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The functioning of the EU ETS carbon market

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UK strongly supports carbon pricing

- The UK supports carbon pricing and the EU ETS as the most cost effective way of driving emissions reductions.
- But the current EU ETS needs to be reformed to improve its effectiveness:

> We need to work towards a market where success is driven by your ability to compete in a market. Not by your ability to lobby Government.
> This will only be possible if carbon pricing works properly.
> Despite its flaws, the EU Emissions Trading Scheme is exactly the kind of intervention that should be made at a European level where collective action is more powerful.
> The UK has worked hard with others to get major reforms that are helping restore a more stable and robust price on carbon.
>
> Amber Rudd, UK Secretary of State for Energy and Climate Change
> 18 November 2015

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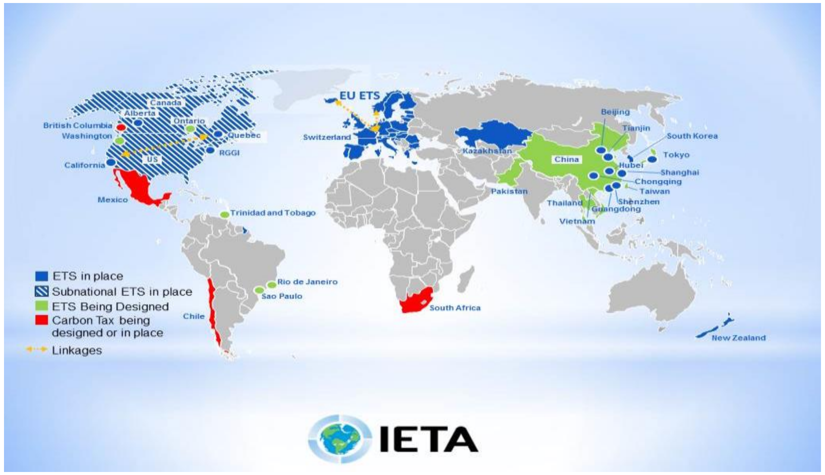
Overview

- Oversupply has suppressed prices
- Political intervention to manage supply bearing fruit:
    - Backloading
    - Market Stability Reserve.
- Significant increase in carbon price 2013 - 2015;
- Evidence of behaviour change
- Increasing prevalence of market based approach worldwide



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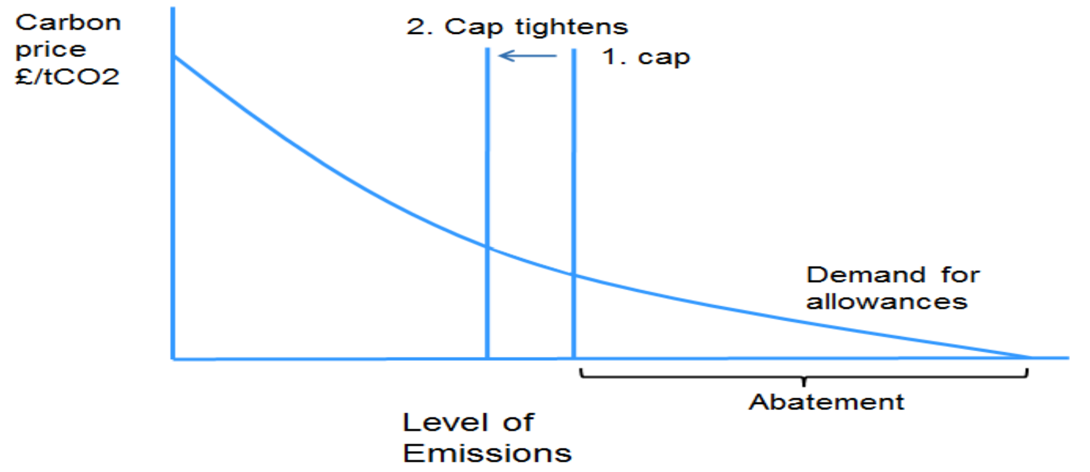
Multiple factors affect the EU ETS price

