

J.P. MORGAN

Market Functioning

January 2013

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J.P.Morgan

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## Market is not functioning

### Fundamentals

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

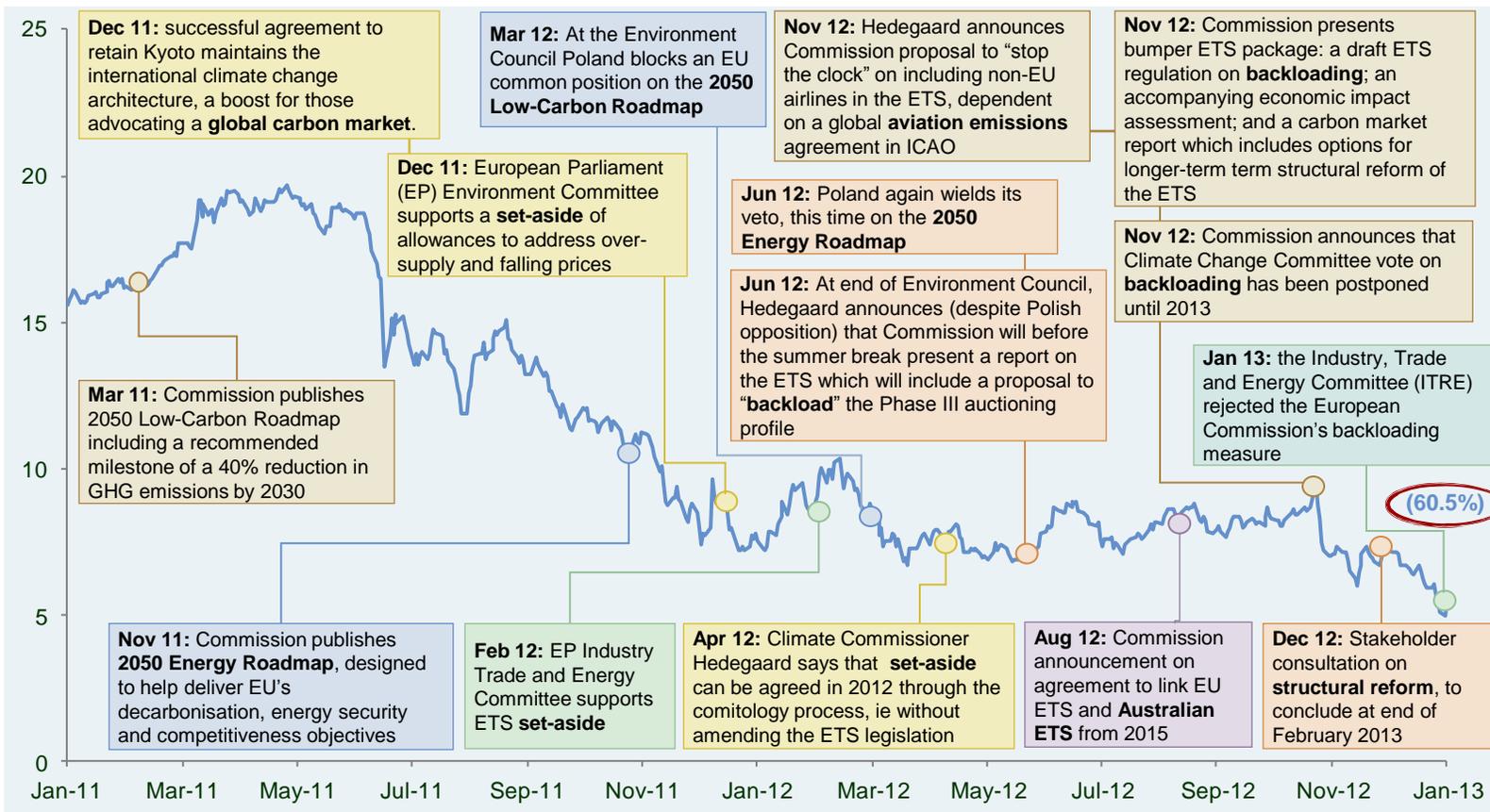
*“There is no floor. Zero is the only floor.”*

