
exponential energy
— FORTUNES

How to play the
hottest energy market
on the planet



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How to play the hottest energy market on the planet

James Allen

Publisher and editor, *Exponential Energy Fortunes*

Last September, a hedge fund manager by the name of Per Lekander did something no one expected.

Lekander, a fund manager at Lansdowne Partners UK LLP in London, is a well-known player in the \$38 billion European carbon market.

He's one of a hundred or so active traders in this corner of the greenhouse gas emissions trading system, buying and selling certificates that give permission to emit climate-changing carbon dioxide gases, which more than 11,000 factories and power stations in the EU need in order to operate.

There are few surprises in the European carbon market, known officially as the EU Emissions Trading System (EU ETS). It's a small, tightly knit market where few secrets are kept for long. It has an inclusive, club-like feel about it.

All of the major traders know each other, having been in the market together a long time. They watch – and attempt to second-guess – each other's movements like hawks.

So when Lekander announced that his €1 billion fund had quietly amassed a 10 million-tonne long position in carbon allowances, it sent shockwaves around the market.

The chat groups on the traders' Bloomberg and Reuters terminals immediately went into overdrive, with the instant messages registering widespread astonishment that Lekander of all people was now so bullish.

This was “Bear” Lekander, after all, who had long been consistently bearish on carbon prices. He had infamously called the EU ETS “a joke”, predicting prices would collapse to as little as €3/tonne.

But fast-forward just ten months, and this little known, so-called joke of a market has – with little fanfare – become the hottest energy market on the planet, with prices now trading at €17/tonne, nearly triple those at the beginning of September, before Lekander announced his €45 million bet.

You might say Lekander has already been proved right.

But as someone who used to cover the market on and off for around seven years, I'm convinced much higher prices are on the cards. In fact, under the right circumstances prices could even rise to €100 within the next few years.

A joke no more.

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So why did Lekander have a change of heart?

And why are prices set to continue their recent explosive growth?

First, some background.

What is this EU ETS?

The first thing to note is that the EU ETS is a totally artificial market. Unlike other energy markets that are based on actual, tangible commodities, the carbon market is entirely created by law.

The market was created by the EU as a way to combat climate change and reduce greenhouse gas emissions. In fact, the EU ETS is one of the main mechanisms the EU uses to move industry away from the most polluting fuels so that it can reach the goals for curbing climate change set out in the 2015 Paris Agreement.

How it works is that the EU sets a cap on the total emissions allowed within the scheme, guaranteeing that they are kept to a pre-defined level.

The cap is turned into so-called EU Allowances (EUAs), each one representing 1 tonne of CO₂ emitted. Allowances adding up to the cap are provided to the companies regulated by the scheme.

Each year this cap gets a little bit tighter. In 2018, around 1.9 billion EUAs were issued and in 2020 that number will be 1.8 billion.

The EU gives about half of this total to industry for free, to help industries like steel, paper, glass and cement-making keep costs down and remain competitive in international markets. But even this free allocation shrinks over time, and many of these companies need to buy even more EUAs.

The other half is auctioned in daily sales all year long. Power stations, industrials and investors can all participate in these auctions.

The companies are required to measure and report their carbon emissions and to hand in one EUA for each tonne they release during the year.

But companies can trade their allowances, providing an incentive for them to reduce their emissions.

If companies emit less than the cap, they are permitted to sell the excess carbon permits to companies that are polluting more. The company polluting less will profit from this transaction, while the company polluting more will pay more.

The system effectively puts a price on carbon, influencing the economics of burning fossil fuels, among other things.

For example, burning coal creates more carbon pollution than burning gas, so coal plant

operators need more permits. The higher the price of the permits, the more expensive it is to use coal rather than gas. Power companies choosing how to generate electricity therefore have an extra cost associated with the more polluting options, so they'll choose gas over coal more of the time.

So while the EU ETS is a totally artificial market, the law has created real demand and supply for allowances.

Power stations, oil companies, industrials, trading houses, banks and hedge funds are all involved in the market, buying additional EUAs for compliance, selling surplus allowances, or betting on where prices will go next.

There are also scores of blue-chip companies involved in this market, names such as JP Morgan, RWE, Shell and Tata Steel.

Quietly, this market is on an absolute tear

Big names might be involved, though that's not to say it's a *big* market. In fact, it's a relatively small market when compared to other markets in the energy complex.