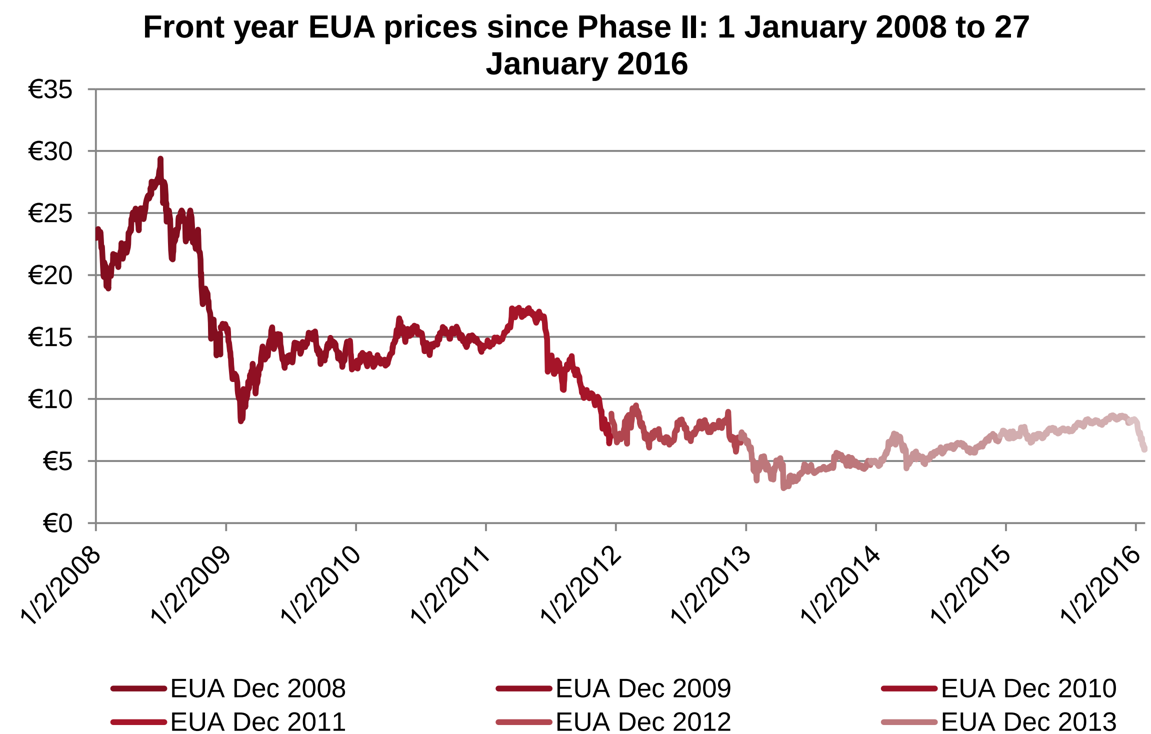
<u>Surplus</u>
- Approx 2 bn

<u>Policy interventions</u>
- Backloading
- MSR

<u>EU ETS market specific</u>
- Demand
- Utility hedging
- Seasonal compliance cycle

<u>Other market factors</u>
- Wider economy
- Coal, gas and power prices
- Clean / dark spreads





