The New Zealand Projects Mechanism and Kyoto: Match Made in Heaven?

What a New Zealand company with a carbon credits award from the New Zealand Government needs to do in order to attract international carbon credit buyers?

EFNZ Seminar on International Markets for Carbon Credits
Intercontinental Hotel, 27 January 2005, Wellington, New Zealand

- CMS Background
- Who is buying?
- What buyers are looking for?
- What a New Zealand company needs to do to attract buyers?

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New Zealand and Kyoto

CMS Background

John O'Brien - Carbon Market Solutions

• Background environmental economics - working internationally on climate change and carbon finance issues for the last 10 years, last 4 based in London;

• CMS works as a project developer to assist companies to maximize the value from their carbon assets;

• Offices in London, New York, New Zealand

• Internationally CMS work with buyers such as the World Bank Prototype Carbon Fund, Dutch Government's ERUPT Programme, the Austrian CDM-JI Program, the European Bank for Reconstruction and Development, the UNEP Finance Initiative and various Corporate Clients;

• Operating in New Zealand since 2003. Clients have included the New Zealand Treasury, assisting a landfill gas methane capture project monetize its credits, and advice to a major New Zealand utility on carbon market selling opportunities;

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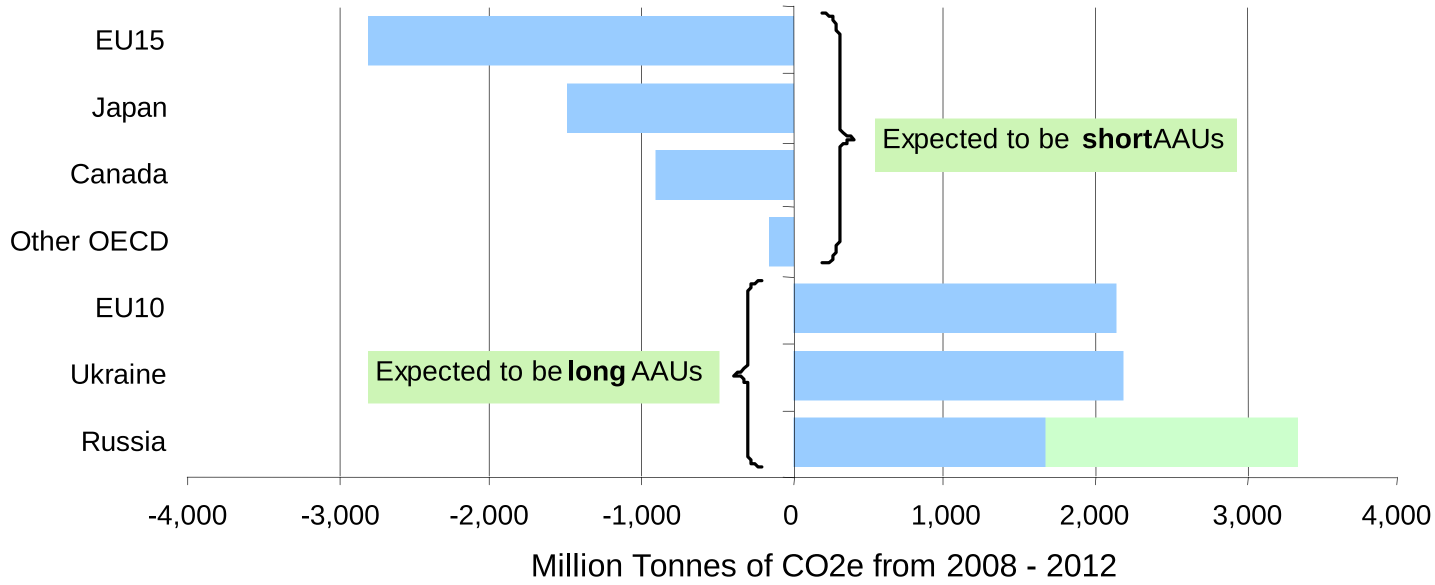
Overview of Who is Buying? (1)

Who is long and who is short?



