

The last year has seen some good returns in stocks and certain asset classes but maybe a less well-known rally is the one in carbon credits. Since the start of 2018 there has been a 433% spike in the price of carbon credits, and they have performed better than the hugely speculative Bitcoin. Ultimately companies that have been polluting the earth are going to have to start addressing it or paying up.

Figure 1: Daily EU ETS carbon market price



Source: Ember Climate Org

Carbon pricing is a mechanism used to address climate change by creating financial incentives for companies and countries to lower their emissions, either by switching to more efficient processes or using cleaner fuels. Carbon pricing can be imposed through taxes, fossil fuel extraction fees or emissions trading systems. The main purpose is to encourage a global shift towards a low carbon economy and essentially play a vital role in fighting climate change.

EU accounts for less than 10% of the world's emissions and an astounding three quarters of the planet's total carbon emissions aren't priced at all. This means that global average prices are sitting at only a few dollars, which is not incentive enough for companies to change their behaviour. Countries where emissions are priced e.g. Canada and South Korea, look to be following Europe's price rally which is a positive sign for a global carbon market.

So how do markets for carbon emissions work? The government sets a cap on the total amount of emissions allowed and CO2 emitters must be granted permits/allowances to emit CO2. Companies whose total emissions fall under the cap may choose to sell their unused credits to those who have surpassed their carbon allowance. As carbon prices grow there is a move towards clean energy such as solar, wind and nuclear.

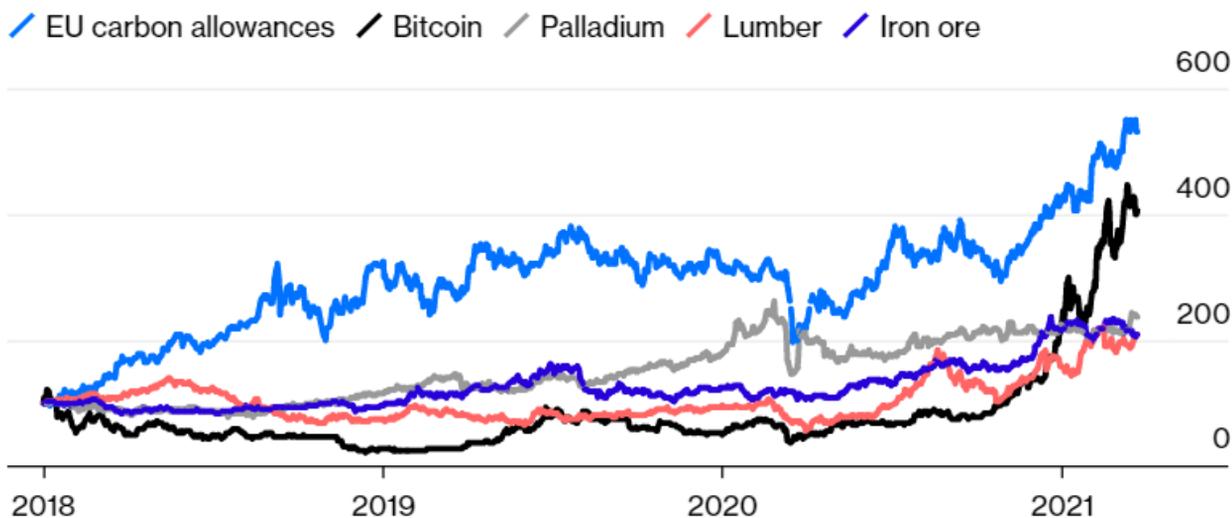
Let us take a deeper look at European carbon credits. Europe uses an ETS (Emissions Trading System) for carbon pricing. Set up in 2005, the EU ETS is the world's first international emissions trading system. It works on the 'cap and trade' principle. A cap is set on the total amount of certain greenhouse gases that can be emitted. The cap is reduced over time so that total emissions fall.

Europe's ETS seemed ineffective for many years as originally too many permits were granted, and the 2008 financial crisis resulted in carbon allowances trading at a very low price. Thus, not making much difference to carbon emissions. In response to this the EU created the Market Stability Reserve (MSR) in 2018 which gives the European Commission the ability to tighten or loosen the supply of carbon units. As a result, the price of carbon started to rise rapidly.

One EUA (EU Allowance) gives the holder the right to emit one ton of carbon dioxide, or the equivalent amount of two more powerful greenhouse gases, nitrous oxide (N₂O) and perfluorocarbons (PFCs).

Investors must now consider carbon risk which is now less of a corporate responsibility measure and more of a performance measure. The burden of reducing emissions is now the responsibility of those emitting it. So, in the future, you can continue polluting, but you will have to pay for it.

Figure 2: Since 2018 EU carbon credits have done better than Bitcoin, Palladium, Lumber, and Iron Ore.



Source: Bloomberg