

EU ETS: A success but a threat of excess supply of allowances in phase two

The EU ETS is approaching the end of its second year. Henrik Hasselknippe and Kjetil Røine of Point Carbon argue that cap and trade is a successful market mechanism for reducing emissions, but some serious issues need to be addressed before Phase Two starts in 2008.

Prices and volumes

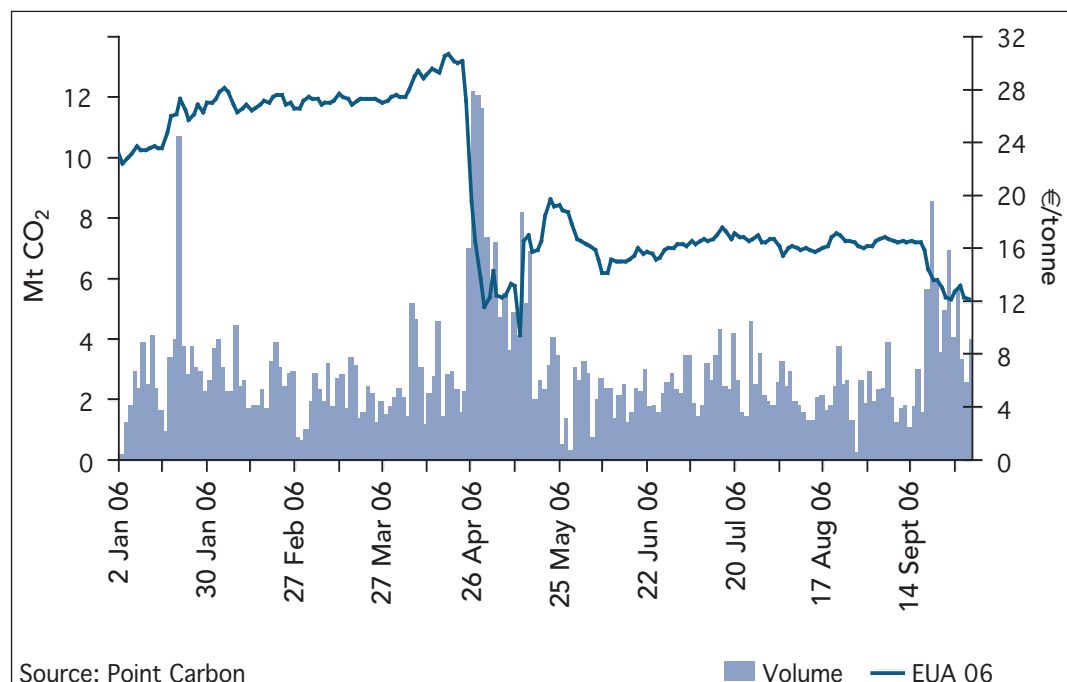
The EU ETS has seen considerable volumes and wildly fluctuating prices throughout 2006. (See Graph A below) In total, 578 Mt CO₂ have been traded year-to-date (3RD October 2006), corresponding to € 11.3 billion. This is considerably above the numbers for the entire last year both for volumes and values (362 Mt and €7.2 bn in 2005, respectively), and indicates a growing market.

The over-the-counter (OTC) market is still

the biggest in the ETS market. During the first half of 2006, 62 per cent of the total volume was traded OTC, while exchanges accounted for 27 per cent and bilateral trades for 11 per cent. ECX is the preferred exchange with more than 75 per cent of the market in H1 2006. Phase Two volumes constituted 25 per cent of total traded volumes. These have in recent months traded more or less in parallel with the Phase One EUAs, but are now tending to delink as more reliable information on Phase Two allocations becomes available. ►

Graph A: A hell of a beating

Daily bid-offer closing prices and corresponding volumes in the brokered and exchanged markets year-to-date.



International trading opportunities

Furthermore, the EU ETS does not only lead to market activity in Europe. The opportunity to utilise imported credits from Clean Development Mechanism (CDM) and Joint Implementation (JI) projects means that European private companies are to an increasing extent looking abroad for their reductions.

Based on transactions recorded in Point Carbon's transaction database, as much as 226 Mt was transacted in the CDM and JI markets during the first half of 2006, with a financial 2006-value of nearly €2 billion. While this was lower than expected, it still shows that there is considerable interest in such projects. The primary CDM market is still the largest market segment by far, with emission reduction purchase agreements (ERPAs) of 193 Mt during the first half year of 2006, valued at €1,545 million. Similar to last year, a handful of projects involving industrial gases dominate and comprise more than 60 per cent of the market. Within the realm of JI, most reductions contracted came from energy efficiency projects. Private companies are still the major players in the CDM arena with 74% of contracted volume in the first half of 2006.

Attracting new investment

The EU ETS has also led to considerable private investments in carbon funds. Including those outside the EU ETS, corporate fund investments constituted 23 per cent of CDM forward transactions and 11 per cent of forward JI transactions in the first 6 months of 2006.

