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# Carbon Monitor

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## The Anatomy of a CER Price Meltdown

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In mid June 2011 the price of a CER (certified emission reduction created from reducing greenhouse gas emissions in developing countries using the CDM or clean development mechanism of the Kyoto protocol) was 13 Euro and the emissions markets were looking healthy. (CER units are acceptable in the EU ETS and NZETS)

Then a matter of couple of weeks later a CER was fetching 9 euro. Why the rapid and precipitous meltdown in prices?

Simply the market rapidly lost its liquidity after a series of events starting with renewed concern as to the sovereign debt of the so called PIGS Portugal, Ireland, Greece and Spain, and the likelihood of defaults. Soon after that the EC issued a directive on energy efficiency targets. Simple analysis of this meant that companies meeting these targets would not need as many CER to comply with the EUETS restrictions.

Combining this with the German markets being on summer holidays the market reacted negatively. Soon brokers stop loss triggers started to intervene and the market flooded with CER as speculators dumped CER in the face of large losses. This overreaction cascaded into a slump that went below 9 euro. Then the EC announced any energy efficiency targets would be designed not to damage the carbon markets and the market according to sources bottomed.

Since finding the bottom CER have traded in two tight ranges between 9-9.20 Euro and peaked at 10.50 Euro. Further announcements of substantial CER issuances coming to the market have dampened demand. December 2011 and December 2012 CER sit around 9.80 as of the 27<sup>th</sup> July 2011.

The effect on the NZETS has been swift. Coupled with a strengthening dollar the NZETS has seen NZU prices fall to the low \$16 range before recovering. CER have become very attractive to buyers as they can be purchased as an option for delivery in March 2012 thereby reducing holding costs. The down side of course is an exchange rate risk but this can be managed. Foresters expecting \$20 or more are way out of the money. Should those post 1989 owners who sold for \$22 be buying back and covering risk?

How are buyers and sellers reacting? And how are projects being held up in the face of slumping prices?

Whilst China has a floor price at which CER are not to be sold the floor changes depending on the type of CDM project, for instance biomass CER floor price is 10.50 Euro. Whilst the lowest floor of 8.50 Euro was not breached it would not in our opinion have mattered as the trading was triggered by stop loss orders and not any real rational response.

Buyers that EITG and its consortium partners are working with continue to offer long term off take contracts. These contracts ameliorate risk by providing fixed floor prices of 7.50 and 8.50 euro with purchase at varying discounts to market in staged tranches. Project developers entering into these contracts can in effect fix their downside and keep the upside paying small premium to market.

Project developers are slow to take up such offers as they appear focused on maximising the CER income with no regard to risk. This of course tests the fundamental concept of whether their projects are actually additional? Would the project have happened without the carbon credit income? If the developers can take all the price risk of the CER price you have to ask the question in EITG opinion.

Realistically smart project developers, including those working with EITG are using our expertise in structuring and managing risk with our consortium partners, are entering into this type of fixed off take contracts. In certain cases as a further inducement buyers are reimbursing project development costs when certain milestones are achieved. This further reduces project developer risk.

As a world leader in managing risk from plantation forestry carbon credits via its carbon pool system EITG has been extending this philosophy to its ever expanding CDM portfolio on 3 continents.

## Field Measurement Regulations in the NZETS Effective 1<sup>st</sup> September

In New Zealand under the NZETS if you have 100 hectares or more of forest land registered in the ETS, or the PFSI, you will be required to use the Field Measurement Approach (FMA) to determine the change in carbon stocks in your forests. It comes into force on 1 September 2011, for the mandatory emissions return covering the commitment period 2008 to 2012. From 1 September 2011 participants will be able to request



their sample plot locations.

If you have 100 hectares or more and are thinking about registering in the ETS or PFSI, be sure you get your application in quickly. It will take time to prepare and process the application, and for you to complete the additional requirements of the FMA, in time for the mandatory emission return. If you are looking at adding or removing land, MAF recommend doing this prior to requesting your FMA sample plots.

[www.bit.ly/maf-fma](http://www.bit.ly/maf-fma)

## Commentary

We have discussed the risks associated with the new FMA particularly for those forest owners that have already sold NZU on the market based on the regional look up tables.

There is a real risk that credits will need to be repurchased and surrendered if a participant's forest is storing less carbon than the look up tables construed.

Remember also that the PSP sample plots will be provided by MAF and not those already selected and used for standing timber calculations. The customised look up tables will be interesting to compare and contrast the forest owner's expectation of standing timber from their own sample plots using the 300 index.