So far this year, more than 2.5 billion EUA futures have changed hands on the main exchange, ICE Futures, which is a tiny amount compared to energy markets such as Brent crude oil.

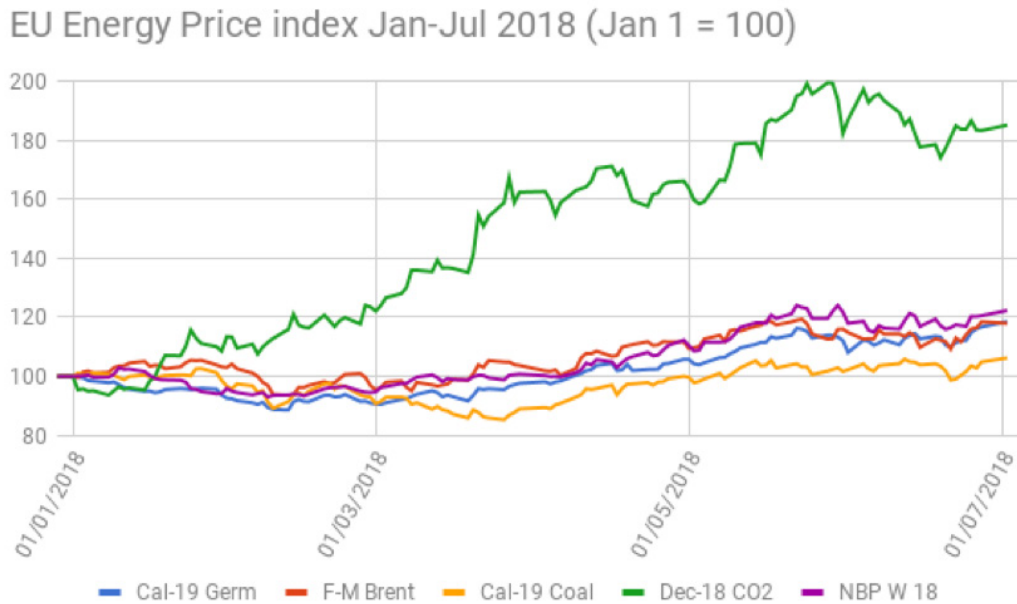
That might be one reason why you likely haven't heard much about it. Certainly, it's not a market you're likely to read much about in the business pages of your daily newspapers. In fact, the market is all but ignored by everyone apart from the few specialist news outlets that cover the market.

So I'm confident that you didn't know the following...

So far this year, EUAs are the best-performing energy commodity on the planet!

That's right. With little fuss, and with precious few column inches, EUAs have risen 109% so far this year. That's compared to a 9% rise in Brent crude oil; 19% gains in natural gas and German electricity; and a flat European coal market.

In fact, since last May EUAs have more than trebled in price, rising from a low of €4.98/mt on 31 May 2017 to a high of €17.24/mt on 20 July this year.



Source: Intercontinental Exchange

The seeds of this rise actually started a few years before, back when EUA prices were much lower.

You see, between 2011 and 2017 EUA prices were depressed, after the global financial crisis hit industrial production hard. As companies reduced operations, they emitted less CO₂. And as industrials slowed down, so did power stations, and a surplus of EUAs developed.

The problem was that there was no way to cut back the number of EUAs that were issued each year. The number was fixed by EU law, so EUAs just kept pouring into the market, even when nobody needed them.

This created a huge oversupply of allowances. At one point there were around 1.8 billion surplus EUAs sloshing around the market. Having traded at a peak of nearly €30 in 2008, prices fell to a low of €2.46/mt in April 2013.

That was a little over a year after Per Lekander called the ETS “a joke”, when he predicted – again, correctly – prices would drop below €3.

Then, Lekander was highlighting how slow the EU would be to react to this surplus. Changes to the regulations would have to be drafted, discussed, picked apart, put together again and then changed out of all recognition by experts, MEPs and member state governments. This process takes years.

So the financial crisis in effect ripped the heart out of the market. Banks closed their carbon trading desks, trading companies went bust and service providers like exchanges and auditors abandoned ship.

The problem was as obvious as the nose on your face, but the European Commission

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first ignored it, then tried some half-hearted measures to fix it, and finally admitted that proper market reform was needed.

