

What Lies Ahead for the Carbon Market

According to Henrik Hasselknippe and Endre Tvinnereim of Point Carbon, what the European Commission decides for Phase Three of the EU ETS (2013-2020) will have important implications for the CO₂ price in Phase Two.

The carbon market in 2007

In 2007, the carbon market matured. It was also the year when climate change was placed at the top of the global political agenda. Following the Stern report, which laid the foundations of the economics of climate change in late 2006, the issue seized even more attention with the IPCC's fourth assessment report (4AR). The report stated that climate change was "unequivocal" and made it extremely difficult for anyone to remain a sceptic about global warming.

In the wider carbon market, total traded volume grew from 1.6 Gt in 2006 to 2.7 Gt in 2007 – an increase of 64 per cent. The value of the carbon traded grew even more, by 80 per cent, to €40bn (\$60bn), in the same period and the growth of the secondary CER (certified emissions reductions) market has been spectacular. Another feature of 2007, was the advent of options trading in EUAs and CERs, although volumes are still very small.

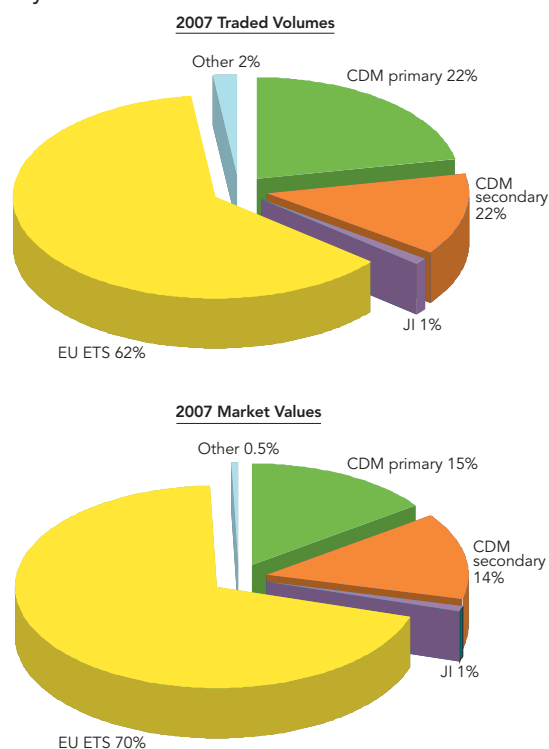
The EU ETS has grown healthily over the course of 2007, with a traded volume of 1.6 Gt and a value of €28bn. This represents a growth on 2006 of over 50% in both volume and value. The distribution between brokers and exchanges was stable at 70:30 in volume terms throughout the year.

Activity within Kyoto's mechanisms – specifically the CDM – grew rapidly in 2007. In total, the CDM market traded almost 1 Gt and €12bn in 2007. Given that CER prices are much higher than in the primary market, the increased CER

volume has significantly boosted the total value of the CDM market in 2007. There was also healthy growth in JI's.

Some of the increased activity in the CDM market is due to a tripling of issuance rates compared to 2006, with 77m CERs having been issued in 2007. Although 2007 saw a significant increase in inflow of new CDM projects, especially within renewables, there is still a squeeze in terms of expected issuance for the first two years of the Kyoto commitment period (2008-09).

Figure 1: Volumes and Values Dominated by the EU ETS



Outlook for Phase Two

The European Commission came in for considerable criticism following the collapse of carbon prices in Phase One. ►

While the overall allocation in 2005 to 2007 was primarily a result of poor historical data used as a basis for NAPs, much of the blame was directed towards the EC. During 2007, the Commission showed determination in cutting allocations and credit limits for Phase Two NAPs as well as pushing for the inclusion of aviation in the trading scheme.

It is now evident that the EU ETS has entered Phase Two with a considerable initial shortfall, and that the system will lead to actual CO₂ reductions. The overriding question is whether these reductions will take place within Europe or if the import of CDM (and JI) credits is flexible enough to ensure that all reductions will happen abroad. At the outset, looking at the rules for Phase Two, it seems that the EC had been very generous in the level of import for European installations, and that the EU ETS could, at least in theory, meet its entire demand through investing in developing countries.

On 23 January 2008, the Commission published its Climate and Energy package, consisting of a suite of policy proposals intended to meet the combined targets of 20% greenhouse gas reductions, 20% renewable energy production, and 20% improvement in energy efficiency, all by 2020. Part of this package was a proposal for a revised emissions trading scheme, to start in 2013. One central element of this review, which has taken the carbon market by some surprise, is the proposal to not allow for any further import of credits from abroad, for least as long as there is no further international agreement.

In principle, what the EC has now proposed for Phase Three (running from 2013 to 2020), will have direct implications for the current trading period. With no further imports than the 1400 Mt of reductions that are allowed for in Phase Two or the possibility to bank these

credits into the next phase, the EC has ensured that more emission reductions will take place within Europe. Whereas the import limit was previously 280 Mt (or 1400 Mt over 5 years), it is now about 108 Mt (same volume, but over 13 years). This reduced import ability could certainly lead to larger scale emission reductions within Europe, and also higher carbon prices.

It remains to be seen whether the current proposal will survive the gruelling co-decision procedure in Brussels. As we see it, this proposal has a high level of political support, and could be approved quicker, and with fewer changes, than many anticipate. If so, we might soon see a firmer price regime for European carbon. ■

