

Some thoughts on speculation

In the last few weeks the price of EUAs has moved like something scary at a funfair. And that's not something which goes round and round, but something which goes up and down and leaves your heart in your mouth. It was at under EUR 12.45 as recently as March; it's been at EUR 16.50 sometimes moving over a Euro in less than one trading session (within a day). It's been a great playground for speculators. And hundreds of Polish installations have been speculating inadvertently, putting at risk hundreds of millions of Zlotys of value. There were probably winners and losers, and as many sleepless nights.

This article takes a look at speculation in the EU ETS. Speculation is something which often gets a bad name, yet done carefully with the right analysis and risk management, it can be a very profitable activity. Interesting, a lot of installations in the EU ETS are speculating on millions or tens of millions of Euros without even realising this. In fact, often when we hear companies saying that they don't want to trade because they don't want to be speculating – it turns out that by not trading they are doing exactly that: speculating, and without proper risk management, to boot.

How can this be?

Speculating means making a bet on the future movement in the price of something. If you think that the price of EUA is going to go up then you speculate by buying EUAs (spot or forward); and you sell if you think the price is going to go down. Under EU ETS any company is making a bet on the price going up when at a point in time it has more EUAs on its account than it actually needs to cover the emissions up to that date. So in the spring of the year when you have received a whole year's worth of allowances but you only have a few month's of emissions, then you hold a net surplus of EUAs, beyond your compliance needs. Annual allocation might be 800,000 EUAs; by the middle of May you might have had emissions of 450,000 tonnes CO₂. So you have on your account 350,000 more EUAs than you need up to that date. You are "long" EUAs – and you are effectively speculating that the price of EUAs will go up. If you didn't think that the price was going to go up, then you would logically sell off the surplus and put the cash in the bank. Not only are you inadvertently speculating that the price might go up, you are taking a very big risk: if the price goes down, then the value of your surplus 350,000 EUAs could fall significantly. One Euro fall means a loss of Euro 350,000.

Careful management of EUAs means making a clear distinction between compliance and speculation. The job of compliance is to ensure that for each tonne of CO₂ emitted, there is a EUA to match. The EUA position should match the commercial position in respect of power production or cement production of whatever the activity of the plant is. That is, at the time the quantities and price of production of the underlying commodity is fixed, taking into account the cost of EUAs, then the plant should ensure that it contracts for the corresponding amount of EUAs at a fixed price. This ensures that each time a sale of power or cement is made, the installation knows the cost of the corresponding EUAs and the margin of the sale is fixed and not at risk.

So trading for compliance purposes means ensuring that there is a balance of EUAs at a fixed price to match the production commitments of the installation.

Trading for speculative purposes is a completely different activity. This is about taking a view on future prices and trading in order to make money against these price changes. You lift up your hands in horror at the idea of this! It is not appropriate for a responsible utility to speculate! The directors would never approve this! How can we put shareholders' money at risk in this irresponsible way? Well, if you analyse your EUA position through the year, you will see that you are probably already speculating like this and the directors and shareholders don't know and don't care!

In fact, if you do it carefully, because you are in the market and have a very good understanding of the power sector (one of the main influences of the price of EUAs), you have a better chance than anyone to make money from speculation, in a responsible way.

How can you do this?

First you need to understand some of the things which shift the price in EUAs, analyse them, and keep an eye on them. The biggest influence is the European power prices. When the dark spread goes up, it becomes more worthwhile to burn fossil fuels to make power, so power companies are more ready to purchase EUAs, so the price goes up. And when the dark spread falls, then the price of EUAs goes down. As players in the power markets, you should have excellent insights into this.

Another influence is the markets. When the FTSE and DAX indices fell recently on the Greek financial crisis, lo and behold the EUA price slumped from around EUR 16 to just above EUR 15. When the markets recovered, the EUA shot back up again to EUR 16. Then when the markets began to fall again, the EUA fell back. Why? Partly because economic depression in the EU means less use of fossil fuels; partly because investors just automatically buy and sell commodities which are in some way related – as the EU ETS is a core policy of the Euro Zone, if the EU splits up, then so will the EU ETS and EUAs will be worthless; partly because if southern European companies are in a financial crisis, then the southern European utilities will be less likely to want to sustain the price of EUAs by purchasing them when they dip. Oil is another influence on prices, although that has perhaps correlated more weakly in recent months.

You also need to keep an eye on European policy and global climate change negotiations. The recent leap in prices from range of Euro 14-15 to a range of Euro 15-16 was partly prompted by European politicians speculating on whether the EU might actually consider a reduction commitment of 30% or even 34%, which would significantly reduce the availability of EUAs.

Finally, consider short-term events, such as an auction by one of the EU governments or the day of announcement of the previous year's emissions – events like this can cause significant swings in the market.

From these factors you can take a view on the market – it might be a short-term view – where will it move in the next few days in advance of an auction; medium term – looking at the next months and an upturn in the economy, or a long-term view about the strength of the EU's commitment to cut emissions.

Once you have a view, the second thing to consider is risk management. What to do if you get it wrong and the price goes in the wrong direction. You need to figure out in advance what is the maximum loss you are prepared to suffer in the interest of having a chance at making the hoped-for profit. If your position is in the red, when it hits your maximum allowed exposure, then you have to ruthlessly and without emotion close the position and realise the loss. To take a loss is the hardest thing to do - there's a strong human instinct not to - but you must; and there is no shame in it. You took a view and in that instance you were wrong. But if you do your homework and stick to the rules, then hopefully once you get a winning position, the gains will far outweigh the cumulative losses of the times when the market had other ideas than you.

Finally, ensure that any speculative trading activity is properly authorised within the company; that management understands the risks and positions which are being taken; and proper procedures for risk management are in place. Remember, that most of the time in the EU ETS companies are unwittingly exposing themselves to the risks of the EUA market, and so even this "accidental speculation" should actually be properly authorised and formalised.

The carbon market is very volatile and hard to predict in the short-term. But it does respond broadly to the fundamentals of demand and supply. If you are in the business of power generation and understand that market, you are better placed than many to take a view on where the emissions prices will move.