



In the March edition of CARBONfirst, Chair of the UNFCCC track of the international negotiations Michael Zammit Cutajar gives his insights into the state of global climate architecture. Ian Johnson takes a look at US climate policy under President Obama, while Christiana Figueres examines supply and demand in the post-2012 market. IDEAcarbon analysts also give updates on RGGI and developments in the Asian markets of Australia, Japan and New Zealand.

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## Inside Policy Track

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*Michael Zammit Cutajar: Chairman of the UNFCCC track of the international climate negotiations*

- Negotiations are on track for agreement in Copenhagen when compared to the run-up to the Kyoto Protocol in 1997; a first negotiating text should be ready in mid-May
- All eyes are on the US to make its first move; the next negotiations meeting in Bonn in March/April will shed light on what the US position is
- Discussions on financial architecture are a “make or break” issue for developing countries and are going to be tough

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***Compared to March 1997 in the run-up to the creation of the Kyoto Protocol at COP3 (when countries were also under pressure from financial crisis and recession in Asia) how do you see the rate of progress in the run-up to Copenhagen?***

Today’s financial crisis is of a different calibre from that in 1997. The attention of governments, world leaders and finance ministers is elsewhere. By comparison, in the run-up to Kyoto there wasn’t the same level of “distraction”. While it will be difficult to convince governments to concentrate, on the upside they do see green investments as a central part of their economic recovery strategies.

But notwithstanding my initial worries a few months ago, we are in fact on the same rhythm now as in 1997. The Chair’s negotiating text that led to the Kyoto Protocol did not come out until April/May 1997, and I will produce a text in May. We are thus on track.

That said, until now countries haven’t really been engaged in actually negotiating. They have been setting out positions, but there has not been much give-and-take or compromise. This is where we stand approaching the March/April meeting in Bonn and particularly the meeting in June when the negotiating text is due.

***US President Obama has indicated a US goal of returning to 1990 levels by 2020. While a significant first step, this target falls short of the industrialized country leadership demanded by developing country parties. Do you expect a sharper commitment by the US?***



A reduction to 1990 levels by 2020 represents a point of convergence between the various bills before Congress and the signal given by President-elect Obama. It is important to remember that as President, Mr. Obama has not made a specific “offer”

Countries are now waiting for the Obama Administration’s first move. The US will be present at the meeting in March/April and we will then learn what their starting position will be. In negotiations, one doesn’t expect countries to play their last cards until the last round is played.

What China will do is of great importance to the US. China is not in the same basket as the US under the Bali Action Plan and all eyes are on Beijing. That Secretary of State Hillary Clinton visited China recently to talk about climate change amongst other things bodes well.

***Are you concerned that the US will come to Copenhagen without a quantified reduction commitment?***

I have heard that the US is aiming to do a deal in Copenhagen. In this regard, the link between the US legislative calendar and the negotiating calendar is very important. Under one possible scenario a domestic bill to cap emissions would be halfway through the legislative process by the time Copenhagen comes about: far enough along to give the US negotiating team a basis for negotiations but still malleable enough for it to be tweaked to reflect the outcome of the negotiations.

The nature of the US commitment is not yet clear. If (as is expected) the US is not willing to join the Kyoto Protocol, one has to ask under what legal instrument the US commitment would be expressed and how it would be related to what other countries are doing under Kyoto. This is very complicated and the issues surrounding it have not yet been addressed.

***How confident are you that all Annex 1 countries will come up with individual country emission reduction targets by 2020 in time for Copenhagen?***

The EU already has a two-level target – 20% below 1990 levels, to be increased to 30% under certain conditions. What these conditions are is not yet clear; they will no doubt be part of their negotiating position. Japan has said it will come up with a target by June, and the domestic debate is ongoing; some targets being discussed are ambitious (the boldest is 25% below 1990 levels) and some are less ambitious. Australia has released a target. The US we have already discussed.

Given that the pro-climate EU has as its higher target 30% below 1990, it is unlikely that the aggregate Annex 1 commitment will be towards the upper end of the 25-40% range.

As an addendum, the idea that targeted reductions should take place by 2020 is not accepted by all Parties to the UN Framework Convention on Climate Change (UNFCCC). It is of course part of the EU’s thrust, but some developing countries ask why 2017 (the end of the second commitment period of the Kyoto Protocol) should not be the targeted year. At the same time for countries like the US a more distant target than 2020 would allow more time to turn emissions growth around. The point is there is a lot of flexibility in the discussions of commitments.

***Which of the five building blocks of the Bali Action Plan (mitigation, adaptation, financial mechanisms, technology transfer, and a shared vision for long-term conservative action) are you most confident or concerned about?***

For developing countries the “make or break” element is a new arrangement for generating and delivering a much larger volume of financial support than has been available hitherto. Relevant questions then arise: as to where the money is to be found (public coffers or the market); as to how to find a more efficient method to deliver and give access to the money; and as to how the money is to be governed – in an old-fashioned, donor-recipient manner or in a more cooperative manner of shared responsibility.



This is the hardest element of the Bali Action Plan, partly because it involves large amounts of money, partly because discussions involve finance ministers (who tend to be tough), and partly because of the difficulties of engaging a whole range of ministries (e.g. environment and finance ministries) and of development cooperation.

The outcome of negotiations on the mitigation effort and whether countries are pulling their full weight, though difficult, are easier to foresee. Discussions on adaptation, where there is little difference on the principles on what needs to be done, are also proving to be easier, although the question of how to finance adaptation runs into the same complications as outlined above. There needs to be a more articulated vision of what needs to be done on technology transfer, e.g. on cooperative R&D, on the deployment of existing technologies, and on transfer. It is unclear how much governments can help in the transfer element; they could focus on investing in R&D and assisting deployment.

***Developed and developing countries in the AWG-LCA have different views on the nature of sectoral mechanisms and the involvement of carbon markets. What role, if any, do carbon market mechanisms have in the AWG-LCA?***

In the Bali Action Plan there is a reference to sectoral approaches and to market mechanisms, and I am preparing a paper for discussion in Bonn of which this subject forms a part. There is agreement to disagree on the idea of trans-national sectoral standards (e.g. an efficiency standard for aluminium producers worldwide). What remains is the idea of sectoral approaches within national plans – countries X and Y would cooperate with and support country Z in the introduction

of more efficient methods in a certain industrial sector, for example cement.

The Kyoto Protocol group (rather than the LCA group) deals with market mechanisms on a formal basis. These mechanisms can however be looked at as a source of funding, and if agreement is reached on how to levy funding on these mechanisms in the LCA group then the ball will have to be passed back to the KP group to enact the agreement (assuming they are Kyoto Protocol mechanisms).

It is not clear whether any new mechanisms will emerge from the LCA discussion. The agenda is open and no item is closed. But given that just nine months remain between now and Copenhagen the chances of a new and global mechanism appearing are low. Countries may go for national market mechanisms (e.g. cap-and-trade). And, while not strictly on the LCA group's agenda, there is the possibility of linking markets – as suggested by the European Commission (though the Commission suggests that it happens outside the negotiations).

***How do the two AWGs interact with each other and at what point will they come together?***

There is an obvious substantive linkage between the two groups, but for many countries it is important that their legal separation is preserved. Nevertheless, now that we are in the final stretch it is pragmatically necessary that the groups work coherently and do not duplicate work. Though there are two tracks, we are working towards a common objective: to reach one political deal.

