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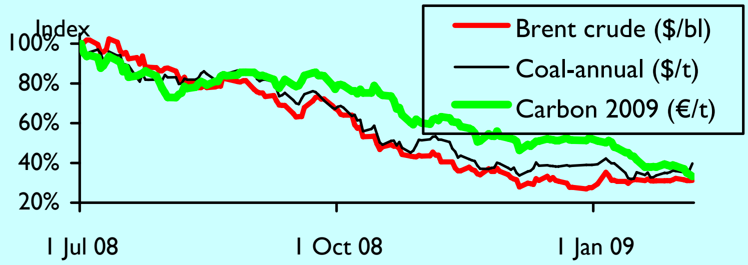
energyperspective

Demanding questions about carbon prices

In this *Energy perspective* we look at the recent slide in carbon values and pick out other areas where falling demand could impact local energy markets.

There is a degree of demand inelasticity and price lagging that has protected the energy industry from the economic downturn so far, unlike other sectors such as car manufacturing, steel production and construction. But the downturn in the wider economy is now materially impacting energy markets, with the down-turn in carbon values being its most obvious manifestation. Here the combination of lower industrial energy demand—meaning lower emissions—combined with firms selling spare permits quickly to raise cash has further depressed the value of a commodity which had been on the slide with other wholesale prices since last summer.

Trends in commodity energy prices—July 2008-February 2009



July 1 2008 =100%

Snow covers demand downturn

Press reports say the current winter is the coldest for 13 years. Last week saw peaks in energy demand with gas flows from the national system reaching a high of 415.7mcm on Monday and a peak on Wednesday on the power system of 56.7GW, just about enough to make the third triad peak of the season as things currently stand.

But these peak figures mask a picture of overall weakening demand:

- this year's peak power demand at 58.5GW is 1GW lower than last year's. The City is reporting comments from generators that demand peaks more typically are 2-2.5GW (around 5%) off;
- winter-to-date power demand (from 1 October) is 2.8% down on year-ago levels; and
- winter-to-date gas throughput on the national transmission system is 2.7% up on last year, but that from users on the regional system is barely changed.

With colder weather meaning more demand for heating, much of the weakening has come from industry which has had to deal with extremely high and volatile energy costs since 2005. This is a long enough period to combine short-term cost management pressures with the shelving of longer-term investment plans. Its tendency to flexible contracts has been encouraged by suppliers keen to reduce their own direct market exposure. But in volatile, largely illiquid and import sensitive wholesale trading structures, British industry is effectively the marginal customer in Europe's marginal energy market. And its predicament is likely to get worse before it gets better. The CBI's latest quarterly industrial trends survey showed that the UK manufacturing sector has seen a net reduction of new orders of 43% over the previous quarter alone.

Fall in carbon values likely to be sustained

The downturn on the demand-side has occurred at the same time as a slump in wholesale energy markets. In their original currencies, commodity energy markets have now fallen to a third of their early July 2008 levels. Sterling's slide over the same period has reduced the impact of those falls here by about one fifth but nevertheless they have still been very significant. Analysts typically expect commodity markets to remain weak this year and into next.

But while oil and coal markets have bottomed out since December, carbon has continued to slide with the extra impetus from industrial selling. Only very recently does the carbon slump appear to have come onto the radar with the remarks we highlighted last week. Since they were made the 2009 EU ETS contract has shed another 15% and is now only just sustaining €10/t. We saw back in 2007 the way carbon prices could collapse to zero once the perception took hold that there were too many allowances about. Then the reason for the surplus was political as most EU states generously over-allocated free permits for EU ETS Phase 1.

