

Carbon Market Australia-New Zealand

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NEWS

Australian government springs CDM surprise

The Australian government's 15 December announcements on a 2020 climate target and rules for its carbon trading scheme (see stories on page 2 and 3) held few surprises, except for one – Australian firms will be allowed to use an unlimited amount of project-based Kyoto protocol credits to meet their domestic obligations.

With limitations only on credits from forestry projects, firms can invest in clean development mechanism (CDM) and joint implementation (JI) projects, and use the resulting UN-issued credits to cover 100 per cent of their domestic emissions.

Expectations had been that there would be a quantitative cap set at somewhere between 5 and 40 per cent.

"The announcement was a huge surprise and quite a big deal," one observer said.

"I think this is very positive for Australian companies, especially those with operations in developing countries, as they can initiate their own CDM projects," said **Sally Burns, director with Sigma Global**, a CDM originator and management firm.

"It allows Australian companies to enter the international markets and reduce their cost of compliance," she said.

The question is whether significant CDM interest from Australian firms will materialise. With the country's 2020 climate target set at a 5-15 per cent cut in emissions from 2000 levels, several market observers said the price of Australian emission units (AEUs) was unlikely to rise much from the current level of around A\$24.

On the contrary, "the government announcement may mean that the AEU price should be lower than it is at the

moment," one broker said.

Secondary CDM credits, known as certified emissions reductions (CERs), for December 2012 delivery currently trade in the European market at around €14 (A\$28.70) – a 20 per cent premium on the AEU.

Unlimited access means CERs will effectively create a cap on the AEU price, rendering the government-introduced price cap of A\$40 irrelevant unless prices increase radically.

But secondary CERs will not provide a cheaper compliance alternative unless the Australian dollar strengthens further or CER prices keep falling.

However, primary CERs – credits that haven't yet been issued by the UN – are currently trading in an €8-€12 (A\$16.40-A\$24.60) range depending on project type, offering Australians a more attractive investment opportunity.

Sigma Global's Burns predicted Australian firms are now likely to start identifying potential primary CDM investment opportunities, despite the market already being relatively crowded with European and Japanese buyers. Japanese firms much prefer the primary market to the secondary because of the lower prices, despite greater risk.

Companies will have the choice whether to invest in projects that are in an early stage of development, or contract CERs on a forward basis without getting involved directly in projects.

Most observers talking to Point Carbon expected Australian firms initially to look in the Asia-Pacific region for projects, especially in China, India and Indonesia.

CONTENTS

- 2 Market comment and prices
- 2 Australia pledges 5-15% emission cut to 2020
- 3 Australia publishes carbon trading rules
- 4 NZ ministry warns against more free allowances
- 5 New Zealand to lift ban on new thermal power
- 5 Australia to bring forward A\$500m renewables fund
- 6 Guest commentary: White paper suggests AEU price below A\$20, by Sean Lucy, Head of Carbon Solutions Group, nabCapital

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Market comment

Quoted Australian carbon prices shifted slightly upwards after the government published its white paper on the carbon pollution reduction scheme (CPRS) on 15 December, but no new trades were reported to have been made.

Bids and offers for the 2011/12 contract moved up around A\$0.50 after the government made its proposals known. Prices have remained stable since, despite most market participants saying they interpret the 5-15-per cent reduction target to 2020 as bearish for the price on carbon.

"People are still concentrating on digesting the white paper to get a sense of what it means for them in the long term," one broker said.

"Most of the traders who put numbers on our screen last week have pulled them now as they don't want to get caught in a long or short position at this time," another broker said.

Market participants agreed the proposal to allow unlimited access to certified emissions reductions (CERs) would in practice work as a price cap for AEU, meaning the upward potential for AEU currently is capped at around A\$28, where the contract is currently trading in the European market.

"But the question is whether the price will ever go as high as the CER price, with a 5-per cent reduction target," one trader said.

The latest Australian emission unit (AEU) transactions remain the two deals heard on 27 November, when the 2011/12 contracted traded at A\$22.80 and the following year's contract went through at A\$24.50.

With Christmas coming up, followed by a traditionally quiet January as Australians enjoy their summer break, a notable increase in market activity is not expected for another six weeks at the earliest. Even then growth is likely to be slow as people will keep their eyes on the carbon trading legislation's passage through parliament.

