Carbon Monitor

Volume 16 Issue 1 February 2011

European Union Bans Credits from the EUETS Post 2013

Last month the EU banned certain types of credits from the EU ETS post May 2013.

The credits which arise from industrial process projects in developing countries are created in the CDM or clean development mechanism of the Kyoto Protocol.

These credits represent some 70% of the credits called CER or certified emissions reductions created under the CDM to date.

The industrial processes involve the reducing of NOx or nitrous oxide, which has a global warming potential of 320 or one tonne represents the equivalent of 320 tonnes of C02 into the atmosphere, or certain HFC or hydro fluorocarbons.

There has been some concern as to the efficacy of these credits as they are cheap to create at 10c per credit worth more than 10 euro. Creating these credits appears to be distorting how plants are operated given that their profits are substantially influenced by the number of CER created.

The EU moved to stamp this out by banning such credits.

NZETS Registrants Regret Not Considering PFSI

Forest owners registering as participants in the NZETS are finding that they have made a mistake in not registering for the PFSI.

Forest owners that have no intention of clear felling or deforesting their land are entering into the NZETS rather than take on the benefits of the PFSI.

Ollie Belton of Permanent Forests International, a progressive creator of voluntary credits sold internationally, told CM that forest owners are incorrectly opting into the NZETS, without considering the PFSI.

Once having sold NZU under the NZETS to transfer to the PFSI the owners are required to surrender NZU units, exit the NZETS, then re apply for the PFSI. Whilst they would then receive the same number of credits, this time in the form of AAU most appear unable to make the change.

CM sees this is symptomatic of bad advice given to forest owners by parties keen to gain large commissions from the sale of NZU units.

Ollie Belton, sees the intended use of the forest as a critical part of the decision of post 1989 forest owners as to whether they choose the NZETS or the PFSI. The PFSI requires permanence of the forest, and is not intended to allow clear felling, albeit selective harvesting is permissible after 50 years providing the carbon density of the site remains unaffected.

The PFSI was slow to take off in its original form as the covenant to keep the land area forest was in perpetuity. Land owners were reported as reticent to encumber the land for future generations in this way. The Government then modified the PFSI permitting selective harvest and removal of covenants on surrender of the credits previously received.

Is the NZETS Dominated by the CER Price?

The NZETS commenced in July 2010 with fossil fuel and electricity sectors required to surrender NZU units to cover 50% of their C02 emissions or pay the Government $25. Certified Emissions Reductions or CER are fungible with NZU and acceptable in the NZETS.

Sectors at risk are either exempt or have received or will receive a ‘free’ allocation of NZU units. The fishing industry has received some 685,000 NZU units. Pre 1990 forest holders will receive units as compensation for loss of land use, or some 16m NZU pre 2012. Allocation is progressing at a slower pace than anticipated. Sectors will need to monetise these credits to offset losses.

Sales of NZU in July represented owners of post 1989 forests who were holding NZU units from forest growth in 2008 and 2009. A limited percentage of the eligible post 1989 forest has registered. Forest owners are wary of registering as the risks are only just becoming widely known.

July sellers received around $17 for their NZU units. Most of these sales were driven by forest managers who took large commissions. A bank moved in as a market maker purchasing NZU in lots as small as 100 units. This was marketed as being with ‘no commission’. In our view it was simply a buy/sell with a margin, however it

Unit 10, 114 St. Georges Bay Road,
P.O. Box 9185, Newmarket, Auckland, New Zealand 1149
p: 64 9 9201092 f: 64 9 9201093 www.eitg.co.nz

did create a more transparent price point. Commentators suggest the price of NZU is capped at $25 less holding costs. Purchasing for surrender obligations in May 2011 incurs holding costs for emitters. Spot prices of NZU units increased to peak at $21.

Meantime the NZD Euro cross rate has improved to around 0.58. European confidence in CER from projects in developing countries has waivered. This has driven fluctuations in the price of CER units in the EUETS. In December 2010 combining these factors resulted in the price of a CER being less than the spot NZU. Emitters started purchasing CER instead of NZU units. The spot NZU slipped to around $19.

The NZU price is now capped by the price of a CER instead of the Government cap of $25. NZ compliance buyers are driven by price initially, being the cost of a compliance unit plus holding costs. CER delivery can be timed with next round of delivery in March 2011. This reduces holding costs. The CER market is significantly more liquid than the NZETS. This offers emitters the opportunity to hedge and provides a clearer exit opportunity. CER units are not constrained by the NZ Government limits on selling of NZUs. Coupled with transaction costs, the underlying credit in NZU often being forestry, and the reality that the CER is the denominating currency of the internationally traded market, given price parity with an NZU what option would a prudent buyer take?

