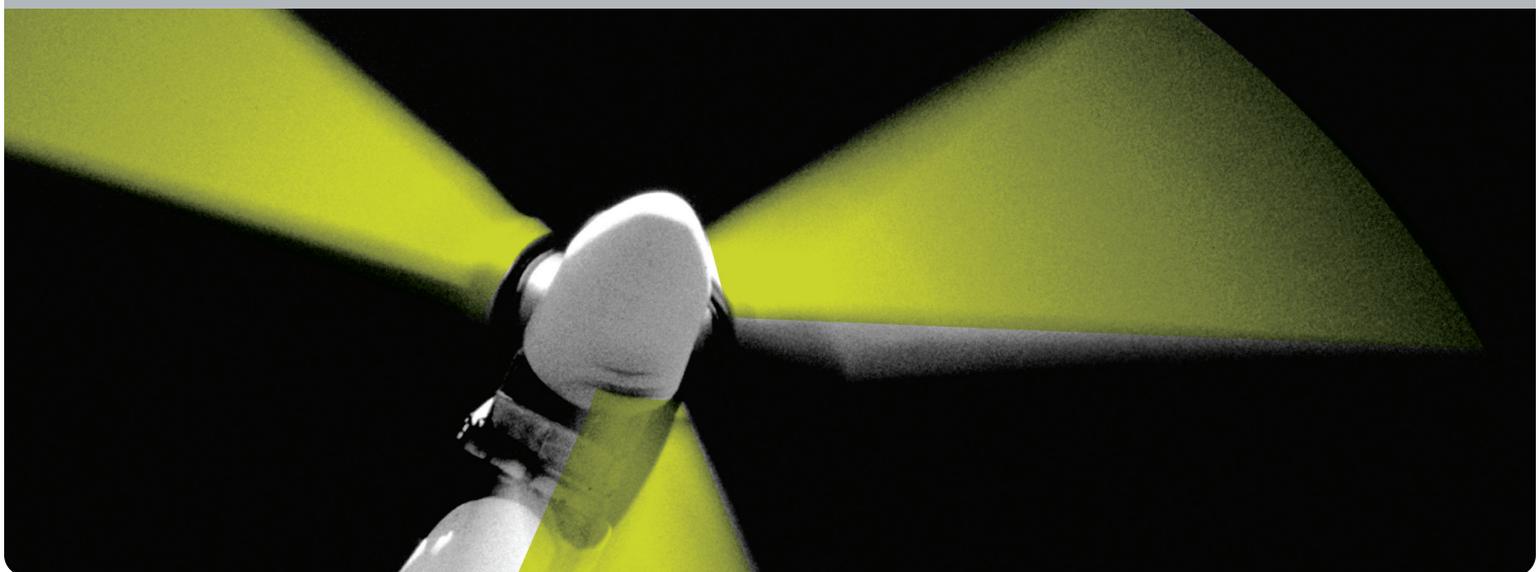


To market, new market: Trading carbon –
what you need and what you need to watch out for

November 2011



When the “flexible price” phase of Australia’s Clean Energy Scheme commences on 1 July 2015, with it will come new opportunities for spot trading in over-the-counter (OTC) carbon derivatives. Now the legislation has passed there will be opportunities for forward trading in emissions units. To take advantage of these, companies need to understand what is required of them and what are the risks.

This paper considers:

- what a carbon unit is;
- who might be interested in trading carbon unit derivatives;
- what OTC documentation parties are likely to adopt to trade carbon units;
- why parties need an Australian Financial Services License to deal in carbon units;
- the floor price issue; and
- how parties can be assured that their title to units is secured under the Act.

The carbon unit explained

The Clean Energy Scheme creates a new form of personal property: the carbon unit. It requires that liable entities surrender these units each financial year to cover their carbon emissions.

The units which can be surrendered during the first three years of the scheme will be either allocated free of charge (as part of the compensation packages under the scheme) or purchased by liable entities from the Government for a fixed price. After the third year of the scheme, the scheme transitions to emissions trading and units which can be surrendered will be issued by the Government in an auction process (in addition to those allocated free of charge as part of the compensation packages). The Australian Government’s reasons for introducing a fixed price at the outset of the Scheme are to promote price stability and to appease some interest groups, however there are others in the market that argue that a fixed price will significantly reduce incentives and opportunities for trading in the spot market.

