

Link trials offer hope to traders eyeing millions in missed opportunities

Today might trigger a sigh of collective relief among EU carbon market participants, as it will mark the first day of a formal full-scale trial to test the software which will link the EU's carbon credit registry with the UN's international registry.

The market is seeking a timely connection between the two registries to guarantee credits will be able to flow between them and allow the import of UN offset credits into the EU market.

The EU registry, known as the community independent transaction log (CITL), tracks the ownership of EU carbon emissions allowances (EUAs), while the UN's international transaction log (ITL) records the transfer of carbon credits issued under the UN's project-based flexible mechanisms.

Every EU member state will be involved in the two-week trial, to be completed on 4 August, but only after that will the developers really know how far away they are from establishing a fully functioning link.

Earlier this month EU environment commissioner Stavros Dimas said the link would be in place by 1 December.

Confidence in the trade of UN offset credits, (certified emissions reductions or CERs) appeared to get a boost after his assurances, with the price difference between this year's EUAs and CERs narrowing to less than €4, its narrowest since November last year.

Market participants had been growing increasingly anxious that a technical connection between registries might not be established before the end of the year, when many of their forward contracts are due to be physically delivered.

The testing process is already running behind schedule. In March, Dimas said software testing with member states could be completed by June, but with the ultimate expectation that a connection would be completed by the end of the year.

Several EU countries, including the two countries with the most EUAs to hand out, Germany and the UK, said they would delay distributing 2008 permits to their industrial sectors participating in the cap-and-trade market, because the link was not in place.

Other member states have gone ahead and allocated their permits when they were given clearance to by the EU, but the volume of spot allowances is relatively small and trading liquidity is very thin. Seven countries have so far issued 2008 EUAs to take the total number of allowances available for spot trading to around 367 million. This is 17 per cent of the 2.1 billion EUAs due to be issued this year.

Companies participating in the EU emissions trading scheme could be missing out on as much as €9 million (\$14.3 million) a day because of delayed allocation of 2008 EUAs, according to research from Italian carbon consulting firm BianconiConsulting.

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EUA closing prices - historical

EUA prices for December 2008 delivery, as assessed by Point Carbon. Prices are published daily at www.pointcarbon.com



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EUA closing prices, OTC

Contract	Bid	Offer	Close	Change
EUA 2008	25.75	25.85	25.80	-0.85
EUA 2009	26.89	26.99	26.94	-0.96
EUA 2010	27.85	27.95	27.90	-1.00
EUA 2011	28.81	28.91	28.86	-1.19
EUA 2012	30.17	30.27	30.22	-1.26

Secondary CER assessment

Contract	Low	High
Dec-08	21.80	21.90
Dec-08-12	22.95	23.05

Quoted prices are euros per EUA/CER, at close of market 17 July, as assessed through Point Carbon's bid-offer-close methodology for the over-the-counter (OTC) market. Changes refer to the last issue of CME.

For methodology, see www.pointcarbon.com.

Market comment

European carbon prices continued their recent trend of following the fortunes of the oil prices this week, rising and falling in sympathy with the volatile front month Brent crude oil contract.

By 17.30 CET on Thursday, the 2008 EU allowance was trading at €25.80 in the brokered OTC market, compared to a close of €26.65 a week earlier.

Last Friday the 2008 EUA price rose €0.85 on the day as the August Brent crude contract soared \$10 to a peak of \$147.50/bbl.

But later this week a falling crude price prompted a 5.1 per cent fall in the most traded carbon contract on Wednesday.

As the Brent front month tumbled to a low of \$132.50/bbl on the Intercontinental Exchange after the release of US weekly oil statistics showed a inventory build-up, the 2008 EUA slid to a finish of €25.15, down €1.30 on the day.

"The market is taking its cue from oil, but I don't think there is the appetite to push carbon back up now," said one trader.

"It will be interesting to see when carbon decouples from crude, I think the 2008 EUA contract will find fundamental support at €23 to €24 no matter what happens in oil," said a second trader.

In German power, which generally moves in line with carbon, the baseload 2009 contract ended Thursday on the European Energy Exchange (EEX) at €82.85/MWh, down €0.95 from the close of €83.80 recorded a week earlier.

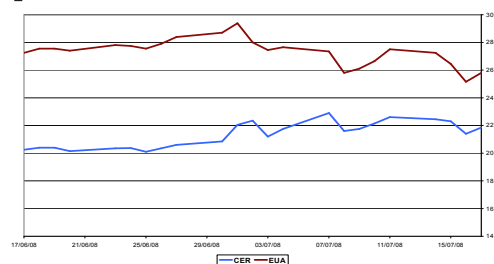
The secondary CER market fell less heavily than EUAs. The 2008 CER contract was trading at €21.85 at 17.30 CET, €0.30 lower than at the same point a week earlier.

