

CARBON TRADING

CER-EAU SPREADS

“A closer look at the current spread between CER (credits generated by emission reduction projects in developing countries and which can be used in the European Scheme for compliance) and EUA (the European CO2 currency). The lack of the ITL (the registry necessary to transfer CER globally) is causing some headaches, but can't explain the spread to the full extent (it's 7,5 EUR/t). There have to be other reasons...”



CER-EUA spread
Source: 3CGroup

3C Group Carbon Investment Advisory: Clemens Huettner

The CO2 market has seen considerable erosion in the value of European Emission Allowances (“EUA”) over the last couple of weeks. While EUA were traded at levels far above of 22 EUR/t (with a peak at 26.00 EUR/t on 30/05/2007), they did not seem to find any support, whilst they fell over the last couple of days. Weaker European power prices and some profit taking activities of financial players for sure have contributed to this drop, but increasingly traders pointed to Certified Emission Reductions (“CER”), quoting them as one of the main reasons for weakening EUA prices. CERs are generated by so called Flexible Mechanism Projects under the Kyoto Protocol, which are mainly realised in China, India and Brazil. To an extent, CERs can be used for compliance in the European Emission Trading Scheme (“EU ETS”). Price-wise, CERs have for quite some time now played a minor role. They have always been priced at a discount to EUA, the main reasons being: the lack of an International Transaction Log (“ITL”), a register, which is needed to transfer CER physically and, owing to their comparatively low “production costs” of < 10 EUR/t. However, the market is aware, that the purely technical ITL problem will be solved in the near future.

Over the last couple of days, activity on the CER side picked up rapidly and more and more natural players in the EU Emission Trading Scheme are now getting interested. Obviously the spread between EUA and CER and the consecutive swap possibility seems now to be widely regarded as a risk free arbitrage possibility, which is certainly correct. It took a number of players some time to take a trading decisions and to make use of this simple operation (CER purchase against EUA sale), which allows for cashing in on the current price difference between CER and EUA.

As a result of these activities and a new wave of freshly imported CERs into the EU, European Emission Allowances have lost value. Moreover the spread between EUA and CERs is tightening. Two weeks ago, CER were traded at a level of 65% of EUA, now they stand at a 27 % discount to the corresponding EUA contract. This development will continue and is likely to accelerate over the next couple of weeks as a number of players, in lieu of shrinking margins, will try to get swap deals done, at the earliest possible. It remains to be seen, how many CERs will enter the market if the demand side continues to grow. Long CER players could artificially hold back their credits and let the spread tighten even further, which would accelerate this development even more. The signals are quite clear: continued CER / EUA swaps will lead to a tighter spread.

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Point Carbon: Jorund Buen & team

A number of factors suggest a narrowing of the gap between CER and EUA prices. First, the CER-EUA price differential is based on secondary CERs with delivery in December 2008. There are two aspects to this: EUAs are also delivered in Dec 08 but trades are settled immediately. This is not possible for CERs until the ITL is operative and countries are eligible to transfer CERs between themselves according to Kyoto Protocol guidelines. Settlement delays are extra troublesome since (knowledge about) counterparty credit risk varies more for CERs than EUAs. Exchange trading (and thus clearing) of CERs is embryonic - partly due to the ITL and eligibility risks - which further highlights counterparty issues. The other main aspect, also linked to counterparty risk, is that an issued CER is not equal to a secondary CER. A secondary CER is not necessarily issued; one market player can guarantee to deliver it to another on a forward basis. As less creditworthy players enter the secondary CER market and more CERs are issued, a difference could develop between secondary CERs and issued CERs. When ITL and eligibility issues are sorted out, the CER-EUA differential could narrow, also for psychological reasons.

If we're heading towards full convergence when trading of issued CERs starts becoming commonplace, then one would perhaps assume a linear trend historically from larger to smaller discounts placed on CERs compared to EUAs. But the CER-EUA differential has varied over time. We think CERs and EUAs will not necessarily converge, and that the arbitrage between CERs and EUAs is not completely risk free.

Why aren't we convinced that CERs and EUAs will converge?

First, the costs of EUA/CER swap should be taken into account. All installations in the EU ETS can surrender CERs for compliance. Industrials are long CERs. Power and heat sector is short both CERs and EUAs. If EU ETS' CER import capacity is to be fully utilised, industrials need to import CERs and swap them with EUAs. EU ETS phase 1 has shown industrials need a significant incentive in order to actively take part in the carbon market at all: their organisations are not geared towards dynamic trading, and they have generally been allocated enough EUAs, for free. The EUA price could have dropped recently because the swap price has become so attractive that those who had bought the spread (that is, bought EUAs and sold CERs) when the spread was limited could sell the spread (sell EUAs and buy CERs) when the spread increased.

Secondly, a CER is linked to a project, unlike the EUA - this means it will carry a "burden" of geographical and project type specific information, which can in theory be used to disqualify it. Third, CERs are units regulated by the Kyoto Protocol, EUAs are not. The EU controls the fate of EUAs post 2012, but not fully the fate of CERs. One example of this is rules for the carry-over of CERs to the post-2012 period, which may differ from those made for EUAs. Also, the recent media focus on carbon credits' quality could lead the EU Commission to implicitly limiting banking by restricting CER imports post-2012 to CERs that meet certain quality criteria.

If there is an arbitrage opportunity in the market it should be taken, or there is not enough liquidity or transparency. So far, the CER market clearly lacks both these characteristics, which could explain why the arbitrage opportunities have only partly been exploited. In principle, one utility that sells off in order to avoid trouble with regards to CER import restrictions could easily flood the secondary CER market in a situation where there are still only a handful of trades every month.

Enough about restrictions imposed on the use of CERs and limitations to the CER market. It is important to be vigilant in case of scenarios where CERs are not converging with EUAs because they're trading above, not below, EUAs. Low-hanging CERs have clearly been sold early. The market could move more towards abatement cost pricing. However, so far there has been no clear evidence that suggests this has been the case. Rather the opposite: the cheapest projects have yielded the highest prices. Why? Buyers probably regarded the risk of non-delivery as being smaller: Counterparties are often more solid in such projects, and annual volumes so large that the risk of downright non-delivery is small as long as one has seniority/first right of refusal.

Factors inherent to EU ETS can cause low EUA prices, and factors external to EU ETS can give CERs a premium to EUAs. Remember, CERs have always been priced at a discount to 2008-12 EUAs, but not to 2005-07 EUAs. Since the CER market is linked to projects and their investment logic, it has so far been more slow-moving and less volatile than the EUA market. Also, China's price floor for CERs (currently EUR8/USD10/CER) is not likely to be adjusted downwards (or upwards) every hour or so, as it is set primarily for domestic reasons. Finally, and most importantly, CERs can so far be used in more compliance regimes than EUAs. If a non-EU carbon market is established, where participants face high marginal costs, and this market accepts CERs for compliance and not EUAs, this could push CER prices above EUA prices. Unlikely? Well, when EU ETS demand for CERs contracted in late spring 2006 after the collapse of EUA 05-07 prices, Japanese buyers (joined by European governments, and multilaterals) maintained interest in CERs. This sent the price several euros higher than the 05-07 EUA price at the time.

To conclude: The CER market has matured, albeit from a low starting point. It has its own price dynamic, which is correlated, but partly decoupled from the EUA market. And CER-EUA swap costs are not likely to disappear.

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