In for the long haul

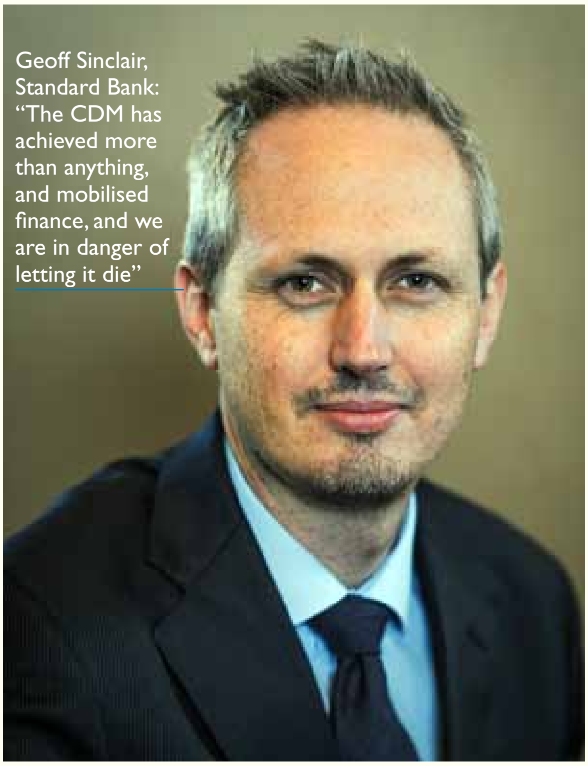
It's been another tough year in the carbon markets – but the winners of *Environmental Finance*'s 13th Annual Rankings are determined to ride out the trough. Peter Cripps reports

When the carbon market met for its annual jamboree this year, at Carbon Expo in Cologne, the mood of delegates was, if not upbeat, certainly determined. In the face of another grim year, blighted by Europe's economic malaise and uncertainty caused by political indecision, the view was that, if you're not in for the long haul, you've no place in today's carbon market.

And those companies triumphing in this year's *Environmental Finance* Rankings have shown their commitment over many years. But the pressures in the market are seeing some turnover among the leading firms – and new markets such as California promise opportunities for established firms and neophytes alike.

But, without doubt, established markets were distressed in 2012. The price of EU allowances (EUAs), which suffered heavy falls in 2011, slipped further in 2012 despite politicians promising a fix to boost prices.

If the EUA market was stuck in the doldrums in 2012, the Clean Development Mechanism was on the ropes



Geoff Sinclair, Standard Bank: "The CDM has achieved more than anything, and mobilised finance, and we are in danger of letting it die"

And if the EUA market was stuck in the doldrums in 2012, the Clean Development Mechanism (CDM) was on the ropes, after an eye-watering fall in certified emission reduction (CER) prices, which were trading at about €0.65 ($0.80) in early December, down from highs of more than €13 in 2011.

"It was the year that wasn't – it was a bit depressing" says Geoff Sinclair, head of carbon sales and trading at Standard Bank in London, voted Best Primary Originator in the Joint Implementation (JI) and CDM markets. Anglo-South African Standard Bank – with its strength in Africa – is one of the few investment banks that has held its nerve in the CDM market, and is frequently associated with pathbreaking deals in more novel areas for carbon finance. But that doesn't mean times weren't tough: "It was a year in which there was a lack of ambition in reducing emissions, and it showed in the market," Sinclair adds.

For the EU Emissions Trading System (ETS), hopes that 2012 would bring some relief from a miserable 2011 were dashed. EUAs, which had peaked at €17.42 in 2011, made further losses in 2012 and were languishing at around €7 at the time of writing in early December.

Efforts by Europe's politicians to address the oversupply of allowances – mainly caused by the effects of economic crisis in the EU on levels of emissions – had, as of early December, been unsuccessful. The European Commission is struggling to get its 'backloading' proposals agreed before the start of Phase III, in January.