Now in Phase 2 allocations are much tighter not least because they were set against Kyoto targets. But the extent of the European industrial turn-down has fundamentally changed the market dynamic. According to *Businessgreen*, power intensive industries have been selling excess carbon allowances at the rate of some €150mn a week over the last two months. Barclays Capital has warned that carbon could fall as low as €9/t, and the market could be oversold this year and next if credit remains tight. "Unlike [EU ETS] Phase 1, the willingness of industrials to monetise these assets [their free carbon allocations] is high, particularly given the tight credit and difficult trading environment," it said, adding: "Indeed, if credit and revenue is tight enough, there is an incentive to monetise the entire 2008 allocation, knowing full well that this will only need to be bought back in 2012 [...] As a result, we see a real possibility that EUAs are oversold in 2009 and 2010, with installations using allocations as credit and then expecting to close these short positions in 2011 and 2012."

Point Carbon echoed these comments. It said recently it expects EU carbon permits to average €12/t this year and €19/t next, amounting to a €10/t cut in its 2009 expectation. "The €10/t level will for sure be tested at some time and we will probably also even see prices below that level during the spring," the analyst said, although it expected the current heavy selling of spot permits to ease off in the summer. Overall EU ETS Phase 2 could be short by 300mn t, implying an average permit price of €24/t over 2009-12, €5 lower than previously forecast.

Although there is a continuing expectation that economic recovery and tighter allocation will lead to higher carbon values by EU ETS Phase 3 in 2013, the current slump has shaken investor confidence. Most notably EDF Energy's chief executive Vincent de Rivaz has spoken of his fears of carbon becoming "the new sub-prime". But the *FT* also said last week prices were so low that the EU ETS "no longer provided an incentive to low carbon development, and seems unlikely to do so in the near future."

Lower carbon values just one challenge

Because it alters the relationship between commodity fuel costs, carbon is key to delivering the extra revenues needed to fund investments in low carbon energy. Its demand-driven slide in value reduces that margin and challenges investment plans struck when long-term value expectations were higher. Should it prove enduring—and the jury seems to be out on impacts beyond 2012 where previously there was confidence about values sustaining at least €30/t—it could prove just one test the energy industry will face as a result of lower demand.

Other challenges may include:

- operating and investing in power stations where volume requirements for electricity are lower both overall and at peak times, limiting the scope for variable and volatile short-term prices that can have so much influence on longer-term price expectations;
- lower than expected values for Renewables Obligation Certificates because the recycling shortfall against demand-driven targets will be lower. As matters stand, this year's power demand downturn will trim around £1/Roc from long-term values compared with the 1% or so annual demand growth we have become used to. A more enduring demand fall will squeeze potential Roc values further (all other things being equal, which of course they are not); and
- the need for suppliers to have a deeper relationship much less based around marginal prices with major users to sustain the volume flows to that sector. There is much talk of the shift from a manufacturing to a services-based economy, but the fact remains that the top 600 or so power users consume a third of all the electricity used in Britain, roughly the same as all householders. It has long been taken for granted by suppliers, but its shrinking would mean a smaller market and commensurate lower requirement for new investment. So it was heartening to hear EDF Energy's chief executive Vincent de Rivaz comment at British Energy's *Talk Power* event last week on the requirement for the new merged company to work in partnership with major users, especially as it has become routine for suppliers to decline to renew contracts or to seek huge security from consumers they perceive to be credit risks.

Energy market fundamentals have changed significantly over the last six months in line with the problems besetting the wider economy. The energy industry, never backwards in coming forwards, has been quick to make the case for consumers to pay more so it can invest securely and help guarantee security of supply going forwards. These arguments will not recede as the down-turn continues and possibly deepens.

We also suspect the industry's calls for more predictability—essentially amounting to a campaign that carbon prices should have a floor placed under them—will be a key part of the recently-announced Environmental Audit Committee inquiry into the role of emissions trading in delivering UK and international climate change objectives. Most of the Big Six have implied that incentive rates under the RO should also be revisited sooner rather than later, with offshore wind being targeted and continuing investment in it being highlighted as particularly problematic in the current environment.

But we do wonder whether these arguments for more support are based on perceptions about demand doing what it always has done. If so there are enough signs out there for those perceptions to be challenged. Ultimately market-based approaches to setting incentives such as carbon and Roc prices are only as good as the underlying assumptions about the wider commercial world on which they are based. If prices and demand are set to remain low for some time yet, the investment outlook might well look very different.