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Carbon markets: Towards a standstill

A scheme that enables rich nations to offset emissions by funding 'clean' projects elsewhere is falling prey to global politicking

As a general rule, when you meet Steven Gray he will tell you he works in London for Climate Change Capital – an investment firm that manages about $1.5bn worth of funds.

But when he enters the acronym-filled world of UN climate change talks, he says he is with a bingo. In UN speak, bingos are business and industry non-governmental organisations – in Mr Gray's case the Carbon Markets & Investors Association, a group representing investment banks such as JPMorgan Chase and Deutsche Bank, as well as rating agencies and other less well known companies servicing the carbon market.

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Bingos must not be confused with youngos (youth non-governmental organisations) or tungos (trade union NGOs), which is how – with no trace of irony – these "observer organisations" are described in the daily programmes at such conferences.

Even aside from the linguistic challenges, it is not always immediately clear why bankers and business people bother with a global negotiating process that forces thousands of people to fly millions of miles to spend hundreds of hours in talks that produce very little.

It is now 14 years since the high point of these negotiations, the Kyoto protocol that is the only existing global treaty on greenhouse gas emissions. That deal was intended as the start of an effort to tackle the issue of climate change, which leaders continue to call one of the most pressing issues of our time. Instead, the talks have declined into an obscure, jargon-filled process whose impotence was painfully exposed at the 2009 Copenhagen meeting, and which

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seems even more irrelevant amid today's economic and financial chaos.

But as the wider world's interest fades, a large group of investors and financiers remains intensely focused on the talks – and the amount of money that has come to ride on them. Most are part of a fast-growing global carbon market that, the World Bank reckons, was worth $142bn last year – 13 times its value six years earlier.

That market is dominated by the European Union's six-year-old emissions trading scheme, the largest cap-and-trade programme. But for many years, a sizeable chunk of money has also come from investors in a market that grew out of a section written into the Kyoto protocol itself: the Clean Development Mechanism.

This measure lets rich countries offset their emissions by paying for poorer ones to pollute less. It has been accused of many things, not least funding projects that might have been built anyway. But it has also helped to channel billions of dollars from the private sector into clean investments in developing countries in the past six years, as much as $100bn by some estimates. "This is not trivial," says Andrew Steer, special envoy for climate change at the World Bank.

But with the first Kyoto commitment period due to end in just over a year – and with little expectation that a conference in Durban this December will deliver agreement on a successor – fears are growing that the CDM will be derailed.

EMISSIONS TRADING: A success that has bred contradictions

The Clean Development Mechanism has managed to be one of the most lauded and contentious measures to emerge from the 1997 negotiations that produced the Kyoto protocol climate treaty.

Nicknamed the "Kyoto surprise" because it arose so late in the talks, it seemed to offer a rare win for both sides of the north-south divide that has long bedevilled climate talks.

The mechanism was designed to let wealthy countries offset their carbon emissions by paying poorer nations to pollute less, the idea being that the developing world would receive help to cut their emissions, while western companies gained a cheaper way of cutting their pollution.

In practice, it means for instance that a German power company can meet its emissions targets by using carbon credits generated by building a wind farm in China. The company can accrue the

This "nightmare scenario", as Mr Gray calls it, would mark the end of the instrument chiefly responsible for catalysing private investment into efforts to tackle climate change.

More than that, it would dent what many of the biggest banks and financial institutions believed would become a hugely profitable part of the youthful carbon market.

The mechanism is just one casualty of a stalemate between the developed and developing world that has enveloped the climate change process. That stand-off has arisen because, although Kyoto was historic, it was also deeply inadequate. Or as prominent figures such as Sir David King, the UK's former chief scientific adviser, puts it, Kyoto is "frozen in time".

That is because it was agreed that only developed countries had to cut their emissions – by an average of 5 per cent against 1990 levels in the five years up to 2012 – because it would be unfair for poor countries to pay to fix a pollution problem that had made wealthy countries rich. Developing countries, including China, did not have to make cuts.

When Kyoto was forged, those wealthy countries credits – each worth one tonne of avoided carbon dioxide – by doing a deal to buy them once the wind farm is built, or buying them on a secondary market that the World Bank valued at just over $18bn last year.

The first CDM project was registered only in late 2004. Since then, the mechanism has prompted billions of dollars of clean investment in poor countries and generated nearly $25bn worth of credits in primary CDM transactions. That is part of the reason some academics described its early financial success as breathtaking.