AEU OTC closing prices (A\$/t)

Delivery	Bid	Offer	Close
AEU 2010/11	-
AEU 2011/12	23.50	24.50	24.00
AEU 2012/13	24.00	25.50	24.50

The prices reflect OTC levels on 18 December. AEU are quoted in A\$. Prices provided by brokerages Newedge, Nextgen and TFS and market traders. For methodology, see www.pointcarbon.com.

Australia pledges 5-15% emission cut to 2020

The Australian government said on 15 December it will cut emissions to 5 per cent below 2000 levels by 2020 regardless of what other nations agree under international negotiations.

If a comprehensive global agreement to handle climate change is in place, Australia will slash emissions 15 per cent below 2000 levels by 2020, the government said.

This would have to be an agreement "where major economies agree to substantially restrain carbon pollution and advanced economies take on reductions comparable to Australia."

At UN talks in Bali in 2007, Australia supported a statement that developed nations should cut their emissions 25-40 per cent below 1990 levels by 2020.

The government argued that a 5-per cent cut in total emissions to 2020 would equal a 27-per cent cut in per capita emissions.

The 5-15 per cent cut from 2000 levels equals a 4-14 per cent cut from 1990 levels.

In 2006, Australia emitted 576 million tonnes of carbon dioxide equivalent, an increase of 4.2 per cent from 1990.

Green groups slammed the government target, accusing Prime Minister Kevin Rudd of having "raised the white flag of surrender on climate change."

"Kevin Rudd has put the coal industry ahead of Australia's children and grandchildren. It will be much more expensive to rectify this historic mistake in the decades ahead. The 2010 federal election is shaping up as a referendum on tackling climate change," Greens Senator Christine Milne said.

"This target is completely unacceptable," said WWF Australia's Paul Toni.

"The Australian Treasury's economic modelling has shown that cuts of 25 per cent are affordable and achievable if part of an international agreement. This should be the government's aim," he said.

Australia publishes carbon trading rules

The Australian government on 15 December proposed rules for its emissions trading scheme.

Guided by an emission reduction target of bringing greenhouse gas output to 5-15 per cent below 2000 levels, Australia said it will implement its carbon pollution reduction scheme (CPRS) on 1 July 2010.

It published a 'white paper' on the scheme, and hopes to see the legislation pass in parliament next year.

The scheme features include:

- A cap for participants to be set after the UN climate meeting in Copenhagen in December 2009;
- 1,000 facilities to be covered;
- A price cap of A\$40 (US\$26.66) from the start, to be increased by 5 per cent annually and phased out after five years;
- Indefinite banking of allowances, 5 per cent borrowing from future vintages allowed each year;
- A ban on export of Australia emissions units (AEUs);
- Unlimited use of project-based Kyoto credits;
- Lowered threshold for free allocation to trade-exposed industries;
- 31.2 million free AEUs per year to the most inefficient coal generators.

The government said it will spend the revenue from AEU auctions to assist households and businesses to adjust to the scheme.

Price control measures

The government proposed a series of measures aimed at controlling the price of carbon permits, especially during the first years of the scheme's operation.

While it dismissed the idea of launching the CPRS with a fixed price for AEUs, it has proposed an initial price cap to reduce the cost of the scheme.

Australia plans to cap the price at A\$40 when the scheme takes off in 2010. The price cap will be increased by 5 per cent annually, then removed after five years.

The cap, equalling €19.82, is likely to prevent a formal link between the CPRS and the EU emissions trading scheme.

The government also proposed to allow firms to borrow 5 per cent from future vintages for compliance purposes each year. This could help companies control costs in case of a supply squeeze.

The government also wants to ban the export of AEUs so as to keep supply of permits at a sufficient level.

The white paper said this ban would only be lifted with a five-year notice, unless a bilateral link is established with a similar carbon scheme in another country, for example New Zealand.

Kyoto credits

Hard pressed by the difficult economic situation, the government abandoned its previous proposal to set a limit on the use of carbon credits issued by the UN under the Kyoto protocol.

From compliance year 2012/13, Australian firms can use an unlimited amount of credits from Kyoto's clean development mechanism (CDM) and joint implementation (JI) for domestic purposes.

CDM credits issued by the UN from 2008 onwards will be eligible for use, except credits that stem from forestry projects.

The government proposed however not to recognise government Kyoto credits – assigned amount units (AAUs) – under the scheme.

Such credits are controversial as they are thought to have limited environmental integrity because most AAU sellers have a surplus originating from the economic turmoil in eastern Europe in the 1990s rather than from ambitious climate change policies.

