

Emission Critical

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Background

On 20 September 2007, the Government released *The Framework for a New Zealand Emissions Trading Scheme* ('Framework Document'), its core price based mechanism for addressing climate change issues in New Zealand. The Framework Document proposed that the legislative mandate for the Emissions Trading Scheme ('ETS') would be through an amendment to the Climate Change Response Act 2002 ('the Act').

On 4 December 2007, the Government announced the introduction of the Climate Change (Emissions Trading and Renewable Preference) Bill ('the Bill') which amends the Act to introduce the ETS. The focus of the Bill is on the core provisions required for the ETS, which are addressed through the introduction of new Parts 4 and 5 to the Act.

The proposed Part 4 of the Act covers the scheme participants, their obligations, allocation of units, compliance and enforcement, offences and penalties, review and appeals, future development and Ministerial review of the scheme. Part 5 will contain the provisions specific to the forestry, transport and stationary energy sectors. Regulations will supply further technical details as the scheme develops.

Following the first reading of the Bill, it will be referred to the Finance and Expenditure Select Committee ('the Select Committee'), which will examine the Bill and prepare a report for the House. The Select Committee stage provides for the public to submit on the Bill and have their submissions heard. Submissions to the Select Committee are likely to close in late February 2008 with the Select Committee reporting back to the house within six months, by June 2008, in advance of the next election.

The Government has made it clear that it is keen to ensure there is robust consultation and intends to seek iterative feedback from stakeholders. We understand that the Select Committee will be amenable to listening to the views of business and other stakeholders. It is therefore critical that stakeholders engage in the consultation process and ensure that they submit on their views and concerns.

While the Government is seeking intensive engagement with stakeholders on the ETS, the Bill includes default provisions that would result in all sectors entering the ETS in line with the original timetable proposed in the Framework Document. We understand that these default provisions have been included to ensure fairness across sectors and certainty that sectors will be included in the ETS, providing comfort to the forestry and liquid fuels sectors that they will not be the only participants in the scheme. The Government anticipates that the engagement process will result in enhancements to the ETS that will be enacted through regulation prior to the entry of the remaining sectors into the scheme.

In this issue of Emission Critical, we provide a commentary on the Bill, including the core design elements of the ETS, the key features of each and highlight changes between the initial Framework document and the Bill.

Point of Obligation

The point of obligation refers to which parties must be participants in the ETS and will therefore be obliged to monitor and report emissions, and obtain and retire emission units (known as New Zealand Units or NZUs) to match their emissions.



The Government does not consider it necessary to place the point of obligation directly on the entity that emits. It is anticipated that price signals will flow across the market supply chain, influencing decisions by producers and consumers regardless of whether they surrender emission units themselves. In the transport fuels sector for example, the point of obligation sits high in the value supply chain, where fuel suppliers face the obligation to surrender emission units, whereas it is the emitters (users of the fuel) that are exposed to the price signals.

The Bill introduces two new Schedules, which define (i) the activities that result in or remove emissions and (ii) the timing of the entry of participants into the ETS. The Bill proposes different approaches to the placement of the point of obligation, depending on each sector. The proposals in the Bill in relation to the point of obligation are consistent with those spelt out by the Government in the Framework Document.

In accordance with the Bill, participants must:

- have an account to hold emission units;
- monitor their emissions in accordance with prescribed methodologies;
- report annually by 31 March on the previous calendar year's net emissions;
- surrender one emission unit for each tonne of carbon dioxide equivalent emissions; and
- retain records showing emissions and removals for seven years.

Core obligation

In assessing the core obligation, the Government considered two sets of design features:

- the choice between a core obligation defined on an absolute basis versus an intensity basis; and
- as a transitional measure, whether to apply a full obligation to surrender units versus a progressive obligation to surrender units.

The Government has decided in principle not to use an intensity-based approach in assessing the core obligation, due to the administrative complexity, less certainty as to the environmental outcomes, implementation complexity, and the lack of cost signals at the margin for emissions growth. The Bill also requires a full obligation, i.e. participants will be required to surrender one emission unit to cover each tonne of eligible emissions.

