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NZ market falls under CER spell, as offset imports rise

Unlimited access to UN offsets in the NZ emissions trading scheme means the value of UN certified emission reductions (CERs), and possibly EU economic growth, will be the driving force behind the price of carbon in New Zealand.
When the New Zealand government redesigned its emissions trading scheme in 2009, the National party gave emitters the option of trading carbon on the global market or paying the government NZ$25 per carbon permit, known as New Zealand units (NZUs), to cover half of the carbon dioxide they emitted.
The intention was to keep the scheme costs low enough to ensure industry remained competitive and softening the regulation's impact on consumers, but high enough to incentivise emission reductions in the country's forestry sector.
But a downturn in the price for UN-backed CERs, largely due to increased supply and an economic recession in many European countries – has put the price of NZUs under pressure, making it cheaper for companies to meet government targets.
"The NZU price is now capped by the price of a CER instead of the NZ$25 government cap," Richard Hayes, director of New Zealand carbon traders EITG, writes in this issue of Carbon Market Australia-New Zealand (see page 6).
Record CER issuance levels seen so far this year have seen offset prices fall 18 per cent in four months, leaving the December 2011 CER contract on ICE Futures Europe, the world's biggest carbon exchange, at just €10.92 (NZ$19.43) versus €13.27 in September.
This has put pressure on New **Continued on page 2**

Australia gears up for fresh attempt at CO2 scheme

Australia is likely to opt for a fixed CO2 price before opening up to an emissions trading scheme with a floating price, according to observers.
The government hopes to introduce a bill to parliament by mid-2011 that would set a price on Australian carbon emissions for the first time.
Climate Change Minister Greg Combet remains tight-lipped over whether he wants to see an outright emissions trading scheme (ETS), a carbon tax or a hybrid model.
But observers expect the Labor government to propose an ETS that would start out with a fixed price.
"The government seems to be testing the proposition that it may implement an ETS with a short-term fixed price moving to a longer-term floating price," said Martijn Wilder, global head of environmental markets and climate change

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Market comment

The spot NZU contract was valued at NZ$19.30 on 27 January, up 1.05 per cent or 20 cents week-on-week, but down 80 cents from 16 December.
Since mid-December the New Zealand permits have been continually pressed down by weaker CERs in the European market, but the price for the UN credits has increased in the EU market this week.
In New Zealand, the March 2012 CER contract traded on 27 January at NZ$20.60, up from NZ$19.90 seven days earlier.
The UN-issued credits rose 3 per cent in Europe the past week as a shutdown of the spot market took a number of natural EUA sellers out of the market.
The EU decided to close all member state carbon registries after cyber criminals stole 1.8 million EUAs from the Austrian and Czech registries.
But earlier in January record issuances of CERs by the UN's CDM executive board had forced the credits down to below €11. By 26 January the board had issued more than 40 million CERs that month.
"CERs continue to pressure NZUs but the difference is now over NZ$1, so demand (for NZUs) is starting to come in," said Nigel Brunel, a broker with OM Financial.
Many domestic NZU sellers still prefer to hold on to their permits in the hope that they will climb above NZ$20 again, Brunel said.
Market participants estimated in excess of 700,000 NZUs had traded in since the beginning of the month, as market volumes were hit early on in January with a number of traders off their desks on holiday.
NZ carbon traders are focused on the March 2012 CER contract, as those would be delivered in time for the May true-up date to cover 2011 emissions.
With the forward CER contract now trading at NZ$20.60, spot NZUs are currently overpriced, according to Brunel.
Applying the cost-of-carry, spot NZUs should trade at around €19 to compete with the March 2012 CER, he said.

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Zealand carbon prices, with spot NZUs closed Thursday at NZ$19.30, nearly NZ$2 below their loftiest levels seen in November.
But buying CERs may be a better proposition for some companies, as Hayes pointed out that CERs hold a number of advantages to NZ units.
CERs can be used in either the EU emissions trading scheme or the NZ market, while non-forestry NZ units can only be used domestically in New Zealand, meaning liquidity in the UN offset is far greater than in NZ carbon.
The price of the two credits are also set by different factors – the NZ units are normally priced by a simple calculation of the government NZ$25 cap minus the holding costs, also known as the cost of carry, which is the opportunity cost of investing that money elsewhere.
Meanwhile, the price of CERs is largely dominated by the price of European carbon permits, which have halved in the past two years and have so far been set by the price of switching from burning coal to make electricity to cleaner natural gas.
"CERs and the price cap are the price drivers, that's it. New Zealand does not have the same coal-to-gas switch capacity as the EU market," said Stuart Frazer with consultancy Frazer Lindstrom.
Under current legislation, events in the European market will only continue to dominate the New Zealand carbon price as long as CER prices are below the NZ$25 cap.
Price dynamics, however, could be set to change as a full review of the NZ ETS will get underway this year, with a view to removing the domestic price cap in 2013.
Frazer expected, however, that the government would opt to continue with the current set-up beyond that year.
"The price control mechanisms are probably here to stay a bit longer. There is a concern that Brussels bureaucrats might decide to implement restrictions (on CER use), which they already have done, that would push up the CER price, and then we suddenly have a high-price scheme," he said.
"NZU prices are relatively low now. But if you go back two years, EUAs were trading at €31 with CERs tracking just below and the oil price was high. Those price levels would be unsustainable for the New Zealand economy."

