PRICEWATERHOUSECOOPERS

Emission Critical

Issue 1 May 2005

Welcome to the first edition of Emission Critical, our new publication for keeping the business community abreast of developments in Climate Change as they relate to New Zealand.

Implementing the carbon tax…

On 4 May 2005, the Government published a consultation paper setting out how it proposes to implement the carbon tax. The tax is a key plank of its policies to meet New Zealand's international obligations under the Kyoto Protocol.

It is critical that businesses understand the implications of the carbon tax and implement strategies to minimise the cost. This issue of Emission Critical provides a summary analysis of how the carbon tax is proposed to be implemented.

Overview

The purpose of the carbon tax is to impose an environmental cost on the use of fossil fuels. The Government believes that a broader awareness of the cost of emissions will change behaviour, resulting in lower emissions.

The carbon tax in detail

The key aspects of the carbon tax implementation are as follows:

- The Government is to initially set the tax at $15 per tonne of carbon dioxide (or carbon dioxide equivalent). The rate of the tax will not be changed in the first commitment period (out to 31 December 2012) unless it diverges significantly and on a sustained basis from the international price, nor will it exceed $25 a tonne.
- The carbon tax will come into effect 1 April 2007.
- The IRD and Customs Service will administer the carbon tax. In order to minimise the administrative cost, the tax will be payable as early in the supply chain as possible, thereby limiting the points of obligation (which will vary from industry to industry).
- Firms required to file regular returns with the IRD will be:
  - Miners of petroleum products, except crude oil sold in its raw state;
  - Coal miners;
  - Oil refineries, in relation to production emissions;
  - Suppliers of domestic jet fuel;
  - Geothermal users; and
  - Certain industrial processes that result in emissions (e.g. calcinations of limestone cement).
- Rather than filing returns, carbon tax will be paid to the Customs Service, at the same time and using the same procedures, as any tariff or excise duty and/or GST by:
  - Importers of coal, gas, and refined petroleum products;
  - Oil refineries, with regard to their refined product; and
  - Importers of carbon anodes, carbon pitch and carbon black.
- The administration rules will be based on the GST system, including when payments are due and use-of-money interest on late payments.

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- It is envisaged by the Government that the tax will be passed onto the emitter, subject to pricing agreements, allowing full pass-through of price increases to customers.
- There are the following exemptions:
  - Farming emissions in the form of methane and nitrous oxide are exempt from the tax (on the basis that the only feasible way to reduce emissions is to reduce output);
  - Exemptions to the tax are available to some firms under the Government's Negotiated Greenhouse Agreement (NGA) policy (refer below);
  - Exported product (as the emissions will occur outside New Zealand); and
  - Embedded carbon, except forests and other biomass.
- The carbon tax will generally be deductible for income tax purposes.

Specific Issues

There are a number of specific issues covered by the consultation paper, some of which the Government is expressly seeking submissions on, and will develop in consultation with business. These issues include:

- How emissions factors for different products will be estimated and applied (e.g. 1 litre of petrol consumable = 0.00240 tonnes of carbon dioxide emissions).
- Pass-through of the tax in circumstances where there may be fixed price energy supply contracts, which do not allow for pass-through of cost increases.
- How existing stockpiles of coal and petroleum products should be treated.
- Whether the proposed administration for each specific industry is appropriate.
- How rebates through the NGA mechanism are administered.

Impact on the economy and business

According to our estimates, the Government can expect to collect approximately $600 million per annum from the carbon tax, with $240 million per annum earmarked for tax relief in the form of rebates and exemptions (mainly in the form of NGAs – refer below). This means net revenue collected is estimated to be $360 million per annum, and this is intended to be recycled into the economy via measures to be announced in the 2005 Budget.

The carbon tax will affect New Zealand's international competitiveness. Major trade competitors such as Australia and the Unites States are not constrained by the Kyoto Protocol. The reality is that New Zealand will be less attractive as a destination for investment.

The Government has indicated that there will be business "friendly" tax measures in the 2005 Budget. In particular, Dr Cullen has foreshadowed changes to the tax depreciation rules which may enable businesses required to invest in new low emission technology to accelerate tax depreciation deductions.

Interestingly, the Government has indicated that the carbon tax may be replaced with an emissions trading scheme after the first Kyoto commitment period (31 December 2012), once an international trading scheme has developed sufficiently.

Submissions

Submissions on the implementation of the carbon tax close on 8 July 2005.

Commentary

For the businesses ultimately paying the tax charge through increases in energy, transport and other products, strategies should be developed to minimise the impact of the carbon tax, either through energy efficiency initiatives, NGAs or the grant scheme (refer below).

For the companies impacted by the administration of the carbon tax, it is important that consideration is given to the detail of the consultation paper and, depending on individual circumstances, we recommend submissions should be made.