What will happen long term? The NZETS review effective 2013 is expected to remove the price cap of $25 and require one unit surrendered for every tonne of C02 emitted. CER's from industrial projects have been ruled unacceptable in the EUETS post may 2013 and may also be excluded from the NZETS. Otherwise there will be millions of CER's post 2012 with the only market the NZETS. China's floor of 9 Euro on a CER would drive the price of a CER and therefore compliance in the NZETS to 9 Euro or $15.51NZD.

Recently Barclays downgraded CER from 14.50 to 13.50 Euro. Point Carbon forecast 15.60 in 2011 rising to 18.40 Euro in 2012. At the current exchange rate Barclays suggest a CER of $23 NZD, and Point Carbon $26.90 NZD. Both of these projections significantly exceed the current NZU price and the latter exceeds the New Zealand Government cap of $25.

Is the phenomenon of the NZETS dominated by the CER price temporary? If the European projections prove correct the answer is yes.

Commentary

For the NZETS to survive and not be swamped with industrial process CER units which have been recently outlawed in the EU post may 2013 the New Zealand Government has to consider making those same units unacceptable to the NZETS at the same time.

CM view is this is an important component of the review of the NZETS currently underway.

Given CER units are issued annually we expect little effect of the dumping of CER from these projects pre May 2013 as other sellers will compensate by holding CER which they see as gaining value.

Immediately post the EU announcement on the 21st January 2012 secondary CER jumped 90 cents from Euro 10.85 to Euro 11.75. The spread an important indicator of the relative value jumped to Euro 1.15 with December 2012 at 10.85 and December 2013 12 Euro.

The pressure to keep these credits from New Zealand lobby groups such as the farming community will be significant as they represent some 70% of the CER units issued to date.

NZETS Review 2011

The NZETS review scheduled to be completed by 30th June 2011 has been announced.

Accordingly Buddle Findlay Legal Update the review reflects the matters set out in section 160(5) of the Climate Change Response Act (CCRA), although the focus is to be on the high-level design of the NZ ETS. In particular:

- Issues to do with design settings arising from international frameworks post-2012
- Whether the scaling up of obligations (from 50% to 100% post-2012) and the inclusion of other sectors (namely agriculture) should occur as currently legislated considering issues of economic competitiveness
- The inclusion of synthetic greenhouse gases, in light of alternative approaches to reducing such emissions.

Interestingly, the Terms of Reference also stipulate several matters which the panel should not focus on. These matters include:

- Whether an ETS is the most appropriate response to climate change for New Zealand
- Whether New Zealand should be taking action on climate change
- Climate change measures outside the ETS.

The CCRA gives the Minister wide discretion to set the scope of review and these matters could have been included. Consequently, the exclusion of these matters and the focus on high-level design is further evidence that the government is committed to the NZ ETS over the long-term and does not intend to re-litigate its policy basis.

In accordance with the CCRA, the Panel will consult with stakeholders. While the CCRA does not require the Panel to take submissions, the Terms of Reference direct them to call for written submissions on issues within the scope of the review. Given the tight timeframe to complete the review (30 June 2011), it seems unlikely that the Panel will call for oral submissions.

The recently appointed panel members bring a range of experience. The appointment of former Labour Minister of Finance David Caygill as the chairperson may indicate the government's desire not to politicise the Panel. The other members all possess technical expertise, and include Julia Hoare, PricewaterhouseCoopers specialist in carbon markets; Tom Lambie, the Chancellor of Lincoln University and farmer; David Russell, former chief executive of the Consumers Institute; and Geoff Thompson, a lawyer and consultant at Duncan Cotterill, with specialist knowledge of forestry aspects of the NZ ETS.

Given the final report is due to the Minister by 30 June 2011 the report will be in the public domain before the next general election. Accordingly, the report can be expected to influence government policy leading into the election and possibly other political party manifestos.

Contact alastair.cameron@buddlefindlay.com

EU Carbon Credit Theft Closes Spot Market

The theft of EUA or European Allowances in the European Emissions trading scheme was announced mid January. Czech holders reported some 1.3m EUA stolen and Austria some 500,000.