*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

# EUA's Political Price Drivers

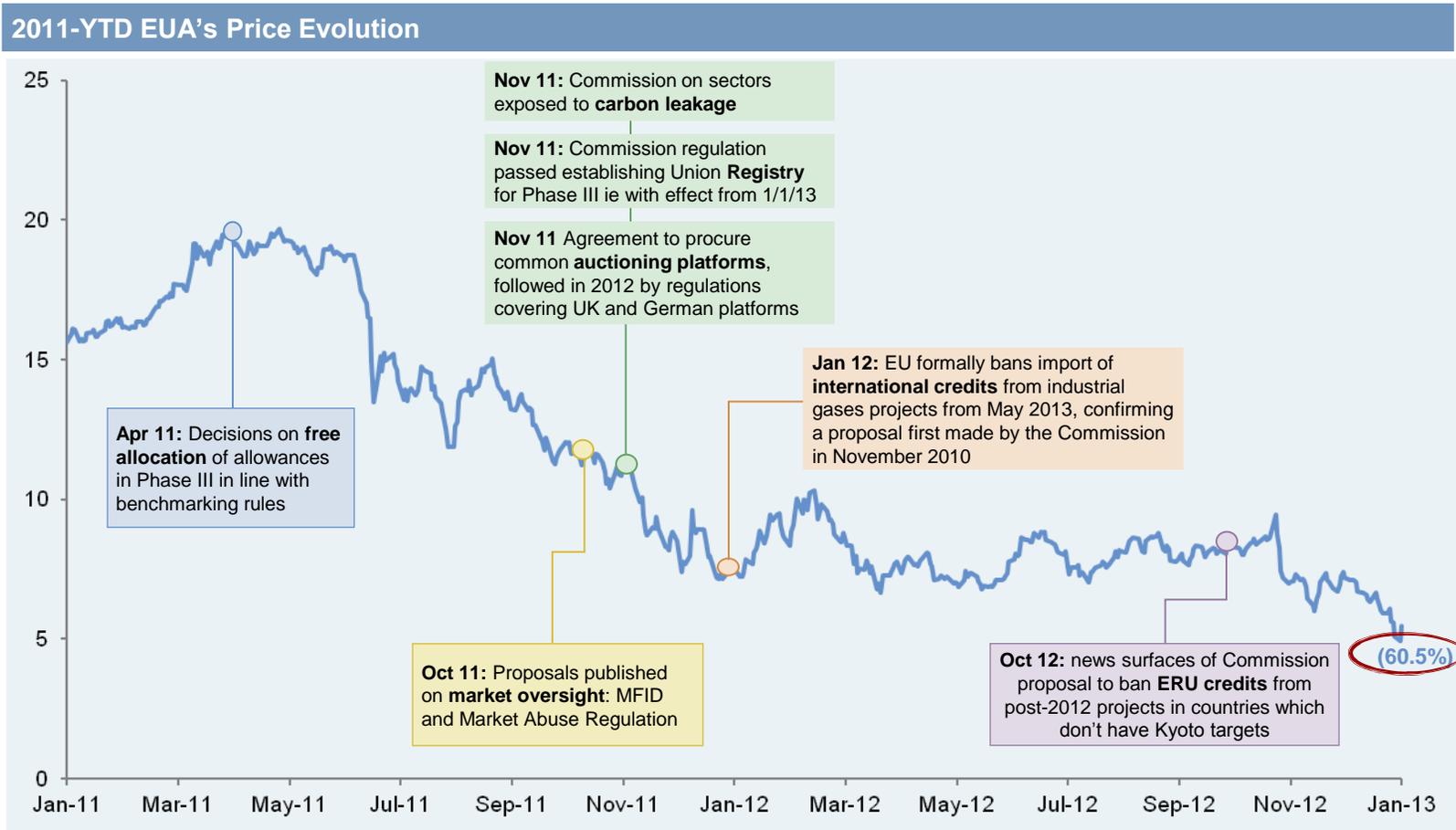
## 2011-YTD EUA's Price Evolution



Source: Bloomberg

- 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.

