

# Evaluating the Performance of the EU ETS

The ETS officially started on 1 January 2005. Andrei Marcu, president of the International Emissions Trading Association (IETA), argues that the priority now is to demonstrate that the cap and trading system (ETS) can deliver a credible reduction in CO<sub>2</sub> emissions while ensuring that the EU remains competitive.

## Setting the scene

The EU ETS has become the focus for the global debate between those advocating different approaches to addressing climate change. Therefore, a lot hangs on the success or failure of the scheme. We must therefore be able to define how the scheme should be measured. We must not be afraid to learn from the current 2005-7 phase in order to improve its performance in the 2008-12 period and beyond.

In addition, the Conference of Parties to the Kyoto Protocol (COP) in Montreal is rapidly approaching and with it the start of a round of negotiations for the post-2012 period. The success of the EU ETS will be an important component in the future of market mechanisms in the post 2012 trading environment.

## Success criteria

How do we define the success of the EU ETS? Its objectives are clearly environmental, but its success will depend on more than meeting these objectives. This means helping the EU meet its targets under the Kyoto Protocol, while at the same time addressing the EU's Lisbon Agenda on competitiveness. A basic measure of success will be to ensure that company culture in Europe changes and that carbon prices are taken into account when operational and asset investment decisions are made.

In essence, the success of the EU ETS will rest on whether it can deliver; price discovery; put a price on a tonne of CO<sub>2</sub> reduction; provide price signals for the development and deployment of low carbon technologies; and enable the EU to move forward on the path to a low carbon intensity economy.

An additional criterion for judging the success of this approach is the vote of confidence that it will/will not receive from society at large, in Europe and elsewhere. Poor functioning of this market, including real or perceived abuses, the credibility of environmental delivery, and the risk of significant economic disruptions will affect the outcome. Excessive price volatility will have to be explained to the public – it is not just another market, it is a bold but still fragile experiment, closely scrutinised by friend and foe, but for opposite objectives. ▶



The experience of the National Allocation Plans (NAPs) is behind us, with some important exceptions. The experience and success of operating the market, of getting the infrastructure in place, of getting all the players in the market is yet to come. So far there is a lot that still needs to be done.

### The operation of the emissions trading market

It is too early to judge the outcome at this stage. On the critical issue of company behaviour there is little doubt that the price of carbon is now a key consideration when business decisions are made in Europe.

We are seeing some significant changes. In the past the market responded to political and regulatory signals but what we see now is a market driven by fundamentals – gas and coal prices and weather conditions. Figure 1 shows the CO<sub>2</sub> certificate (EUAs – EU Emission Allowances) traded volumes and prices for 2005. There has been price volatility and a price spike but that is something that was experienced in the UK ETS with prices settling at much lower levels once all systems were in place. Such volatility is also typical in new and thinly traded markets.

We still see limited liquidity with some of the main players being natural traders, especially the power companies covering their positions. The entry of a number of liquidity providers is an important signal. While volumes are increasing in exchange trading there is likely to be the need to rationalise the number of existing exchanges – there are simply too many of them for the level of trading to support this level of infrastructure.

This fragmentation does not help in a market that is short of liquidity.

The lack of liquidity can be attributed to a number of factors. The lack of a complete infrastructure is an important one. Many of the new Member States, which are long on CO<sub>2</sub> certificates, do not have registries in place, and as such no certificate users in their registries. The credit rating of companies in that part of the world is not well established, if at all, which makes forward trading more complicated. In addition, there is a lack of experience and staff to handle trading. The fact that the International Transactions Log (ITL) has not come on line to verify transactions of emissions reduction units (ERUs) and certified emissions reductions (CERs) will inhibit the emergence of a spot market. This clearly impedes many of the companies that are long from entering the market.

It is unclear to what degree industrial companies that may be long have been selling into the market at the current price. Many of them are not inclined and may not have the experience to participate at this time, but there is anecdotal evidence that they are testing the waters, via their energy traders or by retaining financial institutions or others that have more experience of trading.

