

MSR REVIEW WORKSHOP

Important Note: BNPP AM does not hold any EUAs in any of its investment portfolios



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BNP PARIBAS
ASSET MANAGEMENT

The asset manager for a changing world

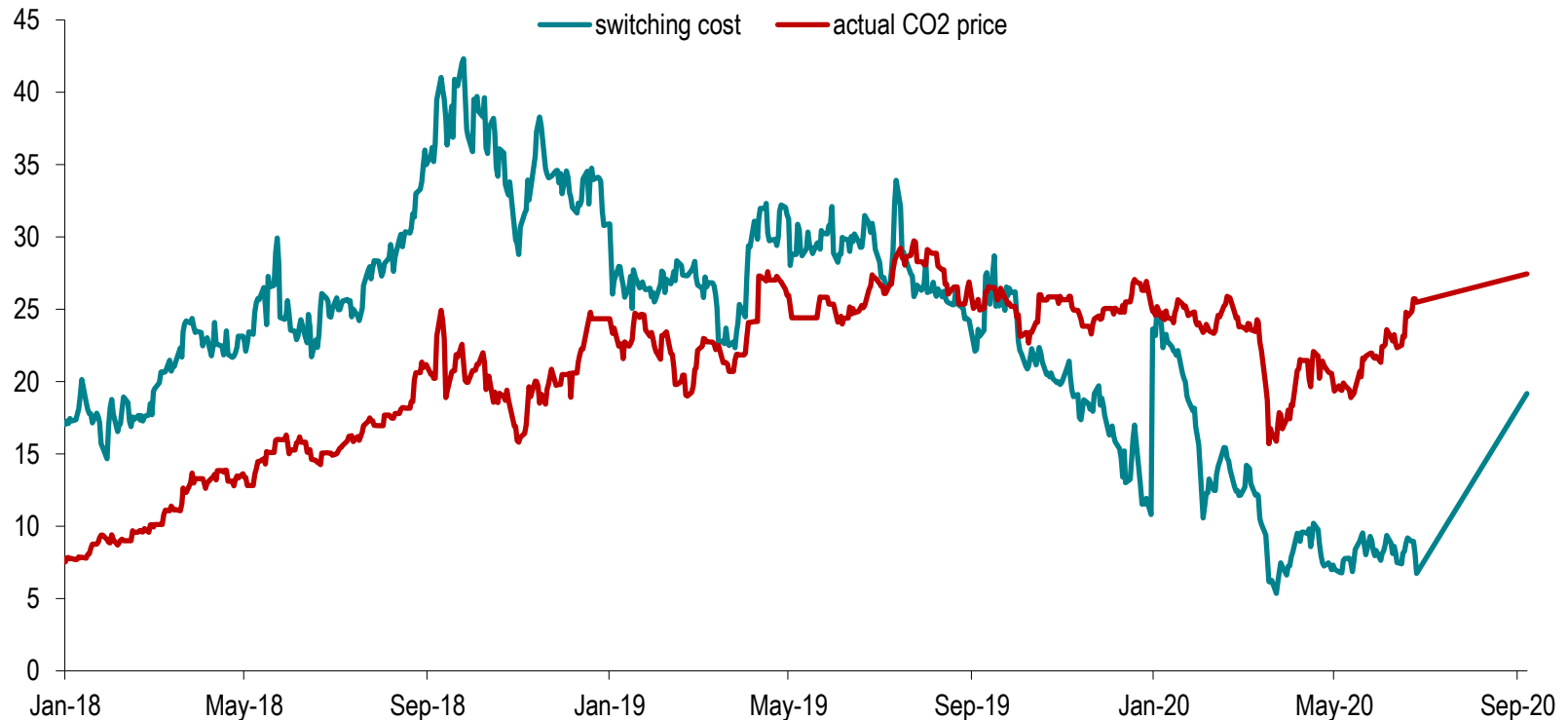
The theory of carbon pricing in the EU-ETS

We postulate that the pricing paradigm of the European carbon market should in theory be a function of three variables:

1. market participants' understanding of the purpose for which the EU-ETS has been established (i.e. the policy objective it is intended to achieve);
2. market participant's perception of the effectiveness of design of the EU-ETS, and hence of its technical ability to achieve the policy objective;
3. market participants' assessment of the political priority attached to achieving this objective, and hence of policymakers' commitment to ensuring that the supply of European carbon allowances (EUAs) is engineered to deliver this outcome.

