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Weathering Decarbonization | Episode 2
Mark Lewis, Partner and Managing Director, Climate Finance Partners LLC

On our second installment of *Weathering Decarbonization*, we welcome Mark Lewis back into the SmarterMarkets™ studio. Mark is Partner and Managing Director at Climate Finance Partners LLC.

David Greely sat down with Mark to discuss where the rubber is hitting the road in the EU-ETS, the impact on market participants and pricing dynamics, and what the future may hold as we move into compliance markets 2.0.

Mark re-joined us Friday night to add his key takeaways from a turbulent week in the EU-ETS to this episode, which you can also read on his blog at climatemarketnow.com.

Mark Lewis (00s):
It's the whole point of having a market and of having a smart market to come back to the title of our conversation here. This is how you get Smarter Markets. You allow for the integration of markets globally so that the price discovery mechanism is unleashed globally across the widest possible sway of emission.

Announcer (18s):
Welcome to SmarterMarkets, a weekly podcast featuring the icons and entrepreneurs of technology, commodities, and finance ranting on the inadequacies of our systems and riffing on ideas for how to solve them. Together we examine the questions: are we facing a crisis of information or a crisis of trust, and will building Smarter Markets be the antidote?
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David Greely (01m 07s):
Welcome back to Weathering Decarbonization on SmarterMarkets. I am Dave Greely, Chief Economist at Abaxx Technologies. Our guest today is Mark Lewis, Partner and Managing Director at Climate Finance Partners. We will be discussing where the rubber is hitting the road in the EU ETS, the impact on market participants and pricing dynamics, and what the future may hold as we move into compliance markets 2.0. Hello Mark. Welcome back to SmarterMarkets.

Mark Lewis (01m 37s):
Hi Dave. It's great to be back. Looking forward to another great conversation.

David Greely (01m 41s):
Oh, me too, me too and since last year when you were here, you have taken on a new role at Climate Finance Partners. So I was hoping we could start off, you could just catch us up a little bit. Tell us a little bit about Climate Finance Partners and what you are doing now.

Mark Lewis (01m 58s):
Sure. Well, I quit my old job at Andurand Capital. I felt I wanted some time off and spent the summer actually starting to write a book on Shakespeare and climate change. So hopefully that will be in all good bookshops later this year and had this great opportunity to join Climate Finance Partners, as you said, which is a fund management come boutique carbon consultancy and advisory service. We are sub-advisors to KraneShares on their carbon ETFs and we are also in the process of hopefully launching a carbon dedicated carbon compliance allowance fund later this year. So just felt it was the right time to launch a compliance dedicated compliance allowance fund. Yeah, so very excited about that.

David Greely (02m 57s):
Well, that's great and speaking of timing, the last time you were here with us, you emphasized that in terms of the EU ETS, you know, that we were over halfway through the lifetime of the EU ETS carbon market and that the rubber was about to hit the road in a big way

with industrials moving to that margin for price formation. Whereas traditionally it had always been utilities that drove price formation under that system. And I was curious, looking back over the past year, has the rubber in fact hit the road and what have been the results?

Mark Lewis (03m 34s):
Yeah, well, I mean absolutely. And you are right to hold me to what I said last time. So I like a great believer in continuity and revisiting what, what's been said before. I think I would answer your question with a qualified yes in that the rubber is in the process of hitting the road. What I mean by that is first of all, look at the price evolution of European carbon allowances in 2025. Okay. Prices were fairly volatile over the course of the year, but we ended the year 16% higher than we began it. We closed at €87.50 having started the year around €75 and I guess at the beginning of the year in January 25, we will come to January '26 in a minute because we have had a lot of volatility here as well. But January '25 we saw prices take quite a big step up.

Mark Lewis (04m 30s):
We went from kind of €75 at the beginning of January to €84 by the end, and I think that was based on a lot of expectation that the rubber was really starting to hit the road. What do we mean by that? What does everybody in the market mean by that? When we say that, what we really mean is that the market is looking down the barrel of five years, five consecutive years of annual deficits. That is to say the supply of allowances to the market will be lower than the demand for allowances. So you will have these consecutive annual deficits that will lead to a reduction in the accumulated inventory that has built up over the last 17 years. Remember, there is still a billion tons worth of EUAs out there, the so-called Teaneck, the total number of allowances in circulation to use the jargon. But in any other commodity market that Teaneck really equates to inventory.

Mark Lewis (05m 25s):
It's what has so far proved surplus to compliance requirements. But remember, as the cap starts to decline aggressively over the next decade and a half, that inventory will fall and it starts falling when you get annual deficits. And we are looking at consecutive annual deficits going forward. So that was the story of let's say the first quarter of last year. Then prices went into a bit of a lull and we really started to see prices come back over the fourth quarter of last year where we went from around €60 a ton in late July, early August to finish the year at €87 a ton. Now was that the rubber hitting the road, starting to hit the road? I think in a sense it was more a question of speculators front running, what they see as the coming industrial demand, right? Because net speculative length in this market increased very dramatically over the final four months of the year.