Front-Year EUA Prices 2008-2018



Source: Intercontinental Exchange

How the market was rescued

It took politicians and regulators around three years to agree to a deal to claw back hundreds of millions of surplus allowances, but early this year, the ink finally dried on the new rules. The reform is known as the Market Stability Reserve (MSR).

From January 2019, the MSR will take out surplus EUAs from the market by cutting the number of allowances that are auctioned each year. By 2023 analysts reckon more than 1 billion EUAs will disappear into a reserve and eventually be cancelled.

That's a whole lot of EUAs coming out of the market. Fewer EUAs in circulation mean only one thing: higher prices!

Back in 2017, Lekander saw this coming. He'd been watching the political process closely, and as early as the spring of 2017 began to quietly build a long position in anticipation of the MSR being approved.

Lekander, and investors like him, were betting on the determination of the EU to do whatever it took – however slowly – to fix its creation. After all, it's not every day that a regulator invents an entirely new market and calls it a flagship policy to address climate change.

They also saw that removing the oversupply would trigger a huge price rally, and the closer the market gets to the start of the MSR, the higher prices are expected to go.

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EUA Prices 2017-2018



Source: Intercontinental Exchange

As I mentioned earlier, industrial companies don't get quite as many EUAs as they need from their annual free handout. They used to, in the early days, but the rules have been tightened and they are being given tougher carbon-cutting targets as well as fewer EUAs.

According to a recent survey of industry and utility companies in the EU ETS, 17% said they have a surplus of EUAs in their account, down from 40% a year earlier. That's a lot of buying that'll have to take place each year to ensure everyone is fully compliant.

This means that industrial companies are beginning to play a bigger role in the market, adding to the demand for EUAs.

Momentum is building for another price jump

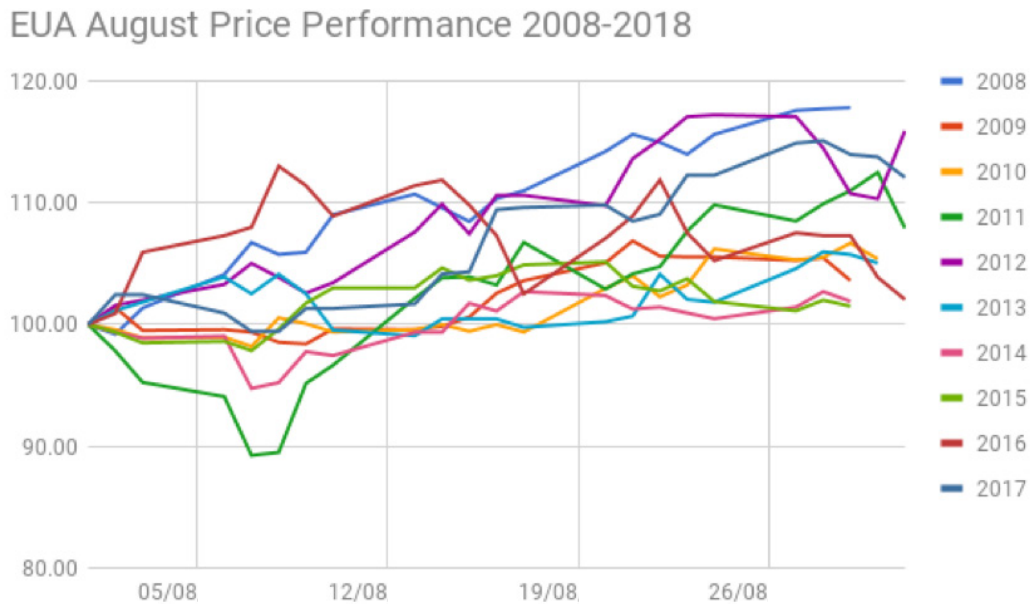
A 109% price increase by July is a good start, but there's even more upside on the cards, over both the short and long term.

Right now is a great time to buy carbon, in fact. You see, although summer is typically a quiet time in most commodity markets, the EU ETS designers mixed it up a little by cutting the daily auction volumes in half during the month of August.

They calculated that if most people are on holiday, then there should be less interest in the sales, and by cutting the supply in half, the risk of a failed auction would be reduced.

But this has had a knock-on effect on prices. In a month where you'd expect prices to drift while everyone is on holiday, prices always rise. In fact, EUA prices have risen every August since auctions began.

