Carbon insurance and the Emissions Trading Scheme

Jo McIntonsh and Ollie Belton

Is it time to take another look at your carbon and the Emissions Trading Scheme? In 2011, I was asked to speak to forest owners at the Carbon Forestry Conference. Back then, the room was full of optimism that carbon and the ETS was expected to be a new and valuable income stream for forest owners. Carbon prices were expected to immediately reach the capped value of $25 a tonne.

As most of you no doubt know, that optimism soon disappeared as carbon prices fell. The actual New Zealand Unit price went as low as $1.50 a tonne in 2013. Foresters were frustrated by the ability for businesses to offset their carbon liability with cheap international carbon units. This was further exacerbated by the 2008 global financial crisis which resulted in lower activity and lower emissions globally. Prices have generally languished at less than five dollars a tonne ever since, well below the level that most people require to make ETS economically viable.

In late 2017 the world changed and the carbon price broke through the magic $20 a tonne mark. As a result, we are seeing a resurgence of interest in carbon. It is now necessary to take another look at carbon, the ETS and what the risk implications are.

Risk – hold or transfer?

A big part of my job is to help clients identify risk and then help them decide how they manage that risk – do you want to retain the risk and self-insure, or do you want to transfer some of that risk to insurance? First of all, the good news is there are insurance policies available for those involved in ETS. There are options for plantation timber owners and also options for native 'lock up and leave' foresters who are part of the permanent forest sink carbon scheme – the Permanent Forest Sink Initiative.

The not such good news is that the ETS scheme is complicated and is difficult for most lay people, insurance brokers included, to get their heads round. This is an area where you really need good advice. All insurance options require you to nominate your sums insured and there are a number of choices around how you structure your policy. Getting this right is vital, which is why I have asked Ollie Belton from Carbon Forest Services Limited to comment later in this article on the main areas for forest owners to consider. From my perspective, there are three main insurance policy options available for forest owners.

Three options

Adding to current policy

Option one is that plantation forest owners can simply add carbon stock tonnes per hectare and a carbon unit value per hectare to nominated standing timber sums to be insured. The carbon values chosen can be obtained from the MPI look-up tables if the forest is less than 100 hectares. If your forest is over 100 hectares use specific participant tables provided to you by MPI once you have registered in the scheme.

This method is a very blunt instrument and relies on you getting the standing timber values and carbon values correct. Given the market fluctuations across both commodities, that is easier said than done.

Rotation timber policy

Option two is to purchase a rotation timber policy. This combines a traditional standing timber policy with collective carbon cover. The policy is divided into two sections. The first is standing timber cover which includes all the usual optional covers such as fire, wind, removal of debris and replanting as well as a second section which covers your collective carbon.

Within the collective carbon section there are more choices and options for you to consider. These include whether you want a fixed price replacement value or market replacement value structure and options to have indexed or future carbon cover for carbon not yet sequestered for one to a maximum fiver-year period.

Future carbon helps to cover shortfall of projected future carbon growth in your trees due to an insured event. Your trees may die causing loss of carbon to emission. The trees may survive but the stress caused to them may diminish future growth for a period of time. Future carbon allows you to main a carbon income for the first five critical years after an event and can help maintain carbon payments if you have entered a forward sold contract until you can re-establish your forest.

Permanent non-harvest forests

The third option is the other policy available for permanent non-harvest forests such as native forests registered for carbon under the Permanent Forest Sink Initiative and exotic planted forests which are not going to be harvested. This policy does not include the standing timber section and focuses only on covering carbon loss risk.

Sold carbon a greater risk

If you have sold your carbon to a third party the risk is greater. You not only have to consider your own loss, but also your contractual obligations to the third party.

These contracts need careful attention. I have seen contracts which make forest owners responsible for 100 per cent of the value of the carbon for all perils including wind and fire, and yet the insurance policy in place has comparatively low wind limit.

What happens if there is a catastrophic loss? For example, a cyclone could wipe out significant standing timber and with it your carbon. If you have a low wind limit, have you just created a large financial gap? I also question some of these contracts as it has no confirmation over who has priority on the insurance placed. If the policy benefits the carbon purchaser in the first instance, that again means the forest owner may be left in financial strife.

Transfer of obligations

For many of you, if you have ETS registered forest planted in the 1990s, you may be beginning to harvest those trees. MPI recently put out information to highlight to forest owners that they are noticing many forest owners are opting to sell the standing trees by granting a forest right. They go on to say that ETS participants need to be aware that this will automatically result in a transfer of ETS participation.

The seller ceases to be the ETS participant. The forestry right holder becomes the new ETS participant, and as such may become responsible for meeting emissions obligations associated with the harvest. They advise anyone about to undertake a harvest, or anyone who is a prospective purchaser to obtain legal advice before they begin.

As with most of my past articles, the best advice I have is to make sure you understand the risk and set your policy values and policy structures accordingly. At this point I will let Ollie Belton finish the article.

Carbon loss insurance

With New Zealand Units trading above $20, forest owners should take note of the increased financial cost when repaying carbon to the government if the forest is destroyed by fire or storm damage. Those at most risk are forest owners who have sold NZUs. In the event of carbon loss these foresters will need to go to market to buy replacements. Because the NZU price has risen 140 per cent over the past two years, it is likely that the forest owner will have to pay back much more than earned from carbon sales, and the amounts can be significant. For example, replacing carbon on an ETS registered 20-year-old radiata block in Gisborne can cost more than $6,500 a hectare at the current price.

Fortunately, carbon loss insurance is available and premiums are relatively inexpensive given the insured values. I would recommend all forest owners who have sold carbon, or are considering selling carbon, to look at insuring as a minimum the carbon replacement risk associated with sold NZUs. Even forest owners who are not NZU sellers may want to consider carbon forest insurance, not as a hedge against carbon loss liability, but as a strategy for protecting lost income if required to repay to the government unsold NZUs.

When getting cover, forest owners should get specialist advice from the right professionals to ensure they are not over-insured and paying too much in premiums, or under insured and exposed to financial risk.

Aon has an insurance scheme for NZFFA members and in support, pays a contribution to the NZFFA.

Jo McIntosh is an Executive Director of Aon and specialises in insurance for forestry and horticulture.

Ollie Belton advises forest owners on how to maximise their carbon value while mitigating the associated risk. This includes ensuring carbon insurance cover is adequate and correct.