

UNPOLLUTED CONSENSUS NEEDED FOR CARBON TRADING

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The problem with pollution has always been that it is someone else's problem. A polluter has been able to get away with polluting because there was no incentive to deal with the mess. Although there are a myriad of rules and regulations about where and when pollution can occur, there has not been much in the way of an incentive system in place. The polluters have been brow beaten into submission by regulators and public pressure, rather than by their own enlightened self-interest.

Over the past decade there has been a growing market in different types of pollution, particularly in the US. Contracts in sulphur dioxide and nitrogen oxide, two of the major pollutants from coal fired-power plants, trade regularly and recently there has been a plethora of contracts to trade greenhouse gas emissions.

The markets for sulphur dioxide and nitrogen oxide were created as part of the 1990 *Clean Air Act* in the US and are domestic markets. However, the market for trading greenhouse gases - or for carbon - is potentially the largest and most international pollution market. The potential size and complexity of such a market creates as many opportunities as there are risks.

The biggest problem facing carbon markets is that they can only exist within a legislative framework and the structure of that framework is critical to the success or otherwise of these markets. Trading in a 'thing' such as a bushel of wheat is easy, because there is a bushel of wheat to sell. Trading in something like carbon credits is more difficult because there is no 'thing'. There is only a concept. No one can describe what a kilo of carbon credit looks like, as opposed to a bushel of wheat or a tonne of frozen orange juice.

The same problem about a 'thing' could be said about most financial commodities, options and the like. However, in the case of the financial markets, there is common ground on what it means to be a shareholder in a company and from that base any number of different derivatives can be created.

The problem with carbon credits is that it is such a new market and a new concept. Without getting into the whys and wherefores of the science behind carbon trading, it is possible that what science has given in the form of a rationale for trading carbon credits, science could easily take away again.

Then there is the political will or otherwise to set up the rules to allow a market to operate. In New Zealand, we have seen the forestry sector get very upset about the Government not allowing foresters to keep carbon credits that they had generated. The issue may have had more to do with the poor returns on forestry at the time than the longer term benefits of carbon markets, but the point remains - those who can create a carbon offset want the ability to sell that offset to someone else for money.

This is where enlightened self interest comes in. By creating a market where people are willing to trade carbon offsets and other greenhouse gas contracts, there is an incentive for carbon offsets to be created - the economics of doing something that might be considered a marginal activity improves because of the creation of another cash flow or value source.

There is no doubt that markets trading in greenhouse gases are the way to go to incentivise people to create carbon offsets. 'Go green and make money doing it' sounds a lot better in the boardroom and around the breakfast table than 'go green because the Government is taxing us to do it'.

But therein lies the issue. Will the Government be willing to introduce market structures that allow New Zealand businesses and individuals to trade carbon offsets and other greenhouse gas contracts? There have been some interesting experiments with TradeMe use as a way of testing to see where a market price might fall for some carbon offsets. While this could be passed off as something of a publicity stunt, the idea is nevertheless a good one.

Industry groups have rapidly formed to take advantage of any carbon offset trading initiatives that the Government may announce. The benefits from trading credits are significant for the economy as it is for the brokers and market operators that would participate.

The question is whether the Government will dictate from on high or allow more of a grassroots consensus.

While there is no state/Federal distinction in New Zealand, a broad political consensus is still required in order to provide the impetus to make such a trading scheme work. Does this come from the top or from the bottom?

Based on its track record, the current Government has demonstrated a 'mother knows best' attitude and there is no reason to think that when the policies are announced, the same won't be true again. Whether this is enough to develop broad political support or consensus remains to be seen.

No investor or market participant is going to want to invest in developing a market if the political winds change and what was proposed is going to be changed. If the Government wants to be successful in developing carbon offset markets in New Zealand, then it has to receive a broad mandate as much from within the political system as from outside it. That means, more or less, all parties in parliament agreeing to the rules.

Markets are successful when the rules are clear, the legal rights of participants are well understood and there is transparency. It is the role of the Government to ensure that the legal rights are clear and well understood. This won't happen without broad public and political support.

The success of markets in greenhouse gases and carbon offsets is entirely dependent on the political process in its initial stages, not on the wishes or whims of market participants. ▀