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Source: Intercontinental Exchange

Obviously, past performance is no indicator of future performance, and while I expect the same price rise to take place again this August, simple probability dictates that every time another August price rise occurs, we take a step closer to it *not* rising. So that's just something to be aware of.

But, in any case, the gains shouldn't stop from there. Once everyone's back from their holidays, traders are going to start looking ahead to the fourth quarter and end of the year. With winter coming, power companies will be planning for the colder weather, and industrials will be ramping back up to full production.

That means August and September are good months to get involved in the market, before the bulk of factories are back at full production and demand for EUAs ramps up.

After that, the next bullish factor on the horizon is in December, when the current main EUA futures contract (the December 2018 contract) expires and when a lot of companies take delivery of EUAs, which they need to do something with.

Most of the industrials and power companies will probably hold on to those allowances ahead of the compliance deadline early next year. So that supply is no longer available to the market.

But traders and investors will want to do something profitable, so instead of banking their profits from the December 2018 position, they'll probably buy into the December 2019 futures, hoping to ride the rally for another year. This demand for the 2019 contract will likely boost prices further.

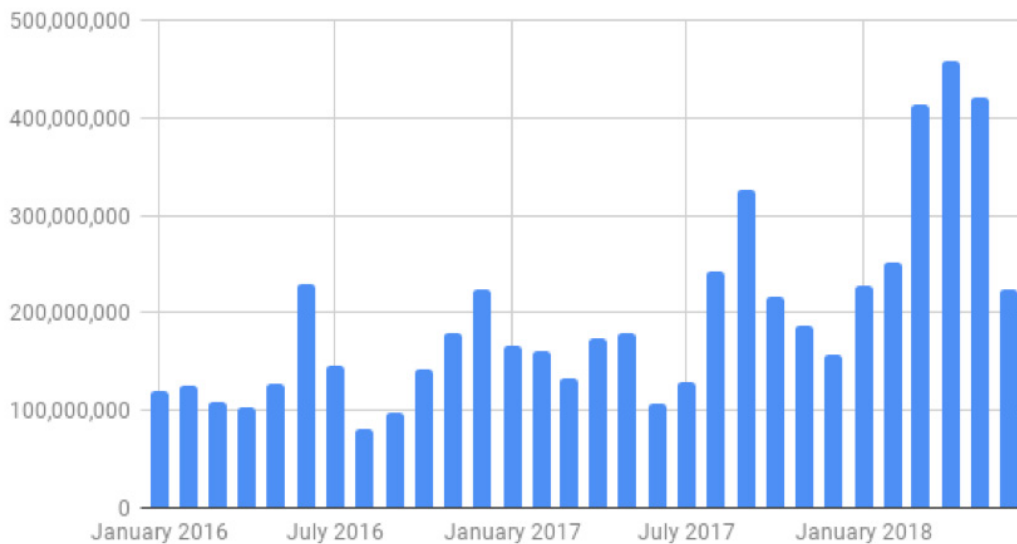
It's no wonder volumes in the market are rising. According to the London Energy Brokers' Association, the volume of EUAs handled by brokers away from the main exchanges has ballooned this year.

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Three years ago brokers handled transactions for less than 100 million EUAs a month. In the spring of this year, they were broking 400 million EUAs a month.

The rising volumes are a sure sign speculators are entering this market, expecting prices to take off.

EUA OTC Volumes 2016-2018 (mt)



Source: London Energy Brokers' Association

Heading to €100/t

They're certainly not alone in thinking that. Earlier this month, German bank Berenberg said prices could reach more than €100/t by 2020, less than two years away.

“In a market that will have a multi-year deficit, where CO2 abatement will not be sufficient to wipe out that deficit, there will be no natural EUA price that will clear the market. Hence €100/t is perfectly feasible,” it said in a research note.

The MSR would ensure the market was structurally short of the allowances needed to cover demand until 2028, it said.

The bank linked the possibility of triple-digit prices to two factors: the fines companies are obliged to pay if they fail to cover their emissions and limitations on the potential to curb those emissions.

It's easy to see why the bank is so bullish. After all, the market has materially shifted. The MSR changes the game for the market's demand/supply balance, and that's never happened before.

Prices of €25 for carbon used to be the norm, before the financial crisis, and I can well

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believe that removing the entire oversupply in this market will drive EUAs back to those levels, at the very least.

