

Emission Critical

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On 20 September 2007, the Government released its much anticipated framework for an Emissions Trading Scheme (ETS) and measures to encourage forestry and more sustainable land use. Emission Critical provides an overview of the Government's announcements and proposed solutions, describes the ETS, how it will function, who will be captured under the proposals, and the implications for businesses.

Background

New Zealand ratified the Kyoto Protocol in 2002 committing New Zealand to a legally binding greenhouse gas target between 2008 and 2012 (the First Commitment Period). New Zealand's target is to maintain its average annual emissions over this period at 1990 levels. However, emissions data released by the Government yesterday shows New Zealand's expected deficit position for the First Commitment Period is projected to rise from 41.2Mt to 45.5Mt. The ETS and the forestry and land use proposals announced by the Government are designed to assist the country to reduce its deficit during the First Commitment Period to 25Mt and to establish a downward trend into the future. The Government will continue to accept some Kyoto liability during the First Commitment Period.

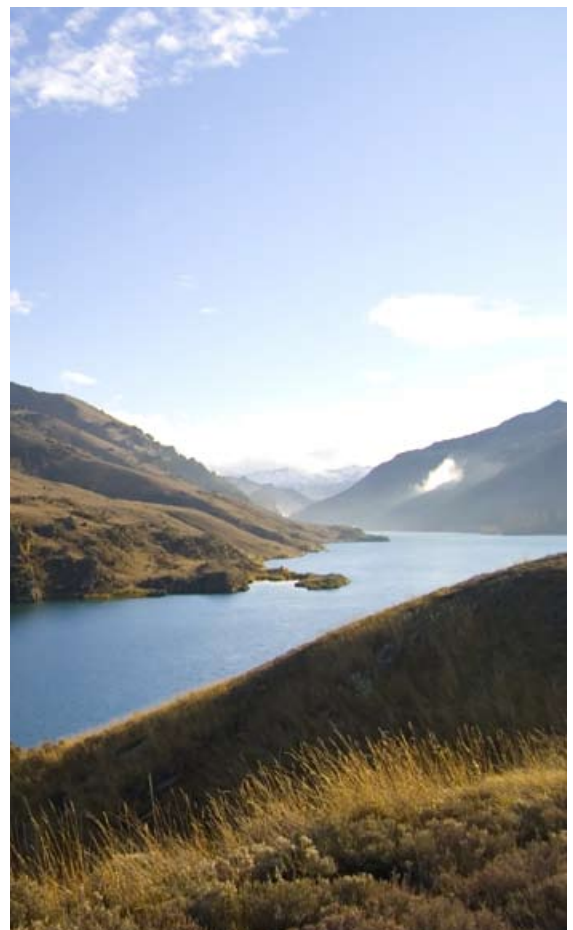
The Proposals – an overview

A cap and trade ETS creates a financial incentive for emission reductions by assigning a cost to polluting. Under the cap and trade system, participants are allocated or purchase a share of capped emissions permits which they can trade with others. The key features of the Government's proposed regime are:

- Economy wide application, capturing all six greenhouse gases covered by the Kyoto Protocol and all significant sources of those gases;
- A phasing in of the sectors, reflecting the differing abilities of the sectors to adapt and the price effects of the scheme on the economy;
- Participants in the ETS will be limited to a small number in each sector, approximately 200 in total (excluding the forestry sector);
- The primary domestic unit of trade will be a New Zealand Unit (NZU); and
- The ETS will be linked with other international markets, allowing both sales to, and purchases from these markets.

In addition to the ETS, the Government has also announced a number of other initiatives and measures to address climate change.

We consider the key issues associated with the ETS, and its implications for businesses below.



What is an NZU?

The primary unit of trade in the ETS will be an NZU. During the First Commitment Period, each NZU will be fully comparable to a Kyoto unit and will be backed by a Kyoto unit in the New Zealand Emission Unit Registry (NZEUR). Participants in the ETS will be able to exchange NZUs for Kyoto units through the NZEUR and sell them internationally.

In addition, NZUs will also be the unit of trade for the forestry sector. ETS participants will be able to carry over NZUs for use in future compliance periods, after 2012, but will not be able 'borrow' from future periods.

It is not currently envisaged that NZUs will be made available for offset projects, although the Government is engaging with stakeholders on the possibility of including the use of offsets in the ETS.

Who is captured?

