

Players get busy in CDM market

With tighter NAPs and growing demand for credits from the Kyoto mechanisms, not least from financial players, the price of CDM/JI certificates will be closely linked to the price of EUAs in the second Phase.

The market for emissions credits can doubtlessly be called an emerging asset class and is already approaching the USD 1 trillion level in terms of market capitalisation. A market of this magnitude certainly attracts attention from the financial players. So, alongside state driven initiatives, a couple of specialised private funds have found their way into the market, offering investors the possibility of both contributing towards climate protection and investing into a new commodity with major opportunities for profits.

Funds like the European Carbon Fund have been acting successfully in the market for years now, acquiring carbon credits from both JI and CDM projects, with more players following in their wake. Power giant EDF recently set up a EUR 300 million carbon fund which will identify and acquire carbon credits for the French major's affiliated companies. German utility RWE, as investor into the World Bank's Prototype carbon fund, is also one of the European pioneers in acquiring carbon credits.

The investment opportunities in this market have also attracted private investors. The first retail fund to enter the market was Klimaschutz Invest set up by Aquila Capital in Germany with 3C as investment advisor. The carbon credits for this product are mainly sourced in South America and South East Asia.

Most of these investment vehicles are placing their money into CDM or JI projects, and the majority of them are centring on China, Brazil and India. With these similar investment strategies, the buying interest comes on top of the already strong demand side for CDM / JI credits.

However, the amount of projects is limited. With JI still in its infancy, it is difficult to predict the amount of generated credits over the 2008 to 2012 period, but an estimated 3,500 projects have been identified world-wide to be suitable for applying the tough CDM/JI rules. While these projects can generate an expected of 1.5 billion credits, the known demand side is far bigger than that, some estimates as high as 2.5 billion credits.

The competition for obtaining the credits of suitable projects which are few and far between will therefore become harder for the buy side, the sellers of the reduction credits (the project developers) on the other hand, can choose from a variety of buyers.

As soon as all funds have experienced that there is a scarcity of projects in the market, will do everything to satisfy their investors' expectations and develop strategies for bringing a sufficient amount of emissions reduction credits on board. This will either lead to co-operations with project developers or technology providers to get exclusive access to projects, a rising price for emission credits, or a broader and more attractive investment package containing up front payments, and project financing.

The European Commission has already decided on the NAP proposals of several member states, while some countries are still awaiting a verdict from Brussels. The Commission's general approach has been to cut allocations, but to show some flexibility with regards to the number of accepted CER. Indeed, some European countries have succeeded in negotiating a lower cap of CERs/ERUs. Germany, for example, could increase the total amount of CER/ERU from an initial 12 per cent to 20 per cent.

This has boosted the demand for Kyoto credits in Europe even further, and in the near term we may see other countries following the German example. In the market, this will lead to some increased selling pressure on Phase 2 EUAs by companies purchasing CERs/ERUs and selling second phase allowances against this position. On the upside, the demand for CERs/ERUs will receive a boost by the same amount, putting upward pressure on the price of these compliance units.

Recent falls in the forward EUA 2008 market, dragging down CER / ERU credits as well, took many market participants by surprise despite the signals from Brussels that the allocation of allowances will be tighter in the Kyoto period. Following simple supply and demand rules and applying the reduction targets of the NAPs known so far, the price for European allowances for phase 2 should be in the EUR 20/t range. And the prices of CDM / JI credits will be closely linked to the price of EUAs.

While at the beginning of the first trading period of the EU ETS buyers paid between EUR 8-10/t for low risk CERs, the market saw prices peak above EUR 18/t in early 2006. Since then the price has fallen considerably to current levels of around 11 euros per tonne.

The continuing political discussions about the allocations within the EU ETS and the current inability to physically transfer CDM/JI credits into the EU ETS justify a price spread, currently at 20 per cent, between EU allowances (the December 08 contract) and CDM/JI credits. While the delivery risk will disappear as soon as the ITL is up and running, the cap on the utilisation of CDM/JI credits in the EU ETS will remain. Moreover, in the price equation for CDM/JI credits, signals from other, non-European trading schemes, which accept them for compliance, will be included.

Despite recent initiatives to establish a post-Kyoto framework for global emission trading, the market will remain fragmented and complex over the course of the next couple of years. Well funded professional financial institutions such as funds, will therefore actively contribute to find the ultimate tonne of greenhouse gas reduction. ■

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