The wrong sort of recycling

Hungary's sale of used carbon credits damages investor confidence.

THE point of carbon markets is to put an efficient price on the right to emit carbon dioxide. Recent events in Hungary show how tricky it is to achieve that goal. At issue is the sale by Hungary's Ministry of Environment and Water of 800,000 certified emission-reduction credits (CERs). CERs are generated by the Kyoto protocol's "Clean Development Mechanism", whereby reductions in greenhouse gases in developing countries can produce a carbon credit for use in industrialised markets. The problem with the sale was that Hungarian firms had already used the CERs to offset their own emissions.

Used credits are worthless on European carbon exchanges. The European Union argues that one credit must equal one tonne of carbon dioxide for its Emissions Trading Scheme, the largest emissions market, to be effective. Since the whole point of the credits is to cut carbon, double-counting them makes a mockery of the system.

But the rules of carbon trading are slacker elsewhere. Hungarian officials say the credits were ultimately destined for a buyer in Japan. Japanese firms can use the credits to prepare for their country's own looming emissions-trading scheme, and the Japanese government can use them to meet its Kyoto commitments. "In Japan's view, so long as some environmental benefit has occurred, then the CERs have a value," says Yuichi Takayama, the boss of Tokio Marine Asset Management.

The trouble arose when these used CERs found their way back—how is unclear—on to BlueNext, an exchange based in Paris. (By that time they were out of the hands of the Hungarian ministry, so technically the country did not break any rules.) Once the European Commission realised what had happened, all hell broke loose. BlueNext temporarily suspended trading on March 17th. That sent the spot price for CERs into free fall. Though trading has since resumed and the price has bounced back to around €11 ($15) per tonne, Abyd Karmali, global head of carbon markets for Bank of America Merrill Lynch, says there are signs that investor confidence has been hit.

In particular, there has been a "flip in the curve" of CER prices. Normally, longer-dated futures contracts are more expensive than shorter-term ones. That pattern has reversed since the Hungarian debacle (see chart), with the price of a CER expiring in December 2012 being priced lower than one running out this year. "This tells us investors anticipate this won't be last time we see recycled CERs hitting the market," says Mr Karmali. Indeed, Hungary has said it intends to sell more recycled credits but will put more stringent rules in place to ensure they do not wash up in Europe.

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The incident adds to the difficulties of finding a successor to Kyoto, which expires in 2012. Its architects believed making the various flavours of carbon credit fungible was the best way to make the system work. Closing the loophole on double-counting could put off new entrants. Keeping it open would be even worse. Flooding exchanges with recycled CERs that do not yield any additional project finance in poor countries would not be doing the market any favours. “The environmental industry has a spectacular knack for scoring own goals,” says Gavin Tait of Croft Consulting.