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Finance for Europe

Limiting the role of financial firms in the EU ETS: Consequences for corporates, SMEs and the market

Executive Summary

1. Financial firms increase efficiencies in the ETS, helping corporates to decarbonise
2. They also improve liquidity, price formation, and market resilience
3. Carbon prices are driven by demand-side factors and public policies
4. ESMA has found no deficiencies in the ETS and no evidence of adverse impacts from the involvement of financial firms

Carbon trading in the European Union: the EU ETS

The EU's cap and trade system (the EU ETS) is the main EU instrument for achieving carbon goals. It puts a price on the right to emit specified pollutants and generates revenue for governments that is used to fund other climate change policy measures or support businesses and consumers in the energy transition

The EU sets a 'cap' on emissions and creates allowances (EUAs) for each unit of emissions under the cap. **The cap declines each year, providing a growing incentive for industry and businesses to reduce their emissions as the market price of EUAs increases**

'Trade' refers to the buying and selling of EUAs undertaken by companies, with supply and demand setting the EUA price. **The ability to trade EUAs provides a strong incentive for firms to reduce emissions in the most cost-effective way**

Companies regulated by the EU ETS must acquire EUAs. **They can buy these on the carbon market or through the EU ETS auctions**. Some companies regulated by the EU ETS receive a certain number of allowances for free

These carbon allowances only exist electronically. Participants in the EU ETS must open Union Registry accounts to hold these carbon allowances. **Out of approximately 11.000 Union Registry account holders today, around 9.500 are corporates – primarily SMEs**

Every year, companies regulated by the EU ETS must surrender enough carbon allowances to account for their GHG emissions. So, like paying a bill with money, these companies account for their emissions using carbon allowances

As long as it is cheaper for companies to decarbonise than to buy additional EUAs, they would be expected to invest in less polluting production processes and efficiency

Limiting the role of financials: impacts on corporates

Corporates and SMEs would face higher costs to trade emissions allowances, with consequences for their long-term decarbonisation strategies if financial firms (FFs) were excluded from the ETS. Utilities would not be able to step in to provide financing to e.g. SMEs as their job is to invest in R&D/renewables and solve the energy crisis

Primary market

- Corporates and SMEs would need to buy European emission allowances (EUAs) directly at auction and pay the full price upfront. They would no longer be able to buy futures/OTC forwards positions from financial firms, with a consequent impact on their working capital

Secondary market

- Corporates and SMEs would no longer benefit from the client facilitation and market making services provided by financial firms
- Corporates and SMEs would experience increased pressure on their already stressed balance sheets and would have to renounce to billions of implicit financing by financial firms
- To ensure the delivery of EUAs for compliance purposes, corporates and SMEs would need to tie their capital to the holding of physical inventory. This is because spot holdings would no longer be sold in the secondary market – at a discount – by financial firms

EXAMPLE 1

Company A	Bank	Company B
Company A cut emissions through a new production process and now wants to sell its excess EUAs	The bank acts as intermediary. It buys A's allowances, and sells futures/OTC forwards to B. B now has capital to invest, and can secure sufficient EUAs by year-end	Company B needs additional allowances by year-end. It also wants cash on hand to improve its production processes

The role of financial firms in the ETS explained

Financial firms' (e.g. banks) business model is essentially a client facilitation business model and market making business model

EXAMPLE 2

Company C

Company C has a compliance obligation to manage for 2023. It buys physically settled emissions futures to do this.

Bank

The bank holds the other side of the futures position and buys physical inventory through daily auctions to manage the risk. It delivers the futures into the exchange at maturity.

