Carbon Monitor

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NZETS – Is there an Arbitrage Opportunity for Post 1989 Forest Owners?

Those that have sold NZU units from post 1989 forestry have a liability to surrender units in the event of a loss such as fire or at harvest.

This risk or so it was perceived ultimately has limited post 1989 forest owners entering the NZETS – on the basis the Government offered to guarantee to cover the carbon liability to those who did not opt in. Carbon Monitor has commented on this in past issues suggesting forest owners should opt in and retain the credits. This of course has been muddied somewhat by the Field Measurement requirements for forests over a certain area. This activity would introduce cost where in the event the foresters were simply retaining credits in 'their bottom drawer' there was no income.

Since the inception of the NZETS forest credits peaked around $23NZD for an NZU in early 2011. Arbitrage was created from fluctuations in NZD terms for CER credits. Emitters were reportedly swapping in and out of CER back to NZU picking up a tidy profit.

Recently we reported our 'silly fool' arbitraging his position and buying back NZU (or the CER equivalent) at some $13NZD and pocketing a nice sum whilst covering his harvest and other potential liabilities.

Now with the price of an NZU around $7 it seems there is a strong argument to do the same and purchase CER around $6 NZD for those post 1989 forest owners who have sold their credits previously.

Commentators have raised this as an issue to consider and no doubt stimulate some activity in the market. Taking a clear profit and covering absolutely a liability appears to make sense. However the type of CER one might purchase is now critical - see the following article.

People have commented – but how do we make sure the CER are acceptable and will work to cover the liability? One option may be to exit the NZETS entirely and surrender the CER?

The European Union Acts to Shore up Carbon Prices

In a move designed to shore up sagging carbon markets, with both EUA and CER at their Phase II lows (phase II 2008-2012), the EU announced that it would withhold permits from the market adding that the expected EUA price would be around 30 Euro.

On the 20th December 2011 European MEP added weight to this voting by a narrow margin to withhold some 1.4bn EUA from the auction markets. Point carbon tweeted @pointcarbonnews that a further vote may dilute the wording to 'substantial volumes' rather than an absolute target.

Since early 2011 EUA and CER prices have fallen from around 15 Euro to 5-6 Euro. On top this is Deutsche Bank was reported as stating with the current economic downturn the existing EU target of 20% by 2020 would be met without the need to purchase CER units.

Point Carbon also tweeted that there is a solid prospect of a vote on a 30% target.

Both these factors will have an interesting effect on the forward pricing of CER in particular. Many brokerage houses have been caught 'long' in carbon with some rumoured to be attributing recent losses to their positions in the carbon market. Part of the rapid drop in price can be attributed to those with long positions being automatically sold out of the market by stop loss orders.

Pricescarbon @pricescarbon indicated an increase in EUA to Euro 8.81 or around 20% in response to the announcements

Industrial Process CER Banned in NZETS

The New Zealand Government announced that effective 23rd December 2011 CERs from HFC-23 and N2O industrial gas destruction projects will be banned from use in the NZ Emissions Trading Scheme.

Certified emissions reductions or CER are produced when a project that reduces GHG emissions that otherwise would not take place is undertaken in a developing country under the so called Clean Development Mechanism (CDM) of the Kyoto Protocol. Projects such as the industrial gas initiatives have been subject to significant criticism based on allegations that CER created are low cost (0.10 Euro) and that plants are being operated to produce CER and not the intended product in effect 'gaming' the CDM and creating credits that lack environmental integrity.

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Forward contracts concluded prior to the 23rd December will be exempt from the ban until June 2013, and where such units are already held in a participant's NZEUR account, these units may also be used.

To be eligible for the exemption a participant must provide a copy of the forward contract and sign a statutory declaration by the **10th February 2012.**

While the headline appears to indicate that all projects from N2O destruction will be banned, the FAQs in the announcement state more specifically that CERs from the following will be covered under the ban:

- The destruction of HFC-23 (under approved methodology AM0001); and
- The destruction of N2O resulting from the production of adipic acid (under approved methodology AM0021).

An ETS Amendment Bill is also planned for 2012 and this is expected to address offsetting for pre-90 land and other issues from the ETS Review Panel's report. It is not yet clear whether or not that could extend to consideration of a general supplementarity limit, or whether this is off the table entirely as a policy option.

So why did the New Zealand Government ban industrial process CER? Simply the EU has outlawed these credits in the EUETS effective end of 2012. Some 64% of all CER issued to date have come from these type of projects and this has increased to some 82% recently in the face of the EU ban as companies rush to produce CER. Such CER if admitted to the ETS would quickly drive down the price due to the volume available and the lack of a suplementarity limit as there is in the EUETS and the AUETS (50%)

Simply put emitters in the NZETS could have and we suspect would have purchased very cheap CER for all their compliance. The scheme as it stands does not require an emitter to purchase any NZU to meet their compliance targets.

So now with the limits in place will the price of an NZU increase? Carbon Match www.carbonmatch.co.nz are showing a premium for NZU. However there remains significant uncertainty in the EU market and this has lately driven down the price of a CER. So cheap CER from projects other than those banned appear to remain available and rumours suggest that emitters have 'stocked up' on cheap CER already.

Will the Australian Carbon Price tank at the Commencement of Trading in 2015?

Spot CERs were quoted at EUR 3.81 in January 2012.

The Australian carbon tax will commence at AUD $23 (approx EUR 15.00) in July 2012, rising at a marginal fixed percentage for the next three years, until 2015 when full trade commences. Up to 50% of Australian liabilities can be covered through CERs and other international offsets. So given the prevailing spot CER price will the Australian spot price crash severely to match the CER price?