- Major buyers are the EU15, Canada and Japan;
- Forget the United States and Australia for now;

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Overview of Who is Buying? (2)

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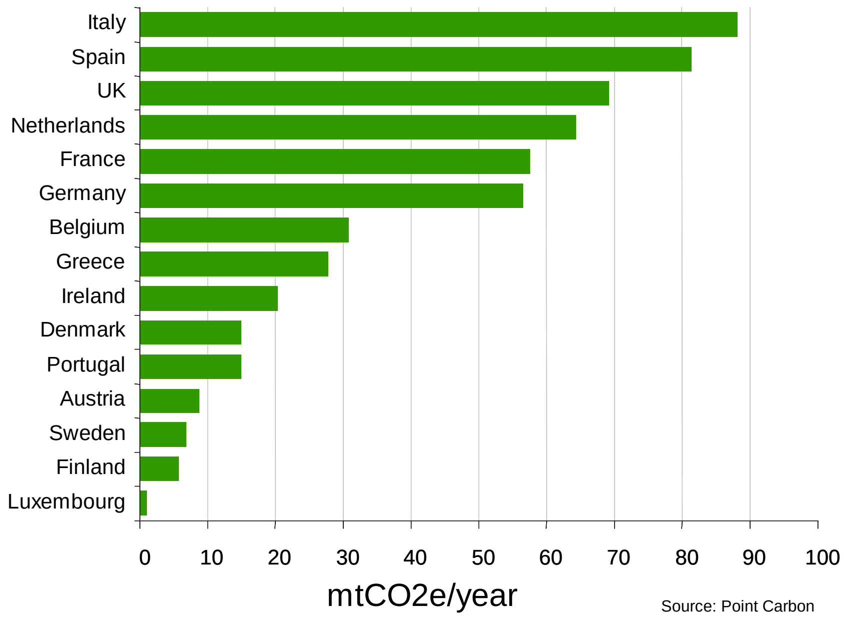
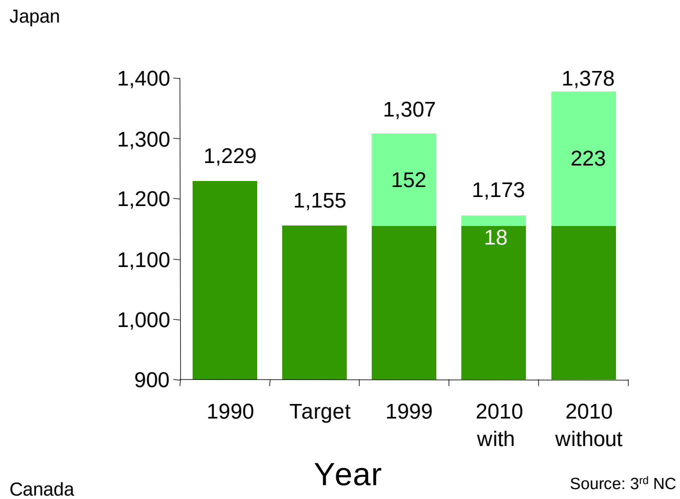
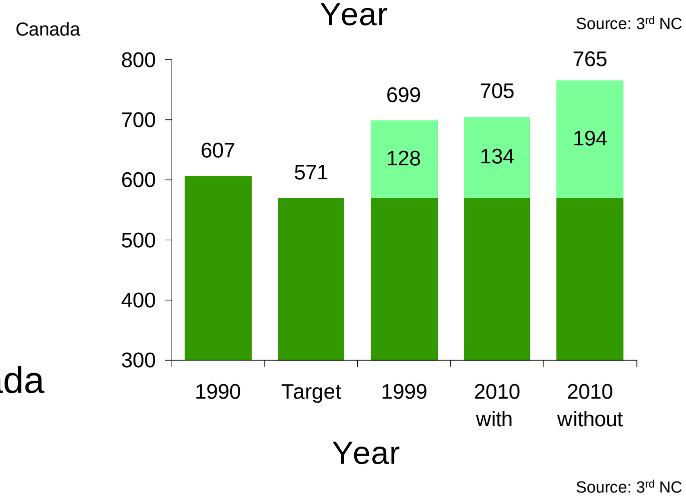
Projected Surplus/Deficit Position in the EU-15, Japan and Canada?

