The ETS - what does it mean?

Many businesses still do not yet fully understand the implications of the New Zealand Emissions Trading Scheme and how it will affect them.

Currently the Emissions Trading Scheme is set to include all sectors of the economy and all greenhouse gases by 2015 and everyone will be hit, either directly or indirectly. Participants in the scheme have obligations to monitor the emissions they produce and to surrender emission units to match those emissions. Those who are not participants will be impacted by costs being passed through the supply chain. This will mean, for example, a rise in transport fuel and electricity prices. Businesses need to understand these implications so that they can assess and prepare for the cost impacts. The obligations and costs start on 1 July and the scheme will be reviewed in 2011.

Background

New Zealand ratified the Kyoto protocol on 19 December 2002. The obligation under the Protocol is to reduce our 2008-2012 greenhouse gas emissions to 1990 levels or to take responsibility for excess emissions. Our Emissions Trading Scheme is the principal means of reducing emissions. It effectively introduces a price on carbon which provides an incentive for people to reduce their greenhouse gas emissions.

How does the scheme work?

The scheme requires 'participants' to surrender emission units to the Crown to cover their direct greenhouse gas emissions, or the emissions that are associated with their products. Generally, participants are those 'upstream' in the supply chain.

The most immediate examples are the oil and electricity companies. Their excess emissions are measured and the cost of the excess at $25 for every two tonnes of CO_2 will be costed into their product and passed down the supply chain to the consumer.

Units surrendered can either be New Zealand Units (NZUs) or a range of Kyoto Units which can be purchased overseas. Some participants, in particular owners of post 1989 forests, earn units for carbon that is sequestered from 1 January 2008. These units are traded between participants in the scheme and only foresters are able to export units, that is trade their units on the world market.

SECTOR	REPORT EMISSIONS	FULL OBLIGATIONS
Forestry		1 January 2008
Liquid fossil fuels, stationary energy and industrial processes	1 January 2010	1 July 2010
Waste and Synthetic gases	Voluntary reporting: 1 January 2011 Mandatory reporting: 1 January 2012	1 January 2013
Agriculture	Voluntary reporting: 1 January 2011 Mandatory reporting: 1 January 2012	1 January 2015

In order to protect the competitiveness of participants in the scheme, there are several moderating features during the transitional period. These include:

- Emitters being eased into the Scheme with a price cap for 2 tonnes of carbon limited to $25.
- A requirement on the stationary energy, industrial process and liquid fossil fuel sectors to surrender one unit per two tonnes of emissions produced (rather than 1 for 1); and
- Some businesses are eligible to receive a free allocation of emission units if they conduct a specified activity that is both emissions intensive and trade exposed. This is to offset the increase in its costs which can impact on a business' competitiveness in the international market and New Zealand's reputation as a place to invest. Allocation to some industry will be awarded at a rate of 90% initially for highly emissions intensive activities, and 60% for moderately emission intensive activities. This will continue until 31 December 2012 when this will be phased out at a rate of 1.3% per annum.

Forestry has been part of the scheme since 2008, and by 2015 the scheme is set to include all sectors of the economy. The key dates for each sector are shown in the above table.

The key features of the scheme for each of these sectors are as follows.

Forestry

Forestry is seen by the Government as the principal source of carbon benefits and one unit per tonne of carbon sequestered in Kyoto qualifying forests will be allocated for growth from 1 January 2008. A carbon forest is one planted since 1 January 1990, on previously clear land.

Owners of older forests (pre 1990) will be entitled to carbon credits as a form of compensation because, if the forest is harvested and the land use changed (the carbon sequestered being lost), there is a heavy penalty applied to the owner. The compensation credits (which can also be sold overseas) will be allocated by the Government later this year. The following exceptions apply to these older forests.

- The area of deforested land must exceed two hectares; or
- If the area of forested land is less than 50 hectares, an application can be made to claim exemption from the scheme.

The owners of post 1989 forests have an option of joining the scheme or not. A decision has to be made by the forester whether the investment benefits of cash flow from carbon unit sales (currently running at $18/19 each) is a worthwhile offset against the requirement to replace the units issued when the forest is harvested.

Fossil fuels

The ETS covers: The petrol, diesel, aviation gasoline, jet kerosene, light fuel oil and heavy fuel oil used in NZ.

Participants: Those who take fuel from the refinery gate or who import it (i.e. BP, Caltex, Gull, Mobil and Shell). Individuals who use fuel do not have obligations under the scheme. However, the cost of emission units will be passed on in the cost of fuel.

Free allocation? No, the fuel sector does not receive a free allocation as the cost can be passed on to consumers.

Fishing quota owners are given a one off allocation of tradable units to compensate for the effect of increased fuel on the value of their quota. The Government has released a consultation document as a first step in the process of allocating emission units. This contains a Draft Fishing Allocation Plan which proposes some rules for allocating units.

