DCI ENVIRONMENTAL CENTER

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# Intelligence Report

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## Prospects for International Emissions Trading [redacted]

***The climate change negotiations next month in Bonn most likely will not achieve a breakthrough to establish an international emissions trading regime, but private sector firms are making progress with pilot trading programs that will bring pressure to bear on the talks for early progress.*** [redacted]

### Cloudy Outlook for Bonn Meetings [redacted]

**EU Moves to Restrict Trading.** In preparation for the June meetings of the climate convention's subsidiary bodies in Bonn, the German EU presidency announced on 10 May that EU Environment Ministers, meeting informally in Weimar, have agreed to a 50 percent cap on international emissions trading matched ton for ton with verified domestic emissions reductions, [redacted] [1] Austria, Denmark, Finland, France, and the UK supported the German push for a concrete ceiling on emissions trading despite last year's understanding with the US to agree to disagree.

[redacted]

1 The German formula set the ceiling at 50 percent of the difference between a country's actual annual emissions for 1994-2000 and its target. The ceiling could be increased with emissions trading if domestic reductions matched traded allowances on a ton for ton basis after 1993. Domestic reductions would need to be verified, but how verification would be implemented remained unclear [redacted]

[redacted]

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[redacted]

The Dutch and Swedish cabinets, however, have been unhappy with the German proposal and won a side agreement allowing more leeway for emissions trading up to 50 percent of their emissions reductions, [redacted] In addition, there is another side agreement with non-climate sweetners. [redacted] The Dutch cabinet, in particular, was reluctant to commit the country to limits on trading before it knows the details of the international trading regime.

- The Swedish cabinet has appointed an experts group to examine how the Kyoto Mechanisms can be used in the Swedish market and to introduce parliament and the political parties to the concept of emissions trading. [redacted].

German control of the emissions trading issue will continue after Finland assumes the EU presidency in July. Helsinki has decided to let Germany handle the issue—a political "hot potato"—through the Fifth Conference of the Parties this October, [redacted]

In effect, the German Green Party delegation from the Environment Ministry in Berlin will have a relatively free hand to pursue the debate in the Bonn talks, control the agenda for the EU caucus on the issue, and do the talking for the EU. [redacted]

**Umbrella Group Hampered by Japan.** The Umbrella Group of non-EU developed countries[3] has an agreed position on unrestricted emissions trading and will provide the leadership at the Bonn meetings in designing the modalities of an international system, but Japan has important reservations. MITI insists on government control of trading due to discomfort with Japanese firms trading directly with multinational firms or indirectly through commodity exchanges [redacted] Moreover, MITI opposes an international registry for trades because it is concerned about legal liability issues arising from mistranslatiions of Japanese-langugage trades.[4] [redacted]

**China and India Oppose Trading, Seek Aid.** Meanwhile, two key players for the Bonn meetings remain opposed to emissions trading. At the root of Sino-Indian

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2 The Dutch formula called for the ceiling to be calculated as 50 percent of the difference between a country's BAU emissions forecast for 2010 and its target. [redacted]

3 The Umbrella Group of nine non-EU developed countries comprises Australia, Canada, Iceland, Japan, New Zealand, Norway, Russia, Ukraine, and the US. Kazakhstan, has attended one Group meeting as an observer because it intends to announce an emissions target at COP 5. [redacted]

4 MITI notes that many of the Japanese written language's 10,000 characters do not translate well into English. [redacted]

opposition to emissions trading is a complaint that it would leave them out of the cash flow since they have no emissions targets and are ineligible to trade. The Chinese and Indian foreign officers last month laid down markers in written submissions to the secretariat of the climate change convention that they oppose emissions trading because it diverts attention away from direct transfers for financing leading-edge clean energy technologies for them. [redacted]

China speaks with many voices, however, and the Chinese State Environmental Protection Administration signed a Statement of Intent during Premier Zhu Rongji's visit to Washington last month to examine market mechanisms, including domestic emissions trading, as tools to reduce sulfur dioxide emissions in China. The Premier evidently overruled foreign office objections in this instance. [redacted]

Chinese agreement in March 1999 on means to implement the pase-out of CFC emissions under the Montreal Protocol suggests, by analogy, what their financial interests are in the Kyoto Protocol. While China had agreed to cease CFC production by 2010, it has now accepted a domestic cap and trade approach to reach that goal. Donors to theMontreal Protocol's Multilateral Fund, in turn, have agreed to transfer $150 million to China for the phase-out, starting with an initial tranche of $20 million and, subject to verified compliance, $13 million annually thereafter [redacted]

Similarly, India and China have expressed an interest in France's suggestion that the Global Environment Facility (GEF) serve as the vehicle for cash transfers for clean energy technologies [redacted] India has caveated the idea, however, by insisting that France and other donors generate incremental funding for the GEF for this purpose in addition to what they have already pledged the fund, which is probably not what France has in mind.

