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Carbon allowances: Niche market or the next big thing?

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As countries like China are joining the EU, parts of the US and others in applying carbon allowances, the secondary market for these instruments is set to grow as well. Will pension trustees see a case for holding carbon in their portfolios?

With governments seeking ways to meet their net zero commitments, regulatory allowances are increasingly being used as a compliance tool to force companies to reduce emissions while allowing the presence of a secondary market, a so-called 'cap and trade' system.

Having left the EU and its large emissions trading system, the UK has launched its own carbon allowances market this year, while China's first market is expected to start operating in July. The US has two allowances markets covering the east and west coasts, and New Zealand and South Korea each have their own systems.

What are carbon allowances?

Allowances, unlike carbon offsets, are issued by regulators in finite number and reduce each year, so purchasing them should become ever more expensive. In the EU, the allowances cover sectors such as electricity and heat generation, oil refineries, steel works, cement, paper and other materials, as well as commercial flights within the European Economic Area; the latter could be extended to other flights after 2023.

While a portion of the allowances is currently handed out for free, the rest is sold at auction to let the market decide the price. Last month, 1tn of CO2 emissions hit a new high of €50 in the EU market, but globally, the price is a fraction of that. To meet the Paris Agreement, a price of about $100 per tonne is needed.

Price for carbon is expected to increase

However, proponents of the tool say the fact that allowances are continually reduced will increase their price, providing ample returns for early bird investors as well as a hedging against climate risk they are exposed to in other asset classes.

"In Europe, since the market was initiated [in 2005], emissions have fallen by 1bn metric tonnes per year," says Michael Azlen, founder and CEO of Carbon Cap Management, which trades carbon allowances as futures.

The fund, which is one year old, does not yet count any pension funds among its investors, but Azlen says carbon could potentially be a longer-term strategic asset class for pension funds. "Carbon has very attractive investment properties but also has shown very low correlation to other asset classes," he argues, adding that his firm has been in discussions with pension funds as well as sovereign wealth funds.

"There is an increasing recognition by pension funds that their equity and bond exposures have significant climate change exposure and that carbon is a hedge," he notes.

However, the market is currently still small, and even though markets are growing fast - China is expected to launch the world's biggest emissions trading system next month, covering 4.5bn* tonnes of annual emissions through coalfired power - there is limited room for investors. The difference in size between emissions markets and global pension assets means pension funds collectively would "swamp" the market if they looked to allocate even just 2% or 5% of assets, Azlen observes.

There is however little sign of pension funds rushing to invest at this point. Gerald Wellesley, a client director at professional trustee firm Punter Southall Governance Services, remains sceptical, saying that "on the face of it, I would be against what amounts to manipulation of carbon weightings in my view".

Wellesley prefers to work with companies, via asset managers, to reduce their carbon footprint as well as their social and governance scores.

"Juggling carbon credits may be a legal means for companies to avoid fiscal or punitive penalties but, for pension trustees, this seems to achieve little for our members and will involve frictional costs that any trading activity incurs that will be borne by the members," he says.

Will companies stop using offsets?

As well as being new to pension fund investors, the allowances regime is also having to explain how it differs from unregulated carbon 'offsets'. At the same time as governments are trying to regulate out emissions through the issuance of mandatory allowances, many companies are likely to try and rely on offsets - such as planting trees - to achieve their own climate change commitments.

"Corporates, when they pledge net zero, to a large extent rely on offsets. It's the cheap way out," says Jan Ahrens, head of research at SparkChange, another fund looking to make emissions allowances accessible to investors, albeit via exposure to physical carbon rather than futures.

By buying offsets, companies "can technically claim that they have reduced emissions", he says but believes that corporates "will still see it's not going to work".

Offsets lack environmental integrity, says Ahrens, a view that is also expressed in a 2016 report for the European Commission. The study found that 85% of the projects covered in its analysis have a low likelihood that emission reductions are additional and are not over-estimated.

Compliance-led carbon allowances, on the other hand, are more transparent and liquid, but there is a consensus that prices are currently still "too low", says Ahrens.

This is also what could make them attractive, as investors might enter a market if they think an asset is mispriced. In the case of carbon, aside from returns, it could provide an opportunity to influence the speed of the economy's transition; among the clients of SparkChange, "some might purely buy it for returns, some for impact", he notes.

Will a carbon border tax force laggards to adopt pricing regimes?

Not everyone is happy with the speed of regulation and growing cost of emitting greenhouse gases, however. "Poland is complaining a lot. Yes, it's painful for them now, but the writing has been on the wall for 15 years," Ahrens notes.

With different countries at different stages of transitioning, the fear is that there could be 'carbon leakage', with companies moving production to jurisdictions with poor or no emissions caps.

To avoid this, the EU is this year planning to introduce a tax on carbon, titled 'carbon border adjustment mechanism', not dissimilar to value added tax in that it falls due when something

crosses a border. The aim of the CBAM is to avoid leakage, as it means third countries might need to start putting a price carbon themselves, the EU anticipates.

However, some fear that this could place an unfair burden on the least developed countries, and the European Parliament is considering making these countries the possible beneficiaries of the revenues generated.

Overall, the CBAM "will force more nations to consider carbon regimes like the EU. Putin discovered that carbon pricing is a thing and is considering it in Russia", says Ahrens, with the US, Canada and Japan all looking into it as well.

"That would force other nations to create similar regimes. At the moment it's the best shot we have" to reduce emissions, he believes, noting that several countries including Germany and Sweden also levy a carbon tax on sectors not currently covered by the EU.

The rapid expansion of carbon pricing through regulation and tax means that carbon is no longer a niche market, says Ahrens: "This will become bigger than oil."

Would you consider investing a portion of your fund's assets in carbon allowances?

*this article has been updated to accurately reflect the size of China's market

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