Stationary energy

The ETS covers: Fuels used in electricity generation and in the direct production of heat in the industrial, commercial and residential sectors.

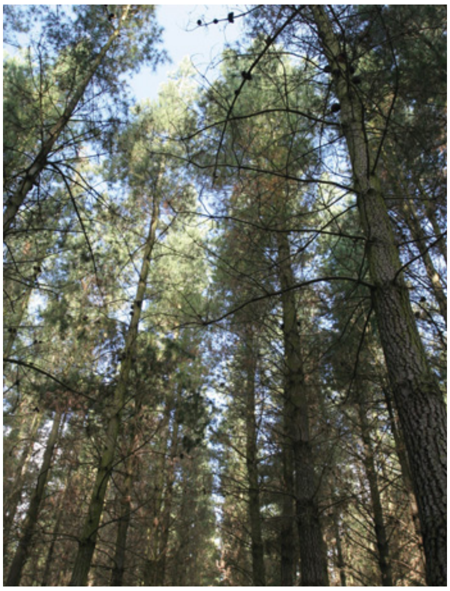
Participants: Those that are:

- Importing coal;
- Mining coal where the volume of coal mined exceeds 2000 tonnes in a year;
- Importing natural gas where the volume of natural gas imported exceeds 10,000 litres in a year;
- Mining natural gas, other than for export;
- Using geothermal fluid for the purpose of generating electricity or industrial heat;
- Combusting used oil, waste oil, used tyres, or waste for the purpose of generating electricity or industrial heat; or
- Refining petroleum where the refining involves the use of intermediate crude oil products (for example, refinery fuels and gases) for energy or feedstock purposes.

Free allocation? No, the cost of surrendering carbon units by the fuel companies will be passed on to the end user. This will see an increase in retail electricity prices.

Industrial processes

The ETS covers: Carbon dioxide from producing iron, steel, aluminium, clinker, burnt lime, glass and gold and Pecs from producing aluminium.



Participants: Producers of the products set out above.

Free allocation? Yes, to specified activities that meet an 'emissions intensive' and 'trade exposed' test. If those industries are participants then the units can be surrendered to meet their obligations. If they are not participants then the units can be sold and the profits used to offset against their increase in costs. Applications for allocation must be filed within the timeframes specified in Gazette notices.

Synthetic gases (starts 2013)

The ETS covers: Hydrofluorocarbons (HFCs), perflourocarbons (PFCs) and sulphur hexaflouride (SF6).

Participants: People who import synthetic greenhouse gases either in bulk or contained within products or appliances.

Free allocation? Yes, to those who re-export synthetic greenhouse gases for destruction or contained in manufactured equipment. Importers of synthetic gases do not receive an allocation as they can pass on the cost to their customers.

Agriculture (deferred until 2015)

The ETS covers: All the major agricultural sources of methane and nitrous oxide.

Participants: The point of obligation is set at the processor level (processors of meat, wool and dairy and fertiliser companies; exporters of live animals; egg producers). This may be changed by an Order in Council to make the point of obligation at the farm gate.

Free allocation? Yes, the allocation will be awarded on an intensity basis.

Waste (starts 2013)

The ETS covers: Methane emitted through the biodegradation of organic waste at a land fill; carbon dioxide, methane and nitrous oxide from waste incinerators (except for carbon dioxide from combusting organic waste).

Participants: Those operating a disposal facility.

Free allocation? No, because the cost can be passed on.

Where to from here?

The Copenhagen Climate Change Conference failed to produce a post Kyoto (ie after 2012) agreement. However, a lot of background work is going on, for example, New Zealand is leading with the Global Research Alliance, intensely seeking answers to farm animal emissions. Europe has had an ETS for many years and our other major trading partners are working on mechanisms for their own greenhouse gas problems. Our expansion beyond the forestry sector will start on 1 July.

A review of the scheme next year could see a delay in the step up of the transitional arrangements for emitters if New Zealand's other major trading partners, including Australia, have not introduced their own greenhouse gas emission control schemes. The outcome of the review will follow the 2011 election.

The penalties for failing to comply with obligations under the New Zealand Emissions Trading Scheme can be hefty. It is important for businesses to get good advice and get their head around the responsibilities, the liabilities and the opportunities that this new environment will bring.

If you need advice regarding these issues please contact us.

Geoff Thompson
Consultant
Tel: +64 4 499 3280
g.thompson@
DuncanCotterill.com

Ben Tothill
Partner
Tel: +64 3 379 2430
b.tothill@
DuncanCotterill.com

Oliver Roberts
Partner
Tel: +64 3 379 2430
o.roberts@
DuncanCotterill.com

Shoshona Goodall
Associate
Tel: +64 3 546 6223
s.goodall@
DuncanCotterill.com