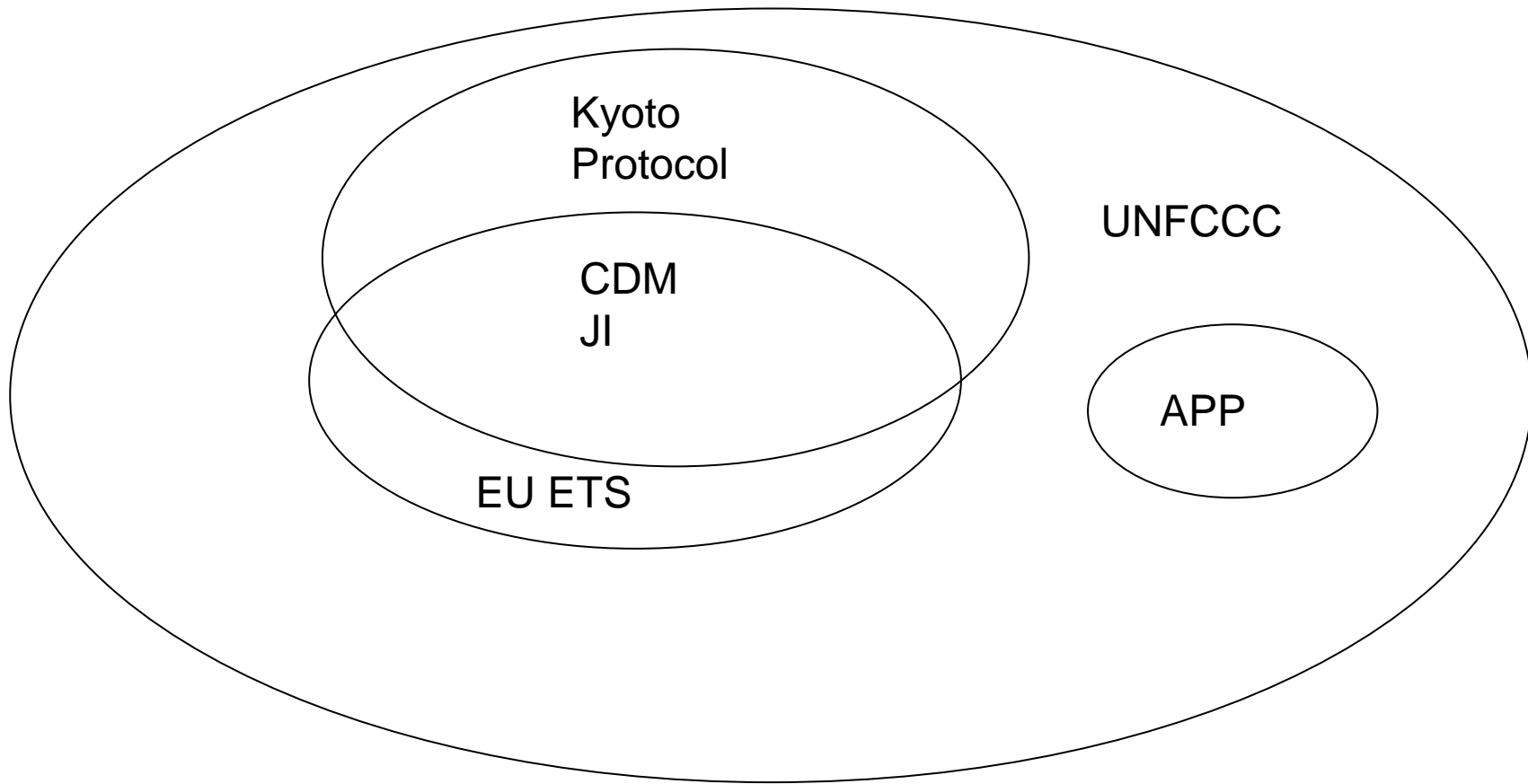




DEFRA

Emissions Trading for Japanese Delegation

26th April 2007





Cap and Trade

- Caps- Kyoto and ETS
- Consequences
 - Invest
 - Cut production
 - Trade
- Longs and shorts



Carbon Instruments

- What is being traded is *measured* as “tCO₂e”: CO₂e is not a commodity.
- ***THIS IS ARGUABLY A MARKET IN REGULATORY RISK***
- Companies/countries are trading to avoid a penalty or tax, or to gain a subsidy.

