Point Carbon™
Carbon Market Forecasting

Carbon Market Europe

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Point Carbon
Point Carbon is the leading global provider of independent carbon price forecasts and analysis of greenhouse gas emissions trading markets.

ViewPoint: 2003 - The end of the beginning?

The adoption and entry into force of the EU emissions trading Directive means that the notion of a carbon-constrained future is soon to become reality for European industry. Even though trades have been few and far between, we have seen the contours of an early (yet embryonic) market for trading of EU Allowance Units (EAUs), with prices quoted in the market increasing from about €6/tCO_2 in April to the current level of €12.50/tCO_2. The bid-offer spread has narrowed over time, which contributes to substantiating the market and provides clearer price signals. We expect activity to rise in Q1 2004, but substantial growth can probably not be expected before the end of March, when NAPs have to be submitted to the European Commission.

Another key issue is the pending proposal to link the EU ETS to the Kyoto mechanisms (CDM and JI). Even though the Council is keen to include project-based credits already in the first phase from 2005-2007, Parliament has so far opposed this. However, recent signals suggest that the Parliament may not resist an early start, possibly also allowing companies to use CDM/JI credits for compliance purposes even if the Kyoto Protocol does not enter into force. Allowing for an early start would send an important signal to companies by reducing legal uncertainties pertaining to CDM investments.

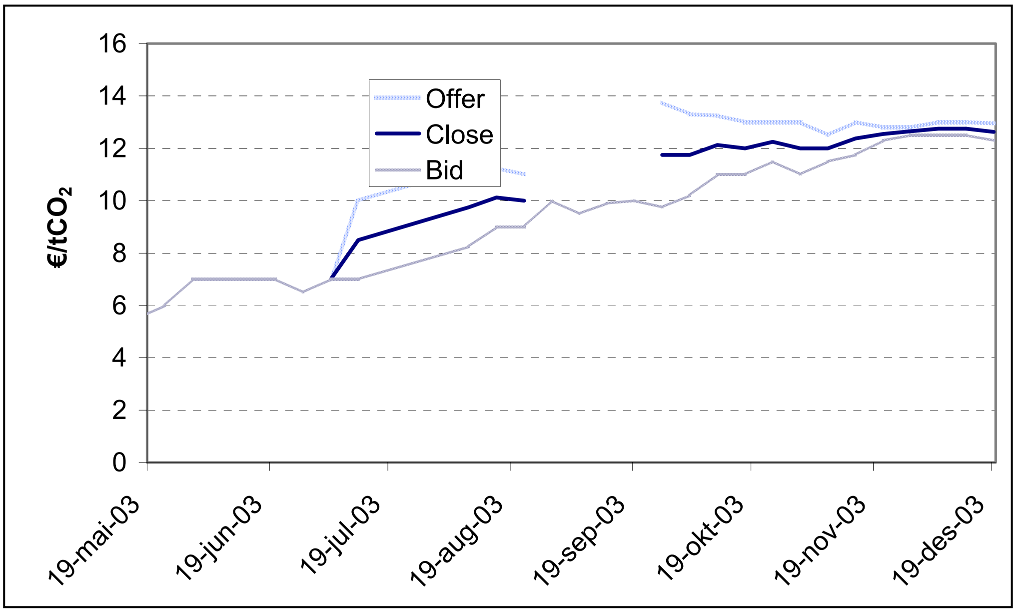
Against this backdrop, 2004 could indeed become a watershed for the emerging carbon markets, with the EU ETS as the engine for sustained market growth.

Atle C. Christiansen, Director – Research, Point Carbon, acc@pointcarbon.com

Carbon Market Indicator

	Bids		Offers		Close	Last
	Volume	Price	Price	Volume	Price	Price
EU 2005	10,000 t	€12.30	€12.95	10,000 t	€12.60	€12.00*
EU 2006	5,000 t	€12.35	€13.90	5,000 t	€13.10	-
EU 2007	5,000 t	€12.50	€14.70	5,000 t	€13.60	-
UK 2003	-	-	£2.20	2,000 t	-	£2.20

Quoted prices are for allowances per tCO_2. EU 2005: Bid: Payment at delivery Q4 2005. €12.30 bids for 5,000 t were also reported. A bid for 5,000 t at €12.50 was reported, but not confirmed. Offer: Payment at delivery Q4 2005. Last: The last trade announced went through 25 November. Volume unknown, terms agreed three weeks previous. *Another trade was made in the week 8-12 December, but price unconfirmed, although it was in the range €12.50-13t. 2006: Bid: Delivery Q3. 2007: Bid: Q3 delivery. Offers: One Q3 delivery, one December delivery. Other: A stream bid for 10,000 t a year was reported at €12/t in 05, €12.50/t in 06 and €13/t in 07. UK: Ready to trade immediately. Last trade in 1,500 t, Tuesday 16 December.



