Guest commentary

The EUA- CER price differential

By Liz Bossley, chief executive, Consilience Energy Advisory Group (CEAG)

The testing of the link between the EU's carbon credit registry and the UN's international registry scheduled to start today is cause for one cheer at least.

Anything that takes us closer to allowing physical delivery of certified emissions reductions (CERs) and EU allowances (EUAs) into European registry accounts and the restoration of the under-nourished spot market is welcome.

The inability to make and take physical delivery of EUAs and CERs in Europe is an ongoing cause for concern. This is particularly so for traders with hedged positions based EUAs who also trade in secondary CERs. Traders of CERs can give and take delivery in non-European accounts, but many have hedges based on EUAs. The physical delivery of these EUAs is limited to registries in those European member states that have issued 'quasi-EUAs', in the absence of 'real' EUAs. I use the word 'real' here to imply EUAs that are tagged assigned amount units (AAUs).

The price of CERs has recently increased relative to EUAs arguably because the former have a clearer physical delivery option, albeit outside Europe. This has narrowed the EUA-CER differential from around a €9 a tonne discount in April to current levels of under €5 a tonne.

As an international benchmark grade of allowance and as a basic tool for hedgers, the EUA has lost ground while the link between the EU registry, known as the community independent transaction log (CITL), and the UN's international transaction log (ITL), has been in limbo. The correlation between the price of EUAs and the price of secondary CERs for delivery on 1 December 2008 has been only 76 per cent over the last year: this is at the limits of hedge acceptability to risk managers. Volatility in the EUA-CER price differential has risen from a low of 10 per cent in October 2007 to current levels of around 35 per cent.

Once the constraint on delivery of both EUAs and CERs is removed by a fully functioning CITL-ITL link, it may be expected that the EUA-CER price differential will again widen, for two reasons:

The use of CERs for compliance is subject to supplementarity limits, which state emissions trading should be in addition to domestic action, under both the Kyoto Protocol and the EU emissions trading scheme (ETS).

Secondly, CERs have a shorter time value than EUAs. EUAs are fully bankable into phase three of the EU ETS. The bankability of CERs is limited.

The 'Kyoto Protocol Reference Manual on Accounting of Emissions and Assigned Amounts'- the UN rulebook - states 'If the Party [an Annex B Kyoto–capped country] has AAUs, ERUs or CERs remaining in its registry after it has retired sufficient units to cover its Annex A emissions, it may request that these units be carried over to the subsequent commitment period.'

AAUs and EUAs can be carried over without limitation. The rulebook also states that 'CERs and emissions reduction units (ERUs) from emission reduction projects may each be carried over up to a quantity equal to 2.5 per cent of the Party's initial assigned amount.'

When an Annex B country hands over its final true-up report in 2015 it has the option to include a list of AAUs, CERs and ERUs that it would like to carry over. The list has to detail the serial number of each AAU, CER and ERU it wishes to bank. By implication, anything not on the list gets cancelled, be it in state, including non-Annex 1 state, or in corporate hands.

At this point in time there is no mechanism whereby a private investor or a non-Annex 1 country holding CERs and ERUs at the end of the true-up period can apply to the UN or to an Annex B capped country to bank its CERs and ERUs. In the absence of positive action to bank them these allowances will be cancelled in 2015.

This bodes ill for the relative value of CERs. ERUs are not yet trading.

However, the proliferation of international trading schemes that will accept CERs and the downward revisions to the estimated number of CERs to be generated to 2012 suggest there may be a rising floor under the EUA-CER price differential.

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