Mark Lewis (06m 33s):
We went from speculative investment funds holding a net position of 20 million tons long in early August to an all-time high by the end of the year of 120 million tons. Now, why did they build up that length? Because the reason they did that was because they are looking at their spreadsheets, they are looking at the forecasts of all the different brokers and service vendors who crunch the numbers on this market and they are seeing this barrel of down this barrel, as I said earlier, of consecutive annual deficits. So that net length built up in the expectation that industrials were going to have to start hedging more aggressively. So in a way, that's why I say I would give a qualified yes to your question. The rubber hit the road in the speculators sensed something dramatic was about to happen and built up this length. As a result, prices went up and that's how this year began.

Mark Lewis (07m 33s):
I will just finish by saying bringing your audience up to date on where we are right now, and then we can get into some of the more dramatic developments we have had already, even though this year is only six weeks old, it's been a dramatic start to the year, but through the middle of January this year, net length and prices continued to rise. Okay and middle of January, we were back at €93. I think the high for the year so far was €93.80. That's the highest price we have seen in this market for two and a half years, since August '23, I think and so that's a sense that the market is smelling the rubber beginning to burn and we can put it that way, but it's not yet. I have to say, and this is why I can't give a definitive yes answer to your question.

Mark Lewis (08m 24s):
I don't think it's yet fair to say that it's the industrials that have been driving the prices. It's really been speculators that have been front running in expectation of industrials stepping in and so just to complete the answer, what has been happening in the first six weeks of the year? Well, we hit that level of €93.80 in mid-January and then right after that, President Trump came out the tariffs on European in connection with the controversy over Greenland and as soon as that happened over the course of a weekend and so on the Monday and Tuesday immediately following the Trump tariff threat, which was coincidentally the weekend before the Davos conference prices

came off quite dramatically. EUA prices fell 10% in the first day and a half following President Trump's comments about a potential tariff over Greenland and then it recovered somewhat. So we went down to €83 I think, and then back to €88 by the end of the week, bit of a rollercoaster.

Mark Lewis (09m 31s):
Then we have had further geopolitical nervousness over the Middle East and we have also over Iran in particular, and gas prices increasing. So we have had quite a few bumps along the road over the last three weeks. So life has got a lot bumpier in the last three weeks and prices have come back down to trading right now around €81.50 as we hold this conversation. But we got as low as €77 last week. So all you are seeing there is some of the, to come back to the, the rubber hitting the road analogy, some of the air coming out of the tires, you know, and, and what that is the speculators reducing their net length. And there's also been one other thing to throw into the mix, which we can get into in greater detail because this is structurally very important, is at the end of last week there was some concern being expressed in Brussels about the pressure on industrial companies that higher carbon prices will have.

Mark Lewis (10m 32s):
Of course, we are living in a very different world, even only, even though it's only one year since our last conversation, you know, president Trump's back in the White House, lots of talk around de-globalization, supply chains, industrial competitiveness. This is even more of a hot issue than it was already a year ago. So some concerns in the market, I think around the question as to whether or not the EU will dilute somewhat the trajectory for the cap, but not before 2030. That will happen really post 2030. So you throw all of that into the mix. It's been a very interesting last three or four months and a very interesting start to the year in particular. But I get the sense the market having suffered these shocks is now kind of back to some kind of equilibrium for the time.

David Greely (11m 23s):
Thank you for that Mark. You know, you have given us so many great threads that I want to pull on in the remainder of the conversation. But first I do want to note for our listeners that Mark and I originally sat down on Monday of this week to record this conversation and a whole lot happened over the course of the week, both in the United States and Europe. Mark was good enough to come back and sit down with us on Friday and give us his most up-to-date thoughts on what everything happening this week meant. So let me turn back to you, Mark. Thank you, and can you put this week together for us?

Mark Lewis (11m 59s):
Thanks very much Dave and appreciate the opportunity to come back on Friday 5:30 European time. As we are recording this segment now, we have literally just had the settlement of this week's closing price. We are closing at, or we are settling at €70.68. Now that compares with the settle on Monday evening. When we recorded the rest of this show, originally of €81.35, we have dropped €11 nearly, which is to say we have dropped 13.5% in four days. That's Tuesday through Friday, right? So what has happened, what has happened is quite simply there have been a number of high profile interventions by European policymakers, by which I mean a very senior European parliamentarian, Peter Liese, who until quite recently was the leading figure in the European Parliament responsible for channeling the, the legislation on the EU ETS through the European Parliament. He made a significant intervention on Tuesday and then on Wednesday the German Chancellor Friedrich Merz made an intervention and both of these inter interventions scared the horses basically.