The difference between the 2008 EUA and CER contracts continued its narrowing trend. It finished on Thursday at €3.95, down from a difference of €4.50 at the same point last week but slightly more than the figure of €3.75 recorded at the close on Wednesday.

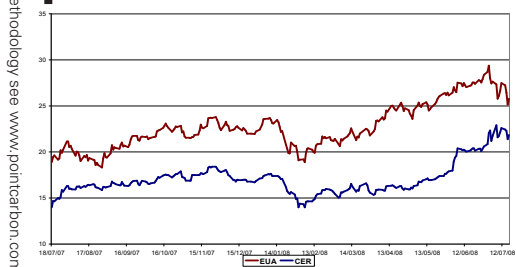
Around 68 million EUAs were traded across all platforms.

EUA and secondary CER prices [€/t]

Last month



Last 12 months



For methodology, see www.pointcarbon.com

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The research found that by 16 June, UK companies had already missed out on €97 million, German companies €336 million, Italian companies €123 million and French companies €75 million.

"If the delay will continue as some say, until the end of the year, the cost could reach cost could reach €267 million for the UK, €923 million for Germany, €337 million for Italy and €208 million for France," BianconiConsulting said.

"In aggregate, it could cost EU companies over €2.7 billion by year end," it said.

The financial calculations were made by taking into account the missed profit which could in theory have been made by companies by using EUA based financial transactions, such as repurchase agreements and swap transactions for EUAs and UN-backed carbon credits, called certified emission reductions (CERs).

"In fact the protracted delay in the issuance of EUAs is effectively preventing EU companies from benefiting from the use of such tools. Also, the spread between EUA and CERs is now slowly closing, thereby reducing the window of opportunity for the EUA/CER swap transactions," the statement said.

BianconiConsulting founder Andrea Bianconi said traders across the market were frustrated at the

missed opportunity of making risk-free profits from such deals.

"This is money that could be made if the link was in place so it's a problem for them. The spot market for EUAs is really dead, there's very little being traded," he said.

"It is a missed opportunity. Even the smaller installations, who may not all be aware of the possibilities of making profits in this way, could have been taking advantage of this."

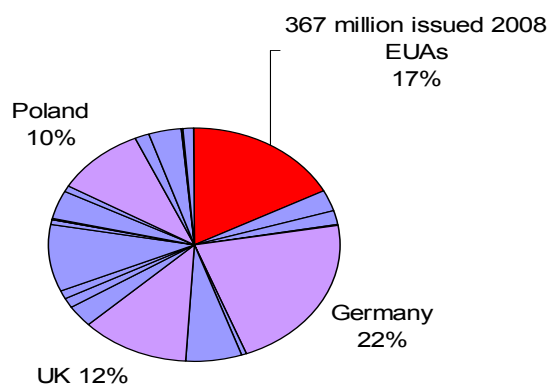
While the lower market volumes and liquidity are the result of the delay in allocating allowances, the economic cost of missing out on such opportunities is very difficult to quantify, one industry analyst who requested anonymity pointed out.

Even with a fully functioning link in place the volume of trading in spot allowances is likely to only be a small segment of total traded volume, he said.

"What the past has shown us is that futures have always represented the largest segment, something like 80-90 per cent in phase one (of the EU emissions trading scheme, which ran from 2005 to 2007)," the analyst added.

Spot EUAs 2008 The pie graph below shows the amount of spot EUA issued to date in 2008 in red. There are around 367 million EUAs issued out of around 2.1 billion due to be issued this year.

Total EUAs to be issued in 2008: 2.1 billion



Norway to rethink NAP as Efta approves allocation but not plan

Norway will have to make adjustments to its national allocation plan before issuing carbon credits to installations covered by the EU cap-and-trade scheme after the European Free Trade Association raised several objections to the plan.

Under a ruling published this week, the Nordic country will have to redefine its definition of what constitutes a new entrant to the scheme, how to allocate allowances to companies that capture carbon dioxide and store it underground and finally on how companies qualify for free allocation of credits.

Efta, which has the final say on the carbon credit plan as Norway is not a member of the EU, did not have any objections to the 15 million allowances per year the country wants to allocate.