However, the Government has not ruled out the use of intensity based measures in assessing how free allocations of credits may be made to ETS participants (refer below for further discussion).

The Bill provides for certain participants to opt into the ETS and become points of obligation. Eligible activities include post-1989 forest land, large purchasers of jet fuel, and large purchasers of coal or natural gas. Interestingly, the Bill indicates that registration as a participant will take effect one year after the application to become a participant.

Given that the liquid fossil fuels sector is due to enter the ETS on 1 January 2009, the window for registration as a participant in the ETS by large consumers of jet fuel, given the year stand-down period, is very small. In addition, the registration needs to be submitted to the as yet to be appointed Chief Executive. This highlights some of the potential issues that may arise as a result of introducing legislation within short timeframes.





Allocation

Allocation was always going to be one of the most controversial issues associated with the introduction of the ETS. In its Framework Document, the Government made the following in principle decisions on the level of assistance:

- in the forestry sector, free allocation would be provided to owners of pre-1990 forests such that the Crown assumes a total liability for deforestation emissions of 55 Mt CO₂e
- the agricultural sector will be provided with a free allocation pool equal to 90 per cent of 2005 emissions when it is brought into the ETS in 2013
- the pool of units for eligible industrial producers will be based on 90 per cent of 2005 emissions from those eligible industrial producers
- indirect emissions associated with the consumption of electricity, as well as direct emissions from stationary energy and direct emissions from non-energy industrial processes, will be included in the concept of emissions from industrial producers
- starting from 2013, when agriculture is brought into the ETS, the free allocation pools for industrial producers and agriculture will decrease on a linear basis so as to phase out assistance completely in 2025
- new sources that begin emitting during the period of the free allocation will not have any access to the pool of free allocations
- firms that cease trading will not retain any free allocation
- no free allocation will be provided to the upstream points of obligation in the liquid fossil fuel and stationary energy sectors, electricity generators, or landfill operators.

The Bill largely affirms the original proposals as contained in the Framework document, with some additional clarifications around some of the specific details.

Allocation to pre-1990 forests

The proposed level of assistance in the Bill to pre-1990 forests remains at 55Mt of CO₂e, of which 21 million units will be allocated in 2008 – 2012 with the remaining 34 million units allocated from 2013 to 2024.

The allocation to pre-1990 forest has been subject to a significant level of discussion during the engagement and consultation process, particularly in regard to the adequacy of the level of compensation per hectare, and that the pre-1990 forests continue to absorb carbon and therefore the relative treatment of post-1989 forest owners is potentially more generous.

Interestingly, while the Government initially agreed in principle to a pro rata approach for the allocation of the 55Mt CO₂e, this has not been carried into the Bill. The Bill provides for the development of an allocation plan that must specify the basis upon which NZUs will be allocated. The Government is seeking input by way of submissions for the targeting of free allocation for pre-1990 forests. The final aspects of the allocation policy have yet to be decided.

Further stakeholder engagement will take place in 2008 on these issues, with the Government anticipating introducing draft regulations covering the forestry sector next year.

Allocation to industry

The Bill provides for free allocation of NZUs to industry, in particular to entities that:

- are considered by the Minister as likely to be trade exposed; and
- have specified emissions above a prescribed threshold (if any); and
 - carry out an eligible industrial process activity; or
 - as a result of the obligations imposed on eligible stationary energy activities, face increased costs in respect of the entity's
 - (a) direct use of coal, natural gas or geothermal steam; or
 - (b) direct consumption of electricity.

In order to determine whether a business in the industrial sector is exposed, the Minister will take into account two matters:

- whether the business competes with firms that operate from outside New Zealand in respect of the products sold into the New Zealand market or exported; and
- if so, whether that business faces higher costs in respect of its emissions than the competing firms and is unable to pass on some or all of the costs due to competition.

