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Hot Air from a Crumbling Kyoto

by

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Abstract

The principle of additionality to ensure environmental integrity of mitigation efforts is central to the Kyoto process. Reduction of greenhouse gas emissions earns carbon credits only if the reductions are additional to what would have happened anyway. But this fundamental principle has been given a go by for the Economies-in-Transition who have been allowed to sell their excess Assigned Amount Units (AAU) resulting from the sharp drop in industrial production as a result of the collapse of their economies in early 1990s. The so-called "hot air" is just like any other Assigned Amount Unit and is bankable across commitment periods that not only enhances their value but also imparts enormous maneuverability to their bankers with ready saleable stocks far bigger than those generated under CDM and JI at high costs and, even more seriously, bigger than the total demand. And there are no production and transaction costs involved in producing or accessing it. The size of this "hot air" is bigger than the entire need for carbon credits by the few countries that actually need them in the first commitment period and, in effect, the supply far outstrips the demand. The reason the carbon credits still fetch a modest price is because it is in the interest of the owners of the hot air not to let the carbon markets crash. About

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150 million of these free AAUs have already been contracted, mostly by Japan, and the sale of another 50 million units is in progress. Largest sellers so far have been Czech, Slovakia and Ukraine and now Poland, Estonia and Latvia have joined those first off the mark. The carbon market has been depressed since the beginning of recession in the world market and this has adversely affected business led emission reduction efforts. As long as the market can continue to access the hot air there is little hope of carbon prices rising to levels that are attractive enough for investments to flow in. The fact that Russia has not yet sold any of its AAU stock till date gives reasons for hope since it implies that atleast to Russia the monetary value of these credits is not as important as the political weight it lends to the country. If it can be persuaded to keep this resource permanently out of the carbon market then it would not be too difficult to ask the EU to ensure, through its own incentive and reward systems, to keep its member countries to do the same. Then only Ukraine and Byelorussia will remain with sufficiently large amount of free AAUs and that the world can deal easily.

Key words: Kyoto Protocol, Hot Air, Emerging Economies

If you thought the first beneficiaries of the Kyoto largesse would be the sinking island countries, some even holding cabinet meetings in lagoon bottoms in a desperate bid to melt the hearts of the world's rich, you could not be farther off the truth. The first real climate money flow, a billion Euros, have gone not to them, or to the deprived billions of other Least Developed Countries facing the brunt of the warming earth, but to some of EU's own. Over the past two years Japan has purchased 97.6 million carbon credits (Assigned Amount Units, to be precise) from Poland, Latvia, Estonia, Czech Republic, Romania and Slovakia besides Ukraine to meet its Kyoto target of emission reduction at an average price of Euro 10 per unit. These are not carbon credits earned for reducing emissions after following the rigorous Kyoto process of Clean Development Mechanism (CDM) or Joint Implementation (JI) but just so much 'hot air', much in news during the 1997 negotiations at Kyoto before it got buried deep and the world forgot all about it. The promise of getting these free carbon credits is what persuaded the Russians and the Eastern Bloc to come on board. Under the Kyoto Protocol Russia and its former communist allies agreed to cap their emissions at 1990 level during the first commitment period of 2008-2012. This would have been a good news but for the fact that their emissions had already come down by as much as half due to the collapse of the iron curtain economies across the world during the early nineteen nineties.

The principle of additionality to ensure environmental integrity of mitigation efforts is at the heart of Kyoto process. This means that reduction of greenhouse gas emissions earns carbon credits only if the reductions are additional to what would have happened anyway. This fundamental principle has been given a go by for these Economies-in-Transition. The size of the bonus is so large that it can cause the entire carbon market to collapse without a trace. Like the bonuses elite bankers paid to themselves for drilling holes in the bottom of the global financial system just over a year back. Russia's emissions in 2007 were 37% lower than in 1990 and may have fallen further to 40% in 2009 due to the global economic downturn. Since Russia's AAU entitlement is its 1990 level of greenhouse gas emissions, an estimated 3.5 to 5 billion AAUs, equal to that many tons of CO_2 credits, can be expected to be surplus in Russia alone during the first commitment period. Another 1 to 1.5 billions AAUs would also be available with Ukraine.

And then there are others now part of the European Union like Poland, Czech Republic and Estonia etc, to count just a few. The size is bigger than the entire need for carbon credits by the few countries that actually need them. So in effect the supply far outstrips the demand and should mean zero prices for the carbon credits if they are released in the market.