Jonathan Navon, a London-based founding partner at CF Partners, voted Best Trading Company, Secondary Markets, says expectation about backloading policies had been the main influence on prices.

"It's been a challenging year – the lack of regulatory clarity makes for a lot of uncertainty, which is never good," he says. This year marks the first time CF Partners has featured in the Annual Rankings, reflecting its growing share of the carbon markets.

Lenny Hochschild, a managing director at Evolution Markets – which won the Best Broker award in several categories, and is a longstanding feature of the Annual Rankings – adds: "The fall in EUA prices was caused by uncertainty at a macro level with regards to the economy and carbon market policy. Uncertainty has been the word of the year."

Many in the market fear tougher action, such as cancelling allowances altogether, is needed to resolve the oversupply problem.

Stein Bjørnar Jensen, global business line director at DNV KEMA Energy and Sustainability, which won the title of Best Verification Company in both the EU ETS and the Kyoto Protocol categories, believes that in order really to tackle the problem, the Commission needs to look even deeper and strengthen the cap on emissions, which is currently at 20% below 1990 levels by 2020.

He adds: "There are too many allowances and the cap is currently set too high."

However, others question the necessity of intervening at all, claiming that low prices are a normal part of the market cycle.

Nigel Felgate, head of emissions trading and energy structured products, EMEA, at Bank of America Merrill Lynch, joint-winner of Best Trading Company, Options, says: "It's definitely been quite a challenging year for the emissions market. [But] the aim of the EU ETS is not to have high emissions prices but to meet the 20% reduction in emissions, and currently Europe is on track to comfortably meet this target. What would strengthen prices more than backloading is certainty about Phase IV and beyond."

Next year, free allowances for utilities will dry up, and this will provide some upward pressure on prices, but the effect of this is set to be overshadowed by the enormous overhang of

Assigned Amount Units (AAUs) – the emissions units issued to governments with emissions caps under the Kyoto Protocol – another lingering problem that politicians failed to remedy in 2012.

A number of Eastern European states, including Poland but most notably Russia and Ukraine, are sitting on huge quantities of so-called 'hot air' AAUs. This is because of economic contraction – and therefore a collapse in emissions – after 1990, the year which was chosen as the 'baseline' against which Kyoto Protocol targets are measured.

Renat Heuberger, CEO of South Pole Carbon, voted Best Project Developer for JI and CDM markets, warns: "The EU, and to a certain extent also the UN, has to solve the AAU surplus issue because if it remains possible for Russia and Ukraine to convert to EUAs and flood the market, it will be completely drowned in hot air."

David Peniket, ICE Futures Europe: "People still have price risk they want to manage"

South Pole's team has been operating in the carbon markets since 1999, and boasts a portfolio of more than 200 CDM and voluntary market projects across more than 20 countries – and it has been recognised in the main rankings since 2010.

Meanwhile, the current low prices are being blamed for causing players to walk away from carbon activities, and there are fears that more will follow.

DNV KEMA's Jensen is one of several market players who believe low prices are driving consolidation in the industry.

Barclays sold project developer Tricorona in a management buyout, while *Environmental Finance* revealed in November that JP Morgan is understood to be looking to sell the world's biggest developer of emissions reductions projects, EcoSecurities.

And there has generally been a trend towards companies trying to diversify away from carbon, with London-based Camco rebranding as Camco Clean Energy, and others reducing the scale of their carbon trading activities.

Despite the weak pricing in the market, volumes have been good. ICE Futures Europe, voted Best Exchange in the EU ETS, says 2012 is on track to be another record year in terms of futures and options volumes, with 8.15 million contracts traded by 27 November, up 22% on the same period a year ago.

"Clearly, we are operating in a difficult macro-economic environment but carbon trading has made tangible progress in 2012," says David Peniket, president and chief operating officer of ICE, which is the dominant futures exchange in the carbon market. "People still have price risk they want to manage. Volumes have been strong – we have seen the market continue to grow in recent years."