The Bill itself does not provide any specific methodologies for allocating the total pool of units to eligible businesses, but provides a process to develop allocation plans. The key stages in developing allocation plans for each sector (forestry, industry and agriculture) are as follows:

- development of a statement of intention to develop a draft allocation plan;
- preparation of a draft allocation plan; and
- recommendation of a final allocation plan.

The size of the free allocation pool for industry will be calculated as follows:

- assessing which firms are eligible (on the basis of trade exposures and an eligibility threshold if applied);
- determining the 2005 emission of the eligible firms; and
- setting the total allocation at 90% of that level.

As the detail of these tests have yet to be determined, the size of the pool and therefore the actual size of the package to industry can not yet be determined.

While the Bill does not include a threshold for determining how many units are available for distribution to the pool of eligible participants, it does retain the option to allow the Government to apply a threshold in determining which industrial firms are eligible to receive free allocations. The Government had previously indicated that the eligibility of individual firms to receive a free allocation would be subject to a minimum emissions threshold of 50,000t CO₂e.

It is anticipated that the issues associated with distributing the pool of free units among eligible industrial firms will be worked through in 2008. Key issues that stakeholders will want to address in the consultation process will focus on carbon leakage (the relocation of production to another country as a result of the imposition of the ETS) and the potential for stranded assets. The public will have the opportunity to participate in the development of the allocation plans, and are encouraged to engage in the consultation process with the Select Committee.

Allocation to agriculture

The Bill limits the assistance provided to agriculture by identifying the initial level of assistance to be provided in 2013, and by defining the level of assistance to be provided moving forward (through phasing out assistance over time). The Bill reaffirms the Government's initial proposals of 90% of 2005 emissions of methane and nitrous oxide from eligible activities in the agricultural firms.





Phasing out of free allocation

The key issue surrounding the phasing out of the free allocation is the extent to which participants' international competitiveness is eroded if their competitors are not facing a price on carbon. In addition, businesses need clarity around future investment decisions and these decisions will take into account signals provided by the Government around future allocations.

The Government's preferred approach to phasing, which has been adopted in the Bill, continues to be a phase-out of free allocations to zero by 2025. As a result of the intensive engagement process, it has indicated that this matter is still open for consultation, including options around a more moderate phase-out once the shape of international negotiations becomes clearer.

The imminent ratification of the Kyoto Protocol by Australia may allay some participants' competitiveness at risk concerns. However the phasing out of the free allocation is still likely to be contentious and as such, stakeholders are encouraged to submit to the Select Committee on this issue.

Growth in emissions

The Government's preferred approach to addressing emissions growth since 2005, is to base obligations on an absolute rather than intensity basis. In addition, new sources of emissions will face the full cost associated with those emissions.

During the engagement process, some parties suggested that the best approach for addressing competitiveness and leakage concerns would be to adopt an intensity based approach, but the Government has reaffirmed its Framework Document position on the basis of administrative complexity and the lack of consistency with New Zealand's economic signals received under the Kyoto Protocol.

This policy could potentially penalise new entrants even though they could be significantly more carbon efficient than an existing participant, and potentially raises anti-competitiveness issues. Interested stakeholders should ensure that they participate in the consultation and submission process with the Select Committee on these issues.

Unit of trade and liquidity

In addition to allocation issues, the unit of trade, liquidity and international linkages are also subjects of significant interest.

The Government has reaffirmed its earlier decision to create a New Zealand unit specifically for the New Zealand ETS. The NZU will be backed by a Kyoto unit in the New Zealand Emissions Unit Register ('NZEUR'). While this gives the Government the flexibility to differentiate between trading rules for the domestic and international markets, this does cause some issues, particularly with the forestry sector, where forestry generated credits are not able to be used for compliance purposes in some Kyoto markets, such as the European Union.