The graph above illustrates the price development in the EU 2005 emissions trading market the last 7 months. As there have been few trades with publicly announced prices, the graph is based on reported bids and offers.

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Guest commentary

ETS linkage: Green edged AAUs hold the key

Many of the companies affected by the EU emissions trading scheme (ETS) are still unprepared to face a carbon restricted future. The expected resulting shortage of allowances available for trading at the outset of the EU ETS will be offset through linkage to the JI and CDM mechanisms. Yet JI projects have been characterised by their complexity, project risk, longevity of bureaucratic procedure, high carbon threshold and significant transaction costs for all parties. Hardly attractive to corporate buyers. The emergence of Assigned Allowance Units (AAUs) transactions in countries like Slovakia and Romania indicates an alternative future.

A switch from track one or two ERUs (the JI currency) to project-backed AAUs will shift the burden of establishing a genuine emission reduction (and project risk) directly to the host government, which will underwrite the risk with its national carbon surplus, effectively attaching a sovereign guarantee to the contract. This will simplify baseline and validation procedures, and enable smaller transactions to occur at greater security, whilst offering greater utility to corporate buyers. The difference between ERUs and project-backed AAUs can be compared to that between higher risk corporate bonds and more secure government or gilt edged bonds. Perhaps we are witnessing the birth of *green edged AAUs*.

In the medium term, in order to overcome the problems of JI, a ring of countries around the Eastern periphery of the EU supplying AAUs to EU companies and governments is likely to emerge. The market is likely to decide for itself that JI has outlived its usefulness. However, with ETS linkage discussions at their peak, the moment is ripe to reevaluate the possible role of AAUs in such structures.

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Market comment

There were no new trades publicly announced in the EU CO_2 market this week either, but the best offer in the market crawled below €13.00/t for the first time in quite a while.

"With COP 9 in Milan firmly behind us, the EU allowance market is slowly winding down for the Christmas break, but many participants are getting set for a big year in 2004," commented **Lucy Mortimer**, broker with CO_2e.com.

"This year has seen the market grow slowly, with new players steadily entering the market towards the end of the year, and many more preparing to start in early 2004. Contract sizes have become more standardised, trades of real volumes rather than just trial trades are starting to materialise, and interest in options on EAUs is on the up. Importantly, there has been a significant change in the mindset of companies looking at the EU ETS. Where once there were environmental managers and engineers looking at the impact of the scheme on their companies, we now see traders and financial directors taking an active role, as the potential for both making significant profits and losses are realised," she told Point Carbon.

"General consensus in the market is that the new year will certainly see increased activity in phase I allowances after the allocation plan are published, but even before then the number of companies with traders and risk lines in place is rapidly escalating, and we are looking forward to an interesting first quarter," Mortimer noted.

While both the EU and UK markets are fairly slow, unable to generate impressively large volumes of CO_2 traded, the carbon market is still very much alive. The Netherlands announced the results of its ERUPT 3, the third call for Joint Implementation (JI) projects this week, through which it will buy 2.6 million tonnes of CO_2e from projects in Bulgaria, Romania, Hungary, Estonia and New Zealand at an average price of €5.46/tonne. Things are happening elsewhere too, according to Mortimer.

"Outside the EU ETS, the Clean Development Mechanism (CDM) market is booming, with active and increasing competition for Government buyers emerging from the private sector. Most private sector CER (Certified Emissions Reductions, the CDM currency) purchase activity is currently in Japan and Canada, with Europe still being dominated by the public sector. The progression of the linking Directive and discussions on implementing a project mechanism even if Russia does not ratify the Kyoto Protocol should increase European interest, however, and we are looking forward to increasing convergence between the Kyoto markets and the EU ETS during 2004," she said.

News in brief

The **German cabinet** has adopted the law that will transpose the EU emissions trading Directive into German law. The law must be approved by Parliament before it enters into force.

The **Estonian Government** has approved a special commission on emissions trading that will work with the country's national allocation plan. Estonia aims to publish its **first draft** in early February.