At all times during the scheme, liable entities will be required to acquire sufficient permits to meet their surrender obligations under the scheme. Once trading commences, parties will be exposed to fluctuations in the spot price for carbon units creating hedging opportunities and driving the new market.

Who are the likely players in the carbon market?

We would expect OTC emissions trading to take several forms, but see particular opportunities for:

- physically settled trades to facilitate compliance buyers meeting their obligations under the scheme;
- physically settled sales of units by entities which receive the units under the compensation packages and wish to realise them for cash to meet increased costs attributable to the scheme;
- cash settled trades which allow both primary and secondary market participants to hedge their exposure to a fluctuating carbon price; and
- cross-border trades which may be entered into by compliance and secondary market players as well as entities looking for international pricing arbitrage opportunities, for example buying “low cost” permits from one market and selling them into another market where permits are priced more expensively.

In the first three years of the flexible price phase (ie. up to 1 July 2018), hedging opportunities may be hampered by the implementation of a floor price (which we will cover in more detail below), but generally it is clear that market players will be looking to enter at least some of these trades.

What OTC documentation do parties need to trade carbon?

Parties may choose to trade carbon units under bespoke “standalone” transactions however, if they have an existing ISDA Master Agreement, we anticipate there will be a simple, effective way of adopting terms which are appropriate in the context of carbon trading. This can be done by adopting the terms of an Emissions Annex as Part 6 of the Master Agreement Schedule.

It is preferable for parties to use an ISDA Master Agreement for several reasons, but perhaps most importantly to obtain the benefit of close-out netting. Under the ISDA Master Agreement a party may, where there has been an event of default or a termination event, close-out their position in respect of all affected transactions and net across the value of those positions to reach one single figure (the “Close-Out Amount”). Effectively, it allows the non-defaulting party to reduce gross exposures across the relevant category (or categories) of transactions to a single net exposure and avoids the risk of a party having to prove in the insolvency of its counterparty (assuming close-out netting is enforceable in the jurisdiction of incorporation of the defaulting counterparty).

It is also preferable for parties to use the 2002 version of the ISDA Master Agreement rather than its predecessor, the 1992 version. The 2002 version reflects more accurately the current state of play in the market, and the treatment of the single payment measure of "Close-Out Amount" is considered by many to be more transparent and objective under the 2002 version.

What is the Part 6 Emissions Annex and how do you incorporate it?

The AFMA Part 6 Emissions Annex was a set of provisions published by the Australian Financial Markets Association (AFMA) in 2009 in response to the Government's proposed Carbon Pollution Reduction Scheme, and which parties could adopt when trading carbon permits. The Annex covers matters like physical settlement, tax (VAT and GST) uplift and parties rights in the event of an abandonment of the scheme.

Under the Part 6 Emissions Annex, the Annex provisions automatically applied to:

- any Emissions Allowance Transaction identified as such in a Confirmation to an ISDA Master Agreement; and
- any Transaction referred to in a Confirmation to an ISDA Master Agreement as being subject to the terms of Part 6.

We expect that AFMA will publish an Emissions Annex on substantially similar terms to the previous Annex to apply in the context of the Clean Energy Scheme, setting out particular elections which have to be made. The parties will need to complete the relevant particulars and make the elections as required in the document.

The 2009 AFMA Emissions Annex was almost identical to ISDA's Part 6 Emissions Annex for parties trading in EU emissions units derivatives. We would anticipate the 2009 draft Annex to be reactivated and adopted with only minor fine tuning. AFMA defines terminology imported directly from the European scheme, such as references to "Allowances" which under the Australian Annex are defined as the relevant emissions units – Australian or international.

The 2009 AFMA Annex and the EU Annex can both be incorporated into either the 1992 version or 2002 version of the ISDA Master Agreement, but for the reasons outlined above, we would advocate using the 2002 version over its predecessor.

What licence do you need to trade carbon units?

Carbon units will be "financial property" under the Corporations Act. Therefore any person who engages in the business of:

- providing carbon unit advice;
- "dealing" in carbon units;
- "making a market" for carbon units;
- operating a market for carbon units; or
- providing a custodial or depository service for carbon units;

will need an Australian Financial Services License (AFSL).

