# Markets in Regulatory Risk: Implications for Carbon Markets

## Briefing Note - July 2006

- *Planning to invest in the carbon market?*
- *Trying to understand the implications of the current and future supply and demand of carbon instruments?*
- *Want to identify the forward carbon price?*

In October, 2003, the European Parliament produced the Emissions Trading Directive (2003/87/EC). This legislation, created the conditions – the necessary elements of market infrastructure - for the largest business-based carbon market yet seen. The necessary elements for an international carbon market comprise:

- Agreed allocation of property rights to liable parties to emit greenhouse gases;
- Monitoring, audit and reporting criteria for each liable party;
- Electronic Registries accounting for the allocation and transfer of property rights by each liable party in each country or State, coupled to a central transaction log; and
- Definition of eligible carbon instruments.

In the EU carbon market, all these criteria have been met, more or less, over the past 18 months.

**"The international carbon markets are markets in regulatory risk. Countries and companies are primarily trading to avoid a compliance penalty…"**

The outcome has been the development of an extraordinary momentum in the carbon market, drawing in financial institutions, market-makers, project developers and a range of business service providers. And, after a shaky start, in which price volatility based on limited information was a presiding feature, companies and market analysts are beginning to get to grips with the minutiae of market information: forward price curves; aggregate supply of carbon instruments; impacts of the drivers of demand (e.g. weather, economic growth and fuel switching).

But does this approach provide a full understanding of the dynamics of carbon markets? We argue that while these are important elements that any participant needs to consider, these markets are devices of government policy, with a specific desired outcome. In other words, participants in carbon markets need to recognise that governments must meet the needs of multiple stakeholders and that political

E$^3$
Environment Economics & Ethics

E3 International was founded in the late 1990s in response to the emergence of sustainability as a mainstream issue for business and a shift in the nature of environmental regulation – from traditional command and control measures to more subtle, more complex and more sophisticated approaches, often characterised by market based instruments and mechanisms.

Our work in the climate change and emissions trading fields is focused on working with leading companies and institutions in both Australia and Europe on climate change policy and strategy.

For more information visit us on www.e3international.com or contact:

**Brisbane**

Stuart Dix
stuartd@e3international.com
+ 61 (0) 7 3878 6030

**Sydney**

Srian Abeysuriya
sriana@e3international.com
+61 (0) 2 9868 1422

**France**

Craig Windram
craigw@e3international.com
+33 (0)6 1836 1598

**UK**

Dr Andy Kerr
andyk@e3international.com
+44 (0) 771 819 2995

expediency will often mould market outcomes. In particular, governments are keen not just to meet a specific regulatory objective, but also be seen to meet multiple stakeholder concerns about how we should achieve that objective.

For example, the stated aim is to use the EU Emissions Trading Scheme to assist European countries to meet their Kyoto obligations at lowest economic cost. Yet:

1. The sector allocation of carbon allowances by governments in the first phase of the EU Emissions Trading Scheme, and early sight of the proposed second phase National Allocation Plans, suggests that governments are caught between two conflicting desires: to protect their industrial interests and to create an emissions cap that forces companies to explore options for reducing emissions. It was notable that:
    a. Only six countries allocated less carbon allowances for the period 2005-2007 than their liable parties emitted in their baseline period.
    b. Only six countries were found to have allocated less carbon allowances than actual emissions by liable parties in 2005.
2. The scope and number of Kyoto project credits (credits derived from Clean Development Mechanism and Joint Implementation projects) used by a liable party are capped in the second phase of the EU scheme. This will lead to more emissions reductions undertaken within European countries, rather than in countries where the cost of reducing emissions may be much lower. This is clearly an inefficient use of sparse resources, driven by the need of governments to be seen to be forcing companies to be “doing something” domestically.
3. Some Governments are considering changes from the proposed application of their New Entrant Reserve in view of the perceived oversupply of EU carbon allowances in the market in 2005: for example, auctioning the allowances. This potential change in the self-defined rules for using the New Entrant Reserve will affect market supply.

These examples – and others are coming to light as the second phase National Allocation Plans are developed – reflect the needs of governments to create a regulatory framework that satisfies multiple stakeholders.

This suggests that companies should:

1. Accept that market rules will not be fixed from one period to another
2. That government intervention to correct perceived failures in market – even if the market failures are inevitable economic outcomes from the market design – is possible, even within compliance periods
3. Factor in alternative scenarios of possible policy interventions that affect market supply or demand of carbon instruments

In summary, the evidence to date suggests that governments will mould carbon markets to meet the particular needs of their stakeholders, which may not correspond to the needs of market participants.

**“In other words, the evidence suggests that governments will mould carbon markets to meet the particular needs of their stakeholders, which may not correspond to the needs of market participants”**