Mark Lewis (13m 18s):
So what were the interventions and what does it all mean? Because I think that's ultimately what your listeners are interested in, right? Well, on Tuesday, Peter Liese said that, well the common thread in both of them, first of all is the issue of free allocations and we recorded a big segment on this obviously in the rest of the episode that your listeners will hear later on. But there is an emerging consensus very clearly that European industry needs more time to adapt to the phase out of free allowances. So both Peter Liese on Tuesday and Friedrich Merz on Wednesday voiced their concern about protecting European industry competitiveness. Industrial competitiveness is obviously probably the number one issue right now in European politics across the entire block and therefore industry has been lobbying very hard in Brussels for more time in terms of the phase out of free allowances so both of them emphasize that.

Mark Lewis (14m 15s):
Now, in and of itself, that's not a big deal I don't think for prices because that doesn't affect the supply demand balance, right? All that effect is how the total number of allowances under the cap are distributed. However, what Peter Liese also said on Tuesday was that we are probably going to have to revisit the rate at which the cap declines in the future currently as, as everyone knows from 2028. So

currently the cap is declining at 4.3% and from 2028 that will increase to 4.4% a year and that gets you to zero by 2039 as we discussed and your listeners will hear on the rest of the show. But what Peter Liese said was, we may have to revisit that and 3.4%, which is a lower linear reduction factor obviously, and therefore it takes longer for the cap to fall to zero would be a more appropriate number.

Mark Lewis (15m 15s):
Now actually when you sit down and work through the numbers, it doesn't make a huge difference and certainly not in the near term. So we have written two blog pieces, special blog pieces this week in response to Liese's intervention and now intervention. So what I am about to say, you can find and digest in more detail at climatemarketnow.com where we publish our regular updates on the European and other compliance markets globally and crunching the numbers. If you move to a 3.4% linear reduction factor from the current 4.4%, all it means is most of the impact. In other words, the increase in the cap that you would get relative to where the cap is in the current legislation the extra, most of the extra volume would be available only from 2036 onwards. So if you assume that the cap starts falling at only 3.4% rather than 4.4% from 2031 then the total increase in the cap relative to the current legislation is 930 million or thereabouts.

Mark Lewis (16m 25s):
And of that number two thirds of that increase comes through from 2036 onwards and instead of falling to zero in 2039, the cap would fall to zero in 2042. So it's a three year extension, it's not a massive deal in the grand scheme of things. Okay? So I think the Liese intervention in and of itself, whilst it led to the market dropping, was not a huge bombshell. This has been discussed in Brussels for the last two or three months. The market news that there were rumblings to the effect that later in the year when we get the actual ETS review the linear reduction factor could and probably would be reduced from the current 4.4%. So the market took that, I wouldn't say it took it in its stride, but after dropping on the news hitting the tape, it came back, the real hammer blow was delivered on Wednesday by Friedrich Merz and his voice obviously carries more weight than probably anybody's in the European Union because he is the Chancellor of the government of the most important industrial country in the EU, the biggest economic power in Europe and the largest emitter of CO_2 in the EU ETS. Now what Merz was very confusing, and again we have deconstructed his intervention on our blog climatemarketnow.com and our take was that he had made a confusing intervention because he talked about possibly postponing the ETS as we have done with the ETS 2. Now again for the benefit of, of our listeners here, the ETS 2 remember is a new compliance scheme which was originally meant to come into force in 2027 and was postponed in December and will not now enter into force until 2028. But when you have Merz saying we might have to postpone the EU ETS 1, people get very jumpy, right?

Mark Lewis (18m 33s):
The market dropped 8% yesterday on Merz's intervention and by the end of the day he was having to row back or at least clarify what he had said and what he said was, it's not about postponing the EU ETS per se but rather postponing the phase out of free allowances. Which again to me is not the main point at issue here. It's really the cap that is, is the driver of the supply demand balance. So all of that to say in the last four days since we did the original recording here, the market has come a very long way. We have dropped €11 euros, 13.5% in four days and there is a reassessment going on, there is a recalibration going on and there seems to be, and there is no doubt about it, a concerted effort amongst the European policymaking elite to talk down the price of carbon in the short term until we can have the formal review of the EU ETS, which was al has already been programmed for a long time to take place in Q3 of this year.

Mark Lewis (19m 39s):
My take at the end of this very turbulent week and we have seen many turbulent weeks over the last 20 years in the history of this market. But this one is taking place in the context as you suggested in your opening remark there, Dave, of a changed global geopolitical environment, right, where we have President Trump a disruptive presence to Europe's policymaking agenda. No doubt and as a result, I view the events of this week as really a short term stock gap whereby European policy makers talk down the price in the short term by themselves time for the EU ETS review in Q3 and we end up probably with two things, a lower a linear reduction factor. In other words, the cap will increase between 2031 and beyond and will now fall to zero probably in 2042 or 2043 depending on when the change in the LRF takes place from whether it's 2031 or even 2029, Liese was suggesting might be possible as well.

Mark Lewis (20m 47s):
Doesn't make a massive difference. That's the first thing and secondly, a phase out of free allowances that will take longer to happen and at the margin, I mean I say it doesn't affect prices because it doesn't change the supply demand balance, it simply changes the way in which allowances are allocated. However, in terms of industry's incentives for reducing emissions behaviorally, it means if you extend free allocation, there is less need for industry to step into the market and hedge their future liabilities. So those are the key takeaways from what's been a very turbulent week and I think we'll end up also one final comment because the commission itself

obviously, and we have to view this in terms of the EU ETS being up and running for 20 years, is one of the European Union's major, major policy achievements. I always say to people, there is only one price that is homogenous across the entire European Union and that is the price of carbon emissions.