The Government's proposals are broad – economy-wide and capturing all sectors and all gases. The ETS will be introduced over a five year period with the timing of each sector's introduction summarised in the following table.

Sector	Commencement of obligations	End of initial compliance period
Forestry (includes deforestation of pre-1990 forest land and Afforestation post-1989)	1 January 2008	31 December 2009 (first compliance period is two years)
Liquid fossil fuels (mainly transport)	1 January 2009	31 December 2009
Stationary energy (including coal, gas and geothermal)	1 January 2010	31 December 2010
Industrial processes (non-energy) emissions	1 January 2010	31 December 2010
Agriculture (includes pastoral and arable farming and horticulture)	1 January 2013	31 December 2013
Waste and other sectors	1 January 2013	31 December 2013

The forestry sector is the first to participate in the ETS, providing price signals as early as possible to minimise the flexibility of foresters to bring forward potential deforestation. The forestry sector will be required to start monitoring their emissions from 1 January 2008, with a two year compliance period running to 31 December 2009 to coincide with other sectors entering the scheme and to allow for the ETS infrastructure to be in place. Different rules apply to pre and post 1989 planted forests, with owners of post 1989 forests having the option of electing into the ETS.

The transport sector, one of the fastest growing sources of emissions in New Zealand, will follow in January 2009 as it is a relatively straightforward sector to address from an administrative and measurement perspective. This sector includes liquid fossil fuels such as petrol, diesel, aviation gasoline, jet kerosene, light fuel oil and heavy fuel oil. The Government intends to capture a small number of upstream participants such as importers and fuel producers.

The large heavy emitting industrial sector incorporates CO₂ emissions from activities such as metal, mineral and chemical industries, and non-carbon dioxide emissions from industrial processes including PFCs and HFCs. This sector also includes electricity generation. The ETS will not apply to these sectors until January 2010. The Government has indicated that this is due to the complexity of these businesses, particularly in relation to potential competitiveness at risk exposures of some of the entities captured within this sector.

The nature of New Zealand's emissions profile is disproportionately skewed by emissions from the agricultural sector. In the interest of fairness and equity the Government has announced that agriculture will be included in the ETS. However including this sector is not straightforward and as such agricultural emissions will not participate in the scheme until January 2013. Further, the Government has undertaken to honour its 2003 agreement to farmers by not introducing a priced based measure until 2013.

How are emission permits allocated?

This was always going to be the political hot potato.

The Minister for Climate Change has indicated that NZUs will not be issued free to emitters where they would be able to pass on the cost anyway, and therefore their profits would be largely unaffected. In Europe, the free allocation to entities that were able to pass on the cost, resulted in a number of businesses receiving windfall gains. The Government is looking to prevent a similar occurrence here.

As a result, in the transport and industrial process sectors there will be no free allocation of units to either those companies in the fuel supply chain or to electricity generators. In contrast, the Government has proposed that those emitters who face international competition from firms not currently facing emissions pricing, should receive free allocations of units although these will be capped at 90% of their 2005 emissions.

In the forestry sector, post-1989 forest owners will be able to opt into the ETS and be eligible for 100% of the carbon credits although they will be required to surrender units if carbon stocks fall for example on harvest. Pre-1990 forest owners who are not currently eligible for credits under the Kyoto Protocol will receive an amount of free credits based on historic rates of deforestation, which they will be able to trade if they do not wish to deforest.

While the agricultural sector will not be required to participate in the ETS until January 2013, the Government has indicated that farmers will benefit from free allocation of NZUs at that time based on 90% of their 2005 emissions, which depending upon the approach adopted, could be allocated directly to farmers themselves.

The Government has also indicated that in principle it does not intend to provide allocations to new sources of emissions during the period of free allocations, and that firms that cease trading will not retain any free allocation, preventing companies profiting from the sale of 'hot air'.

