

CSFI

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Is there a future for carbon trading? A round-table discussion with Abyd Karmali (Bank of America/Merrill Lynch), Guy Turner (New Energy Finance), Sam Fankhauser (London School of Economics/Globe International) and Larry Lohmann (The Corner House). Held on Thursday, February 4, 2010 at Innholders Hall, 30 College Street, London, EC4R 2RH, from 12:30-2:15pm.

The introduction at the CSFI round-table on the future of carbon trading began with an assertion that carbon trading had been little affected by the financial crisis – an assumption that unified the panel in disagreement. All the speakers agreed that the financial crisis had had a big impact on the direction and future of carbon trading. At a macro level, the crisis was the driver behind unambitious carbon targets and falls in the price of carbon, which at its peak sold for €30 (per one tonne of CO₂), fell to €8 at the height of the crisis and now hovered at around €15.

One speaker outlined what the markets had been looking for from the Copenhagen conference: clarity on targets, clarity on the future for market mechanisms and clarity on future mechanisms (such as of REDD - Reducing Emissions from Deforestation and Forest Degradation). The financial crisis weakened the resolve of many countries to push for a tougher outcome from Copenhagen. He felt that politicians had failed to make a convincing case to voters on climate change. Presenting it as an insurance policy, i.e. being 1% to 2% worse off in exchange for mitigating the potential effects of climate change, would make the case more clearly.

On the future for carbon trading, the speaker felt that there would now be a shift in policy making from the UN-led, top-down approach to an increased emphasis on domestic or bottom-up policy and actions. The problem, for markets, was that this generated uncertainty and that would have an impact on capital moving into carbon markets. Although, as another panelist noted, regional or state-level trading schemes (in the US) could add up to 1/3 of US emissions and boost momentum.

One panellist noted that the volume of trading increased in 2009 (showing good year on year growth) and was valued at US\$130 billion. He also predicted that the market could be worth US\$3 trillion by 2020 if the US and Australia implemented cap and trade schemes. Another panellist, while agreeing that carbon markets had functioned reasonably well, was more bearish about future growth prospects given the increased uncertainty.

One speaker had a very different view as to both the effectiveness of carbon trading schemes and their future. He felt that the collapse of the whole market was increasingly likely. He outlined a series of mishaps, such as fraudulent sales, over-allocations, VAT scandals and dubious offsets abroad that, even if they could be addressed, were indicative of the underlying problems with carbon trading. He also felt that the use of complex financial instruments could result in a *sub-prime* carbon crisis.

The speaker also said that grass roots resistance was on the rise given that it appeared to a number of communities in developing countries that businesses (factories, etc) were the beneficiaries of carbon trading and they, in return, were getting unpopular projects (such as dams) imposed on them.

He also addressed what he felt were the difficulties with other market based mechanisms such as REDD – which could dispossess many indigenous communities by imposing property rights. Another member of the panel disagreed vehemently with that analysis and felt that it was the very absence of private property rights that led to the destruction of forests.

The speaker also asserted that the biggest long-term problem facing the survival of the carbon market was that it simply didn't deliver the climate change objectives. He felt that schemes such as the Emissions Trading Scheme (ETS) actually discouraged long-term investment in crucial sectors such as electricity generation, providing incumbents with an excuse 'not to invest' in better technology. Nor did it provide the necessary long-term investment horizon for big, capital intensive projects. Offsets were slowing the shift away from fossil fuels (with credits purchased from abroad) and deferring more immediate action.

This view was challenged by the other members of the panel. One speaker cited the 3% fall in emissions in 2007-08 (the first on record) as evidence that cap and trade worked. His research, after factoring in the impact of the recession, attributed 40% of that decline to the ETS. He noted that power companies, for example, in the absence of a carbon price, would emit more carbon. Another member of the panel noted that although the EU ETS had kept emissions within a particular cap; in the long-term other interventions would be necessary to meet climate objectives.

One of the panelists also challenged the assertion that the ETS discouraged long-term investment in new technologies. Based on interviews with the heads of 15 of the largest EU power generators, 14 indicated that carbon emissions were being factored into and changing investment decisions.

Another panelist challenged the idea that CDO products in carbon markets are sub-prime. They were smart instruments that divided risks into manageable tranches. And the underlying assets were very transparent (they were sitting on a database in Copenhagen).

Whilst agreeing that there were a number of problems with the ETS, one of the speakers felt that cap and trade was still preferable to a tax on carbon. Taxes, in addition to being highly politicised, were inflexible. Unlike the price of carbon, which had declined during the recession and given additional breathing space to businesses, tax rates remained largely unchanged over the cycle.

In terms of meeting overall climate objectives, the speaker felt that there was an evolving consensus on what tools should be used. At one end of the scale – where cheap and easy methods to cut emissions could be employed – he felt that regulatory measures were the best tool. At the other end – where very large investment and a long time horizon were required – government sponsored or financed projects to support new technology would be most effective. In the vast middle, however, he felt the carbon market could provide the appropriate incentives to reduce emissions.

One panellist also pointed out that investment decisions were based on a longer term view of carbon prices, which were assumed to be higher. This was particularly so post 2012 when credits (although only 30% of the total) would begin to be auctioned off, as opposed to freely allocated. Even in the US (pre cap and trade), carbon prices were already being factored into investment decisions. One panellist felt that interest would be sparked elsewhere once carbon auctions demonstrated their ability to raise government revenue.

One must be aware of confusing a decline in emissions with dealing with the climate change problem, noted another member of the panel, as they were not the same thing. He reiterated his opposition to carbon trading based on its overall ineffectiveness at addressing climate change. Another speaker felt that regulatory add-ons might be necessary to achieve what the ETS alone could not. Other possible measures included implementing some kind of floor on the carbon price. Given the lack of US leadership on this issue, some members of the panel felt that the new drivers in the market would come from the East (Tokyo and Seoul, for example). It was also clear that the debates on whether to tax or trade carbon would continue.