A person who engages in any of those activities in relation to derivatives in carbon units will also require an AFSL.

Note that the concept of "dealing", where the product being traded is not a derivative and is not issued by the person trading it, is confined to trading on behalf of third parties (ie. broking). Therefore, an AFSL will usually not be required for:

- a liable entity to acquire carbon units for its own compliance;
- an entity that receives an allocation of carbon units to transfer or sell them to another person on its own behalf;
- a person that trades carbon units solely through a licensed broker (provided that it does not do so with such regularity that it "makes a market");
- a person that buys and sells carbon units on its own behalf (also provided that it does not do so with such regularity that it "makes a market").

A person that engages in a business of trading in derivatives over carbon units (as opposed to trading in physically settled carbon units) is likely to require an AFS licence to do so, unless it trades only through a licensed broker, or is able to rely on an exemption for trading in derivatives to manage a risk in its business, where the trading activity is not a significant part of its business.

If you do not already hold an AFSL, you can find out more about the [licence and the obligations here](#).

Floor price issue: what is it and will you be affected?

What is the floor price?

An eligible international emissions unit cannot be surrendered during the first three years of the scheme (the fixed price years). For the next three years, the flexible charge years from 1 July 2015 to 30 June 2018, an eligible international emissions unit cannot be surrendered unless the person pays the charge imposed on that surrender (section 124 of the Clean Energy Bill).

The surrender charge will be an amount ascertained in accordance with the regulations, but will not exceed \$15 (in the first flexible charge year), \$16 (in the second flexible charge year) and \$17.05 (in the third flexible charge year) (section 8 of the Clean Energy (International Unit Surrender Charge) Bill 2011).

Who will be affected?

Imposing a surrender charge on eligible international emissions units during the first three flexible charge years will mean for those liable entities (mostly large users of electricity and large power generators) who buy forward eligible international emissions units in order to fix their cost and lock in a price during the first three flexible charge years will have two exposures.

- Firstly, they will be exposed to the difference between the spot price of the eligible emissions unit and the surrender charge (**the floor price cost**);
- The second exposure will be the loss they incur on the forward trade itself, being any drop in the spot price of the eligible emissions unit below the purchase price that was initially paid for the unit (**the trade loss cost**).

There are many who argue that the design of the floor price under the scheme will produce an inequitable result for those entities who have proactively taken steps to hedge their cost as they will be exposed to both the floor price cost and any trade loss cost, whereas entities who have not bought forward eligible international emissions units will have exposure only to the floor price cost.

The Government's design of this floor price mechanism is not yet finalised, and several alternative arrangements are under discussion which might facilitate forward trading in international emissions units, but until the final form of the Regulations is known there is a significant disincentive to acquiring international emissions units for the first three flexible charge years.

Security measures under the Clean Energy Scheme: Are they adequate?

Why should you care about emissions unit integrity?

In the EU carbon market, "phishing" and cyber theft of permits has recently severely undermined confidence in the market. **Bona fide purchasers of units without notice of their defective title** have been victims because the legal frameworks failed to provide for this problem.

In Australia, the legislation has adopted a significant improvement in market design over the EU scheme, in order to address this issue.

How does the Regulator address security risk and protect customers?

The Clean Energy Regulator will be empowered to act to prevent the system from being undermined. The Regulator will be able to:

- unilaterally close, with notice, any Registry account if an account holder has breached the Registry regulations;
- correct any errors in the Registry, on the Regulator's own initiative, if an entry was made without cause, is wrongly in the Registry or has been wrongly removed;
- do any of the following in order to ensure the integrity of the registry or to prevent, mitigate or minimise abuse of the Registry or prevent, mitigate or minimise criminal activity involving the Registry:
 - suspend the operation of the Registry;
 - defer giving effect to a transfer instruction for up to 48 hours;
 - refuse to give effect to a transfer instruction;
 - impose conditions restricting or limiting the operation of an account for a specified period; or
 - suspend a person's registry account; and
- refuse to make an entry in the Registry for a Kyoto unit being transferred in from a foreign account if it has reasonable grounds to suspect that the instruction is fraudulent.

The Regulator's powers do not protect the innocent upon whom the fraud was perpetrated.