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## Feature

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### *US climate policy 60 days into the Obama presidency*

*By Ian Johnson, Chairman of IDEACarbon*

- The Obama administration is prepared to act to reduce emissions through the EPA with or without Congress; first steps have already been taken
- Congress wishes to pass climate legislation to make EPA action more effective; with a larger democratic majority a well-made bill has a good chance of passing
- It is essential that a consensus exists between Congress and the White House by Copenhagen to ensure that what is agreed in talks is acceptable at home

The US legislative and executive branches are moving to enact comprehensive cap-and-trade legislation in 2009. Below follows an analysis of the outlook for US climate policy.

#### ***The executive branch***

The Administration has already taken several steps to reverse Bush era policies on climate change, and is peopled with officials who know and understand the climate change issue. The signs are that the Environmental Protection Agency (EPA), led by Administrator Lisa Jackson and with the support of President Obama, is pushing ahead with emissions-reducing regulation, which it will make use of in the case that Congress fails to act of its own accord.

As instructed by the Supreme Court, Lisa Jackson has instructed the EPA to prepare a long awaited “endangerment finding” that will ascertain whether or not CO<sub>2</sub> poses a significant threat to public health. If the finding is in the affirmative then the EPA will be legally permitted to regulate CO<sub>2</sub> emissions under the Clean Air Act. The EPA is also setting up a greenhouse gas (GHG) emissions registry – a first step on the path to regulation. The EPA was instructed to take these steps in 2008 but was prevented from doing so by the stalling tactics of the Bush Administration.

Notwithstanding these moves the White House is fully aware of the importance of

working with Congress in drafting climate legislation, and of the opposition it will face from Congress and industry if it chooses to go it alone.

#### ***The Senate***

Congress is keen to enact its own legislation, in the belief that a tailored climate bill will prove more comprehensive and effective than a similar effort by the EPA alone. Both houses of Congress are busily preparing legislation and are working with the White House to this end.

The Committee on Environment and Public Works (EPW), chaired by Senator Barbara Boxer (D), is the main Senate body concerned with climate legislation. Senator Boxer has said that her committee could prepare and release a cap-and-trade bill within weeks.

An EPW bill will likely build upon the Boxer-Lieberman-Warner (L-W) bill, which came to a vote on the Senate floor last June and represents the most successful attempt at reducing US emissions yet (for the content of this and other bills see below and table 1). The Bingaman-Specter bill, with its cost containment provisions, will be influential, as will the Dingell-Boucher bill released into the House of Representatives last October, especially for more conservative Democrats.

The make-up of the committee has tilted in the Democrats’ favour in the 111<sup>th</sup> Congress (11 vs. 8 compared to 10 vs. 9 in the 110<sup>th</sup>



Congress), meaning that Senator Boxer may be able to push through tougher legislation than before. Though the pro-climate Republican ex-Senator John Warner is no longer present, he has been replaced by the also pro-climate Senator Arlen Specter (R).

More broadly in the Senate the predominantly pro-climate Democrats have a reinforced Senate majority of 56 (plus two pro-climate Independents) vs. 41 Republicans. According to Energy and Environment Daily, 47 senators are highly likely or quite likely (35 and 12 respectively, made up of 42 Democrats and five Republicans) to vote yes to climate legislation in 2009. When L-W came to a vote last summer, 48 senators were in favour vs. 35 in opposition.

Those Democrats sitting on the fence mostly form part of the Gang of 15 Midwestern senators concerned with coal power and industry. In order to reach the 60 votes required to pass a bill the Senate will thus need to win over the entire Gang of 15 and two Republicans. Of the 48 in favour of L-W, nine were in the Gang of 15 and three were Republicans. A carefully drafted climate bill would therefore stand a good chance of garnering the necessary support to pass.

### ***The House of Representatives***

In the House the main body concerned with climate change is the Committee on Energy and Commerce (E&C), chaired by Rep. Henry Waxman (D). The Subcommittee on Energy and Environment (E&E) is chaired by Rep. Edward Markey (D), who also chairs the House Committee on Energy Dependence and Global Warming. Rep. Waxman has said that he will push out a climate bill from the committee by Memorial Day, which falls on the 25<sup>th</sup> May. Though ambitious, the combined weight of Rep. Waxman and Rep. Markey, with the help of Rep. John Dingell (D) and Rep. Rick Boucher (D) (the former chairmen of E&C and E&E respectively), should make this goal achievable.

The details of the impending bill are not yet clear, but as in the Senate it is likely to contain

elements of L-W and Dingell-Boucher, the former for reasons of its past success and the latter for its popularity amongst industry. Rep. Markey's Investing in Climate Action and Protection bill (iCAP, released in June 2008) will also likely be of influence. It is the strictest of all the main climate bills, favouring steeper reductions and high levels of auctioning. Again, a carefully constructed bill has a good chance of securing sufficient votes to pass.

### ***How will a future bill look?***

The content of the aforementioned bills provide a hint of what a future climate bill might look like. The determination of a mid-term (i.e. 2020) target is perhaps the most controversial issue of all and will likely be one of the last aspects of a bill to be finalised. L-W and iCAP all advocate a return to 1990 levels by 2020 (or 17-20% below 2005 levels by 2020, which is more or less the same). President Obama and Special Envoy for Climate Change Todd Stern have also endorsed a return to 1990 levels by 2020, though no official position has yet been revealed. Consensus exists around the long-term target of an 80% reduction below 1990 levels by 2050. All past bills would cover upwards of 80% of US emissions.

Cost containment is a big issue, referring to how one can manage or soften the impact of cap-and-trade on the economy, industry and consumers. Bingaman-Specter would controversially limit the allowance price to US\$12 in 2012 and US\$23 in 2025. While reducing the impact of cap-and-trade on the economy, there are concerns that distorting the price signal would dampen the incentive to invest in clean technology.

The other bills would employ more tested means of containing costs. Nearly all of them favour the use of large amounts of domestic or international offsets or international allowances, up to almost 2 billion tonnes in the case of L-W and iCAP, with a strong focus on domestic or international forestry credits as a means to achieving targets. While reducing costs domestically, the use of so many offsets would mean that little domestic



emission reduction would take place and that emissions may get locked in over time.

The use of Clean Development Mechanism (CDM) credits is proving contentious, as many question the desirability of transferring money and resources to economic competitors that do not have comparable reduction commitments. The environmental integrity of the CDM is also in doubt.

The extent of auctioning varies between the bills. iCAP would impose almost 100% auctioning from the start, while Dingell-Boucher would be much more favourable towards industry and the power sector (hence its popularity amongst conservative Democrats). In order to bring pro-industry Congressmen on board it may be expedient, at least initially, to limit the amount of auctioning. How to use auctioning revenues is an important issue, again to ease the transition to a low carbon economy and to stimulate investment in clean technologies.

Concerns about carbon leakage the loss of competitiveness to other countries without similar reduction commitments have led to suggestions that the US impose a tax on imports from such countries. Whether such a tax would be compatible with World Trade Organization rules is unclear, but the subject remains a source of debate in Congress.

Finally, it is likely that a bill will put the EPA in charge of environmental regulation (as do L-W, Dingell-Boucher and iCAP). It is uncertain as yet whether a bill will amend the Clean Air Act to regulate CO<sub>2</sub> – Dingell-Boucher and iCAP would while L-W would not – and who or what will be in charge of carbon financial regulation. Dingell-Boucher and iCAP would make the Federal Energy Regulatory Commission (FERC) primarily responsible for market oversight, in tandem with the Securities and Exchange Commission (SEC). L-W would create a new body to do the job.