Point of obligation

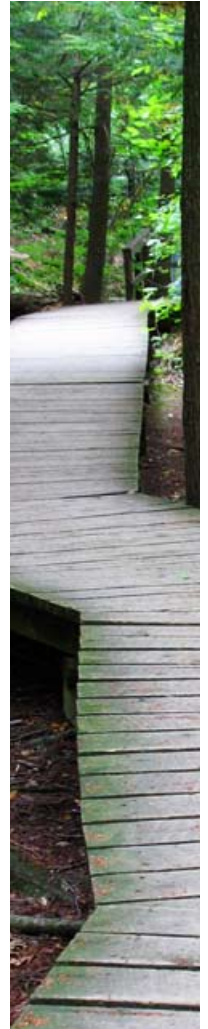
The point of obligation refers to where in a supply chain the obligation for accounting for emissions arises. There is a balancing act to be had here also, between sending the right signals to those who create the emissions, and the costs of compliance. Generally, it is appropriate to target the emitters, but in some cases this is impracticable. The Government has adopted a general principle of placing the obligation for emissions upstream in each market to limit the number of participants, facilitate administration and provide appropriate incentives to change behaviour.

In the forestry sector, generally landowners are the most appropriate point of obligation for emissions from deforestation of pre-1990 forest land, and for post-1989 afforestation. NZUs (and associated liabilities) would be awarded to landowners or forestry right holders as appropriate (if they opt to receive them).

In the transport sector, it is impracticable to directly target all those who generate emissions through operating their vehicles, boats, trains or planes. Instead, the point of obligation will be a small number of firms high in the supply chain, in particular fuel suppliers taking fuel from the refinery or those who import it.

In the industrial sector given the breadth of industries involved and gases produced, the point of obligation will differ. In some instances, the emitter will bear the obligation, such as aluminium smelting, while for other sectors the point of obligation may be on the importer. In respect of the stationary energy sector, the Government has yet to decide as to whether the scheme will apply directly to importers or extractors of fuels, or those that actually produce energy and emissions from the fuel.

The Government has indicated it is yet to finalise its approach to the point of obligation for the agricultural sector. Its options include at the farm level, the processor level or possibly a sector body level, although it has indicated that its preferred approach at this stage is to impose direct obligations on processing companies, such as fertiliser manufacturers, dairy processors and meat processors.





What are the implications for business?

Increased costs

Most business will experience increased costs as a result of the introduction of the ETS. These costs are likely to manifest themselves in two ways:

- directly as they cause emissions; and/or
- indirectly as a result of the increased costs of fuels and electricity used.

However, to date, many businesses likely to be affected by the regime have yet to adequately consider their greenhouse gas emission profile or how they will implement monitoring, reporting and verification requirements and are therefore unable to assess the potential financial impacts on their operations.

It is advisable that those businesses that have been targeted under the proposed framework undertake a greenhouse gas inventory (or carbon footprint) and have the inventory independently verified. This will allow them to properly assess the impact of the regime on their business, develop a robust carbon strategy and in preparation for operating under the ETS, and avoid potential penalties for non-compliance under the scheme.

Compliance and enforcement

Participants in the ETS have an obligation to surrender NZUs for each tonne of emissions generated, which will require participants to calculate emissions, report specific emission activities and comply with administrative requirements.

The Government's preferred approach for compliance is similar to that used in the New Zealand tax system – one of self-assessment with reporting undertaken at least annually. However, the Government has indicated that it is still evaluating other options, such as the frequency of monitoring and reporting, and independent verification of emission reports. Annual reports will need to be submitted by 31 March the following year and emissions surrendered at the same time. Timeframes will therefore be tight and businesses will need sound systems in place to enable compliance.

In order to allow businesses to build capacity, the Government is expecting participants to commence reporting six or 12 months prior to them assuming surrender obligations. For the agricultural sector, although it will not participate in the ETS until January 2013, the Government is proposing the sector will start measuring and reporting its emissions in 2011.

The penalty regime under the ETS is significant. There will be civil liabilities for failure by participants to meet their obligations and criminal liability where a participant does so knowingly. In the situation where a participant fails to surrender the required units, there is a requirement to make good the shortfall within 90 days of a determination of a breach by the administering agency, a financial penalty of \$30 per tonne of shortfall, as well as a 'name and shame' procedure.

In the situation where a participant knowingly fails to meet this obligation, the unit make up increases by a factor of two, the financial penalty to \$60, with the possibility of criminal convictions.

Where there is a failure to meet other obligations, civil penalties start at \$4,000 for the first infringement, \$8,000 for the second and \$12,000 for the third infringement. Where the participant fails to meet the obligation knowingly, criminal penalties may follow, larger fines and personal criminal convictions.

These penalties may have severe consequences – businesses will need to up-skill quickly to ensure that they understand their emissions profile and how they will identify on a timely basis, any potential shortfalls that they may need to make good.

