

Politics hinders ETS progress in Central and Eastern Europe

Political ranglings in Central and Eastern Europe (CEE) delayed the start of trading in carbon allocations and markets were massively over-supplied with carbon allowances. Gergely Szabo and Edit Kiss of Vertis Environmental Finance argued that a firm political commitment to reducing CO₂ emissions is essential for the success of ETS.

Setting the political scene

Riots in Budapest - The collapse of the coalition in the Czech Republic - Resignation of Ministers in Poland. Because of these and other political distractions, environmental issues are very low down on the priority list for the Central and Eastern European (CEE) states. But EU membership brought obligations, one of which was the EU ETS.

It came as no surprise that the larger accession states were slow to implement EU ETS. This article seeks to shed light on what has happened so far with within CEE and what we can expect in the future.

Phase One – National Allocation Plans

The Phase One was due to start in January 2005 but it was not until Autumn 2005 that registries came online in the Czech Republic and Slovakia. These were followed by Hungary, which started operation just before the compliance period (April 2006). The laggard was Poland, which only finalised and established its NAP in July 2006. The delays were substantial and due to political squabbles about allocation rather than administrative problems, but in reality a lot of other EU countries were late as well.

The extent of gaming in the initial NAP process was revealed in May 2005 when it

appeared that CEE countries had ended up with surpluses of EUAs: Poland 32 million, Czech Republic 14 million, Slovakia 5 million and Hungary 5 million. At least the CEE countries were not hypocritical – none had ever claimed that climate change was a political priority for them.

Phase One – ETS Trading

Slovak companies, pushed by a particularly active brokerage firm, began trading forward as early as 2003. The initial burst of activity slowed as companies across the region began to tackle technical issues like monitoring and reporting, became concerned at the lack of any domestic regulation and as buyers began to be more rigorous about credit terms.

Trading only began in larger volumes as the registries came on line. The Czech market rapidly took the lead and became the most developed in CEE. Much of the 2005 and 2006 surplus of Czech companies was sold well before the price collapse in May 2005. Very few companies from Hungary and Poland managed to take advantage of the high prices and now many will still say they are waiting patiently for prices to go up to the twenties before they sell.

Why have the Hungarians and the Poles been apparently so slow to come to



market? The reasons are quite different. The Hungarian economy underwent a thorough privatisation in the 1990s, almost all its industry was sold to international groups. These – including many power companies, cement companies, and others – tend to manage EU ETS compliance and trading centrally. This means that their surpluses are bought inter-company and do not come to market directly. Indeed the centralisation often extends to the point that local companies (including some power plants!) are not allowed or encouraged to include the cost of carbon in their marginal cost analyses, rather defeating the object of the scheme and leading to elementary errors in business decision-making.

Polish industry was hampered by a long tussle in the finalisation of the NAP. Disagreements occurred both internally and with the European Commission. Assigning blame for this is difficult – perhaps it is just in the nature of things that consensus takes longer to come when there are so many (over 1000) institutions to satisfy in the context of a democracy. Many more industrial companies have state ownership or are influenced by the state, which means that their decision-making tends to be slower than private sector counterparts. This leads to long delays in companies coming to market, particularly when there is political turbulence. They must be kicking themselves now, though, trying to shed 32 million tonnes of surplus EUAs at a price of €11 when they have seen it at €30 and could do nothing at the time.

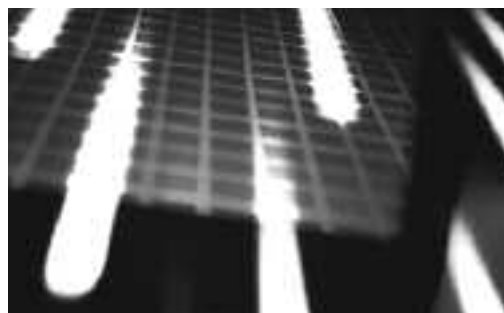
Since the Summer break however, Polish companies have begun to trade with increasing confidence, coinciding with the fall in the oil price and a €3-4 slump in the EUA price.

Looking forward to Phase Two

Second phase NAPs are well advanced, but there are many outstanding questions. Most of the CEE countries are basing their estimates on projected production data and most likely will have interminable discussions with the Commission until their allocations are finally accepted.

CEE environmental ministries have zero political clout, and zero political support from above. This means that they are not in a position to impose NAPs, which would put any pressure on industry. It only takes a few phone calls from influential energy companies and the Minister of Environment gets his pink slip. So the national environment ministries have to adopt a quite different tack. They play along with industry, and prepare a NAP, which keeps the domestic market happy but it allows the EU commission to pull it to pieces. It is a risky game – a kind of grün realpolitik – but they have few alternatives.

A shortage of allowances in the second-phase in the EU ETS is vital for the future of the scheme and would stimulate investment in cleaner technologies in Central and Eastern Europe – something the region still badly needs. Easy linking to Kyoto and a loose NAP will put off any clean-up for another five years. Western Europe has to take a lead in cutting the allocation and the Commission needs to be firm with Central and Eastern Europe. ►



Bulgaria and Romania

The big news recently is the approval of Bulgaria's and Romania's accession to the EU from the 1st of January 2007. These countries have been working hard on EU ETS and are assuming that they will join for the last year of the first trading period. This should make the market even longer than it is, and, having learnt from the mistakes of other countries in the region, companies in Bulgaria and Romania are not likely to hesitate long before starting to trade. With a combined population of 30 million, and some big industrial plant rusting out there, these countries represent an estimated further 130 million allowances in the scheme. Assuming a surplus of some 10% (which seems to be par for the course), this means a flood of some 13 million likely to come to market.

Next steps and way forward

The attitude of market players towards trading in the CEE region has evolved strongly in the last year. Operators now understand monitoring and reporting. Many have now traded, and have benefited commercially. But few operators in CEE actually operate their businesses to take into account the marginal cost of CO₂ emissions, and some are actually prevented from doing so by their owners. There is also often an assumption that new investments, even into coal-fired plant, will be granted enough allowances for the cost of emissions not to be a significant burden.

However on a positive note, installations covered by the scheme have accepted being part of the system, consensus has been reached on allocation, registries work, many of the operators have executed their first trades, and some are just starting to incorporate the value of

the carbon in production and investment decision. Despite the hiccups, a dramatic change in attitude has taken place - more and more consider the scheme an opportunity instead of a burden.

The next steps – of incorporating the cost of emissions into operating and investment decisions – are some way off, and are unlikely to be widespread until a firmer hand is shown by politicians who need to send out a clear signal that this is a system which will endure and will make the cost of carbon significant and permanent. ■

