Carbon trading grunts into life

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Investors in the fledgling market in greenhouse gas emissions have seen their share of volatility and shocks in the past three years.

Shares in several carbon trading companies have fallen sharply in the past year, and traders have had to cope with a crash in the carbon price and uncertainty over the future regulation of the market.

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A delay to technology linking the European Union's emissions trading scheme to the system run by the United Nations has proved troublesome, and a report out this week from the UK's Financial Services Authority warned of a litany of risks to the market, from a lack of liquidity to the possible mis-selling of emissions products.

But most carbon traders remain optimistic about the future, pointing out that teething problems are to be expected in such a young market, and that the market itself is based on a strong fundamental – the need to tackle climate change.

James Cameron, vice-chairman of Climate Change Capital, says: "Entrepreneurs like risk, because risk is opportunity, so you should not complain about risk. We are still very strong believers in the carbon market."

Climate Change Capital remains privately owned, but the Alternative Investment Market plays host to a small clutch of carbon trading specialists. The City of London is widely acknowledged as the world centre of carbon trading, which is mainly carried out by investment banks, energy brokers, power generators and oil and gas companies.

The global trade in greenhouse gases was worth about €40bn last year, up 80 per cent on the previous year, and is expected to increase to €63bn ($98bn) next year, according to Point Carbon, the market analysts.

Most of the trading was carried out under the EU's emissions trading scheme, but about €12bn came from the United Nations system of emissions trading under the Kyoto protocol.

The emissions trading market took off in early 2005 with the start of the EU's emissions trading scheme. Under the scheme – the first of its kind – companies in certain energy-intensive industries such as power generation and steel-making were issued with free permits for each tonne of carbon dioxide they may produce, which they can trade with one another.

Companies producing less CO_2 than their allowance can sell their excess allowances to other companies that lag behind in lowering their emissions.

Companies can trade their permits through exchanges, such as those run by Climate Exchange, Nordpool and Nymex, or buy and sell directly with one another. But the bulk of the market is made up of over-the-counter trades through brokers.

The idea of the scheme is that companies are encouraged to cut their emissions of CO_2 at the lowest possible price. Companies can cut their emissions by improving their energy efficiency or installing low-carbon technology. Companies can also buy "carbon credits" issued by the UN to projects such as wind farms or solar panels that cut emissions in the developing world.

But the EU's scheme has not worked quite as intended so far. In the first phase of the scheme, from 2005 to the end of 2007, permits were over-allocated, meaning most companies had a surplus and thus no incentive to buy permits or to cut emissions.

When the glut was discovered, the price of permits crashed from more than €30 to less than €10.

The cap on carbon has been tightened for the second phase of the scheme, which runs to 2012. Instead of a surplus, there should be a difference of a few per cent between what companies are expected to emit and the number of permits they have been allocated.

However, this could be substantially affected by a worsening economic situation – any industrial slowdown would lead to a decline in emissions, narrowing the shortage of permits and cutting their price.

The uncertain future of the market was also underlined when the European Commission unveiled its proposals for emissions cuts earlier this year, when a row broke out over whether companies should have to buy their carbon permits after 2013, when the scheme enters its third phase.

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