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emissions market news from Less Carbon and SmartestEnergy

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Countdown to the EU ETS - a look at some of the key issues...

With the EU ETS fast-approaching its January '05 start date, now is a good time to review progress on some of the issues which are key to the operation of the carbon emission market.

In recent months, market activity has increased from single figure trades per week of around 5k EU allowances (EUA) to weekly traded volumes in excess of 500k EUAs. During this period, the price has fallen from €13/EUA to €8.00-9.00/EUA, with movements within the range a consequence of announcements giving detail about the EU Member States' National Allocation Plans, (NAPs). Latterly, the market has fallen to the bottom end of the range, but continued buyer support has kept the value above €8.00. It will be interesting if to see if this support continues into 2005 when the NAPs are finalised.

NAPs are not the only supply-side influence on the value of EUAs. For example, since September, the Linking Directive now allows Kyoto credits to be imported into the EU ETS. However, there is some uncertainty about how these credits known as Certified Emission Reductions (CERs), will be traded or retired with in the EU ETS, as European law does not allow interference with the Kyoto legislation, which in turn governs the handling of Kyoto credits. CERs are currently bid at around €5.00/CER.

Demand-side influences are also at the fore, with the UK keen to make sure that aviation and shipping emissions are included from 2008, having pledged to use its Presidency of the EU in 2005 to raise the issue. It faces an uphill struggle however, to agree the formula for calculating the effect of aviation emissions at ground level, although there is general acceptance by the carriers of the benefits of a trading system.

A number of other issues are still unresolved, in particular a market standard EUA legal contract, although there has been marked

progress following harmonisation of the treatment of VAT, and the publication of IFRIC3 which details the accounting treatment for EUAs. VAT on EUA transactions will be due at the place of supply for domestic transactions and at the place of delivery for cross border transactions. The issue of permits and the auctioning of EUAs are exempt. Under IFRIC3, EUAs will be treated as intangible assets and variations in their value will be reflected in the revenue account. This will have implications for companies who make regular statutory disclosures and who will have to explain subsequent revenue volatility to their stakeholders.

As the EUA only exists in electronic form, member states are required to establish national registries. Three systems are available. GRETA, based on the UK ETS registry has been adopted by Denmark, Finland, Italy, Netherlands, Sweden, Slovenia, Lithuania, Ireland, Norway, and of course the UK; Seringas, the French offer has been adopted by France and Germany, whilst the third software option has been adapted from the US SO₂ trading scheme and is being developed by PQA, the company behind the Kyoto system. All of these systems will need to be compatible with each other and with the centralised EU Transactions Log to enable cross border transactions to be correctly recorded and validated.

Most of those countries which have committed to a system are expecting EUAs to be issued towards the end of Q1 2005, whilst those member states which have yet to sign up to a supplier will inevitably experience delays in the issue of EUAs.

The EU ETS has made significant progress and continues to attract interest from not only those implicated within the scheme but also traders and brokers, which will in time lead to a liquid market for emissions compliance within the EU.

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- President Putin delivered the Russian ratification papers to UN leader, Kofi Annan in Nairobi, paving the way for the Kyoto Protocol to enter into force on February 16th 2005.
- The first Clean Development Mechanism (CDM) project, Nova Gerar landfill in Brazil, was registered by the CDM executive board in November.
- With George Bush back in the White House for a second term, it is unlikely that the US will ratify the Kyoto Protocol in its current format. However, Senator McCain (Arizona) is again pushing for climate stewardship legislation to limit US domestic emissions.
- The Arctic Climate Impact Assessment report was published, which was a comprehensively researched and independently reviewed evaluation of the Arctic climate. This concluded that the anthropogenic effect on the climate is becoming more pronounced, and many longer-term impacts could be reduced significantly by reducing global emissions over the course of this century.
- Stephane Dion (Environment Minister of Canada) has stated he intends to make Canada the champion of Kyoto, not only by meeting the Kyoto target but working towards cutting emissions by 70% over the next 50 years.
- The UK increased the allocations in its National Allocation Plan (NAP) by almost 20mt in response to revised future emissions projections. It is currently being considered by the EU Commission along with several other NAPs requiring approval before the end of 2004.

Unlocking Value in Global Markets through Environmental Management

The verification of carbon emissions is a key factor in the success of emissions trading markets. Operators of installations, or developers of projects, must incorporate the requirement for the verification process within their plans, to ensure time, resource and budget is available. Verification will provide the operators with an independent opinion of the accuracy of reported emissions data.

