

Year VII n°20 - July 2022 ETS CO₂ Outlook

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ENERGIA

Coal to gas relative strength and the switching target are expected to drive the CO₂ price short-term variations. Meanwhile, since the implementation of the *Fit for 55* reforms to the ETS is now set to proceed as scheduled, the underlying trend is assumed to remain positive both in the *Reference* and in the *Best-Case* Scenario. With tensions on the European gas and power markets piling up ahead of the winter season, the probability for The European Commission imposing a gas price cap and/or rationing is becoming higher and higher. This is not expected to involve the ETS though, which should remain linked to market dynamics.

FRAME OF REFERENCE AND METHODOLOGY

REF-E Energy Outlooks are elaborated by MBS Consulting experts on the base of proprietary suites and market knowledge. Econometric and structural models, as well as our expert sensitiveness, detailed knowledge of regulation, and accurate monitoring of market outcomes underlie our elaborations.

Gas and electricity forecasts take into account the diverse geopolitical and economic hypothesis deriving from the potential war duration and outcome. The European Union and each single nation reaction to the disruption generated from the deterioration of both diplomatic and commercial relations with Russia are seen as key determinants of the future equilibrium of the energy markets.

In this perspective, we defined three scenarios. The **Worst Case** is characterized by permanently high prices amid a long lasting conflict which would lead to import-export bans and economic retaliation, trade flows interruption, commodities supply sharp reduction, negative or zero economic growth and the energy transition process failure. In the **Reference scenario**, prices will remain high in the short-term amid diplomatic and commercial tensions, while the energy transition process will continue and dependence on Russian commodities will be reduced. Gas and other fossil fuels supplies from alternative routes will increase initially limiting prices upward potential and successively leading to a normalization path. The economic growth suffers a contraction over the next two years, followed by recovery. The **Best Case** scenario would materialize in the event of favourable weather conditions and a fast energy transition, supported by low inflation and a faster economic recovery, reducing demand over the next few years. This would limit prices upside potential and then fuel a downward acceleration.

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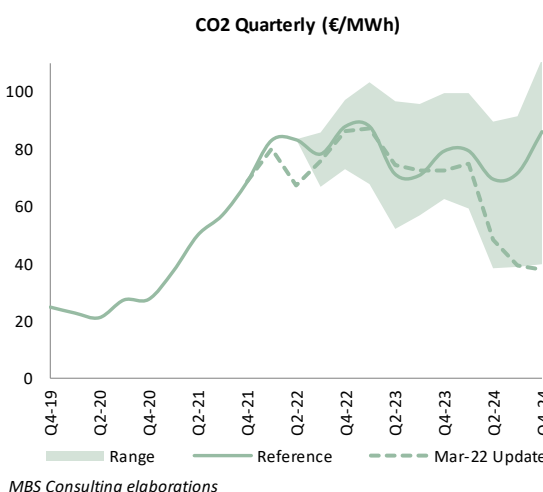
ETS CO2 OUTLOOK

The ongoing energy market crisis casted doubts on this year being the right time for the implementation of the ETS reform: such reform is expected to strengthen the system, provide support to the CO2 price, and, consequently pile up on record high electricity prices. Nevertheless, on 29-June the European Council reached an agreement on the ETS revision. Negotiations with the European Parliament must follow towards the final adoption of the reform, but the EU Council agreement in itself leads to a revision of the CO2 price scenarios previous assumptions.

The expected postponement of the ETS revision and the possibility of other forms of regulation supporting the European energetic transition, such as incentives or, going forward, bans on particularly polluting technologies being implemented, are out of play. Even more so, the *Worst Case Scenario* contemplating the possibility of the ETS system itself being put on hold as a consequence of fuels scarcity and permanently high prices became highly unlikely.

Our three CO2 short-term price forecasts scenarios (*Reference*, *Best* and *Worst Case*) are still based on the coal to gas switching modelling as long as seasonal patterns are concerned. However, since the implementation of the *Fit for 55* reforms to the ETS is now expected to proceed as scheduled in the second half of 2022, the CO2 price underlying trend is assumed to remain positive in the *Reference* and in the *Best Case* Scenarios.

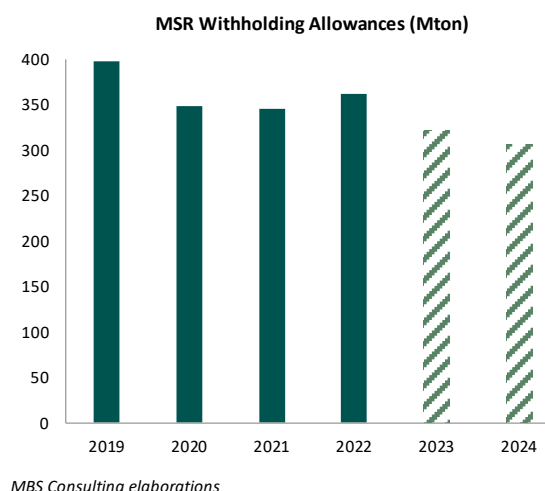
In the *Best Case Scenario*, the CO2 price is expected to average close to 100 €/MWh both in 2023 and 2024, supported by the regulatory framework and by the economic recovery, despite and easing of the gas price. In the *Reference Scenario*, a weak economic growth weighs on demand, counterbalancing the supportive impact on the CO2 price of the ETS reforms. The price consequently stabilizes near 80 €/MWh till 2024. In the *Worst Case Scenario*, high inflation and economic stagnation have a significantly negative impact on activities, demand and financial operators appetite for risk, pushing the CO2 price below 60 €/MWh in 2023.