Amund Utne, director of competition and state aid directorate in Efta's surveillance authority, told Point Carbon that Norway will have to address these three objections before issuing allowances.

"Once we have no objections then we will need to have a list of individual installations and after that then they can issue allowances," Utne said.

Efta's Surveillance Authority (ESA) ensures that European Economic Area rules are properly enacted and applied by Efta states Norway, Iceland, Liechtenstein.

"The government will now review ESA's objection before it takes a decision on how to proceed," Norway's environment ministry said in a statement today.

Analysts divided over short term price of EUAs

Analyst opinion is mixed over the short-term price outlook for European carbon, as long-term bullish forecasts are tempered by concerns over an industrial downturn, a potential fall in commodity prices, and how many UN offset credits will be used by the end of the year for compliance.

Market jitters over the past two weeks have resulted in high volatility in the 2008 EU allowance price. Fears that this year's meteoric rise in oil, gas and coal prices could collapse has left the market nervous about the current price of EU carbon allowances (EUAs).

The benchmark contract crashed from a closing price of €29.38 at the start of the month down to a closing price low of €25.15 on 16 July. Analysts continue to hold long-term bullish forecasts for EUAs on the back of the tighter cap in phase two of the Kyoto protocol, but short-term predictions differ sharply.

Point Carbon analysts are bearish, with a forecast that the 2008 EUA will settle at an average of €25.00 for the rest of 2008, mainly because demand will be dampened by a high volume of UN-backed offset credits, known as certified emission reductions (CER), used for compliance.

2008 EUA prices are not expected to fall much below €20.00 independent of how far the oil price falls, said the manager of Point Carbon's analyst team, Kjersti Ulset, who forecast an average price of €25.00 for the contract for the rest of the year.

Ulset added that the carbon market hinges on the volume of UN-backed offset credits that will be used for compliance.

"The biggest uncertainty is the use of CERs in the short term, how many will be issued by end of year, and will market players use their time-flexibility, both in terms of borrowing EUAs from next year as well as using CERs issued at the start of 2009," she said.

Meanwhile, analysts at French bank Societe Generale hold that the 2008 EUA price will clear at €28.00 to €29.00 in the last quarter of the year. The lack of abatement this year through fuel-switching, when utilities choose to run gas rather than coal, will continue to underpin the carbon price irrespective of a sudden fall in oil prices, according to analyst Emmanuel Fages

Fages expects slowing industrial output in Europe will reduce carbon dioxide emissions by around 15 million tonnes, or around 0.7 per cent of the total.

Meanwhile, analysts at Deutsche Bank believe the 2008 EUA price could still tip €40.00 by the end of the year if the market is factoring in long-term carbon dioxide emission reduction targets.

Bulgaria eyes sales of surplus Kyoto GHG credits

The Bulgarian government is expected to decide by the end of the year the amount of Kyoto protocol greenhouse gas credits it will sell, a government official told Point Carbon this week

Under the Kyoto agreement, Bulgaria is expected to have a surplus of some 35 million tonnes of carbon dioxide equivalent annually during the Kyoto's protocol's first compliance period 2008-2012.

"I expect there will be decision (by the Bulgarian government) at the end of the year," the official said.

Canada, Denmark, Japan and Netherlands could be "possible buyers" of the surplus credits, he said, pointing out that negotiations have yet to begin.

"It (sale of surplus credits) is not urgent at the moment. It's more important for the implementation of the EU ETS (emissions trading scheme)," he said.

Bulgaria effectively joined the EU's cap-and-trade market when it officially became a member of the bloc on 1 January 2007.

In October last year, the European commission ruled to let Bulgaria issue 42 million carbon dioxide (CO₂) emission allowances annually to installations covered by the ETS in 2007 through 2012 - a decision contested by the government. Bulgaria had asked for an average 68.6 million per year in the period 2008-2012 and 52.8 million allowances in 2007, particularly due to the country's growing economy during the past six to seven years.

Ireland still to decide on EUA auctioning plans

Ireland has yet to decide whether to auction or sell around 500,000 EU allowances over phase two of the bloc's emissions trading scheme, but officials expect to dispose of the credits before the end of the year.

The country's national allocation plan (NAP) set aside the allowances, the revenue from which will be used to cover the administrative cost of the scheme, according to Ireland's Environmental Protection Agency (EPA), which prepared the plan.

"There has not yet been an official decision taken as to whether we will be auctioning or selling these allowances," an EPA official told Point Carbon.

"It also won't necessarily be the case that the sales will be broken up into five tranches of equal size every year," the official said, adding that for an auction or sale to occur by the end of the year, plans would have to be finalised by September or October.