### ***The international scene***

Both Congress and the White House are increasingly focussing their attention on the role of the US in international climate

discussions. Conscious of the Senate's decision not to ratify the Kyoto Protocol under the Clinton Administration, both Congress and the White House are aware of the necessity to work together to develop a common consensus.

The US will need to bring this consensus to Copenhagen and the negotiations preceding it in the knowledge that an agreement made at the negotiations will be acceptable at home. A bill need not have passed through both houses of Congress and become law, but there does need to be some clarity on what provisions it will contain to ensure the compatibility of positions of executive and legislative branches of government. An unpassed bill, and the flexibility therein, may be beneficial in that it would be able to adjust to decisions made at Copenhagen.

Achieving consensus is no small challenge. 67 votes are needed in the Senate to ratify a treaty, meaning that all Democrats (including the Gang of 15) as well as ten Republicans will need to be won over. The Senate is traditionally sceptical of a climate treaty, primarily for reasons of competitiveness, carbon leakage, and the need for major developing countries to take on some sort of commitment (sectoral or otherwise) along with the US.

Combined with this is the fact that there is a certain amount of disappointment amongst countries that President Obama has only come forward with a 0% from 1990 by 2020, and that the US may come under a certain amount of pressure to increase its target to a more ambitious level. The EU is urging all developed countries to adopt a target of 30% below 1990 by 2020 in the line with Intergovernmental Panel on Climate Change recommendations. This is a position with which China and the G77 would agree.

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Table 1: US cap-and-trade legislation

| Bill & scheme   | Scope & launch date | Reduction target, cap & coverage  | Auctioning & offset use  | Pre-emption  |
|---|---------------------|---|--|--|
| <b>Lieberman-Warner America's Climate and Security Act (Boxer amendments)</b> | Nationwide; 2012    | 1990 levels by 2020; 70% below 1990 levels by 2050; 2012 cap of 5,775 MtCO <sub>2</sub> e; 80% coverage of emissions  | 51% auctioning in 2012 & 100% in 2036; 30% of allocation in domestic, international & forestry offsets or international allowances   | No pre-emption of state & regional cap-and-trade; provision of mechanisms to merge with federal scheme |
| <b>Bingaman-Specter bill</b>  | Nationwide; 2012    | 2006 levels by 2020; 60%+ below 2006 levels by 2050 contingent on international effort; 2012 cap of 6,652 MtCO <sub>2</sub> e   | 24% auctioning 2012-2017 rising to 53% in 2030; 10% of reduction requirement in international offsets; price cap of US\$12 per tCO <sub>2</sub> e in 2012 rising to US\$23 in 2025 | Silent on pre-emption  |
| <b>Dingell-Boucher bill</b>   | Nationwide; 2012    | 6% below 2005 levels by 2020; 80% below 2005 levels by 2050; 2012 cap of 4,987 MtCO <sub>2</sub> e rising to 6,167 MtCO <sub>2</sub> e in 2017; 88% coverage of emissions | Different options for auctioning ranging from low levels up to 100%; 5% of reduction requirement in offsets in 2012 & 35% in 2024  | Pre-emption of state & regional cap-and-trade; silent on mechanisms to merge with federal scheme       |
| <b>Markey Investing in Climate Action and Protection Act (iCAP)</b>           | Nationwide; 2012    | 20% below 2005 levels by 2020; 85% below 2005 levels by 2050; 2012 cap 6,098 MtCO <sub>2</sub> e; 87% coverage of emissions   | 96% auctioning in 2012 & 100% in 2020; 30% of allocation in domestic & international offset or international allowance use   | Silent on pre-emption  |
| <b>Waxman Safe Climate Act</b>  | Nationwide; 2011    | 1990 levels in 2020 and 80% below 1990 in 2050  | Unspecified level of auctioning; use of offsets not mentioned  | No pre-emption state & regional cap-and-trade; rewards early movers                                    |
| <b>President-elect Obama</b>  | Nationwide          | 1990 levels by 2020; 80% below 1990 levels by 2050  | 100% auctioning from the start; limits on offset use   | Silent on pre-emption  |

Source: IDEACarbon



## Feature

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### *Supply and demand in the post-2012 market*

*By Christiana Figueres, Vice-Chairman of the Carbon Rating Agency*

- Negotiators are tinkering with the idea of reforming and expanding the CDM in the post-2012 framework
- While there is uncertainty as to the actual supply of credits, there is a risk that a sectoral mechanism will flood the post-2012 global carbon market
- Numerous policy and technical options to mitigate this risk exist on the both demand and supply sides of the market

In recent years, the case for scaling up global mitigation efforts has been widely called for. In addition to deeper commitments on the part of developed countries, appropriate action by developing countries will be needed to meet this challenge. While carbon markets are important for this purpose, the Clean Development Mechanism (CDM) as it is currently structured is unlikely to mobilize the needed reduction volumes.

Against this background, several options to reform and expand the scope of the CDM (or to create a complementary carbon market mechanism) have been proposed by various Parties and observers as a vehicle to accelerating the deployment of low carbon technologies in developing countries. According to most proposals, they would complement self-financed efforts of developing countries.

Japan has proposed a transnational benchmark for energy intensive sectors, below which companies would get rewarded for better performance with the issuance of credits. The EU has proposed the “no-lose targets” concept, in which developing countries would voluntarily propose a reference line to be reached through domestic efforts and would then be allowed to sell any surplus emission reductions, but would have no penalty for not achieving that reference. With the support of other non-Annex I countries, Korea has proposed a

registry to recognize the mitigation efforts already underway in developing countries, and an expansion of the CDM to include policy-based and nationally appropriate mitigation actions that can be quantified.

While the notion of an expanded CDM is now on the negotiation table, no discussion has been held yet on the specific design features of any of the options. The many design features to be negotiated relate to, inter alia:

- Environmental integrity: As efforts move from a project to a policy or sector level, establishing baselines and measuring performance becomes more complex task and is associated with considerable uncertainty.
- Capacity: New mechanisms must be feasible to set up; not all countries may (yet) have the capacity at the government or corporate level to manage national or sector-wide mitigation efforts.
- International governance: What changes would have to be made to the current governance structure of the CDM? It is unclear how carbon market players such as funds, project developers or brokers will be integrated into new mechanisms, or their investment attracted.
- Most importantly, market balance: There is a risk that new mechanisms may boost the supply of credits far beyond their demand in the international carbon market.



Table 1: The continuum of options for scaling up carbon finance mechanisms

| Option                    | Feature  |
|---------------------------|--|
| Regular CDM               | Crediting of specific individual project activity  |
| Programmatic CDM          | Aggregation of multiple activities in a sector   |
| Sectoral CDM              | Credits are issued if sectoral emissions are kept below sector baseline                                  |
| Policy CDM                | Credits are issued for verifiable mitigation generated by specific policies                              |
| (Sectoral) No-lose target | Non-Annex I party proposes no-lose target (for a sector) – crediting of emission reductions below target |

Source: IDEAcarbon

The demand for emission reductions by 2020 will obviously depend on the depth of emission reductions which industrialized countries are willing to take. However, even under a stringent scenario that is not politically acceptable, the update of the Investment and Financial Flows paper of the UN Framework Convention on Climate Change (UNFCCC) estimates that demand will not surpass 1.7 GtCO<sub>2</sub>e. The same paper assesses the abatement potential of the developing world at approximately 5 GtCO<sub>2</sub>e by 2030 in sectors currently eligible under the CDM, plus an additional potential of at least 1.6 GtCO<sub>2</sub>e in reductions of emissions from deforestation and degradation (REDD) which are not included in the current CDM. Obviously the full technical abatement potential will not be realized, but the mere order of magnitude evidences the striking imbalance between low demand from industrialized countries and much greater potential supply on the part of developing countries for the post-2012 period.