After some uncertainty caused by EU Energy Commissioner Loyola de Palacio, European Commission President **Romano Prodi** confirmed that the EU will stick to the Kyoto Protocol, not look for a way to escape due to the uncertainty regarding Russian ratification.

A trade was reported last week, brokered by **Natsource**, for 5,000 allowances. The price was not confirmed, but it was within last week's bid-offer spread.

The **Swedish Government** has submitted a report to the Parliament containing a set of principles that should guide the Swedish allocation plan. In the report, the Government proposed to allocate **between 17 and 18 million tonnes of CO_2** to the Swedish industry covered by the EU ETS annually from 2005 to 2007. In addition, it proposed to set aside some 2 $MtCO_2$ for new entrants and increased capacity at existing plants.

Belgium has decided to use a wide interpretation of which installations should be included in the EU ETS, thus increasing the estimated number from 280 to some 325.

Germany's conservative CDU party urged the Government to set aside free allowances for new entrants. The alternative would be for any new installations to have to buy all CO_2 allowances needed in the market. (ENDS Environment Daily)

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The European cement industry and emissions trading

CO_2 emissions from the EU15 cement industry
1990: 138 Mt*
2002: 145.5 Mt*
Change 1990-2002: +5.4%
* Direct emissions data. Indirect emissions from cement production, adding up to approx. 10 Mt annually, are largely compensated via indirect savings obtained through the co-incineration of waste in cement kilns.

Main actors
The biggest EU15 cement producers are Buzzi Unicem (Italy), Cimpor (Portugal), Dyckerhoff (Germany), Heidelberg Cement (Germany), Italcementi (Italy), Lafarge (France) and RMC United (UK). In addition comes Holcim, which has its main office in Switzerland, but which has activities in many EU countries.

Voluntary climate change related commitments made by the EU cement industry
The cement industries of several EU countries have made voluntary commitments. The cement industry of **Belgium** has signed an agreement aiming to reduce CO_2 emissions and increase energy efficiency.

In **France**, the cement sector set CO_2 emissions reduction targets for the period 1990-2000. **German** cement industry made a commitment in regards to specific energy consumption, adding up to a CO_2 emissions reduction of 3 Mt a year by 2005. A similar commitment has been made since, running to 2012.

Dutch cement has signed a covenant with the Government, providing it with energy production reduction targets, while in the **UK**, the cement industry has signed the Climate Change Agreement with the Government.

Current climate change related policy regulations covering the EU cement industry
The cement sector is covered indirectly through energy efficiency regulations on buildings.

Source: CEMBUREAU

Electricity price rise scare for cement industry

Like the other energy-intensive industries scheduled to participate in the EU emissions trading scheme (ETS), the European cement industry has concerns about the costs the industry might experience when the scheme is introduced in 2005. It is particularly the chance that the electricity sector compensates its increased costs by rising prices that worries the cement industry.

"CEMBUREAU and its members are working hard to get the allowances that will allow cement production to remain and develop in Europe," said Dr. Jean-Marie Chandelle, Chief Executive of CEMBUREAU, the European Cement Association.

"CEMBUREAU and other energy-intensive industries covered by the emissions trading Directive will take action to ensure that electricity prices are not artificially increased as a result of the interpretation of the cap and trade system by utilities," he told Point Carbon.

"Whilst the real cost of CO_2 emissions in the electricity sector can, of course, be passed on to industrial users, windfall profits which might materialise in certain Member States are highly objectionable and should be avoided," he argued.

Even though the cement industries in some EU countries have taken on voluntary commitments to reduce greenhouse gas emissions, total CO_2 emissions from the EU cement industry increased by 5.4 per cent between 1990 and 2002, as a result of increased production volumes in some countries. This would indicate that in the carbon constrained reality of the EU ETS, the cement sector would find itself on the buy side of the CO_2 emission allowance market.

According to the industry itself, it has three main measures to reduce emissions:

- Improvement of energy efficiency (a maximum of 2% is still feasible)
- Reduction of clinker/cement ratio
- Increase in the use of waste as alternative fuel

While CEMBUREAU does not want to quantify CO2 emissions reduction potential through these measures, the industry is rather keen to make sure that the upcoming market is a liquid one, with allowances available for those that need to buy.

Chandelle told Point Carbon: "CEMBUREAU advocates full allocation for process and alternative fuels CO_2, together with immediate and uncapped conversion of Certified Emissions Reductions (CERs, the CDM currency) and Emissions Reduction Units (ERUs, the JI currency) into allowances."