Meanwhile, CER prices in the CDM – the world's only global carbon market – have fallen dramatically this year as a lack of demand for credits was exacerbated by a glut of supply.

Fears are now rife that the market is on the verge of collapse, despite UN climate chief Christiana Figueres's recent insistence that it still has a future and is merely in "a dip".

As Figueres pointed out, there was no shortage of supply of credits in 2012, as it passed two significant milestones. In November, it celebrated its 5,000th project, while two months earlier the UN announced that 1 billion CERs – equivalent to 1 billion tonnes of carbon dioxide – had been created in the decade since the scheme was started.

> *"There are too many allowances and the cap is currently set too high"*
>
> Stein Bjørnar Jensen, DNV KEMA

The supply of credits was boosted amid a rush to register projects before the EU closes the door to those in developing countries after 2012, from which point only existing projects, or those in least developed countries (LDCs), will be eligible for its ETS.

There has been a surge in the number of industrial gas emission reduction credits for sale before they are excluded from the scheme in 2013, adds Sinclair.

And there has also been an increase in the number of emission reduction units (ERUs) – offset credits for JI projects – on the market, undercutting CERs on price, according to Felgate.

"We are going through a significant change into a new phase III world … and it could be an EUA-focused market going forward," he added.

Even if the CDM market does survive, the low prices currently being paid for CERs will deter investment.

The UNEP Risø research centre reported that the number of projects entering the pipeline fell to 37 in November, down from 317 in April.

And Joel Bluestein, a Washington, DC-based senior vice president of fuels and power at ICF International, which was voted Best Advisory/Consultancy in several categories, says: "With continuing low prices, projects are not making it onto the drawing board at all."

There is no shortage of market players making impassioned pleas to politicians to help the CDM survive.

Standard Bank's Sinclair says: "They need to keep the CDM – it's the only thing that's actually doing anything in developing countries in terms of emissions reductions. The African market is starting to bubble on the CDM just when prices are starting to go down. At the policy level, anyone in the market who is not frustrated is asleep. The CDM has achieved more than anything, and mobilised finance, and we are in danger of letting it die and people may not come back once they've had their fingers burned."

He points to Kenya, which is classified as developing, as an example of a country that will suffer as a result of Europe's plans to focus solely on LDCs.

Nigel Felgate, Bank of America Merrill Lynch: market to become "EUA focused"

	Winner	Runner-up
EU Emissions Trading System		
Best Broker, Spot & Futures	Evolution Markets	Tradition
Best Trading Company, Spot & Futures	Vitol	= Barclays = Macquarie
Best Broker, Options	Evolution Markets	Tradition
Best Trading Company, Options	= Bank of America Merrill Lynch = Vitol	–
Best Advisory/Consultancy	ICF International	PwC
Best Law Firm	Baker & McKenzie	Norton Rose
Best Verification Company	DNV KEMA	TÜV SÜD
Best Exchange	ICE Futures Europe	EEX
Kyoto Project Credits (JI and CDM)		
Best Primary Originator	Standard Bank	Camco Clean Energy
Best Broker, Secondary Market	Evolution Markets	= Tullett Prebon = Tradition/TFS Green
Best Trading Company, Secondary Market	CF Partners	Vitol
Best Advisory/Consultancy	ICF International	Enecore
Best Law Firm	Baker & McKenzie	Norton Rose
Best Verification Company	DNV KEMA	TÜV Nord
Best Project Developer	South Pole Carbon	Enecore
North American Markets (California)		
Best Broker	Evolution Markets	= BGC Partners = Karbone
Best Trading Company	Vitol	Element Markets
Best Offset Originator	Blue Source	EOS Climate
North American Markets (RGGI)		
Best Broker	Evolution Markets	Tradition
North American Markets (All)		
Best Advisory/Consultancy	ICF International	Karbone
Best Law Firm	Baker & McKenzie	Van Ness Feldman
Best Verification Company	First Environment	Ruby Canyon Engineering
Best Project Developer	EOS Climate	Blue Source
Australasian Markets		
Best Broker	TFS Green	Nextgen
Best Trading Company	Westpac	–
Best Advisory/Consultancy	RAMP Carbon	CO2 Australia
Best Law Firm	Baker & McKenzie	Norton Rose
Best Project Developer	CO2 Australia	= Perenia = RAMP Carbon

