Book review

Mastering emissions trading

IN THE medium term, "we will all become emissions traders, either directly or indirectly," predicts a new book published by the Consilience Energy Advisory Group (Ceag). The claim is based on the book's theory that, ultimately, the emission's market will impinge on most other markets on the planet. Over time, more countries, more greenhouse gases (GHG) and more industries will be covered by international emissions regulations. Emissions trading will, therefore, become increasingly central to the world economy and relevant to individuals.

The European Emissions Trading Scheme (ETS) commenced at the beginning of this year and the Kyoto Protocol entered into force in February 2005. Ceag, a consultancy specialising in energy markets and trading, says European power prices have already increased to reflect the cost of compliance with legislation to reduce GHG emissions. "Power is the engine of economic growth and any factor that effects the price of electricity has a direct influence on the international economy," says the book, entitled *Climate Change and Emissions Trading: What Every Business Needs to Know**.

The book's main focus is emissions trading. However, says Liz Bossley, chief executive of Ceag, before it is possible to understand the emissions market, it is necessary to define what is being bought and sold when emissions are traded and to consider the scientific and regulatory framework in which the business operates. "This determines the market supply and demand fundamentals for the emissions trade." The book investigates this framework in detail.

Says Bossley: "The commodity we are being invited to trade in the emissions market is regulatory risk. The risk is two-fold: the risk of incurring a government penalty for excessive emissions of GHGs; and the risk that the size of any such penalty might change after investment plans have been implemented."

The book looks at the development of the forward and physical contracts in emissions and at the range of electronic exchanges that are offering emissions futures contracts. It examines legal basis risk in over-the-counter contracts in view of the competing terms of trade offered by the International Swaps and Derivatives Association, the European Federation of Energy Traders and the International Emissions Trading Association.

It concludes that, whereas the emissions market is unlikely to need a swaps contract, exchanges that offer an options contract are likely to achieve substantial turnover. "Companies are uncertain if they will be net buyers or sellers of emissions allowances in future years," says Bossley. "We don't exactly know how the Annex B countries will transpose their Kyoto commitments into national law, allocating allowances to individual companies. Also, companies that plan to invest in plant to reduce their emissions may be uncertain when the plant will come on stream to deliver the cuts in emissions they require to meet Kyoto or EU ETS targets. This market is crying out for an options contract."

However, she also says there is not yet enough historic market data to assess what option premia to charge and how volatile the price of an emissions allowance will be.

The book includes chapters on emissions measurement, verification and compliance issues. It also contains warnings of unexpected pitfalls for joint-venture installations and for asset traders. □

**Climate Change and Emissions Trading: What Every Business Needs to Know* is a 200-page book available at a price of £99.50 per copy from www.ceag.org/whatsnew.html