A number of options have been suggested to balance the market, focusing on both the supply and the demand side. On the demand side, the most obvious approach is to increase the level of ambition of Annex I reduction targets, although ultimately their total demand potential is limited by their emission levels. Ironically, instead of moving toward increasing demand, the EU and the US have already made public their intention to restrict the entrance of international offsets into their GHG accounting systems, effectively applying import quotas that reduce the demand and reduce the incentive for developing countries.

Another demand side option is the creation of a new market for emission reductions that would be retired or discounted, but in any event not used on a ton-to-ton basis for compliance. Annex I parties would commit internationally to purchasing a certain amount of such credits, which would not be fungible with credits stemming from the offset market.

On the supply side, technical mechanism design matters. Determining the crediting baseline is the most important challenge here as there is a trade-off between the level of ambition and the setting of sufficient incentives. If the policy or sectoral baseline is set too high, the global carbon market may be flooded with credits without any real emission reductions, resulting in very low prices and thus reduced incentives to participate in the new mechanism. An extremely low baseline could reduce the number of credits to be issued to an extent that participation becomes similarly unattractive.

Another supply side option that has been suggested is the idea of a time window or sunset clause, understood as a trigger mechanism for developing country graduation to Annex I. The trigger would take the form of a limit on cumulative transfers of credits by each non-Annex I Party. The Party would be expected to graduate to Annex I and adopt a hard reduction target when the limit is reached, effectively capping credit supply. This option is understandably not acceptable to G77 countries.

Another option is discounting. Discount factors would be used to decrease the



number of credits sold or bought and could thus prevent a market overhang while also improving the environmental integrity of the offset market. The key question is where the discount is applied, either in the process of issuance or when they are used by Annex I countries. If applied on the demand side, only a certain percentage of purchased credits can be used for compliance and the remainder must be retired. There would be no loss for the seller. Conversely, issuing only a certain percentage of emission reductions with credits would reduce the financial incentive to implement the new mechanism.

There are many decisions to be made about the future of the CDM. If Parties agree to keeping the fundamental structure of the CDM and expanding it to include either sectoral or policy-based actions, it may be necessary to review some governance and operational issues of the CDM in order for the mechanism to be able to effectively cope with the higher volumes. Should however Parties decide to create a separate and complementary market it could be advisable to initiate a pilot phase to test the functioning of the new forms of crediting and to draw lessons for their final design. This idea is similar to the Activities Implemented Jointly pilot phase that preceded the CDM.

The potential expanded scope of the CDM and of the other flexibility mechanisms is being negotiated at the same time and within the same process as the new reduction obligations of Annex I countries, for the obvious reason that future commitments depend to some extent on the availability of supply. Although not all the modalities and procedures will be decided by Copenhagen, Parties do need to make some fundamental decisions: whether to expand the CDM and if so with which new forms of crediting; and

whether to create an additional and complementary market system and if so for which asset classes or for which participants. These basic decisions will have to be reached as part of the larger Copenhagen package, which will also include the new emission reduction obligations of Annex I countries.

The context that needs to be kept in mind as these decisions are being considered is that because developing countries can in principle reduce at much higher levels than industrialized countries can absorb through the market, support for mitigation cannot be restricted to the single instrument of the market. Independently of the design features of the future market, the new mechanism can only be one financial instrument to incentivize mitigation in developing countries, and will have to be complemented by one or several specialized abatement funds. Some proposals have already come forward for channelling the emission reductions from some specific sectors (e.g. industrial gases, REDD) through a targeted abatement fund instead of through the market. In any event, international financing, the market and specialized funds may have to be complementary to the mitigation actions which developing countries are already undertaking on a self-financed basis.

The challenge in Copenhagen is to strike the balance between what developed countries deem sufficient and what developing countries deem acceptable. Annex I countries will need to feel comfortable with the financial and technological support that they offer, and developing countries will need to feel that they have strong enough incentives and enough assistance to undertake the necessary mitigation actions.

***For further information please contact [info@ideacarbon.com](mailto:info@ideacarbon.com).***



## Analysis

### *RGGI and the EU ETS: how the two markets compare*

- RGGI's market structure has much to offer the EU ETS in terms of design and may serve as a model for future cap-and-trade schemes
- The banking of allowances between periods and 100% auctioning has allowed for a much more stable allowance price in RGGI than in the EU ETS
- Covering only the power sector RGGI lacks liquidity, which dampens market activity; the EU ETS' greater size and scope negates this problem

As of March, there are only two mandatory cap-and-trade GHG markets in operation: the US Regional Greenhouse Gas Initiative (RGGI), and the EU Emissions Trading Scheme (EU ETS). There are significant differences between the two, but the younger US market offers a glimpse of what an auction-based market may look like, and therefore some insights into Phase III of the EU ETS, when auctioning will play a significantly larger role.

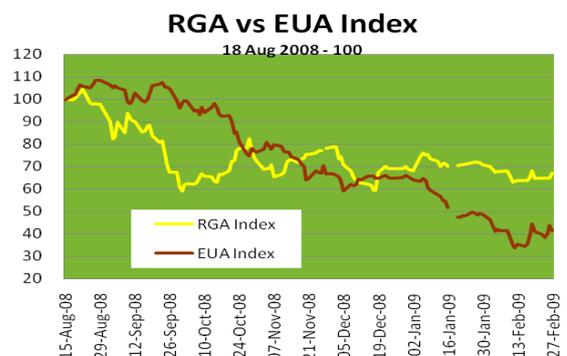
RGGI may be only two months old but already it is highlighting some distinct differences in design between it and the EU Emissions Trading Scheme (ETS), which IDEACarbon believes will enhance its reputation as a model for future schemes. There are lessons for regulators and market participants in the respective experiences.

As has been widely discussed, the EU ETS over-allocated emissions allowances in its first phase (2005-2007), and prices for EUAs fell to €0.01 as Phase I neared its end. RGGI too is believed to have over-allocated permits in its first compliance period (2009-2011), but is unlikely to see prices collapse in the same way. The scheme sets a cap on utility emissions in ten north-eastern states of 188 million short tons per year for the period 2009-2014, but estimates suggest that actual emissions could come in up to ten million tons below that level, at least for the first three or four years, and the onset of recession raises the prospect that the oversupply could be both deeper and longer.

Nevertheless, it is instructive to note that the recession so far has had relatively little impact on RGGI allowance (RGA) prices compared to EU allowance (EUA) prices. There are two fundamental differences between the two schemes that suggest the RGGI allowance price will not collapse.

Firstly, RGGI rules allow unused allowances to be banked from one period to the next, whereas EU ETS Phase I rules did not. Banking of unused allowances reduces the chance of a structural surplus in any one compliance period, encourages companies to transfer their surplus allowances to later years when they may need them more, and the ensuing continuity thereby also provides a longer-term price signal to the market.

Figure 1: RGA and EUA prices in RGGI and the EU ETS



Source: CCX, ECX and IDEACarbon

The other major difference between RGGI and the EU ETS is that all RGAs are allocated through auctions, while free allocation has



been the predominant method of allocation in Phases I and II of the EU ETS. Auctioning effectively internalises the cost of carbon and will deflect any accusations of windfall profits as occurred in Europe. It also means that all participants in RGGI start out with a zero balance, and need to continually buy RGAs until such time as their balance matches their emissions.

