

FOCUS: Carbon Funds Lure Pensioners Despite Risks

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LONDON (Dow Jones)--European pension funds and other large investors are stepping into the unregulated and volatile market for carbon credits, even though it is uncertain the market will continue to exist beyond 2012.

The \$11 billion global carbon market is mired in doubts over whether the Kyoto Protocol, the treaty on global warming that established the market as a way to help reduce greenhouse gas emissions, will last beyond then. If it doesn't, demand for such credits could fall substantially, dragging down prices.

But despite wild swings in prices this year, pensions funds are stacking up investments that market backers anticipate may bring returns of 15% to 25%, or higher, in part to satisfy pensioners who want to help slow climate change.

Carbon credits trade over-the-counter, making the market for them opaque. Most expire in 2012, so they are more akin to a bond that matures rather than a stock.

Rather than buying and selling carbon credits directly, pension funds are investing in funds that finance emissions-cutting projects around the world. These funds are betting that they can more than repay the cost of these projects by selling the credits the projects generate to companies in industrialized countries to offset emissions-reduction obligations.

Carbon funds have raised \$7 billion from investors between 1999 and the middle of this month, according to New Carbon Finance, a market research firm.

"It's a small area, but definitely one of growing interest, especially for leading pension funds, which are looking to diversify into different areas and uncorrelated assets," said Paul Deane-Williams, senior investment consultant at pension-consulting company Watson Wyatt Worldwide Inc. (WW).

But the nascent market has also been volatile as companies and investors try to gauge demand.

The value of carbon credits is closely linked to the price of European CO2 allowances, the currency of the European Union Emissions Trading Scheme. Throughout 2005 and part of 2006, the price of CO2 allowances climbed to more than EUR30 a ton amid speculation that industry was having a tough time complying with the caps imposed by the European Union and national

governments. But the price plunged more than 60% over six trading days in late April and early May to EUR11.40 a ton after European countries began disclosing their capped industries had emitted less CO2 than permitted under their 2005 allowances. Prices have since recovered somewhat and have traded within a band of EUR14.80-EUR17.35 a ton for the past two months. They've recently begun to fall below EUR13 due to falling energy prices.

The carbon credit market is riskier than other alternative energy investments, such as the wind sector, said James Cameron, co-founder and vice chairman of Climate Change Capital, a U.K.-based environmental private-equity group that has launched two funds that invest in carbon credits and finance emissions-reducing projects.

Investments in windfarms typically earn relatively stable returns of 9% or higher due to government subsidies that include electricity tariffs or special certificates. One of the big risks for the global market for carbon credits is that projects won't meet international standards or won't produce enough carbon credits to fulfill their contracts, possibly leaving clients empty handed when time comes to surrender the credits.

But Cameron said the growing desire to tackle climate change will force governments to keep pushing to reduce carbon emissions, regardless of what happens to the Kyoto Protocol.

His fund has lured investments from ABP and PGGM, two giant Dutch pension funds. PGGM, which has EUR74 billion under management, committed EUR200 million to the fund, called CCC Carbon Fund II and which is expected to close at more than \$1 billion by the end of the year. ABP, which rivals U.S. giant California Public Employees' Retirement System, or **Calpers**, as the world's largest pension fund, has committed EUR275 million.

"It's part of our focus on sustainable investing and an opportunity to invest in carbon credits via projects that capitalize on the transfer of technology from developed to under-developed countries," said Reitze Douma, PGGM portfolio manager.

Fund managers say such funds are less risky than actively buying and selling carbon credits themselves. London-based F&C Asset Management is a substantial investor in Trading Emissions PLC (TRE.LN), an investment fund set up to buy tradable instruments in projects developed under the Kyoto Protocol.

"It would be too high risk for us to invest directly in carbon credits because we don't have the expertise. But long-term, we think the ETS (emissions trading system) is the right approach and will succeed despite the rocky period in late April and May," said Karina Litvack, head of corporate governance and socially responsible investment at F&C, which has GBP 107 billion under management. She described the investment in Trading Emission as a "very tiny amount" of overall assets.

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