Those that have opted into the NZETS to receive credits but not sell them and therefore preserve their right to harvest in the future (free of the Government's guarantee to cover credits at harvest) are in our view faced with unfair cost. However the obligation to use the FMA is once every 5 years, and if suitable the PSP used by forest owners presently could be changed to the same MAF PSP to minimise the extra costs of measuring two lots of sample plots.

To those foresters with timber growing at seriously goods rates in excess of the norm in the region, EITG members being some of these, are up for a bonus of potentially 50% more credits issued to their accounts.

## New Zealand ETS review Part Summary

Forestry allocations have been much, much lower than expected - only 25% of the 76.1 million forestry NZUs expected by the end of 2012 have been allocated to date.

Similarly, the annual allocation to Emissions Intensive and Trade Exposed industries is 25% less than was

expected – at 3.5 million units per annum rather than 4.7 million.

However, in aggregate, physical emissions from the industrial, electricity and transport sectors (over the first 6 month period ending 31 Dec 2010) were also much lower than projected, at 16.3m tonnes, rather than 18.86m tonnes. This appears to be mainly due to lower than expected emissions from the electricity sector. Emissions reported from Transport were actually higher than expected at 8.039m (cf 6.84m as previously estimated).

Of the approx 8.3 million units surrendered on 31 May 2011 to cover emissions from 1 July - 31 December 2010, only 133,150 were imported CERs.

Finally, Minister for Environment Nick Smith has requested a further update from the ETS Review Panel before publishing their Review report. This is in order to allow them to take into consideration the announcements made more recently by Australia, including the exposure draft legislation released recently. That report from the Panel and more detail from Government on the future direction of the NZ ETS are expected any time now.

Commentary courtesy of [www.carbonmatch.com](http://www.carbonmatch.com)

## What are the Potential Risks in Land Transfer under the NZETS

It appears that if a party purchases land that is involved in the NZETS, something that can be established from a search of the land title, there is no independent search that can be performed to establish the position of the land in terms of the NZU units issued, surrendered or sold.

According to the NZEUR [www.eur.govt.nz](http://www.eur.govt.nz) the registry where all carbon credit transfers are recorded, such information is confidential to the participant and is not publicly available.

The question is, if this is the case where does a purchaser's legal advisor go to establish the adjustments or indeed a reasonable price, when settling or negotiating a land transaction? Accepting the current land owner's representations appears not to be a reasonable approach.

Even before settling a piece of land the price needs to be established when entering into an initial contract for sale and purchase, and this cannot be done without full knowledge of the status of any NZU or AAU units issued. Provision could be made in the contract for a formula to adjust the price at settlement (as is the case

with rates, and bodies corporate) but where can the data for the calculation be sourced from?

Perhaps one could write to the NZEUR on settlement date with a waiver from the current land owner to disclose the EUR transactions for that piece of land?

## Questions on the NZETS from Forest Owners

After meetings in South Waikato a rural Bank Manager wrote to us with a few questions on the NZETS and forestry:

*Q. Owners with more than 100ha must use the field measurement approach (FMA). I've heard this method often calculates more carbon units/ha than the published default look-up tables? I have friends with about 95ha. Their question is how strictly do MAF(Ministry of Agriculture and Forestry) adhere to the requirement that any forest(s) totalling less than 100ha cannot use the field measurement approach?*

A. The rule is quite clear – you must have more than the 100ha. MAF also decide the total area when you apply. With the FMA the associated persons rules DO NOT apply, that is if you are a beneficiary say of a trust with 10ha and own 95ha then you are not included in the FMA even though the total holding is 105ha. Similarly you can have 95ha in the PFSI and 95ha in the NZETS and are not included in the FMA.

Given this is a specialist legal test we recommend you seek independent legal advice on this and any other points. One final issue is the FMA may in some cases provide LESS credits than the old look up tables, the risks are significant to those already selling credits. We cover this in recent [carbon monitors](#). The potential for increased NZU from the FMA is just that, and given the PSP (permanent sample plots) are MAF selected I would be cautious.

*Q. For a forest owner sells some or all of their carbon units, are the sale funds taxable? If so, when they harvest their forest and have to buy units back again, is the cost of these units tax deductible?*

A. Post 1989 forest owners are liable for income tax on their NZU or AAU unit sales and similarly can deduct the costs of purchasing units for surrender at harvest or to cover some other loss like fire. There is no GST. Income and expenditure are assessable in the year they occur. Again this is a specialist area and specialist advice should be sought. Units are outside of the trading stock regime, that is they are not taxable when created, but only when sold or transferred. Again the definition of 'sold' is wide and transfers of

any kind may trigger a tax liability if not handled correctly.