The fact that RGGI allocates more or less continuously, rather than the vast majority up-front as the EU ETS does, means that installations must treat compliance as more of a supply-chain issue than an asset-management one. Hence the relative stability in price.

The temporary technical shortfall in allowances versus emissions may mitigate somewhat against the trading part of a cap-and-trade scheme, but the longer compliance periods, as well as the fact that RGGI will auction allowances for two compliance periods at a time, means that as installations and traders can build up a bank of allowances and so trading opportunities and activity will emerge over time. It also means that over time, RGA prices may become more volatile.

### **Market dynamics**

The two auctions that have been held so far have issued a total of 44 million RGAs to the market. RGGI's auction supervisor has reported that a large majority of successful bidders in the auctions have been compliance companies. In the first year of RGGI, we believe utilities are looking to buy RGAs to cover both current-year base- and peak-load emissions, and year-ahead base-load emissions, as they secure year-ahead power sales in much the same way as in Europe.

The total volume of trading on the exchanges has been just half the total volume auctioned at 24 million short tons. The recession means that there is likely to be less overall activity in the market at the outset, since committing cash to purchase RGAs at auction that will not be surrendered until 2011 may not be an attractive strategy for some companies. It

may be worth waiting to purchase RGAs from the secondary market.

At the same time, data from the US Commodity Futures Trading Commission (CFTC) shows that in the futures market, banks have taken significant short positions, while utilities are more long than short. Clearly banks have begun to build positions based on bearish market expectations (see table 1).

The further development of speculative trading will depend in large part on the liquidity of the market, which in turn will depend on the rate at which new allowances are injected into the market via the auctions. Given that RGGI currently schedules quarterly auctions each of around 20-30 million RGAs, the inflow of allowances into the system will be relatively slow. The design of RGGI means that the market will remain structurally short until the final auction in each year. This could mean that utilities continue to constitute the majority of successful bidders and will marginalise financial and trading companies until into 2010. But by mid-to late 2010 there should be a significant volume of tradable RGAs that would permit more intermediaries to enter the market.

Equally, the size of the market may discourage speculative trading to a certain degree. At 188 million short tons, and with a sizeable portion of the allocation staying in utility hands, there may simply be insufficient liquidity to support non-compliance trading. If we compare the daily trading volumes in RGGI and the EU ETS, it is clear that size of market has some influence.

In addition the low outright price of RGAs leaves little room for speculative trading except for holding long positions. Trading activity in the run-up to each of the two auctions completed so far shows that the market has been able to "manage" the exchange price to historic lows immediately before the auction has taken place, giving successful bidders at least some opportunity for speculative sales at a profit.



In the EU ETS the large cross-section of industrial companies, who have been given (free of charge) emissions allowances equivalent to their business-as-usual emissions, represent the sell-side of the market, particularly in the current recession. In RGGI there is no natural sell-side in the immediate future, unless we count the short-term surplus allocation.

What RGGI needs therefore is a greater pool of liquidity, which will come over time, as well as some sell-side activity from utilities which are able to carry out fuel-switching to reduce emissions and develop a structural surplus of RGAs. Until then it is unlikely to display the level of liquidity and volatility that we have seen in Europe.

An inherent drawback of RGGI is that it covers only utilities: without the participation of other sectors there is a risk that the market may become one-dimensional, with all participants looking at the same fundamentals. For example, if the same economics apply to all it is unlikely that only some utilities would engage in fuel-switching and generate surplus allowances. Engaging different market dynamics from different industrial sectors would create greater ebb and flow of demand and supply and boost liquidity and volatility.

Nevertheless, the benefit of RGGI lies in the fact that European power generators can get a preview of how a full auctioning market operates and how their US counterparts manage their exposure.

Table 1: RGGI trading positions ('000 short tons)

| Non-Commercial |       |         | Commercial |       | Total |       | Non-Reportable Positions |       |
|----------------|-------|---------|------------|-------|-------|-------|--------------------------|-------|
| Long           | Short | Spreads | Long       | Short | Long  | Short | Long                     | Short |
| 713            | 2,558 | 110     | 4,897      | 3,081 | 5,720 | 5,749 | 58                       | 29    |

Note: Commercial refers to utilities and non-commercial to other players  
Source: CFTC Commitments of Traders Report 24<sup>th</sup> February 2009

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## Analysis

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### *The Pacific nations: Australia, Japan and New Zealand*

- Australia, Japan and New Zealand are struggling to enact climate change legislation and are unlikely to be leaders at Copenhagen
- Australia is the most pro-climate of the three and is in the process of passing legislation to set up a cap-and-trade scheme in 2010
- Industry and government opposition in the context of the recession is proving to difficult to overcome

The island nations of Australia, Japan and New Zealand differ significantly in their domestic agendas based on the strength of their governmental commitment to climate legislation and the impact of the recession. Despite their differences, all three countries have committed to CO<sub>2</sub> reduction targets. The outlook is for a quantifiable, albeit unambitious, reduction target.

#### ***Australia: slow progress***

Australia's climate change plan comes under the name of the Carbon Pollution Reduction Scheme (CPRS). Currently standing but still contested, it will implement a 5-15% emission reduction from 2000 levels by 2020 and a 60% cut by 2050. At the 15% end this is an effective return to 1990 levels. It launches in July 2010 and will cover 75% of Australia's total emissions.

It allows unlimited Kyoto offset imports and will recognize credits generated post-2012. Forestry credits are not permitted, nor is the export of Australian Emission Units (AEUs). Agriculture is excluded in the short-term. Possible inclusion will occur in 2015, given that agriculture contributes about 16% of Australia's emissions (2006 data).

Barring delays incited by opposition parties and the Australian Industry Group (Ai Group) (that represents manufacturing, engineering and construction firms), the CPRS bill is expected to be sent to the House for vote and passed by early summer, anticipated in June

2009. It is also contingent on support from the Senate, where unlike in the House the Labour supporters of the CPRS are not in the majority.

The Liberal opposition has criticised the economically damaging effects of the CPRS, citing unpalatable economic costs for industry and a slowing Australian economy. At the same time it has argued that Prime Minister Rudd's Labour government has set targets that are too weak, and not enough to win the conviction of developing countries in Copenhagen. The Ai Group has encouraged CPRS to be pushed back until 2012, to allow the financial markets to bounce back and firms time to prepare.

Allowing unlimited Kyoto offset imports for compliance is an obstacle to the integrity of the scheme as it currently stands, as rather than abating domestically, Australian installations can purchase cheap credits below the target floor price of A\$20. Such a provision will also reduce liquidity and hinder trading. It may be necessary to put some sort of limit on imports if the CPRS is to garner enough support to pass. Australia's almost 30 million tonne potential demand would constitute 6-7% of the global demand for Kyoto credits (currently 440-510 million tonnes per year) and would provide a boost to the Kyoto markets post-2012.

Pre-emptive emissions trading is already under way in an emerging carbon futures



trading market in Australia. When mature this market is expected to be about one fifth of the size of the EU Emissions Trading Scheme (ETS) in terms of volume. Already over a dozen trades of AEU's have gone through between private companies, across a range of settlements (from 2011 to 2013), with prices varying from A\$18.00 to A\$24.5. Exchanges in fact are already competing – ASX Ltd. and enVex are targeting rival futures contracts – though plans are on hold until the CPRS is passed.