EU deficit (2008-12, $mtCO_2e$/year)



Japan and Canada ($mtCO_2e$)





- Countries with most difficulty have done least (e.g - Spain, Italy)

- Linking directive of the EU ETS and regulations in Japan and Canada will allow companies in these countries to buy from CDM and JI projects outside Europe (including New Zealand);

AAUs also for Japan and Canada

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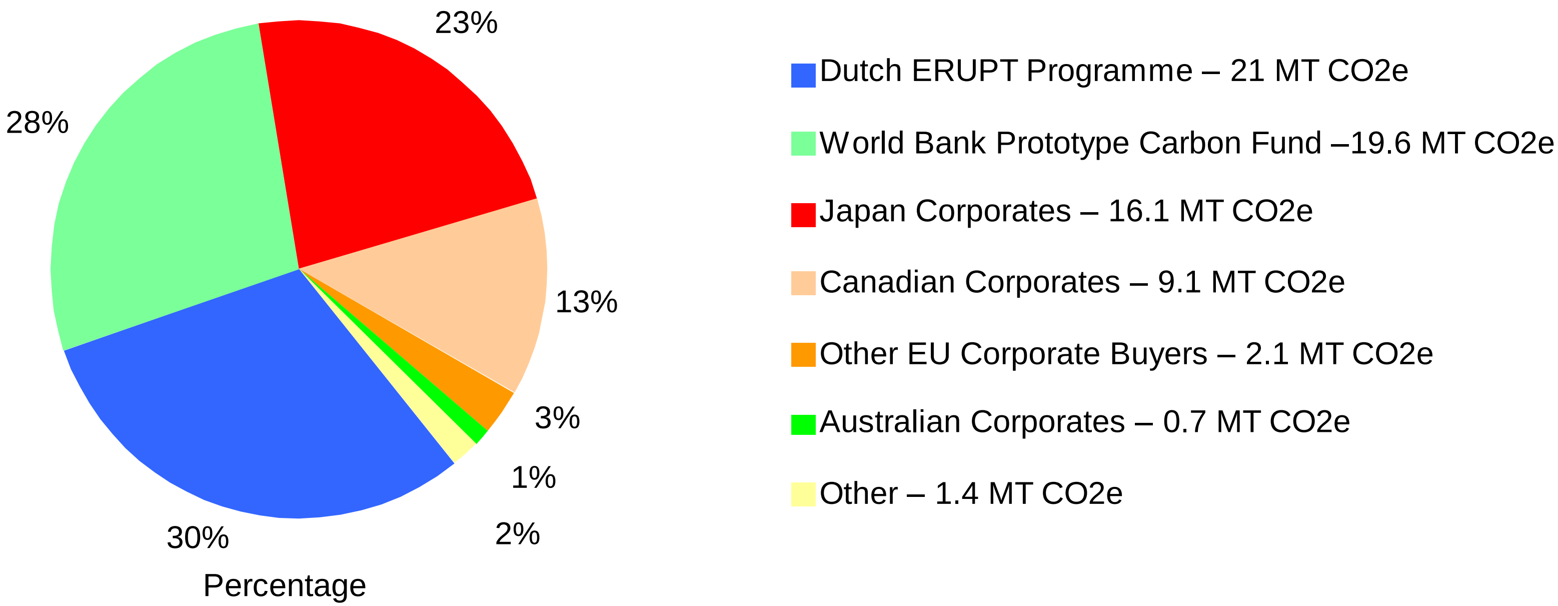
Overview of Who is Buying? (3)

<u>Market Share by Major Buyers of CERs and ERUs as of December 2003</u>



- 70 million tonnes contracted by the end of 2003, 140 million tonnes by the end of 2004
- Many more buyers coming into the market as of 2005 … Who are they?

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Overview of Who is Buying? (4)

	Comments and Information	Interested in NZ Credits
Dutch ERUPT Programme	Target of 100MT CO_2e (500 million euro) , ERUPT V last round 250,000 tonnes co2e minimum	YES
Austrian CDM/JI Programme	Budget of 288 Million Euro second round tender currently open 100,000 tonnes co2e minimum	YES
German KfW Carbon Fund	Budget of 50 Million Euro - just started Normally 250,000 tonnes co2e but possible 100,000 tonnes co2e minimum	YES
Japan Carbon Fund	Budget of 140 million USD - just launched at COP10 in December 2004 No stated minimum or maximum	Maybe
Belgian Carbon Fund	Budget of 50 million euro - new tender being launched in next few months No stated maximum or minimum	Maybe
Spanish/Italian Carbon Fund	World Bank Managing. Budget of 240 million euro (Spain) Initial budget of 15 million euro (Italy) - No stated minimums	Unlikely
Corporates in EU ETS, Japan, Canada	15,000 companies in EU, 300 of them (mainly in power sector) hold most allowances and will trade frequently - 250,000 tonnes minimum for most	Increasingly YES

Others European governments also - Portugal, Ireland, Scandanavian Governments etc ...