About 150 million of these free load AAUs have already been contracted, mostly by Japan, and the sale of another 50 million units is in progress. Largest sellers so far have been Czech, Slovakia and Ukraine and now Poland, Estonia and Latvia have joined those first off the mark. There has been a general lack of transparency in these sales perhaps because of the very nature of the product on sale and the many possibilities of underhand dealings that such transactions offer. Darkness rarely fails to bring its own hue to the events and Slovakia's sale of 35 million AAUs to a US registered company Interblue at Euro 5, less than half the ruling price, has provided much ammunition to the opposition parties in that country. It turned out that Interblue, the company which made the single largest transaction in carbon market's short history, was located in a tiny garage in the backwaters of US. The scandal has already claimed the scalp of the then Environment Minister of Slovakia but that may not be the end of story yet.

The hot air is just like any other Assigned Amount Unit. It is bankable across commitment periods which mean these can be held for long if the current prices are not attractive enough. If there were no bankability of the hot air beyond the first commitment period it would have induced these countries to sell their free grants in the market at what ever price they could obtain in the first commitment period itself. This would have meant in effect that credits generated from CDM and JI in the first commitment period would have become practically unsalable before 2012. Bankability of these free credits not only enhances their value but also imparts enormous maneuverability to their bankers with ready saleable stocks far bigger than those generated under CDM and JI at high costs and, even more seriously, bigger than the total demand. And there are no production and transaction costs involved in producing or accessing it. Compare it with the credits generated from CDM where transaction costs can often be as high as the cost of causing emission reduction. And credits from CDM forestry projects cannot even be banked.

The reason the carbon credits still fetch a modest price is because it is in the interest of the owners of the hot air not to let the carbon markets tank. If they flood the markets with their free grants they would not just bottom the price of credits from CDM but also of their own largesse.

There has been little noise from rich countries on the hot air even as they put much pressure on China and India to take on mandatory emission reduction targets from which they were specifically excluded under UNFCCC and the Kyoto Protocol. Which is not surprising at all because this is an extremely cheap resource at their command, to be used if they fall in need of it. It is a perfect hedge against high carbon prices, one they can pretend to criticize but take full advantage of. To ease embarrassment the fig leaf of Green Investment Schemes has been invented which supposedly funds environmentally sound projects out of the proceeds of the hot air credits. Italy and Switzerland have already entered into purchases of this nature and others are waiting in the wings.

The carbon market has been depressed since the beginning of recession in the world market and this has adversely affected business led emission reduction efforts. There are not many reasons to invest in reducing emissions except the carbon market, such as it is. The depressed prices of carbon, and the near surety that it would not rise beyond its present levels of just about euro 15, will discourage future investments in reducing emissions with serious consequences for the earth. As long as the market can continue to access the hot air there is little hope of carbon prices rising to levels that are attractive enough for investments to flow in.

It is this access to hot air that has to be curtailed. Russia and its former allies do not like the disparaging word hot air. For them it is not compensation enough for the huge social and economic costs that their countries had to bear in transition to capitalism. To them this means equity – being at par with the rich. Search for equity is always the demand to be placed at the high table of those above, those below not only must fight their own battles but also bear the additional weight of those that just joined the table above.

The fact that Russia has not yet sold any of its AAU stock till date gives some reasons for hope, though. It appears to imply that atleast to Russia the monetary value of these credits is not as important as the political weight it lends to the country. If it can be persuaded to keep this resource permanently out of the carbon market then it would not be too difficult to ask the EU to ensure, through its own incentive and reward systems, to keep its member countries to do the same. Then only Ukraine and Byelorussia will remain with sufficiently large amount of free AAUs and that the world can deal easily.

China and India, along with Brazil, South Africa, Mexico and South Korea, the biggest producers of carbon credits through CDM, are the most to gain if carbon prices stabilize at a significantly higher threshold than now. All these countries have good political capital with Russia. They should use it now in this task of persuading Russians to keep their free AAUs permanently out of the mandatory carbon market. Rather than leaving it to the US or EU it is these countries, particularly China and India, that should initiate dialogue with the Russians. There would be a price to it and perhaps a small window of using these AAUs under specific circumstances and it is the task of the negotiators to keep the price within reasonable limits and the window at a place in the house where there is no need to ever open it .

The challenge that global warming poses is so huge that it needs several proactive leaders and it can no longer be left to the US and EU only. China, India, Brazil and South Africa, among others, must begin taking up issues that have a bearing on climate change mitigation and adaptation. So far they have only been responding to proposals, and pinpricks, from West.

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