Australia should now be able to bring quantifiable targets to the negotiating table in the Copenhagen negotiations. Though 5% certainly appears small (and 15% tenuous), it echoes the position of the US's proposed return to 1990 levels by 2020 which President Obama mentioned in the run-up to his election.

### ***Japan forced to take back seat at Copenhagen?***

Despite its economic prowess, Japan is unlikely to be among the climate change leaders in Copenhagen. It lacks the moral and practical authority to provide leadership in the COP 15/MOP 5 talks as the government is struggling get its own house in order and is still locked in internal negotiations to come up with a plan which meets powerful industry needs and lofty environmental targets. It is proving very difficult to muster the support of a majority of players involved in the climate change sector.

Japan has thus far only come up with voluntary emissions trading schemes due to strong opposition from the powerful Keidanren business federation, and there are still strong objections to the possible introduction of a mandatory system from major polluting companies, such as utilities, cement, chemical and steelmakers. Even in the US, where federal leadership was absent, there are three regional schemes, one of them the Regional Greenhouse Gas Initiative already enjoying reasonable trading volumes. The Japanese voluntary scheme, in force since the end of October, has barely registered any

trading of significant volumes. The difference between the schemes is that one is voluntary while the other two are compulsory.

To get around this, the government recently announced the creation of a new body to promote carbon trading. The Tokyo Electric Power Co chairman, Tsunehisa Katsumata, was appointed as head of the new government-private sector organisation in an effort to secure industry buy in.

President Obama is putting some pressure on Japan to face up to these issues, which were discussed when Prime Minister Taro Aso visited Washington earlier this month. Despite the many pressing economic challenges facing the two leaders, climate change was also discussed in the meetings and a low level working group from the two countries was formed in the run-up to Copenhagen.

As a consequence, Japan has had to get on track its domestic scene and agree on targets in order to come up with schemes to fulfil these targets. Earlier in February a top climate policy advisory panel published six scenarios as a basis to decide a national greenhouse gas emissions target to 2020 which the government promised it would announce by June. A working group of experts will make a final proposal by early April at the latest.

Below are the six preliminary scenarios, based on a 2020 target year and an assumption that Japan's real gross domestic product grows by 1.6% a year on average to 2020. The vastly different targets underline the schism which exists in Japan between industry and environmentalists.

1. Under current trends of corporate investment in energy efficiency carbon emissions rise by 6% versus 1990. Clean energy sources, excluding nuclear energy, would account for 4% of primary energy supply.
2. If the corporate sector voluntarily applies the most advanced, energy efficient technologies, carbon emissions fall by 4-



- 5% from 1990. The share of renewable energy sources is 7-8%.
3. If Japan matches the investment that the EU will have to make to cut its greenhouse gas emissions by 20% by 2020 from 1990 levels, Japan's carbon emissions rise by 0-7%.
  4. If Japan matches the investment all rich countries would make under a joint goal to cut emissions by 25%, its emissions would fall by 1-12%.
  5. If Japan spends as much as a proportion of gross domestic product as other rich nations to meet a common 25% goal, its emissions would fall by 16-17%. Renewable energy would reach about 10%.
  6. If Japan cut its emissions by 25%, the same as other rich countries, it would require a jump in the renewable energy share to 13%.

But Japanese sources say the body will propose emission targets which are below the IPCC suggested 25-40% below 1990 levels range, perhaps on par with the US and Australia. Nonetheless such a target would mean that the Japanese government will miss the opportunity to lead the fight against climate change.

### ***New Zealand backtracking***

Under previous Prime Minister Helen Clark New Zealand committed itself to carbon neutrality by 2020, passed legislation to include all sectors and all gases in carbon trading by 2013 and in short, positioned itself as a global leader in climate change. When the Labour Party lost the election in 2008 and the National Party under new Prime Minister John Key took over under the auspices of

national change, the climate change package came under immediate review.

This raised questions as to the integrity of the scheme, and the emissions reductions already under way. The ETS kicked off in January 2008 with emissions from forestry, with transport joining in January 2009. But as PM Key took over, doubts and delays over the longevity of the existing scheme and emissions obligations led to the renegeing of forestry projects. Instead of the existing cap-and-trade, PM Key has mentioned he may decide on a carbon tax instead. Options for the scheme are being reviewed and expected to be finished by September 2009, with a preliminary report due in April.

New Zealand's obligation under the Kyoto protocol is to keep emissions at 1990 levels by 2012, and current estimates by the government show that an (quantitatively insignificant when viewed on a national scale) additional 21.7 MtCO<sub>2</sub>e will be emitted above the 1990 figure. Currently this shortfall can be met by Assigned Amount Unit purchases for both the government and private sector – a clause critics have attacked for a lack of actual emissions reductions.

The takeaway from these developments is that just as Australia and Japan have done, New Zealand is shying away from more aggressive targets. Most likely now, the current ETS will remain in place with softer sectoral targets and elimination of carbon neutrality by 2020, but some quantifiable target coming out of the ETS review. New Zealand will not have a strong impact on the negotiations in Copenhagen as it currently stands, but if PM Key can put forward a concrete, ambitious plan for New Zealand this could change.

***For further information please contact [info@ideacarbon.com](mailto:info@ideacarbon.com).***



## Carbon Calendar™

**Notes:** Events of particular significance are highlighted in bold. Market-oriented events are shaded in grey. Conferences are in italics.