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Overview of Who is Buying? (5)

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A comparison of Government and Corporate Buyers ...

Government Buyers

Advantages

•Pays Transaction Costs up to Nz$90,000;

• Pays up-front cost up to 30 - 50%;

• Assumed Kyoto Risk (no longer matters)

• Unlikely to have payment issues/credit problems

Disadvantages

•Slow turn-around time and bureaucratic

• Inflexible on price

Corporate Buyers

Advantages

• More companies to choose from

• May pay higher price

• Quicker turn-around time

• Contracts more flexible (for negotiation)

Disadvantages

• Counterparty credit risk of buyer;

• Unlikely to pay up-front payment (maybe 10%)

• No reimbursement for transaction costs

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What are Buyers Looking for?

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Carbon Buyers want

- 1 - projects with low risk,

- 2 - projects with significant volume

- 3 - projects offered at a low price ...

Experience to date in the market has been that 2 or 3 out 10 projects assessed are short-listed for further review by buyers and 1 out of 10 is contracted

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What are Buyers Looking for? - Low Risk

Buyers want to minimize risk associated with the carbon transaction. Specifically ...

- Kyoto eligibility risk (Government Letter of Approval, sound baseline analysis, additionality)
- Low Project Technical Risk (technical capabilities of the applicant)
- Financial Risk (financial standing of the applicant)
- Technology Risk (proven technology or not?)
- Counterparty Credit Risk (credit rating of the applicant)
- Regulatory Risk (has project got a resource consent?, is activity required by law)
- Delivery Risk (underperformance of project leading to lower emission reductions)

Projects awarded ERUs by the New Zealand government are highly likely to be JI projects and are likely to be valid compliance units for companies in the EU ETS but it is not 100% certain and there will be difficulties along the way.

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Volume - Small Projects will have difficulty selling Credits

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Conservatively, developing one joint implementation project is typically going to cost Nz$80 - Nz$150,000. Project Development Costs: Nz$60 - Nz$125,000 Validator Costs: Nz$20 - 25,000.

> 250,000 t ERUs (2008-2012) →	Companies with a Government Award & a Good Story to Tell should have limited problem selling
>100 - 200,000 t ERUs (2008 - 2012) →	Will be more difficult but still possible for Companies with a Government Award - Companies need to find ways to minimize transaction costs
<100,000 t ERUs (2008 - 2012) →	Will be extremely difficult to find a buyer due to small volumes. Transaction costs can wipe out any additional returns from carbon credits

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Volume - How to help the small projects (<100,000 t co2e)?

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What can be done to help small projects? - There are several options.

•Government/Private Sector to provide Small Project Financing Facility to Support Transaction Costs in preparing the JI Project (e.g - CDM model being undertaken in many CDM countries) - *unlikely*

• Private Sector to develop some kind of aggregation fund to pool smaller projects to make them attractive for larger buyers;

•Develop standardized guidelines for preparing full documentation for small projects to reduce transaction costs for small projects - *possible*

• Government policy creates a link between NGAs and Projects mechanism with low transaction costs- *for consideration*

• Clear linkage between New Zealand projects and EU ETS - *difficult but possible*

OR IF NOTHING IS DONE SMALL PROJECTS SHOULD ...

