According to Dr Anthony White, MBE, Senior Adviser to Climate Change Capital, the credit crunch has had a depressing impact on the carbon market short term, but may have improved the longer term outlook.

More Volatility in the Carbon Market

SETTING THE SCENE

When the contamination of the financial markets initially came to light, there were optimists who thought that "sustainable investments" could possibly be beneficiaries. After all, "green investments," backed by investment funds or major industrial companies could surely be regarded as more reliable than sub-prime mortgages. At first, this seemed to hold true but, as Summer moved into Autumn and the infection spread into the wider economy, the crisis began to have an adverse impact on the carbon market.

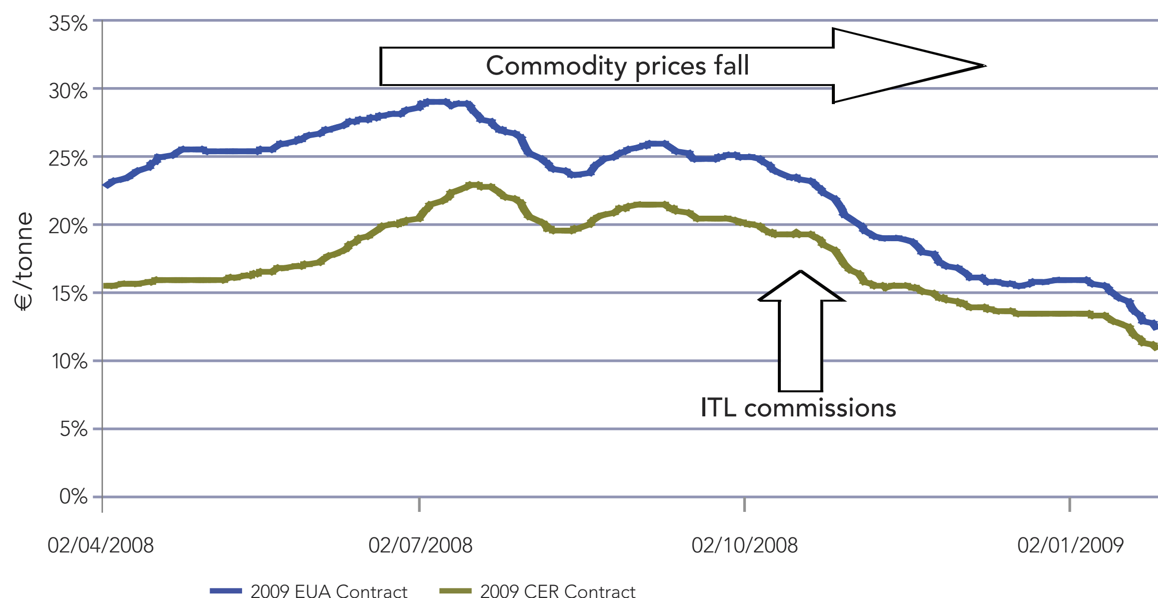
The subsequent credit crunch has affected carbon prices via three price drivers: the economic fundamentals underlying the carbon market; the detailed design of the market; and the trading behaviour of market participants. It would have been satisfying to claim that this was well anticipated before it occurred. However, the application of some hindsight may help prepare for the future.

RECENT PRICE MOVEMENTS

The cost of abatement is the fundamental carbon price determinant and this was adversely affected by the fall in oil prices, which fed through to gas prices. The subsequent price fall was amplified by the reduction in the estimates for economic activity in the EU, which is expected to impact through Phase II of the EUETS. Therefore, both the costs of abatement and the underlying demand for CO_2 allowances fell.

The market was further undermined, paradoxically, by the commissioning of the International Transaction Log in October 2008. As a consequence, this reduced the spread between CER and EUA prices in the run up to October **(See Chart A).** Furthermore, in November, the European governments, primarily Germany and the UK issued 700 mt of allowances. As a result, the CO_2 price in early October was further undermined.

Chart A – Carbon Prices



As the full extent of the financial crisis became apparent during the Autumn, credit for many traders tightened or even became non-existent. Consequently, those with EUAs lodged in their registers realised that their holdings represented a potential source of immediate cash. Or, viewed another way, since the forward curve for EUAs is so flat (2009 EUAs @ €10.7; and 2012 @ €10.9 on 28 January, 2009), their registry holdings represented a very cheap source of finance.

As a result, many traders liquidated their holdings, further undermining the CER prices. This also implies that there is now less cash readily available for investments in CER-generating projects, and the potential for these projects to generate CERs capable of being monetised during the Kyoto period is diminishing, as the end date of 31 December, 2012 draws closer.

MARKET DYNAMICS

The climate change optimists, i.e. those hoping that an international agreement on greenhouse gas emissions will be concluded at the Copenhagen "Conference of the Parties" in December 2009, were somewhat relieved by the EU's confirmation of the energy and climate package during the French presidency. The 20, 20, 20 target for 2020 remained intact, which explains the slight, but short lived, price stabilisation in December 2008.

> "However, it appears that the market is not looking so far ahead."

However, these optimists were disappointed, though not surprised, by the lack of consensus to emerge from the Poznan COP on the structure of the post - 2012 Kyoto regime. Although the EU agreed a slightly higher limit on imports of CERs into the EUETS for Phases II and III (1.611 bt, up from the Commission's proposed 1.43 bt), the outlook for new Clean Development Mechanism projects is still very hazy, especially as only projects registered before the end of Phase II will be able to generate CERs that may be converted into EUAs.

As a consequence, the carbon market, at least interest in new projects, appears to have stalled. The market is waiting for an international agreement to be concluded before capital will be deployed on a large scale; and this is dependent on the attitude of the new administration in the US. There was plenty in Obama's campaign remarks and his inaugural speech to give the optimists some hope; but financiers are likely wait to see the legislation, before investing.

LONGER TERM OUTLOOK

This creates something of a paradox. Whilst the near term outlook for prices is weak on account of the lower economic activity leading to a potential over-supply for Phase II, in terms of EUAs and available CERs, the outlook for Phase III prices remains rosy.

The confirmed CO_2 emissions cap for the EUETS was set on the assumption that the extremely exacting renewables and energy efficiency targets will be met. However, not a single member state within the EU has yet adopted the radical new measures that will be required if these targets are to be met. Therefore EUA prices in excess of €40/tonne are still possible and, given the ability to use Phase II allowances to meet Phase III obligations, some price tension should be expected. However, it appears that the market is not looking so far ahead. Alternatively, the market could be counting on the EU meeting its renewables targets, or that the EU will relax its CO_2 targets. Both would be brave assumptions.

In conclusion, it would appear that the credit crunch has served to depress the carbon market in the short term, but improve the longer term outlook. However, such volatility is not exactly conducive to investment.