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UP IN SMOKE Two Carbon-Market Millionaires Take a Hit as U.N. Clamps Down

**EcoSecurities Sees
Shares Slide 70%;
'In the Gray Zone'**

By **JEFFREY BALL**
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OXFORD, England -- Marc Stuart and Pedro Moura Costa have become multimillionaires in a booming new market designed to fight global warming.

Now, their empire is under attack.



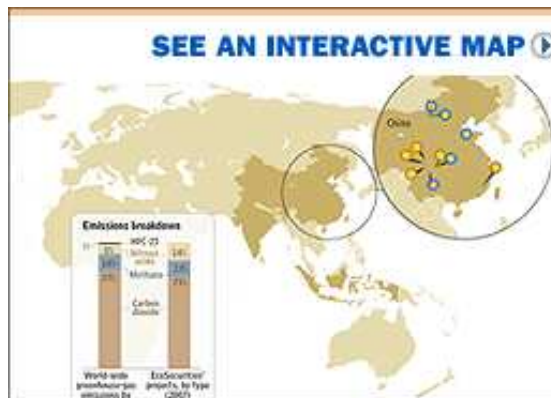
Marc Stuart

Their firm, United Kingdom-based EcoSecurities Ltd., helps companies in the industrialized world meet their obligations to pollute less by selling them "credits" that fund clean-air projects in poorer nations. Last year, some \$9.4 billion in these credits were traded, up from almost none four years earlier.

The market's anything-goes early days now appear to be ending. United Nations officials who regulate the trade have started questioning scores of proposed projects, from hydroelectric plants in China to wind farms in India. The issue: whether they provide real environmental gains, or are just padding the pockets of middlemen like EcoSecurities.

EcoSecurities' woes are a prime example of how tough it is proving to be to launch a coordinated world-wide attack on global warming. The carbon-credit industry's growing pains come just as Congress is considering similar pollution-cutting rules targeting U.S. industries.

EcoSecurities is one of the main players in an international market that was created as part of the Kyoto Protocol to combat global warming. A key premise of the system is that, because greenhouse gases damage the atmosphere no matter where they originate, society should attack them first where the cleanup is cheapest, in the developing world. But policing that far-flung market has proved to be tricky because it involves valuing a commodity, climate-warming emissions of gas, that is far less tangible than oil or gold.




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The "credits" sold by EcoSecurities and its rivals are supposed to fund clean-air projects in the developing world that otherwise wouldn't get built. But the U.N. is worried that players in the market may be gaming the system by putting a green imprimatur on some projects that would have happened anyway, defeating the intent of the U.N. program.

The tougher U.N. scrutiny is necessary to "ensure the environmental integrity of the system, because otherwise it's not achieving its purpose," says Kai-Uwe Barani Schmidt, the top administrator for the U.N. board that referees this trade.

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See a map with photos and details on some of EcoSecurities' top credit-generating projects world-wide.

EcoSecurities is one of the largest and most aggressive of a dozen or so major firms that scour the globe for projects like these, then profit by selling credits to help fund them. The main buyers are companies in Europe and Japan, whose governments have ratified the Kyoto Protocol, a global agreement imposing pollution caps on industrialized nations. Like EcoSecurities, most of the project developers are based in Europe.

That business is now in turmoil. Late last year, EcoSecurities said it would fail to deliver one-quarter of the credits it had promised. Its stock has fallen nearly 70% since that write-down -- and 80% since its peak last summer. The firm's two co-founders, Messrs. Stuart and Moura Costa, have lost about \$147 million on paper due to the stock's overall decline.

Mr. Stuart acknowledges that his firm, in its race to dominate the field, sometimes pushed the envelope. "The first couple of years, this business was a land grab," he says. But many projects, he says, didn't generate as many credits as originally estimated, leading to last year's big write-down.

The firm's approach "was very successful at first, but it did leave a bit of a mess to clean up," says Mr. Stuart, a former Ultimate Frisbee champion at the University of Pennsylvania, who holds a master's degree in environmental law and economics from the London School of Economics. He is frank about the problems the industry faces.

"I guess in some ways it's akin to subprime," says Mr. Stuart, 43 years old, referring to the subprime-debt woes rattling the U.S. economy. "You keep layering on c- until you say, 'We can't do this anymore.'"

Pushing Back

EcoSecurities has helped assemble about 10% of all developing-world projects approved so far by the U.N., more than any other player. Its main rivals include Camco International Ltd., which says it, too, has had projects delayed. Another rival, AgCert International PLC, says the tightening of U.N. rules has contributed to the company's filing for protection from creditors in Ireland, its home country.

