Footprints to a global market

CARBON TRADING

Mike Scott looks at progress since the EU's emissions trading scheme

To the outside observer the carbon market, which started in 2005 with the advent of the European Union's emissions trading scheme (ETS), had a rocky beginning.

The price crashed in 2006 after revelations that member states had been too generous in allocating carbon allowances. There was also controversy over bankers making millions by cleaning up emissions of hydrofluorocarbon gases, which have a global warming effect 11,000 times as powerful as CO_2 and are priced accordingly.

Many thought hydrofluorocarbons should have been tackled by regulation rather than by emissions trading. Also, fears remain over the robustness and transparency of voluntary carbon markets.

Yet market participants point to the astonishing growth in trading, which from 2005's standing start hit €40bn (£31bn, $62bn) in 2007, according to analysts Point Carbon, with the overwhelming majority of that linked to the EU emissions scheme. "This is a market with just one ETS up and running in Europe – and some trading in Japan – and this year it will probably exceed the size of the cotton market, which has been a traded commodity for 200 years," says Nigel Scott, managing director of portfolio management at Climate Change Capital, an investment management group.

Some of the setbacks of the EU's first phase, which ran from 2005 to 2007, have served to strengthen the second phase, which ties in with the first compliance period for meeting targets to cut emissions under the Kyoto Protocol. "Companies over-represented their allocation needs and lost a lot of trust by making the European Community and national governments look stupid," says Lionel Fretz, chief executive of Carbon Capital Markets, a fund manager. The over-allocations also undermined their argument that an ETS would ruin their competitiveness and emboldened the Commission to insist on tighter national allocation plans in phase two.

"Despite the teething problems, the EU scheme works very well. There is a significant price of carbon that commands attention. Most commentators think the scheme is short this time around and there is now greater certainty out to 2020 [as the EU has confirmed the ETS will continue that long]," says Mr Fretz. The prospect of allowances being auctioned from 2013 has also focused attention, he adds.

According to Daniel Waller, knowledge leader in carbon at consultants AEA Technology, the EU proposes that, from the start of phase three in 2013, an increasing percentage of allowances will be auctioned every year, reaching 100 per cent in 2020.

New Carbon Finance, the specialist analyst, says the US market alone could reach $1,000bn by 2020 – if it continues on its present course of having a solely domestic scheme that does not allow the use of overseas allowances. In addition, Australia, New Zealand and Japan are all looking at setting up trading schemes.

> 'People will start playing around and the market will become increasingly sophisticated'

There remains significant opposition to a global scheme, with the EU proposing to restrict the amount of capital development mechanism allowances that can be used in its scheme. It is a feature of all the proposals for cap and trade schemes in the US that they "either prohibit or severely restrict the transfer of allowances from trading schemes in other parts of the world, including the EU ETS and the Kyoto Protocol's clean development mechanism and joint implementation schemes," says New Carbon Finance.

Even though the CDM and JI mechanisms exist expressly to encourage emissions reductions in developing countries, where they are much cheaper than in mature markets, the developed world is wary of signing up to anything that "subsidises" emerging markets and undermines competitiveness at home.

Many in the market say that, once those subject to cap and trade realise the cost of excluding foreign allowances, this will change. New Carbon Finance says that, under the Lieberman-Warner Bill, currently the frontrunner in the race to introduce a scheme in the US, businesses there would face a carbon price of $35-$40 by 2015, while CDM credits for carbon reduction projects in the developing world are available for $10-$20 a tonne. Allowing US companies to trade credits with Indian or Chinese groups would bring the US price down to as low as $15 a tonne, saving the US economy $145bn per year, says Guy Turner, New Carbon Finance's director.

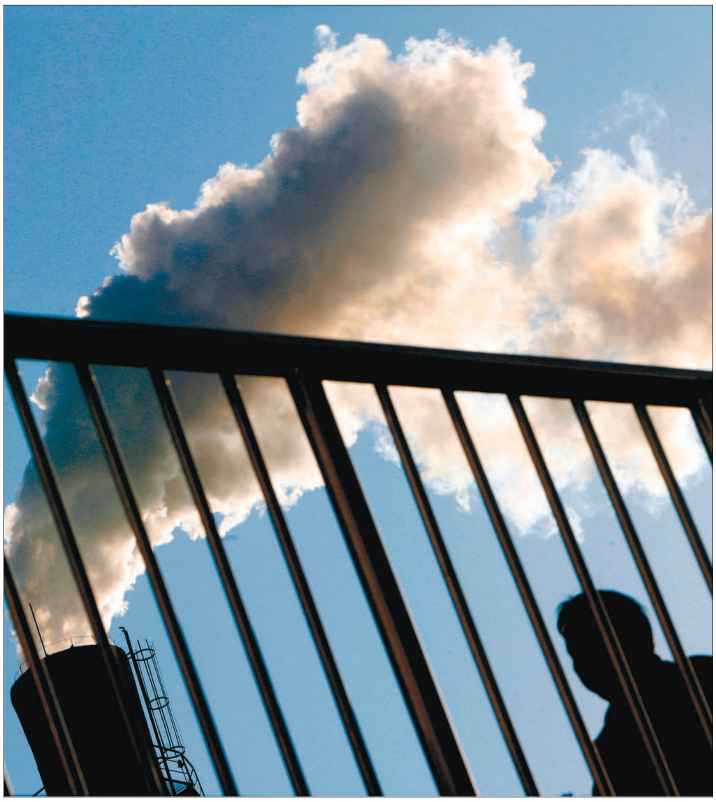
Nonetheless, there is optimism that the market infrastructure will develop. "There is a lot to be sorted out with the International Transaction Log," says Mr Scott. (The ITL was established by the UN to verify the validity of transactions of Kyoto units) "Compliance buyers are our base and they will expand" once everything falls into place and new sectors such as aviation are added, so that "more compliance buyers will start trading contracts for longer tenures, banks will be able to provide more services, liquidity will increase, and the efficiencies created will benefit everyone".

According to research firm Verdantix, a wave of new players is emerging to service this nascent market: Bluenext for emissions trading, Carbonium for project development, and First Climate for emissions broking, while the world's leading stock, derivatives and commodities exchanges such as Nasdaq, Nymex, Eurex and NYSE Euronext have been taking stakes in fledgling carbon trading exchanges.

Many believe a global market will emerge organically. "Defra [the UK's Department for Environment, Food and Rural Affairs] is working with those countries setting up schemes to ensure they map with the EU ETS. You will see almost an organic growth of a global ETS – individual schemes will link together until we get global coverage," says Mr Waller.

As the global spread of the carbon markets increases, the market will deepen, with more products being offered. "Once everything is sorted out, people will start playing around and the market will become increasingly sophisticated," says Mr Brown.

Some in the EU are against encouraging speculation but that is short-sighted, says Mr Scott, because speculators provide liquidity.



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