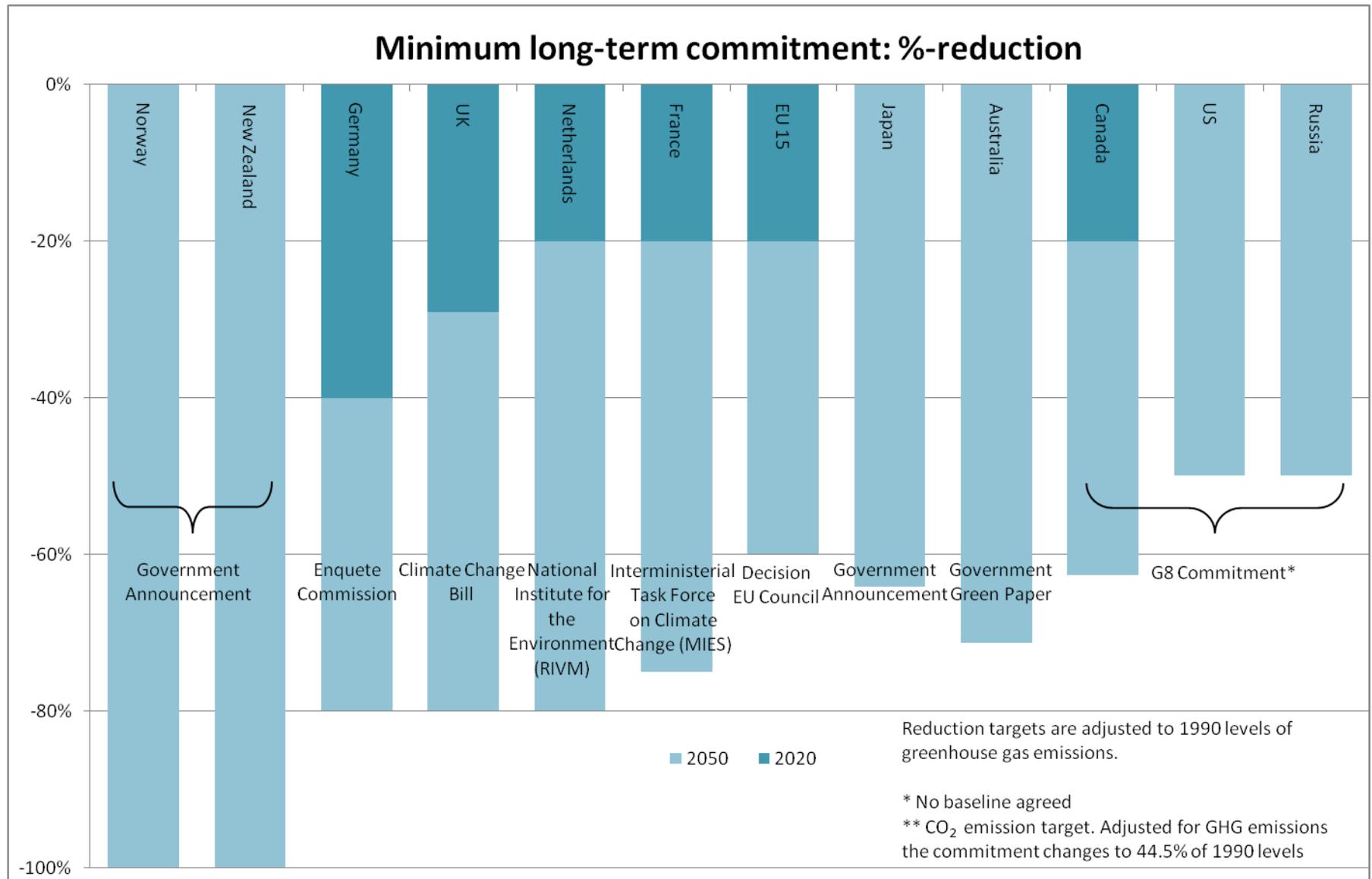
|                       |   |   |  |
|-----------------------|---|---|--|
| 17-18 March 2009      | 4th Annual European Energy Policy Conference 2009                         | <i>The conference will address all areas of energy policy, including climate change and energy security.</i>  | Brussels, Belgium                                    |
| 17-19 March 2009      | <i>Carbon Market Insights</i>   | <i>Annual conference organised by Point Carbon. The biggest conference of market participants of the year.</i>  | Copenhagen, Denmark                                  |
| 18 March 2009         | 3rd RGGI regional auction   | Third auction of 2009 allowances under the US Regional Greenhouse Gas Initiative, and will offer 31.5 million allowances for 2009 and 2.2 million for 2012 compliance. The reserve price will remain at \$1.86 per allowance.                       | <a href="http://www.rggi.org">www.rggi.org</a>       |
| 19-20 March 2009      | <b>EU climate summit</b>  | <b>Participants will discuss the European Commission's proposal for a global climate agreement to be negotiated in Copenhagen in December.</b>  | Brussels, Belgium                                    |
| 23-25 March 2009      | <b>46th Meeting of the UNFCCC CDM EB board</b>                            | <b>Meeting to discuss new methodologies, project registration and CER issuance under the CDM</b>  | Bonn, Germany  |
| 24 March 2009         | UK EUA auction  | The UK government will auction 4 million EUAs in this sale, and a total of 25 million EUAs in 2009.   | <a href="http://www.decc.gov.uk">www.decc.gov.uk</a> |
| 25-26 March 2009      | <i>Reviewing Emissions Trading &amp; Climate Change Policy Summit</i>     | <i>The conference will review the outlook for emissions trading in New Zealand following the recent general election.</i>   | Wellington, New Zealand                              |
| 26 March 2009         | <b>Pre-sessional consultation for the seventh session of the AWG-KP</b>   | <b>The consultations will include sessions on emissions trading and the project based mechanisms, on land use, land use change and forestry as well as on the scale of reductions to be achieved by Annex I parties.</b>                            | Bonn, Germany  |
| 26 March 2009         | Auction of 350,000 CERs on the Climex exchange                            | The CERs will come from a 49.5 MW wind power project in China that is currently in the pre-registration phase. Crediting is expected to start in the third quarter of 2009.   | <a href="http://www.climex.com">www.climex.com</a>   |
| 27 March 2009         | Expiry of Chicago Climate Futures Exchange March RGA contract.            | Date of delivery for those holding positions in futures contracts.  | <a href="http://www.ccfex.com">www.ccfex.com</a>     |
| March 30-April 9 2009 | <b>Seventh session of the AWG-KP and the fifth session of the AWG-LCA</b> | <b>Official negotiations on the implementation of the Bali roadmap and the development of a post-2012 system. The two Ad Hoc Working Groups cover, respectively, Annex 1 Parties to the Kyoto Protocol, and developed and developing countries.</b> | Bonn, Germany  |
| 30 March 2009         | European Climate Exchange March 2009 EUA, CER futures expiry date         | Date of delivery for those holding positions in futures contracts.  | <a href="http://www.ecx.eu">www.ecx.eu</a>           |



|                      |  |  |  |
|----------------------|--|--|--|
| 30 March 2009        | NordPool March 2009 EUA, CER contracts expire  | Date of delivery for those holding positions in futures contracts.   | <a href="http://www.nordpool.com">www.nordpool.com</a> |
| 31 March 2009        | EU ETS deadline for submission of verified emissions reports for 2008  | Installations participating in the EU ETS must present 2008 verified emissions reports by this date.   | EU ETS   |
| 1-2 April 2009       | <i>Wall Street Green Trading Summit VIII</i>   | <i>A two-day conference covering all aspects of environmental finance and green trading including carbon trading, RECs, cleantech venture capital initiatives.</i>   | <i>New York City, New York, USA</i>                    |
| 1-3 April 2009       | <i>Navigating the American Carbon World</i>  | <i>Organised jointly by CCAR, IETA and Point Carbon. This is a unique landmark partnership which combines a level of global carbon market expertise, depth and industry involvement unrivalled among any other North American carbon market event.</i> | <i>San Diego, California, USA</i>                      |
| 02 April 2009        | <b>G20 Summit in Response to the Global Financial Crisis</b>   | <b>This meeting will continue to debate how best to address the global financial crisis and its impact on sustainable development.</b>   | <b>London, UK</b>                                      |
| 7-8 April 2009       | <i>Carbon TradeEx America</i>  | <i>Carbon TradeEx is the successor to Carbon Forum America and is organised by Koelnmesse.</i>   | <i>Washington, DC, USA</i>                             |
| 14-15 April 2009     | <b>EU environment ministers' informal meeting</b>  | <b>Discussions to further the implementation of the EU Energy and Climate Package and enact EU climate policy</b>  | <b>Prague, Czech Republic</b>                          |
| 16-17 April 2009     | <b>Joint Implementation Supervisory Committee (JISC), fifteenth meeting</b>  | <b>Meeting to discuss new methodologies, project registration and ERU issuance under JI</b>  | <b>Bonn, Germany</b>                                   |
| 21-23 April 2009     | <i>Carbon Trade China 2009</i>   | <i>This event will gather different levels of CDM owners &amp; developers and tailor-make the conference for them.</i>   | <i>Beijing, China</i>                                  |
| 22-24 April 2009     | <b>G8 Environment Ministers' Meeting</b>   | <b>New technologies for alternative resources and energy saving will be one of the themes of the G8.</b>   | <b>Syracuse, Italy</b>                                 |
| 30 April 2009        | EU ETS deadline for surrender of EU Allowances   | Installations participating in the EU ETS must surrender 2008 EUAs by this date.   | EU   |
| 1-12 June 2009       | <b>30th session of the UNFCCC Convention subsidiary bodies (SBSTA and SBI) 6th session of the AWG-LCA and the 8th session of the AWG-KP.</b> | <b>Official negotiations on the implementation of the Bali roadmap and the development of a post-2012 system.</b>  | <b>Bonn, Germany</b>                                   |
| 1-12 June 2009       | <b>Conference of the Parties for Officials (SB30)</b>  | <b>Formal negotiations on post-2012 climate change policy continue here.</b>   | <b>Bonn, Germany</b>                                   |
| 7th-18 December 2009 | <b>15th Conference of the Parties to the UNFCCC</b>  | <b>COP15/MOP5: Parties intend to finalise a post-2012 global climate agreement here.</b>   | <b>Copenhagen, Denmark</b>                             |



