A bunch of hot air – why a year of Trump presidency has not affected carbon markets

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TO THE POINT

- Developments in carbon markets last year were independent of the change in the U.S. administration. Some 6.3 Gt worth of emission allowances and offsets were traded in the various national and regional compliance markets in 2017. That represents a 5 percent increase year-on-year. With prices recovering strongly in Europe and rising in the Western Climate Initiative in the U.S., the overall value was up 22 percent up from 2016.
- Carbon markets continue to be the climate change mitigation instrument of choice in many parts of the world. 2017 saw the launch of the world's largest ETS in China and the adoption of major reforms in the EU and California-based emission trading systems, tightening these markets and providing direction towards 2030.
- Most of the Trump administration's attempts to fulfil his campaign promises at home took the form of proposed massive budget cuts to relevant programmes. However, throughout 2017 Congress pushed back on repeated efforts to axe existing green spending, revealing that even a Republican-controlled U.S. legislature favours basic environmental protection.
- The process to repeal the Clean Power Plan (CPP) was set in motion in 2017. Overall, replacing the CPP likely slows U.S.-wide emission reduction efforts in general, and any new carbon market activity these could have caused. It does not, however, directly affect existing North American carbon markets – these have been growing in terms of volume and value.
- Given current trends in U.S. renewable energy investment and the rapid shuttering of its coal-fired power facilities, the U.S. may very well achieve its Paris Agreement target of a 26-28 percent reduction from 2005 levels by 2030 whether it is withdrawing from the agreement or not. A coalition of populous states has vowed to meet the Paris targets within its respective members' jurisdictions - the group includes major emitters like New York and California, which have stringent emission reduction policies at the state level.
- While the Trump effect is not tangible yet at the international level, over time the lack of commitment from the U.S. could wear on its international counterparts and influence their willingness to step up mitigation ambition in the next years Paris review cycle.

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INTRODUCTION

In his election campaign, Donald Trump promised a decidedly anti-environmental agenda if he became president – he vowed to cut funding for the U.S. Environmental Protection Agency (EPA), roll back its signature climate change regulations created under Obama known as the Clean Power Plan, withdraw from the Paris Agreement and "end the war on coal."

Trump's election victory raised much speculation about the effect on climate policies both in the U.S and globally. Would the Paris Agreement collapse with a U.S. withdrawal? Would carbon markets plummet amid fears that emission trading systems would be dismantled?

One year of pursuing this agenda, however, has had remarkably little effect on actual climate change mitigation policy, which is to date moving ahead at the international and regional levels despite (and to some extent precisely because of) Trump's efforts.

This analysis takes stock of what actions the Trump administration has actually taken during his year in office, and looks at impacts for overall climate policy internationally and in the U.S. - and for carbon markets around the world.

U.S. FEDERAL CLIMATE POLICY

Proposed budget cuts to environmental programmes, the appointment of Scott Pruitt as the new director of the Environmental Protection Agency (EPA) and start of the repeal of the Clean Power Plan (CPP) are key actions taken to fulfil the campaign promises. What steps were actually taken over 2017 and to what degree have they brought about change in the U.S federal climate policy?

> "replacement for CPP will probably not facilitate carbon trading

Axing budgets – not so easy after all

Most of the Trump administration's attempts to fulfil his anti-environmental campaign promises took the form of proposed massive budget cuts to relevant programmes – but throughout 2017 Congress pushed back on repeated efforts to axe existing green spending, revealing that the U.S. legislature favours basic environmental protection, even with a Republican majority.

Specifically, Trump's team in May proposed a 31 per cent cut to the EPA's budget for 2018. Republicans in Congress replaced this with a 1 percent cut in their 2018 appropriations bill, which has still not been agreed (see below). Similarly, Trump's budget proposal from May included a 70 percent cut to the Department of Energy's Office of Renewable Energy and Energy Efficiency - Congress instead increased the budget for that institution, albeit by less than 1 percent. Legislators also opted to retain the budgets of other government bodies related to environmental protection: the Bureau of Land Management and the U.S. Fish and Wildlife Service, the latter of which manages national wildlife refuges and protects endangered species, were both to take budget cuts of 13-14 per cent in 2018 according to Trump's May proposal – Congress opted to increase their budgets by about 1 percent, too.