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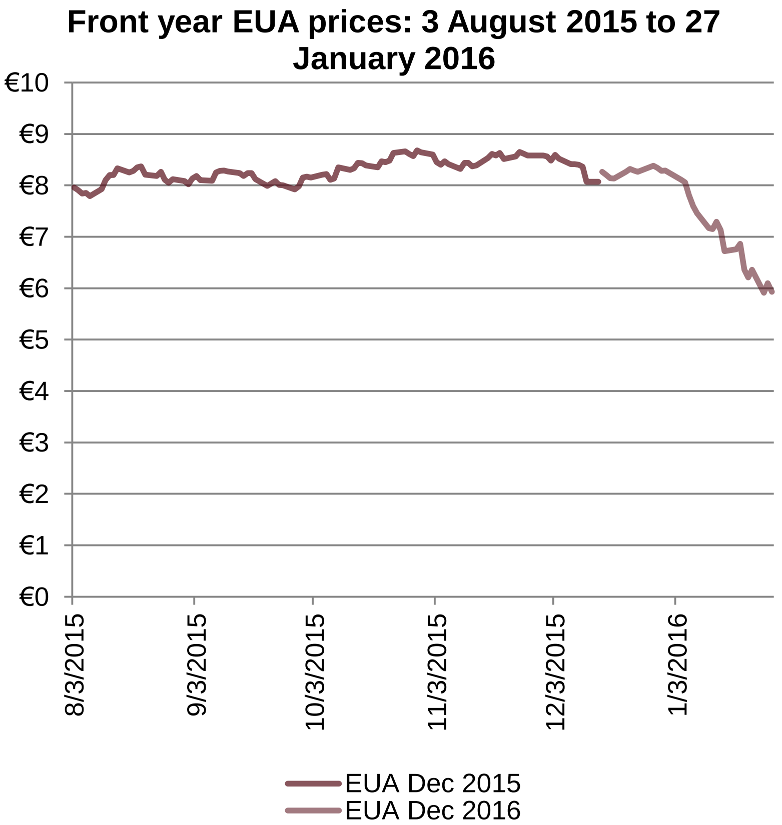
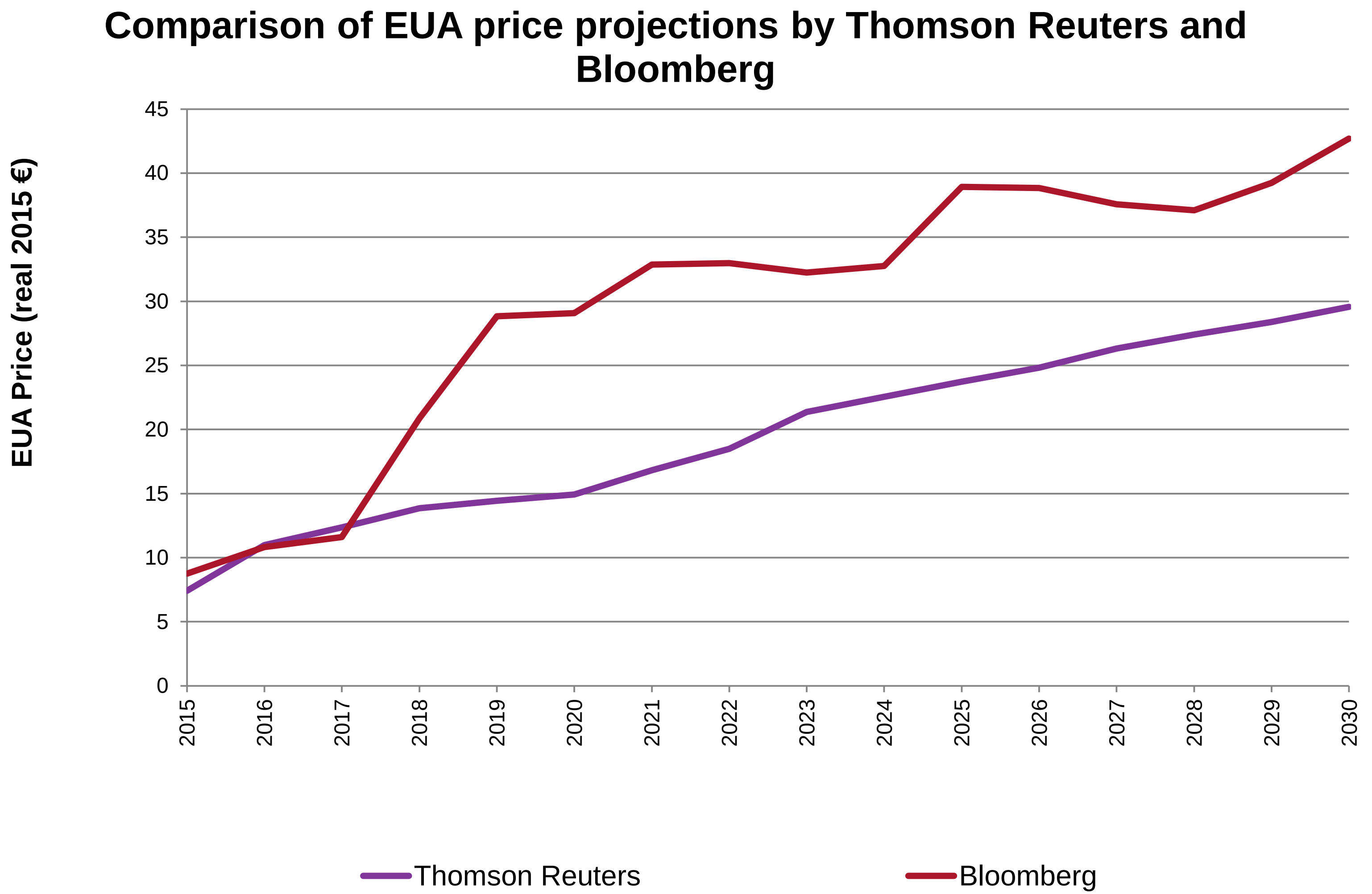
There has been a significant correction in recent weeks

