Uncertainty clouds emissions trading future

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AUSTRALIA is entering unknown territory with the transition to an emissions trading scheme. The global carbon market is full of imponderables. Indeed, the greatest unknown is whether it will work.

In the hiss of escaping gas, sleepers will come into play. The list includes carbon cowboys arbitraging carbon's spot and future price - according to *Environment: Yale Magazine*, there are 90 hedge funds and 80 private equity funds operating in a market that is still in its infancy - and governments creating a glut by handing out privileges to politically powerful polluters in the form of free permits.

Then there is the potential volatility. Europe's emissions market is a case in point. According to the World Bank, the spot price for European Union emissions trading scheme allowances went from a record high of €28.73 in July last year to a record low of €7.96 in February. That could be a taste of things to come. The problem for business and investors in carbon markets is the lack of certainty, and as the late investment strategist and author Peter Bernstein pointed out, placing large bets on an unknown future is worse than gambling. At least in gambling you know the odds.

As a result, governments here and overseas will continue to come under pressure to replace emissions trading with a carbon tax.

Former US undersecretary of commerce in the Clinton administration, Robert Shapiro, recently told the Trade 2020 conference that cap and trade was "very vulnerable to vested interests, and therefore too weak to deliver the necessary emission reductions".

The powerful Committee for Economic Development of Australia concurred. In a warning to countries around the world, CEDA's research and policy director, Dr Michael Porter said: "The community needs to appreciate that the CPRS (carbon pollution reduction scheme) is not trading of carbon emissions, but of carbon credits, and derivatives of financial obligations relating to greenhouse gases. And this trade has to occur across some of the most problematic financial jurisdictions worldwide." The elephant in the room: how to manage a cap and trade scheme smoothly in a way that reduces greenhouse gas emissions.

Dr Joseph Mason, of the Ourso School of Business at Louisiana State University and a senior fellow at the Wharton School, has argued that the difficulty of regulating global financial markets could set the stage for carbon dioxide to become the next bubble. That would impair cap and trade's ability to reduce emissions.

In testimony to the US Senate last week, Mason said European market volatility - created by extreme weather, low rainfall affecting hydro-electric and nuclear plants and political decisions - showed how cap and trade might discourage renewable energy investment without reducing emissions.

"The European experience … is important because the primary purpose of a cap and trade carbon market is to provide long-term incentives for firms to invest in clean-air technologies," he said. "Such technologies - nuclear assets or clean-air coal assets, for example - are extremely costly to build … private investment in these types of assets only makes sense if the long-term benefits of the investment are clear. With carbon permit prices fluctuating wildly, long-term signals regarding the carbon-reducing benefits of investment in clean-air technology are clouded at best and non-existent at worst."

The problem with a spot and futures market for emissions, he says, is that it is unpredictable. It does not conform to standard price analysis for commodities.

He also warned that handing control of the market to a central bank or board was problematic. The performance of central banks was only measurable against long-term economic growth, which could take years to evolve.

A central board overseeing the market, he said, would be subject to conflicts of supply, demand, protecting the environment and containing costs. Managing a carbon market would be more complex than managing money supply, which already leads to cyclical booms, crashes and credit crises. That made US Federal Reserve chairman Ben Bernanke's job look like a piece of cake.

A board would also need to guard against speculation, ensure transparency in the financial statements of business that use carbon contracts and be able to change the terms of contracts if flawed. That was just too hard. The easier alternative, Mason said, would be a carbon tax. The infrastructure for a cap and trade scheme would take years to develop and fine tune, but the infrastructure for another tax was already there.

Still, carbon taxes have three disadvantages. First, no one knows how big the reduction in emissions will be - it might take several years to discover that the taxes were not that effective in reducing demand. Second, these taxes need to be global and taxes are hard to co-ordinate internationally as countries are protective of their tax independence. And politicians are unlikely to go down that path because of the political fallout. Electorates generally don't trust the way governments use taxes and there will be claims that a carbon tax will be just another vehicle for ripping off the public

The alternative is investing in a scheme that might not reduce emissions at all and could result in a bubble that would make the US housing meltdown look like a picnic.

There are no simple solutions. Assuming the Senate passes the CPRS and Copenhagen comes up with directives, global warming management strategies will remain a work in progress for years to come.

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