Ireland has been given clearance to allocate its phase two allowances to its installations but, like the UK, has

chosen not to allocate the permits until the European software overseeing the transfer of carbon credits, the CITL, had linked up to the UN's International Transaction Log (ITL).

Ireland held three auctions which resulted in the sale of over 1 million EU allowances during phase one of the scheme. There are not likely to be further allowances available to be sold off in Ireland during the second phase because the country's NAP opted to retire any surplus permits in its reserve for new entrants to the scheme.

Ireland's NAP will allocate 22.28 million allowances a year from 2008 through 2012.

Union Fenosa switches from coal to gas

Spanish utility Union Fenosa boosted gas-fired production by 37.8 per cent while cutting back coal-fired generation almost 42 per cent in the first half of 2008 compared to 2007, the company reported this week, in line with the trend across the whole Spanish power sector.

New capacity allowed the generator to raise production at combined-cycle plants to 7,766 GWh from 5,656 GWh in 2007. Refitting work was the official reason for production at its coal-fired plants dropping to 3,311 GWh from 5,695 GWh in the first half of 2007, but higher carbon costs are also likely to have played a role.

Despite improved rainfall across Spain in the second quarter, Fenosa's hydroelectric production was down 35.8 per cent to 1,373 GWh compared to the first half of 2007. With nuclear production also down 8.5 per cent overall non-renewable generation was 6.3 per cent lower than in 2007.

The company did not provide total CO₂ emissions figures for the period, but reported that the cost of CO₂ rose to €46.2 million compared to €5 million in the first six months of 2007, with carbon prices averaging €23.74 compared to €1.42 in the same period last year.

Norway to invest in Mongstad CCS plant:

The Norwegian government was given a green light by European regulators this week to fund a project to test carbon capture and storage (CCS) technologies at the Mongstad oil refinery.

The Mongstad test centre, which will run for five years between 2010 and 2014, will cause only a limited distortion of competition which will be outweighed by

the benefits of improving knowledge in CCS, according to the European Free Trade Association Surveillance Authority (Efta), a group whose members are the EU's close neighbours Iceland, Liechtenstein, Norway and Switzerland.

The test project is part of oil company StatoilHydro's plans to build a power plant at the Mongstad refinery.

It will test post-combustion CCS technologies on emissions from both the Mongstad oil refinery and the new power plant up to 2014, when a full-scale CCS system must be up and running.

Aviation should pay 2.4 times more for GHG pollution: report

Aviation has escaped lightly under the terms of its inclusion in the EU cap-and-trade market because the sector should be paying 2.4 times more for its greenhouse gas pollution than an industry which is solely emitting carbon dioxide, according to a new report.

The so-called multiplier effect, whereby airlines pay more for the emissions of gases like nitrous oxide and for the creation of cirrus clouds, should be 'above 1.5, with a best guess value of 2.4 and the upper limit of uncertainty range around 4', the report said.

The findings of the report published by Belgian university Catholique de Louvain, will be considered by the EU commission which is preparing a proposal on a multiplier for aviation that is due to be published at the end of the year.

EU cap- and-trade regulation of all flights taking off and landing is due to start in 2012.

Japan, Ukraine ink pact on carbon credits transfer

Japan has signed an agreement with Ukraine to buy the former Soviet Republic's surplus allowances for greenhouse gas (GHG) emissions as part of its efforts to meet its greenhouse gas reduction target under the Kyoto protocol on curbing global warming.

The memorandum of understanding, signed by Ukraine's Environmental Protection Minister Heorhiy Filipchuk and Japanese Ambassador to Ukraine Matsuo Mabuchi in Kiev this week, covers the basic framework for the Japanese government to purchase Ukraine's surplus GHG emission allowances, or assigned amount units (AAUs).

A Ukrainian government official confirmed that the country had signed a memorandum of understanding with Japan that opens a possible future channel of trade in international carbon credits. The governments of Japan and Ukraine have yet to work out the details of the AAU transaction, including the specific amount and price.

For Japan, it is the second such memorandum of understanding, after the first one signed with Hungary last December. Japan is also negotiating similar AAU transaction deals with some other countries, including the Czech Republic, Poland and Russia.

The Ukrainian government has said it aims to sell some 1.2 billion AAUs over the Kyoto period.

UK govt sees CO2 emissions 26% below 1990 level by 2020

Britain's emissions of carbon dioxide (CO2) are expected to fall 26 per cent below the 1990 level by 2020 – in line with proposed legislation, the UK government said in an annual report to parliament published this week.