AAUs. Kyoto targets given to Annex B countries are referred to as Assigned Amounts (AA) and the total for any country can be measured in 1 tonne of CO₂e amounts called Assigned Amount Units (AAUs). Hence a country's Assigned Amount is the number of tonnes of CO₂e that country is allowed to emit in the 2008-2012 period.

CERs. CDM Projects generate Certified Emissions Reductions. CERs earned from the year 2000 onwards can be traded or banked and used to meet Kyoto 2008-2012 reduction targets. These can also be used to meet EU targets under the Linking Directive. Use in the EU scheme will be capped.

ERUs. 'Activities Implemented Jointly', now called JIs, generate Emissions Reductions Units. No ERUs have so far been granted but they can be traded or banked and used to meet Kyoto 2008-2012 reduction targets. ERUs cannot be used to meet EU targets under the Linkage Agreement in 2005-2007, but may be used in the first commitment period which coincides with Phase Two of the European scheme.

RMUs. Carbon Sinks or sequestration projects generate Removal Units. Carbon sequestration is a temporary benefit. RMUs cannot be banked for use in a future period and cannot be used to meet EU targets under the Linkage Agreement in 2005-2007.

EUAs. European Allowances granted under a National Allocation Plan of an EU member state. These can be banked between years *within* the 2005-2007 period, but cannot be banked for use in 2008-2012 Kyoto period- except France and Poland.



EU- Important Principles

- Unfettered transferability between persons *within* the Community
- Transferability between persons in EU and persons in third countries *where scheme is recognised by EC*
- But any individual, company or regulatory authority can open a European registry account and use the EUA as a compliance instrument for any scheme.