The Government has also decided that for the period 2008 – 2012 (at a minimum), linkages will be established with the international Kyoto markets, through establishing inter-changeability between NZUs and Kyoto units (subject to certain restrictions). This ensures that there will be sufficient liquidity in the domestic market and that prices will be aligned with those in international markets. It has also left the door open for linking the ETS to other countries domestic trading schemes through regulation. Given Australia's imminent ratification of the Kyoto Protocol, it would be desirable for Government officials to work closely with their Australian counterparts, to align the ETS with Australia's proposed scheme. Addressing sectoral issues (such as the treatment of forestry) and the detail of the unit of trade, would facilitate linking between the two schemes at a later date if desired.

The Act already excludes certain types of units from the NZEUR (including Certified Emission Reductions ('CERs') and Emission Reduction Units ('ERUs') relating to nuclear projects). In the Framework Document, the Government decided not to place restrictions on the types of Assigned Amount Units ('AAUs') that could enter the ETS or restrict entry for CERs from HFC reduction programmes, which have attracted negative publicity globally. The potential inclusion of 'hot air' credits raises complex issues such as environmental and reputational considerations; costs of compliance; liquidity; and price volatility.

This approach also carries through into the Bill, although the Government has provided itself with the flexibility to restrict the type of emissions units that may enter the NZEUR. Restrictions will not be retrospective, applying only from that date forward.

New Zealand will be short of domestically generated NZUs and as a result will need to source Kyoto compliant credits offshore. The most likely source will be CERs. Currently secondary CERs trade at around 80% of the value of a European Union Allowance ('EUA') or approximately €18 (approximately NZ\$35). Interestingly, the Explanatory Notes to the Bill now consider the impacts of the ETS under three pricing scenarios, \$15/t CO₂e, \$25/t CO₂e, and \$50/t CO₂e, whereas the Framework Document only disclosed pricing impacts of the \$15/t CO₂e and \$25/t CO₂e scenarios.

Compliance and enforcement

It is envisaged that the Ministry of Economic Development will be responsible for implementing the ETS, supported by other Government agencies such as the Ministry of Agriculture and Forestry, as required.

The main administrative provisions of the ETS will be given to an administrator (called the 'Chief Executive' in the Bill). The Chief Executive's functions include:

- requiring or obtaining information from participants about their activities;
- issuing 'emission rulings' (see below);
- correcting errors in emission reports (and issuing assessments where participants fail to report); and
- taking enforcement proceedings and imposing penalties where participants fail to comply with their obligations.

The Chief Executive has a variety of powers to request information, including powers of entry for investigation. The Bill also gives rights of review and appeal to those who may dispute the Chief Executives decisions. However, a major concern at this stage is that this position is yet to be filled. The Chief Executive's role entails a number of functions and given that the ETS commences 1 January 2008, the need to appoint someone in this role is therefore pressing.

Participants will be required to monitor their emissions and removals and report annually by 31 March for the previous calendar year. The ETS model is based on a self-assessment framework, similar to that employed by the Inland Revenue Department. The Chief Executive will have the ability to audit the compliance of emissions returns.

The Government has previously spelt out penalties for failure to surrender sufficient units to meet emission obligations, which included both a make good provision, as well as a financial penalty of \$30 for each unit. The Government has softened its approach for the first year of compliance for participants, requiring participants to make good the shortfall but not imposing a financial penalty.

The Government has also signalled that the Chief Executive will be able to issue advance rulings, which will bind the Chief Executive to a particular interpretation of the legislation.

Conclusions

The Bill amends the Act to allow for the introduction of the ETS and covers the core issues required to ensure that the ETS can be implemented.

The Government has reaffirmed most of the decisions originally raised in its Framework Document but some decisions have been deferred and will be governed by regulations, including the treatment of pre-1990 forests, the emission units that will be allowed into the ETS, the phase-out of free allocations and the potential for the use of an intensity based approach within the free allocation cap.

We strongly stress that interested stakeholders get actively involved in the consultation process with the Select Committee to ensure that their views and issues are considered.



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