The Government is also engaging with stakeholders on options to help ensure truthfulness and accuracy of compliance information, including independent third-party verification procedures, increased frequency of reporting, and potentially binding rulings on proposed actions to meet their obligations.

Accounting, tax and controls

Since the withdrawal, in June 2005, by the International Accounting Standards Board (IASB) of the standard for accounting for emission allowances and carbon credits, IFRIC 3 Emissions Rights, the industry has been plagued with a diversity of accounting treatments. While the IASB does have the topic of emissions trading on its agenda, work on the topic is not expected to start until the end of 2007 and the estimated project completion date is yet to be decided.

There are a host of approaches that are being used to account for emission rights created under cap and trade schemes. However, there are only a few approaches that we consider are not in conflict with the requirements of other International Financial Reporting Standards.

The most significant issues include when an asset should be recognised for an emission unit, how much should be recognised, how to account for the income arising from the grant of the unit (in all approaches as a government grant); and when and how much of a liability should be recognised in respect of emissions that have been made.

There is no one perfect solution at the present time, and, until further guidance is received from the IASB, businesses need to select a method that best fits their circumstances and complies with current accounting standards. We would anticipate that it would be unlikely that a New Zealand standard or interpretation would be issued that would apply specifically to New Zealand, in the absence of international guidance.



From a taxation perspective, a Government Discussion Document is scheduled to be released within the next week. There are a number of income tax and GST issues that need to be considered in relation to the treatment of NZUs. Given the tight timeframes for introducing the appropriate ETS and tax legislation, it is virtually certain that the required legislation will not be passed until 2008. Therefore, forestry companies with 31 March balance dates will be required to comply with announced tax rules on the appropriate treatment of NZUs but without any legislative framework in place. However, the Government has indicated it will provide guidance on how to treat credits and liabilities for tax purposes during this period.

The introduction of the ETS will require consideration by entities in respect of their internal control frameworks. Care needs to be taken with the overlay of a traditional controls set-up to carbon trading because of the differences to established financial markets and the uncertainty on risk exposures. Key steps for a controls framework include:

- putting a formal risk management policy in place that establishes a clear understanding of an entity's objectives and guidelines for its risk management actions, including whether the entity will attempt to cover all its future carbon credit needs over a set horizon or whether treasury have limited discretion in adding and removing credits;
- clearly define risk exposures. A process of forecasting ongoing carbon credit requirements will need to take into account an entity's responsiveness to the cost of carbon in taking abatement measures. Thus reporting may need a focus on the discipline of variance analysis on forecast exposures.

In relation to carbon credit trading, the liquidity of the market itself needs careful consideration. Traditional Value-at-Risk limits on trading positions held will need to be modified to take into account market liquidity. And how reporting determines the value of the positions held may require compromise in traditional segregation controls. Neither rigid adherence to nor total abandonment of best practice risk management steps is likely to work – businesses will need to assess on a pragmatic basis what will work.



Where to from here?

Having announced its in-principle decisions on the design of the ETS, the Government will now engage on the core design of the scheme and commence targeted engagement with the forestry sector, liquid fuels sectors and Maori, before making its final decisions and introducing a bill into Parliament, scheduled for December 2007.

In early 2008, the Select Committee will call for public submissions on a bill for the ETS, with the view to passing the ETS legislation later in 2008.

Concurrently, targeted engagement will take place on the detailed design features for other sectors, resulting in changes to legislation and regulations to accommodate these sectors. There will also be ongoing engagement with major stakeholders and Maori on subsequent design decisions, regulation and implementation through to the end of 2012.

The Government also intends to release the New Zealand Energy Strategy, the New Zealand Energy Efficiency and Conservation Strategy and the Transport Implementation Plan in October 2007. In addition, it is anticipated that the ETS Tax Issues Discussion Document will be released by the Government within the next week.

Summary

The Government has decided to adopt an ETS as its core price-based measures for mitigating climate change and the underlying principles have been agreed. While there are a number of detail decisions still outstanding, on which the Government will continue to undertake consultation, it is unlikely that any significant changes of principle will be made.

With an economy wide focus, the impact of the ETS will be felt by all businesses, predominantly through the price of their own direct emissions or indirectly through energy consumption. Businesses need to understand their greenhouse gas emissions profile in order to be able to assess the likely financial impact on their operations, and to evaluate potential options for managing and mitigating exposures.



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