

Firmer Price Expectations for Phase Two and Beyond

In terms of reducing CO₂ emissions, Phase One of EU ETS is seen as a failure but, according to Moffatt Associates' latest quarterly survey, market participants believe a viable trading mechanism has been established, lessons have been learned and prices in Phase Two could be firmer depending on plans for Phase Three.

Setting the scene

At the onset of Phase One, neither the EU Commission nor market participants had access to reliable emissions data. This lack of basic information and the tendency of some governments to be over-generous towards their own industries meant there was an over-supply of CO₂ allowances.

To begin with, the price of allowances in Phase One rose steadily to its peak level of about €30 per tonne in April 2006, but collapsed in May 2006 to under €10 per tonne, when more reliable data became available and on fears that some countries were likely to give their industries generous emission caps in Phase Two.

The Commission has acknowledged these failings and has been far stricter about the level of allowances granted to EU member states in the second phase. The caps have been tightened by about 7% and some countries, mainly in central and eastern Europe, are currently taking legal action against the Commission's allocation.

More significantly, the second phase of the ETS expands the scope of the scheme. All greenhouse gases, and not only CO₂, are now included, and external CDM (Clean Development Mechanism) and JI (Joint Implementation) credits can be introduced through the EU's 'Linking Directive'.

Aviation emissions are now expected to be included in the programme from 2012, a year later than had been proposed by

the Commission and European Parliament. This follows a decision by EU environment ministers at the end of last year to postpone implementation. As well as aviation, the plan is to include maritime emissions in the ETS at a later stage.

In a sign of the growing influence of the ETS, Iceland, Norway and Liechtenstein, all members of the European Economic Area but not of the EU, are expected to join the scheme in a move that the Commission says is the first international agreement of its kind. The EC will now examine the national allocation plans submitted by the three EEA members and the hope is that extending the ETS to other countries will help to strengthen the scheme.

Developments in 2007

Despite the collapse of the CO₂ price in 2006, traded volumes have continued to expand. The EU ETS has grown significantly over the course of 2007, with a traded volume of 1.6 Gt and a value of €28bn. This represents a growth on 2006 of over 50% in both volume and value terms. The volume distribution between brokers and exchanges throughout the year was stable at 70:30 in favour of brokers.

Activity within Kyoto's mechanisms – specifically the CDM – has also expanded in 2007. In total, the CDM market traded almost 1 Gt and €12bn in 2007. Growth in the secondary CER (certified emissions reductions) market has been spectacular with 77m CERs being issued in 2007. Given that CER prices are much higher ►

than in the primary market, the increased CER volume has significantly boosted the total value of the CDM market in 2007. There was also healthy growth in JI's.

Market balance in Phase Two

Phase Two requires the EU to reduce emissions by 1.5bn tonnes and it is expected that roughly 1.3bn tonnes of this will come from imported CDM credits (see above). The market expects that fuel switching inside the EU will provide the remaining reductions to meet the cap. As a result, CO₂ prices are being driven by variations in coal and gas prices, and prices for coal, gas, electricity and carbon continue to chase each other.

Despite tighter emissions caps within the EU, there is a risk that CO₂ prices in Phase Two could be lower than expected. This is because of generous CDM import allowances and the possibility that the demand for EUAs could weaken as a result of (a) weather conditions reducing power generation, (b) increase in renewable generation and/or (c) increase in energy efficiency.

In our recent survey, market participants were unanimous in their view that CO₂ prices will be firmer in Phase Two but there were mixed views on whether CDM would weaken the market (**See Table of Questions and Responses below**).

There was widespread support for the statement that CO₂ allowances should

not be allocated freely and should carry a cost or be auctioned. In addition, according to respondents, the average price deemed necessary to trigger a significant reduction in CO₂ emissions was 35 euros per tonne.

Looking beyond 2012

Attention has now turned to what will happen in the third phase of ETS post 2012. The Commission has been conducting a review of the ETS, with input from market participants and other interested parties, and on 23 January 2008 it published the results of this review as part of an energy and climate package, which contained a range of draft legislative proposals.

The measures are designed to cut CO₂ emissions by 20% by 2020 compared to 1990 levels. The commitment would rise to a 30% reduction, if other industrialised countries agree to make comparable efforts as part of a global agreement to combat climate change, post 2012. The aim is for trading sectors in Phase Three to be required to reduce emissions by 21% by 2020, compared to 2005 levels.

As had been widely expected, national governments will lose their role in setting overall caps for carbon emissions after 2012. Instead, the Commission will set one EU-wide cap on the number of emission allowances, instead of 27 national caps. This should even out the allocations and avoid the risk of

Survey Questions and Responses

	Agree	Disagree	Don't Know/ No Comment
CO ₂ prices will be firmer under Phase II than Phase I	100%	0%	0%
The price of allowances in Phase II will be too low to stimulate investment in low carbon technologies	17%	73%	10%
Offset credits (i.e. Certified Emissions Reductions from CDM projects outside the EU) will weaken the market	47%	43%	10%
CO ₂ allowances should not be allocated freely but should carry a cost or be auctioned	77%	7%	17%
Phase II of ETS will be tougher and could lead to a price of at least €40 per tonne	55%	31%	14%

those companies operating in countries with stricter governments being at a disadvantage.

In Phase Three, which will run from 2013 to 2020, emissions allowances to heavy emitting industries covered under the EU ETS will be reduced each year so that the target of a 21% reduction compared to 2005 levels can be achieved by the end of the period. That would mean 1.72 bn tonnes of CO₂ equivalent emissions compared with just over 2 bn tonnes now, allowing for new entrants.

Another major change from the present arrangements is that a much larger share of allowances will be auctioned rather than being allocated free of charge. It is estimated that around 60% of the total number of allowances will be auctioned in 2013, and this proportion will increase in later years.

Other modifications include the redistribution of part of the rights to auction allowances from member states with high per capita income to those with low per capita income, largely countries in eastern Europe. The aim of this particular amendment is to enable the latter to invest in environmentally-friendly technologies.

A number of new industries, including aluminium and ammonia producers, will also be incorporated into the ETS post 2012, as well as two further gases, nitrous oxide and perfluorocarbons. In addition, member states will be allowed to exclude small installations from the scope of the system, provided there are measures to achieve an equivalent contribution to emission reductions.

Price impact of Phase Three

The EU Commission's ambitious targets of a 20% reduction in GHG, 20% renewable energy production and 20% improvement in energy efficiency, all by 2020 will, if achieved, have a significant impact on the carbon market in Phase Three and beyond.

A key component of Phase Three is the EC proposal not to allow for any further CDM import credits for at least as long as there is no new international climate change agreement. Curtailing imports and/or allowing Phase Two credits to be carried over into Phase Three could mean more CO₂ reductions in Europe and also higher EU carbon prices.

The Commission is desperate to avoid a situation where a low CO₂ price undermines investment in low carbon technologies. The hope is that the centralisation of cap-setting, a reduction in the volume of imported credits available for compliance and the large auctioning of allocations, will set the stage for a more competitive environment, where the price of carbon will be set by the actual costs of reducing emissions through investments in the EU, rather than reliance on the CDM market for most of the abatement. ■

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