

Carbon trading on the cusp

After a tough 2009, winners of *Environmental Finance's* 10th annual market survey are hopeful that 2010 will be the breakthrough year for carbon markets around the world.

Mark Nicholls reports

Not for the first time, the global carbon market is on the cusp. Many market observers believe that 2010 will be either the year that carbon trading comes of age, or the year that it is relegated to the sidelines in the fight against climate change.

At the time of writing in late November, prospects for a legally binding post-2012 treaty emerging from the Copenhagen negotiations in December were in the balance, although hopes were high that a 'politically binding' deal could set the stage for a fully elaborated agreement in 2010.

A crucial element of any international deal – domestic climate change legislation in the US – remains tantalisingly out of reach. Despite the House of Representatives passing the Waxman-Markey bill in June, companion legislation is stalled in the Senate. The bills would commit the US to reduce emissions to 17–20% below 2005 levels by 2020, and establish a potentially enormous carbon market. But some analysts fear that if legislation is not passed in the next few months, it will fall foul of US mid-term elections due next November, and face potentially indefinite delay.

"It would definitely be a step backwards in terms of federal legislation", if agreement was not reached in the Senate in early 2010, says Lenny Hochschild, a managing director at New York-based Evolution Markets, which won a

slew of placings in this year's *Environmental Finance* market survey, including Best Broker in North American Mandatory Markets, a position it has won for the past four years.

However, he detects "a quiet optimism that, in the first four or five months of next year, we will see some real progress". While analysts are speculating that the bill sponsored by Senators Barbara Boxer and John Kerry may be abandoned, Kerry is working behind the scenes with Republican moderate Lindsey Graham and Independent Joe Lieberman on an alternative bill. "That's the right mix of people to get the form of language that 60 senators can live with," says Hochschild, referring to the 'filibuster proof' majority need to overcome opposition to legislation in the Senate.

The creation of a cap-and-trade programme in the US would, at a stroke, dramatically increase the size of the global carbon market. Indeed, the passage of legislation would mean that "liquidity would improve dramatically," Hochschild states. He reports steadily growing interest in so-called pre-compliance trading, with utilities and industrial emitters testing the waters and purchasing carbon offsets that they expect will be usable in a future regulated market. Hochschild estimates US volumes this year in the "tens of millions of tonnes" of both primary and secondary trading (that is, purchases direct from projects, and



Martin Kruska, First Climate: "Attention is shifting to post 2012"

subsequent trading). Most interest is in credits from landfill gas projects, forestry activities and methane-capture from dairy facilities, he adds. Prices for 2009 and forward vintages range from \$6.50 to \$10/ton of carbon dioxide equivalent (t CO₂e), he says.

Hochschild adds that "it is impossible to predict what will happen to prices" when – or if – a climate bill lands on the president's desk; there are simply too many variables, such as the stringency of the cap, and the rules governing offset use.

Kyle Danish, a partner at Van Ness Feldman, which shared the runner-up Best Law Firm, North America slot with Skadden, Arps, says that the US carbon market is "in some senses, like the CDM [Clean Development Mechanism] eight years ago. There are still questions about what rules will ultimately apply."

Chris Schaffer, Houston-based carbon trader at energy trading firm Vitol, which was voted Best Trading Company for North America, agrees that, even once legislation is passed, the market faces "quite a long, relatively cloudy period," as the bills charge an administrator, probably the Environmental Protection Agency, with coming up with frameworks for the creation of offset credits and allocation.

However, he says that "very rapidly, activity is coalescing around CAR", that is, offsets using the Climate Action Reserve protocols, which are seen as likely to be admissible in a future compliance regime. He also expects liquidity to gravitate towards listed futures contracts on the exchanges.

