2007 Market Perspective

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2007: A transition year – the good…

2007 is the year the carbon markets started to walk

Confidence in Phase 2 of the EU ETS grew

- The EU Commission sent clear signals to the market on key elements including
  - targets for Phase 2;
  - broadening of the scheme to include other GHGs and sectors;
  - longevity of the scheme into Phase 3

Secondary CER market took off

- The secondary market for CERs expanded dramatically from 2006
  - Contracts are standardizing
  - Increasing confidence in infrastructure (though undoubtedly there will be more surprises)

International negotiations have renewed life

- The US is on path (at the start, but finally moving) to domestic regulations on GHGs
- Renewed commitment from Japan
- Australia is making promising noises

…and the to-be-improved

While much progress has been made, there are a number of issues to be addressed

Voluntary markets

- 2007 saw rapid growth in interest and controversy around the voluntary markets
- There is a strong need for standards and solid infrastructure (a registry) to build confidence and also prevent the voluntary markets from tarnishing project offsets generally

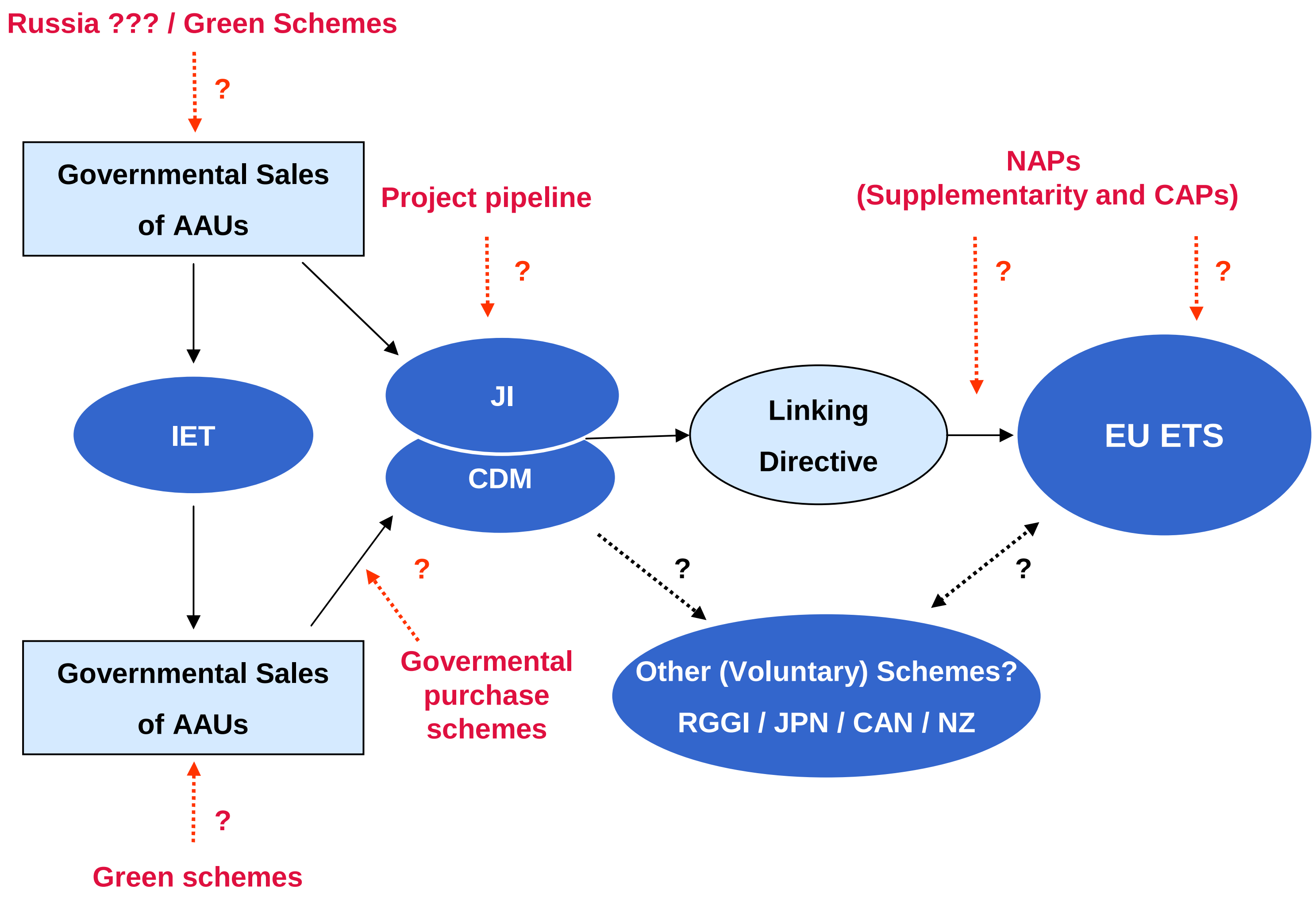
US GHG policy and international linking

- While the US is moving along a path towards policy on GHGs, it is far from clear what the policy will look like
  - There is strong skepticism in the US on project offsets generally
  - Challenge is to promote eventual linking and convergence between the US, other government systems and the broader international framework

Future of CDM and JI

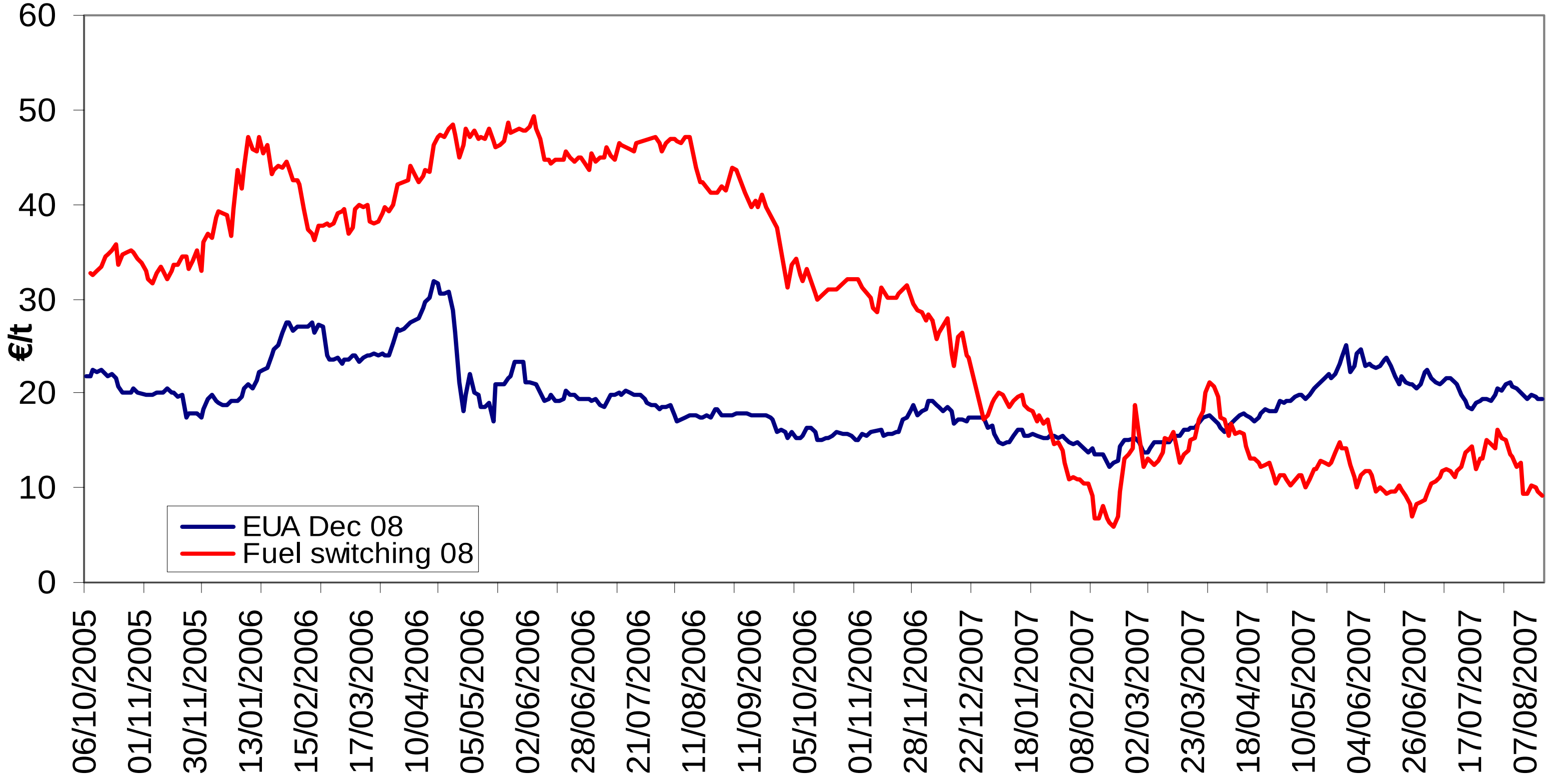
- CDM, and to a certain extent JI, has made significant progress this year with close to 100M CERs issued
- However, project types and investment needs are changing – the challenge for CDM is how to evolve to:
  - Incorporate benchmarking and simplify the process of approving projects
  - Incent the next generation of emissions reduction projects and new technology development
  - Address concerns around the 'tail' of certain projects, such as HFC