The other thing to remember is that government policies are only going in one direction. We're not likely to see Trump-style support for coal here in Europe, so targets will only continue to tighten. Even Germany is debating how to switch away from coal.

And most importantly, there's no sign yet that those hedge funds and savvy investors are cashing out.

Analysts have estimated that speculative buying this year has topped 160 million tonnes, contributing to the 109% price rise since 1 January.

If we also assume that utilities also started buying last year to get ahead of the price rise, then it's clear that the really serious players still expect prices to go up.

What are the downside risks?

The main risk is that prices have already been on a tear. A trebling in prices in 14 months is pretty extraordinary, after all, and it's possible that the hedge funds and savvy investors decide that it's time to get out.

Now that's not the same thing as saying prices are about to fall, because I don't think they will. There's still plenty of future demand from industrials, and I think the reality of the MSR starting in January will also trigger additional speculative demand.

But there is still a risk that the market has already exhausted the explosive growth, and that from now on prices will only stagnate or rise intermittently.

Another risk is that the MSR won't be able to remove the oversupply. While the MSR is calibrated to take out a portion of surplus each year, it's possible that EU emissions drop, and demand for EUAs shrinks, faster than the MSR can react.

This might happen if, for example, more industries like steel and aluminium relocate outside of the EU.

The EU is also set to review how the MSR has worked in 2021, and could easily change how many EUAs can be removed or added each year from 2023.

There is also a Brexit-related risk. The UK is seen as oversupplied with EUAs, that is, it hands out and auctions more EUAs than industry here needs. So if the UK were to quit the EU ETS – and there's a strong chance it will – then the overall market might tighten.

But equally, if UK companies are allowed to sell off their unneeded EUAs before the UK leaves, that could flood the market and depress prices.

Remember, too, that the EU ETS is a totally artificial market. It's created by law, which means that it's particularly vulnerable to changes in regulations and to political interference. I've often seen prices move really sharply while regulators are meeting in

Brussels, or after an MEP sends a tweet about what's been decided.

There's always a risk that the regulator, the European Commission, decides to intervene in the market again, as it did when it created the MSR. It's hard to see how the Commission would do something that undermines the market, but you can't rule anything out.

How to get a piece of the action

The EU has in the past allowed individuals to open accounts and buy EUAs, but rules have been tightened after a spate of VAT fraud earlier in the decade, and it's not so easy any more.

Instead, you can use spread bet EUAs at certain spread betting sites that make a market in EUAs. The spread is usually 6-7 euro cents, so the market has to move at least ten cents to make any trade worthwhile. Spread bets are also extremely risky, and you can be wiped out entirely if the position moves against you.

So for me the easiest and best way to play the ETS market is to invest in an exchange-traded fund (ETF) that tracks the prices in the main ETS contract, giving you exposure to the total EUA price.

[ETFs Oil Securities Limited](#) offers two such ETFs, one denominated in euros (CARB LN), which is the same currency as the main ETS contract, and one in sterling (CARP LN), which is priced by multiplying the euro product by the FX rate of the day.

This means that for CARP LN, the performance reflects the performance of the underlying contract plus the EUR/GBP currency pair over the same period.

I'm going to recommend purchasing the euro-denominated ETF (CARB LN) to fully reflect the currency of the underlying contract, although you may want to purchase the GBP product instead.

Both are available to buy from all the major brokers in the UK.

Another thing: the prices in the ETFs don't match exactly the underlying carbon contract (as they were launched at an arbitrary price) but they are directly correlated, behaving in exactly the same way.

For both funds, the fund prospectus recommends you invest for five years, which would take you to 2023 and the last year of the really big MSR withdrawals, so the timing is pretty much perfect.

Obviously any investment into a commodity like carbon is going to be risky, but having been on the inside of this market and chatted with traders for around seven years, I've never seen the same degree of confidence in the price direction.

For sure, from day to day there are reverses, but the trend is most definitely your friend.

Action to take: BUY ETFS OIL SECURITIES CARBON EUROPE (EUR) (LSE:CARB)



Currency: EUR

Price: 08/11/2019: €17.42

52-week high/low: €21.00/€12.96

NAV: 07/11/2019: €17.40

Until next time,

James Allen

Editor, Exponential Energy Fortunes