This would be good news for the Chicago Climate Futures Exchange (CCFE) – the subsidiary of the Chicago Climate Exchange that lists a number of contracts for mandatory US emissions markets – and which was voted Best Exchange. "Trading in the US carbon markets has shown strong growth, with open interest

How the survey was conducted

Companies were e-mailed in October and November and asked to nominate the leading banks, brokers and service providers in emissions markets, weather and catastrophe risk and renewable energy finance, via an online survey.

Voters were asked to vote only in those categories in which they had direct experience and to make their judgments on the basis of: efficiency and speed of transaction; reliability; innovation; quality of information and service provided and influence on the market, not just the volume of transactions handled. Almost 1,500 completed responses were received.

Only one vote per company site was allowed and those firms that nominated themselves had their votes disregarded.

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on CCFE reaching record highs in recent weeks, up 75% from this time last year," says president and CEO Satish Nandapurkar.

Such growth would likely be dwarfed by the market's acceleration if a federal programme is introduced. The very size of any federal cap will drive early action, Vitol's Schaffer believes: "It's such a large market, [emitters] will be looking to move early ... [its size] necessitates early price discovery."

But, predicts Erin Craig, CEO of San Francisco-based carbon offset company TerraPass – voted Best Offset Originator, North America – demand for offsets is likely to swamp supply. "Most analysis shows that offsets under a regulated US regime ... will be supply-constrained," she says.

The Waxman-Markey bill allows for the use of up to 1 billion domestic offsets (each equivalent to one tonne of CO₂) to be used in its putative cap-and-trade programme – but, given the wide range of economic activity covered by the cap, there is expected to be limited potential for offset projects.

However, says Craig, a regulated market would likely unlock pools of investment in reduction projects: "The constraint will be in getting the investment needed to get projects to happen. We're hoping that when a law passes, that would come: in a compliance regime, there would be emitter money coming in, which would be great – at the moment, it's private equity and investment funds."

Increasingly, say market participants, those companies active in the European carbon market and in developing Kyoto projects, via the CDM and Joint Implementation (JI), are keenly eyeing a future US carbon market. That they are looking for new opportunities is unsurprising: trading volumes in the carbon markets dipped for the first time, quarter on quarter, in the second half of this year, according to figures from New Energy Finance.

The London-based analysis firm estimated that the value of the market fell to \$30 billion in the three months to the end of September, down from \$38 billion in the second quarter, with volumes falling from 2.143 billion tonnes of CO₂e to 1.760 billion.

It blamed part of this on efforts to stem apparently large-scale value-added tax (VAT) fraud, which came to light in May and which had boosted volumes in the EU Emissions Trading Scheme (ETS). So-called carousel fraudsters had been trading spot EU allowances (EUAs), charging VAT on the sale, then disappearing before paying the tax to the authorities. In response, several member states suspended the charging of VAT on EUAs – a move that was followed by a drop in spot volumes on the BlueNext exchange from a daily peak of 19.2 million tonnes (Mt) on 2 June, to an average of 2.2Mt for the rest of the month.

But volumes were also boosted at the start of the year by a wave of selling as recession-

GHG EMISSIONS

	Winner	Runner-up
EU Emissions Trading Scheme		
SPOT & FUTURES		
Best Broker	Tradition	GFI
Best Trading Company	Barclays Capital	BNP Paribas
OPTIONS		
Best Broker	Evolution Markets	= Tradition = Tullett Prebon
Best Trading Company	RNK Capital	Barclays Capital
Best Advisory/Consultancy	ICF International	First Climate
Best Law Firm	Baker & McKenzie	Norton Rose
Best Exchange	ECX	BlueNext
Best Verification Company	TÜV SÜD	DNV
Kyoto Project Credits (JI and CDM)		
Best Primary Originator	First Climate	= EcoSecurities = TFS Green
Best Broker	Evolution Markets	= TFS Green/Tradition = Tullett Prebon
Best Trading Company	BNP Paribas	Barclays Capital
Best Advisory/Consultancy	ICF International	First Climate
Best Law Firm	Baker & McKenzie	Norton Rose
Best Exchange	ECX	BlueNext
Best Verification Company	TÜV SÜD	DNV
Best Project Developer	EcoSecurities	First Climate
North American Mandatory Markets		
Best Broker	Evolution Markets	Tradition
Best Trading Company	Vitol	Element Markets
Best Offset Originator	TerraPass	–
Best Offset Broker	Evolution Markets	Tradition
Best Advisory/Consultancy	ICF International	Power & Energy Analytic Resources (PEAR)
Best Law Firm	Baker & McKenzie	= Skadden, Arps, Slate, Meagher & Flom = Van Ness Feldman
Best Exchange	CCFE	–
Best Verification Company	First Environment	= DNV = SCS
Best Project Developer	EcoSecurities	Blue Source
Australasian Markets		
Best Broker	Next Generation Energy Solutions	
Best Trading Company	AGL	
Best Advisory/Consultancy	PricewaterhouseCoopers	
Best Law Firm	Baker & McKenzie	