Mark Lewis (21m 50s):
There's no other price across Europe. There is the same in every single country, but that price is so this is a real achievement. It's driven down emissions and that should never be forgotten. The Commission will certainly be reminding people in Q3 that that needs to be remembered. And so I think what they will do is tie the phase out of the longer term, phase out of free allowances and the more generous timeframe to commitments on the part of industry. Hey, if we are going to give you free allowances for longer, you have to commit to investing in low carbon technology into decarbonizing your industrial manufacturing processes. So those are the big takeaways from this turbulent week and I think we're all glad that it's the weekend now.

David Greely (22m 40s):
And I am glad that you were able to make time to come back with us, Mark and bring us up to speed on those key takeaways from a turbulent week. I really appreciate that. So our listeners have your most up-to-date assessments of the markets and you know, thinking back to where we started this conversation, I think one thing that definitely has held up is that it's difficult to tell when the rubber will really hit the road when the regulators are able to lower the height of the road. But that said, I would love to get back to where we were recording our conversation on Monday because so many great threads there to pull on so many long-term developments that will be tracking that. You know, I think the events of this week to give a little bit more context to why what we were talking about is so important. So thanks Mark and we will get back to the previously recorded conversation. You had brought up these inventories of allowances that are out there and I am curious, following on to your conversation about speculators, I am curious where, who holds those allowances? Have these been held by the utilities or the industrials in preparation or our investors sitting on these and other financial market participants? I am just curious about where those sit.

Mark Lewis (23m 54s):
That is a really great question. I would say it would be a very, very laborious and difficult exercise to go through and check. I think in theory you probably could because you could look at the historical allocation of allowances to industry and look at how much industry has actually had to, how many allowances industry has had to hand over the last 17 years since 2008 this scheme has been running but overall I would say this my kind of sense that the majority of those allowances is indeed held by industry. I would say certainly over 50%, probably something approaching 70% of that roughly 1 billion tons is held by industry. By which I mean you know, the steel industry, the cement industry, oil refiners, cement, glass, pop and paper utilities will be a much smaller number because utilities were never over allocated in the first place. They have always had to purchase their allowances on the open market.

Mark Lewis (24m 54s):
But nonetheless, some of them certainly will still have surpluses because in particular the larger utilities that have both coal and gas power plants and which choose to run either coal or gas as a function of the carbon price and sometimes as has happened over the last year, gas prices in Europe came down and at the end of last year, certainly gas was very much in the money cheaper than coal and if you had contracted to sell coal fired generation, you would have bought more allowances than you needed, right and they won't necessarily have sold all those allowances straight away on the market. They can hold them for their own trading purposes or because they themselves think, hey allowances are going to go up. They have got better information than anybody. It's like who's got the best information on the oil market? Well the oil companies, funnily enough, so they have their own trading departments and they are very savvy in terms of both long-term structural setup but also month to month and even day to day trading activities and then finally of course speculators do hold some of it. But I would say that's a very small amount because most of the speculators don't have physical registry accounts. Most speculators trade only on the futures market. They're trading paper futures, not physical allowances. So yeah, I would say probably 70% is industry, 20% maybe utilities and 10% other actors investment funds, commercial banks may be holding as a proxy for industry and so on.

David Greely (26m 34s):
Do you feel like industry and industrials are starting to feel the pinch of this yet or not quite?

Mark Lewis (26m 41s):
Some of them are certainly of, I think there is two dynamics in play and this is where also the politics starts to get very important again. So the two dynamics in play, remember very simple. First of all, the cap is declining, which means the overall pie if you like, the pie of

allowances is shrinking, it's getting smaller every year and then at the same time the number of allowances that are being allocated free of charge to industry is also declining. So the pie is declining and the amount of the pie that you are getting free of charge is also declining right now if your industry, that means you are getting fewer allowances every year, which means there is probably now for the first time for a lot of these companies a shortfall versus what they need to meet their compliance requirements. So they have to go into the market and start buying or they can still use probably some of the allowances they have accumulated over the years that form part of the TAC that we were just talking about.

Mark Lewis (27m 42s):
They can take those off the balance sheet and use those for compliance and it will be for each company to decide what the optimal strategy is for that particular activity. But those are the two key dynamics that will force industry over the second half of this decade between now and 2030 to become more actively engaged in the market. And that's why of course, to come back to our original where we started this conversation, that's why speculators have been pushing prices up in advance of that because they think there is going to be a big change in the behavioral psychology of industry.

David Greely (28m 19s):
Yeah and in terms of the impact of that on pricing dynamics, and I realize probably too soon to tell, but kind of curious when you think about what factors prices will be more responsive to in the future when it was very much about the power sector, imagine like often gas, coal prices spreads or strong drivers. Sounds like as you get more industrials it's more kind of the overall economy trump tariffs, how are you thinking about how the pricing dynamics may evolve?

