

.AFTER. COPENHAGEN: THE CHALLENGE FOR FINANCIAL SERVICES

A BREAKFAST CONVERSATION AT
MANSION HOUSE

21ST JANUARY 2010



Post Copenhagen Business Breakfast 21st January 2010¹

Purpose of the Breakfast

The breakfast brought together some of the City's pre-eminent thought leaders in the field of carbon trading and carbon finance. The purpose of the breakfast was to identify thought on what the City requires in terms of fiscal, legal and infrastructural arrangements for it to continue to be the global centre for carbon trading.

¹ This breakfast was held under the Chatham House Rule, whilst substantive discussions are disclosed, the speakers and their affiliations remain anonymous.

Background

The world's first emissions trading market was in Chicago, as the concept of Emission Trading was invented in the US, where it was successfully used to combat acid rain, by reducing Nitrogen and Sulphur emissions (NO_x and SO_x).

Emissions trading is a prime example of using a market-based mechanism to achieve an environmental goal, as it does not impose a particular type of technology or set rigid limitations on how much can be emitted. The rationale behind emission trading is to ensure that the required overall emission reductions take place where the cost of the reduction is lowest.

In the closing years of the 20th Century the City of London Corporation, the body helps maintain and enhance the City's place as a world-leading international financial centre, published research indicating how the trading proposals contained within the Kyoto Protocol presented a business opportunity for financial services. The result was the establishment of the UK Emissions Trading Scheme, the world's first green house gas trading scheme.

Two years later, the knowledge, experience and infrastructure that London gained from this market enabled it to secure its place as the home of the EU Emissions Trading Scheme (EUETS) and thus become the world centre for expertise in every aspect of Carbon Finance.

In spite of the global economic slowdown, the market for trading carbon dioxide jumped by 68 percent last year compared with the previous year, although the net value showed only a marginal increase due to a fall in the price of carbon- \$136 billion in 2009, up from \$133 billion in 2008.

The EUETS accounted for the largest share of carbon trading, equal to 68 percent of the global market. The second-largest segment was the international Clean Development Mechanism market, followed by the Regional Greenhouse Gas Initiative, the first mandatory cap-and-trade system in the United States. (see <http://www.rggi.org/home>). That new market showed a 10-fold increase in volume, rising from 71 million tons of carbon dioxide traded in 2008 to 765 million tons in 2009, worth a total \$2.5 billion.

The City of London is currently the global centre for the carbon trading industry. This is not an accident- the City of London Corporation identified this opportunity back in 1999 and worked hard to ensure that

the regulatory and fiscal environment were fertile places for this industry to take root.

Carbon is set to become the world's most traded commodity over the next decade and the City will have to fight to keep its primacy in this market. However, carbon is an artificial commodity and carbon trading relies on political will for its continued existence.

Whilst interest in Carbon Trading continues to rise, many politicians are looking to the "low carbon economy" as the magic bullet that will lead their countries out of recession. The City, with its deep pools of finance is the natural place to come for companies seeking to finance new ventures in this field, and already some commentators are beginning to warn that steps should be taken to prevent a "carbon bubble" from arising.

The failure of COP15 (Copenhagen) to obtain legally binding emissions reductions has potentially serious implications for carbon trading, much depends on a successful outcome to COP 16.

Summary of Discussions, Part I

On the consequences of failure.....

Climate change is one of the largest and most complex “collective action problem” mankind has ever faced. However, despite more than a decade of talk there still needs to be much substantive progress in curbing emissions.

The problem is more than a simple cost-benefit equation as it requires the balancing of enforcement, intergovernmental and intergenerational issues, as well as the equitable distribution of the burden between developed and undeveloped countries.

If these issues cannot be resolved, the danger is that action on climate change will end up in Limbo thus undoing much of the progress that has been made to date.

Copenhagen (COP 15) saw broad agreement on the issues, but no agreement on binding emissions reduction. Whatever agreement is reached in Mexico at COP 16 it is essential that it is efficient, effective and equitable.

The consequences of failure are serious- carbon markets, particularly the trade in Clean Development Mechanism (CDM) credits is suffering due to uncertainty over a deal being agreed past 2012. As a result 2010 will be a very difficult year for project developers in developing nations.

Furthermore, if there is no global agreement, UK national policy on climate change be harder to advance as the UK cannot carry the burden alone and cannot penalise its own industry.

This uncertainty has major implications, not just for the carbon markets, but for energy infrastructure and other, long term, carbon intensive investments.

On International Perspectives.....

At Copenhagen, some were inflexible on the issue of monitoring and verification, (a key component to a binding international agreement). It is difficult to see how they will pull back from this position.

The US was broadly supportive of Copenhagen; however culturally, the US has faith in technology as a means of solving problems such as climate change. To this end geo engineering is more attractive than regulation and Congress is now in a position to filibuster any legislation on Cap and Trade.