For full story, see www.pointcarbon.com/news

Australia gears up for fresh attempt at CO2 scheme (cont.)

at law firm Baker & McKenzie.

This view was backed by fellow lawyer Anthony Hobley, global head of climate change and carbon at Norton Rose Australia:

"They could go for a fixed price for a period of time first in order to avoid the tax debate, but I expect that they ultimately will switch to an ETS," he told Point Carbon News on 25 January.

But while details are yet to emerge, Wilder dismissed speculation that Prime Minister Julia Gillard's government might opt for a scheme that only covered the electricity sector in the initial stages.

"I would be very surprised if ultimately a scheme was limited to the electricity sector only. I think there is a recognition that it needs to be more than that," he said.

Former Prime Minister Kevin Rudd failed to pass the carbon pollution reduction scheme (CPRS) in 2009, but observers reckon the current administration has a better chance to pass climate legislation despite strong resistance from the opposition coalition.

During the CPRS debate the Labor government was accused of watering down the scheme to appease the coalition.

This time the government is seeking a different approach, having learned a lesson from the way the CPRS debate developed in 2009, according to Hobley.

"At the moment they are quite rightly trying to manage the debate by focusing on the need for a price on carbon rather than the precise mechanics of how it will be implemented," Hobley said.

"They want to win the argument on having a price on carbon before they get entrenched in the details."

The Greens, which will hold the balance of power in the Senate from 1 July, voted against the CPRS in 2009, but are now on board with the government and working on the details of the scheme with three independent senators.

The Green party wants a tax rather than a trading scheme, but believes the scheme's target is more important than design, and wants the government to raise its current target to cut emissions 5 per cent below 2000 levels by 2020.

"Once (the government) has reached a decision on a model the challenge will be securing the necessary support of the Greens and the independents to pass it, which is not a simple task." said Baker & McKenzie's Wilder.

"There is an expectation the government will deliver real measures that deliver emission reductions and expectation that is probably more along the lines of a 10 per cent target."

Despite expecting a two-tiered process towards a carbon market, Hobley anticipates that the government will seek to legislate for the period after the fixed carbon price is removed.

"I think they will try to lock it all in at once, but some are concerned that this will also lock in a fairly low price in the early years," the Norton Rose lawyer said.

Wilder warned that setting the fixed price too low would jeopardise investments in the Carbon Farming Initiative (CFI), an offset mechanism being prepared for the agriculture and forestry sectors.

"Unless that short term price is sufficient it is unlikely investment in CFI measures will occur," he said.

"Early trades under the CPRS began at A$25 and any initial fixed carbon price will need to be at that level or above – a cost possibly tempered by the inclusion of CERs and other units such as possibly NZUs."

Hobley reckons Australia will be ready to start its emissions trading scheme on 1 July 2013 if it can successfully manoeuvre the obstacles ahead.

The government's first steps begin on 3 February, when adviser Ross Garnaut will present the first of eight government-commissioned papers on climate policy, an update of his 2008 climate change review used by the Rudd government.

It is unclear how the recent devastating floods in Queensland will affect the debate.

Some observers say that if Australians link the floods to climate change this would reinforce calls on the government to act by passing ambitious climate legislation.

However, others note that the massive costs incurred by the floods could be used as an argument that Australia cannot afford to put a price on carbon.

"The government is under a lot of pressure, they know they must deliver. I think the next six months will be a very critical time," Wilder told Point Carbon News.

NZ carbon trader agrees terms on 2.5 million credits

Trading firm CO2 New Zealand has agreed terms on the sale of 2.5 million carbon credits, it announced on 23 December.

Australian environmental services provider CO2 Group, which owns CO2 New Zealand, did not disclose where the New Zealand Units (NZUs) had been sourced, or who is line to buy the credits.

The transaction is by far the largest announced since the NZ emissions trading was launched, and single-handedly represented more than a quarter of the some 950,000 NZUs that traded in 2010, according to data collected by Point Carbon News.

At the time of the transaction CO2 Group said that spot NZU prices have fluctuated between NZ$17 and NZ$21, valuing its portfolio in the range of NZ$42.5 million and NZ$52.5 million.

