



Will the ETS deliver in phase two?

By Hugo Robinson, Analyst, Open Europe

Phase one of the EU emissions trading scheme (ETS) didn't work well for the environment, or in building confidence in carbon markets. It was hoped that phase two would be better. Unlike in phase one, there will be scarcity in phase two. But lax import limits on Kyoto credit use mean that most, and quite possibly all, of the likely phase two shortfall can be covered by importing credits from project-based mechanisms overseas. Given reports showing that many such projects that are either environmentally deficient or economically wasteful (or both), an ETS which simply essentially results in the import of vast numbers of Kyoto credits may not be a very cost-effective way of reducing emissions.

The price of carbon in Europe in phase two will depend on the price of credits from the Kyoto mechanisms. But according to a recent (April 2007) report by Professor Catrinus Jepma at the University of Groningen, there will be a supply of around 5.75 billion tonnes worth of Kyoto credits coming onto the market, while there is only going to be demand for 3.5 billion tonnes' worth. A falling price for Kyoto credits may drag down EU prices with it.

How low could it go? Well, in its 2003 impact assessment looking at the effect of linking to the Kyoto mechanisms, the Commission suggested that importing 12.7% of emissions would reduce the price of carbon in the ETS from €26 to €4.8 – even without considering the effect of the huge oversupply of Kyoto credits which has emerged. In practice the EU as a whole will actually be able to import up to 13.6% of its emissions. So once again the ETS may fail to put a serious price on carbon.

EUA closing prices - historical

EUA prices. The graph below shows daily bid-offer close EUA Dec 2007 prices from December 2004 (blue line) in the OTC market, and EUA Dec 2008 from Sept 2005 (red line). The data was updated 9 August 2007. The data is published daily at www.pointcarbon.com.



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EUA closing prices

	Bid	Offer	Close	Change
OTC				
EUA spot	0.06	0.14	0.10	0.01
EUA 2007	0.10	0.12	0.11	0.01
EUA 2008	19.60	19.65	19.63	-1.05
EUA 2009	20.00	20.10	20.05	-1.04
ECX				
CFI Q4 2007	-	-	0.10	0.01
CFI Q4 2008	-	-	19.65	-1.05
CFI Q4 2009	-	-	20.08	-1.03
EEX				
EUA Spot	-	-	0.08	-0.01
EUA Dec 2007	-	-	0.10	0.00
EUA Dec 2008	-	-	19.61	-1.01
EXAA				
Spot	-	-	0.10	0.00
Nord Pool				
EUA spot	-	-	0.10	0.01
EUA Dec 2007	0.09	0.11	0.10	0.01
EUA Dec 2008	19.65	20.20	19.80	-0.85
Powernext				
Spot	-	-	0.10	0.02

Quoted prices are for Euros per EUA, at close of market 9 August (31 July for EEX), and reflects week-on-week market prices using a bid-offer close methodology. Changes refer to the last issue of CME. For over-the-counter (OTC) methodology, see www.pointcarbon.com.

Market Comment

European carbon for next-year delivery slumped 5 per cent week-on-week to close at €19.63 Thursday, down €1.05 on last week. Traders said declining fuel fundamentals, particularly German power, provided the downward direction.

The December 2008 contract started on an upward trend and peaked at €20.84 last Friday, but softening gas and German power prices made it more profitable for utilities to burn gas rather than

coal, thus removing their appetite for carbon.

The contract was trading around the €20-level for large parts of the week, with traders saying CO₂ lacked direction. "There is no strong momentum either way," one trader said.

Carbon has stayed in the €19-21 range for seven days, and one trader said "I can't see us moving out of that band anytime soon."

The CER market was quiet most of the week, though a flurry of trades went through on Wednesday. The December CER-EUA spread rose to around 83 per cent towards the end of the week, while the strip spread remained at 75-76 per cent.

In total, 29.5 million EU allowances traded over the period, with brokers accounting for 19.95 million. The remainder traded primarily on the European Climate Exchange.

Mixed views on commission's phase two preparations

UK-based think tank Open Europe this week released a report which concluded that the first phase of the EU emissions trading scheme has been a failure. The same criticism has been voiced previously, both by companies and organisations in Europe and stakeholders in the US, Canada and Australia who have studied the EU ETS in the process of setting up their own domestic or regional schemes.

The hardest-hitting criticism during phase one of the EU ETS has concerned the vast surplus of allowances in the market.

The scheme was introduced to reduce European CO2 emissions, but facilities covered by the ETS increased emissions from 2005 to 2006, and over 150 million excess allowances were available in the market. This has brought the price down from around €30/tonne in April 2006 to €0.10 in August 2007.

The European commission in its ruling on national allocation plans for the 2008-2012 trading period has attempted to address the situation by making significant cuts in the number of allowances member states can allocate in the upcoming five-year period. As a result, six member states are hauling the commission to court to have the decision overturned.

The key question is whether market observers believe the commission has been successful in creating a shortage in phase two. Analysts such as Point Carbon and Societe Generale have announced they expect a phase-two price around or above €30 per tonne, but the

availability of Kyoto protocol offset credits casts uncertainty over the market's net balance.

"We believe the commission has managed to create a situation where the market is short," said one analyst of a UK-based bank. "There is only a limited amount of CDM credits than can be imported, and we believe quite a bit of fuel-switching will be necessary," he said.