In what form Congress' version of the 2018 budget actually passes, however, remains to be seen: it will have to be changed to pay for tax cuts included in the U.S. tax bill passed in December 2017. At the time this analysis went to print, the US federal government was shut down because the budget had still not been agreed and agencies can't operate without a budget.

The fate of the Clean Power Plan

Trump's appointment of Oklahoma Attorney General Scott Pruitt as EPA director went some way toward achieving an agenda hostile toward climate change mitigation: in his previous position, Pruitt had led lawsuits by groups of states against the EPA, specifically on the Clean Power Plan (CPP) his agency is in charge of implementing. Under Pruitt, the EPA has moved forward with a repeal of the CPP to be continued throughout 2018.

Established under the Obama administration and officially published in 2015, the CPP is a regulation under the U.S. Clean Air Act that limits carbon dioxide emissions from existing power plants, aimed at reducing them roughly 3 percent below 2005 levels by 2030 in line with the United States' overall Paris Agreement target. The rules would have given states broad flexibility on how to implement those limits, allowing for market-based approaches that could have led to new or bigger U.S. carbon markets. The CPP never made it to implementation, since it was put on hold already in early 2016 because of court challenges (including the one Pruitt brought).

In March 2017, Trump signed an executive order calling for the EPA to review the CPP, and in October Pruitt's EPA issued a notice of proposed rulemaking to repeal it. The public comment period for this proposal was extended in November, to 16 January 2018. In December, the EPA released an "Advance Notice of Proposed Rulemaking" soliciting public comment on what a replacement rule for the CPP should look like – signals from the EPA suggest a replacement would consist of a much narrower rule aimed merely at increasing efficiency at certain power plants. Such a measure would not facilitate carbon trading among states or regions as the previous version could have.

Overall, replacing the CPP will likely slow down federal-wide emission reduction efforts in general, and any new carbon market activity these could have caused. It does not, however, directly affect existing North American carbon markets – these are actually growing in terms of volume and value (see North America carbon markets section below).

What war on coal?

As for the vow for "ending the war on coal," Trump has failed miserably, although there was never such a war in the first place: coal's decline in competitiveness as an energy source (due primarily to cheaper U.S. natural gas prices) started long before Trump campaigned for president.

> "coal's share of power generation mix will fall below 30 percent

The trend continued in the first year of his presidency, and all signs point to a further coal decline throughout the rest of his tenure. Roughly 13 GW of coal electricity at plants all over the U.S. are set to retire in 2018, following similarly large shut-down rates in the two previous years, according to January 2018 data from the Energy Information Administration (EIA).

Coal's share of the U.S. power generation mix, which was over 40 percent just a decade ago, will fall below 30 percent this year. U.S. coal production (mining) increased slightly in 2017 due to increased exports, but will decline again this year and next according to EIA projections.

INTERNATIONAL CLIMATE POLICY

The first months of Trump's presidency saw intense lobbying from world leaders, including the Pope, to convince him not to pull out of the Paris Agreement. In May, he nevertheless announced that he will. Respecting the legal formalities of the agreement, the earliest point in time the U.S. can officially withdraw is November 2020 – the U.S. will thus continue to participate in the negotiations to the end of Trump's current term.

World leaders immediately responded by reiterating their commitment to uphold the Paris Agreement. A Sino-European summit last June expressed "unhappiness about the American climate decision" and in September Canada joined the two for a special summit to advance the implementation of the Paris Agreement.

Xi Jinping and Barack Obama had discussed climate change mitigation on several occasions leading up to the Paris summit in December 2015 - many viewed these talks as having paved the way for the Paris Agreement breakthrough. It now seems likely that Europe will take the role of partnering with China in a joint push for global climate change mitigation.