Mark Lewis (28m 53s):
Right, so I mean in theory what we should see is like any market, the price is a function of where supply meets marginal demand, right and so we are looking now instead of, as you rightly said, Dave, instead of the so-called fuel switching price in the power sector, which you rightly identified as having been the main driver of prices really ever since this market came into being in 2005 to the marginal cost of abatement in industry and the whole point of having an emissions market as opposed to a carbon tax is that from an economic efficiency point of view, allowing the market to discover the lowest price that clears the market, that's the whole point of having a carbon trading market. Now nobody really knows yet what the marginal cost of abatement for the steel sector is or for the cement sector or for oil refining and so on.

Mark Lewis (29m 52s):
But I think what everybody is assuming is that it's significantly higher than where carbon prices are trading at the moment. So, and this by the way, it's a great question to ask because this also explains why there is growing political nervousness around the risk of much higher prices on a 1, 2, 3 year view, right? Because if for sake of argument, we just allow the market to continue price discovery until we get a clear signal that this is where abatement is happening. Say the steel sector can achieve significant decarbonization reduction in emissions at a carbon price of €150 a ton, just for sake of argument, then that would be the price towards which we would gravitate and you get a chunk of decarbonization happening at that level and until the cap declines so much that then other sectors have to start abating more aggressively. And you do this progressively until the market clears.

Mark Lewis (31m 00s):
I think however, there have been a number of assessments projections, let's say pricing projections by market analysts suggesting that prices could, could go to €150 or even higher on a three to five year view that have made some people in Brussels very nervous, particularly as we also now have this, as we mentioned, free allowance is declining because we have also had the introduction of the carbon border adjustment mechanism, so-called CBAM from January this year. That's a slow start, slow burn. But that becomes progressively more important and that is why pre allowances are being phased out because companies outside Europe, exporting into Europe who are under the scope of CBAM will have to start paying the same carbon price as European producers. Now you put all of that together, there are a lot of industrial companies in Europe who are lobbying very hard in Brussels for either an extension of the period of free allowances so that they continue to receive free allowances or for a change in the trajectory of the cap.

Mark Lewis (32m 09s):
And we can come back and revisit all of these points because they are super important and some member state governments who are also arguing for that. And of course the other variable in all this, which plays to the point around the convergence between compliance markets and not so much voluntary markets, but the offset market is the other thing Europe could do to soften the blow on industry is allow offsets into the EU ETS. Again, none of this is going to happen before 2030, but between 2030 and 2040 they could allow so-called

Article 6 credits under the Paris agreement into the scheme to soften the blow. Now you know, those are all different ways in which industries exposure to higher carbon prices could be reduced and I think all three of those issues are being debated hard behind closed doors in Brussels at the moment because we have the so-called EU ETS review coming up in the third quarter of this year now, but the EU ETS review is really all about fixing the rules beyond 2030, not about changing the rules between now and 2030, but all of this culminated last week.

Mark Lewis (33m 19s):
I mentioned the price volatility already that we have seen since the beginning of the year and last week was a particularly volatile week because there were news reports from a German newspaper handles black and then Bloomberg on Thursday reporting that the EU was looking at some of these either perhaps reducing the linear reduction factor. Remember at the moment the cap reduces at 4.3% per year and then from 2027 at 4.4% per year, which means the cap force to zero by 2040 is very clear that that will no longer be what happens. The cap will be extended beyond 2040 because there is nobody, I think in the whole of Europe who thinks that European industry can physically decarbonize to zero by 2040 unless you want to shut down the whole of European industry.

David Greely (34m 06s):
It's a fascinating problem. This is why we call it price discovery, right, in that the billion dollar question is as the price moves up, what will be the margin of adjustment? Will it be industry, find a lower carbon process that can make the adjustment and that'll become some technology will become profitable, will it go all the way to the extreme of shutting down the European steel industry which no one wants? And so in the interim, will then voluntary carbon market credits be allowed, will CBAM make sure that it's not just European steel being shut down so that steel's produced in in another country? So I would love to come back to some of those points, but I wanted to ask you first, are you seeing a change in how like the, the, the market participants are managing their risks given no one really knows where the price is going to go right now?>

Mark Lewis (34m 59s):
Right, well I would say look, it varies from industry to industry and it varies I guess also from large sized companies to smaller sized companies. You know, there are lots of, this is a very unequal market by nature, right? You know, so if we talk about the power sector first, the power sector has been very simple from the beginning because the thing about the power market is you don't face competition from outside Europe or there's hardly any electricity. You have got the link between the interconnector between the UK and the EU and the interconnector between some, some far eastern European and Balkan countries that are not part of the EU. But to all intents and purposes, the EU consumes all of its own electricity, which means you don't have to worry about competition from outside. Which means European utilities who have had to pay for all of their allowances ever since 2008 just passed through the cost of the consumer.