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Negotiated Greenhouse Agreements (NGAs)

It is recognised that the international competitiveness of some New Zealand firms or industry groups could be at risk because of the carbon tax. For firms prepared to undertake meeting world's best practice (WBP) targets in the management of their greenhouse gas emissions, the Government is prepared to negotiate a full or partial exemption from the carbon tax. This is called a Negotiated Greenhouse Agreement.

To date, the mechanisms for obtaining an NGA have been cumbersome. Therefore, on 20 April 2005, the Government announced measures to streamline the NGA process.

To be eligible for an NGA, a firm's international competitiveness must be considered to be at-risk as a result of the Carbon Tax. The current eligibility criteria are:

- Is the firm's output internationally traded and are the climate change policies of competitor countries less stringent?
- What is the impact of a $25 per tonne of carbon dioxide charge (i.e. carbon tax) on the competitiveness of domestic output? Either:
  - Will the charge significantly increase costs (due to more than 20% of the NGA participant's expenses being energy and emissions related)? or
  - Will the charge reduce profitability (earnings before interest and tax) by more than 10%? or
  - Will the charge move the firm significantly below the appropriate industry or the firm's weighted average cost of capital?

Once the above criteria are satisfied, the firm is eligible to negotiate an NGA.

The next step is to define WBP in emissions management for the firm, and the setting of a pathway against which progress towards attaining it is measured. As part of the 20 April streamlining announcements, the applicant firm must now appoint an independent expert consultant to determine WBP. This is then checked through the appointment by the New Zealand Climate Change Office (NZCCO) of an independent "validator".

Under an NGA, exemption to the carbon tax is only provided up to WBP. If a firm under-achieves against WBP then it will be liable to pay carbon tax on the difference between actual emissions and WBP emissions. Likewise, if it over-achieves then carbon credits will be issued by the Government, which can be traded and converted into cash.

Other than for electricity, NGA exemptions (rebates) will not cover "second-round price increases", referring to an increase in a price or service that does not result from the application of the tax input itself, but rather from application of the carbon tax to a substitute product (e.g. charcoal is a renewable substitute for coal and may increase in value as a result of tax on coal).

Obviously, for an NGA to be worthwhile to pursue, the benefit of the carbon tax exemption must outweigh the cost of the NGA application and any capital cost necessary to meet WBP. This assessment is made difficult as all NGAs expire in 2012 (being the end of the first commitment period under the Kyoto Protocol), meaning capital investment decisions which may have a longer payback period will require an assessment by the firm as to whether exemptions post-2012 will be available.

Firms of any size may apply for an NGA although, to date, applicants have typically been larger firms.

Only two NGAs have been concluded (NZ Refining Company and OceanaGold) and applications to negotiate NGAs have been received from a number of other firms. As at 20 April 2005, the Government has publicly named six other firms as eligible to negotiate (Newmont Waihi Gold Mining Company, Norske Skog Tasman, ACI Glass Packaging New Zealand, New Zealand Aluminium Smelter, Fletcher Building and Carter Holt Harvey's key manufacturing operations). At the same time, negotiations are underway with other organisations and other eligibility decisions are under consideration.

Whilst there is no time limit on when NGA applications can be made, the NZCCO has indicated that it wishes to complete the majority of NGAs by June 2006 and this will be done on a first-come, first-served basis.

The NGA process has proven to be complicated and costly. Applications are being bogged down and even with the new streamlined process, it is going to be difficult for businesses to secure the necessary exemptions by April 2007, unless they begin the application process now.

Small & Medium Enterprises (SMEs) Grant Scheme

On 15 April, the Government announced a new package of measures to drive innovation within energy intensive small and medium size enterprises (SMEs).

The Government believes that in employing simple no cost and low cost energy efficiency measures, most businesses should be able to more than offset the impact of the carbon tax. However, some energy intensive businesses will need assistance to adjust.

The centrepiece of the package is a grants scheme. Pilot projects will be undertaken with firms in energy intensive sectors from 1 July 2005 where selected firms will receive cash grants to assist them to introduce and demonstrate energy efficient technologies relevant to each sector. This will be backed with training and education initiatives.

The sectors covered by the package are:

- wood processing;
- food processing;
- basic metals;
- non-metallic industries;
- paper and paper products;
- tourism transport;
- glasshouse crops;
- fishing; and
- irrigated dairy and arable farming.

For businesses in these industries, the policy clearly offers an opportunity to minimise the impact of the carbon tax. However, the budget for the scheme is $1.48 million per annum over the next three years. This is clearly insignificant in the context of the carbon tax revenue collection estimates provided earlier.

If you have any queries regarding how the Government's climate change policies will impact your business or assistance with strategies to maximise the opportunities available, please contact one of the PricewaterhouseCoopers Climate Change Services Team.

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