The EU Commission Agreement on a New ETS Framework Supports the CO2 Price

The member states common position aims at a 63% reduction of emissions in the sectors covered by the ETS by 2030. In this perspective, the number of available emission certificates curtailment will be obtained by:

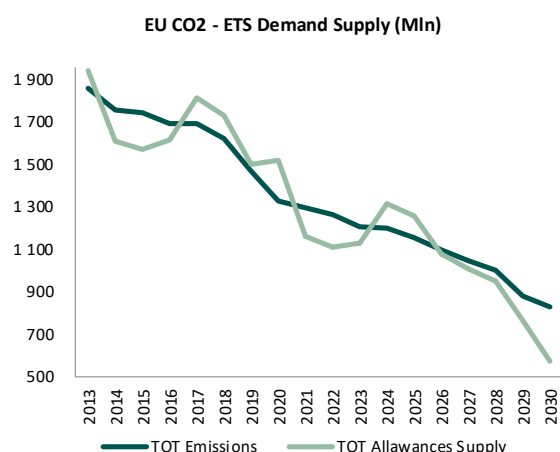
- a **one-off reduction of the overall emissions ceiling** by 117 million allowances (re-basing)
- an **increase in the annual reduction rate** (linear reduction factor) of the cap by 4,2% per year, from 2.2%
- a **strengthening of the market stability reserve (MSR) mechanism**, prolonging beyond 2023 the increased annual intake rate of allowances at the 24% rate and setting a threshold of 400 million allowances above



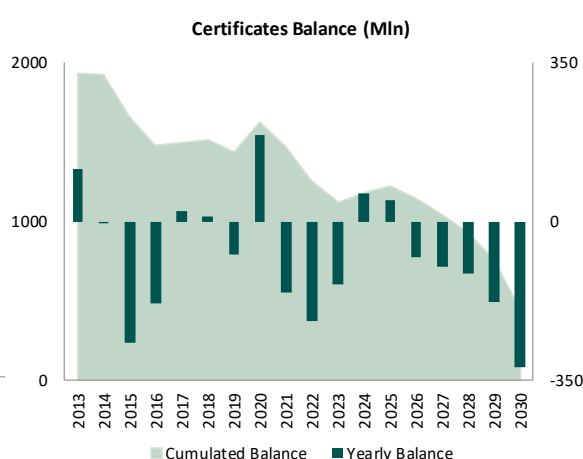
which those placed in the reserve were no longer valid, but the Council also agreed on the possibility to activate the release of MSR quotas on the market, in case of excessive price rise automatically

In addition to the above supply curtailment measures, **the Council agreed measures aiming at a demand reinforcement**, with an impact on the CO2 market balance perspectives, which would be at least partially smoothed by a contextual increase of auction volumes:

- **inclusion of the maritime shipping emissions within the scope of the EU ETS:** obligations to surrender allowances should be introduced gradually for shipping companies and member states heavily dependent on maritime transport benefit from a 3.5% redistribution of the ceiling of the auctioned allowances. Taking into account geographical specificities, further transitional measures may be applied to small islands, winter navigation and journeys relating to public service obligations, while measures to reduce the risk of carbon leakage in the maritime sector should be strengthened
- **gradual phase out of free emission allowances for the aviation sector** by 2027 and alignment of the proposal with the global Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA). 20 million of the phased-out free allowances shall be set aside to compensate for the additional costs associated with the use of sustainable aviation fuels and limited transitional derogations allowed under specific geographical circumstances
- **progressive phase out of free allowances for the sectors covered by the Carbon Border Adjustment Mechanism (CBAM)** over a ten-year period between 2026 and 2035, with a slower reduction at the beginning and an accelerated rate of reduction at the end of the period.



