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## AAU Trading and the Impact on Kyoto and EU Emissions Trading. Before the Flood or Storm in a Tea-cup?

Ingo Ramming, Dresdner Kleinwort and Carbon Trade & Finance\*

\*The article was written in September 2008. It represents the views of the author and does not necessarily reflect those of Dresdner Kleinwort or Carbon Trade & Finance.

The debate on the trading of Assigned Amount Units (AAUs) and the impact of the sale of a substantial part of so-called 'hot air' has been discussed since the inception of the carbon markets. The main focus has been on Russia and the Ukraine. Russia alone would have the potential to sell more than 4 billion AAUs and could therefore easily flood the market. However this scenario is fairly unlikely. Nevertheless, the trading of AAUs and the use of Green Investment Schemes is a reality, and market participants in the Kyoto and European emissions markets need to be aware of the opportunities and potential risks.

### Introduction

The carbon market was the fastest growing financial market in recent years with turnovers rising from US\$31 billion in 2006 to US\$64 billion in 2007. While the European Union Emissions Trading Scheme (EU ETS) still dominates the carbon markets with a turnover of more than US\$50 billion and EU Allowances (EUA) are a benchmark for the pricing of other offset credits, the project based market generating Emission Reduction Units (ERUs) and Certified Emission Reductions (CERs) is catching up. The growth in the turnover of ERUs and CERs is fuelled especially by financial investors, who provide the necessary funds to realise primary

projects and to develop a liquid secondary (CERs) market. While technical issues such as the uncertainty around the International Transactions Log (ITL) have been key drivers in recent months for the price of 'offsets' and the spread between CERs and EUAs, we can expect that in the future, carbon prices and spreads will depend primarily on supply and (compliance) demand. The supply of cheap AAUs from Economies in Transition (EIT) would, therefore, be an important driver for CER and ERU prices in the Kyoto regime.

### Supply and Demand in the Kyoto Market

Estimates are that the 'Kyoto gap', that is, the aggregate 'short position' of the deficit countries (excluding Canada) is between 2.4 and 2.8 billion tonnes of CO<sub>2</sub> equivalent (CO<sub>2</sub>e) emission reductions. The demand for carbon credits between 2008 and 2012 will be driven primarily from European and Japanese governments and the private sector, especially EU ETS.

The supply will be provided by the project based mechanisms – the Clean Development Mechanism (CDM) and Joint Implementation (JI) – and International Emissions Trading, in other words, the sale of AAUs. It is expected that project credits will generate between 1.5 and 2.5 billion tonnes and will only be able,

therefore, to cover part of the Kyoto gap. Conversely, AAUs could theoretically fill the gap more than three times over. It is important to note that the system would be more or less 'balanced' by the participation of the US and Canada. With both countries either not participating, or most likely not fulfilling, their Kyoto target, the market is long, which could be a bearish signal for carbon prices.

Graph 1: Development of EUAs, CERs and the Ratio CERs/EUAs



## Supply of AAUs and their Impact on Offset Prices

There are, however, several factors that reduce the likelihood of such a flood of AAUs leading to a price implosion:

- the inability of EU ETS companies to use AAUs for their compliance;
- political and reputational risks for governments purchasing significant amounts of AAUs to reach their Kyoto target; and
- the interest of EITs to bank AAUs post-2012 in order to have a cushion for future growth.

Most important is that AAUs are not allowed for compliance in the EU ETS and are, therefore, not a direct substitute for EUAs. This is especially important as the EU ETS is by far the largest emission market, and it is expected that most companies in the EU ETS will use CERs and ERUs up to the defined CDM and JI limit. This expectation is based on the assumption that project credits will trade at a discount to EUAs and that the National Allocation Plans are tight for Phase 2, and even tighter for Phase 3. Finally, it is based on the expectation of full bankability of EUAs between the second and third phase of the EU ETS. Taking all this into account, it is expected that there will be a demand of approximately 1.3 billion tonnes between 2008 and 2012 from the EU ETS, leaving the CER/ERU supply at 200 million to 1.2 billion tonnes after the EU ETS.<sup>1</sup>