Second phase (2008 – 2012): much more complex!



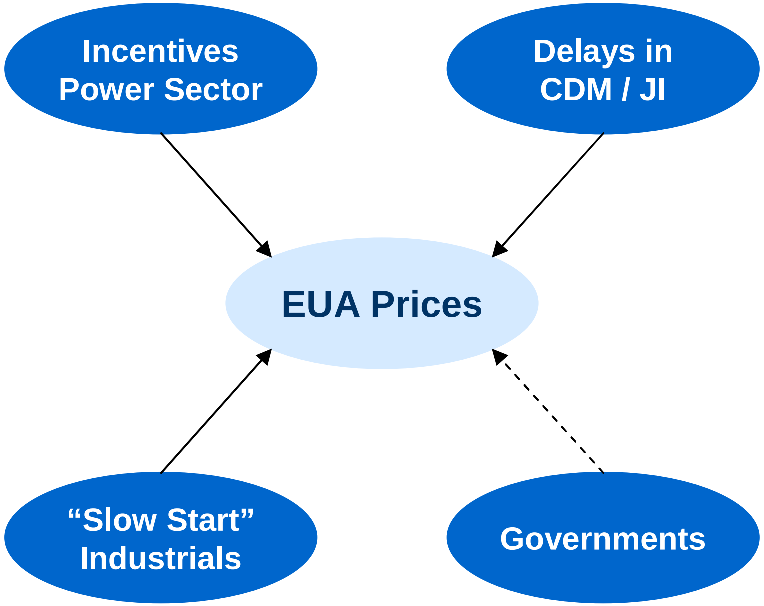
Fuel Switching Costs Came Down in the UK