The white paper did not bar the government from buying AAUs should it need to in order to comply with its Kyoto target.

More free permits

The white paper said it is unlikely that a significant amount of emissions would leak to other countries as a result of the CPRS, but nevertheless the government decided to boost the amount of permits handed out for free.

It lowered the threshold for energy-intensive trade-exposed

industries to qualify for free permits under the scheme.

The green paper published in July suggested that industries emitting at least 2,000 tonnes of CO₂ per million dollars of revenue be given 90 per cent of their needed permits for free.

Firms emitting 1,500 tonnes per million dollars of revenue would get 60 per cent of permits for free.

The threshold for the lower range of compensation has been lowered to 1,000 tonnes of CO₂ in the white paper, qualifying many more facilities to get free permits.

The white paper also allows for a new way of calculating whether a company qualifies: if a company's trade share is defined as more than 10 per cent of the value of its domestic production in any year between 2004/05 and 2007/08, it will qualify for free allocation.

Dirty coal

The government also proposed to compensate coal generators as a strongly affected industry.

During the first five years of the CPRS the government will allocate A\$3.9 billion worth of AEU's for free to the highest polluting coal generators.

The government said the allocation will be decided using an assumed AEU price of A\$25, meaning the coal industry will get 156 million AEU's for free over the period, or 31.2 million per year.

The free permits will be reserved for coal plants emitting more than 0.68 tonnes of CO₂ per MWh generated.

The white paper also outlined a A\$6-billion compensation package to households, A\$2.4 billion in fuel-related assistance to consumers and a A\$2.15 billion climate change action fund to help businesses and organisations make the transition to the CPRS.

NZ ministry warns against more free allowances

New Zealand should not increase free allocation of emission rights, the environment ministry said on 10 December.

Upping the amount of emission units to be given out for

free instead of auctioned would be the same as increasing taxes in order to "provide assistance to particular parts of the economy," the ministry said.

The points were made in the ministry's briefing to incoming Climate Change Minister Nick Smith.

The new government has established a committee which will review the country's emissions trading scheme.

In the run-up to the 8 November election, Smith mentioned several times that trade-exposed industries should receive more allowances for free, as should some key industries such as fishing.

The government's concern is that trade-exposed industries, if faced with a cost on carbon emissions, could shut down operations in New Zealand and move to countries without carbon caps, such as China, India or Indonesia.

It is expected that the government review of the carbon trading scheme will reflect this concern, and modify the scheme accordingly.

But the ministry of environment pointed out that 70 per cent of the country's emissions is related to trade-exposed activities, including food exports.

New Zealand's international obligations to cut greenhouse gas emissions are also likely to be increasingly stringent, it added.

"It is not in our long term interest to shelter particular sectors of the economy from the economic pressures that New Zealand faces, regardless of whether that sector's competitors face the same price of carbon or not," the ministry said.

"Further, the existing legislation sets out a balance between sectors as industry and agriculture are treated in the same manner," it said.

"Adjusting that balance of generosity between sectors in any major way runs a risk of unravelling the balance that is currently built into the legislation," it said.

The scheme approved by parliament in September included provisions that industry and agriculture get free allowances to cover 90 per cent of their 2005 emissions when they joined the emissions trading scheme.

From 2019 onwards, this share should be reduced and eventually phased out entirely in 2030.

Energy generators and the liquid fossil fuel sector would not receive any permits for free.

The ministry also advised Smith not to be pressured by business while the ETS review is carried out.

"There are a number of areas in the NZ ETS implementation process where there will be pressure to complicate the ongoing design of the NZ ETS. This is understandable; firms will want design to reflect their particular circumstance as much as possible," the briefing document said.

"The NZ ETS design should, however, be kept as simple as possible. This is critical to build in as much clarity and workability to the processes going forward."

New Zealand to lift ban on new thermal power

The New Zealand government is planning to lift a 10-year ban on new thermal power stations that was introduced under the previous government and passed into law in September this year.

Energy and Resources Minister Gerry Brownlee on 16 December tabled legislation that would remove the ban and open up the way for building new coal- and gas-fired power plants.

"The government strongly supports renewable energy but a thermal ban now puts our security of supply at risk," Brownlee said in a statement.

"Thermal generation, particularly from gas-fired generation, is the insurance card underpinning the security of our electricity system," he said.

The new National party-led government shares the previous Labour administration's target of boosting renewables' share of electricity generation to 75 per cent in 2025, up from current levels of around 66 per cent.