- Carbon one of the best performing commodities in 2015, bucking trend of other commodities
- But significant correction in carbon prices since start of 2016:
  - Speculative trading;
  - Reaction to wider market / economic events;
  - Lack of demand from utilities as a result of warm weather; suppressed power prices and clean / dark spreads;
  - Industrial participants monetising allowances held ahead of new 2016 allocation
- Long-term impacts unclear



What might affect EU ETS carbon prices in the future?



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Carbon market perspective: part 1

Liquidity

- Generally good but illiquid compared to other markets
- Improving in the EUAA market

Volatility

- Varies over the year:
  - Traditional peaks around the EU compliance period;
  - Half volumes in August tend to increase prices.
- Lower in 2015 – lack of policy driver following MSR agreement;
- MSR agreement helped provide more certainty to the market about future availability of allowances, factored into prices.
- But highs in late 2015 possibly driven by speculative trading;

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Carbon market perspective: part 2

Market participation

- Limited direct participation in auctions.
- Indications that secondary market participation has reduced
- Lack of interest from SMEs.
- Cover ratios in auctions reduced though bidder numbers stable
- Minimum bid/clearing price spreads have reduced

Transparency

- Data published on allowances to be auctioned and free allocation.
- Auction platforms publish auction data
- MiFID II – position reporting / hedging activity.

Registry security

- Important that Registry remains secure and resilient.
- UK will work closely with the EC and other Member States.

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Carbon market perspective: part 3

<u>Financial regulation – MiFID II</u>

- Emissions allowances brought fully into scope but intention to minimise impact on compliance installations.
- May affect volatility and participation.
- Uncertainty about final thresholds for exemptions:
  - Compliance installations still affected if they breach thresholds
  - <u>Market share test</u> unlikely to impact on many participants;
  - <u>Main business test</u> more of a cause for concern about potential impacts around ancillary activity. Uncertainty about what constitutes hedging activity
  - Trading activity may be impacted by uncertainty.

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UK position on Phase IV

- An EU ETS cap in line with the EU's target of at least 40% domestic GHG emission reductions by 2030 from 1990 levels;
- A secure, liquid carbon market;
- Targeted, cost-effective and risk-based carbon leakage support;
- The minimisation of administrative burdens on operators, especially small emitters;
- Funds that support decarbonisation of the UK's and EU's industrial energy sectors are administered cost-effectively

UK position paper published 9 November 2015:
https://www.gov.uk/government/publications/uk-position-on-phase-iv-of-eu-ets