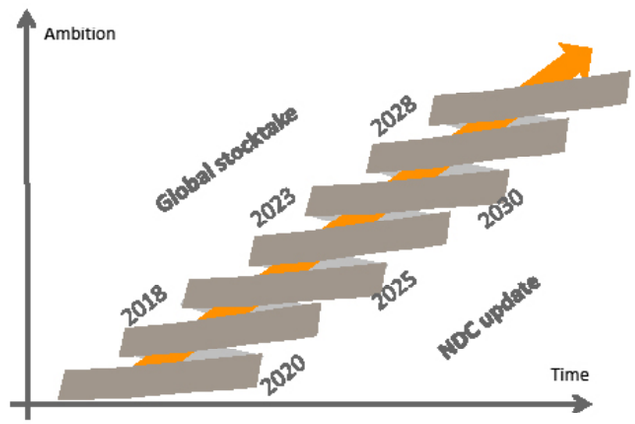
Half of the carbon market participants responding to the Thomson Reuters annual carbon market survey last spring said they expected China and EU to maintain momentum in international climate action. It is still too early to conclude whether they were right, but Beijing and Brussels have clearly expressed their commitment to the Paris Agreement. Both are tightening legislation to reduce their own emissions and both will disburse vast amounts of funding for clean energy projects in developing countries. Despite all this, they have still not proved that they can work together as an engine strong enough to push the rest of the world to ramp up ambitions: the 2017 international climate summit, COP23, showed that the old ghost of "common but differentiated responsibilities" re-emerged and hindered the forging of a strong Sino-European alliance.

> "Congress did not approve proposed funding cuts to the UNFCCC

While the Trump effect is not tangible yet at the international level, over time the lack of commitment from the U.S. could wear on its international counterparts and influence their willingness to step up mitigation ambition in the next years Paris review cycle (illustrated by Figure 1). While Parties to the Paris Agreement will take stock of the collective efforts towards the Paris long term goal already this year in the 2018 facilitative dialogue (the so-called Talanoa dialogue), there is little expectation of a step-up of national targets already now. However, in the 2025 review (and every five-year thereafter) the logic is that countries will step up their ambition level at par.

An altogether different question is what the withdrawal from the Paris Agreement means in terms of the U.S.'s practical contribution to the

Figure 1: The Paris Agreement review cycle



Thomson Reuters Commodities, January 2018

UNFCCC process in the years up to 2020. Congress did not approve the Trump administration's proposed funding cuts to the UNFCCC. Furthermore, reports from the COP23 Bonn summit suggested that the U.S. delegation had not received new instructions, and thus in a certain respect were taking part in discussions as if nothing had happened. See our recap of COP 23.

Given current trends in U.S. renewable energy investment and the rapid shuttering of its coal-fired power facilities, the U.S. may very well achieve its target under Paris (26-28 percent reduction from 2005 levels) by 2030 whether it is withdrawing from the agreement or not. A "July 2017 study by consulting firm Morgan Stanley" projected that renewables' cost competitiveness in 2020 would cause the U.S. emissions trajectory to come in under target levels even without any federal government policies aimed at curbing emissions.

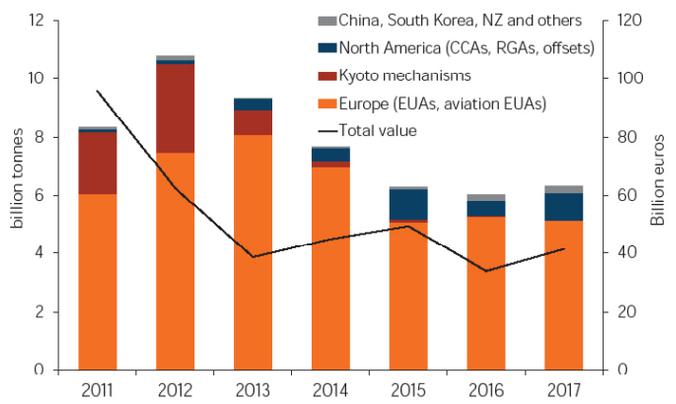
Moreover, a coalition of populous states has vowed to meet the Paris targets within its respective members' jurisdictions - the group includes major emitters like New York and California, which have stringent emission reduction policies at the state level.

