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The Failure of the Carbon Market

C/M/S/ Rui Pena & Arnaut

By Mónica Carneiro Pacheco

The Macondo disaster in April 2010, the accident in the Fukushima Nuclear Power Station in March 2011 following the earthquake that shocked Japan, and the European/U.S. embargo on oil from Iran in 2012, have changed the driving forces of the energy sector worldwide.

All these factors, in conjunction with the current European debt crisis and the critical situation in the Middle East and Northern Africa following the "Arab spring" that began in May 2011, have utterly shuffled the perception of what was considered to be the grounds of European energy policy in the current decade of 2010 until 2020.

Recently, the European energy policy has suffered one more quake with the rejection by the European Parliament, on 16 April, 2013, of the EU Commission proposal to postpone part of the auctions of CO_2 licenses attempting to avoid the collapse of the European carbon market.

The creation of an Emissions Trading System (ETS), one of the mechanisms of the Kyoto Protocol, that was launched in Europe in 2005 to substantially reduce the CO_2 emissions at the Community level on an economical rational way, aimed a reduction of the marginal costs caused by the necessity of reducing the emission of the economic agents involved. The basic mechanism of such market is the initial attribution of a limited number of emission licenses (transferable within the ETS which correspond to one ton of equivalent CO_2) to the economic agents that within their activities release such gases to the atmosphere.

Therefore, one operator that has produced an higher quantity of CO_2 emissions than those authorized by the licenses that were initially attributed need to buy licenses that cover the excess of its emissions. On the contrary, an operator that has produced fewer emissions than licensed has the possibility of selling the license that did not use in the market and make a profit.

This mechanism allows higher gains to the economic agents that a system that fixes limits and correspondent penalties, and contributes to the development of technologies creating global reductions on emissions.

The number of licenses that were attributed should have been less than the needs of market players to create a strong incentive to the reduction of emissions, but this was not the case.

There are two main reasons for this. The first one is the recession which affects many industries in Europe and has reduced industrial demand for the licenses. The second is the fact EU granted too many carbon licenses in the first place (more than the necessities) which has provoked an overload capacity in the carbon market (at the end of 2012 there were more than a million of licenses not being used).

The EU Commission proposal to take 900m tons of carbon licenses off the market now and reintroduce them later, when — it was hoped — demand would be stronger (the proposal is referred to as "backloading") was meant to raise the carbon licenses price, but the EU Parliament has rejected such proposal (334 votes to 315) justifying that such raising would be prejudicial to the competitiveness of the European industry and would raise de electricity bill.

This decision had an immediate effect on the market with the tone C02 falling, on 17 April, to 2,75 euros.

But this decision will have also many consequences in the long term and at different levels.
The collapse of prices of the licenses means that it is cheaper to buy licenses than investing in the reduction of pollution, and may compromise the target of transforming Europe into an energetic economy, efficient and with low production of CO_2, satisfying simultaneously the energetic and environmental requisites.

Cheaper carbon makes coal (considered a "dinosaur" due to the CO_2 emissions) more attractive than cleaner gas. Currently, coal plays an important role not only in Asia as well as in Western economies and we are assisting power generators switching from gas to coal, and to build more coal-fired power stations than they would otherwise do.

The European Parliament's vote might also change the design of new schemes in countries (like Australia, South Korea, California and several Chinese provinces) that over the past few years have followed the EU in establishing or proposing cap-and-trade schemes. China might (for example) keep price fluctuations within a narrow band by setting floor and ceiling prices, as California does and other countries may follow.

At national policy level this decision will have effects on the policies on climate change namely in respect of renewables which will turn less attractive to investors.

Low prices of carbon together with the cuts on the feed-in tariffs that have occurred in many countries in Europe have caused a slowdown in renewables and may compromise the target of accounting for 20% of total European electric output by 2020.

In Portugal, the boom that we have been seeing for the past decade has started to slow down, due to the cut back in subsidies per MW/hour for the generation of renewable energies, in an attempt to balance the public budget, together with other measures that have been taken within the bailout package.

However, investments are still being made in onshore and offshore wind, whose projects were approved before the budget cutting.

So it is important that the backloading proposal or other reforms do not die and that the Carbon Market does not turn in a model not to follow.

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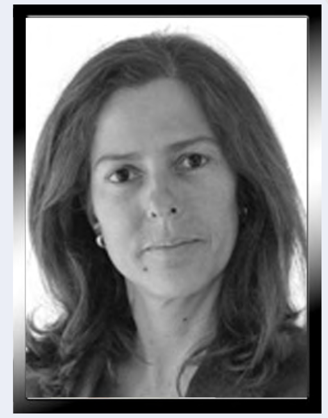

Mónica Carneiro Pacheco is Partner at CMS Rui Pena Arnaut and co-heads its Energy Practice. Mónica has been developing her activity within the area of Public Law, particularly focused on Energy Law, PPP Projects, Public Procurement, Concessions and Environment. Mónica has also been developing her activity within the energy sector, projects and financing, inclusive.

She has recently advised VINCI concessions in its winning bid for the privatisation of up to 100% of the share capital of ANA - Aeroportos de Portugal, SA (the concessionaire for Portuguese public services airport operation that manages all airports in mainland Portugal).

Monica Carneiro Pacheco can be contacted by phone on +351 91 919 00 20 or alternatively via email at monica.carneiropacheco@cms-rpa.com