• Be Prepared to Accept an extremely low price or NOT to sell at all;

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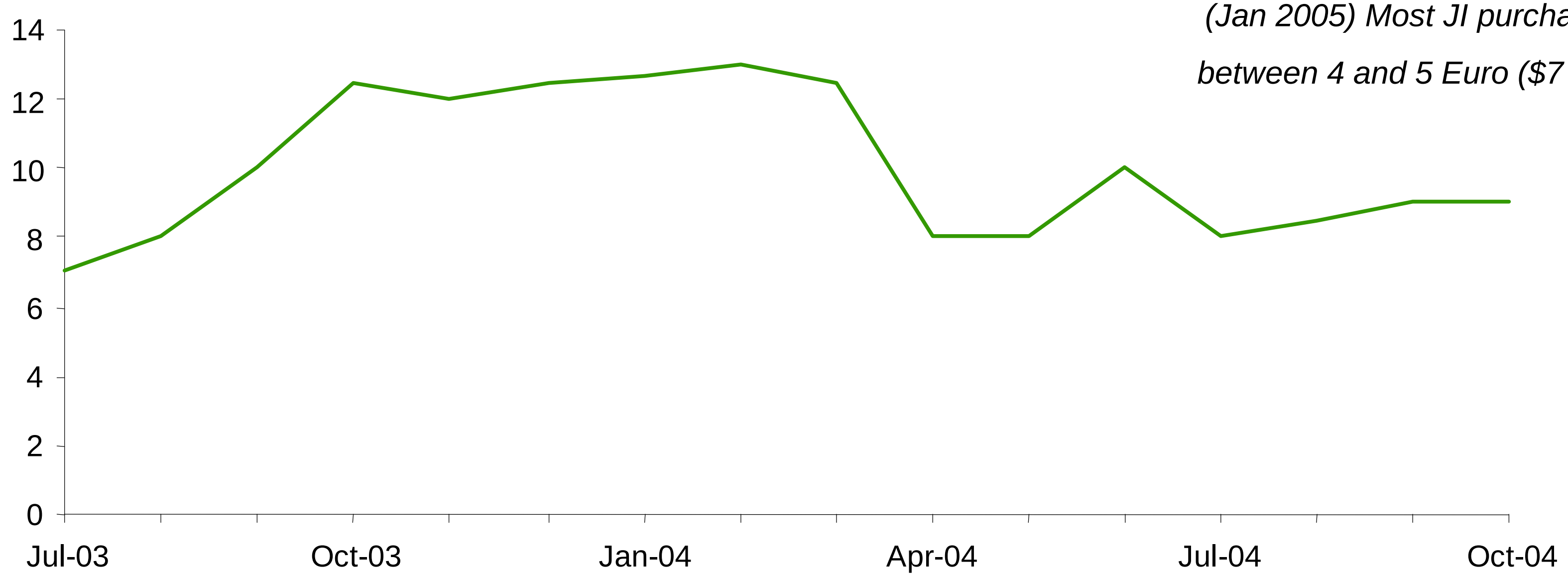
Low Price - Some Thoughts on Carbon Pricing

EU Allowance Prices have trades over the last 18 months between 6.5 euro/tonne and 13 euro/tonne. Spot market price is currently drifting down trading at 6.75 euro/tonne (20 Jan)

(Jan 2005) Most JI purchasers would like to pay between 4 and 5 Euro ($7 - $9.5 NZD for ERUs)



ERU Price from JI projects has been 3 - 6 euro over last 24 months.
Highest price ever achieved believed to be 8.5 euro/tonnes

ERUs from JI projects should typically be worth less than EU Allowances
ERUs have a higher level of risk associated with them than EUA's

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Advantages and DisAdvantages of New Zealand Projects

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Advantages →

- Some High Quality/Low Risk Projects
- Lower Risk - Business Environment
- Strong Government Institutional Support/Policies

Disadvantages →

- Small Size of Many NZ projects;
- Distance to Market
- Competition from Russia, CIS, Eastern Europe
- Undercut on price possibility

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Comparing New Zealand to Russia and Other ERU Sellers