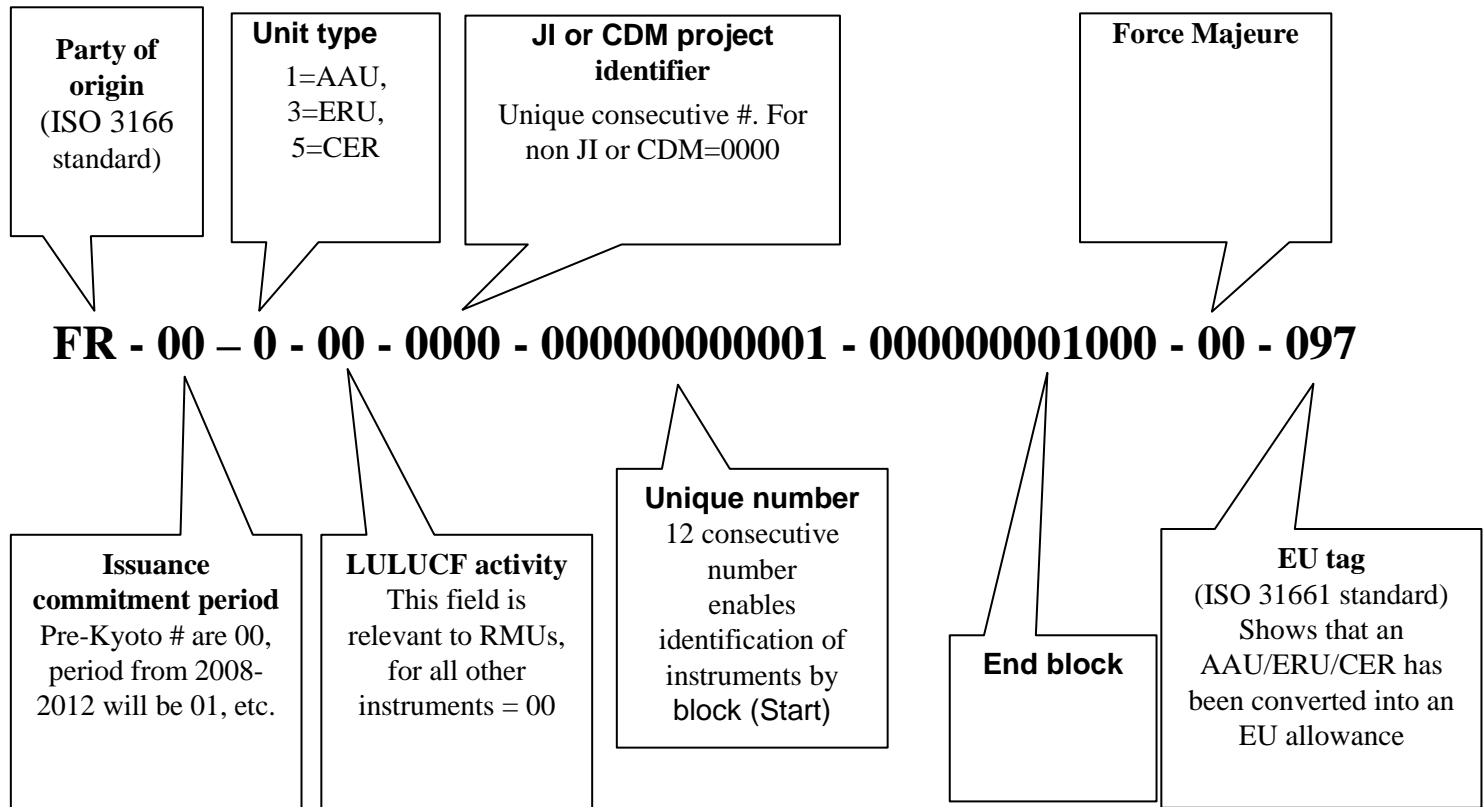


Registries and Transaction Logs

- Allowances are assets held in registries
 - National Registry
 - CDM registry- where CERS are generated
- Transaction Logs-checking and clearing mechanisms
 - Community Independent Transaction Log (CITL)- operational
 - International Transaction Log (ITL)- not yet operational



Allowances



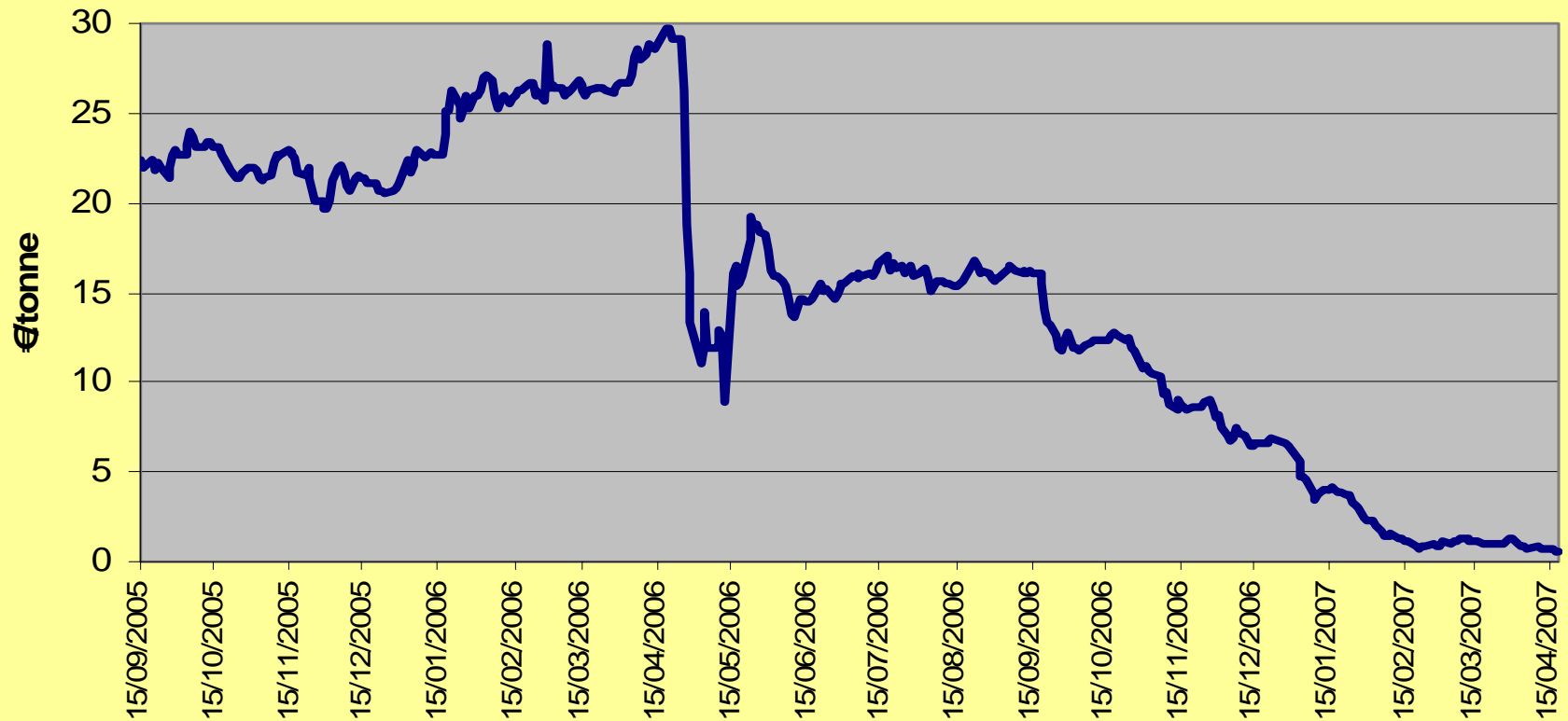


Fungibility

- Registry system and person holding accounts provide basis of emissions 'currency'
- Single international carbon price
- New schemes do not need to re- reinvent the wheel
- Do not need an MOU with Europe, but it helps



