IDEAcarbon

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Markets, Policy & Risk

Midday Market Update

May 16 2012

IDEACARBON MARKET TODAY

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Look out for: Quiet macro day tomorrow, German inflation out on Friday before the open. CITL still not put full 2011 ETS compliance data up yet, watch that space

Key market drivers: Greek capital flight is worrying markets today, energy complex following macro and carbon following both, correlations generally tight

Carbon Market Sentiment Index:*

▲ +0.25

Responses ranged from: -0.5 to +0.5

*A sample of market participants are asked whether they are bullish or bearish for afternoon trading on a scale of +4 to -4.

THE ENERGY COMPLEX AT A GLANCE

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Product	Midday
December 2012 EUA	▼ €6.39/mt (down €0.18)
December 2013 EUA	▼ €6.80/mt (down €0.17)
December 2012 CER	▼ €3.58/mt (down €0.06)
December 2013 CER	▲ €3.93/mt (up €0.03)
German 2013 base power	▼ €48.90/MWh (down €0.20)
Calendar 2013 API 2 coal	▼ $101.00/mt (down $1.75)
Calendar 2013 TTF gas	▼ €26.05/MWh (down €0.15)
€/$	▼ $1.2703 (down 0.0057)
Front-Month Brent crude	▼ $110.73/barrel (down $1.51)

Spread	Midday
German 2013 Clean Dark Spread	▲ €10.77/MWh (up €0.38)
German 2013 Clean Spark Spread	▲ -€5.83/MWh (up €0.17)

Climate Spread	▲ €16.60/MWh (up €0.21)
German 2013 Dirty Dark Spread	▲ €16.91/MWh (up €0.21)
German 2013 Dirty Spark Spread	▲ -€3.20/MWh (up €0.10)

Data represents upward or downward movement in key prices at 12:00 CET since last close.

OUR MARKET VIEW

MAY 16 2012

Tuesday was another difficult day across the eurozone. Despite some excitement over better than expected GPD data in Germany (which, as we said yesterday, was an overreaction given the poor PMI data already in for April) share prices and the euro were down amid news that Greece failed to form a unity government and avert a new election, together with deepening speculation the nation will have to leave the euro currency bloc.

Carbon continued to follow fundamentals, with Dec-12 EUAs down 1.6% to close at €6.57. Dec-12 CERs remained unchanged however, at a lowly €3.64. Going against the recent trend of low volume Dec-12 EUAs (13,201), total EUAs (22,073) and total CERs (8,009) all traded in strong volume, perhaps because there was more news to trade on than on Monday. News that Connie Hedegaard said the European Commission would present its report on structural actions, including the options of set-aside under the EED and a tighter overall 2020 target before the summer recess, did not appear to provide much price support.

Once gain the energy complex followed the financial markets – with Cal-13 German Power (-0.5%), API-#2 Coal (-0.6%) and TTF gas (-0.4%) and equities (-1.1%) down and still affected by the Greek calamity. German 10-yr Bund Yields were up 0.9% however, which could either be a sign things are really bad, with people (potentially) losing their faith even in Germany, which happened before last November or it could simply the deterrent or worsening real returns at the current levels.

The capital flight going on in Greece is at the heart of whether the country can stay in the euro or not. Since May 6 capital outflows from Greek banks have been around €700m per business day and total deposits stood at around €170bn at the end of March (so more like €160-165bn now). The only way banks can prop themselves up in this capital flight is by turning to the Bank of Greece for emergency liquidity assistance (ELA). ELA is collateralised and JP Morgan assumes a 50% haircut on collateral. Outstanding loans at Greek banks total €250bn but €60bn of ELA has already been drawn down to that means only €65bn of additional ELA can be drawn, or to put it another way, around 40% of remaining deposits.

The only other option is for the Bank of Greek to effectively print more money which banks could use for deposits, however this would lead to a steep rise in Greece’s Target2 liability i.e. the amount it owes other euro-zone member state central banks. Greece’s current liability is around €100bn and if Greece exits and that gets divided up between the other banks the Bundesbank will take the brunt of the loss. When Wolfgang Shauble says Germany’s ready for a Greek exit presumably he means with a €100bn Greek Target2 liability, not a much larger one, so it’s very hard to imagine the other EZ central banks allowing Bank of Greece to print more. In such an event the Bank of Greece would probably be forced to leave the euro so that it could prop its banks up with Drachmas instead.

