Parliament do now?
- A 19 February vote in favor of backloading will not be the end of the parliamentary process.
- The EP would still have to vote in plenary on the regulatory amendment, possibly in March or April.
- A no vote on 19 February would leave the Commission’s strategy in tatters, and the market would surely respond accordingly.
**EUA’s Technical Price Drivers**

### 2011-YTD EUA’s Price Evolution

- **Apr 11:** Decisions on free allocation of allowances in Phase III in line with benchmarking rules.
- **Oct 11:** Proposals published on market oversight: MFID and Market Abuse Regulation.
- **Nov 11:** Commission on sectors exposed to carbon leakage.
- **Nov 11:** Commission regulation passed establishing Union Registry for Phase III with effect from 1/1/13.
- **Nov 11:** Agreement to procure common auctioning platforms, followed in 2012 by regulations covering UK and German platforms.
- **Jan 12:** EU formally bans import of international credits from industrial gases projects from May 2013, confirming a proposal first made by the Commission in November 2010.
- **Oct 12:** News surfaces of Commission proposal to ban ERU credits from post-2012 projects in countries which don’t have Kyoto targets.

Source: Bloomberg

- Following the aborted Climate Change Committee (CCC) vote in December, the Brussels institutions have been looking at the decision-making process.
- Member State indecision continues.
Volumes Are Up Yet Prices are Plummeting....

**Annual Total Volume & Settlement Price**

Source: The ICE

Source: ICE, J.P.Morgan’s data
…and Open Interest Remains High…

Total Open Interest Evolution

…but this is all explained by the fact that some market participants are able to take advantage of carry-trade opportunities in the market…

Source: ICE, J.P.Morgan's data
When Not Considering Current Carry Trade, Volumes have almost halved and Market Participants are Retrenching

J.P. Morgan’s Flow Data

Had it not been for large one-off transactions due to competitors exiting the market or to fundamental supply, volumes would have seen a massive reduction.

- When removing carry trade activities from the market, it is plausible how flow has been hit since 2011 and most specially in 2012, showing how unhealthy market has been in the last years.