## Commitment Monitor





## IDEACarbon pCER Index™ March 2009, Week 50

IDEACarbon’s pCER Index™ is a weekly pricing study undertaken to assess primary Certified Emission Reduction (pCER) price ranges on the buy and sell sides of the carbon market. The index captures what market participants would currently pay for pCERS in four different risk categories, by asking the following question:

**A clean development mechanism (CDM) project is at validation and plans to request registration by the end of 2008. How much would you currently pay (as a buyer) or receive (as a seller) per CER for the 2009-2012 strip with the following characteristics (all payment on delivery)?**

- (a) The validation, registration and volume risk are taken by the buyer
- (b) As (a), but the seller takes the validation risk
- (c) As (b), but the seller takes the registration risk
- (d) As (c), but the seller takes the volume risk

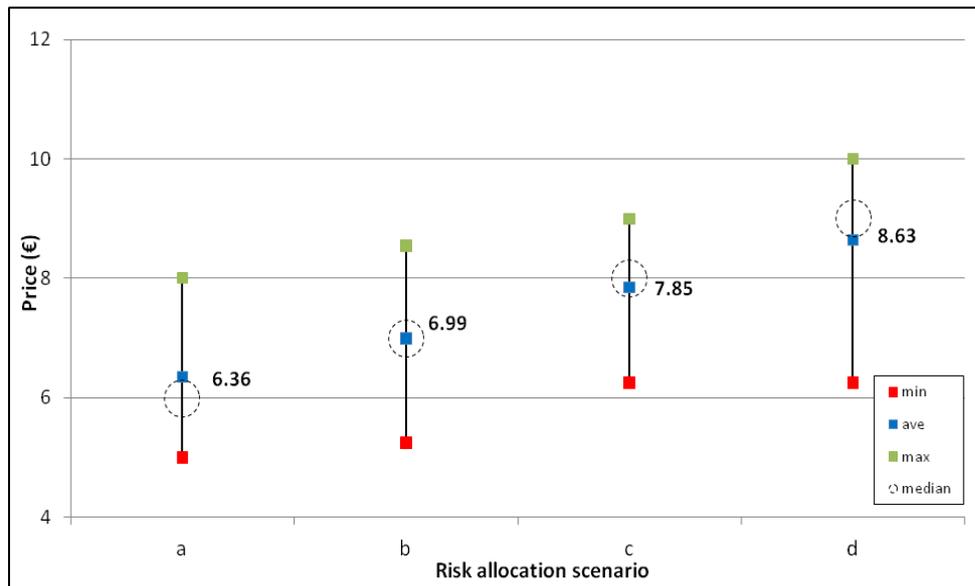
Results revealed the following prices for the four different scenarios.

Table 1: pCER Index results

|             | Scen. (a) | Scen. (b) | Scen. (c) | Scen. (d) |
|-------------|-----------|-----------|-----------|-----------|
| <b>Max.</b> | 8.02      | 8.55      | 9.00      | 10.00     |
| <b>Avg.</b> | 6.36      | 6.99      | 7.85      | 8.63      |
| <b>Min.</b> | 5.00      | 5.25      | 6.25      | 6.25      |

(outlying data points were trimmed)

Figure 1: pCER Index results



Markets continued on their upward trajectory, as DEC09 EU Allowances (EUAs) and secondary CERs (sCERs) settled at €11.87 and €10.82 up from last week’s €10.98 and €9.99. Oil’s boost, short covering for April compliance, and more bullish sentiment as EUAs broke the €11 barrier all contributed to this rise. The pCER market received support as well, following the bounce two weeks ago. In part, this came



on the back of optimism in the EUA and CER markets, where exchange volumes have been up along with prices. Otherwise, support came from greater buyer interest in the market in tandem with sellers being more willing to part with CERs (rather than develop unilaterally and hold onto the credits). Market participants cited sellers on the one hand coming to terms with the lower price trends vis-a-vis summer heights, and on the other hand were assuaged by higher secondary market prices this week. The trend toward indexed sCER pricing has also contributed to the upswing in pCERs – the middle of the pCER Index revealed values around €7 and €8 (with indexed prices at 70-85% of sCER prices even higher), up from the €6-7 range seen just a few weeks ago. In tandem, the floating price terms are increasingly popular, with indexed pCER prices to the European Climate Exchange (ECX) sCER contract (in a 70-80% range according to respondents). Additionally, one pCER respondent cited buyers looking at large transactions bidding up pCER prices on the premise that the market is already rebounding. The forecast for scenarios (a) through (d) to sustain a rise to a €6.25-€8.50 range thus took place as expected.

Significant buying interest was reported from the Australian market as speculative buyers and expected compliance players begin to look for good value projects and existing portfolios from struggling companies. The unlimited CER import provision in the Carbon Pollution Reduction Scheme (CPRS) whose draft legislation was released this week has fed market growth, and though the scheme's launch has not been verified for 1<sup>st</sup> July 2010, the entrance of Australian buyers in the carbon space is a near certainty.

Geographically speaking, Latin American and “exotic” (i.e. outside China and India) projects are drawing more attention. These projects, ranging from energy efficiency and biomass to forestry and methane capture have also actualised higher prices, in part because they have been greener, and providing more sustainable development benefits to smaller buyers. From a timing perspective, post-2012 remains the most viable option for buyers and sellers to transact new projects. A respondent noted post-2012 fixed term pricing contracts established by buyers alongside an agreement with the seller to share the upside if CER markets are higher than the fixed price at time of delivery. This certainly provides a risk hedge to both sides on the up and downsides.

A quick median and mode breakdown of the pCER prices for each scenario reveal the following

**Table 2: pCER Index Median and Mode**

|               | Scen. (a) | Scen. (b) | Scen. (c) | Scen. (d) |
|---------------|-----------|-----------|-----------|-----------|
| <b>Median</b> | 6         | 7         | 8         | 9         |
| <b>Mode</b>   | 6         | 6.5       | 8         | 9         |

Premia paid for each scenario have narrowed in their differentials as the overall pCER Index spread has come in from prices gravitating to the downside. Scenario (c) registration risk at €0.85 was the highest premium this week followed by scenario (d) volume risk at €0.78 and scenario (b) validation risk at €0.63. The spreads across scenarios remain have widened to well above €2 now, as higher prices are bringing greater discrepancies among the scenarios and project participants diversify from China – where a floor price of €8 supported the market. As different geographies are breached, price ranges widen from the more common €8-12 range to €6-€18 in some cases.

The outlook is unchanged from last week. Looking ahead, additional 2009 allowance allocation through March and surrendering of 2008 EUAs in April will be a price driver on the EUA side but impacting sCERs as well if significant selling and swapping occur. Primary CERs are expected to be range-bound, skewed toward the upside, especially as buyers return to the market.

**For queries, or if you would like to participate in the index, please contact [tzoltani@ideacarbon.com](mailto:tzoltani@ideacarbon.com).**