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The European Allowance and Certified Emission Reduction Price Difference

IDEAcarbon has issued an analysis explaining the difference between EUA (European allowances – currency of the EU trading system – EU ETS) and CER (certified emissions reductions from UN approved projects in developing countries) prices.

Between the middle of March and the end of May, prices for December 2008 EUAs jumped by some 22%, while prices for the corresponding secondary CER contract rose by just 10%.

The sCER-EUA price differential swelled by over 53% during this period. Anybody selling EUAs and replacing them with CERs on March 17th would have made €5.78 per tonne, but on May 26th the profit would have been €0.10 per tonne. Since the beginning of June the price gap has narrowed again to €6.99 – higher than but close to what it was before – as the price of sCERs rose and that of EUAs fell a little.

What caused this differential in the first place, and why has it now begun to narrow?

The differential appears

Market fundamentals play a key role. In the early stages of phase II trading (phase I was 2005-2007), participants assumed that the CER import quota was generous enough to cover the entire phase II shortfall. Secondary CER prices had the same compliance value as EUAs and hence theoretically the same price, with some discounts to reflect the higher risks of CERs.

But in its January announcement at the start of phase II, the European Commission placed an EU-wide limit of roughly 1.4 billion CERs on the use of credits for compliance until 2020 (if no post-2012 international agreement comes into force). This CER limit is less than the amount companies need in order to comply with their emissions caps, thus creating a constraint upon the CER market.

Given that fewer cheap CERs can enter the EU ETS than are required, the market would need to look for other means of compliance. And so prices for EUAs should rise to the level of the marginal cost of abatement, while the price of CERs relative to EUAs should fall as demand tails off.

Also of relevance is the fact that liquidity is far lower for sCERs than for EUAs. The daily sCER market

volume is on average around 10% that of the EUA market. The CER market is thus more sluggish in its movements than the EUA market, and is slower to respond to market signals. The result is the price gap. By this rationale, the gap can be expected to narrow further as the CER prices catch up (see below).

The CER market is subject to institutional obstacles, and the trade in sCERs for forward delivery is backed by an underlying asset that in almost all cases has not yet been issued. Because there are so few issued CERs available and so few countries that can currently accept them, transparency is lacking.

There are several major institutional hurdles to the proper functioning of the market. For a start, EU member state registries are not yet connected to the UNFCCC's International Transaction Log, meaning that CERs cannot move into EU buyers' accounts. Secondly, most EU member states have yet to issue 2008 EUAs to their installations. With no EUAs in their accounts, there is little at present to encourage small and medium-sized industrial companies to enter the market in any way.

Knowledge too is lacking. According to a poll carried out in early 2007 by the JIN Foundation, fully one-third of EU companies surveyed were unaware that CERs could be used for compliance. And almost 60% of respondents said they wouldn't use CERs in any case. While more companies will doubtless have learned more about using CERs for compliance in the past year the other, other obstacles remain.

The differential narrows

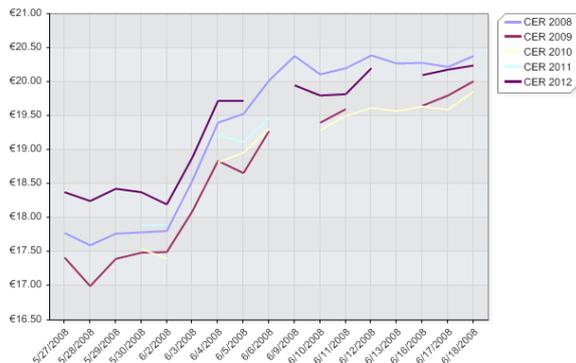
Returning again to market fundamentals, last month the UNEP announced that it had revised its supply projections for pre-2012 CERs to around 1.5 billion by 2012 (in line with prior IDEAcarbon pre-2012 supply estimates of 1.4 billion). The market is now beginning to understand that CER supply (when public and non-EU ETS demand is factored in) may fall below the magic 1.4 billion mark. This is clearly taken as a bullish price signal, and CER levels should be partially narrowing the gap to EUA prices. If this is the case, then we should see CER prices continuing to rise.

Alongside this it seems that the CER price has belatedly begun to react to the changing price level of

EUAs and will resume its regular position about €5-6 below the EUA price.

Finally, it could be that market participants have begun to capitalise on the profit to be made from swapping their EUAs to CERs. Most companies have by and large been allocated as many EUAs as they need to cover business-as-usual emissions. They are thus presented with an opportunity to swap EUAs for cheaper CERs up to the maximum limit allowed by their national allocation plan.

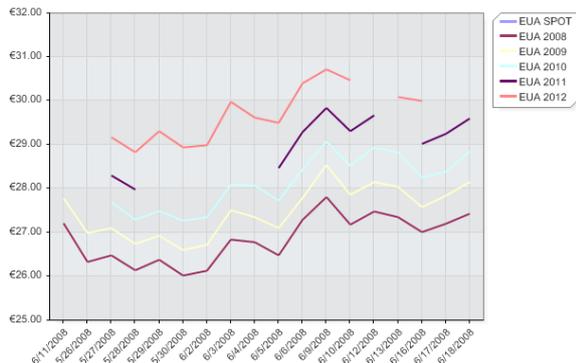
In some countries this can be as much as 20% of their original allocation of EUAs, though across the EU the average is closer to 10%. Carrying out the swap generates considerable amounts of cash for these companies, and releases extra EUAs which can be used by utilities, who have the bulk of the EU ETS's shortfall in allowances. A wave of CER-EUA swapping would cause the EUA price to fall and the sCER price to rise, thereby significantly narrowing the price differential that existed.