The report, which sets out progress of the UK's climate change programme, put provisional estimates for CO2 emissions in 2007 at about 543.7 million tonnes or 2 per cent lower than the previous year.

In 1990, UK's net CO2 emissions were 592.4 million tonnes, according to the report, published by the Department for Environment, Food and Rural Affairs (Defra).

Last year, the UK's Labour government proposed a statutory target to reduce CO2 emissions through domestic and international action by at least 26 per cent by 2020 and by at least 60 per cent by 2050, against a 1990 baseline. However, the UK, which has several national and international targets to reduce climate-changing gases, will fall short of meeting a national target to reduce CO2 emissions by 2010.

"The updated projections confirm that, although we expect significant reductions in carbon dioxide emissions by 2010, the projected fall to about 15.5 per cent below 1990 levels, would not be enough to achieve the domestic goal to reduce carbon dioxide emissions to 20 per cent below 1990 levels by 2010," the report said.

Guest commentary

The EUA- CER price differential

By Liz Bossley, chief executive, Consilience Energy Advisory Group (CEAG)

The testing of the link between the EU's carbon credit registry and the UN's international registry scheduled to start today is cause for one cheer at least.

Anything that takes us closer to allowing physical delivery of certified emissions reductions (CERs) and EU allowances (EUAs) into European registry accounts and the restoration of the under-nourished spot market is welcome.

The inability to make and take physical delivery of EUAs and CERs in Europe is an ongoing cause for concern. This is particularly so for traders with hedged positions based EUAs who also trade in secondary CERs. Traders of CERs can give and take delivery in non-European accounts, but many have hedges based on EUAs. The physical delivery of these EUAs is limited to registries in those European member states that have issued 'quasi-EUAs', in the absence of 'real' EUAs. I use the word 'real' here to imply EUAs that are tagged assigned amount units (AAUs).

The price of CERs has recently increased relative to EUAs arguably because the former have a clearer physical delivery option, albeit outside Europe. This has narrowed the EUA-CER differential from around a €9 a tonne discount in April to current levels of under €5 a tonne.

As an international benchmark grade of allowance and as a basic tool for hedgers, the EUA has lost ground while the link between the EU registry, known as the community independent transaction log (CITL), and the UN's international transaction log (ITL), has been in limbo. The correlation between the price of EUAs and the price of secondary CERs for delivery on 1 December 2008 has been only 76 per cent over the last year: this is at the limits of hedge acceptability to risk managers. Volatility in the EUA-CER price differential has risen from a low of 10 per cent in October 2007 to current levels of around 35 per cent.

Once the constraint on delivery of both EUAs and CERs is removed by a fully functioning CITL-ITL link, it may be expected that the EUA-CER price differential will again widen, for two reasons:

The use of CERs for compliance is subject to supplementarity limits, which state emissions

trading should be in addition to domestic action, under both the Kyoto Protocol and the EU emissions trading scheme (ETS).

Secondly, CERs have a shorter time value than EUAs. EUAs are fully bankable into phase three of the EU ETS. The bankability of CERs is limited.

The 'Kyoto Protocol Reference Manual on Accounting of Emissions and Assigned Amounts'-the UN rulebook - states 'If the Party [an Annex B Kyoto-capped country] has AAUs, ERUs or CERs remaining in its registry after it has retired sufficient units to cover its Annex A emissions, it may request that these units be carried over to the subsequent commitment period.'

AAUs and EUAs can be carried over without limitation. The rulebook also states that 'CERs and emissions reduction units (ERUs) from emission reduction projects may each be carried over up to a quantity equal to 2.5 per cent of the Party's initial assigned amount.'

When an Annex B country hands over its final true-up report in 2015 it has the option to include a list of AAUs, CERs and ERUs that it would like to carry over. The list has to detail the serial number of each AAU, CER and ERU it wishes to bank. By implication, anything not on the list gets cancelled, be it in state, including non-Annex 1 state, or in corporate hands.

At this point in time there is no mechanism whereby a private investor or a non-Annex 1 country holding CERs and ERUs at the end of the true-up period can apply to the UN or to an Annex B capped country to bank its CERs and ERUs. In the absence of positive action to bank them these allowances will be cancelled in 2015.

This bodes ill for the relative value of CERs. ERUs are not yet trading.

However, the proliferation of international trading schemes that will accept CERs and the downward revisions to the estimated number of CERs to be generated to 2012 suggest there may be a rising floor under the EUA-CER price differential.

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