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battered industrial emitters brought newly-surplus allowances to market. Prices, unsurprisingly, slumped to a low for the second phase of the EU ETS (from 2008 to 2012) of €8 (\$12), leading to much hand-wringing about whether the EU ETS was working in driving emissions abatement.

John Molloy, head of environmental products at Tradition in London, voted Best Broker, EU ETS Spot & Futures, for the third year in a row, is sanguine about the price fall. "Recessionary pressures through the end of 2008 resulted in lower expectations of likely emissions for 2009. The response of the EU ETS was to act pretty much as expected ... Pricing was susceptible to falls under conditions which member states and the [European] Commission couldn't have envisaged."

Despite plunging prices, industrial emitters were able to turn to the EU ETS to raise much-needed cash, as lower emissions freed up allowances. Louis Redshaw, head of environmental markets at Barclays Capital, once more voted Best Trading Company, EU ETS Spot & Futures, said that at the start of the year the bank deliberately set out to provide "a whole raft of credit-crunch proof trades", that allowed clients either to put on hedges

without using credit lines or monetise unneeded allowances.

"For example, we were able to provide credit lines for doing forward trades by [taking] spot allowances as collateral ... basically putting in place collateralised structures ... to get around credit constraints," he says.

Low prices in 2009 did little to dent the growth of the European Climate Exchange (ECX), which was voted Best Exchange in both the EU and Kyoto credits markets. "From an environmental point of view, I want a high carbon prices, because a high carbon price drives behaviour," says Patrick Birley, ECX chief executive. "But low prices don't mean low volumes – what kills volumes is low volatility. The volatility of prices means people need to manage the risk associated with it."

Neil Cornelius, a London-based principal consultant at ICF International, which won three Best Advisory titles in the survey, argues that, despite the sell-off, the EU ETS remains a "robust, credible" system. "Among the major players involved, there is a level of confidence that there will be a price signal going forward."

And he says that there are signs that EUA prices are beginning to reflect longer-term supply and demand drivers. "In recent periods, the EUA price has been higher than that nec-



Erin Craig, TerraPass: "Offsets under a regulated US regime ... will be supply-constrained"

essary to balance the [EU's electricity generating] portfolio," he says. That is, it has been higher than that required to encourage power generators to run less-polluting gas-fired plants over more emissions-intensive coal-fired generation – which is the main short-term mechanism the market uses to meet EU emissions targets.

Rather than responding only to this short-term price signal, traders are also factoring in the tighter targets in the third phase of the EU ETS, from 2013 to 2020. "This is encouraging for architects of the scheme. If CO₂ prices are

tasty

holy

valuable



Methane avoidance and biogas projects are just one part of First Climate's high-quality carbon credit portfolio.

being set by long-term drivers ... there should be more price stability," Cornelius says.

However, critics argue that the EU ETS is not delivering prices to encourage more expensive abatement technologies such as carbon capture and storage (CCS) – around €60–90/tonne for demonstration projects, according to consultancy McKinsey.