MBS Consulting elaborations



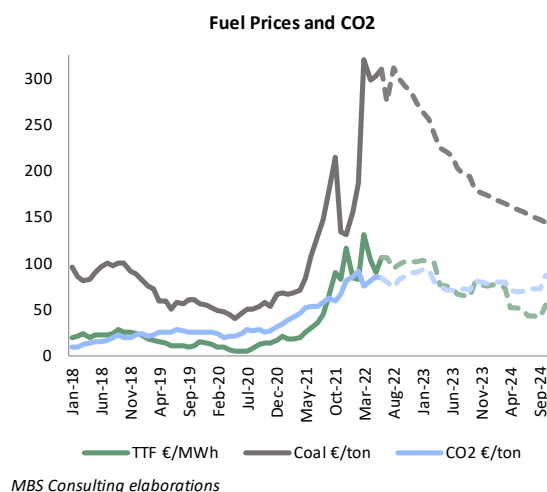
MBS Consulting elaborations

In the second half of this year, the above Commission proposals, approved by the European Parliament on 22-June, will be subject to trilogue between representatives from the European Commission, the European Parliament and the Council of Ministers to reach a provisional agreement on the relative legislative acts, which will therefore not be implemented before 2023.

The Council also agreed to create a **new, separate, ETS for the buildings and road transport sectors**. The new system will apply to distributors that supply fuels for consumption in the buildings and road transport sectors, with a reduction trajectory and the linear reduction factor set at 5.15% from 2024 and 5.43%. The start of the auctioning and surrender obligations will be delayed by one year compared to the Commission proposal (auctioning of allowances from 2027 onwards and surrender from 2028 onwards) and is not seen as having an impact on the actual CO2 ETS price.

Gas and Coal Markets Dynamics and Economics Impact on the CO2 Price

The European energy complex is entering an unprecedentedly critical winter season, with the gas and the coal markets under stress (see [Commodities](#) and [Gas Special Outlooks](#)). Expectations are for both the markets conditions remaining tight, following the reduction of gas flows from Russia, which makes thermal coal production essential for the European system security, and the ban on coal imports becoming effective in August. The recent, stronger than gas, coal price upward acceleration left the CO2 unchanged though, since the EU Commission agreement on the ETS reforms bullish impact counterbalanced the potentially negative impact of the coal price rise.

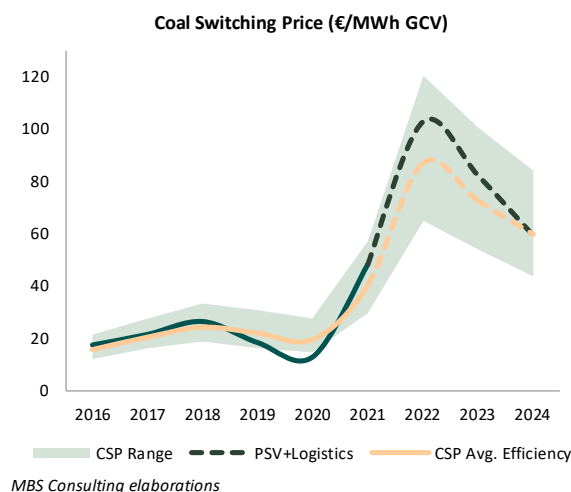


Despite expectations for a faster normalization of the coal price over the coming years compared to gas, amid a resuming decarbonization process and weaker competition on the world market for coal supplies than LNG (which would theoretically lead the CO2 price above 100 €/ton in 2023 and then push it sharply back below 70 €/ton in 2024 when the gas price should also move lower), the CO2 price is in fact expected to stabilize and average just below 80 €/ton over the next two years. This is due to an expected negative impact on certificates demand led by the European economies slow down in 2023, followed by a progressive recovery in 2024 and a relative demand resumption, which would counterbalance the parallel fuels market gyrations described above.

Gas and Coal Markets Dynamics and Economics

In this context, thermoelectric generation would still remain economically favoured compared to gas for average efficiency plants, while the switching should be guaranteed for low efficiency coal plants to high efficiency gas ones. Nevertheless, coal production may still be fully exploited over the next winter season, should gas supplies from Russia be curtailed.

Should the LNG supplies should be available to Europe and the infrastructures needed to receive it lead to an overall rebalancing of the European gas market and prices finally move lower, this would guarantee the average efficiency switching again by the end of 2024, while the implementation of the ETS reforms is expected to put the CO2 price on a progressive growth path.



With tensions on the European gas and power markets piling up ahead of the winter season, the probability for The European Commission imposing a gas price cap and/or rationing is becoming higher and higher. This is not expected to involve the ETS though, with the gas and coal prices dynamics seen as having just a short-term impact on the CO2 price and the ongoing *Fit for 55* related reforms maintaining it on a medium to long-term upward path.

EDITOR-IN-CHIEF
Virginia Canazza

DIRECTOR OF ENERGY OBSERVATORY
Claudia Checchi

EDITOR
Simona Soci

TEAM
MBS Consulting Practice Energy

PUBLISHER
MBS Consulting S.p.A.

EDITORIAL OFFICE, EDITING
Dalia Imperatori
Phone +39 02 89096061
E-mail: d.imperatori@mbsconsulting.it

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MBS Consulting S.p.A.
Società diretta e coordinata da Cerved Group S.p.A.

via degli Olivetani 10/12
20123 Milano

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