SPECIAL REPORT

'Carbon trading' enriches the world's energy desks

Doubling in size every year, innovative market may reach $200 billion by 2010

By Simon Kennedy, MarketWatch
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LONDON (MarketWatch) -- The global carbon-trading market is doubling in size every year, putting it on course to become one of the biggest earners for energy desks and raising the question of whether emissions trading is environmentally effective or just another revenue stream for investment banks.

More than $40 billion of carbon-dioxide permits will be traded this year -- small fry compared to oil or other energy markets. But almost everyone agrees it won't stay that way for long.

"Conservatively, we think it's going to be worth $3 trillion," said Peter Fusaro, chairman of Global Change Associates, an energy consulting group.

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To put that into perspective, $3 trillion is roughly the size of the combined markets for oil, natural gas, electricity and coal today, Fusaro says.

Admittedly he's looking at the long term -- as far ahead as 20 years -- when more carbon markets will have opened up.

But others also see significant growth in the shorter term as well. Point Carbon, another consultant in the emissions-trading field, believes the market could reach as much as $200 billion by the end of this decade, according to its director Henrik Hasselknippe.

Banks and brokers want to get in on the ground floor, meaning just about every major firm with an energy trading desk is active in the carbon market.

In North America, Morgan Stanley (MS) and J.P. Morgan (JPM) are probably the most active firms in emissions trading.

Meanwhile in Europe, the most developed carbon market, dealer-broker Tullet Prebon (UK:TLPR: news, chart, profile) and Calyon, the investment banking arm of Credit Agricole (FR:004507: news, chart, profile) are among the most active.

Pros & cons

Proponents of carbon trading programs, such as the European Union's Emissions Trading Scheme (ETS), say they are the most effective way of cutting emissions while limiting the financial impact on industry.

But critics have dismissed carbon trading as ineffective, hard to enforce and susceptible to political pressure from the big oil and electricity companies it is intended to control.

So can these schemes really lead to a significant reduction in greenhouse gas emissions or are they just a way for industry to pay lip-service to the green agenda?

The concept of emissions trading, also known as cap and trade, is simple: Companies that produce carbon dioxide and other greenhouse gases receive credits that give them the right to emit a certain amount.

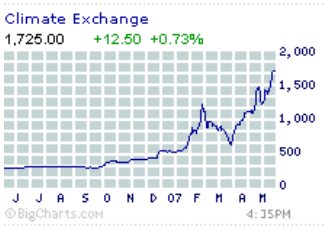
Companies that emit less carbon than their credits allow can profit by selling any excess credits on the open market, while those that exceed their emission allowance have to make up the difference or face heavy fines.

Allowing the free trade of these permits provides an incentive for companies that can cut emissions relatively cheaply to do so. Those that would incur huge bills in cutting emissions can instead buy permits -- ensuring the lowest overall cost to the economy, the theory goes.

So the key to an effective scheme is in both ensuring that the overall number of emission permits is set low enough to force a cut in emissions and that the market is liquid enough for companies to buy and sell permits when needed.

It's this second factor that demands the presence of the investment banking community.

"A lot of the market is financial players, and they are vital because they provide the liquidity," said Neil Eckert, chief executive of carbon trading platform Climate Exchange (UK:CLE: news, chart, profile) .



"Without them, the utilities simply couldn't trade," he added.

Some of the European banks have gained an "early mover advantage," because membership of U.S. carbon trading schemes is only voluntary, said Point Carbon's Hasselknippe.

But emission trading actually originated in the U.S. with the sulfur dioxide market, which has been around for 10 years. So any gap can probably be closed fairly quickly, he noted.

Price collapse

The level of caps has been one of the biggest objections to cap and trade. The argument, in short, is that companies will cheat. They will exaggerate their emissions and apply pressure to governments to set a high cap that they can then easily meet without actually cutting pollution.

One of the main pieces of evidence cited for this manipulation is the first stage of the European Union's carbon trading scheme.

Carbon prices in the scheme, which runs until the end of 2007, have collapsed to around 0.50 euros a ton after it became clear that member countries had handed out far too many permits.

Climate Exchange's Eckert readily admits that some companies have bluffed over their emissions. But you only need to look to the second phase of the European plan to show that regulators are now taking a tougher line, he said.

Caps for 2008 have been set much lower and this is reflected in the price, with futures contracts trading at close to 20 euros a ton for the second phase. In fact, Eckert argues that the first phase was always going to turn out this way and the EU simply failed to get this message across.

"The pilot scheme was a throwaway scheme. The EU just got its PR wrong," Eckert said.

With tougher caps in place, prices under the second phase, which runs until 2012, should prove fairly volatile, moving in response to oil and natural gas prices and the weather.

The most obvious correlation is with natural gas -- higher gas prices mean utilities switch more electricity production to coal-powered stations; but coal is more polluting, so the price of carbon climbs.

This volatility will drive volumes and will also attract hedge funds, dozens of which are already involved in energy trading.

"People trade volatility, they don't trade prices, and that will attract speculators," said Global Change's Fusaro.

Falling emissions

The evidence on whether emissions achieve their goal -- cutting pollution -- is mixed.

In the U.S., sulfur trading has successfully cut emissions by more than 50% in the last 10 years.

In Europe, meanwhile, the excessive allowances originally handed out by the EU's carbon scheme means there hasn't been much evidence of significant carbon emissions cuts so far. But that is starting to change, said Hasselknippe.

A survey of the EU's emission scheme members carried out by Point Carbon earlier this year found that 65% of respondents are now running internal abatement programs to cut carbon-dioxide emissions.

That result is a sharp contrast to a similar survey the previous year, which found the ETS had led to emissions abatement plans at just 15% of respondents.

Companies' own emission reduction plans, however, aren't going to be enough to meet their caps in many cases. Which is why the systems allows for another method, known as offsetting.

Offsetting allows environmental schemes that reduce carbon emissions in other countries to generate credits that they can then sell through the European trading scheme.

The system means companies can effectively offset their own emissions by funding a solar lighting project in India or a tree farm in Africa.

The practice has been another bone of contention, with critics arguing that the actual amount of carbon offset by these programs is extremely difficult to quantify and that offsetting can be seen as a get-out clause, which prevents companies and individuals from making any significant change in their own behavior.

Point Carbon's Hasselknippe argues that the regulation of offsetting programs is actually extremely strict in the carbon trading market.

The problems with offsetting are mainly in the completely unregulated retail market, where consumers pay a few dollars to offset the carbon from their family vacation, he added.

There are still big questions to be answered on offsetting, Hasselknippe conceded. Mainly they center on how many of the projects will actually come to fruition, as many are in politically unstable regions or rely on new technologies that are still being tested.