carbon emissions

The advent of the European Union Carbon Emissions Trading Scheme has brought new risks in the area of carbon emissions exposures for businesses.

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In ratifying the Kyoto Protocol on global warming and climate change in 1997, the European Union (EU) undertook to reduce its carbon dioxide emissions to below 8% of 1990 levels by 2010. To effect this change the allocation of allowances under the EU Trading Scheme was designed to encourage 14,000 companies in the Scheme to engage in strategies directed at reducing carbon emissions.

Our client, a power company, faced into the first year of the Scheme with an estimated allowance shortfall of around 300,000 tonnes of carbon emissions. The company had to source additional allowances to meet the deficit. Furthermore, in order to satisfy the regulator, the company had to prove that the procurement process was ‘reasonable and prudent’. The issue for the company was, therefore, how to achieve the purchases of additional allowances in a developing (and volatile) market at a price that, at the end of the period, would be deemed reasonable. The company approached Bank of Ireland Global Markets to create a solution as we had identified the emissions market as a potential issue for our clients. By the time the Scheme was launched in January 2005, we had established a proficient dealing capability in this embryonic market.

Our challenge was to design a product that would both reflect the price movements in the market over the year and afford our client flexibility to adjust the purchase amount in accordance with their variable power output. The process was complicated by the lack of a developed options market. There was, however, a newly established futures market, the ECX (European Climate Exchange) which operated through the IPE (International Petroleum Exchange) in London. This exchange ultimately held the key to the product we structured in this case.

We offered our client an Average Emissions Rate Agreement (AERA). Under this structure our client could specify the number of allowances to be purchased for the following month. The price at which the allowances would be purchased was based on the average daily close of the current month ECX futures contract. Delivery of the allowances would be made on a quarterly basis. In addition, our client was happy that they had achieved a cost effective and flexible solution.