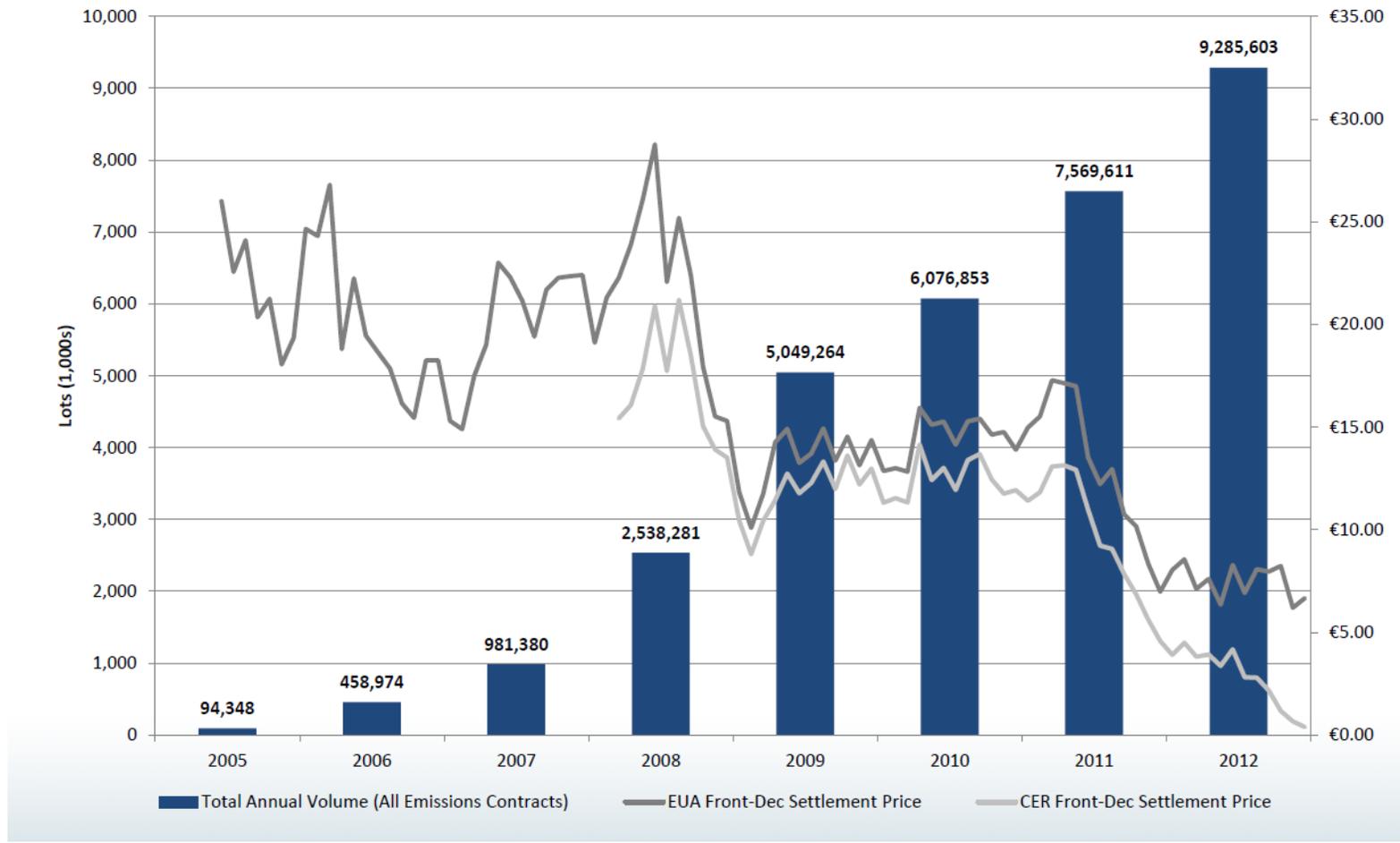
# EUA's Technical Price Drivers



- 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