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EU Price Update

All allowances continued to firm in the last month



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MAF Regulations for Forestry

What will the forestry regulations describe for carbon assessment?



Environmental Intermediaries & Trading Group Limited

The forestry regulations will ultimately describe when and how these two approaches (look-up table and measurement) are to be used to assess carbon in pre-1990 and post-1989 forests. The measurement approach is not yet covered in the regulations but will be included in the forestry regulations in relation to post-1989 forest land at a future date as technical details are finalised.

What is the look-up table approach?

Look-up tables have been prepared to enable pre-1990 forest participants to determine emissions from deforestation and for post-1989 forest participants to determine their net carbon stock changes (that is, removals during forest growth and emissions during harvest).

The look-up tables for Pinus radiata were prepared by modelling the carbon content of an average forest, of a particular species, age, and region. Tables for other exotic species will apply nationally and not regionally because there is not enough data available to predict regional variations for the minor exotic species. Further tables will cover emissions from the post harvest decay of the below ground biomass (the roots) and the woody and fine litter left on the forest floor.

A look-up table approach for measuring carbon stock change is:

- simple to apply
- affordable to forest landowners
- achievable in the available timeframes
- administratively simple
- able to be applied retrospectively.

What is involved in the measurement approach?

The measurement approach is proposed to be introduced in subsequent regulations. It involves sampling a forest using standard forest inventory procedures where measurements of tree diameter and height are taken within sample plots randomly spread across the forest. It will also be necessary to determine wood density.

The field data collected will be used in a series of empirical equations to calculate total tree volume, total forest biomass (both above and below ground) and hence total carbon stocks. A mechanism will be provided to extrapolate these figures backwards to 1 January 2008 and forwards to mandatory emission return dates. A MAF ETS website will allow participants to calculate their carbon stocks using their field measurements. The measurement approach is more expensive than the look-up table approach because it requires field measurements but it provides a more accurate site specific calculation of total carbon.



The method by which wood density is to be determined is not yet finalised. If the method requires samples (either wood cores to measure density directly or the prediction of density from soil samples and mean annual temperature) there will be an additional cost, but this will be minimised if the samples are taken at the same time as the field measurements. On report back, after the consultation period, the regulatory impact statement will provide more analysis of all the costs to participants of the density option and of the measurement approach as a whole.

What is proposed for post-1989 exotic forests?

Ultimately participants will have the ability to assess carbon stocks for post-1989 forests using either the measurement approach or the look-up table approach. There will be rules that govern when each method can be used and these are described below.

The look-up table approach should be ready for use soon after the legislation is passed. The measurement approach is more complex and will not be ready for use before early 2009. Participants who are required to use the measurement approach will therefore be able to use the look-up approach initially and then switch to the measurement approach when it is available with no loss of entitlement.

<http://www.maf.govt.nz/climatechange/legislation/regulations/page07.htm>

Maori Party Call on NZETS

Catherine Beard, executive director of the Greenhouse Policy Coalition, says the Maori Party's call on 10 June to have a cross party approach to reduce government, personal and business dependence on oil is laudable, but their call to bring forward the emissions trading scheme is at odds with their concerns about the increased costs for consumers from emissions trading.

"There is no escaping the fact that by leading the world with the toughest and most comprehensive emissions trading scheme, increased costs are going to flow through to businesses and consumers – over and above the high cost of oil we are facing at present."

Catherine Beard says a quick read through the submissions to the Finance and Expenditure Select Committee on the emissions trading Bill shows that those multinational companies that are already covered by the European emissions trading scheme have calculated that the cost of the proposed New Zealand scheme will be much greater than the costs they face in Europe.

"The Maori Party seems to be concerned that a free allocation of 90% of 2005 allowances is a 'free ride' for industry and agriculture at the expense of households. The reality is that no company or

agricultural entity is likely to get 90% free allocation as this is an amount that is to be shared amongst all those deemed eligible and once thresholds are applied the free allocation might be spread quite thinly."

"The other reality is that if New Zealand businesses have to take on increased costs due to an emissions trading scheme that their international competitors do not face, they lose their competitiveness and ultimately either go out of business or move their business to a country where they do not have to face those costs and can remain competitive."

"It will be no 'win' for householders if businesses are forced to relocate to Asia and jobs are lost and wages contract. The impact on householders is unavoidable in an emissions trading scheme as they will pay through higher prices for fuel and electricity, higher prices for food and transport as businesses pass on higher energy costs. If businesses cannot stay profitable and are forced to close or relocate, householders pay even more dearly through fewer job opportunities and lower wages".

Catherine Beard said the Maori Party are right to be concerned about sending the right signals to industry and agriculture to reduce emissions, because the current Bill does not achieve that aim. "The current Bill sends the signal to business to exit the country – not invest in new cleaner technology. With every new tonne of carbon priced at the full international price of carbon (between \$30-50/tonne) it will be cheaper to run old plant for longer and exit the country when the plant is at the end of its life."

"A better approach would be to make industry face a price of carbon if they are above world's best practice in emissions intensity (emissions per unit of output) and to reward them with units to sell if they are better than 'world's best practice'. That way industry is incentivised to keep investing in new technology to reduce emissions and it is investment in new technology that will put us on a path to a lower carbon future."

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projects and strategies.

EITG corporate advisory provides high-level briefings and advice on building robust responses to emerging regulatory structures.

EITG Carbon Pool provides forest owners with a robust platform to access local and international markets while dealing with harvest and other liabilities.

EITG provides trading platforms and strategies based on extensive mitigation and avoidance platforms under JI and CDM, with matched offset packages for emitters.

EITG is part of an international consortium with representation in Asia/Pacific, UK, USA and South Africa

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