

COMMENTARY

Kyoto Pigeon Comes Home to Roost

Russia must be singled out as a potential threat to achieving a meaningful carbon price in the first Kyoto commitment period

By Liz Bossley

- Russia has reduced its emissions by 30% since Kyoto's base year
- How it chooses to use this surfeit will have dramatic implications for the 2008-12 period
- The sale of AAUs by Russia could be linked to other trade discussions such as gas price negotiations

Russia has been handed a substantial surplus of assigned amount units (AAUs) from the Kyoto process purely as a consequence of the choice of 1990 as the base year against which to measure emissions target reductions.

In 1990 Russia's economy was on the verge of the post-Soviet collapse that has reduced its actual emissions by an estimated 30% since the base year.

When Russia ratified the Kyoto Protocol in 2004, allowing it to come into full force and effect in February 2005, concern over the size of the Russian surplus took a backseat to the necessity of keeping the protocol alive after the US and Australia opted out.

This surplus is referred to in the market as "hot air" -- a surplus of emissions allowances that has been generated without any effort to cut emissions or introduce clean technology.

Russia's inventory estimate for 1990, which was published in Russian at the beginning of January 2007, is 3.4 billion tonnes of carbon dioxide equivalent (tCO₂e), up about 600 million tCO₂e from its previous estimate of the same data of 2.8 billion tCO₂e.

The country's 2004 inventory estimate is 2 billion tCO₂e, suggesting that Russia will have an annual allowance surplus of approximately 1.4 billion tCO₂e in the first Kyoto commitment period.

The United Nations will rule on the accuracy of this estimate once its Initial Report, which was submitted late, has been accepted or rejected.

How Russia chooses to deploy its

surplus in the market, whatever its finally agreed size, will have a profound impact on the price of allowances and the ultimate success of the Kyoto Protocol.

Going long

Subject to the evaluation of all the Initial Reports from all the Annex B countries, it looks very likely that the market overall will be long of AAUs in the 2008-2012 period.

Phase I of the European Union's Emissions Trading Scheme (ETS) has provided a stark lesson on the price consequences of there being a surplus of allowances.

However, there are two reasons why the consequences of a Kyoto surplus might be less severe than that seen in the ETS.

First, unlike European allowances (EUAs), issued in the ETS' first phase, all Kyoto allowances, with the exception of some removal units (RMUs), will be bankable into the second commitment period. Thus, if the price falls too low, countries with a surplus may choose not to sell them, but bank them for the second commitment period when the emissions caps are expected to be lower.

Secondly, AAUs can only be traded by countries, rather than by companies or individuals, unless a domestic cap-and-trade system is introduced.

This will introduce an element of political rigidity into the price of AAUs that will limit the correlation between the price of AAUs and the price of EUAs.

The prospect of buying hot air from Russia is unpopular with the other Kyoto Annex B countries, which will struggle to cut their emissions to an average of 5% below 1990 levels by 2008-2012, such as Canada and Japan.

These countries are very short of allowances, but are reluctant to buy hot air unless there is an effort to "green" it. In other words, the revenue generated should not simply be added to the Russian treasury coffers for general use, but earmarked for investment in emissions reductions and new clean technology.

Attempts to tag the revenues directly from sales of AAUs will be resisted by Russia.

The solution to this impasse would be the investment by countries in need of AAUs in Russian joint implementation (JI) projects.

However, Russia has not yet fulfilled the eligibility criteria to host Track One JI projects --- although it has now submitted its Initial Report, it does not have a working registry and does not have a Designated National Authority to authorise projects.

Once an authority has been set up, Russia will be able to host Track Two JI projects, which are subject to more regulatory oversight by the UN than are Track One projects. ▶▶

Russia will serve as a price-setter, capable of directing the market.

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When ratifying the Kyoto Protocol in 2004, the Russian Economic Development and Trade Ministry announced that its laws were not sufficiently developed to move to a compulsory domestic emissions trading system similar to the European model.

Cap-and-trade

Moscow has stated its support for cap-and-trade emissions schemes in principle, but has no immediate plans to impose caps on the company or installation level.

A domestic cap-and-trade scheme in a country with a substantial surplus of Kyoto AAUs would be a curious concept.

The first decision the regulator of such a scheme would have to make would be where to set the caps for sectors, companies or installations in its economy. If these caps were set in line with its Kyoto country cap this would involve handing over a substantial surplus of AAUs to the private sector.

Such a move would be unprecedented

for Russia. The country's energy sector is the largest emitter in Russia and has a high degree of foreign involvement.

A domestic cap-and-trade system that distributed surplus AAUs to the private sector would see part of the surplus handed over to foreign companies. The only way to avoid such a step would be to set the domestic caps well below 1990 Kyoto base year levels.

In the absence of a devolved domestic cap-and-trade scheme, Moscow will be hugely influential in the 2008-2012 period.

In essence, the country will serve as a price-setter, capable of directing the market through announcements of increasing or decreasing the supply of AAUs to the market. Russia has a poor track record of wielding market power benignly, as evidenced by its tendency to resolve oil and gas disputes by withholding supply.

It is very likely that the sale of AAUs by Russia will become linked to other trade discussions with third parties. For

example, it could become linked by Russia to:

- gas price negotiations carried out by Gazprom;
- any further discussions between Russia and Japan on the disputed territory of the Kuriles islands;
- negotiations concerning the Burgas-Alexandropouli pipeline to transport Urals crude from the Black Sea to the Aegean;
- European attempts to get Russia to ratify the Energy Charter Treaty.

The Kyoto Protocol has dealt Russia a powerful hand in future trade negotiations and the future of the cap-and-trade concept depends on Russia using this power wisely. ■

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