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The Coming Carbon Bubble

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Remember the nasty real estate meltdown? All those investors snapping up CDOs and CDSs and other acronyms nobody could really keep straight, but no one cared because we were all going to make a killing. And then the bottom dropped out of the market when somebody realized we had no idea what any of these exotic entities were actually worth but we started to worry that it might not be nearly as much as what we'd been told. So then the government had to come along and give the banks a ton of money and we're all OK now as long as you don't look at the national debt or foreclosure rate or a host of other still-dismal numbers.

Well, it's good to see we've learned our lesson. We'll never get carried away like that again! Except that we might. If you thought the real estate mess was bad, fasten your seat belts and tuck all personal belongings inside the car because the carbon market is set to take off.

On June 26, after a lot of bickering and wrangling, the House passed the American Clean Energy and Security Act. Although the bill's narrow margin of victory (219 to 212) makes Senate passage an open question, it's more likely than not that some form of emissions-control bill will be passed by Congress sometime this year. The Obama administration is pushing hard for a law to be on the books before the U.N.'s climate change conference in December. The powers that be are also strongly in favor of a market-based mechanism called "cap and trade" to regulate and, hopefully, reduce emissions.

Under cap and trade, the government will issue a fixed number of carbon credits that will give the bearer the right to release a ton of carbon into the atmosphere over the course of a year. In future years, the number of credits issued will shrink, reducing our collective emissions to a degree scientists tell us is necessary to keep from turning the planet into a sauna. In other words, the government is going to create, out of thin air, a market for a commodity that could easily grow to eclipse even the current energy markets.

The system is based on a similar plan used successfully back in the '80s to reduce the amount of sulfur dioxide, the main cause of acid rain, in the air. That program operated successfully, but carbon dioxide is a much bigger and more complicated issue, and SO₂ trade flourished in an era before banks were creating and trading the type of exotic derivatives that are now both common and problematic. Currently, there's a small amount of carbon and other emissions trading in the United States, mostly due to regional regulations or voluntary initiatives, but this market is set to explode once federal emissions regulation comes into play.

A reliable guesstimate is that around 6 billion carbon credits a year will be in circulation, at least initially. Commodities like corn and soybean have markets that are 10 to 20 times the size of the crop itself, a result of the derivatives market. Some financial instruments sustain markets as large as 30 times that of the underlying instruments. Early speculation called for credits to be sold for

anywhere from \$13 to \$20 a pop. Even taking the low end of these estimates, carbon is on track to be a three-quarters-of-a-trillion-dollar market. In a speech given last month by Bart Chilton, commissioner of the Commodities Futures Trading Commission, he forecasted that carbon trading could grow to become a \$2 trillion futures market within five years.

A big reason the real estate crash was such a colossal mess is that no one was regulating the most exotic—and most in need of regulation, many would argue—derivative instruments like the credit-default swaps that almost sunk AIG (AIG). Is it reasonable to assume that a carbon market, especially one that's being built essentially from scratch, would have stopgaps and safety valves built into its infrastructure?

Maybe. The Obama administration is certainly more regulation-minded than Bush 43, and Congress is dutifully following up on populist outrage generated by mortgage-related misdeeds. Still, there are still many, many ways oversight could fall short. For instance, trading carbon on an exchange would give greater price transparency and keep parties from engaging in the kind of speculation that crippled the mortgage-backed securities market; however, it's safe to say that the financial services industry will lobby hard against any sort of exchange-trading requirement for carbon, as it has with other classes of derivatives.

Wall Street is already making its presence known. According to the Center for Public Integrity, there are 130 finance and insurance industry lobbyists currently working on climate change. Matt Taibbi's recent takedown of Goldman Sachs (GS) in *Rolling Stone* (excerpt here), while delivering in his usual paroxysm of indignation, nonetheless raises some valid concerns about Goldman's cozy relationship with top economic officials and advisers. Alumni of the investment-banking giant are certain to have a hand in shaping the government's stance on carbon trading, which means the resulting system will benefit them first and taxpayers (not to mention the environment) second.

Since carbon is essentially a commodity, it's safe to assume that the Commodity Futures Trading Commission would inherit the responsibility for overseeing the CO₂ market. Unfortunately, not everyone is convinced the CFTC is up to the task. In a CNBC interview, Michelle Chan from environmental group Friends of the Earth laid into the CFTC's Bart Chilton over Chilton's assertion that the commission is willing and able to weed out speculative run-ups in prices or even outright fraud. Although CFTC Chairman Gary Gensler made headlines on Tuesday when he called for curbs on speculative investing in the energy markets, he didn't offer a plan to do so. Skeptics have already started asking if the commission is willing and able to tackle this issue. As recently as last fall—when the memory of \$4-a-gallon gas was still fresh in America's mind—acting Chairman Walter Lukken told the House committee on energy and commerce that speculators had nothing to do with the rapid run-up in oil prices.

President Obama has backed away from his campaign-trail pledge to auction off 100 percent of the carbon credits in circulation; in fact, current plans call for auctioning off a mere 15 percent of them and giving away the rest to power companies. Aside from the ire this has created in those who see the giveaway as a capitulation to the energy industry, eliminating a mechanism that would establish the base price for carbon credits could have market implications. If all credits were auctioned, they'd have a stated value right off the bat. If they're given away, that creates much more uncertainty about their actual value, which sets the stage for the kind of fall holders of many mortgage-backed securities took last year.

The market's also going to be expanded—and complicated—by carbon offsets. Offsets are get-out-of-jail-free cards that allow the bearer to pollute beyond what it would ordinarily be permitted. They work like this: Entities that take carbon dioxide out of the atmosphere—like agricultural concerns whose plants convert CO₂ back into oxygen—get offsets for that biochemical activity. They are then free to sell those offsets to power plants and other emissions-spewing companies.

How much money will offsets eventually be worth, and how many of them will be out there? No one knows yet, but agribusiness—especially the ethanol-producing corn sector—is lobbying hard for generous offset allowances. This is going to have an impact on the price of carbon credits. If enough offsets are pouring into the market, the value of the credits will be deflated.

Finally, the recession itself threatens to throw another monkey wrench into the stability of carbon pricing due to reduced industrial production. Less production means fewer greenhouse gas emissions, which means lower demand for credits. Take a look at the European Union Emission Trading Scheme, the largest emissions market in the world today, to see what we mean. Europe, in general, is a few years ahead of the United States when it comes to this whole emissions-reduction game; as a result, their carbon market can, in some instances, be a useful crystal ball.

As recently as last summer, the going rate for a carbon credit in the European Union was about €30. Recently, though, holders have been hocking them for as little as €10 since buyers can't drum up the necessary credit to pay the pre-bust prices. Europe also gave away, rather than auctioned, the credits. This decision factors into the current price deflation: Since utilities got the credits for nothing, they're still making money even if they're selling them for peanuts.

The U.S. carbon market is barely out of the womb, and there are already a whole slew of variables that could knock it into disarray. If the administration can keep its eye on the ball when it comes to regulation and not be distracted by the sweet nothings the i-banking community is sure to be whispering in its ear, CO₂ will grow into a stable and well-adjusted market. If not, we're looking at our next problem child. Hope for the best—but don't exhale just yet.

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