Cornelius agrees, but says that one "silver lining" of the recession is that it has lowered the EU's emissions trajectory, pushing back the date at which technologies like CCS will be needed to meet the EU's emissions goals. "There is some uncertainty as to whether we will need large-scale CCS by 2020," he says.

Nonetheless, he counsels against intervention in the EU ETS to raise carbon prices – arguing that the scheme was designed to place a cap on emissions, not set a carbon price or underpin one technology or another. Tinkering by policy-makers is likely to increase uncertainty among investors, rather than underpin it, he says.

But the recession has offered little in terms of silver linings for CDM project developers, as low carbon prices have exacerbated problems with an increasingly onerous project registration process. EcoSecurities – a leading London-listed developer – will end 2009 as a

Scuppered by the Senate

The Obama administration's climate change team will have been watching developments in Australia's Senate in recent weeks with growing unease. In early December, after agreeing a hard-fought compromise with the Labor government on its flagship climate change policy – the Carbon Pollution Reduction Scheme (CPRS) – the opposition Liberal Party imploded, defenestrated its broadly pro-CPRS leader Malcolm Turnbull, and voted the CPRS legislation down in the Senate for the second time.

The move appears to make little sense politically. By rejecting the legislation, the Liberal-National Party opposition risk triggering a snap election which would likely see the Labor government increase its vote. Support for action on climate change appears strong in Australia – and a key factor in Labor's election victory in 2007.

But the Liberal party's new leader, climate change sceptic Tony Abbott, has set his face against the CPRS, which he has described as "a great, big tax to create a great, big slush fund".

The Senate's move will have dismayed early participants in Australia's carbon market. However, Sam Larkey, eco-markets trader at AGL – the utility which for the second year running was voted Best Trading Company, Australasia, in our market survey – puts a brave face on the news: "AGL has anticipated a range of market designs in our trading activity, so the scheme does not necessarily have to be legislated [for] trading in future permits."

He expects trading to continue, despite the uncertainty, noting that the government has pledged to re-table the legislation in February. However, the lack of clarity is helping no-one, he believes.

"It is AGL's belief that Australia needs to have a carbon policy in place as soon as possible to provide investment certainty for business," Larkey says. "In that context, we would urge all parties to seek to negotiate an outcome that will be good for the environment, good for business and good for the country."

Environmental Finance and Carbon Finance 10th Annual Market Survey 2009

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Best Primary Originator Kyoto Project Credits (JI & CDM)

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part of JPMorgan, following its £129 million (\$212 million) acquisition by the investment bank in October. For Belinda Kinkead, its head of implementation, the past 12 months have been "like Groundhog Day".

"Every year, I think [the CDM project process] has to get better. But I've been feeling that way for the last three years," she says.

The company – voted Best Project Developer for both the Kyoto and North American markets – has been tracking how long it takes to get CDM projects through the system. In April 2006, validation of projects took, on average, 183 days, registration 67 days and issuance of credits 20 days. Now, those numbers have more than doubled – to 414, 190 and 76 days, respectively.

"If things continue as they are, we calculate that only 789 million CERs will be issued by August 2013," she says. This compares with estimates from the UN Framework Convention on Climate Change secretariat that the CDM pipeline is set to deliver 1.69 billion certified emissions reductions (CERs) – and down even from the more conservative forecast of the UNEP Risø research centre, which currently puts the number at 1.149 billion.

Kinkead accepts the need for scrutiny to

be applied to proposed CDM projects for environmental reasons, but she argues that many delays are about poor process and limited accountability. She is hopeful that time might be found at Copenhagen for reform of the CDM process.

But while the primary CDM market is struggling, the secondary trading of CERs – once they've been issued to project developers and sold into the market – is rising. According to New Energy Finance figures, trading rose between the second and third quarters by 36% in volume terms, to 232Mt from 170Mt, and 46% in value, to \$4.3 billion from \$3 billion.