"Does the EU really expect Kenya to implement its own cap-and-trade scheme?" he asks. "And if not, what is the mechanism for incentivising low-carbon technology?"

Martijn Wilder, a Sydney-based partner at Baker & McKenzie, voted Best Law Firm in several categories, says: "It's disappointing that there's been this incredible amount of emissions reduction through the CDM and it's been the only mechanism that has private sector investment, and it's being increasingly phased out."

Wilder and his team have been at the heart of the CDM since its inception – and combine transaction work with deep involvement in the policy and regulatory arena in which carbon markets exist. "I would not say [the CDM's] dead but the road ahead for it is very challenging unless there's some kind of restructuring of the demand curve."

DNV KEMA's Jensen says the CDM and JI are both needed to help drive decarbonisation until 2020, when a new international climate agreement is supposed to enter into force. "We need CDM and JI to bridge the gap until 2020 and I still hope that the leaders of the world will see that they need a mechanism to help cover that gap."

But if the CDM market is depressed, there are more encouraging signs in new markets.

California celebrated its first full auction in November, which was hailed as a success by Mary Nichols, chairwoman of the California Air Resources Board (CARB).

Jan Mazurek, senior fellow at ICF, says the fact that the auction went off "without a hitch, at low cost, and with no manipulation" means that it marked "an incredible milestone and a great cause for celebration". ICF attributes its success in the rankings to its approach applying "ground-up fundamentals-based analysis", says Steve Fine, one of its vice-presidents.

However, legal challenges still hang over the market. While 2013 contracts were successfully sold, albeit marginally above the floor price, sales of 2015 allowances were woefully undersubscribed, reflecting fears over the scheme's future.

Kevin Townsend, chief commercial officer at Blue Source, voted Best Offset Originator in the California market, says: “I wouldn’t call the market healthy by any means because there’s so much uncertainty driven by lawsuits filed against CARB, placing doubts into buyers’ minds. I’m expecting more to be filed. [The challenges are] reflected in the price and are undermining the market.”

The lack of confidence is due partly to the fact that the market is still finding its feet and many issues are still being resolved, such as that of CARB reserving the right to invalidate credits at a later date.

Michael Carim, a New York-based senior associate at First Environment, voted Best Verification Company in North American markets for every year since 2008, has been “frustrated” by the slow progress in resolving outstanding issues, and is still waiting to be officially accredited as a verifier, so his team can start signing-off projects amid an anticipated shortage of supply of offsets.

He says: “We feel stalled at our end as a verifier. A number of people have called me over the past six months and said ‘I have a project I would like to get verified, how much would it cost?’, and we don’t have a good answer for them.”

Yet he is optimistic that his team will be able make progress in the first quarter of 2013.

And there are also broader hopes that California will overcome other obstacles in its path and may yet inspire similar markets to link to it in other parts of North America.

“Australia and California will be the two markets where we expect to see trade increase next year”

Lenny Hochschild, Evolution Markets

Quebec is expected to be the first North American market to link to California, although Washington and Oregon could also be candidates.

EOS Climate was voted Best Project Developer in North America, improving on its runner-up position in that category last year. The company is mainly focused on the California market, where Joe Madden, its chief business development officer, says the first auction was “tremendously successful”.

He adds: “There are states that may not have the resources on their own to create a programme, but if California is successful, the road has been paved for someone to adapt things that have been proved quickly and easily.”