With a public demand of 600 million to 1.3 billion, two things are crucial for the future supply and demand and, therefore, the price development of offset credits: first, the amount of project credits actually generated and, second, the compliance strategy of governments. The question in this respect relates to how deficit countries will reach their Kyoto target. Will they purchase project credits or consider AAUs? And, in the case of AAU buying, will they accept cheap 'hot air' or focus only on 'greened' AAUs?<sup>2</sup>

The worst-case scenario would be if governments con-

sidered balancing their entire deficit with the purchase of AAUs, as prices of these surplus AAUs are likely to be marginal. In such a scenario, demand for more expensive offset credits would be very limited, which would lead to a dramatic oversupply of project credits between 2008 and 2012. This development would be more likely if no future global climate agreement were agreed and only limited bankability of project credits existed post-2012. In this scenario, CERs and ERUs would trade at only marginal prices and have a negative impact on EUA prices as well. Even more importantly, such an event would not only lead to collapsing carbon prices but endanger the ultimate goal of the Kyoto Protocol, the reduction of greenhouse gas emissions.

As mentioned above, however, this scenario is very unlikely. International Emissions Trading and the sale of AAUs is dominated by deficit countries in the EU-15 and Japan. With an over-supply of available AAUs, potential buyers are able to define the quality of the so-called 'greening' and the amount actually being purchased. 'Gourmet AAUs' with very credible and documented greening will require a similar effort as ERUs and should, therefore, trade at similar levels. The risk of surplus countries rushing into the market to sell their 'hot air' and flood the market with cheap credits should, by consequence, be very limited. Instead, market participants should bear in mind that AAU trading could play a key role in balancing supply and demand in the case of disappointing delivery rates of JI or CDM projects. Assuming that the greening procedure of AAUs is transparent and follows international guidelines, greened AAUs could actually play the role of a safety valve in the Kyoto market.

## Conclusion

While, in the past, the carbon market focused primarily on the EU ETS and the CDM, AAU trading and Green Investment Schemes have returned to the agenda recently. It is key for market participants to take into account the risk that a large part of the AAU surplus could hit the market. Even more importantly, governments need to consider in their compliance strategies that purchasing significant amounts of non-greened AAUs will have not only a negative impact on the price but might also hurt the emissions market in general, putting the credibility of the entire mechanism at stake. Greened AAUs will play a significant role going forward as a safety valve to balance the Kyoto market. This will be especially true if delivery rates of CDM and JI projects or the results of domestic policies and measures disappoint. Recent discussion and the actual purchase of AAUs should be seen, therefore, more in light of creating a safety valve than triggering a flood.

<sup>1</sup> Source: Dresdner Kleinwort.

<sup>2</sup> Under the Kyoto Protocol many EIT were allocated emission commitments well above their current GHG emissions. Even allowing for rapid growth the GHG emissions of these EITs will be clearly below the relevant Kyoto targets. This surplus is often called "hot air". Article 17 of the Kyoto Protocol allows countries to sell their surplus AAUs to countries in deficit. From a legal point of view, all AAUs are the same. Accordingly there is no difference between "green" and "normal" AAUs. Nevertheless many buyers oppose such "hot air"-trading on the grounds that it would undermine the spirit of the Kyoto Protocol. The idea of "greening" of AAUs links the transfer of AAUs to emission reductions and hence makes the purchase of AAUs more acceptable. This "Earmarking of Funds" is often defined as a Green Investment Scheme (GIS) and the resulting AAUs as greened.

**Dresdner Kleinwort and Carbon Trade & Finance**

*Ingo Ramming is a Managing Director at Dresdner Kleinwort and an Executive Director and member of the board of Carbon Trade & Finance. From 1993 to 1996 he worked as a journalist and editor for different magazines covering the German financial market. He worked from 1996 to 1999 and 2001 to 2007 at Dresdner Kleinwort being responsible for Interest Derivate and Hybrid structuring and GHG emissions. Between 1999 and 2000, Ingo worked with Enron, focusing on energy structuring and fuels and assets. Ingo was among others responsible for the first ever ISDA documented EU allowance transaction in June 2004 and the first ever cash settled EU allowance transaction in December 2004. Carbon Trade & Finance ranked first for trading Emissions Reductions Units (ERUs) in both the primary and secondary markets in the 2008 Environmental Risk survey.*