
CLIMATE CHANGE

EMISSIONS TRADING SCHEME HERE

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Only New Zealand lawyer named in the top 10 world-wide climate change legal advisers, *Chambers Global Guide 2008*.

Bell Gully only New Zealand law firm named in top 12 international climate change legal practices, *Chambers Global Guide 2008*.

New Zealand's emissions trading scheme is here, with the passing of the Climate Change (Emissions Trading) Bill in Parliament last night.

The main purpose of the Climate Change (Emissions Trading) Act is to introduce an economy-wide, all gases, scheme. While the Act maintains the main overall features from the first draft of the Bill, there have been a number of key aspects amended, refined and more clearly defined. In this update we provide a summary of the key features of the New Zealand emissions trading scheme (ETS).

The scheme's key features

While a lot of the detail of the ETS is yet to come in regulation, the Act sets out the mechanics of the ETS, including:

- clarifying the activities that give rise to mandatory obligations and the right to participate under the ETS;
- in the context of specific business activities, who will or could be a participant in the ETS;
- details of a participant's obligations to measure and report emissions and to surrender emission units to account for the reported emissions, as well as the penalties for failing to comply with obligations;

- the basis on which units will either be allocated without charge, or sold, to participants by public tender; and
- which units may be surrendered for compliance purposes.

Staggered sector entry

Entry of the relevant business sectors into the scheme is staggered. The forestry sector has retrospective obligations from 1 January 2008.

Stationary energy and most industrial processes follow from 1 January 2010.

The liquid fossil fuels sector was to enter a year earlier from 1 January 2009.

However, the Prime Minister announced a policy change earlier this year, given the rising cost of fuel. This change has been reflected in the Act and liquid fossil fuels will now enter from 1 January 2011.

Agriculture, waste, and industrial processes involving SF6, HFCs and PFCs are the last sectors to enter, from 1 January 2013.

Some coastal shipping and fishing (where vessels hold fuel purchased off-shore and travel through New Zealand's coastal waters) will also be included in the ETS, if an Order in Council is passed.

Inclusion of forestry

Pre-1990 forestry owners receive a one-off allocation of New Zealand Units (NZUs), with compliance obligations for deforestation. The number of NZUs each forestry owner is to receive depends on whether the land is the subject of a Crown forest licence and Treaty negotiations, or how long the current owner has held the land.

Post-1989 forestry owners generally may choose whether to:

- opt into the ETS and receive NZUs for net carbon stock increases, with the right to harvest but incurring compliance obligations for any net carbon stock decrease; or
- enter into a covenant not to harvest or deforest for 99 years under the Permanent Forest Sink Initiative (an initiative sitting alongside the proposed ETS), and thereby be awarded Assigned Amount Units (AAUs) for carbon sequestration; or
- choose to do neither, in which case the forestry owner will have no liabilities for harvesting or deforesting, but will also have no opportunity to receive NZUs or AAUs for any carbon sequestration occurring on their land.

Any NZUs or AAUs allocated or awarded to forestry owners will not be temporary in nature (unlike forestry units from Kyoto clean development mechanism projects). Such units have the same features as non-forestry NZUs/AAUs and are available for trading and for compliance use on the same basis.

Allocation and auctioning of units

The primary unit of trade under the ETS is an NZU. Each NZU is backed by a Kyoto-compliant unit, primarily an AAU. The responsible Minister will allocate NZUs without charge to the forestry and

agricultural sectors, as well as to trade-exposed entities (although only for the proportion of their production which is trade exposed), with a phase-out of free allocation for agriculture and trade-exposed businesses expected to start in 2018. The Minister will also allocate NZUs free of charge to fishing operators in New Zealand for three years in 2011, 2012 and 2013, to soften the impact of increased fuel costs these operators will face following the introduction of the liquid fossil fuels sector into the ETS. It is expected that all free allocation will be stopped by 2030.

In other sectors, where the cost of carbon is expected to be passed through, ultimately to the consumer, from an upstream participant, there is no free allocation. Instead, NZUs will be auctioned by way of public tender.

Types of allowances permitted for trading

NZUs, Certified Emission Reduction Units (CERs) - except CERs from nuclear projects and a special type of CER called a ICERs from forestry projects in developing countries, Removal Units, Emission Reduction Units and AAUs (originating from New Zealand, including under its Projects to Reduce Emissions Scheme and PFSI) will be accepted for compliance purposes under the ETS. tCERs (also, like ICERs, originating from forestry projects in developing countries) will be permitted to be surrendered for compliance purposes with the Minister's consent. We do not expect a significant amount of trading in tCERs in New Zealand.