Based on information from the carbon funds and interviews with compliance buyers and other market participants, we calculate that carbon funds are currently heading towards a total capitalisation of

€3.7bn, of which €3.1bn has already been committed by fund investors. This represents a more than threefold increase during the last year.

It is worth noting that cash return carbon funds (providing cash rather than carbon credits as a return to investors) are a much more recent innovation and have seen a growth lately. These funds see carbon credits as an investment opportunity with potential for growth in value and also a new asset type with an interesting risk profile that makes it particularly interesting for hedge funds.

The unexpected surplus of allowances

Verified emissions data from 2005 for more than 10,000 installations covered by the EU ETS were expected to be published on 15TH May 2006. This would have indicated whether the price of EU Allowances (EUAs) was correctly set.

In late April, emissions data from several Member States leaked into the press, and prices started to fall rapidly as many of the countries turned out to be long on allowances. The official data was inadvertently made public on Friday 12TH May, showing a total long position of 66.9 Mt with most countries and installations reporting. On that day, the market plunged to close at €9.25. Prices rebounded the ►



following week, trading as high as €19.55/t on 23RD May, before beginning a very slow decline that has continued to today (current prices are about €12/t for delivery in 2006).

The total surplus of EU Allowances (EUAs) stands at 97.2 million for the 2005 calendar year. Across the EU-21, Poland, Germany and France were the longest countries, while Great Britain and Spain dominate the other side of the scale. The power companies were on aggregate short, while all other sectors faced an aggregate long position, metals being the longest.

What caused the surplus? In general, the industrial companies point to “reasonable treatment” in the allocation process, combined with over-optimistic projections for future production. While there is recognition of the fact that allocation formulas for Phase One provided industry with generous allowances, it is worth pointing out that lower than expected industrial output was a factor.

Evidence of CO₂ abatement

Is there evidence of CO₂ reductions taking place? There have clearly been some site specific reductions, such as increased energy efficiency and bio-fuel based power production (e.g. in the pulp &

paper sector). Closing of production, either permanent or temporary, is also a reason for surplus allowances – as was production transfer. But this would only apply for a small handful of installations and not for the industry in general.

In the metals sector, production levels in 2005 fell compared to 2004, partly due to high level of stocks in the supply chain. Demand has increased again in 2006, which is likely to bring with it higher emissions. Efficiency improvements have already been made at a number of installations, and there is not much potential for further increased efficiency. In fact, if one looks only at reported historical emissions versus production levels, and the 2005 numbers, there has been an increase in efficiency of 19% since 2000-3. Some impressive improvements can also be found in the ‘others’ sector, which has increased its efficiency by 26% since 2002. It is still difficult to say exactly how much of this is due to actual improvements and how much is due to inflated historic figures for emissions – but the latter is considerably more likely than the former.

In other sectors there are also specific situations which have led to emissions reductions. In the cement sector there is ►



some evidence of increased use of alternative fuels and repairs or replacements of kilns during 2005. In the chemicals sector, there has been some disruption to production (in particular in the UK) in Q4 2005, due to high gas prices.

However, in general the majority of the emissions reductions that have taken place cannot be explained by major abatement initiatives arising from the introduction of the EU ETS. The question is whether the scheme will prompt major abatement initiatives in 2006 and 2007.

Getting it right second time around

In total, 15 Member States have now submitted their NAPs to the EC. The Commission has stated that countries who do not submit their plans by 12TH October 2006 will face infringement proceedings. This, however, might seem like a toothless threat, since such proceedings are cumbersome and lengthy - typically lasting more than a year - and the EC needs to resolve issues quickly. Thus, we assume that although the EC will be



increasing the pressure on the laggards in the weeks to come, it is unlikely that it will actually take any Member State to Court.

With regard to the outcome of the Commission's NAP assessment, we still think that the EC will assess the NAPs in a strict manner. In a meeting of the Climate Change Committee (consisting of the Commission and Member State officials) before this Summer, the Commission reiterated its position clearly to the Member States. For the countries which have already reached their Kyoto targets, the 2005 aggregate verified emissions data will be the starting point for assessment of the NAPs. Member States who still have some distance to cover before reaching their targets will have to allocate allowances below the 2005 level.

In conclusion, it seems reasonable to say that the EU ETS, despite some serious errors, is a success as institutions and mechanisms are established and work properly, and traded volumes and prices have reached significant levels. However, in order to meet the Kyoto targets in the first Kyoto period, to which the EU ETS is intended to contribute significantly, it is important to ensure a strict market in Phase Two. The caps suggested in the current national allocation plans (NAPs) seem to be generous and the Commission should therefore reduce these caps to avoid an over-allocation of allowances which would undermine the effectiveness of the scheme. ■