By and large, it seems that power companies are selling forward and



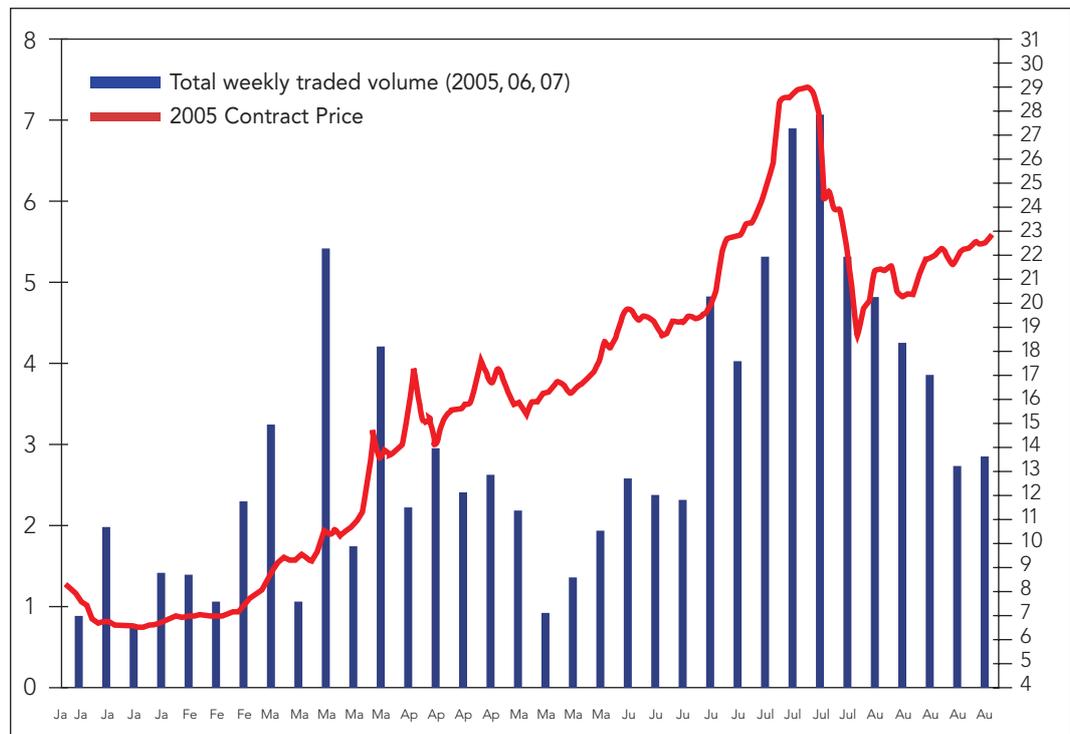
covering their positions. Given the high price of gas there has been no switch between gas and coal and the argument has been made by respected market players that prices will have to hit 70 euros for that switch to take place. Industrial companies in Europe will not be able to absorb such a high energy cost and stay competitive.

One could argue that as markets respond to the signals they get at any time, this market is showing an imbalance between demand and supply. Demand is expected to be about 220 million tons for the period 2005-7 in the EU. This does not suggest a significant shortage.

The main reasons for supply shortages have been outlined above. Another factor

restricting supply is the lack of CDM and JI credits (i.e. emissions credits derived from investing in emissions reduction technologies in developing economies). While there is an expectation that 50 million CERs are waiting to get in the market, regulatory uncertainty means that the market is not recognising this potential supply. One exception may be CERs from industrial gases. Given the methodologies approved, the risk seems much lower and there could be temptation to go short on certificates at a price of around 20 euros on the expectation of CERs at seven to ten euros. One encouraging development is the increasingly strong presence of the private sector in the CER market, a reversal from the time when the World Bank was the only player.

Figure 1 – CO<sub>2</sub> Certificates (EUAs) – Volume (in millions) and Price (in euros)



Source: Natsource Europe Ltd

### Looking to the future

The coming months are critical for a number of reasons. 1 December 2005 is the first contract settlement date and we will then see how physical delivery is expedited. Part of the push for completing the infrastructure will have to take place at the COP in Montreal – specifically the ITL. Business will lobby hard to get this done ahead of the current 2007 timeline. It is hoped that the registries will be on-line soon and that the COP will unlock the CDM and will give prompt start to Joint Implementation. In addition, the demand/supply imbalance will be alleviated if there is strong indication that Green Investment Schemes will become reality and will be used for sovereign compliance, thereby freeing CERs and ERU for corporate compliance.

The last few COPs have been uneventful but the Montreal COP has an important agenda for the business community, especially those who believe in the use of market signals to tackle climate change.

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*Dupont and TransAlta, and is dedicated to the creation of an efficient and environmentally robust market for greenhouse gases to address the issue of global warming and climate change.*

*Andrei spent most of his career in the power industry with Ontario Hydro in Toronto, Canada where he was involved in contracts, energy efficiency, regulatory affairs, and international operations.*

*As Deputy Managing Director of the E7 and Chair of the Climate Change Subcommittee he has had the opportunity to work on issues related to sustainable energy development in a sector critical to development and in implementation of Agenda 21.*

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Please note that the views expressed in the above paper are those of the author and do not necessarily represent the views of IETA or its members.