But the programme has not been perfect. China alone accounts for nearly half of all the credits registered under what some jokingly call the "Chinese Development Mechanism".

In addition, critics say it is too hard to know if some CDM projects would have been built anyway, and whether others create "perverse incentives".

Among the most controversial CDM projects were those that destroyed HFC-23. This unwanted refrigerant by-product is many times more potent than carbon dioxide, the main greenhouse gas, so its destruction generates large numbers of credits.

CDM Watch, a Brussels-based campaign group, estimates it can cost as little as 17 euro cents per tonne of CO2 equivalent to destroy HFC-23, but the credits generated have been worth €12 and more apiece on carbon markets. That encouraged production of a chemical that would not have happened without the CDM, it says. The European Union recently clamped down on the use of such credits in its emissions trading scheme.

Some want the CDM replaced – a prospect that alarms investors battling with regulatory changes to the existing programme. As Geoff Sinclair at South Africa's Standard Bank asks: "Why invent the wheel again, especially when you haven't got the first one turning around properly yet?"

were expected to include the US, and would have accounted for 51 per cent of global emissions, according to the Pew Center on Global Climate Change. But that figure ended up falling to 30 per cent because the US, then the world's biggest emitter, failed to ratify the treaty, which came into force in 2005.

Within a few years, China had overtaken the US as the largest emitter, and the emissions of other emerging economies were also growing. As a result, the share of global emissions covered by countries signed up for Kyoto cuts fell from 30 per cent in 1997 to 25 per cent in 2008, the Pew Center says.

Today, a number of the rich countries, including Japan and Canada, that signed up for those first reductions have suggested they cannot support another round unless the US and China take part. Neither is likely to.

For their part, China and a grouping of poorer developing countries insist on a second commitment period, a move some say seeks to confine the cuts to the wealthy. Knowing that the CDM is popular in the rich world because it offers a relatively cheap way for companies to cut their carbon emissions, they appear to be using it as a bargaining tool. At the last big UN climate change gathering in Bonn this summer, Mr Gray says he heard officials from China and poorer nations say "there should be no CDM if there is no second commitment period" of the Kyoto protocol. "This is the first time they have started to say this publicly," he says.

Such negotiating strategies matter to investors. "We have a responsibility to our investors and if they ask, 'Is the CDM going to continue after 2012? ' I cannot answer with 100 per cent certainty that it will," he says. He thinks the chance of the CDM ending is "unlikely". But, as he says, "the issue is much more pressing now".

Kim Carnahan of the International Emissions Trading Association is also concerned by what she heard from developing countries in Bonn. "It's obviously a bargaining strategy but, for market participants, it's sending an incredibly strong warning signal: don't invest in this mechanism post-2012," she says.

The wind industry is unsettled too. The mechanism has helped kick-start projects in several countries – including China, which last year overtook the US in new annual wind installations. “The fact that we don’t know where the CDM process is going means there is a great uncertainty for the future of wind investments in some developing countries,” says Rémi Gruet of the European Wind Energy Association.

Compounding this ambiguity is a question about whether the CDM can legally exist if there is a gap between the end of the first commitment period (which falls at the end of December 2012) and the start of any new one that might be negotiated.

The CDM website says its activities are not tied to specific commitment periods but that, if there is no second Kyoto round, “parties may wish to provide guidance on how activities under the CDM may continue”.

Asked to clarify, Martin Hession, chair of the scheme’s executive board, tells the Financial Times: “The CDM board has a continuing mandate to register projects and issue credits on application. But ultimately it’s a matter for agreement by parties whether they continue to use it.”

Some analysts, such as Trevor Sikorski of Barclays Capital – which has a significant presence in the CDM business – believe this is a recipe for uncertainty. He highlights a UN paper published last year that set out the legal position if there is a gap between the current commitment period and a subsequent one. It suggested that, while the CDM was not specifically linked to the first period, its future depended on how its mandate was interpreted. Its goals include both helping wealthy countries to meet their emissions targets, and poor countries to reduce their pollution.

“The big legal question is does the CDM have to fulfil all of these to continue or only some?” says Mr Sikorski. If it has to meet them all and yet there are no new targets, the UN paper says this could “argue against its continuation”.