- It is also worth noting that Indian Environment Minister Paul recently urged the Confederation of Indian Industries to take advantage of the Clean Development Mechanism (which will generate tradeable credits) to attract foreign investment. [redacted]

The Buenos Aires Conference of Parties last fall indicated, however, that China and India do not necessarily represent the views of other developing countries in the Group of 77 toward emission trading. The African delegations split dramatically with China and India over implementation of the Kyoto Mechanisms. [redacted]

**Progress in the Private Sector**

True to UK Chief Scientist David Fisk's prediction last year that traders would make greater progress than governments in setting up emissions trading, several private sector firms are developing rules for trading among themselves and are launching pilot programs, BP/Amoco, for example, has been trading emissions allowances among its business units worldwide—including its North American unit in Cleveland—since last September. Internal trading has driven down the price of allowances to $18 per metric ton of carbon dioxide. The company's target to reduce greenhouse gas emissions 10 percent from 1990 levels by 2010 has been reinforced by personal performance contracts between the Group CEO and the chiefs of its business units. The company will cap natural gas flaring, wring efficiency gains out of refinery operations, and install new technologies on production platforms.

The International Petroleum Exchange (IPE) in London is preparing to set up a market for trading emissions allowances. IPE has asked Canadian and UK consultants to design a standard contract for allowance traders and brokers. In addition, IPE is working with the Confederation of British Industries and the UK government to create a single pilot program for the whole country, according to press reports

Elsewhere, Royal Dutch Shell is subsidizing the International Emissions Trading Association (IETA) to encourage member firms to set up emissions trading programs, IETA will provide trading backup services, including internet trades, certificaiton and verification of allowances, and promotion of CDM projects that may produce emissions credits for trading. The Climate Action Network's criticism of IETA as an inappropriate commercial initiative for the UN Conference on Trade and Development (UNCTAD) as a non-profit organization overlooks the potential benefit of emissions trading to developing countries,

- NOORDPOOL, the Scandinavian electricity pool, is interested in trading emissions allowances among its participating utilities, and the Sydney Stock Exchange in Australia has encouraged firms to begin trading on a trial basis.

- NYMEX has agreed to set up an electronic exchange with Deutsche Bourse in Frankfurt for futures contracts based on Germany's deregulating electricity market and to be tied into EUREX for broader selling, according to press reprots. The potential is there for emissions trading as well.

In addition, several Canadian firmsand NGOs jointed with the federal government last year to start a pilot Greenhouse Gas Emission Reduction Trading program. It has rules for baseline determination, additionality, proof of ownership, double counting for buyers' and sellers' accounts, and bverification. Canadian stockholders keep a registry for the regime. [redacted]

Despite MITI's concern, Tokyo Forex Company is setting up a network for brokering emissions trading by the end of the year, and a number of Japanese financial institutions want to get involved in an emissions trading business, according to the Japanese press. [redacted]

**Looking for a Nod** [redacted]

As informal markets for trading open in anticipation of a formal diplomatic accord, trading firms are looking for signals from governments that they are on the right path, [redacted] IPE, for example, wants guidelines on trading procedures and says it would welcome a faster pace for the Bonn negotiations. BP/Amoco has warned governments that it will be unable to expand its pilot program in the absence of an international trading regime. [redacted]

Several governments have given positive signals, [redacted] Norway's parliament has encouraged Statoil to engage in emissions trading as a contribution to achieving the national emissions target. British Columbia has created a pilot program for the province, and New South Wales has expressed support for trading. Moreover, the Australian and New Zealand governments have encouraged as many firms as possible to start trading early with a veiw to creating a big market with ample liquidity. [redacted]

In addition, the UK—whose foreign office opposes unrestricted trading—has given a green light for UK firms to trade emissions, in effect, acknowledging the BP/Amoco pilot program. Chancellor of the Exchequer Brown, in his March 1999 budget, recognized emissions trading as a cost effective way for energy-intensive firms in the UK to reduce emissions and earn credit for the "climate change levy" imposed by the budget, according to press reports. He invited firms to commit to emissions reductions in exchange for a lower tax rate. [redacted]

## The IPE Plan

**How IPE Works.** The Exchange trades gas oil (heating oil), Brent crude, and natural gas futures contracts to manage price risks in volatile markets. IPE operates in a regulated environment with all contracts passed through the London Clearing House that acts as an independent guarantor with its own financial reserves. Visual and audio systems monitor all activities of registered floor traders and create a record of all transactions. In addition, an electronic Energy Trading System is available as a supplement to vocal trading for natural gas futures. Deals are anonymous, but transparency is served by Quote Vendors relaying prices—including bids (buy) and offers (sell)—and volumes of all deals electronically in real time to 15,000 end users in 85 countries. IPE also feeds price information to NYMEX in New York and SIMEX in Singapore.

**Applications to Emissions Trading.** IPE sees a bright future for emissions trading because firms will have incentives not only to buy and sell allowances but also to improve the management of their energy resources, reduce energy consumption for cost savings, and stimulate production efficiency innovations. Some investment banks view environmental compliance in general as a natural by-product of "value drivers" such as restructuring and innovative marketing, according to the financial press.

Although emissions trading under the Kyoto Protocol will not necessarily involve future contracts per se, several parallels exist.

- Paper trading of signed contracts will occur rather than physical transfers of metric tons of carbon dioxide.
- Transparency of prices and volumes will be needed as benchmarks for trading.
- Buyers and sellers will be working with a time horizon for deals to exchange allowances at some future point—immediately in anticipation of the 2008-2012 commitment period or during the commitment period.
- An independent third party will be needed to guarantee the financial integrity of deals—a clearing house, investment bank, or other financial instution.

Moreover, the market will be a global one because allowances will be a fungible as traded oil.