CARBON MARKETS MADE GAINS IN 2017

Emission trading systems are national or regional, and governed by rules that are beyond the Trump administration's purview. The EU Emissions Trading System (EU ETS) is a European project, the South Korean and the Chinese ETSs are sovereign national systems, and the markets operating in North America (the Western Climate Initiative known as WCI, whose main participant is California, and the programme among nine eastern states, known as RGGI) are both governed by non-federal rules.

Our annual survey of carbon market players, for which answers were collected at the very beginning of Trump's presidency in March/April 2017, illustrated only mild pessimism as to carbon markets' future compared to the previous year: 45 percent of respondents expected international carbon markets to expand through 2030, whereas 21 percent agreed with the statement that they will recede. In 2016 the shares of responses were 48 and 20 percent respectively.

Figure 2: World Carbon Markets 2011-2017



Thomson Reuters Commodities, January 2018

Developments in carbon markets last year were independent of the change in the U.S. administration. Some 6.3 Gt worth of emission allowances and offsets were traded in the various national and regional compliance markets in 2017. That represents a 5 percent increase year-on-year. With prices recovering strongly in Europe and rising in the WCI, the turnover (aggregate value of transactions) reached €41 billion. As illustrated by Figure 2, that is 22 percent up from the slump year of 2016, but still short of the €49 bn traded in 2015. Find further details in the report Year in Review: Decreased uncertainty as carbon market reforms conclude available on Eikon.

> “WCI market value increased under Trump’s first year in office

Market growth in 2017 was spurred mainly by the conclusion of important policy review processes that affect carbon market rules for many years to come. Several of the world’s ETS were revamped and/or extended, with the changes setting the rules for carbon trading through 2030 and thus providing certainty for market players. In the case of Europe and RGGI, the new rules will reduce the current surplus of emission allowances.

European policymakers in November struck a deal on major reform of the EU ETS after two and a half years of negotiations. The reform sets the rules for the fourth trading phase (2021-2030) and aligns the ETS with the block’s 2030 climate ambitions. The reform will considerably tighten the carbon market balance from 2019 onwards and gradually lift prices from today’s levels of € 8.5/t to € 24/t in 2030 according to Thomson Reuters Point Carbon latest forecasts. The reform also includes a massive cancellation of 2.4 billion surplus allowances – a real signal of long term climate ambition from European policymakers. For a detailed analysis on the effect of the reform on market balance and prices available read our report on Eikon EU ETS phase 4 is a done deal – what effect on market balance and price?

California state legislators in September passed a law extending the Western Climate Initiative (WCI) through 2030. We attribute the WCI’s gains in 2017 to market participants appreciating the clarification that the regional carbon market will continue throughout the next decade. See more details in the next section.

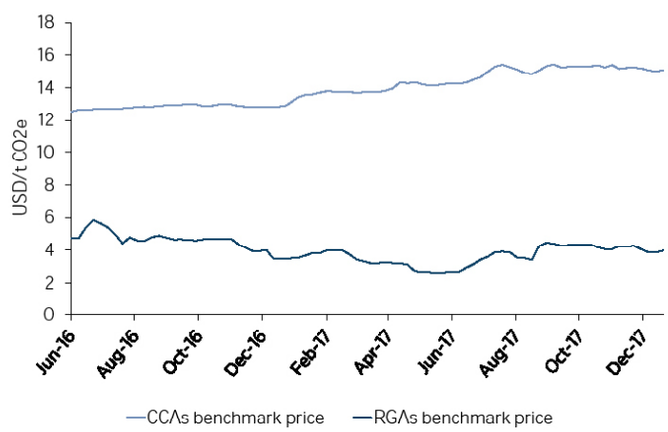
China announced the launch of its national trading system in December 2017. The scheme will be the world’s largest, almost double the size of the EU ETS (~3.5 Gt vs ~1.8 Gt). Initially covering the power sector, the system is set for an eventual expansion to other sectors in a phased approach as the system moves beyond the initial test phase. Read our QA on the national ETS on Eikon “**No Fanfare? The knowns of the Chines national ETS.”**