Fuel Switching Costs UK in Summer 08 vs. EUA Prices Dec 08



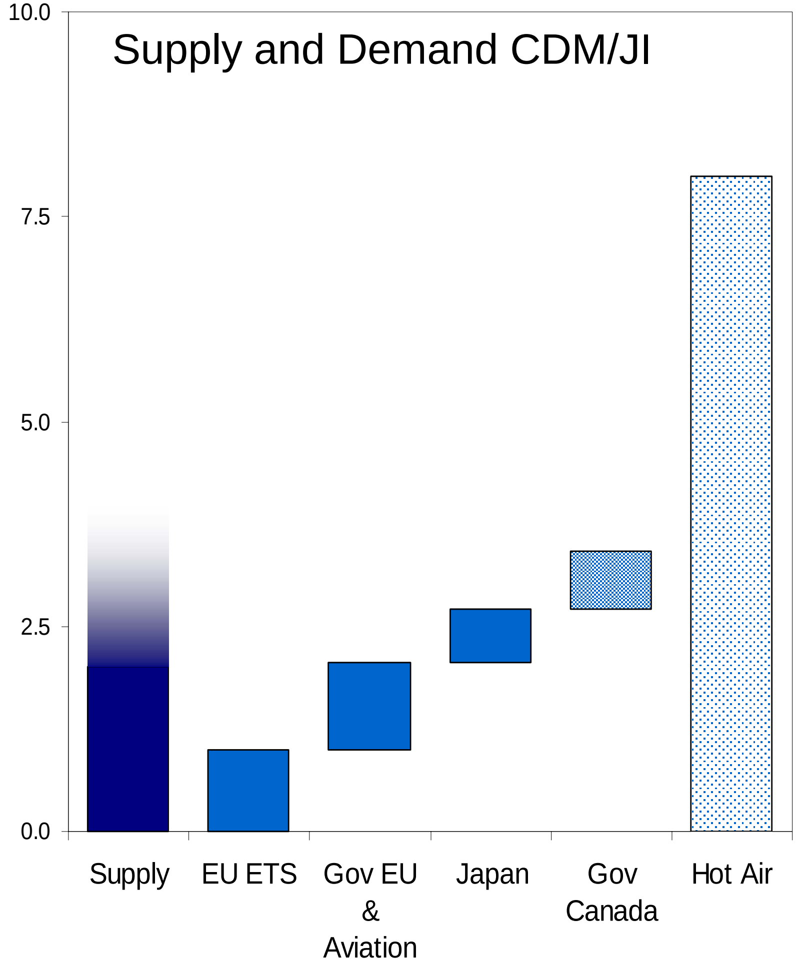
... but EUA Dec 08 prices do not seem to be very correlated to fuel switch costs!

2nd Phase Prices Might Peak by 2009 – 2010



- Industry as well as central Europe might be hesitant to sell potential long in the market in the beginning, hence they might come to the market later in Phase 2
- Over time more CERs / ERUs will come to the market as more projects mature, depending on price signal from the EU ETS
- Again depending on EUA prices, governments may have more incentives to step into GIS / IET, lowering their demand for CDM / JI
- Volatility might decrease over time as uncertainties will diminish