In Japan there is a split in attitudes to COP16 between heavy industry, who are sceptical and the hi-tech sector who are pro. Japan is cautious about carbon trading and some there believe it may be the cause of a derivatives bubble, however the prevailing view is that a low carbon future will require high economic growth (driven by technology).

In Asia, the COP 15 process was viewed with scepticism. In general the challenge of climate change is viewed in the context of threats to social stability (e.g. mass migration due to sea level rise or drought), however energy efficiency, energy security and energy cost (peak oil) are seen as issues of concern. Technology is seen as the key.

Between May 31 and 10 June 2010 a meeting of government climate ministers will take place at the UNFCCC headquarters in Bonn. These pre COP 16 negotiations will take shape the outcome of any agreement made in Mexico.

Conclusions.....

- Agreement on binding international carbon reductions at Cancun will be difficult
- Energy efficiency and renewables are safe bets no matter what happens with respect to climate change- the issues of peak oil and energy security are not going away. The City of London Corporation should consider research into determining the types of investment vehicles required to drive growth in these areas.
- Key figures to be approached with respect of the plans in place for the ministerial meeting in Bonn.

Summary of Discussions, Part II

On Carbon Trading

Many will contend that failure of COP16 is not an option, as a failure to tackle climate change is unacceptable. It is therefore likely that some kind of agreement will be produced. However it is not clear whether there is a real desire for binding international reduction targets. Some say that a bottom-up approach may emerge, with separate national/regional commitments being set up under the umbrella of the Copenhagen Accord.

If this later scenario does prevail, Voluntary Emissions Reduction (VER) products are likely to become more important instruments. They would allow fungibility between national schemes and would also help developing nations who would be hamstrung by the collapse of CDM as a project funding route. However, standards and verification would be important factors to consider.

Copenhagen yielded the concept of REDD+ (Reduction in Ecosystem Degradation and Deforestation) a response to CDM subsidies which may have encouraged deforestation. REDD+ will be supported by \$1 billion committed by US. Forestry is a major issue on the developing economy agenda, but the investment potential of forestry is poorly understood. Funds are available but risk products associated with forestry are needed in order to help investors spread risk effectively. Skills are also needed to commoditise forest projects and thus get the volume needed for trade to take off.

However, if REDD+ is to be considered as a vehicle for carbon management there is a need for a separate market because of the potential for REDD+ to dilute the EUETS.

On Managing carbon.....

Investor pressure is crucial if industry is to take a low carbon path - energy efficiency and cost are useful drivers. Interesting work is being done linking carbon intensity to portfolio management, carbon abatement curves may be a useful way to report carbon in company accounts. However, for this to become more commonplace, simple, standardised accounting methodology is required. This would not stop investment in high carbon sectors, but would allow money to be priced effectively.

There is evidence that carbon is beginning to act on ratings (especially in Europe) this is set to increase dramatically under phase III of the EUETS.

Some say that UK Governments have been perceived to have done less than was hoped for in the way of practical delivery. Carbon bonds may be a way of countering this criticism.

Carbon Bonds are one way of making government commitments more real- they enable hedging of the risk associated with government policy uncertainty. Bonds work by linking country performance against emissions reduction to bond yield. The funds raised from bonds do not need to be hypothecated for climate change activities. Carbon Bonds would not add to PSBR- governments around the world have to innovate and differentiate their bond offerings in order to raise funds.

Conclusions.....

- Consideration should be given to establishing a City of London Standard for VERs, this would assist developing countries and certification and verification services could be important
- Research could be conducted into the feasibility of establishing a REDD+ / Forestry products exchange.
- The City's innovations with respect to managing portfolio carbon exposure could be publicised.
- The advantages of issuing Carbon Bonds should be communicated to governments.

Summary of Discussions, Part III

On opportunities

Driving change in technological choice is the key to reducing carbon intensity by society- the private sector needs to find the levers – particularly through investor pressure.

Climate change is a gateway to sustainability. Sustainable finance is a major strength of the City and it should consolidate its lead in this area.

Climate change risk in terms of adaptive risk is not being considered yet- research in this area should lead to the development of new risk management products.

Energy efficiency is a huge part of the story- China has a long way to go with respect to energy efficiency- this is a massive opportunity for businesses. However, technology transfer is not just from west to developing economies- China, India and Brazil can and do export to the west, and the investment opportunities associated with this field need further research and promotion.

Nuclear energy is the elephant in the room although the proportion of nuclear in mix of world's energy supply is in decline. The key problem is commercial viability- costs are high and it is difficult to get reliable and unbiased data thus making investment risky.

Many investors are looking to move into the low carbon field, but there is a lack of products to invest in. the City need to develop more investment vehicles in this area.

Conclusions

- A number of research opportunities exist which may assist the City in taking this agenda forward.
- Another meeting to be held in advance of COP16.