

What's Hot: Progress on 'Fit for 55' breathes life into EUA market

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As of Friday, 28 October, EU carbon emission allowances (EUA) had extended their largest weekly gain in 5 years following a strong rally over the preceding six days¹. This happened during a week when the first 'Fit for 55' proposal was agreed². The EU has strengthened targets for CO₂ emissions from road transportation.

To understand this price action, it is important to reflect on what happened in the EUA market between August and October.

Source: Bloomberg, data as of 03 November 2022. Generic first Emissions – EUA futures contract price shown.

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EUA prices fell sharply in August after reaching an all-time high of EUR98.42/MT³. Two main things triggered the collapse in prices. First, Poland's Prime Minister called for a suspension of the EU's Emission Trading System (ETS)⁴ to deal with the stress of rising prices. Poland's state-owned electricity company even launched an advertising campaign blaming the ETS for the country's high energy prices.

Second, there had been much talk about reforming Article 29a of the EU Emissions Trading Scheme (ETS) Directive – the mechanism designed to reduce instability caused by price spikes. Despite the high price volatility of EUAs and the sharp price increases in the past two years, the clauses under Article 29a have never been invoked.

In our [September blog on EUA prices](#), we outlined how the past sequence of events, that were weighing on EUA prices, were unlikely to materialise further. The suspension of ETS had neither any legal basis nor any political will. And the triggering of Article 29a is an ambiguous process and it wasn't certain that its thresholds were likely to be hit. Even if we disregard the technicalities of Article 29a, the principle remains that the ETS [Market Stability Reserve](#) was designed to reduce the historic oversupply of EUAs and used only to counter any major shocks to the system. As a result, we took the view that markets had overreacted even though the fundamentals for EUA remained strong.

In the blog, we also suggested that post summer, we expect to see more momentum on the 'Fit for 55' legislative front. As per the press release by European Council from 27 October 2022: The Council and

the European Parliament reached a provisional political agreement on stricter CO2 emission performance standards for new cars and vans. The goal of the agreement is to move towards zero-emission mobility.

Pending a formal adoption, the co-legislators agreed to a:

- 55% CO2 emission reduction target for new cars and 50% for new vans by 2030 compared to 2021 levels
- 100% CO2 emission reduction target for both new cars and vans by 2035.

The proposal to revise the CO2 emissions performance standards for cars and vans is part of the 'Fit for 55' package. Presented by the European Commission on 14 July 2021, the package aims to enable the EU to reduce its net greenhouse gas emissions by at least 55% by 2030 compared to 1990 levels and to achieve climate neutrality in 2050.

At WisdomTree, we believe this development sends a strong signal to markets that the EU is committed to the 'Fit for 55' package. As rules covering other sectors not currently legislated under the ETS (like buildings and shipping) are unveiled, we may see more positive price momentum in EUAs.

This does not rule out volatility in the short-term. Europe is still faced with a precarious energy situation over winter. Oil and natural gas prices can have an indirect effect on EUAs. For example, if energy supplies are ample and industrial activity continues at or close to normal levels, demand for EUAs will also stay at normal levels. If activity needs to be curtailed, emissions will automatically fall and so will the demand for EUAs.

In the medium term however, Europe's focus remains on the energy transition. REpowerEU – the policy proposal to wean off Russian energy dependency – also focuses on speeding up the energy transition away from hydrocarbons in general. In short, the energy shock is unlikely to derail EU ETS from being the cornerstone of EU's climate policy. The recent rally in EUA prices appears to be a realisation of this from markets.

1 Source: Bloomberg.

2 <https://www.consilium.europa.eu/en/press/press-releases/2022/10/27/first-fit-for-55-proposal-agreed-the-eu-strengthens-targets-for-co2-emissions-for-new-cars-and-vans/>

3 On 19 August 2022, source: Bloomberg.

4 <https://www.euractiv.com/section/emissions-trading-scheme/news/eus-von-der-leyen-rebuffs-polish-call-to-suspend-carbon-market/>

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