



# Cap and trade

by Sherree DeCovny illustration Valero Doval

Exchanges are positioning themselves to take advantage of the potential boom in carbon trading.

**E**UROPEAN CARBON contract volumes doubled between the third quarter of 2008 and the same period in 2009. The EU currently issues more than 2 billion metric tons of carbon allowances a year, but observers maintain the market could potentially grow to 10 times that size in the next several years. Exchanges are positioning themselves to take advantage of what may become a booming market.

As the carbon market has matured, the players have become more diverse. "Compliance players, the companies that need to purchase allowances to offset their emissions, are active participants," says Fredrik Voss, Vice President of carbon and business development at NASDAQ OMX Commodities. "In addition,

financial firms and speculators see an opportunity to provide liquidity in the hope of making profits."

Two types of carbon emissions credits, the European Union Allowances (EUAs) and the UN-operated Certified Emission Reduction Units (CERs), are traded in the open market. Most EUAs were handed out for free during Phase 1 and Phase 2 of the Kyoto Protocol. Once Phase 3 begins in 2013, most allowances will be auctioned in a similar fashion to government debt.

**IT IS ANTICIPATED** that the auctions will boost secondary trading. Power plant operators currently hold their free allowances until they need to use them, so many allowances never reach the secondary market. When operators are required to purchase allowances, they will probably sell those they do not need on the open market.

Secondary trading of EUAs started in 2004 in the exchanges and in the OTC market. Since then carbon con-

tracts have become part of the mainstream exchange landscape, which has driven several partnerships. NASDAQ OMX acquired the clearing, consulting and international derivatives products of Nord Pool. Eurex has a close collaboration with the European Energy Exchange. NYSE Euronext has a stake in BlueNext. In addition, the Intercontinental Exchange has partnered with the European Carbon Exchange, the current market leader on the carbon derivatives market.

The Polish Power Exchange (PolPX) began offering an EUA spot contract in September 2006, but the trading session only runs between 11:00 a.m. to 2:00 p.m. on Tuesdays and Thursdays. Given the limited session, trading volumes are low.

From January 1, 2010 PolPX will link to NASDAQ OMX Commodities via a bridge. PolPX members will be provided access to NASDAQ OMX's global carbon market as non-clearing members thus enabling them to trade EUAs and CERs.

Towarowa Gielda Energii (TGE), the operator of PolPX, will have responsibility for its members' trading activity in the carbon market, while the Warsaw Commodity Clearing House will be responsible for clearing carbon transactions made by TGE members, which will include collaterals, clearing and contracts delivery. This arrangement will enable both PolPX and NASDAQ OMX Commodities customers to interact with a wider pool of liquidity providers and make the venues more competitive.

"The biggest CO<sub>2</sub> players in Poland currently go directly to other exchanges in Europe," says Irek Lazor, Vice President of the PolPX Management Board and CEO, Warsaw Commodity Clearing House. "We hope that through our initiative with NASDAQ OMX Commodities, we will be able to grow our business by providing Polish companies with a window to the global CO<sub>2</sub> markets."

Looking ahead, the UN is holding a meeting in Copenhagen in December 2009 to decide the next steps in addressing climate change. Even if a new global deal is not struck, the EU has already decided to extend the existing program to Phase 3. If a new agreement is reached, Europe will take on a more ambitious emissions reduction target.

The 27 EU member nations must

comply with the legislation. Other nations, including Norway, have stated they will also implement the rules. Some Eastern European countries that are applying for EU membership are not ready to comply but will be subject to the legislation once they become members.

**EUROPE MAY BE** the center of the carbon markets for now, but all eyes are on the U.S. Many believe the market will become truly global if the U.S. Congress passes pending legislation. In June, The House of Representatives passed the American Clean Energy and Security Act of 2009, the Waxman-Markey Bill – broad-based energy legislation containing provisions for a cap and trade program and reducing U.S. carbon emissions by 17% from 2005 levels by 2020. Senators Boxer and Kerry have introduced a similar bill in the Senate, requiring a 20% reduction of carbon emissions during the same time frame. Both versions require an 83% reduction from 2005 levels by 2050. President Obama wants Congress to approve a climate bill before the Copenhagen meeting.

Voluntary markets already exist in the U.S. For instance, the Regional Greenhouse Gas Initiative (RGGI), which operates in the northeastern states, is similar to the European program. Participants in the RGGI are also

## No cap and trade down under

Australia is the fourth largest producer of coal, and 85% of the nation's electricity comes from it. Australia also has the highest per capita emissions in the developed world. Cap and trade legislation failed to pass in the Australian Parliament in August 2009, but plans are in the works to reintroduce the bill in the next few months.



Irek Lazor, Vice President of the PolPX Management Board and CEO, Warsaw Commodity Clearing House

discussing the time frames and benchmarks by which emissions must be reduced. Allowances may be auctioned to individual states, but the maturities and lot sizes may be different from the EUAs or CERs.

"It will look very much the same and will trade the same," says Jubin Pejman, Vice President of Americas at Trayport, the dominant front-end technology vendor in the carbon market.

Supporters say cap and trade is the most effective way to allocate resources to reduce carbon emissions. A transparent exchange-traded market allows a forward curve to be generated, thus sending clear pricing signals to power plants and liquidity providers enabling them to make hedging and trading decisions. ■