CO2 Group has previously announced a number of tree-planting projects in Australia, with the credits generated targeting the Australian voluntary market as well as the international market under the UN's clean development mechanism (CDM).

New Zealand net exporter of carbon credits

New Zealand last year remained a net exporter of carbon credits under the Kyoto protocol, according to data released this month in the government's Emissions Unit Register.

The data showed that nearly 720,000 assigned amount units (AAUs) – the governmental carbon credits under Kyoto – were shipped overseas in 2010. A further 447,000 AAUs were converted to emissions reduction units (ERUs) and sold abroad by companies hosting joint implementation (JI) projects or by foresters taking advantage of the NZ ETS rule allowing them to sell their credits to overseas buyers.

With AAUs and ERUs changing hands in the international carbon markets at around €7-10, the deals would have been worth up to NZ$20.7 million for New Zealand sellers.

The data showed a continuation of the trend starting in 2009, when New Zealand sold 1.14 million credits abroad, the total amount shared in equal proportions by AAUs and ERUs.

The New Zealand government will use AAUs to comply with its target under the Kyoto protocol, which binds the country to limit its emissions to 61.9 million tonnes of CO2 equivalent per year in the 2008-2012 period, the same level as in 1990.

In 2008 New Zealand emitted 75.1 million tonnes, but after deducting emissions from land use, land use change and forestry, the number stood at 48.9 million tonnes.

Meanwhile, the registry data also showed NZ companies last year bought 640,000 certified emissions reductions (CERs) and ERUs from foreign sellers – "presumably by NZ ETS participants able to use units for NZ ETS compliance purposes", lawfirm Buddle Findlay said in an emailed update.

The government last year allocated 2.9 million New Zealand units (NZUs) to fisheries, forest-owners and emissions-intensive industries, while a further 4.6 million were transferred for entitlements, the data showed.

Unwanted CERs tipped for China, not NZ

China is likely to use certified emissions reductions (CERs) ruled ineligible in the EU to meet its own 2020 goals, observers say.

The EU on 21 January banned CERs from HFC 23 destruction projects, a big money spinner for China, for use in the third phase of its cap-and trade scheme, which runs from 2013 through 2020.

But while the credits may be banned from the EU, some participants say China could use the offsets to count towards its own 2020 target rather than going to alternative markets, such as Japan or New Zealand, the latter often mentioned as a potential future destination for the CERs.

"Theoretically it is possible to sell the credits from the industrial gas projects to buyers in other carbon markets," said Chen Huan, director of the government-owned China CDM Fund.

"But in practice I am afraid it will be very difficult since the EU's decision will set a market trend and may cause oth-

ers to follow," he said, adding that the UN-endorsed HFC projects can count towards China's target if they are not sold as offsets under the clean development mechanism (CDM).

China has been the largest seller of the industrial gas offset credits, generating around 40 million CERs a year, with EU ETS companies by far the largest buyers.

China has pledged to reduce the carbon intensity of its economy by 40-45 per cent under 2005 levels by 2020.

Analysts are reluctant to quantify what the target could mean in terms of absolute cuts in tonnes of carbon dioxide equivalent (CO2e), as the goal depends on how China's economy performs over the next decade.

But 40 million tonnes a year of CO2e available from HFC projects already up and running would be "quite a significant part", according to Jusen Asuka, director of the Institute for Global Environmental Strategies in Japan.

The cuts would come cheap – at $2-3 (€1.5-2.2) per tonne of CO2e – and would be a welcome contribution to Beijing's efforts as the central government is struggling to inspire local administrations to take on province-level ambitions.

"They (China) will surely be using this for their own target," said one Beijing-based trader with a European firm who requested anonymity. "They will never admit it, but this is cheap, cheap abatement," he said.

New Zealand has been flagged as one possible alternative market ineligible CERs, since the country has no limitations on credit use.

However, market participants doubted the relatively small market would end up purchasing the controversial credits.

"No one is going to buy those on a forward basis here now, there's no interest," Nigel Brunel, a broker with OM Financial told Point Carbon News.

New Zealand will carry out a review of its cap-and-trade scheme by the end of this year, and market participants have been careful about taking future positions, pending any rule changes to the system.

Forty million CERs a year from China would dramatically push down New Zealand carbon prices because the volume represents more than the total emissions of all the entities covered by the country's scheme.

"If someone tries to use New Zealand as a dumping ground for such credits, I think the government would turn around and ban them," said Brunel.

Japan, the world's largest buyer of assigned amount units (AAUs) under the Kyoto protocol, has been mentioned as another potential home for the credits.

Japanese companies will likely only have voluntary domestic targets with no quality restrictions on offsets, following plans to delay the proposed start of the country's mandatory carbon trading scheme.