This is the second such ‘theft’ of EUA the first being a break in to electronic account controls and the unauthorised transfer of EUA to another holding account.

The reaction has been swift and the EU shut down spot trading and transfers of EUA immediately. The futures market, the predominant market remained operational as the trades are physically settled via transfers only once a year.

A systematic search of registries should have quickly identified where the ‘stolen’ EUA were residing, permitting their return and casting suspicion on the owners of the holding account where the credits were found. Surprisingly Holcim, the target of the first EUA theft, is still reporting serial numbers of stolen EUA that have yet to be recovered on its web site.

Unlike New Zealand the EUETS is comprised of a range of separate country related registries rather than one central register. Commentators suggest a proposed move to single EU registry post 2012 will assist in dealing with threats. At the same time it is expected security will be tightened, noting the perception it is currently lax. Some tens of thousands of Euro need to be spent to create the security against millions of Euro in the theft.

The NZEUR or emissions units register is electronic. All units hold a serial number which indicates country of origin plus unique serial numbers.

Such a theft in New Zealand or any other UN approved registry under the Kyoto Protocol could be dealt with swiftly by the authorities.

Suspending transfers of such credits had the effect of protecting potentially innocent parties becoming the recipient of stolen credits.

As such electronic registries offer substantial owner protection.

However the current practice in the NZETS of transferring credits reliant on delayed payment still begs the question of payment risk.

So called T+3 or T+5 payment terms are concepts from exchange based trading. Typically exchange trades do not have settlement risk. Selling shares on the NZX for instance is settlement T+3 (days) for delivery and payment. Brokers guarantee settlement both in delivery of the stock and payment.

Adopting these same practices in the NZETS creates risk for sellers as there is no broker settlement guarantee.

Some parties discount the risk as buyers are ‘of substance’. No one would argue that for instance Westpac bank would not honour their purchase agreement. However there is no regulator in place to enforce payment.

EITG believes there is a strong basis in the sense of payment certainty for exchange trading of NZU and allied units. Given some off shore trades are T + 15 this emphasises even more the risk relating to payment.

Why people are taking this risk raises the question whether or not they see the NZETS as just some

windfall lolly scramble? They certainly are not looking at the risk of loss of payment in the context of the obligation to surrender credits. Such an obligation would remain even if there was non payment.

EITG Point Carbon Reuters Guest Commentator

EITG Director Richard Hayes was guest carbon commentator in the January Carbon Market Report.

The report can be downloaded at http://www.pointcarbon.com/news/cmnanz/1.1500629

Carbon Market Participants Survey

Ecosystem Marketplace announced an open call last week for participation in the *State of the Voluntary Carbon Markets* and *State of the Forest Carbon Markets 2011* reports.

If you have bought or sold in the voluntary or forest carbon markets, report basic transaction data until Feb. 14 here: http://www.ecosystemmarketplace.com/pages/static/survey_2011.php.

Contact Details

Terry Quilty	ph 64 21 250 6789 fax 64 9 920 1093 skype terryquilty email terry.quilty@eitg.co.nz
Richard Hayes	ph 64 9 920 1092 m: 64 21 310 301 fax 64 9 920 1093 skype richardshayes email richard.hayes@eitg.co.nz
Simon Baillieu	ph 27 82 558 9616 skype sbaillieu email simon.baillieu@eitg.co.nz
Martin Albrecht	ph 64 21 565 682 martin.albrecht@eitg.co.nz skype goodground
Iain MacDonald	ph 64 27 438 2544 iain.macdonald@eitg.co.nz

'Carbon Monitor' is a client service of EITG.
EITG develops, facilitates and engineers Carbon Mitigation projects and strategies.

EITG corporate advisory provides high-level briefings and advice on building robust responses to emerging regulatory structures.

EITG Carbon Pool provides forest owners with a robust platform to access local and international markets while dealing with harvest and other liabilities.

EITG provides trading platforms and strategies based on extensive mitigation and avoidance platforms under JI and CDM, with matched offset packages for emitters.

EITG is part of an international consortium with representation in Asia/Pacific, UK, Europe, USA and South Africa

To subscribe email subscribe@eitg.co.nz with your full contact details.

Let your thoughts be known at www.ghgemissionstrading.wordpress.com

This blog is designed to discuss all aspects of emissions trading and GHG as well as the Kyoto Protocol

Join twitter for updates from EITG www.twitter.com/eitg

www.eitg.co.nz