

# Saving the world one carbon credit at a time

**Nigel Brunel**

I have worked as a broker in the financial markets for about 20 years. I'm not a greenie, but I have become greener during my career – which is primarily focussed on carbon trading for OMF (OM Financial). OMF transacted the first trade under the ETS in March 2009. We have transacted over 12 million tonnes of carbon since and operate [www.comtrade.co.nz](http://www.comtrade.co.nz) – a platform for the trading of local and international Kyoto units. Our focus is the “compliance carbon” market.

I knew very little about climate change four years ago but I have since read quite a bit about it – both sides of the argument – and continue to do so. I am not a climate change zealot but I'm reasonably convinced we are having an impact, so to me it's all about risk management and how we address those risks. The estimate is the world's population is going to be 10 billion in 30 years and it's also estimated food production will need to increase 70% to meet that demand. That's going to require a huge amount of energy. If you listen to Christine Lagarde, managing director of the IMF, it's our dependence on oil and its volatile nature that is a big threat to global economic stability.

Therefore – let's put the whole climate change argument aside for one moment – the simple reality is that the planet receives an abundance of free energy every day in the form of wind, tides, solar and geothermal. The cost to build the infrastructure to harness that energy, however, is in the billions. Perhaps the creation of a demand for renewables is the right solution to these potential problems? That's what injecting a price for carbon into the global economy does – it creates bottom-line incentives for businesses to change energy use. It encourages renewable energy projects, investments such as forest sinks, and funds green innovation.

There are two ways to inject that price:

- 1) Tax – the government levies a tax on emitters and uses those taxes to create the infrastructure and incentives. The good thing about tax is that it's easy to administer. The problem is what level of tax to apply, and when to adjust it if the economic situation changes – such as during recessions or booms. The other

issue is what criteria the government uses to fund “green projects”. The problem with this approach is that governments tend to waste money, and we have no guarantee the taxes collected will be used in the right areas.

- 2) A form of Emissions Trading Scheme – whereby businesses take responsibility for emissions themselves and both report and pay for emissions. You also need a mechanism to create allowances that emitters can buy in lieu of trade. And there is also need to provide funding for renewable energy projects. The problem with all this is that it is still a politically created market, that cannot run on its own steam and requires a bureaucracy to both manage and regulate it. Changes in regulations provide unwelcome shocks to these types of markets.

In New Zealand, we have a hybrid of both – emitters have a choice – we pay a \$25 tax per tonne of emissions or buy units on the local or international market to cover those emissions. Unlike Europe, we have no cap on emissions: we have an intensity based scheme with a floating price that is capped at \$25. At this stage, emitters are responsible for only 50% of their emissions although this will be phased out in the coming years.

One sector that is excluded from our ETS is agriculture – where 50% of our emissions come from. Listening to government ministers and sources it's clear agriculture will enter the ETS only in 2015 or later, provided there are practical technologies to reduce emissions, and provided our trading partners have made further progress with their climate change policies to reduce emissions.

The printing press for carbon units under Kyoto are the CDM (Clean Development Mechanism) and JI (Joint Implementation). Under the CDM, credits can be earned if additional renewable projects are developed. Even though Kyoto officially ends this year, the mechanism for creating CERs (Certified Emission Reductions) will remain.

In New Zealand, units can be earned by forest owners of (post-1989 plantings) for sequestering carbon within forests (sinks). These units can be

claimed every year or every 5 years by putting a return into the Ministry of Agriculture. Once confirmed, these credits are issued and can be sold to local emitters. With new or relatively new forests there is an obligation to repay approximately 75% of all carbon claimed if the forest is harvested (or suffers some form of destruction). However – provided the forest owner remains in the ETS – the remaining 25% is repaid through regrowth. This effectively gives the forest owner a safe level of carbon they can sell. It has to be stated: there are no free lunches in growing carbon in New Zealand. Indeed, there are substantial risks that small growers face – especially those with a single-stand/age forest, let alone the matter of price volatility. Emitters must file a return for their January-to-December emissions by March of the following year and hand over units, or pay the tax by May of that following year.

How much of emissions are we talking about in our scheme? By signing Kyoto, New Zealand agreed to keep its emissions to its 1990 level of just over 60 million tonnes. The revised ETS by the National government in 2009 excluded agriculture – which accounts for about 30 million tonnes – and adopted a 2 for 1 emission requirement. Effectively meaning there was approximately 15 million tonnes of demand annually under this scheme. In the first half year – 1 July 2010 to 31 December 2010 – the demand was 7.5 million tonnes. Most of this was met with NZUs (NZ Units), as they were predominately the cheapest unit. The price range for NZUs between April 2010 and December 2010 was \$17 through to about \$21.

We have just finished the March deadline for the 2011 emissions year – and what a year it was! This was the year we saw an 80% decline in the global price of carbon, pushing the NZU price from \$20 to under \$7 in early January 2012. NZUs lived at a premium for a good part of that year – meaning emitters purchased cheaper European units such as CERs and ERUs. We expect the vast majority of surrender units this year to

be Industrial gas CERs – which have now been banned from our scheme unless purchased before December 2011. Many emitters have filled their 2011 and 2012 year with these cheap European units.

The government is reviewing the scheme here later this year – here are our picks:

- 1) Delay of agriculture
- 2) Phase out of the 2 for 1 emission liability over 3 years
- 3) Increase in CAP price from the existing \$25/tonne
- 4) CAP on emissions
- 5) Decrease in full acceptance of EU Permits
- 6) Auction of NZU permits
- 7) Alignment with Australia

The big IF in this list is whether the government will apply some restriction to the amount of NZUs that have to be surrendered. There is some concern in the market that there won't be enough NZUs to satisfy demand. On the other hand, if demand was to increase to say 20 million tonnes this year and remain at that level between 2013 and 2017 (according to the gazette announcement last week) note that the Government expects to hand out about 225 million NZUs to forest owners, and some more for allocation to industry. Our pick is that the government will restrict the amount of European carbon that can be surrendered – possibly by 25%. We don't expect this measure to have any impact on prices in the economy.

The fear is that forest owners will simply raise prices to unrealistic levels following any restriction in access to European carbon. But that is not what we are hearing on the ground from forest owners – many baulk at selling carbon below \$10. Double figures are necessary to start raising interest.

In conclusion: our ETS is here to stay, and the price of carbon in our economy is not going away.

## About the Author: Nigel Brunel

I am Director of Carbon & Energy with OMF with over 20 years' experience in commodities, equities, foreign exchange, futures, carbon, energy and derivatives markets - Spot & Forward - OTC and Exchange Traded. I currently focus on the New Zealand carbon market and the ETS. Our clients include the emitters, forest companies and traders with interest in NZD denominated local and European carbon. OMF has been active in the carbon space for nearly 4 years having transacted the first trade under the ETS in March 2009. Since that time we have transacted in excess of 12 million tonnes of carbon. We have recently created CommTrade - [www.commtrade.co.nz](http://www.commtrade.co.nz) - an electronic platform for the trading of OTC carbon and energy related products.