EcoSecurities is pushing back. It notes that the vast majority of its projects ultimately get approved. And it argues the U.N. crackdown hurts the environment more than it helps, since it delays clean-air projects and cuts off a funding source. It says regulators have failed to set clear rules -- and now they're changing their standards midstream.

One thorny issue: Who should vouch for the quality of clean-air projects? EcoSecurities says the U.N. scrutiny adds bureaucracy because it duplicates work already done by independent auditors who are hired to vet all projects. The U.N. panel should stick to an "executive and supervisory role," EcoSecurities says.

U.N. officials have questioned whether the auditors have been tough enough. The concern centers on whether auditors, who are hired by project developers, are adequately staffed to police the environmental legitimacy of the swelling number of projects. The auditors strenuously defend the quality of their oversight.

While that debate rages, EcoSecurities has been busy refocusing on projects less likely to raise red flags. For instance, it is shifting to projects to curb secondary greenhouse gases, such as nitrous oxide, produced in obscure industrial processes like nylon making. The problem, as EcoSecurities executives point out, is that targeting secondary gases does nothing to combat fossil-fuel use,

which according to the U.N. is the primary man-made contributor to global warming.

The situation is "extraordinarily frustrating," Mr. Stuart says.

The trade in developing-world credits results from a provision of the Kyoto Protocol called the Clean Development Mechanism. A 10-member U.N. board vets proposed projects to ensure their environmental legitimacy. The independent auditors accredited by the U.N. act as the board's field inspectors, traveling the globe to certify whether a project is up to snuff.

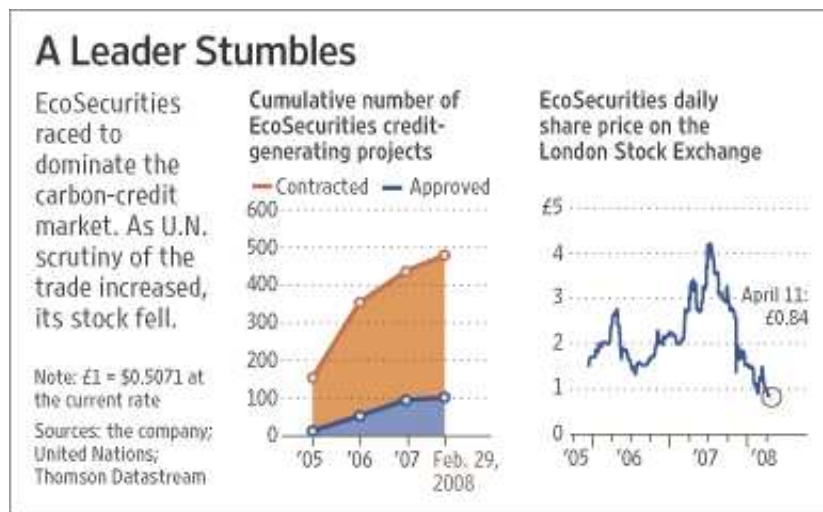
Each credit is essentially a permission slip to emit one ton of carbon dioxide into the atmosphere. Currently these credits sell for \$16 to \$24 apiece.

EcoSecurities went public in late 2005 and was an immediate market darling. Mr. Moura Costa, 44, a Brazilian forestry expert living in Oxford, recalls that by early 2006 he was telling the firm's lawyers to ink contracts for new projects at the rate of one per working day. "It was a madhouse," he says.

Permissive Board

Over the next 18 months, EcoSecurities contracted more than 200 additional projects around the world -- from Nicaragua to Inner Mongolia -- promising tens of millions of emission credits. Its stock price nearly tripled. Messrs. Stuart and Moura Costa became multimillionaires on paper.

EcoSecurities' rise coincided with a permissive U.N. board. In 2004 and 2005, the board automatically approved 95% of the projects proposed to it, according to U.N. statistics.



Mr. Schmidt of the U.N. says the board was thinly staffed at the time. By its current standards, he says, some proposals "probably went through without" proper scrutiny.

In mid-2006, there was an early hint that regulators were toughening their stance. The issue: manure.

Decomposing manure at farms emits methane, a greenhouse

gas. The projects involve placing a tarp over the manure to capture and dispose of the rising gas. EcoSecurities expected at least 10% of its credits to come from projects like these.

But in 2006 the U.N. tightened its rules, requiring animal farms to measure the amount of methane they were capturing rather than simply estimating the number based on a formula -- and use the lower number. That move slashed by more than one-third the number of credits a typical animal-waste project would produce for sale.

Suddenly, the projects no longer made economic sense, Mr. Moura Costa says. EcoSecurities canceled most of them, erasing about \$100 million in potential profit.