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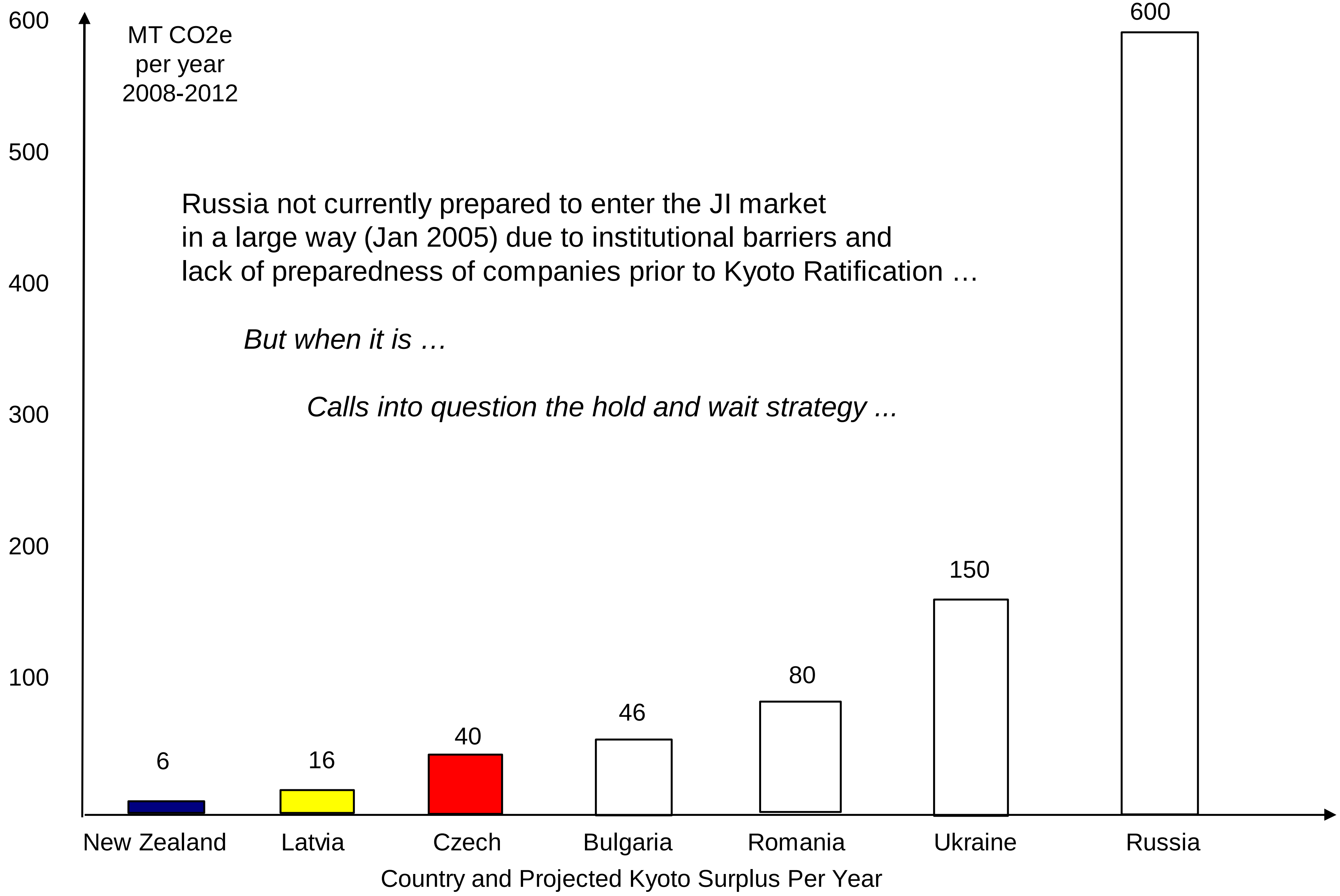

Russia not currently prepared to enter the JI market in a large way (Jan 2005) due to institutional barriers and lack of preparedness of companies prior to Kyoto Ratification …

But when it is …

Calls into question the hold and wait strategy ...

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Conclusion - Some Thoughts on Trading Strategies

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What can New Zealand companies do to maximize opportunities for selling their ERUs?

- Prepare all documentation early (PDD, baseline study, monitoring plan, validation) makes it easier to find a buyer - don't try to sell first and then prepare documentation;
- Diversify risk by not selling all credits to one buyer;
- Companies with more than one project seek to minimize risk by holding part of porfolio;
- Sell conservative volume to reduce risk with an option to buy the surplus up to the award amount?
- Seek buyers that are willing to pay up-front payment;
- Seek Carbon Banking Opportunities for depositing units and earning interest
- Seek Gold Standard Certification may increase price
- Smaller projects seek aggregation or be prepared to accept a very low price;

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Thank You

Thank You !

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