To cut a long story short, the capital flight from Greece is accelerating and the rate of acceleration could well be the factor which determines when Greece is forced out of the euro.

Were Greece to leave the euro, what would that mean for emissions? Firstly, and most obviously, it would probably mean more pain for the country’s economy in the short term, with the corresponding drop in emissions which accompanies a fall in economic output. Looking at the example of Argentina in 2001 when, after unsuccessful attempts at austerity, it was forced to de-peg the peso from the US dollar, after initially losing 5% of GDP in one quarter, the country benefitted greatly from having its own currency and grew GDP by 63% over the next six years (for our relevance, Greece until the end of Phase III of the EU ETS).

With the Drachma devaluing as it would, Greece’s foreign debt would become unpayable and it would almost certainly be defaulted on, as Argentina’s was. Exports would become more competitive (Greece’s exports account for around 24% of GDP), while imports would become disproportionately expensive, leading to an increase in domestic production. Both increased exports and reduced imports, leading to a rise in domestic production would boost Greece's emissions significantly. So far so good for a Grexit.

There are two important ways in which Greece is different (which apparently Paul Krugman and Mark Weisbrot have neglected) and could throw a spanner in the works. Whereas Argentina's exports are largely commodities, one fifth of Greece's exports are tourism. While it's hard to predict, there's certainly a risk that tourism in Europe is unlikely to boom post-2012 in the way commodities did post-2001. Secondly, and far more importantly, is that not all imports can be produced domestically. Crucially, Argentina has plenty of domestic oil and gas, Greece doesn't. Therefore while Argentina was lucky enough not to have to buy oil in its newly devalued currency Greece would not be so lucky. With energy being the lifeblood of the economy it's hard to see how Greece would not suffer dramatically from the rise in the cost of its energy supplies. High energy costs will not only curb energy use and cut emissions directly, they would also stunt growth and thereby emissions, via lower demand.

Additionally BDEW, the German energy industry association, published energy consumption and production data showing that energy consumption for Q1 2012 was -1.4% lower YoY. Since German GDP for Q1 came out at +1.2% YoY that looks a lot like the trend of falling energy/GDP ratio that we saw last year. Last year energy GDP ratio across the eurozone fell around 8%. Given that we have a view that eurozone GDP is likely to be negative this year (it was flat for Q1 both MoM and YoY), this points to another sizeable drop in total ETS emissions for 2012.

CHARTS

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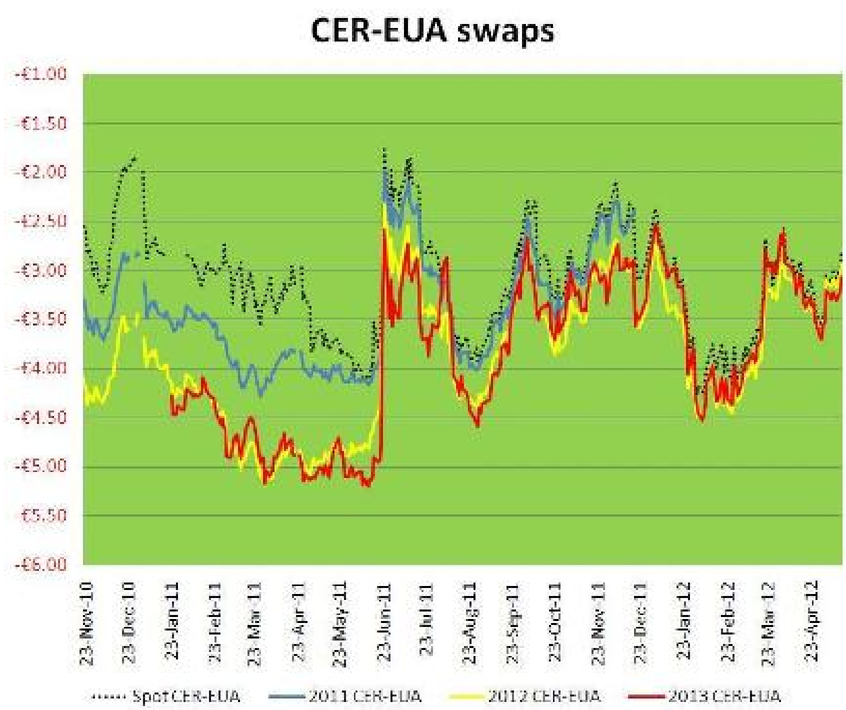
Chart 1: Swaps broke the tight range yesterday and showed some shrinkage



Source: IDEAcarbon using ICE data

Chart 2: The timespreads continue to shrink even further

Source: IDEAcarbon using Montel, ICE data

Chart 3: EUA follow through to support at €6.35 and watch the all time low of €5.99 traded at the beginning of April.

