Ministry for the Environment and Emissions Trading Group

Carbon Markets Workshop

4 April 2008 – Ilott Theatre, Wellington

Participating in Carbon Markets: risks and legal issues

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Overview

- Primary/secondary CER market risks
- Risk mitigation
- Developments in NZ legal regime for trading

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Primary CER market

- Initial transaction between project developer and buyer
- Risks:
  - Project performance risks
    - Expected credit yields fall short of actual yields
  - Registration risks
    - Risk that project is not registered (or reviewed)
    - Delays in registration
  - Host country risks
    - Uncertain legal/investment regimes; local requirements
  - Contractual risks
    - Pay in advance?
    - Ranking if multiple buyers participating in same project?
    - Delivery risks?
    - Counterparty credit risk?
- Prices tend to be lower, reflecting higher risk factors
- Risk mitigation:
  - Buying motivation?
    - Compliance (short term/long term)
    - Speculation/banking
  - Project due diligence important
    - What type of project?
    - What country?
    - What stage of development?
  - Contractual terms

Secondary CER market

- Resale of issued CER credits (OTC, bilateral or exchange traded)
- Risks:
  - Delivery risk
  - Counterparty credit risk
- Prices higher than primary CER market, reflecting reduced risk factors
- Risk mitigation:
  - Clearing (either exchange traded or cleared OTC)
  - Contractual terms

Allowance Market

- Sale of EUAs, NZUs etc
- No project performance-type risks (risks typically similar to secondary CER market risks)

NZU Price Drivers

- NZU prices will track global prices
  - Convertibility of NZUs with Kyoto units
  - Weak domestic supply of surplus credits (in the short-medium term)
- But which product?
  - EUAs?
  - Secondary CERs?
  - AAU? (and what type of AAU – GIS or non-GIS?)
- Weather and energy markets in Europe have a large effect on EUA price (power sector emissions cover 60% of total EU ETS emissions)
- Secondary market CER price tracks EUA price (because CERs can be used for compliance purposes in EU ETS)
- Secondary market spot CERs trade at a discount to spot EUAs (due to limits on usability)
- Different price drivers for primary CDM market (broad price range depending on risk factors)
- Increased trading in AAUs (may be an additional price driver)

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Risk mitigation – accessing the market

- Investment in/buying from carbon funds
  - Access to international expertise, who can access primary markets
  - Diversification of risk
- OTC/broker trades
  - Increasing use of standardised documentation
  - Can avoid project performance risks
- Exchange traded–products
  - Standardised documentation
  - Avoids project performance risks
  - More transparent price discovery and fee structure
  - Clearing avoids counterparty risk
  - Issues with eligibility of some types of CER credits – could create a tiered market?

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Risk mitigation - contractual terms

- Choosing a degree of delivery risk:
  - Failure to deliver excused if seller acted reasonably/prudently
    - no sanctions for non-delivery
  - Failure to deliver not excused
    - Not treated as a force majeure (e.g. if yields do not achieve expectations)
    - Replacement obligations – but need to ensure "quality" of replacement credits is the same
    - Seller must compensate if buyer does not receive agreed number of credits – but compensation formulae can vary
    - Some credit risk remains
- Lower degree of delivery risk means higher price

General legal system risks for trading

- Important to provide certainty in relation to legal treatment of carbon credits

- Why?
  - Nebulous product creates legal uncertainty
  - Uncertainty results in transaction costs
  - Potential barrier to market development (incl derivative markets)

- Questions:
  - What is a "carbon credit"?
  - How is title passed?
  - How can I prove I own the credit?
  - Can I claim a security interest in the credit?

NZ legal developments

- Emissions Units Settlement Systems and Futures Bill
- The Bill clarifies:
  - An “emission unit” is not a “security”
  - Registration on a register is prima facie evidence of legal title
  - “emission units” are personal property under the PPSA
  - The circumstances in which a person takes “possession” for PPSA purposes
- Why important?
  - Provides basis for establishing legal title
  - Provides certainty as to the timing of the acquisition of title and possession
  - Provides a more certain basis for contractual representations as to title
  - Allows security interests to be registered
  - Provides a clearer legal framework for trading activities

Legal developments in clearing and settlement

- New regime to be inserted in the Reserve Bank of NZ Act will enable a clearing and settlement system to be "designated" and regulated

- Why important?
  - Clearing house will assume delivery and payment risk
  - New provisions provide that registration of carbon credit trade cannot be refused because transferred through designated settlement system
  - Overall a least risky trading option

- Intended to:
  - facilitate development of derivative markets for carbon credits, especially a futures and options market (leading to deeper and more liquid carbon markets in NZ)
  - attract overseas participants to carbon markets in NZ

Future legal developments

- Regulation of registry services?
  - Important due to nebulous nature of carbon credits
  - Maintaining standards of robustness, security, ensuring no "double ownership" etc

- Greater integration into global markets likely to lead to convergence of standards on:
  - Legal treatment of carbon credits?
  - Transfer mechanisms?
  - Registry services ?

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