Graham Dennis, Clayton Utz, Sydney

Carbon Trading

Slide 1

Slide 2

Slide 3

How emissions trading schemes work

- Two basic models:
  - Cap and trade, or
  - Baseline and credit

CLAYTON UTZ

Slide 4

Cap and trade:

- Cap the total level of allowed emissions in a given period.
- Allocate permits (free or by auction) up to the cap level.
- Allow the holders of permits the choice of emitting, or selling their permits to others.
- Emitters surrender permits totalling their emissions.
- Impose a penalty or charge for emitting more than the number of permits surrendered.

CLAYTON UTZ

Slide 5

Baseline and credit

- Establish a baseline (typically historical or "business as usual") emissions.
- Award a credit for behaviour that is better than the baseline.
- Impose an obligation on emitters (or other liable entities) to surrender a certain number of credits (typically percentage of emissions) for their emissions.
- Impose a penalty or charge for any shortfall in surrender of credits.

CLAYTON UTZ

Slide 6

Offsets

- Often an additional component of a cap and trade scheme.
- Applies to sectors of emissions (or countries) where emissions are not capped.
- Award a credit for positive behaviour that reduces emissions in that uncapped sector (typically on a baseline and credit basis).
- Allow the credit to be surrendered under the cap scheme, as a substitute for a permit.
- Increases emissions in the capped sector, but nets out because of the reduction in the uncapped sector.
- Inclusion of offsets allows a greater range of activities / sectors to participate, and assists with finding lowest cost abatement.

CLAYTON UTZ

Slide 7

The Kyoto Protocol

- Essentially an international cap and trade scheme.
- Applies to countries. Binds countries.
- Developed countries are capped, others are uncapped.
- Developed countries are allocated permits ("Assigned Amount Units" or "AAUs") totalling their permitted emissions in the compliance period (2008-2012).
- Countries can use up these AAUs, by emissions in their country, or can trade them to other countries.

CLAYTON UTZ

Slide 8

Kyoto Protocol – compliance + penalty

- Capped countries can decide themselves what measures to take domestically to get their emissions down to the level of their AAUs – e.g. domestic schemes, taxes, regulation, education, buy more AAUs…
- A country whose emissions for the compliance period exceeds its assigned amount (including the results of trading):
  - has 1.3 times the shortfall deducted from the next compliance period;
  - must develop a compliance action plan;
  - can be suspended from trading.

CLAYTON UTZ

Slide 9

Kyoto Protocol offsets

- In addition to the AAU permits, the Kyoto Protocol has 3 offset credits available:
- CERs: Certified Emission Reductions, which can be earned from "Clean Development Mechanisms" in uncapped countries.
- RMUs: Removal Units, which can be earned by countries from reductions in emissions in capped countries relating to land use, land use change, and forestry.
- ERUs: Emission Reduction Units, which can be earned by "Joint Implementation" (JI) programs that reduce emissions in capped countries. ERUs are converted from, and hence reduce, the host country's AAUs or RMUs. When transferred to another capped country they increase the recipient country's assigned amount of permitted emissions.

CLAYTON UTZ

Slide 10

Voluntary offsets

- Voluntary offsets: credits created under schemes that are outside the Kyoto Protocol or compulsory domestic schemes.
- "VERs": Verified Emission Reductions. Usually accredited and audited to demonstrate emission levels, or emission reductions, that would be better than "business as usual". Need to be created in a sector that is not already under emission control regime.
- A number of standards and schemes, including:
  - "Gold Standard"
  - "GHG Protocol"
  - "Greenhouse Friendly"
- Traded for "public relations" purposes – bought by organisations that wish to demonstrate their "greenness" or "carbon neutrality".

CLAYTON UTZ

Slide 11

Legal nature of these units

- AAUs, CERs, ERUs: international contractual promises made under the Kyoto Protocol, which is part of an international convention (UNFCCC).
- Domestic scheme units: Typically either:
  - Transferable statutory licence or permit (if consequence is prohibition or penalty);
  - Transferable tax credit (if consequence is tax or charge);
- VERs: Typically transferable chose in action, representing promise by abator that certain action has occurred, or not occurred.

CLAYTON UTZ

Slide 12

Use of offsets

- Countries can buy these Kyoto offset units from other countries, or the projects that generate them.
- Traders can buy the Kyoto offset units and sell them to capped countries.
- Some capped countries allow emitters or traders in their country to surrender the Kyoto offset units against liabilities owed to the country under domestic schemes (e.g. EU scheme).
- Purchase of the offset units, or obtaining them by surrender under domestic schemes, allows the country to increase its emissions in addition to the AAUs held.
- Query future of offset mechanisms post-2012.

CLAYTON UTZ

Slide 13

Is there a role for banks?

- Arbitrage opportunities, particularly between international schemes and domestic schemes.
- Also arbitrage due to insufficient price discovery and demand-supply information.
- Liquidity providers, brokers between sellers and buyers, who are often in different jurisdictions and sectors, and who can't see each other to trade.
- Investment opportunity (?!!), if you think price of carbon will rise as targets tighten and reductions become more expensive.
- Offering risk management products – carbon price hedges.

CLAYTON UTZ

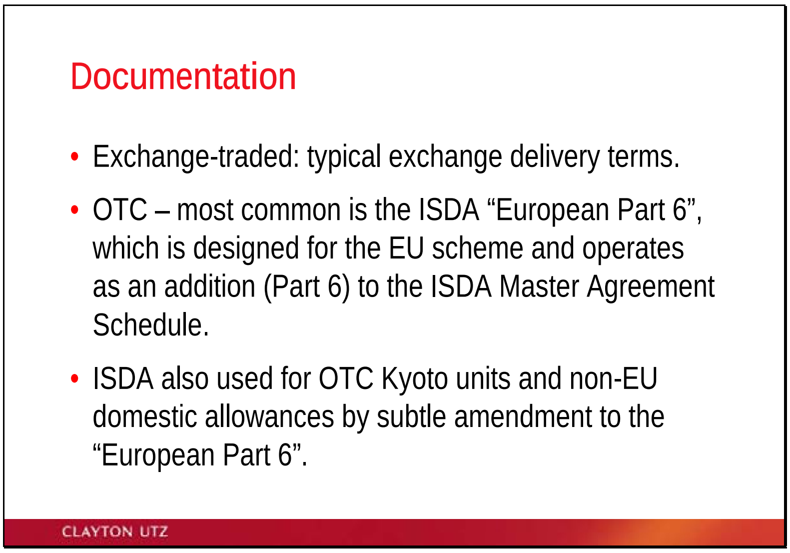
Slide 14

Trading methods

- Exchange trading of EU allowances and Kyoto offsets, particularly on European exchanges.
- Bilateral OTC trading.
- Brokered OTC trading.
- Some cash-settled derivatives against future prices.
- Kyoto units and EU allowances delivered via registries.
- VERs delivered by private transfer.

CLAYTON UTZ

Slide 15


Documentation
• Exchange-traded: typical exchange delivery terms.
• OTC – most common is the ISDA “European Part 6”, which is designed for the EU scheme and operates as an addition (Part 6) to the ISDA Master Agreement Schedule.
• ISDA also used for OTC Kyoto units and non-EU domestic allowances by subtle amendment to the “European Part 6”.
CLAYTON UTZ