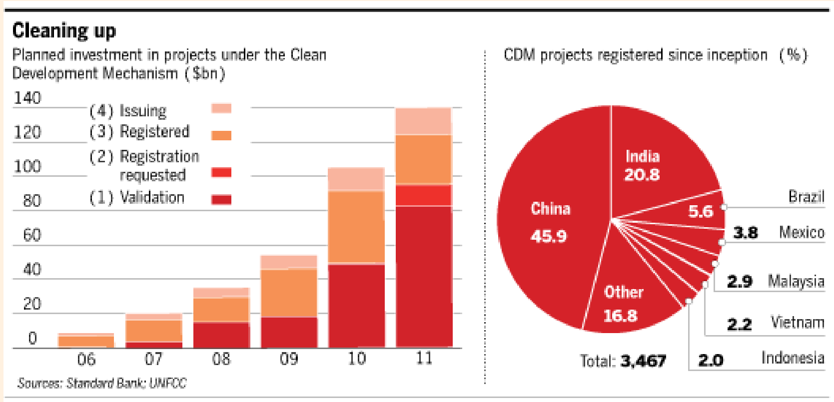
The issue could be clarified by negotiators in Durban but Mr Sikorski thinks this doubtful if the CDM is now a bargaining tool in the talks. While “conventional wisdom” suggests the scheme enjoys enough broad support for a lenient interpretation of the mandate to be agreed, it is telling that this has not happened.

“Why was the future status of the CDM not clarified at [earlier UN talks in] either Copenhagen or Cancun [in 2010]?” asks Mr Sikorski. “It was certainly an issue that was identified. The answer is that this is now a political decision.” And so, he says, there is “at least a material risk that the CDM enters a period of suspension”, until the UN talks produce a new set of targets. Whenever that might be.

• • •

The CDM faces extra pressures because it is so dependent on the EU emissions trading scheme, which obliges big polluters – from power stations to cement companies – to buy carbon credits if their emissions exceed a certain level. Similar schemes are planned in Australia, California and elsewhere – but, for now, European companies are by far the biggest buyers of credits generated in developing countries through the CDM. And that gives European officials big influence over what those credits are worth.

Doubts about whether the EU will toughen its greenhouse gas reduction targets, now set at a 20 per cent reduction by 2020 from 1990 levels, have long troubled investors, as have recent EU decisions to limit the use of CDM credits generated from contentious industrial gas projects.



Amid this uncertainty, the value of initial CDM transactions between developers and investors plunged by nearly half to $1.5bn in 2010, its lowest level in six years, according to the World Bank, well down from its peak of $7.4bn in 2007.

In addition, the EU scheme is only going to accept CDM credits from new projects from 2013 if they are generated in so-called least developed countries, which include conflict-torn nations such as Somalia.

Standard Bank has just invested in an Australian carbon project developer, Cool NRG, which has beaten the 2012 deadline by registering a CDM project that replaces incandescent lights with energy efficient bulbs.

Still, the carbon markets are kept alive by a confidence that climate change fears will inevitably prompt more, not less, global action to limit the greenhouse gas emissions that underpin demand for carbon credits.

It was that sort of confidence that created the Kyoto protocol and the CDM in the first place.

The question is whether today's climate negotiators will ever be in a position to produce anything quite like them again.

ThamesFord | October 7 2:54pm | Permalink Report

Global Climate change perspective

http://www.forbes....disputable-winner/

barrie harrop | October 6 5:44am | Permalink Report

A Map of Organized Climate Change Denial.
http://dotearth.bl...ate-change-denial/
e

Michael McPhillips | October 1 7:28pm | Permalink Report

I believe we are making a catastrophic mistake in not taking the fact of climate change very seriously. The temperature of the planet is determined to all intents and purposes by how much ice is on the planet. There is ample visible evidence to indicate that this is melting and doing so at ever increasing rates. Using the use of grit at Heathrow as evidence is unscientific. All it indicates is that when it is colder in one place on earth it is warmer in other places and un-refuted evidence shows that the poles are warming faster than anywhere else.

In the case of carbon dioxide's part in this we rely on science. The infrared (IR) radiation leaving the planet does so at wavelengths between around 3 microns (millionths of a metre) and 90. This is a scientific fact based on the wavelength of 15 degree C radiation. IR has no effect on N2 or O2 molecules but causes CO2 to vibrate; atoms in the molecule have to be different for an affect - another scientific fact. To find the frequency rates at which the molecule vibrates and thus how often it can hit and pass on heat to an O2 or N2 molecule you use the formula c=fw where c equals the speed of light (300 million metres per second), w equals the wavelength of the radiation and f the frequency of vibration.