Source: IDEAcarbon using ICE data

TECHNICAL ANALYSIS

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[DEC12 EUA] (€6.37 – 10:17 GMT)

Held above support at €6.50 after the break below €7.00 at the start of the month, but seeing a break down again in early trade. Follow through to support at €6.35 and watch the all time low of €5.99 traded at the beginning of April. Below there renews the current weakness. Need to get back above €7.00 to negate the growing weakness and then above €7.55 to show some sign of an upside reversal.

[RESISTANCE €7.00, €7.55, €8.25] [SUPPORT €6.35, €5.99, €5.75]

[DEC12 CER] (€3.60 – 10:17 GMT)

Continuing to see very weak price action following the track lower from the congested trading around the €4.00 area. Price remains vulnerable to a test down to the key support lows at €3.27. Expect this to hold the price, any failure opens further weakness. Resistance at €4.00 through to €4.40 capping the upside for now.

[RESISTANCE €4.00, €4.40, €5.00] [SUPPORT €3.50, €3.27, €3.00]

NEWS ANALYSIS & COMMENT

MAY 16 2012

Tough times ahead for Australia

Since the Copenhagen Accord, Australia is committed to reducing emissions by 5% below 2000 levels by 2020, which equates to 160 million tonnes of carbon dioxide equivalent in 2020, which alongside Australia's growing population, represents a reduction of 23%. However, it emerged yesterday that according to recent analytics from clean energy firm RepuTex, Australian companies will have to reduce their emissions by 35% in 2020 in order to reach the target, with a cost of reducing emissions potentially reaching as much as AUD $18.8bn. The new figure assumes that including recent growth forecasts by 2020 a reduction of 35% will need to be achieved, just to allow for the country to come under their agreed cap of a 5% reduction, whilst also assuming that the purchasing of offsets follow the Treasury's forecast of AUD $29/tonne.

The reason for such a growth in Australia's emissions has been attributed to a significant spike in output from the liquefied natural gas industry, with RepuTex forecasting a possible rise of emissions from this sector by 150% over the next decade. Their analysis also states that emissions from the power and materials sectors will also rise by 4% and 3% respectively, although it does expect that emissions from the highly carbon intensive metals sector will drop by around 13% by 2020.

The Australian ETS will become a fully fledged Emissions Trading Scheme by 2015, with the price of permits being set by the market, and an overall cap that will meet the required reduction of 5%. There is also the possibility that the cap may be tightened in line with significant global efforts to reduce emissions, and depending on the level of global ambition, the Australian cap may rise to between 15% and 25%.

Comment

We are of the opinion, as stated yesterday, that more nationwide emissions trading schemes will only add positivity to the notion that a global emissions trading scheme may one day become viable. However, looking at the above forecast with regards to the level of cuts needed just to enable Australia to meet its current emissions goal, along with political sentiment and opinion towards the current Australian Government, a global scheme may seem further away than once thought.

An Asia-Pacific trading scheme involving South Korea, Japan, New Zealand and Australia looks a possibility, but when you consider the current political backlash aimed at Julia Gillard's current Government, there is a strong possibility that she may be ousted in the next election, which would put the current Australian scheme under immense pressure. Gillard's backtracking in 2011 over plans for a carbon tax or trading scheme, and her announcement that she does now support the plans have caused her support to go into free fall.

Gillard's current support for emissions trading, along with her opponent's unequivocal opposition to climate action, has changed the political landscape in Australia. It may well be the next election that decides whether Australia's fledgling scheme will remain or be disbanded if the opposition gain the majority. This in turn could have a devastating effect on the possibility of a Pacific based trading scheme, or even global scheme.