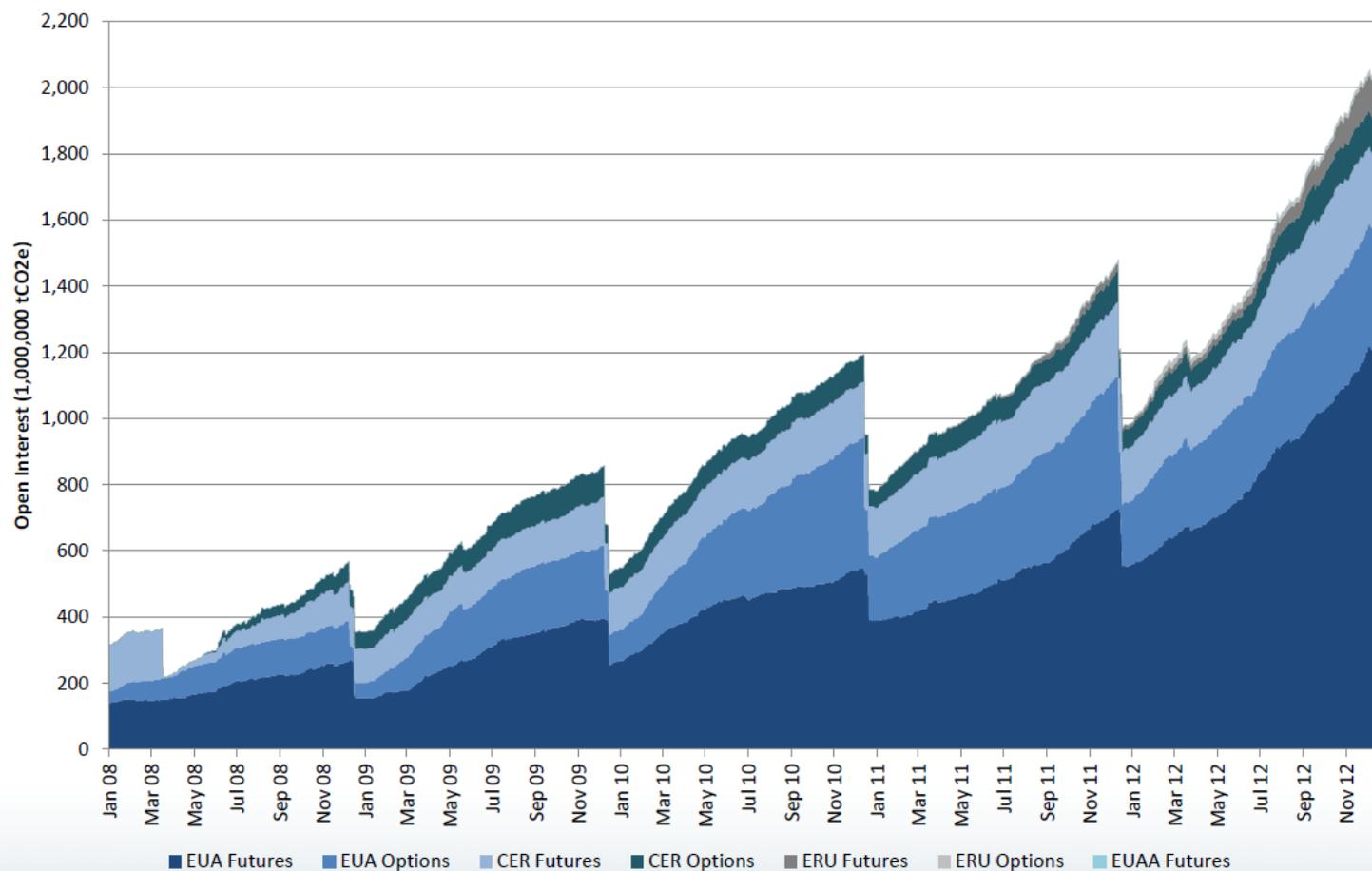


Source: The ICE

Source: ICE, J.P.Morgan's data

...and Open Interest Remains High...