Mark Lewis (35m 57s):
And so what you get with electricity is the full allocative efficiency of carbon. In other words, the consumer is being incentivized to switch to cheaper forms of electricity, less carbon intensive forms of electricity. So as far as they are concerned, there is no change in behavior and no change in lobbying. The power sector is decarbonizing anyway. You don't need a carbon price anymore really to incentivize the decarbonization of the power sector because the cheapest forms of new electricity generation are solar and wind anyway. And that's what's happening. So that will continue for the other sectors in terms of changing behavior and what is going on there, I think there is a number of points to be made. And the first is, and this worries me quite a lot, I totally understand why there is a lot of concern around high prices and the impact of industrial on Europe's industrial competitiveness.

Mark Lewis (36m 53s):
But if you start tinkering with the rules and saying, well we need to give more free location to these extend free allocation for longer to these sectors or to these companies because they are particularly at risk, I think you introduce an element of moral hazard into the market because for the last, ever since 2008, the broad set of rules for this market has been fixed and certainly since 2021 it has been very clear according to the legislation, the current legislation that free allowances were going to be phased out. So if you extend free allowances, there is an argument that you are penalizing the companies that have been playing by the rules, right? The ones that have been preparing for the phase out of free allowances and saying, well this is coming, we need to be responsible and start making investments in lower carbon intensive production equipment. I have sympathy of course for European industry in an environment of high energy prices because of all the geopolitical stuff with Russia, Ukraine, and the gas and all the rest of it.

Mark Lewis (38m 02s):
On the other hand, I think, you know, we have to be honest and say that large parts of European industry have had a long time to prepare for this changing environment. They have been given free allowances for a very long time and they should have been using that time to prepare for the era of decarbonization. So I think the European commission and the European Union more broadly have to tread very carefully here. Yes, industrial competitiveness is a bigger issue than it was even a year ago and certainly than it was five years ago before we had the explosion in European gas prices. But Europe needs to maintain the integrity of its carbon market and above all it needs to maintain the incentives for decarbonization that carbon pricing provides and I think if you start changing the rules now too radically and on too much of an ad hoc basis subject to what pressure you are getting on any given day, any given month from a particular industry, ironically you risk deferring investment in decarbonization such that five years from now we have to go through that process again and people say again, well we can always get the EU to soften its targets if we lobby hard enough. So this is a very delicate balance that they have to strike here. And obviously that's what the market is focused on and that's why we have had this volatility in prices over the last two to three weeks because of this flurry of stories around the lobbying that is happening.

David Greely (39m 38s):
Right, which I think naturally brings me to a topic I wanted to ask you about, which is Davos. I saw you were recently there. You have got government leaders, policy makers, business leaders, kind of all gathering and I was curious, what's the temperature on changing the rules or sticking to the rules and what broadly was the conversation there concerning these markets?

Mark Lewis (40m 03s):
Yeah, well we had some great conversations with investors in Davos. A lot of interest still in compliance carbon markets, but undoubtedly a lot of concern over Europe's place in the world. Not just in terms of energy costs and industrial competitiveness, but the broader question of Europe's geopolitical alliances and standing in the world and the point I have made consistently over the years, whenever there have been these slings and arrows of outrageous fortune as Hamler calls them, the changing events, the vagaries of politics, the one thing that Europe is renowned for globally is its climate diplomacy. It's really been the leader in developing tools to fight climate change and I think globally that has been its preeminent diplomatic achievement. So that is not to be underestimated and we shouldn't overestimate either the extent to which the current US administration marks a permanent shift in even the United States attitude towards climate change.

Mark Lewis (41m 17s):
We know that we are under an administration at the moment in President Trump that is particularly hostile to the idea that climate change is even happening. That doesn't mean that the US is now forever on a path of saying, you know, we don't think climate change is real and we are going to discourage carbon pricing and put tariffs on and so on. So we have to keep the faith, Europe has to keep the faith and I think that is a message that certainly we were trying to convey in Davos and in a way there is an argument for saying that the European carbon market had got ahead of itself. I mean I mentioned this idea of speculators front running, the industrial buying and hedging. And I think prices had run up very aggressively from what I said, €60 euros late July, early August to €93 Euros only five months later in the middle of middle of January.

Mark Lewis (42m 11s):
You know, that's a 50% increase in only four and a half months, five months. That's not helpful really when there is political pressure on pricing, you know, so a more orderly increase in prices is really what ideally you would want to see. So I think Davos, there was a sense that this still matters. Europe should still be flying the flag for dealing with climate change and the other things to say is the United States is not the only superpower in the world anymore and China is taking climate change extremely seriously, is the world's number one renewable energy superpower by a mile and that will only increase going forward and is constructively engaging on the Paris Agreement and on this. And China has tremendous leadership, obviously geopolitically in a large part of the world, in the global south in Asia and so on. So it's easy to feel down if you are in climate change and carbon markets at the moment. But we have been here before, we've weathered storms, political storms like this before, and I think you have to keep your eyes on the horizon because climate change is not going away. But in Davos, you know, climate change was not the focus that it has been in some of these WEF conferences in previous years for obvious reasons. But the threat of climate change certainly has not gone away. It's accelerating, it's getting worse, and we should be continuing to keep a focus on carbon pricing as the preeminent tool to fight it.