"We've had a good trading year," says Simon Dent, head of European carbon, gas and power marketing at BNP Paribas in London, which was voted Best Trading Company, Kyoto Project Credits. His investment bank does not invest equity directly in CDM projects, but acts as an offtaker and structured buyer of carbon credits, and he acknowledges that "moving projects through the pipeline has been more difficult, and slower."


However, he cautions that carbon market participants should temper their criticisms of

the CDM process with an acknowledgement of the environmental sensitivities involved. "We're frustrated, as are all the other market players, that the system is slow. But we believe that we need to defend the credibility of the CDM," Dent says. "If the powers that be believe the system needs to be more stringent, we back that as well."

Others question where the stringency is directed. "If it was about improving environmental integrity, I would say it's absolutely necessary," says Sven Kolmetz, head of carbon management services at TÜV SÜD in Munich, voted Best Verification Company, Kyoto Project Credits. "But if you look at the registration rate, I doubt if environmental integrity has improved." A frustration voiced by many developers and verifiers is that requests for review issued by the CDM's regulator are often for minor presentational infractions, rather than for substantive errors.

Nonetheless, Kolmetz attributes his firm's success in this year's survey to the low project rejection rate achieved by TÜV SÜD – of only 2.6% at the validation stage, compared with a market average of 6.7%. This is down to a centralised approach taken by TÜV SÜD to maintain tight quality control, he says.

The firm has likely also benefited in the



Voted Best Verification Company North American Mandatory Markets 2008 and 2009



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survey from the temporary suspension in the past 12 months of both of its main rivals – DNV and SGS – by the CDM Executive Board (EB), for “non-conformities” with the CDM rules.

Kolmetz acknowledges that “all auditors are vulnerable” to such suspensions, noting that new accreditation standards were introduced earlier this year by the EB which meant that TÜV SÜD had to rapidly reallocate human resources. “Implementing a new standard in such a short time period was a big challenge.”

Looming particularly large over the Kyoto project markets is, of course, the question of what comes next; what will a post-2012 climate agreement look like, and what role will be played by the CDM and JI? Martin Kruska, a director at German carbon asset manager First Climate – voted best Kyoto projects originator in our survey, among other placings – says that his clients are tying up loose ends on their pre-2013 purchases.

In terms of primary project origination – contracting directly with projects – buyers are “looking to fill the last remaining gaps” in their portfolios, he says, with larger buyers “definitely through” – although he notes that Japanese buyers have re-entered the market “quite heavily” in recent months.



Simon Dent, BNP Paribas: “If the powers that be believe the system needs to be more stringent, we back that”

“Attention is shifting to post 2012,” Kruska says. First Climate was an early mover in post-2012 carbon origination, with its €125 million Post 2012 Carbon Credit Fund, launched in 2008. Kruska says that “competition has increased over the last six to nine months,” with compliance buyers starting to

“enter into fully-fledged contracts”. Previously, buyers favoured option contracts.

The one caveat, he says, is that “whatever is issued must be fungible with the EU ETS” – the Commission is due to decide in 2010 which types of CDM credits, and from which jurisdictions, will be eligible for use in Phase III of the EU ETS, which runs from 2013 to 2020.

Undoubtedly, questions about the shape of the post-2012 carbon market are deterring investors from committing capital, says Martijn Wilder, a Sydney-based partner at Baker & McKenzie, voted Best Law Firm in all four markets covered in our survey. “One of the biggest challenges the market has is regulatory uncertainty – around the slowness of the international negotiations, and the slowness of the domestic schemes coming up.

“But we’re seeing lots of appetite for post-2012 credits. The CDM will continue, and demand will come for CERs from these domestic schemes. People are overestimating the supply in the market ... There continues to be appetite to do CDM projects, but it’s harder to find them and the volumes are smaller.

“That’s the real question. If you believe the carbon market will continue to grow, it’s vital to have [offset] supply – and people are overestimating the supply in the market,” he adds. **EF**

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