The Spot Price of EUAs

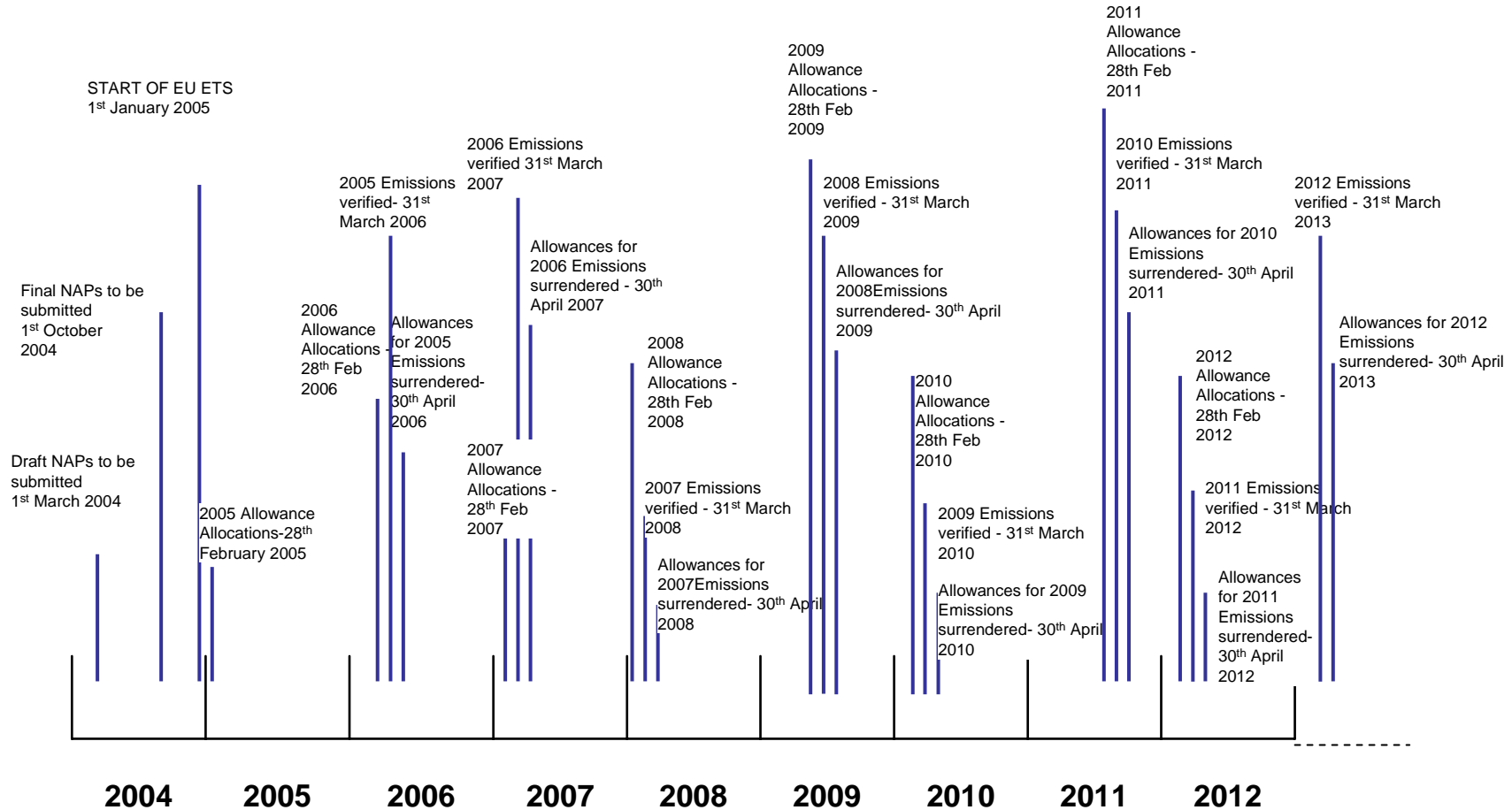




Emissions Traded Instruments

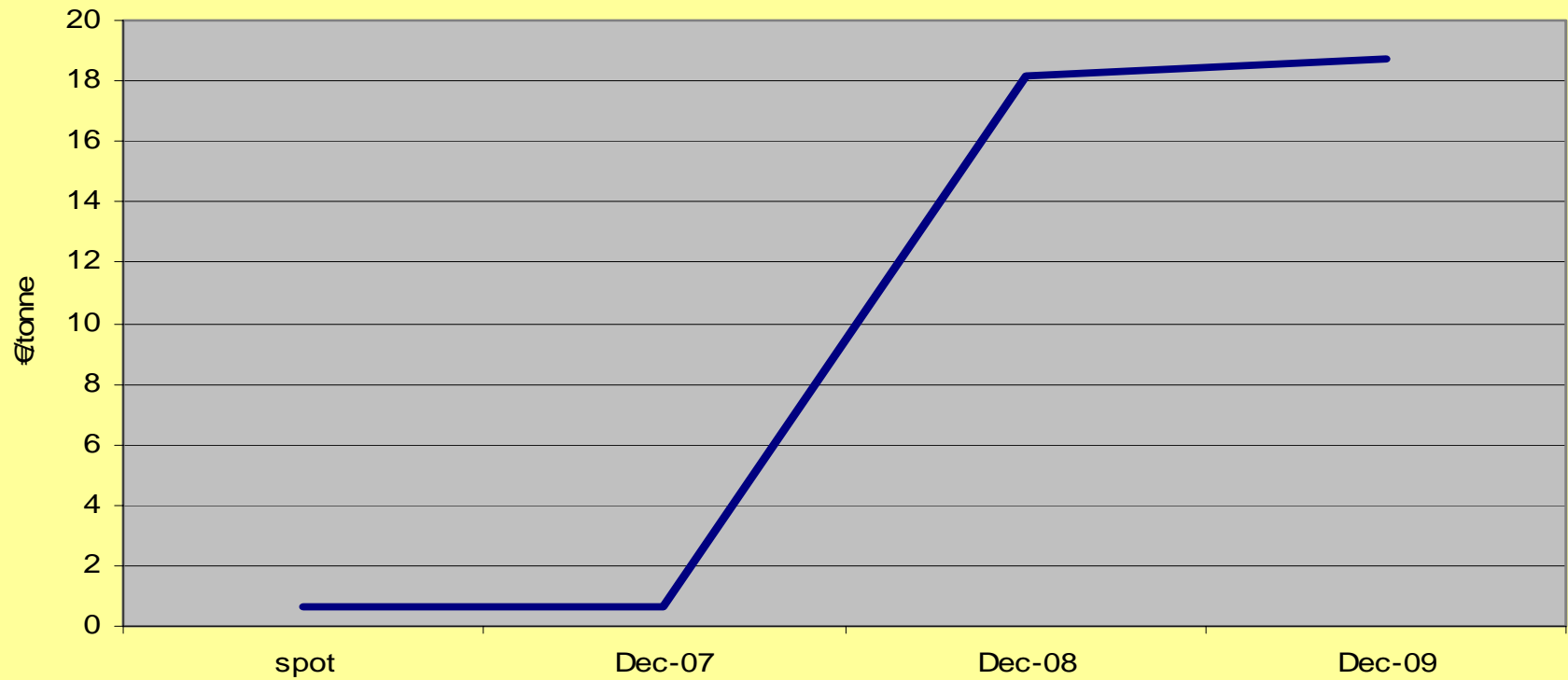
- Spot Contracts
 - Delivery (transfer in registry) is immediate.
 - Buyer makes payment within 5-10 business days of receipt of confirmation of delivery.
- Term Contracts
 - Not yet. Possible in theory, but vintages and carry forward needs to clarify
- Forward trades
 - Terms (price, quantity, vintage, delivery) are agreed now
 - Payment made now or later
- Future Trades
 - Like forwards, but traded on a regulated exchange with credit security
- Spreads
 - Differentials
- Swaps
 - Not yet. Possible in theory, but benchmark pricing needs to clarify
- Options
 - The right but not the obligation to buy/sell allowances at a set price for a specific premium

The Timeline for the EU ETS





Forward Emissions Price Curve 25th April 2007





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