So dividing 300,000,000 metres per second by 3 millionths of a metre you get 100,000,000,000,000, which is the maximum number of times a single molecule of CO2 can hit a N2 or O2 molecule and heat it, in one second. Similarly, dividing the speed of light by 90, (giving 3,333,333,333,333), which is the minimum number of times that that can occur. If you think those numbers fantastic then another scientific fact is that the molecules of air in the room you are in collide about 6,000 million times per second.

If that does not convince everyone of how potent CO2 can be as a greenhouse gas then I do not know what can. There are now over 390 ppm of CO2 in the atmosphere and the increased flooding and natural disasters along with greater desertification and loss of ice from shelves, sheets, and glaciers, should be ample evidence of a dangerously warming planet.

FT readers should take note that saving the planet is an economic opportunity. 30 year bonds are sound investor assets so why cannot the total fossil fuel reserves be similarly valued? If we can only burn 565 GtCO2 (gigatonnes of carbon dioxide equivalent) of the 2,795GtCO2 of remaining reserves within the next 40 years to prevent catastrophic climate change, a carbon free emission rate would make the reserves not burned a very good investment to come to fruition in around 50 years, the time it takes for CO2 to be washed out of the atmosphere if most emissions were drastically reduced.

It is doable, economically, physically, and politically, though the latter is what could prevent it happening.

User7716759 | September 29 11:49pm | Permalink Report

We should be building Thorium reactors. But then there would be no carbon emissions to offset.

ThamesFord | September 28 3:31pm | Permalink Report

To follow on from my last post here is an analogous way to consider how the mechanisms of the Carbon Trading Exchange do OR don't work. It is slightly tongue in cheek - but then again, many a true word is spoken in jest! I hope the AGW alarmists don't pick up this as their next idea!

In light of the economy overheating and causing chaos in the economic climate, government economists have declared that the science is settled and that the overheating is due to those evil excess profits successful companies make. Profits have long been suspect of being a green house mass linked to much of the turmoil in the economic atmosphere.

The proof of Antidisestablishmentatrian Geo-Economic Warming (AGW) is proven beyond a doubt because their pre-determined-outcome models say so.

Forthwith there will be the establishment of a profit credit exchange. It is very simple. A government panel will be established to decide just the right amount of profits companies should produce according to their size, such as they see fit to make the economy work. The risk of too much success could drive the world to an economic meltdown!

On an arbitrary basis, but favoring companies researching green money technology (such as growing money on trees and end of the rainbow enterprises etc) the less economically viable companies will be awarded profit credits. The more successful companies will be able to buy these credits to offset their excess profits and the poorer performers will benefit from the sale proceeds to prop up their unviable propositions that a venture capitalist without connections to the crony-capitalist cabal, wouldn't touch with a barge pole.

Of course the desired reduction in profits will be achieved, not because the green money technology will succeed but because the successful companies will have no incentive to succeed where, ever decreasing profits are subject to ever more punitive profit credits allocated to unviable companies. Some suspect that the eradication of the successful companies, the survival of the unviable ones and the destruction of the free market system was the plan all along.

Left with no successful companies to tax or for the unviable one to compete with, the green-money technology companies are now forced to raise their prices in a strangely market driven approach they then go out of business, where upon the politicians blame it on an after effect of the previous overheating.

Social engineering outcomes are unviable.

ThamesFord | September 28 2:19pm | Permalink Report

Maybe the efforts and expertise of CDM can be redeployed elsewhere...

Could they not join with other governments and the UN to sponsor a Intergovernmental Panel on Credit Change (IPCC, say) to investigate the causes of Global Overheating of the Markets.

Surely there are economists who can readily show a correlation between the rise in production of toxic assets with the increased heat in the markets. It must be claimed that the oceans of credit are drowning the small island markets and undermining the former glacial pace of prudent banking via the ice-cap melting of restrictive credit that once was the bedrock of secure if, somewhat frozen assets.

As the, once polarized, bear markets succumb to the changing environment can we not target and demonize the apparent cause of the Random Patricide being emitted from the polluting risk engines of the Banks' Special Underwriting Vehicles (SUV's), which are stifling the diversity of the global portfolio's precious underlying assets?

The Banks have to take a hit on Random Patricide emissions to undermine the fibre of their structured products. A "Slap & Flax" legislation, if you like, is needed combined with a new market for risk emission credits to break the boom & bust cycle.

