

Guest commentary***Dynamic trading for 2010***

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True to market predictions, the volume of traded options in the EU carbon market continued its upward trajectory in 2009. We expect this trend to continue into 2010, and March presents some particularly interesting trading opportunities.

2009 marked the first full year of EU carbon options trading and correspondingly, EUA options volumes on the European Climate Exchange (ECX) experienced 71 per cent growth year-on-year with 415.5 million tonnes traded. CER options only began trading on ECX in May 2008, and they showed some growth with 91.1 million traded against 2008's figure of 67.8 million – up 34 per cent year-on-year. This discrepancy in the growth differentials seems somewhat self-perpetuating, as a perceived lack of liquidity in CER options is potentially driving some counterparts to use EUA options as a quasi-hedge. The result may be an inflation of EUA option volumes while drying up CER option liquidity.

Another factor in the continued growth of EUA options volumes is continuing global financial uncertainty and reduced access to cheap lending. Options can provide a source of financing when other alternatives are not available.

For instance, your hedger or natural-type player can optimise his positioning and perhaps raise a little cash in the market and by selling put options. Under this strategy, the trader does not mind “going long” the market while collecting premium as long as the strike price is at an appropriate level. We've often seen this particular type of trade played out specifically in the back end of the EUA curve. This is presumably due to the expectations about an economic pick-up (leading to higher industrial output and therefore higher emissions, the higher premiums which can be achieved due to the associated time value, or the assumption that phase three of the emissions trading scheme will be much tighter, which would ultimately have a profound influence on the back-end of the phase two due in part to bankability of EUAs.

Another type of options player are those with optimal operations, who perhaps predict a long EUA position going forwards but do not wish to act in the market by selling actual EUA futures. In some cases this has been due to financial, compliance or just internal constraints. These options traders have been prevalent in the market throughout 2009: selling out-of-the-money call options, maybe taking the view that if EUAs reach a certain level (the strike price) then they would become an active seller. In any event, why not collect a

little premium, the reasoning goes.

In 2009 we also noted that the appetite for downside (i.e. buying of out of the money put options) did not abate. Perhaps not surprising given the start to 2009 we saw in the underlying price! At some stage however, we will no doubt see the reversal. These apparently sentiment-driven trades have had the effect of a continuing steep skew to puts and a rather flatter skew for calls. Throughout the last two years trade sizes have increased and as previously stated it's our assumption that this is in part due to some participants opting to use EUA options rather than CER options to perform quasi-hedges.

However it is also evident that more users have to hedge positions given the unpredictable environment and possibly tighter margins, this is unlikely to change anytime soon. Something to look out for this year will be the possibility of liquidity in both the quarterly future and quarterly options contracts for the first time. Typically, liquidity only exists in the March futures contract, before the annual deadline to surrender EUAs for compliance at end of April. For the first time, we will have both a listed quarterly future and option contract.

Adding some confusion, the March option has an underlying of the December future, primarily due to the extra liquidity in December versus March futures. The ECX has opted to do so mainly for the benefit of those that seek to trade volatility as these types of trades require a liquid underlying market to perform and subsequently manage the delta. This however does mean that there exists a degree of basis risk when trading the March option which may have interesting ramifications as March expiry approaches.

This basis risk aside, March options should provide more opportunity for directional speculation, as these products are cheaper due to the shorter time to delivery. This should encourage more participants that may be active in other options markets to get involved. The shorter-dated expiry means they are now also a better fit with the other energy complex options instruments, perhaps encouraging dispersion-type traders looking to trade these instruments against each other. Naturally, we have seen the usual market activity occurring but a notable point is the amount of participants which intend to come to market for 2010, presumably primarily due to them alternating their trading strategies in response to the vagaries of the market.

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