He estimated the total market shortage over the five years to be around 300 million allowances.

"One problem with phase one was that there was no benchmark for emissions. We have that now. The commission has been a lot stricter dealing with the NAPs, and have put in place quite a few measures to make sure the situation we saw in May 2006 does not happen again," he said.

An analyst at a German utility said it was too soon to comment on the market balance, but emphasised one change in the scheme that he considered a significant improvement.

"A part of the structure in a scheme where you set a cap in the beginning is uncertainty. This makes it likely that the price will first increase, then decrease. If there had been a stronger link between phase one and phase two via banking, this could have helped phase one," he argued.

"A lot now depends on phase three. If there is scarcity then and banking from phase two is used, the phase-two price will not go too low," the analyst said, stressing that this would

hold true even if there was no real shortage in the phase-two market.

The 2005-2007 period of the EU ETS has also been strongly criticised by industry for allowing electricity producers to cash in billions in windfall profits at the expense of energy users.

Asked what the EC had done to address this situation in phase two, Vianney Schyns of the Dutch-based Utility Support Group said "hardly anything."

"The EU High-Level Group's advice on issues such as benchmarks and new entrants weren't even put on the commission's agenda," Schyns said.

"The issue of windfall profits has been a very big discussion, and there is increased awareness that we don't want this. But the only thing that has been done with it is through shorter allocation. Most energy companies are now 25-30 per cent short, but that means that 70-75 per cent of the windfall profits will still be there for the next five years," he said.

"The current system gives an incentive to produce less, which we find quite perverse," he said. He also pointed out that there was "no contingency plan" by governments for what to do with energy-intensive users if the EUA price stayed at €25-30 through the trading period.

"It is disappointing that despite a lot of discussions, nothing has happened on these issues," he said.

Carbon news this week

US President **George W Bush** last Friday followed up on his promise from the G8 meeting in June, and invited representatives from 15 of the world's largest greenhouse gas emitters as well as EU and UN officials to a meeting on climate change in Washington, DC on 27-28 September.

The meeting, which will focus on the international community's response to global warming in the post-Kyoto period, will be held only three days after UN General Secretary Ban Ki-moon holds similar discussions in the UN headquarters.

"The United States is committed to collaborating with other major economies to agree on a detailed contribution for a new global framework by the end of 2008, which would contribute to a global agreement under the UN Framework Convention on Climate Change by 2009," Bush wrote in the invitation.

The meeting, the invitation said, would aim at discussing an agreement which could include a "long-term global goal, nationally defined mid-term goals and strategies, and sector-based approaches for improving energy security and reducing greenhouse gas emissions.

The heads of state of France, Germany, Italy and the UK were invited from Europe. In addition, Australia, Brazil, India, Indonesia, Japan, Mexico, Russia, South Africa and South Korea will be present.

UK parliamentarians reviewing the Labour government's draft climate change bill last Friday urged a tougher law to cut GHG

emissions by 2050.

"We recommend that the bill should be amended to require both the government and the Committee on Climate Change to include within their monitoring and reporting a clear analysis of all emissions which contribute to global warming, including non-CO2 greenhouse gas emissions," said a report published by the multi-party Joint Committee on the draft bill.

The draft bill, published in March, seeks a statutory goal of a 60 per cent reduction in CO2 emissions through domestic and international action by 2050, including an interim binding target of 26-32 per cent by 2020.

An appointed committee will oversee a system of "carbon budgets" set at least 15 years ahead, with progress reported annually to parliament.

Meanwhile, German utility **RWE** announced this week it had spent around 25 per cent less on carbon allowances in the first half of 2007 compared to the corresponding period in 2006. However, it said it expected to have to purchase around half the CO2 allowances it will need in the 2008-2012 period, estimating it would have to buy 72-77 million EUAs every year in the five-year period.

"At present, we believe that free certificate allocations in the second trading period in Germany will only cover slightly more than half our carbon dioxide emissions in Germany. Free certificates allocated for the period from 2008 to 2012 are anticipated to cover 75 to 80 million metric tonnes a year. By comparison, 2006 CO2 emissions by RWE's German power stations amounted to 147 million metric tonnes. These figures include power plants not owned by RWE that we can

deploy at our discretion on the basis of long-term agreements," a statement from the company said.

CEO Harry Roels said at a press conference that RWE expects to spend around €150 million on imported carbon credits during the early years of phase two.

A spokeswoman for **Lithuania's** Prime Minister Gediminas Kirkilas told Bloomberg Thursday that the country is likely to file a lawsuit against the European commission over its national allocation plan for the second trading period of the EU ETS.

Lithuania had proposed to allocate 16.6 million EUAs per year to its installations over the trading period, but in November 2006 the commission ruled that the country would only be allowed to hand out 8.8 million credits.

Lithuania has since submitted two revised allocation plans to Brussels, the latest asking to allocate 11.01 million EUAs per year, but the commission stands firm on its initial decision.

The Czech Republic, Estonia, Hungary, Latvia, Poland and Slovakia have all filed lawsuits against the commission over their allocation plans.

Spot carbon trading platform **Climex** this week decided to lower its transaction fees to half a cent per EUA for the remainder of the year. The previous fee had ranged from one to five cents, but as the EUA spot price has dropped to around €0.10, Climex decided to slash the fee.

The Climex Alliance comprises Netherlands-based New Values, Hungary's euets.com and the Spanish Sendeco2.

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