In the event the market self corrects as it, annoyingly, has the habit of doing, then surely the preferred results can be overlaid to "hide the benign" nature of the solutions.

User3085877 | September 28 2:01pm | Permalink Report

The diplomatic wrangling is certainly interesting, but the issue of additionality should at least be mentioned in any article about CDM.

I used to work as a CDM consultant, and I am fairly sure that the vast majority of projects that CDM helps to fund would almost certainly have happened anyway, even without carbon financing. Which means that CDM functions as a gigantic loophole in the Kyoto Protocol - it allows European countries to avoid making domestic emission reductions but produces very little in the way of overseas reductions in return.

If CDM is scrapped after 2012, I'm not sure we should be so sorry. There are much more honest, less convoluted ways to finance clean development.

ThamesFord | September 28 12:22pm | Permalink Report

It is important to realize that there is a viable question on whether the changes in climate are dominated by human causes.

The Montana Supreme court restricted the EPA based on two skeptical reports; one backed by 1000 scientists. The proponents of anthropogenic global warming including the EPA did not provide a scientific basis for their arguments.

http://www.cfact.o...s-climate-skeptics

caveat emptor

User261875 | September 28 10:54am | Permalink Report

I am a scientist, and feel that it is my duty repeat to anyone who thinks that Global Warming is caused by humans - IT IS NOT.
Climate changes all the time, human caused Global Warming is a deliberate and very dangerous myth. There is plenty, I mean plenty of excellent, moderate and truly scientific literature saying just that. Prof Bob Carter is one of the best putting the message across (check Amazon for his excellent book).
As to how dangerous the delusion of Global Warming is - just look at the last three years' chaos at Heathrow, which relied on the UK Met office (hot proponents of the AGW idea). Last year they actually bought in less grit than usual, on advice that a third cold winter has only once chance in 8000. The globe is actually COOLING, and nobody is preparing for that, because it would mean admitting to fraud and stupidity on a truly global scale.
Oh, by the way, we are a second decade into XXI century, I would like to see the promised sea rise please. Al Gore promised what, 6-8 meters sea rise by 2100? Surely we should have at least 10% of that already? Or it was just to scare public into action, as he admitted himself? And the rest of

"evidence" is just as good? To scare the public into Carbon Trading (which now accounts for more trading by volume than oil or iron ore)?

Domenic Carratu | September 28 9:13am | Permalink Report

Reality is that there are too many more pressing issues to fix now (um, like avoiding outright economic depression, pulling the West out of its various wars in the Mid and Near East, etc etc). Solving a potential problem that is anyway intergenerational at present is simply NOT a priority at present

Malab | September 28 8:52am | Permalink Report

Several CDM projects in China (especially in the southern provinces) are not "additional" at all (i.e. the credits that are generated do not produce any environmental benefit. Many approvals (for the FSR-Feasibility Study Report, Evironmetal approval,...) are backdated by friendly local officials to prove the "additionality" and induce the UNFCCC into believing that the projects should benefit from CDM.

edouard | September 28 7:44am | Permalink Report

The goal of zero emission is being replaced by the policy of zero commitment. It is hard to understand that in the western world, characterized by an over production of almost everything and a chronic lack of demand, we can't find resources the save the world. Citizen should elect lobbyists instead of politicians, it wouldn't be perfect, but it works.

MacroMacro | September 28 7:35am | Permalink Report

What we need is the Eu to raise carbon taxes and then pay fro clean power in the BRICS.

User4309933 | September 28 7:25am | Permalink Report

making a business out of the environment, where the actual goal is to reduce CO2 and increase resource efficiencies

John Hawkins | September 28 2:35am | Permalink Report

I could only imagine how humerous the Chinese find this program.....the EU, which is starved for funds is transferring funds to subsidize their competitors and push Europe even further in to debt.....amazing.

luctoretemergo | September 28 1:28am | Permalink Report

The CDM is a quasi business instrument that operates in an artificiall market that was created on the basis of a political decision and scienfifically dubious grounds.

A growing body of science is putting ever more questionmarks around the very premise -man-made CO2 driven global warming- for the carbon trading scheme, at the same time as the political rug -and thus the very raison d'etre- is being pulled from under the structure.

It seems to me that a good number of oportunistic investors -or shall we call them speculators - who invested in what is for all intents and purposes is a junk status tax, stand to take a well deserved bath come 2012. The Chicago Carbon Exchange which folded a little while ago comes to mind.