However, Randy Lack of Element Markets, runner-up in the Best Trading Company category in North America, warns that other US markets are unlikely to link to it in the near future.

“We were closer two or three years ago under the Western Climate Initiative (WCI) when other states had come out with their intention to join up, but that’s been impacted by the changing political environment and the lack of action on the federal level,” he says.

And he adds that the California market is still lacking liquidity because most credits in the auction were bought by emitters, whereas banks have yet to fully embrace the market.

Meanwhile, other carbon markets elsewhere in the world also moved forward in 2012, notably Australia (see box) which will link its scheme with the EU ETS, while South Korea has made more modest progress.

Evolution’s Hochschild adds: “Australia and California will be the two markets where we expect to see trade increase next year.”

But looking into the more distant future, it is China that is sparking the imaginations of many in the carbon markets.

Its seven pilot schemes – in Beijing, Shanghai, Tianjin, Chongqing and Shenzhen, as well as Guangdong and Hubei provinces – will begin in the first quarter of 2013, with a unified national ETS following in 2015.

Baker & McKenzie’s Wilder adds: “When China says it’s going to decarbonise its economy, it means it. Everyone thinks China will move quickly, no doubt about it. It will probably take a bit longer than they originally thought, but our view is that they are pretty serious about it and a lot of work is being done under domestic trading schemes.”

Wilder adds that the next year is expected to remain challenging for carbon markets globally, but after 18 months he expects to see a recovery, mainly as a result of the “transformational” developments going on in new markets. **EF**

Australia: a year of two halves

The past 12 months have been mixed, say the winners of the Australasian carbon categories: while the year finally saw the introduction of a domestic carbon price in Australia, the longer-term view is being clouded by weak prices in future partner the EU Emissions Trading System (ETS). Slow progress on getting the country’s land-based offset programme, the Carbon Farming Initiative (CFI), up and running and continued political uncertainty around the Carbon Pricing Mechanism (CPM) haven’t helped either.

“It’s been challenging,” says Phil Cohn, director at RAMP Carbon, which was again voted Best Advisory. Historically low prices in the EU ETS – including in the Clean Development Mechanism (CDM) sector, in which RAMP is active – has made life more difficult, he adds.

But this has been balanced out by an increase in work for Australian businesses, Cohn says – a trend seen by all the winners.

“We’re definitely seeing, with the start of the CPM in Australia, an increased focus on carbon and how people can manage their carbon liability,” says Mike McKensey, Sydney-based head of carbon trading at Westpac, voted Best Trading Company.

And CO2 Australia, winner in the Best Project Developer category and runner-up for Best Advisory, has been focused on getting projects through the lengthy CFI system, says CEO Andrew Grant. The Sydney-based firm, which reported its best ever results in October, had its first methodology for the programme approved in late November – which took 18 months, Grant says, decrying the unnecessarily long and complicated process.

McKensey says that a lack of supply of Australian Carbon Credit Units (ACCUs), the credits issued to CFI projects, is hindering the market from taking flight: emitters can use ACCUs for up to 5% of their liability during the 2012–15 fixed price period – which equates to roughly 70 million credits per year. “That demand significantly outweighs supply at the moment,” he adds.

But all three are bullish for 2013, despite the looming federal elections – the opposition has vowed to repeal the legislation underpinning the CPM if it is victorious. However, the CFI would remain in place, but with the government as the sole buyer, in reverse auctions.

“It’s a different dynamic,” says Cohn of the opposition’s plan.

Either way, McKensey says “increased certainty will help the market”, and predicts an increase in hedging activity next year, as does Cohn – including for EU allowances and CERs.

Meanwhile, for CO2 Australia, the focus will stay on the CFI, as well as any CDM opportunities, says Grant. Its activities in New Zealand have ground to a halt, he says. “[Domestic abatement] is uneconomic at low carbon prices,” Grant says, adding that CERs instead are dominating the offset market there now. **EF**