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Market meltdown? Carbon trading is just warming up

First, the price of the EU's credit allowances crashed. Now shares in companies that trade in them are falling too. But getting polluters to change their ways will be a process of trial and error, says Mike Scott

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Is the carbon market a success or not? If you were to look at the share prices of companies involved in generating carbon credits, you would conclude that this was a business to steer clear of.

Analysts New Energy Finance reported in May that shares in the carbon credit groups EcoSecurities, Camco International and Trading Emissions had plummeted 75 per cent, 50 per cent and 20 per cent respectively from their highs last year, while Agcert, once a leader in Clean Development Mechanism carbon credit markets, saw its shares fall 99 per cent before they were suspended in February. EcoSecurities' shares dropped further last week when it emerged that it was suffering delays in getting UN-certified credits.

However, in the first six months of 2008 the global carbon market was worth €38bn (£30bn), almost as much as the €40bn recorded for the whole of 2007. There is a perception that the carbon market is a failure because of one event – the crash in prices of EU allowances in 2006. Yet in many ways that price crash was a vital step in the market's evolution. It came about when it emerged that virtually all EU member states – the UK was an honourable exception – had issued too many allowances, after intense lobbying from industry. This meant that the high emissions industries covered by the scheme had no incentive to cut their carbon usage and so would not need to buy allowances.

The victory turned out to be a pyrrhic one for business because it made the European Commission more determined to have tighter national allocation plans and create a meaningful carbon price in the market's second phase, which runs from 2008 to 2012. As a result, the price is fairly robust at €24 and a shortage of allowances is predicted, meaning that companies will have either to cut their emissions or buy allowances from others that have done so.

"The over-allocation would be disastrous if it was continuing, but it was a Phase 1 issue," says Sam Fankhauser, managing director of IDEACarbon, which recently launched a carbon credit ratings service. "Phase 1 was a learning phase, when we did not even know what emissions installations were responsible for. We know that now and Phase 2 looks much more robust."

In the third phase of the Emissions Trading Scheme, from 2013, the Commission plans to centralise the allocation process rather than have 27 member states deciding on their individual allocations.

"As a pure financial product, the carbon market is working well," says Lionel Fretz, chief executive of Carbon Capital Markets, which avoided the share price drops of its peers only by virtue of not being listed.

"However, it is in generating credits that we are having problems – and it seems to be getting worse, not better."

The Clean Development Mechanism is a victim of its own success, says Mr Fankhauser. It cannot issue credits quickly enough because it does not have enough trained staff but it has also tightened up its criteria so developers are not receiving all the credits they had hoped for – and in some cases had already sold. Project

validators – who ensure that emissions cuts have been made – such as SGS, Lloyds and DNV are also suffering from staff shortages. The upshot is that projects are being delayed.

This is a real problem, says Bruce Usher, chief executive of EcoSecurities. "It is good that the verification and accreditation process is strict, but it just takes too long – projects are stuck in the pipeline for one to two years and there are only four and a half years left until the Kyoto Protocol expires."

Projects do not start generating carbon credits until they are registered by the UN, so such lengthy delays can be costly, especially for companies that have sold on the credits, known as CERs (certified emissions reductions), to buyers who need them to comply with their Kyoto targets. If they cannot deliver the CERs, they could suffer the same fate as AgCert, a Dublin-listed company forced into examinership (the Irish equivalent of administration) after running short of cash.

As if that weren't bad enough, on the other side of the process, there is a hold-up in one of the key parts of the carbon market infrastructure, the link between the UN registry (the International Transaction Log or ITL) and the registry for the EU Emissions Trading Scheme (the CITL, or Community Independent Transaction Log). This seemingly arcane link is vital for the carbon market because the current phase of the Emissions Trading Scheme coincides with the compliance period for the Kyoto Protocol. Without it, businesses that need to buy credits cannot use Clean Development Mechanism credits – which are cheaper than EU allowances – to meet EU compliance requirements.

The European Commission says it is testing the link now and that "it will definitely be up and running by the end of the year", a statement that does not inspire huge confidence, given that it said that about its April 2007 deadline and the December 2007 deadline. There is much more at stake this time, though – 2008 contracts for settlement must be delivered in December.

If the link is not established, companies that have sold contracts forward will be unable to deliver the credits they promised, with one observer suggesting there would be "market meltdown". However, these are teething problems, or issues for particular companies that have failed adequately to manage their risks, says Matthew Whittell, finance director of Climate Exchange, who adds: "In any rapidly growing free market, there will be winners and losers. The market is bigger than any individual participant."

The carbon credit market is risky, adds David Metcalfe, chief executive of the research firm Verdantix, and if companies such as EcoSecurities do not perform well, that is just part of the learning process in getting the business model right. "It is a new market that is entirely regulation-driven, and those regulations change regularly," he says. "On top of that, you have to operate in countries that do not necessarily have a great market structure themselves."

EcoSecurities' Mr Usher agrees that his company's travails are teething problems, albeit fairly challenging ones. "This is a new market and we will get some of it right and some of it wrong. Not only do I see nothing wrong with this, I don't think we have any choice. Anyone who thinks we can do this perfectly is deluded, and anyone who says we cannot do anything until it is perfect is just wrong."

However, he says that the long-term prospects for carbon markets globally are good. Most market observers think that the US will have a federal cap and trade scheme within the next few years. If it does, it will dwarf the EU market, with New Energy Finance predicting that it could be worth $1 trillion by 2020.

Australia has just announced plans for its own emissions trading scheme, and the EU has said its scheme will continue regardless of what happens in negotiations to create a post-Kyoto climate change agreement. These are moving slowly, although it is hoped they will speed up when the US gains a new President.

"Ultimately, the market will be judged on whether they deliver environmental benefits at a relatively low cost,"

says Climate Exchange's Mr Whittell. "The carbon price is changing the way emitters do business. None of us is clever enough to work out what is the best way to tackle climate change, but if we have a global carbon price, the market sorts it out. Even with the over-allocation in Phase 1, the EU Emissions Trading Scheme still saved about 100 million tons of carbon. Phase 2 should be even more effective."

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