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CLIMATE TRANSFORMED

Trigger happy

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Trigger-happy

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A few people have been talking about whether EUA prices are coming close to triggering an intervention to calm prices, so I though I'd quickly go through what I understand to be the rule and the different possible interpretations. Please drop me a line if you have a different take on this.

If you're not familiar with Article 29a, it's a dusty, poorly-lit corner of the EU ETS Directive that gives the European Commission the authority to intervene in the market to calm prices if they've risen too far too fast.

By the way, the UK ETS is about to trigger its own version of this intervention, called the Cost Containment Mechanism, after UK Allowance prices averaged more than the government-set trigger price between September and November. Bear in mind though that the parameters of the UK's CCM are slightly different than the EU settings.

So, to the EU ETS first:

Article 29a of the Directive says:

"1. 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 on the European carbon market, the Commission shall immediately convene a meeting of the Committee established by Article 9 of Decision No 280/2004/EC."

2. If the price evolution referred to in paragraph 1 does not correspond to changing market fundamentals, one of the following measures may be adopted, taking into account the degree of price evolution:

(a) a measure which allows Member States to bring forward the auctioning of a part of the quantity to be auctioned;

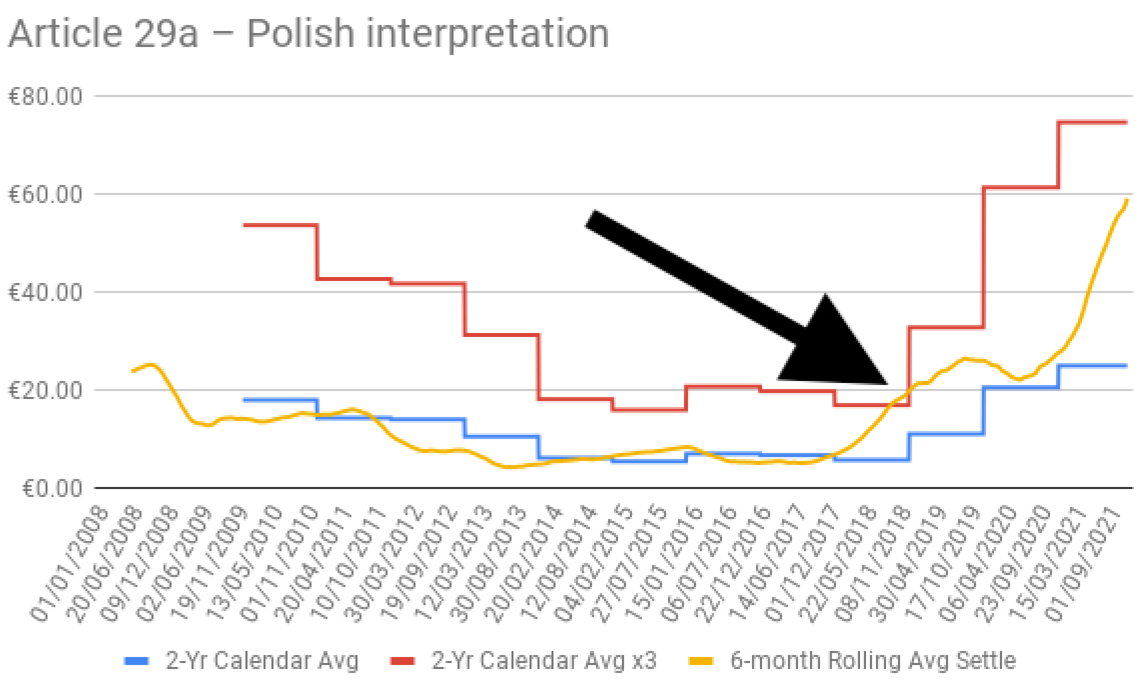
(b) a measure which allows Member States to auction up to 25 % of the remaining allowances in the new entrants reserve."

In this post I'm going to focus on paragraph 1 above, namely, the methodology for calculating whether or not the trigger price has been reached. There are so many ways in which to interpret the language here that there's no single, simple formula.

To start with, what does the regulation mean by "six consecutive months"? Do they mean a rolling six-month average price, an average of the last six complete calendar months, or just six monthly average prices? If you apply each of these three variables to any series of EUA prices you'll get three different results.