The EU-ETS: the end of the fuel-switching paradigm

Dec-20 EUA price versus implied fuel-switching level, Jan-2018-Sep 2020 (€/t)



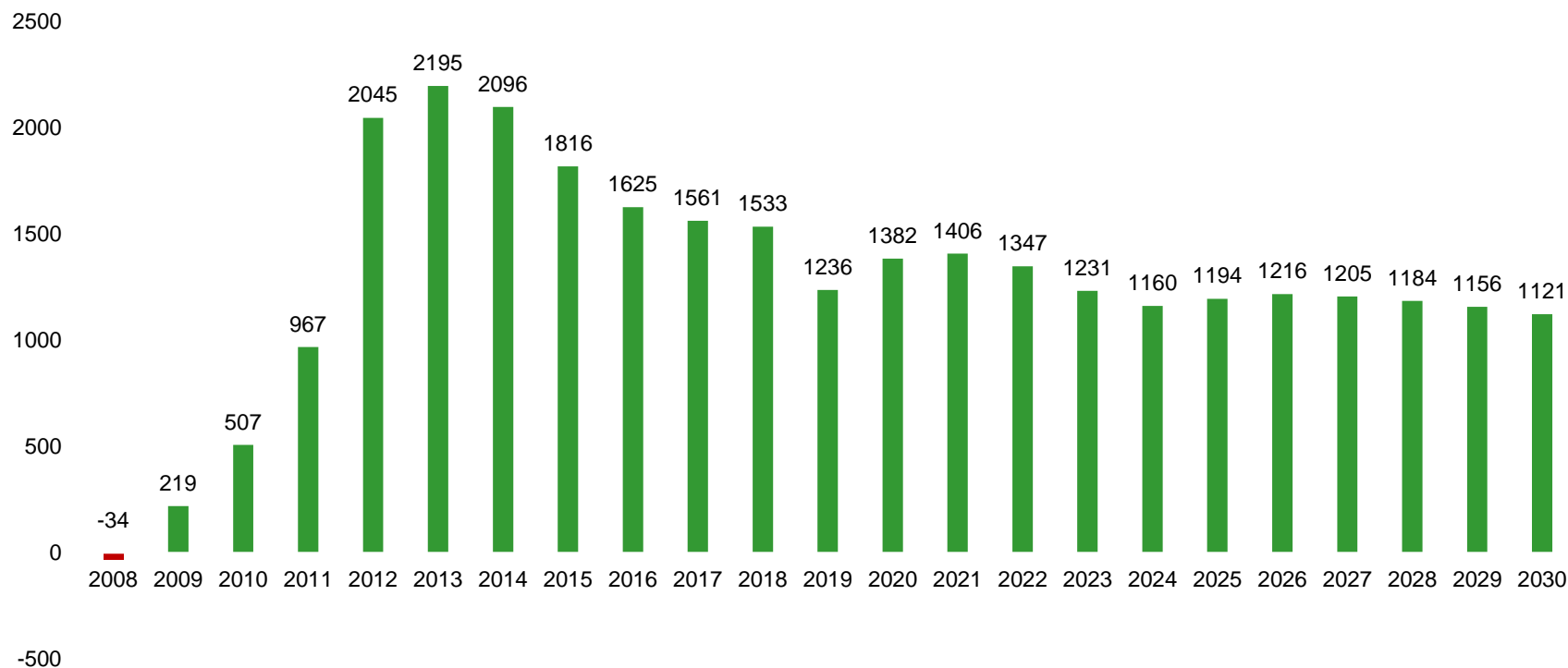
Source: BNP Paribas Exane

- Given the economic shock to the EU-ETS from COVID, the price of EU carbon allowances (EUAs) has held up remarkably well in recent months
- Perhaps more significantly, though, and as can be seen, the Dec-20 EUA contract has also traded at or above the upper end of the coal-to-gas fuel-switching range for most this year.