In addition to the three largest schemes, 2017 also saw reform processes underway in several jurisdictions, like **South Korea** and **New Zealand. Kazakhstan** has decided to restart its trading system, **Mexico** is developing its scheme and **Colombia** is also embracing emissions trading.

NORTH AMERICAN CARBON MARKETS

Although the U.S. government’s position on environmental issues took a U-turn over the past year, North America’s biggest environmental market was not affected: trading of carbon emission permits continued throughout 2017, with overall traded volume and value growing significantly since the previous year.

Figure 3: 2016 - 2017 price development in RGGI and WCI (the price of the benchmark contract)



Source: Intercontinental Exchange (ICE)

The market consists of two major emission trading systems. In the Regional Greenhouse Gas Initiative (RGGI) effective in nine north eastern and mid-Atlantic states, power generators buy allowances to cover their carbon dioxide emissions. The larger Western Climate Initiative (WCI) covers big emitters in most sectors of California’s economy, plus that of Quebec and Ontario. While RGGI stagnated due to a longstanding oversupply, WCI saw a huge jump both in terms of volume and value. Some 628 Mt worth of CCAs were traded in 2017, up from 338 Mt the year before. Turnover increased from €4.1 bn to €7.4 bn. See overall volumes and value in Figure 2 and price developments for carbon allowance units in WCI and RGGI in Figure 3.

RGGI's decline over 2017 is not noteworthy, as market participants know the scheme's caps are too generous given the region's decreasing power sector emissions. Prices had been going down for a while due to lack of demand, and transacted volumes sank accordingly. However, regulators from the RGGI states spent much of the year figuring out how to make the program more stringent in the context of its required review process, which resulted in new rules in late December that we expect will tighten the market significantly.

With the open meetings of the review process clearly going in the direction of tighter caps, allowance prices actually increased significantly from mid-year as emitters started hedging against tougher future compliance obligations under the stricter rules. These extend the market through 2030 and steepen the region's required downward power sector emissions trajectory to a 30 percent decline. The new rules also tackle the sizable bank of surplus allowances covered entities have built up during years of oversupply through an allowance "budget adjustment" for emissions permits from pre-2021 vintages.

California leads the way

What really influenced North America's 2017 carbon market performance were the growth factors in the WCI: bullish policy developments in California and the entry into force of Ontario's ETS. The latter occurred in January 2017, with the province officially linked to California and Quebec via joint allowance auctions starting in 2018. But even not counting the volume Ontario contributed, there was nearly a doubling of activity in the WCI's secondary market, with 370 Mt trading on exchanges compared to 187 Mt during 2016. This growth in volume was accompanied by higher prices, making for an overall higher market value under Trump's first year in office than in the previous years.

The price increase was mostly due to the required gradually rising floor price at WCI auctions ($13.57 for November's auction), but the last two auctions in 2017 cleared at prices well above their floor price and were both oversubscribed. The reason: California state legislators in September passed a law extending the state's carbon market through 2030. We attribute the WCI's gains in 2017 to this certainty that the regional carbon market will continue throughout the next decade, and we expect further increases in traded volume going forward because several features of the law aim to tighten California's ETS.

These developments were independent of the Trump administration's climate policies, as Ontario's ETS was set in motion long before the U.S. election campaign and California's extension of its ETS was expected regardless of who was in the White House. However, climate change inaction at the federal level likely increased California legislators' perceived need to strengthen their state's flagship emission reduction program – the bill extending it and thereby creating market certainty for another decade may not have passed as quickly or by as large a margin had it not been an opportunity to show a progressive California in the face of a backward federal administration.

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