Verification involves a trained team of individuals to conduct an independent assessment of three aspects of the data reporting system. These key areas, assessed during the verification, are the management control of the system, the plant monitoring processes and the accuracy of data sets. The verification will be conducted against the principles of completeness, consistency, accuracy, faithfulness and materiality. These are often best managed through an acknowledged framework, such as the international environmental management system ISO 14001.

Verification follows a procedure of strategic review, to understand the emissions profile and identify any key risk areas, verification, reviewing reported data sets and evidence, and peer review, having an assessor independent of the process reviewing the verification decision.

It is this verification process that provides the anchor for the trading market. Without transparent data collection processes and independently verified data, the carbon commodity markets simply could not function. The verifier will unlock the market value of clients' reported emissions data and respective tonnage of carbon, at both entity and project levels. It is the robustness of the accreditation process that verifiers must subject themselves to that ensures confidence in the verification activity.

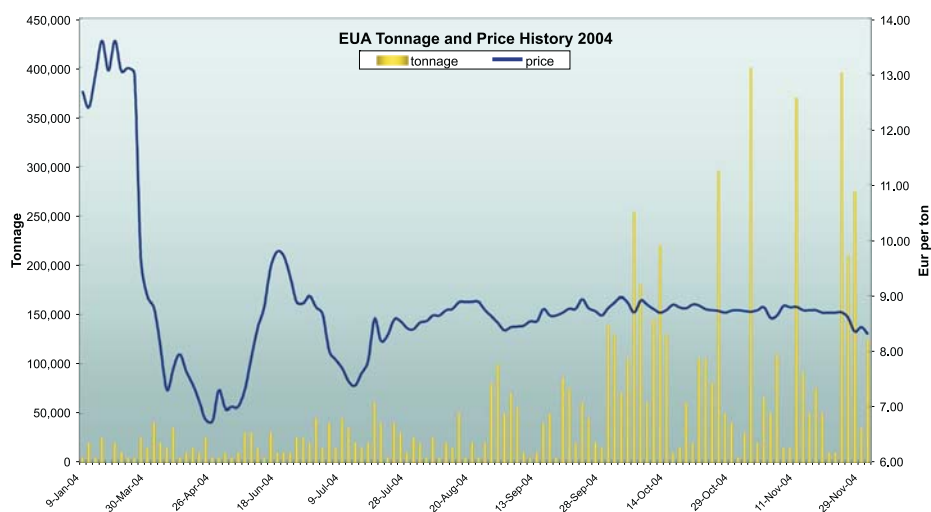
Accreditation is the process of licensing verifiers to conduct the verification work. A thorough review of the verifier's management system is conducted to ensure the integrity and consistency of their own verification procedure and to ensure that it conforms to agreed guidelines for the schemes within which they operate, for example the procedures and modalities of the Kyoto Protocol. In summary, verification brings quality control to emissions trading markets.

It is clear that the CDM Executive Board (EB) is taking a strict line on the Modalities and Procedures in the submission, validation and registration of CDM projects. A number of new methodologies have been rejected and recently the first registration was

recommended for review. The validation process ensures that the plans drawn up for the project are accurate according to the CDM rules and will deliver the emissions savings calculated by the developer. It is the role of the validation/verification body to ensure the accuracy of a project developer's plans and reported data. The EB's rigorous review of standards will ensure confidence in the validation process going forward.

There is much more to be done and this is still the early stages. Next year will see installations and verification bodies across Europe attempting to interpret the EU Monitoring and Reporting Guidelines - the rules for the EU ETS - for emissions covered by the EU ETS. The CDM EB will undoubtedly see a marked increase in the number of projects being proposed and registered. BSI will continue to evangelise on the necessity for a robust verification process and a consistency of approach to ensure uncertainty is minimised. If accreditation regimes across the EU Member States vary in stringency, for example, it could have serious repercussions on the transferability of carbon credits across the scheme.

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The chart indicates the trading history of EU allowances for the year to date. The price shown is the average of the Euros paid per ton per trading day, and the volume is the total tonnage traded. Source: TFS Brokers

Carbon Price Commentary

- Prices continue to be range bound with the recent downwards trend accelerated by a large seller offloading surplus allowances as a result of a more generous allocation.
- Volumes continue upwards as the most active traders increase the lot sizes in which they transact and engage in spread trades between vintages. There are few active traders but more are expected in the first quarter of 2005
- The Tenth Conference of the Parties to the Kyoto Protocol, meeting at present in Buenos Aires, may give momentum to the market as discussions commence on the position of the US on emissions trading together with reduction targets by the developing world countries after 2012. In addition, there is unlikely to be a large volume of CERs coming to the market in the first phase of the EU ETS.