The EU-ETS surplus under the current -40% EU-wide target

Our modelling of the EU-ETS under the current legislation for the EU-wide -40% target and the current rules for the MSR projects that there would still be a very large market surplus of EUAs in 2030 of 1,150Mt, not least owing to the structural impact that we expect the COVID pandemic to have on emissions over the next decade,

BNPP AM projection for total EU-ETS surplus (including aviation) under current 2030 EU -40% target (Mt)

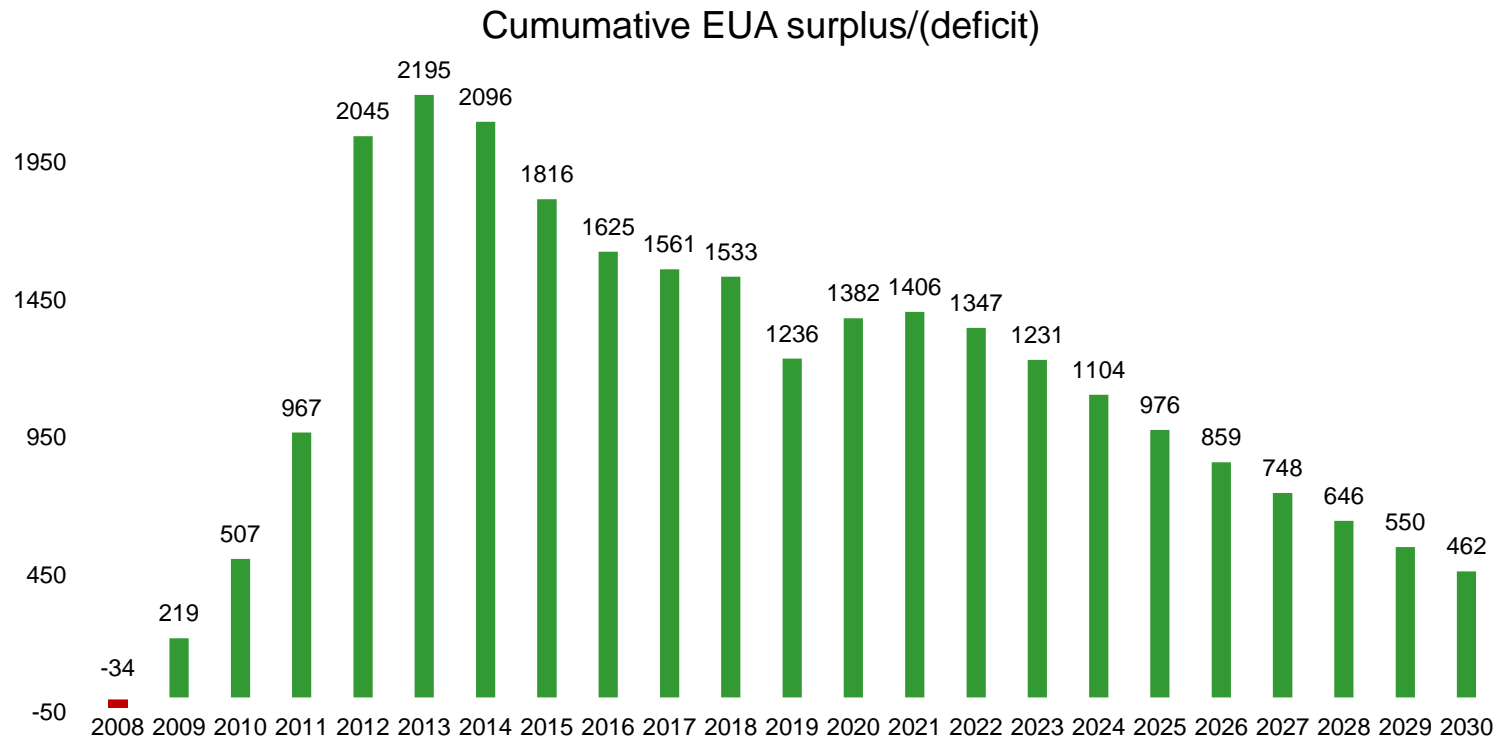


Source: BNP Paribas Asset Management Research Estimates.

The EU-ETS surplus under a -55% EU-wide target

We have modelled a scenario for the EU-ETS under which the recently proposed -55% EU-wide target for 2030 is adopted, showing how this might compare with the EU-ETS under the current -40% target. Owing to the structural impact that we expect the COVID pandemic to have on emissions over the next decade, our scenario modelling of the EU-ETS under a -55% target projects that there is still a market surplus of EUAs in 2030, albeit a significantly smaller one (462Mt) than would be the case if no change were made to the current -40% target (1,150Mt).

BNPP AM scenario modelling of EU-ETS surplus (including aviation) under potential EU –wide -55% 2030 target (Mt)



Source: BNP Paribas Asset Management Research Estimates.

Reality check: COVID and the EU-ETS (2)

- However, what matters from a pricing point of view in the face of any projected surplus of EUAs are two things:
- Expectations regarding further tightening of the cap beyond 2030, and potentially before 2030 as well;
- Who is holding this balance of surplus EUAs (compliance players or financial investors), and hence how likely they are to be traded on the market.
- On the first point, our conclusion regarding the price action in EUAs over the course of 2020 in general, and since the rebound from the low of €14.3/t in late March in particular, is that the market seems already to be pricing in a scenario similar to the one we have modelled. In other words, we think the market is already effectively assuming that the Commission's proposal for a more ambitious -55% 2030 EU-wide target will result in a significant reduction in the surplus of EUAs in the market out to 2030 compared with the surplus that would accumulate under the current -40% EU-wide target.
- On the second point, it is very difficult to know how the surplus of EUAs in the market breaks down between compliance players and financial investors, but to the extent that a more ambitious 2030 target will tighten the number of EUAs available to compliance players over Phase-4, then other things being equal it seems reasonable to assume that these players – especially industrials – will be more reluctant to sell any surplus holdings they might have in the future. In turn, this makes EUAs a more interesting asset class for financial investors.

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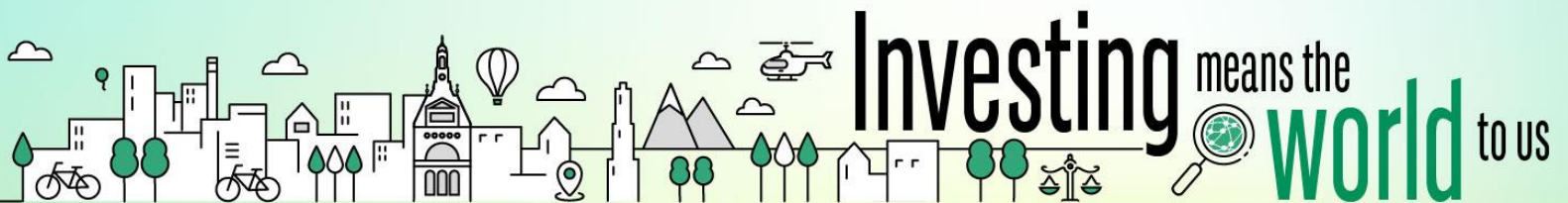
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