Carbon market â€œgrowthâ€• is mainly fraudulent, World Bank report shows

by Oscar Reyes
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The global carbon market grew in 2009. Far from signalling a success, this reflects a massive increase in fraud, the dumping of surplus emissions permits by industry, and a rise in financial speculation.

â€œGlobal Carbon Market Grows to $144 billion Despite Financial and Economic Turmoilâ€• was the headline with which the World Bank (WB) announced its annual State and Trends of the Carbon Market 2010 survey. Readers of the report, however, will draw a less optimistic conclusion about the strength of the carbon market.

Fraud boosts trade

The EU Emissions Trading System (EU ETS), the world's largest carbon market, was mainly responsible for the increased volume of trade, yet a significant proportion of this was linked to a value added tax (VAT) â€œcarouselâ€•Â fraud. Thi illegal manipulation involved the rapid sale of European Union Allowances (EUAs, the unit traded within the ETS) from country to country. It accounted for up to 90 per cent of carbon trading in 2009 on some exchanges - most notably, BlueNext in Paris.

The WB report also confirms that traders shifted large volumes of EUAs from one country to another in order to gain free short term financing from the time lag in making VAT payments. Although it doesn't calculate exact proportions, the Bank reports that this was a key factor in the 450 per cent increase in â€œspot tradesâ€• in the EU ETS (a spot trade happens immediately, as opposed to at a set date in the future â€“ and these forms of exchange are unregulated). This amounts to a â€œ75-fold increaseâ€• in the first six months of 2009 compared to the equivalent period in 2008.

The VAT loopholes have since been closed, but this has not stemmed the tide of carbon market corruption cases.

Never one to miss the opportunity to spin failure as success, the WB reports evidence of VAT and other fraud attempts as â€œevidence that the emissions market is maturing and becoming mainstreamed within the European economy on the grounds that â€œEntities donâ€™t seek out loopholes in insignificant markets, fraudsters do not focus on small businesses.â€•

The cap that does not cap

Corruption and manipulation are not the only reasons why the EU ETS grew while other markets declined, but the other explanations make equally unhappy reading for carbon market optimists.

First, EU-based industry cashed in on its huge surplus of permits as the recession started to bite. The WB now estimates a surplus of 970 Mt CO2e (million tonnes) by the end of phase 2. This would account for almost 40 per cent of the â€œreductionâ€• that the EU claims will be required of power companies and industries covered by the ETS in phase 3 of the scheme. This figure might yet be higher if companies decide to purchase a significant number of offset credits and â€œbankâ€• these too. Legally, it could rise to 1.6 billion tonnes CO2e.

In addition, companies will be allowed to purchase an additional 50 per cent of their â€œreductionsâ€• in the form of offsets. This overall figure masks the fact that new ETS rules will allow power producers in the UK and Germany (currently the largest buyers of emissions permits), as well as companies operating in Spain and Italy (which allowed vast quantities of offsets in phase 2) to buy more than 50 per cent of their â€œreductionsâ€• in the form of offsets. The net result of this could be that the EU ETS will require very few domestic emissions reductions before 2020, and quite possibly none at all.

Growing speculation

The third explanation for a larger volume of trade within the EU ETS is an increase in speculation. In 2009, the Bank reports, the carbon market:

â€¦witnessed a growing presence of funds, energy-trading firms, and increasingly sophisticated utilities and industrials that used the options market for hedging (both volumes and prices) and profit-making transactions. The bulk of activity now comes from volatility and other relative value trades rather than asset-backed trades (i.e., financial and technical trades now account for a greater portion of market activity than do trades for compliance purposes).

Put simply, carbon trading is not primarily practiced to cut emissions, as its advocates claim. Instead, trading takes place to make speculative profits, or to â€œhedgeâ€• the risks that large energy companies face in relation to changing fossil fuel prices and currency fluctuations.

Further Reading

World Bank, State and Trends of the Carbon Market 2010 Â

Collection of recent media reports on carbon markets and corruption

â€œAnalysts say global carbon trading volume down 10%â€• Point Carbon, 7 July (subscription required)