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Investors face risks in race for carbon credits

By Emma Saunders
in London

Investors are rushing to secure carbon credits from environmentally friendly power projects in the developing world but are failing fully to recognise the risks, according to carbon trading experts.

Arne Eik, a senior analyst at Point Carbon, believes that only about 70-80 per cent of expected credits materialise. Investors will pump about $4.5bn into the quest for these credits this year, in some cases relying on arbitraging a tiny chance of failure with no guarantee the projects will ever generate credits.

Last year, at least two such projects funded from the UK and Ireland ended in failure, with the loss of more than €5bn ($7.9bn) in expected revenue.

"Lots of hedge fund cash is chasing the same projects," said Garth Edward, head of emissions trading at Citi. "The price gets pushed up. Yet some of these projects have no development team and no consultants."

Carbon trading investors – including hedge funds, banks and utilities – can invest in green power generation in developing countries in return for certificates that can be sold in the European Union.

There are two types of these certificates of emission reduction (CERs): one before the project is completed and one after. The difference between the two prices is a measure of the risk that the project will not complete.

However, carbon traders say the prices are converging, effectively reducing the valuation of risk. There is no evidence of a corresponding increase in the likelihood of projects being completed.

Typically, a pre-completion or "primary" CER sells for €8-€15, reflecting the individual nature of each project and its risk. The range used to be €7-€10.

The upward shift in prices has narrowed the gap with post-completion "secondary" CERs, which trade in the EU for about €16.

The reason for the rise is thought to be an increase in demand for primary CERs from hedge funds in particular, awash with cash following a shift from other asset classes amid the credit crunch. There is also a rising number of hedge funds committed to investing solely in emission reduction projects.

The risk to investors, and to hedge funds in particular, lies in selling secondary CERs before the project is completed to mitigate risk.

A licence to print money

By James Mackintosh

It is not often that investors get the chance literally to print money, but creating carbon credits is a pretty close second best.

The opportunity has been grabbed by investment banks, hedge funds and specialist venture capital groups, which have raised billions to spend on reducing emissions, mostly in the developing world.

The aim is to secure carbon credits for an emission reduction, which can then be sold to big industrial groups in the developed economies that find it cheaper to buy credits than cut their own emissions.

Precise details about how big this market is and everyone active in it are impossible to pin down.

But London's Man Group is one of dozens of groups trying to cash in, having set up a special entity last week to oversee its environmental investments. Its first venture, MTM Capital's China Methane Recovery Fund, has raised €400m ($632m) to install methane extraction equipment, generating electricity from the greenhouse gas at Chinese coal mines.

Man expects to raise another two environmental funds of at least $500m this year, although it is aiming to minimise political and regulatory risk by requiring another source of income, not just carbon credits.

Claude Devillers, founder of Merzbach Group, a New York adviser to green power projects now raising its own carbon fund, said investors were finding it difficult to deploy cash. "Finding the projects is the hard part," he said. "Our approach has been focusing on access to the hard assets."

The long-term nature of most projects make traditional hedge fund structures inappropriate. As a result, hedge funds entering the area are mostly adopting very long lock-ups, preventing investors leaving, or are using venture capital structures where money is returned only when projects are sold.

Investors are taking risks many are not used to. There are political and regulatory dangers and often the financial risk of falling permit prices, which are not always hedged.

Fund that failed to hit goal

One of the first hedge funds dedicated to carbon emissions trading quietly shut down in December after failing to meet money-raising goals. The Carbon Trading Fund, run by David Bates, managed to raise only about $5m, instead of the $125m hoped for, because investors were deterred by the 2006 carbon price collapse, when it became clear that many European countries had issued too many credits.

"The fund was launched early in the [carbon credit] process," said Chris Day, chief executive of PCE Investors, which provided the regulatory platform for Mr Bates, who could not be contacted.

"Investors quite reasonably sat on the sidelines."