CDM/JI has its own pricing fundamentals…

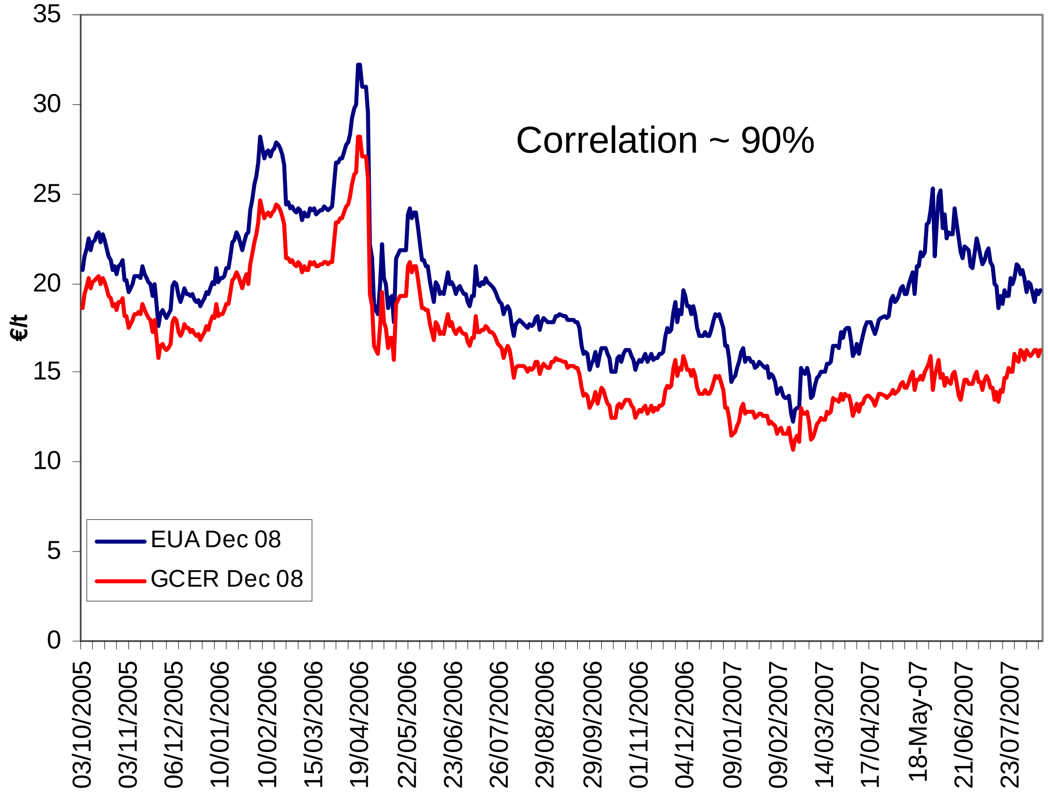


Supply and demand seem to be rather balanced, prices for CERs/ERUs are often assessed to be between 10-20 €/t

- The pipeline of CDM/JI projects will most likely under-deliver
- Canada (estimated total demand of about 0.8 Gt) has indicated it possibly will not honour its Kyoto commitment (fully)
- Japan recently re-affirmed its commitment to meeting Kyoto targets
- Inflow of so-called hot air from Russia and Ukraine is increasingly unlikely, particularly from Russia, as it positions for the post-2012 negotiations. However, if the “hot air” were to come to the market, those volumes supersede the potential demand from the Kyoto countries.

CDM/JI will have its own market mechanism but might determine prices in the EU ETS

…but is correlated to EUAs although it is more volatile…



- Historically there has been a strong correlation between CERS and EUA pricing as CERs usually traded at 75 - 85% of the EUA price.
- However, over 2007, the discount for CERs increased up to about 35% and subsequently came down to 20% again.
- As a result correlation between EUA and CER prices came down from 98% to 90%
- Another way of looking at it is that the increase in EUA prices did not result in a similar increase in the CER price
- This might be the first signs of the market reflecting the notion that EUAs and CERs are actually two separate markets although there is a strong link
- It might also reflect the feeling that the supply of CERs is bigger than the demand in the EU ETS

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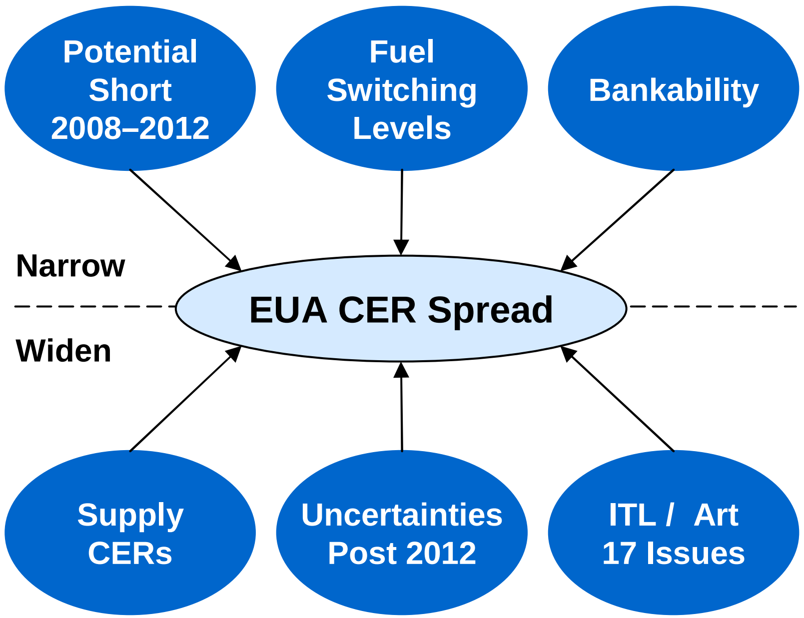
Where should the spread be, fundamentally?



Fundamentally, EUA – CER spread should narrow:

Given the fuel switching levels (summer UK) and the potential overall short in the EU ETS, one could argue that EUA prices should be similar to CER prices

- In the end, post-Kyoto might become the price driver for the second phase, similar to what happened to the first phase
- CER / ERUs may become an important instrument for banking between the two phases

However, current events are likely to result in a spread, for the time being:

The combination of uncertainty about post Kyoto and the current expected supply of CERs might force some selling of CERs

- Current ITL / Eligibility issues might keep some compliance parties out of the market

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