It won't as the price floor of $15 AUD will prevent that. Companies will still be able to meet 50% of their obligations with international instruments such as CER. However they will be liable to pay the Australian Government the difference between the purchase price and the floor price. There is a discussion paper out at present on exactly how this may be implemented.

The other issue is what will the international price for carbon in 2015? From reading reports from Barclays Capital it appears the price today is a consequence of oversupply emerging from two elements, the rush to issue industrial gas CER prior to the post 2012 EU ban and the NER 300 auctions of EUA by the EIB that resulted in the market going from long to short. The CDM pipeline from UN RISO suggests much less in the line of CER from post 2012 and the supply/demand situation in 2015 is far from clear.

Is the EUETS a Success or Failure?

Barclays and other analysts are praising the market saying it is working and suggesting the price drop is a function of oversupply. They argue an oversupplied market will see the price dropping.

That may be true, but what about the intent that created the market in the first place?

Phase I of the EUETS saw the price collapse from 30 Euro to cents towards the end of 2007. Analysts believe that the collapse was from misallocation of units in Phase I.

It seems that the same thing is happening towards the end of Phase II or the Kyoto Commitment period which ends this year.

What are the possible factors?

1. The EU in recession meaning that growth in emissions are less than expected as they follow economic growth generally
2. The NER 300 where a large scale auction of EUA was passed to the EIB to raise money

for CCS (carbon capture and storage) projects
3. Unclear policy statements such as the renewable energy targets announced in April 2011, that needed urgent clarification that these were not a substitute for market instruments
4. Regulatory changes as to the EUETS access for CDM projects
    1. Industrial process CER
    2. Coal efficiency projects
    3. Large Scale Hydro (>20mw)

Since the ban on industrial gas CER was announced the race to issue CER in these projects has seen them increase from 64% of the CER issued to over 80%. Volumes have skyrocketed and are expected to continue to increase.

However there is a limit to the volumes of CER able to be surrendered in the EUETS, compare this to the AUETS in 2015 allowing 50%, and the NZETS with no limits.

The EU parliament has responded to the collapse in EUA prices by first voting to set aside 1.4bn EUA from auction, which on a second vote was re worded to 'large volumes'

The set aside can only be temporary whilst the EU works on implementing a more stringent limit for 2020, down from the 20% of 1990 levels to 30%. Something they say could take 18 months.

Even the addition of Airlines into the ETS (see twitter @eitg) is being dealt with largely by grand parented allowances.

So what may happen next? After the market moved substantially from long on carbon with the announcement of the NER300 it is reportedly heavily short.

Options have remained pretty static indicating traders are not sure where the market will end up.

Common sense says that the market is intended to place a price on emitting. Everyone would agree the current price is not one that provides a clear message to emitters to change behaviour and certainly not one that would encourage them to make long term investments in reducing emissions. Its too easy to wait, stock up on cheap credits and ride out the market.

Time for the regulators to remind everyone why we have carbon trading. But when will they act?

Carbon Credit Leasing Offer – What are the Questions to Ask?

Recently TBK capital sent out a document entitled Carbon Credit Leasing Offer. The essential elements of the offer were summarised in their email as follows:

Summary

- *Our client is seeking a limited area of established forests for long term lease.*
- *Rental of $200-$250 per hectare per annum (plus GST) paid annually in advance.**
- *To qualify, forests must be first rotation radiata planted after 1989.*
- *Our client takes a registered lease of the owner's forest and takes on all carbon credit liability.*
- *The owner retains ownership and possession of land, tree crop, and cutting rights.*

Our Client

- *Our client is a New Zealand owned and operated company that is in the business of Carbon Farming. They own, lease and plant forests for carbon credits.*
- *They supply bulk carbon credits direct to large energy companies and oil companies who need carbon credits to meet their legal obligations.*
- *They currently have 10,000 hectares of forestry under management.*
- *They have recently completed the largest sale of carbon credits in New Zealand history.*
- *Their team includes experts in carbon credits, forestry, finance and insurance.*

In essence their client appears to want to take a registered forestry right that specifies the NZU issued from the forest growth accrues to them for an annual fee per ha.

EITG was asked to look at this and we made the following observations:

1. The price of NZU on Carbon Match late January was around $7
2. At a lease price of $200 per ha (they claim the GST as an input) that is around $10 per credit on 20 credits per ha or $6.66 on 30 credits per ha
3. The international market, where there is no practical restriction on credits entering the

NZETS is around Euro 3.81 or $6.14 (@0.62 exchange rate)

4. Whilst the international market prices remain at this level NZU according to commentators are expected to remain at low levels
5. Non binding advice on the issue of who is liable for surrendering the credits from MFe in a telephone conversation around July last year was
    a. Whilst Mfe say the liability would be chased through the Lessee and the Directors of the Lessee in the event that company failed
        i. The liability could still ultimately attach to the land
    b. There is no legal precedent that Mfe were aware of in this area

Questions that leap to mind are

1. Who is behind this offer?
2. What is their financial status?
3. What does the insurance provide, and is the Lessor an interested party in the policy?
4. What obligations does the Lessor have in the event of loss during the no harvest period?
5. What legal advice do they have that the Lessor is not ultimately liable?
6. Is any legal advice addressed to the Lessor?
7. What is the actual situation with liability if the lessee fails? Or cannot honour its obligation to surrender sufficient credits?
8. What about the obligation for field measurement in 2012?

It's a simple scheme on the face of it. In a falling market probably not that profitable. At $20 per NZU it was of course highly profitable provided they had resolved the issue of the cost of credits at harvest and their attendant liability. At $7 per NZU we wonder if the same applies?

As a footnote NZ Carbon Farming Limited contacted EITG about this article on our blog and we invited them to answer the questions posed on the blog.

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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 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

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