"I think Japanese companies won't hesitate to use HFC CERs even if the EU puts restrictions on them," said one Tokyo-based trader who wished to remain anonymous.

"If HFC (CERs) are sold at the same price as AAUs, there would be some opportunity to buy," he said.

The question is if there would be sufficient demand.

Despite some being fairly active in the AAU market, most Japanese companies have pulled back from the carbon market having bought all they need to meet targets.

The economy is still reeling after the global economic crisis in 2008, which has kept a lid on domestic emissions as industrial output declined.

"I think there might be some demand in Q1 2013, as companies must make final adjustments regarding their 2012 emissions, but not very big," the trader said.

EU market shaken by cybertheft

The European carbon market was shook on 19 January, when reports emerged of thefts of EU allowances from member states' registries.

Some 1.3 million EUAs were stolen from the Czech registry, a further 500,000 from Austria.

The scandal came on the back of a similar episode in December, when criminals stole 1.6 million EUAs from cement company Holcim's account in the Romanian registry.

The EU proceeded to shut down all 27 member states' registries in an attempt to ensure further market disruption. European countries are currently working to upgrade the security levels, but around half of EU registries are expected to remain offline for at least another week.

The shutdown means the European spot carbon market is shut temporarily.

Spot trading only represents 10 per cent of market volume, but is preferred by many natural sellers of EUAs, and their absence contributed to pushing the December 2011 EUA price up by 3.74 per cent to €14.97 the first five trading sessions without spot supply.

Will the CER domination of the NZ carbon price last?

By Richard Hayes, Director, Environmental Intermediaries and Trading Group

The NZ emissions trading scheme (ETS) commenced in July 2010 with fossil fuel and electricity sectors required to surrender NZU units to cover 50 per cent of their CO2 emissions or pay the government NZ$25 per tonne. UN-issued certified emissions reductions (CERs) are fungible with NZUs and eligible for compliance in the NZ ETS.
Sellers of NZUs in July were mostly owners of post-1989 forests who were holding NZUs from forest growth in 2008 and 2009. Only a limited percentage of post-1989 forest-owners eligible to participate in the ETS has registered, as they are wary about the risks of the scheme, which are only just becoming widely known.
In July, sellers received around NZ$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 NZUs in lots as small as 100 units. This was marketed as being with 'no commission', although in our view it was simply a buy/sell with a margin-However, it did create a more transparent price point.
Commentators suggest the price of NZUs is capped at NZ$25 minus the holding cost. Purchasing for surrender obligations in May 2011 incurs holding costs for emitters. The NZU spot price increased to peak at NZ$21 in late 2010.
Meanwhile the NZD-euro cross rate improved to around 0.58 while European confidence in CERs from projects in developing countries waivered. This drove fluctuations in the price of CER units in the European market.
In December, a combination of these factors resulted in the price of a CER dropping below the spot NZU. Domestic emitters started purchasing CERs instead of NZU units, and the spot NZU price slipped to around NZ$19. The NZU price is now capped by the price of a CER instead of the NZ$25 government cap. NZ compliance buyers were initially driven by the domestic price, estimated as being the cost of a compliance unit plus holding costs. But CERs can be purchased on a forward basis, with delivery in March 2011 – still in good time for the May compliance deadline – which reduces holding costs. And as the CER market is significantly more liquid than the NZ ETS, emitters are offered the opportunity to hedge and provided with a clearer exit opportunity.
The New Zealand government has imposed restrictions on selling NZUs abroad for non-forestry sectors. However, these restrictions do not apply to CERs. Add the facts that CER transaction costs are lower and that the UN credits are the denominating currency of the international carbon market, what option would a prudent buyer take given price parity between the two carbon credits?
In the short term the current situation could threaten the emergence of the NZ ETS into a fully functional market, as we would expect that the scheme will be dominated by CERs once buyers understand their extensive benefits over the NZU.
But what will happen long term? We see three predominant factors:
- The NZ ETS review is expected to remove the NZ$25 price cap and require that one unit is surrendered for every tonne of CO2 emitted;
- CERs from industrial gas projects have been ruled unacceptable in the EU ETS from May 2013 and may also be excluded from the NZ ETS. If not there will be millions of CERs issued after that with New Zealand their only possible market destination;
- CER pricing. Barclay's has downgraded 2011 CER price estimates from €14.50 to €13.50, while Point Carbon forecasts a price of €15.60 in 2011 rising to €18.40 in 2012. At an exchange rate of 0.58, Barclay's suggest a CER price of NZ$23, Point Carbon NZ$26.90. Both projections significantly exceed the current NZU price and the latter exceeds the New Zealand government NZ$25 cap.
Is the CER domination of the New Zealand scheme temporary? If the European projections prove correct, the answer is yes.

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