Imported AAUs (i.e. those AAUs which originate from another country) will not be accepted for compliance purposes under the ETS unless the features of the imported AAU fit within the criteria set out in regulations, which have not yet been



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released. This distinction has been driven by the Green Party and is focused on ensuring that only imported AAUs with environmental integrity be permitted to be surrendered for compliance purposes under the ETS. With the detailed criteria yet to be released, this may hamper the early trading of imported AAUs by some participants who are wary as to whether the imported AAUs they are seeking to buy would later be permitted to be surrendered.

The restriction on the use of imported AAUs for compliance under the ETS reduces the pool of available units - not to mention potentially cheaper units - for participants to purchase in an already short market. It is possible the "environmental integrity" restriction will drive the price of NZUs and New Zealand originating AAUs to track closer to secondary CERs than it would have otherwise. We would expect to see some companies seeking to mitigate their future trading costs by entering into early trades, despite the current "environmental integrity" uncertainties under the ETS, for "green" imported AAUs such as Green Investment Scheme AAUs (GIS AAUs). Increased early trading in PFSI AAUs, and forestry NZUs, is also likely.

International trading

International trading is recognised and permitted by the Act. That said, the Minister retains the discretion to restrict the types of units (such as the restrictions on imported AAUs) that may be traded internationally, may enter the ETS, and that may be used for compliance purposes. NZUs may be traded internationally, in which case they will be converted into AAUs by the Minister. Subject to the requirement not to breach the compliance period reserve (a mechanism to ensure New Zealand retains sufficient AAUs to be able to meet its own Kyoto obligations), there is

no restriction on the number of units that may be traded internationally.

Future international linking with other emissions trading schemes is foreshadowed by the inclusion of "approved overseas units" as a type of unit that may be surrendered for compliance purposes.

International linkage

New Zealand's Registry was linked to the International Transaction Log (ITL) earlier this year. That linkage has already caught the interest of traders, with an account-holder in the New Zealand Registry receiving the first units transferred country-to-country - from Switzerland to New Zealand - through the ITL. (Those units were then bought by Bell Gully for its purposes in the first New Zealand transaction on the Registry).

Although countries in the European Union are not yet linked to the ITL due to issues with their Community International Transaction Log linking to the ITL, this is expected to be overcome by the end of 2008.

Rules for the operation of the carbon market

Trading will be available to anyone eligible to open a holding account with the Registry (which includes people residing overseas who meet the eligibility requirements), not just participants.

Of particular interest to those in the financial sector will be the rules relating to the operation of the carbon market. The Act attempts to preserve flexibility for parties to trade NZUs in any manner they choose. This could be via over-the-counter trading, trading on a regulated exchange, such as NZX's TZ1 exchange, or trading through an internet-based platform.

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Innovation Fund

A contestable Innovation Fund comprising 150,000 carbon credits (worth potentially \$7.5 million at today's prices) a year from 2010 to 2012 may be accessed by certain entities in the industrial sector, including trade-exposed businesses, and the stationary energy sector, to help drive the uptake of innovative technology that will significantly reduce or have the potential to significantly reduce industrial emissions.

For many eligible companies, the receipt of units from the Innovation Fund will be a driver for implementing innovative technology resulting in real emission reductions for both that company and at a national level. However, for businesses who made significant investments to take early action to reduce their emissions, the financial assistance their competitors may get from the Innovation Fund to take similar action may appear inequitable (if it is significant).

Assistance for households

Households will be receiving a one-off electricity rebate in 2010 to assist with higher energy prices, and may receive assistance with insulation and energy-efficiency, from a \$1 billion fund established for that purpose.

The introduction of the ETS provides a level of certainty for those persons with compliance obligations, but with a number of regulations yet to be released and the possibility of National being in Government following the upcoming elections, the detail of the operation of the ETS is not yet certain. While this may dampen the extent of initial trading, those entities with potentially large compliance obligations are still likely to proceed with early trades to secure sufficient units at favourable prices in order to minimise their financial exposure in future compliance years.

* Bell Gully's climate change team is available to advise in detail on the ETS and its implications, and on carbon trading in general.