Along with the other energy-intensive industries, CEMBUREAU issued a position paper on the European Commission's linking Directive proposal, arguing that the introduction of a cap on project credits that can be used in the EU ETS "is likely to discourage companies to enter into CDM and JI projects due to the uncertainty regarding the convertability of credits", and that "the limitation would reduce the transfer of technologies to developing countries, with the sole impact of increasing the cost of compliance with the emissions trading Directive". CEMBUREAU expressed hope that the Council would soon adopt a more open position on the linking Directive.

Cement production in 2001 by country ('000 tonnes)	
Spain	40 520
Italy	39 885
Germany	30 989
France	20 559
Greece	15 446
Poland	12 268
Great Britain	11 261
Portugal	10 162
Belgium	7 815
Austria	3 863
EU15 total	**191 607**

The table shows the major cement producing countries participating in the EU ETS in 2001 in 000 tonnes. Production includes exported clinker and cement produced with imported clinker. Production totals exclude intra-trade clinker.

Source: CEMBUREAU, December 2003

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Allocation process slowing as all await Commission guidelines

As 2003 crawls towards the end, three months remain for the current 15 EU Member States to submit the national allocation plans (NAPs) under the EU emissions trading scheme (ETS), while the acceding countries will have another two months to sort out all the details. While most Member States have managed to gather the required data, the overall progress of the allocation process has so far been slower than expected.

Initially, Austria, France, the Netherlands, Latvia, Italy, Luxembourg, Slovakia and the UK all announced that they would publish the first draft of their NAPs before the end of the year. However, one by one they have delayed it until mid or late January. Currently, only Latvia and Slovakia upholds the ambition. Whether they will succeed remains to be seen.

What they are all waiting for is the allocation guidelines from the European Commission. The emissions trading Directive leaves a number of definitions and criteria for allocation open to various definitions, and Member States need guidance from the Commission on how to proceed. Slovakia is one of the countries that have gotten the furthest in the process, even setting a total cap for CO_2 emissions for the included companies. Said **Gabriela Fischerova** at the Slovak Ministry of Environment:

"I am disappointed that so many definitions have been kept open for so long. The process would have been simpler if we could feel certain that we have interpreted the text correctly. We have tried our best, and will just have to see what the Commission says. If the guidelines, when they are published, do change some of the criteria, I hope it is in order to simplify the process, not change it."

The guidelines have been expected in December, but as of yet they are not ready. Commission officials are hopeful that they can be made public on 23 December. Although a draft version of the guidelines has been circulated, this would mean that in practice, it would be January before Member States can seriously take the guidelines into consideration.

Another issue that has made life hard for bureaucrats across Europe trying to put together a NAP is the definition of what constitutes an installation. While France has signalled that it will use the narrowest possible definition, substantially reducing the number of installations that will be included, Belgium will choose the opposite road and include as many as possible. A country as important as Spain is still in the blue over which installations will participate in the scheme. The legal consequences of this are as yet unknown.

In the meantime, European industry will continue its nail biting. It should be getting quite competent at that by now.

Council to debate linking Directive

On Monday 22 December, the European Council of Environment Ministers will debate the Commission's proposal on how to link credits from project mechanisms to the EU emissions trading scheme (ETS).

In the debate on the linking Directive, there are four issues that are particularly contentious: whether use of CDM credits should be allowed in the first period from 2005-2007; the suggested cap on the amount of JI and CDM credits that can be used in the EU ETS; whether credits from land-use and nuclear power can be used in the EU ETS; and how to avoid double counting of credits from JI projects.

The Italian Presidency will issue a position paper that is likely to address all these areas in some way. It has made no secret of its support for allowing companies using CDM credits already from 2005.

Taking also into account last week's comments from the Parliament's rapporteur Alexander de Roo, there is a chance that supporters may win. However, Italy has also in some connections advocated the use of JI credits regardless of whether Russia ever ratifies the Kyoto Protocol. The country is likely to meet much tougher resistance on this issue.

It is also understood that the Italian Presidency may attempt to remove or rewrite the Commission's article on introducing a 6 per cent cap on the usage of JI and CDM credits in the EU ETS.

The European Parliament will give its opinion on the linking proposal in April, and if it cannot agree a common position with the Commission before the elections that month, the linking Directive is unlikely to be adopted before 2005, i.e. after the start of the EU ETS.