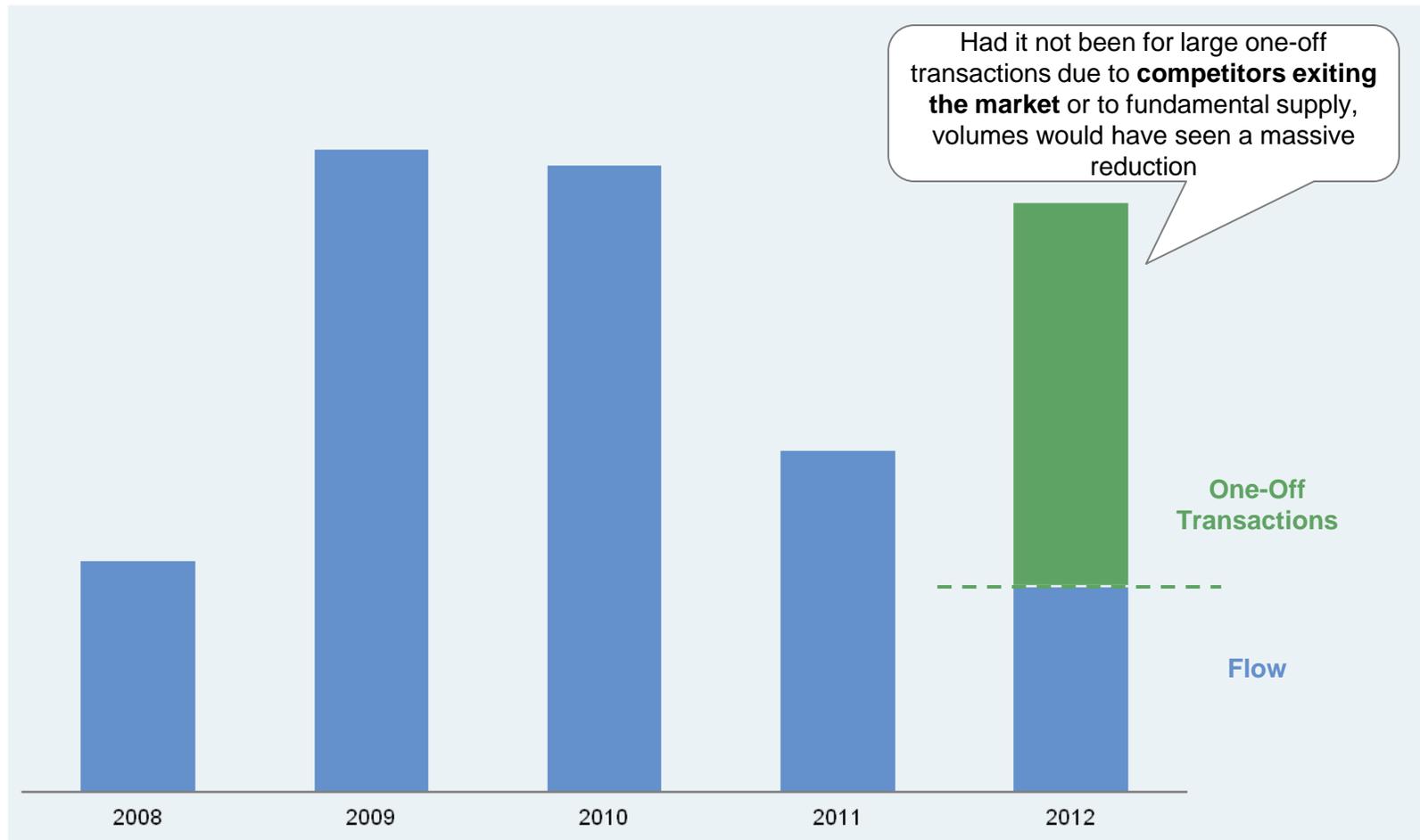
Total Open Interest Evolution



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

# When Not Considering Current Carry Trade, Volumes have almost halved and Market Participants are Retrenching

## J.P. Morgan's Flow Data



Source: J.P.Morgan's data

- 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