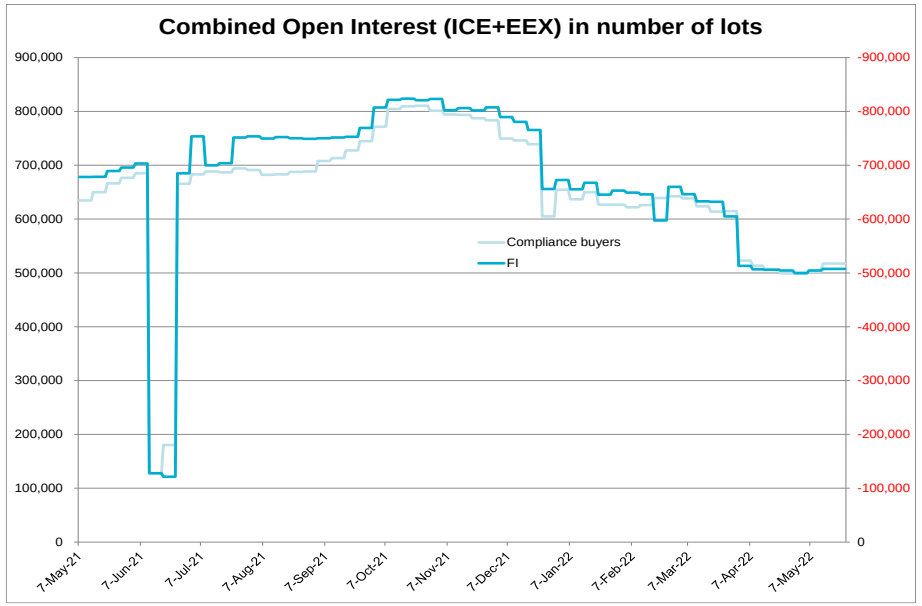
EXAMPLE 3

Company D

Company D foresees an excess of EUAs for the 2022 compliance year, but a shortage for 2023. It sells Dec. 2022 futures and buys Dec. 2023 futures.

Bank

The bank holds the other side of the futures position. It takes delivery of the spot in Dec. 2022, holds this as a hedge, and makes delivery in Dec. 2023.



The graph above, representing the split of Open Interest for the Intercontinental Exchange (ICE) and the European Energy Exchange (EEX) clearly shows that the positions held by financial intermediaries are almost identical – with an opposite sign – to those held by compliance buyers. FFs take the other side of the market, hedge themselves by buying spot certificates and provide the implicit financing (to the forward date).

- In all cases the market impact from financial firms activity is zero, and the net effect is to provide liquidity and financing to compliance users

Why do carbon prices change?

ESMA and the ECB found **no deficiencies in the ETS and no evidence of adverse impacts from the involvement of financial firms**

Several factors have led to the acceleration of the price increase since early 2021:

- Particularly cold weather at the beginning of 2021 causing energy demand to rise
- High gas prices encouraging producers to switch from gas to CO2-intensive coal generation, increasing demand for carbon permits
- EU Commission's "Fit for 55" package reinforcing the role of the ETS as the EU's major decarbonisation tool
- Phase 4 of ETS entails shrinking the supply of EUAs, further limiting the amount available in the market

SUMMARY: Prices in the carbon market respond to 4 key factors

1. Supply and demand
2. Climate and energy policy reforms
3. Macroeconomic developments
4. Cost of emissions reductions

The recent price increase can be attributed in large part to the effects of EU ETS reforms, high gas prices, and the impact of COVID-19 recovery

Effects of limiting the role of financials in the ETS

Limiting the role of financial firms (e.g. banks, CCPs, exchanges) would significantly weaken the ETS

Risk	Detail	Impact
Insolvency risk	Corporates and SMEs with compliance obligations may not be able to find a counterparty to take the opposite side of a transaction, leaving them unable to protect themselves against price fluctuations	**Increased risk of insolvency for energy producers or energy-intensive industrial firms**
Functioning of auctions	Auctions may be impaired, as restrictions in participation limit demand for allowances, which may result in auction prices no longer being representative or auctions failing to clear	**In absence of successful auctions, allowances would not be brought into circulation as planned**
Impacts on market architecture	The “plumbing” of the market would be impaired as a consequence of Central Counterparties (CCPs) and exchanges being banned from holding registered accounts	**In the absence of CCPs and exchanges, trades would no longer be cleared and settled**
Impacts on SMEs	Removing financial firms would increase the capital needs of SMEs as they would now need to pay for EUAs upfront to guarantee access to them via auctions (out of 11.000 Union Registry account holders, around 9.500 are corporates primarily SMEs)	**SMEs would face higher capital costs to guarantee access to EUAs and may even lack resources to participate in Exchange Traded Markets**

Financial firms provide an efficient form of financing for European utilities

Limiting the role of financial firms from the ETS would raise the cost of capital for utilities as they would need to draw on more traditional lines of credit or use less efficient structures to finance companies which are facing volatility in the market at a time of high gas and power prices