Negotiable title – the Australian answer to the European phish

The Clean Energy Bill does protect the innocent defrauded by providing for negotiable title to units.

It sets out that the registered holder of a carbon unit is the legal owner of that unit, provided that they purchased it in good faith for value without notice of any defect in the title. The Clean Energy (Consequential Amendments) Bill provides the same protection for registered holders of eligible international emissions units entered onto into Registry.

What does this mean? If the Regulator fails to prevent a holder from becoming the registered holder of a fraudulent unit, for value without notice of a prior fraud, you will nonetheless have good title without the need to prove a chain of title all the way to the original holder of the instrument.

What if another person has obtained and hold units fraudulently? The courts are empowered to act when a person has been convicted of specific crimes under the Criminal Code 1995, relating to fraudulent conduct or making misleading and deceptive statements. The court may order the relinquishment of units if any or all of the person's units are directly attributable to their offence.

It is very important that these safeguards are in the Clean Energy legislative package when it is passed.

What about the effect of the carbon price and existing power trades – can you recover the carbon cost?

Whether contract prices in existing electricity trades will be able to be adjusted to reflect the carbon cost will depend on many variables, most notably whether the parties have taken steps to price for carbon under their existing trades.

One mechanism commonly adopted by electricity market players is the inclusion of AFMA's Carbon Benchmark Addendum. How does it work? It effectively allows parties to increase the contract price of their trade by an amount equal to the product of the Average Carbon Intensity of power generators (as published by the Australian Energy Market Operator (AEMO)) and the Carbon Reference Price (determined by methodology developed by AFMA's Electricity Committee.) However, whether the Addendum you have incorporated will apply depends on several factors, especially during the fixed price period (where there is no spot market in existence).

AFMA has published four versions, in December 2008, December 2009, March 2010 and August 2010 and parties have traditionally adopted the latest version in their trading documentation. What matters is that they define a "Carbon Scheme" differently. Unless the proposed scheme fits the definition under the particular Addendum adopted, it may not operate.

If you have existing electricity trades, particularly if they incorporate the 2008 or 2009 Addenda, then you may need to seek advice about whether you will be able to adjust the fixed price to take account of the carbon price. Without an operational Addendum your prices may not be reflective of a carbon-inclusive power price come 1 July 2012.

Conclusions

Parties who are interested in trading carbon in the new Australian carbon market need to start thinking now about preparing the right documentation, making sure they have their AFSL in place and keeping informed of issues relevant to the design and implementation of the new Clean Energy Scheme.

The passage of the legislation means that "change of law" clauses in contracts will no longer be able to be relied upon to implement price increases for contracts entered after the law has been passed.



Graeme Dennis

Partner

T +61 2 9353 4106

F +61 2 8220 6700

M 0419 666 262

gdennis@claytonutz.com



Louise McCoach

Partner

T +61 2 9353 4679

F +61 2 8220 6700

M 0408 647 915

lmcoach@claytonutz.com



Romany Sloan

Senior Associate

T +61 2 9353 4777

F +61 2 8220 6700

M 0434 155 441

rsloan@claytonutz.com

Sydney

Level 15
1 Bligh Street
Sydney NSW 2000
T +61 2 9353 4000
F +61 2 8220 6700

Melbourne

Level 18
333 Collins Street
Melbourne VIC 3000
T +61 3 9286 6000
F +61 3 9629 8488

Brisbane

Level 28
Riparian Plaza
71 Eagle Street
Brisbane QLD 4000
T +61 7 3292 7000
F +61 7 3221 9669

Hong Kong

703 - 704
The Hong Kong Club Building
3A Chater Road
Central Hong Kong
T +852 3980 6868
F +852 3980 6820

Perth

Level 27
QV1 Building
250 St. Georges Terrace
Perth WA 6000
T +61 8 9426 8000
F +61 8 9481 3095

Canberra

Level 8
Canberra House
40 Marcus Clarke Street
Canberra ACT 2601
T +61 2 6279 4000
F +61 2 6279 4099

Darwin

17–19 Lindsay Street
Darwin NT 0800
T +61 8 8943 2555
F +61 8 8943 2500

www.claytonutz.com

Persons listed may not be admitted in all states and territories. This document is intended to provide general information. The contents do not constitute legal advice and should not be relied upon as such.
© Clayton Utz 2011