David Greely (43m 55s):
And in terms of that preeminent tool, I have heard you remark recently that we are moving into compliance markets 2.0 and I wanted to ask you what do you mean by that?

Mark Lewis (44m 06s):
Well, particularly what I really mean is, is actually what we have already been discussing, that the period where you move away from just the power sector setting the price, and you really allow price discovery to impact all these other price discovery to be unleashed in all the other key emitting industries. And Europe is further advanced than some of the other jurisdictions that have carbon pricing regimes in terms of that evolution. And I think on an 18 month, 24 month period, a horizon, that is exactly what we are going to see. So that's really, really what I meant by it and if you look at California, even California, you start to see annual deficits on the modeling that most forecasters have for the California carbon market. That that market is going into consecutive annual deficits from next year and this will start having an impact on exactly the same argument, the accumulated balance of, of allowances, the bank of allowances that has so far accrued, which is around 370 million tons that that will start falling over time. So there, and, and Washington, Washington state is already in carbon markets 2.0 land because they already have an accumulated deficit, which is why the price by US standards is much higher than any others. Almost at the level of European prices. I mean, you know, around $75 a ton. So those four markets, EU, UK, Washington, California, are heading into that 2.0 zone where the rubber famously hits the road. And we have to see price discovery across a whole range of industries that have not yet been subject to the price discovery process.

David Greely (46m 12s):
Another area where the rubber's hitting the road that brought up a little bit earlier is the much, much discussed EU carbon border adjustment mechanism or CBAM, you know, it's really moved from what was a reporting exercise to more of a reality just starting January 1st of this year. So it's early days, but wanted to get your thoughts on how's it going so far and is it playing out as intended?

Mark Lewis (46m 42s):
Yeah, I mean, this was always going to be a very technically complicated thing to implement, right? Already, even before 1st of January and bear in mind the, the legislation on this was passed to three years ago. The closer we have got to the actual implementation, the more there has been fine tuning and issues discovered and so on. So last year, about a year ago, we already had a significant tweak in taking out a number of small, the threshold for inclusion in CBAM was raised so that really small importers were not affected by it. So you are really trying to focus on the big industrial importers of goods from outside the European Union. So that was a smart thing to do. But I would say the one kind of serious glitch we've had so far is, which was only last month, few weeks ago, the European Commission allowing for a temporary suspension of CBAM rules on the fertilizer sector. Now, the fertilizer sector is obviously extremely politically sensitive because fertilizer has a big impact on food prices, right and so I think that was the logic behind that. When we are already in an era of high food prices, this is why inflation in so many countries has been stubbornly high. And I think there was a concern that if you introduce CBAM for fertilizer imports from day one, that will only contribute to a worsening short-term worsening of inflation in the, in the food sector at a time when consumers in Europe are already struggling with high prices. So clearly again, you, you have this question of moral hazard. If you exempt one sector from CBAM, isn't there a risk then that other sectors will engage in special pleading? And now for the time being, my latest understanding of events at the moment is that fertilizer exemption is temporary and it will be included sooner or later, but we don't have a fixed date on, and there is no other sector at the moment where an exemption is planned or imminent, but nonetheless, there has been a precedent set.

Mark Lewis (48m 31s):
So these glitches are, I think, normal when you introduce something as comprehensive and technically complicated as putting a price on all goods that meet that have an embedded level of carbon in them and so far, I think other than the fertilizer thing, there haven't been any major issues reported, but clearly the bigger pressure is around this question of free allowances and whether or not there is an extension of free allowances and therefore that would entail by definition a change in the timeline for phasing out free allowances, which is the flip side to CBAM. So any extension of free allowances will mean that CBAM is not fully implemented for longer because just to remind the audience, I mean CBAM was introduced on the 1st January. If a 100% of the policy was implemented from day one, what it would mean was that there were no more free allowances handed out to European companies and at the same time, all imports from outside Europe in the sectors covered by CBAM would pay 100% equivalent carbon price to that being paid by the Europeans. Instead, what we have gone for is a classic European compromise where free allowances, and therefore the carbon price for imports is only progressively introduced. So free allowances will not be reduced to zero until 2034 under the current legislation. Right, so that's nine years away, and this year it's only two and a half percent is a very, very, very soft start and then I think we get up to 10% next year and then it increases over time such that by 2034 importers of goods from outside European Union are paying 100% of the carbon price and no European company is receiving any free allowances at all. We will see if that, that's where we end up because as we have mentioned throughout our conversation, there is a lot of lobbying going on at the moment, and it may well be that some sectors at least receive free allowances for longer or that there are other ways found to provide free allowances to industry.