Still, investors remained impressed with the company, because it continued to grow. Last July,

with the stock near its peak, Mr. Stuart sold 2.2 million shares for about £8 million, or about \$16 million, and Mr. Moura Costa sold 1.3 million shares for about £5 million as part of a secondary offering, according to financial filings. The two men remain the biggest shareholders with a 20% stake between them.

Having money was a big change for the two men, Mr. Stuart says, recalling that when EcoSecurities was young he routinely charged up thousands of dollars of debt on his credit card to help keep it operating. After the stock sale, Mr. Stuart traded his 1994 Mercury Sable for a \$55,000 black Lexus hybrid sedan.

Around then, the U.N.'s crackdown started in earnest. The U.N. staff zeroed in on projects they had reason to believe might be financially viable even without revenue from the sale of credits. Last year, the U.N. board gave automatic approval to only 57% of proposed projects, down from 95% in 2004 and 2005. Overall, it rejected 9% of proposed projects last year, more than double its rejection rate in 2006.

One of the proposals blocked was an EcoSecurities project at a grain-processing plant in Uberlandia, Brazil, to replace oil-fired boilers with one using renewable energy like scrap wood. The U.N. said EcoSecurities hadn't proved that it needed revenue from selling credits to make economic sense.

EcoSecurities wasn't surprised the project got shot down: The company's own calculations showed that replacing the boilers made marginal economic sense even without the sale of credits.

The project "was in the gray zone" of the rules, Mr. Stuart says. He likens the U.N. panel to the Internal Revenue Service: "You push things as hard as you can, within what you think are reasonable guidelines. But every now and then the IRS will push you back."

Value Judgment

The U.N.'s Mr. Schmidt says it doesn't surprise him that borderline projects like these get submitted. "If I were not to expect such behavior, I would be living in the wrong world," he says. Nevertheless, he says, "I don't see this particular case as trying to cheat."

Determining whether or not a project needs carbon-credit revenue is "a value judgment," he says. "It is one of the biggest challenges" of the carbon trade.

Mr. Schmidt, who has known Messrs. Stuart and Moura Costa for more than a decade, says he respects the company. "We have a very good relationship," he says. "We also know we have certain roles to play."

U.N. officials acknowledge that calculating whether a project can be economically viable without carbon-credit revenue is subjective. For instance, the calculus can swing widely based on whether oil prices surge, or fall. Similarly, it involves guesstimates of how long a project -- whether a hydroelectric generator or methane-recapture effort -- will remain operable.

EcoSecurities has more than 100 projects approved by the U.N., and only a handful rejected. But many of its proposed projects now are being held up by the U.N. for review. That's bad news for EcoSecurities because it delays its ability to start selling credits. The company originally operated on the assumption that U.N. approvals would take two months, on average. But now they're taking an average of nine months.

Obsessed with Detail

Starting last year, the regulators were "getting more and more obsessed with detail," raising questions that weren't relevant to projects' environmental integrity, Mr. Moura Costa recalls. He and other EcoSecurities executives expressed frustration to U.N. officials. The company's message, he says: "This is ridiculous."

Last fall, concern about the U.N.'s more activist role boiled over at EcoSecurities' headquarters here in Oxford. The company uses a computer database it calls "Carbo" to monitor the rate at which its projects produce credits. As the U.N. clamped down, Carbo's "siren was going off," Mr. Stuart recalls.

In October, EcoSecurities executives gathered in the boardroom to confront a striking reality: In the space of months, the entire landscape of their industry had changed. Poring over their biggest projects, they debated how much of their business would need to be simply written off.

A big write-down "would have significant consequences to the company," Mr. Moura Costa recalls warning.

Ultimately, on Nov. 6, the company announced its write-off of 23% of the credits it had promised to deliver. Its stock fell 47% that day.

Since then, the stock has fallen further. It closed Friday on the London Stock Exchange's AIM at 84 pence, giving it a market capitalization of £94.9 million.

Last month, EcoSecurities, which has 300 employees in 30 offices world-wide, reported a widened loss for last year of €45 million on revenue of €7.2 million.

EcoSecurities' largest shareholder, other than the two founders, is banking giant Credit Suisse, which bought an approximately 9% stake last summer when the stock was near its peak. Since then, Credit Suisse has lost two-thirds of its \$60 million investment.

"We don't believe the market is valuing the stock fairly," says Paul Ezekiel, who heads Credit Suisse's carbon business and who sits on EcoSecurities' board.

Given the lack of clarity in the U.N.'s rules, it's not fair to fault EcoSecurities for trying to maximize the number of credits it produces, he says. "It's like saying the speed limit's going to be between 50 and 90. So do you drive 55 or do you drive 85?"

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