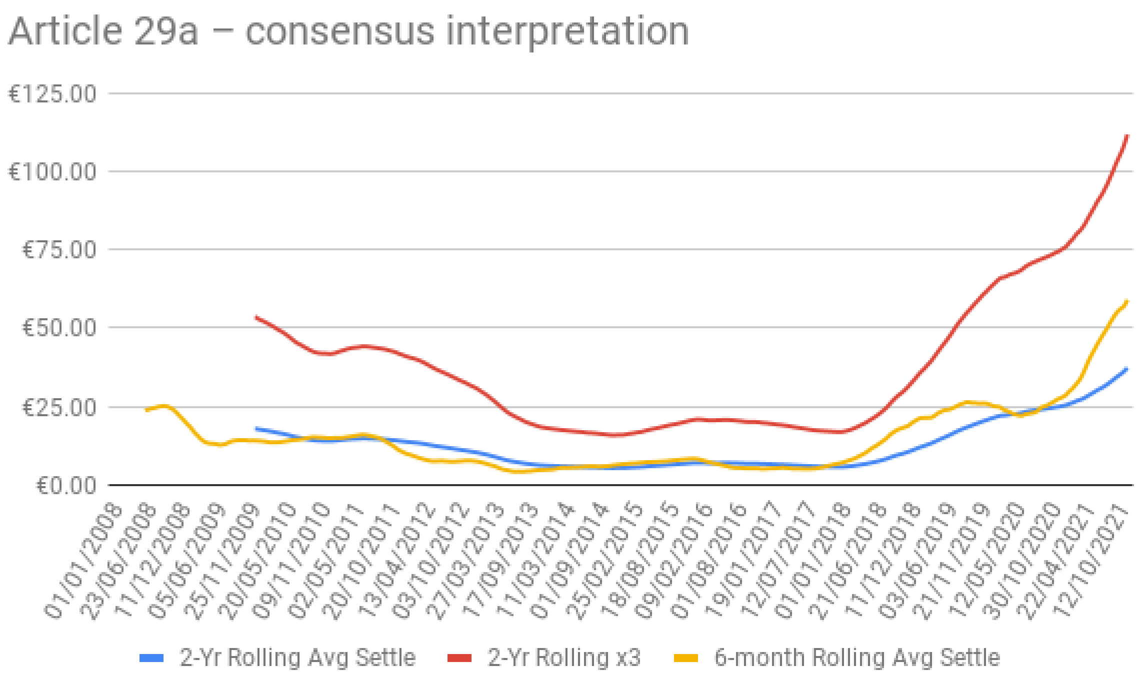
Similarly, what does the regulation mean by "two preceding years"? A rolling average or just the average price over the two preceding calendar years?

This is particularly relevant because in 2018, when EUA prices had just started their long-term increase, the Polish government claimed that the Article 29a trigger had been reached. And if you look at Chart 1 below, it's clear that Poland was interpreting "two preceding years" to mean two full calendar years.



The black arrow points to the moment (moments?) in late 2018 when the six-month rolling average exceeded the equivalent of three times the average price over the calendar years 2016 and 2017.

Meanwhile, most everyone else I talked to at that time was interpreting "two years" to mean a two-year rolling average right up to the current day, and that produces the result in Chart 2:



And as you can see, in this version the six-month rolling average never got close to the equivalent of three times the rolling two-year average price.

And because the European Commission did not call a meeting of the Climate Change Committee when the Polish interpretation appeared to indicate that the trigger had been pulled, we can (sort of) assume that the Polish interpretation isn't correct.

Quickly circling back to the UK ETS, the rules for the Cost Containment Mechanism look very similar, but there are some intermediate elements to the formula that reflect the fact that this is a new market, starting from zero.

To quote from the UK ETS legislation:

The CCM is triggered "where the monthly average carbon price is more than:

(a) 2 x the 2-year average carbon price for 3 consecutive months, if the last consecutive month is in 2021;

(b) 2.5 x the 2-year average carbon price for 3 consecutive months, if the last consecutive month is in 2022; or

(c) 3 x the 2-year average carbon price for 6 consecutive months, if the last consecutive month is in 2023 or any subsequent year.

To be clear, the UK ETS started only in May this year, so more than half of the price data required to calculate the average price is actually EU ETS price data. On top of that, there's a gap in the data between January 1 and May 19 this year, because the UK ETS wasn't running until May.

To make life easier for us all, the UK regulator has been publishing its calculated trigger level each month, which you can find here.

The table below shows the trigger levels, and what average prices the UK market has generated:

	Average price	Oct trigger	Nov trigger	Dec trigger
July	£44.15	£48.37		
Aug	£48.44	£48.37	£50.37	
Sep	£58.36	£48.37	£50.37	£52.88
Oct	£60.98		£50.37	£52.88
Nov	£60.50			£52.88

The key takeaway here is that the UK market has triggered its version of Article 29a because the trigger formula was set up to be more sensitive in 2021. Remember the 3 monthly average prices only need to be higher than twice the two-year average, not the three times that the EU trigger requires.

The UK trigger will be slightly less sensitive in 2022 – prices will need to average more than 2.5 times the average for three successive months – and will match the EU parameters in 2023 – when the price will need to exceed three times the two-year average for six months rather than just three.

In short then, we're quite a way away from any regulatory intervention in the EU ETS right now, and this may be the only time the UK mechanism is triggered for some time to come.

Having said that, Peter Liese, a German member of the EU Parliament and one of the legislators responsible for guiding the EU ETS reforms, told a webinar today that he was in favour of short-term intervention in the market, just to calm things down a little while energy prices are so high.

How exactly the EU is going to do that remains to be seen, since outside Article 29a, I can't think of any way to adjust supply or moderate prices. But we're in uncharted territory here, so who knows...

EDIT:

I was contacted by Bo Qin at Bloomberg New Energy Finance, who suggests there is a third way to calculate the Article 29a trigger.

Going back to the EU ETS Directive:

"1. 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 on the European carbon market, the Commission shall immediately convene a meeting of the Committee established by Article 9 of Decision No 280/2004/EC."

What if the two preceding years end at the same point where the most recent six months begin?

If we take December 7 as our starting point, the six-month average would run from June 7 to December 7 2021, and is €59.35 while the two-year average would be June 7 2019 through to June 7 2021, and is €28.88.

That would produce the following chart which, you'll agree, gives us an outcome that's a lot closer to the trigger level than either of the other ones.