*Q. A farm has say 20ha of forest on it. If the farmer sells all or part of the carbon units earned, then sells the farm, how does the prospective purchaser verify if the forest is (a) part of the ETS and (b) how many units may have been sold? A purchaser needs to know this to compare farms they may be considering to purchase.*

A. (a) When registering for the ETS the property title is updated noting the ETS registration. Buyers are alerted to the registration but not the status; that is whether credits have been issued or sold.

A. (b) The NZEUR is a register with all transactions logged. The name on the EUR has to be the same as the name on the title. A buyer should be able to search the NZEUR to find the transactions i.e. the credits issued, surrendered and sold thereby giving them an ability to quantify liability or for that matter assets. This facility is NOT available in the current EUR. Apparently MAF will issue a statement to the registered owner as to any outstanding liability. This of course is not sufficient to establish both the asset and liability position of a given forest block.

EITG has made enquiries as to how MAF and the EUR propose to handle the sale of land. We intend to report on their replies at a later date. The preliminary position is that the regulator would pursue the participant at the time of any issue arising before pursuing a land owner.

Given this the ultimate liability is attached to the land (albeit some parties attempting to lease carbon credits via a forestry right say they have legal advice to the contrary) Any ETS liability appears to rank ahead of any mortgage security. Buyers therefore need to be wary of what happens to their deposits on unconditional date as banks often won't agree to removal of a mortgage without payment in full. An issue relating to carbon credits could cause withholding of proceeds of a sale to meet this liability for instance. Again this is a technical area requiring specialist legal advice.

A further complicating factor is the emergence of the FMA and the retrospective adjustment in the form of a reduction in NZU previously issued (and sold) when field measurements are used in 2012.

*Q. Most forests are insured against fire. How does one get that cover extended to the loss of the carbon units that would be lost if the forest burned down. I have asked my insurance company (NZI) who have advised they will not cover carbon units?*

A. There are new schemes including [www.nzcarboninsurance.co.nz](http://www.nzcarboninsurance.co.nz) that provide ways to potentially address this risk. Large insurers are not currently offering carbon insurance as we understand it.

Please note: these questions and answers are indicative only and are prepared as examples and should not be relied upon as professional advice. These are complex areas untested in the Courts. You are advised to seek your own professional advice from appropriate specialists. Full terms of use of any information provided are on our web site [www.eitg.co.nz](http://www.eitg.co.nz)

## Assistance for pre 1990 Forest Owners in Southland

Those wishing to receive their free allocation of NZU units as compensation for loss of ability to change land use must apply before 30<sup>th</sup> November 2011. Paul Cox of Forest Tech Services in Matura is offering to assist forest owners. He can be contacted on 0274514 196 or 03 2033014 email [fts\\_pmcox@ispnz.co.nz](mailto:fts_pmcox@ispnz.co.nz)

## Australian Carbon Farming Initiative

For a project to be approved under the proposed legislation it will have to pass the Additionality test.

This test is one of whether the project would have in fact occurred without the CFI in place, a so called business as usual test (BAU)

The concept of additionality has been in place for a long time as a key component of whether a project in a developing country would receive CER credits under the CDM. The CDM includes a financial additionality test. Financial additionality is not a requirement of the CFI. Rather common practice will be the key arbiter of additionality, the question being *'is the proposed project common practice in the region in which it is proposed?'* Answer no, and the additionality hurdle can be met.

Approved methodologies will be issued, and parties may submit methodologies to be approved. Use of an approved methodology will be key to achieving registration. A proposed 1-5 year audit cycle allows issuance of ACCU (Australian carbon credit units) after submission of each audit that must be completed by a Registered Greenhouse & Energy Auditor.

A proposed positive and negative list will be published with positive list projects able to be approved and negative list either not approved or requiring much more detailed environmental, social and economic impact data to be approved.

Examples in consultation of positive list include capture of land fill methane, and negative list monoculture plantation forestry or changing the management of existing monoculture away from wood fibre to carbon farming.

Those who moved early in anticipation of the CFI will not be disadvantaged and projects post 1<sup>st</sup> July 2010 will be eligible once the methodologies and scheme are approved.

## Our 'Silly Fool' Closes his liability and Nets \$65k

Back in March 2011 a carbon monitor reader, the self characterised 'silly fool', wrote suggesting it was time to take the money for his post 1989 forest carbon credits and run, forgetting the potential liability as the returns from the carbon credit sales made up for that risk.

Recently he wrote to us saying he has replaced the 10,000 NZU units he sold at over \$20NZD with a similar number of CER units at \$13.50 and collected a tidy \$65,000 whilst at the same time covering his future harvest liabilities.

Read more on our 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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