Mark Lewis (51m 13s):
This was mentioned in a Bloomberg story last week, which caused a drop in the price because there is a so-called buffer of allowances being held back by the EU under the EU ETS directive, the so-called CSCF buffer, Cross-Sectoral Correction Factor. We don't need to go into the ins and outs of that is exceedingly technical, but there is 380 million tons worth of allowances that have been held back. Now those allowances are coming to market one way or the other, so it shouldn't really be too much of an issue for the market. It caused a drop in the price on Thursday when the Bloomberg story came out because I think some people interpreted it to mean, oh, these 370 million allowances, which we know have to come to market between now and 2030 anyway, may come to market much more quickly than we thought and I don't think that's at all what's going to happen, but what was being floated by a very influential now academic, but former very senior member of the European Commission, Jos del Beck in some ways, the architect of the EU ETS, and he was the head of the DG Climate Action Directorate. So he was the guy, the civil servant, the most senior civil servant in charge of the EU ETS for the first 20 years of its operation and he is now an academic, very influential academic who publishes a lot of theoretical pieces around the EU ETS, and he would have given an interview to Bloomberg suggesting that that buffer of allowances, the 380 million, instead of being auctioned to the market, which is the default way in which they will come to market, could be allocated for free on top of the free allowances that are already out there to companies that commit as long as the company is receiving them commit to making long-term investments in decarbonization. Now, on the face of it, that's actually quite a smart thing to do, but not if you front load it and give these companies 380 million tons in the next year because that again would have a very negative impact on prices because those companies wouldn't need to go into the market again for a while.

Mark Lewis (53m 21s):
So as ever, this market keeps us on our toes. I think the price action since the beginning of the year has been a salutary reminder that nobody has a right to make money betting on. There is no such thing as a one-way bet in any market, however constructive the setup looks. And I think there were too many people at the beginning of this year in the speculative fund community who just thought this is a one way bet. Prices can only keep going on up and they forgot. They rather forgot that there is a political element to this market and you have to pay attention to what is happening in Brussels and you have to be able to separate the signal from the noise in all the political chatter that goes on in Brussels.

David Greely (54m 10s):
Another potential source of allowances that regulators and the people in Brussels might allow, which is projects from the voluntary carbon markets. Do you think there is any appetite for allowing those types of credits into the EU ETS?

Mark Lewis (54m 31s):
We have to be very clear on the terminology here, David. I would just sort of take issue with the use of the word voluntary rather than offset. I think if we say offset, we are on very safe ground projects, we are on very safe ground, but I think the only credits that could conceivably be considered for inclusion in the EU ETS beyond 2030, again, this won't happen before 2030, are so-called Article 6 credits under the Paris Agreement. Now these are project credits as you rightly say. So let's say for example, Mexico has a mangrove project and that project is reducing emissions quite significantly on a 40-year basis. Mexico can choose to do one of two things. They can either say, well, this is great, these emissions reductions are happening, and we are going to count those emissions reductions towards our own Paris target under our so-called NDC. Every country has a target for reducing emissions under the Paris Agreement. Or they could say, well, hey, these mangrove credits command a high price on the international market. They have traded a premium to other project credits. We can sell them onto the market internationally as long as we make a so-called corresponding adjustment whereby we commit to not counting those emissions reductions even though they happened on our territory towards our NDC. Instead, we give the right to those emissions reductions to the people buying those credits. Now, this is where if Europe is smart, what they would do is they would say, okay, it's too difficult to get to absolute zero emissions in Europe for the ET s by 2040, but what we can do is allow in a certain quota of offset under the Article six project mechanism that would do a number of things. Number one, it would be a safety valve on prices for European companies that, and that would be the clear, economically smart thing for Europe to do in terms of industrial competitiveness.

Mark Lewis (56m 37s):
Number two, it would help scale up the Article 6 market globally so that it becomes a genuine, and this is where the contrast with what you mentioned in terms of the voluntary market is super important because the voluntary market has been around forever, right? But it's still a market that's only worth about $600 million a year. The global compliance market is worth about 700, $800 billion a year. What we want to see is an offset market globally achieving real emissions reductions, scaling up so that it's of a size much closer in magnitude to that of the global compliance market. And I think Article six is the way you can do that and the beauty of doing it through

Article 6 is that all of the tons that we are measuring here are captured under the accounting framework of the Paris Agreement. So there would be no risk to Europe in accepting credits under the Article six mechanism because there is no question of double counting. You are not undermining the integrity of the of the Paris Agreement. On the contrary, you are supporting and cementing the integrity of the Paris Agreement because you are using all emissions reductions globally in the most efficient manner possible. It's the whole point, again, it's the whole point of having a market and of having a smart market to come back to the title of our conversation here. This is how you get Smarter Markets. You allow for the integration of markets globally so that the price discovery mechanism is unleashed globally across the widest possible sway of emissions.

David Greely (58m 19s):
Thanks again to Mark Lewis, Partner and Managing Director at Climate Finance Partners. We hope you enjoyed the episode. We will be back next week with another episode of Weathering Decarbonization. We hope you will join us.

Announcer (58m 33s):
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