But not at the expense of energy security, Brownlee said.

The National party says banning construction of new gas-fired power plants will cause existing coal-fired plants to emit even more greenhouse gas emissions.

Brownlee also proposed to lift the previous government's ban on traditional, inefficient light bulbs.

"This government has real concerns about telling people they have to move to energy efficient light bulbs by decree," he said.

Australia to bring forward A\$500m renewables fund

Australia will make its entire Renewable Energy Fund available over the next 18 months, Prime Minister Kevin Rudd announced on 14 December.

A fifth of the A\$500-million (US\$333 million) fund will be available for projects in 2008-09.

The remaining A\$400 million can be invested the following year, if there are enough good candidate projects.

The Labor government had initially intended to dish the money out over the next 12 years, but brings it forward in order to boost the economy.

"The government believes the time has come to prepare a solar revolution, and renewables revolution, for Australia's future," Rudd said in a statement.

The fund includes a renewable energy demonstration programme, a biofuels research and development programme and a geothermal drilling programme.

Australia's target is to increase renewable energy's share of electricity generation to 20 per cent in 2020.

Australia this week also introduced draft legislation to expand its mandatory renewable energy target scheme.

If approved, the legislation will allow people who install solar panels to get renewable energy certificates (RECs) that can be sold to companies that have to comply with the scheme.

The credits will act as an upfront capital cost subsidy worth around \$7,500 for purchasers of solar PV systems, the government said.

The aim of the legislation is to accelerate the deployment of renewable energy sources in Australia.

Guest commentary: Australian business to shift focus to carbon fundamentals in 09

By Sean Lucy, Head of Carbon Solutions Group, nabCapital

It's been a big year for carbon in Australia. Starting with the ratification of the Kyoto protocol at the end of 2007, the last twelve months has seen an intense period of policy development down under.

The latest chapter in the process was the release on 15 December of the Carbon Pollution Reduction Scheme (CPRS) white paper.

Much of the debate since then has focussed on the environmental and economic impacts of the scheme.

Environmental groups have criticised the medium-term target range of 5 to 15 per cent below 2000 levels as insufficient, and argued that the transitional assistance package to industry is too generous.

Industry groups, on the other side, have talked up the costs in the context in the current economic crisis.

Whatever your view on these questions, there is no doubt that the CPRS white paper has fundamentally shifted business thinking on climate change in Australia.

A clear sentiment has emerged that business as usual on carbon is over. The focus for 2009 will shift from engaging with government about the design of the scheme to management of the fundamentals – supply, demand and risk.

On the supply side, regulated business will have three broad options: acquire Australian Emission Units (AEUs) in the monthly ascending clock auctions (which will cover 65 per cent of available AEUs) or from the secondary market; purchase CERs from the international market; or generate AEUs through forestry activity.

The fact that the white paper provides for unlimited certified emissions reductions (CER) imports, and CER validity through to 2020, will make the clean development mechanism an attractive option for regulated businesses with operations in Asia.

Demand side activities will focus on driving down emissions. Over 2008, we have seen an increased emphasis on low emission power sources, such as co-

and tri-generation, and this can only accelerate in 2009.

Though, for many businesses, the bulk of their emissions will be unable to be reduced without significant investment and this is unlikely to occur in the short term.

Developing effective risk management strategies will be challenging for many companies.

The market is likely to be fairly volatile initially, due to imperfect information and widely varying levels of sophistication from market participants.

A full suite of financial risk management products will also take time to develop. Consequently, the initial approaches are likely to revolve around securing supply of compliance units through projects (CDM or CPRS compliant forestry).

The market reaction to the release of the white paper has been subdued. There have been few reported trades, leaving open the question of how the short and medium term targets will effect pricing.

Pre-white paper we were seeing small volume transactions in the low \$20 range. However, the government decision to give the CPRS a soft start (essentially holding emissions at Kyoto target levels to 2013) has the potential to drive prices down slightly.

NabCapital's analysis of the amount of abatement required by the white paper for the 2010/11 compliance year, and available marginal abatement cost data suggests a sub-A\$20 price.

As market activity accelerates in early 2009, on the back of the improved certainty around the scheme design, it will be interesting to see how this affects the early players' thinking.

Are you interested in contributing a guest commentary for Carbon Market Australia-New Zealand? Please contact the editor, Stian Rekev, at sr@pointcarbon.com.

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