Carbon Monitor

Volume 16 Issue 9 October 2011

The NZETS Review Report

The Panel was comprehensive in its coverage of the issues and thorough in its consultation. Good job on collating and interpreting the myriad issues. The Panel highlighted the need for clear long-term signals, the need to balance short-term costs and long-term benefits. It also sought to dispel the myth that New Zealand is "ahead of the rest of the World", stating that it is simply incorrect to say that our international competitors are not taking any action.

The Panel noted that uncertainty is a key theme, both at international and domestic levels. In particular it observed the availability and eligibility of Kyoto units post-2012 is unclear.

The Panel considered that there would be a persistent and possibly increasing premium around the environmental integrity of units, noting the high level of environmental integrity of NZUs and the need for Government to urgently clarify what restrictions, if any, might apply to the use of CERs from industrial gas projects.

While New Zealand should be conscious of Australian developments, it should not necessarily be bound by the features of any particular overseas scheme, although the need to preserve and improve access to international carbon markets was also noted elsewhere in the report.

The Panel made a number of specific recommendations for consideration by the Government:

Government should urgently consider whether HFC CERs pose a significant risk and whether a time limit should be imposed on their eligibility:

To maintain the integrity of the New Zealand scheme, it may be necessary for the Government to make certain types of HFC CERs ineligible under the scheme, with a notice period to be given so that businesses which have already bought these units in good faith have an opportunity to surrender or sell them.

The Panel noted that no objections were raised towards CERs originating from large Hydro projects and that it does not follow that just because certain types of emissions units are ineligible under one emission trading scheme that they should also be ineligible under the NZ ETS. However the potential risk to New Zealand's incentives to abate, and the associated reputational risks, were noted as a concern.

Phase out the Transitional Measures More Slowly than Currently Legislated

Under current legislation, the two-tonne for one-emission-unit obligation and the fixed price option of $25 per NZU are due to expire from the beginning of the 2013 compliance year, effectively doubling the impact of the ETS on energy and fuel bills of households and businesses.

The panel has obviously struggled to reconcile the equally valid viewpoints that a) current macroeconomic uncertainty justifies some continuation of "transitional assistance" and b) we do need to call a tonne a tonne at some point.

The resulting recommendation is probably best described as the SUPRE approach to carbon; alter the current "2 for the price of 1" deal to a "3 for the price of 2" in 2013 and "6 for price of 5" in 2014. Then, we'll finally see the real price of the sweater in 2015. I just hope you all like fractions.

Retain the cap and review in 2017

The recommendation that the cap be retained but increased slowly and reviewed again in 2017 is more straightforward and, if adopted as policy, would in fact be helpful to the development of the forward market. The Panel suggests adding $5 a tonne to the current fixed price of $25 per tonne from 2013 onwards. This would see the fixed price rise to $50 per tonne in 2017.

Offer the same slowed transitional arrangements to incoming sectors

Presumably driven by a sense of fairness, the report also included a recommendation that the same 2 for 1 (from which the stationary energy, industrial process and liquid fossil fuels sectors have benefited since mid-2010) also be offered to the incoming waste and agriculture sectors. The result would be that for some sectors the "transitional measures" would continue, and at lower price levels, than for other sectors. While we support the intention to moderate cost, we think that the approach proposed is convoluted and confusing. If greater assistance is required for a particular sector, then this can be provided through a greater level of free allocation, but a 2 for 1 which becomes a "3 for 4" and then a "6 for 5" basis is flawed.

Further recommendations

Bring Agriculture in as planned in 2015
The Panel recommends that Agriculture remains within the ETS on the timetable that is currently legislated, with mandatory reporting beginning in 2012 and surrender obligations beginning in 2015, albeit on a moderated basis as above. The Panel also strongly supported a farmer point of obligation, rather than a processor level of obligation, although we note that this would not preclude processors procuring carbon credits on behalf of farmers.

Fix the 1.3% reduction in allocation such that it is straight-lined
The problem with the current decline in levels of free allocation is that the wording of the legislation would see the size of the decrease get smaller every year. For both highly emissions-intensive and moderately emissions-intensive industries, the decrease would become negligible and rounding rules in the Act would see free allocation to the tune of 38% continuing on an indefinite basis for emissions-intensive industries. The fix suggested is to straight-line the decrease such that it is equivalent to 1.3% of the original amount of assistance, each year.

Consider the potential introduction of a "Cap" in the next ETS review
Given the current intensity basis of allocation and lack of a cap, there are risks that new, potentially emissions-intensive industries could significantly expand the volume of allocation. An absolute cap on the total allocation amount should be considered.

Remove the ban on NZU exports from non-forestry sectors
The Panel considers that, in principle, the ETS should allow exports from all sectors as soon as possible because an open ETS is more efficient than a closed one. We note that, in the continued absence of an actual cap on allocations in the NZ scheme, this may diminish the attractiveness of forestry NZUs to overseas buyers in future (recognising that this market is very limited at current price levels in any case).

No price floor
The administrative complexity of this caused the Panel to recommend that no price floor was introduced.
Maintain existing thresholds for allocation

The Panel recommended that the allocation thresholds of 90 per cent allocation for highly emissions-intensive activities and 60% allocation for moderately emissions-intensive activities should be maintained. While some submissions were for in-between threshold levels to be identified and applied the Panel considered that the benefits of this change would likely be outweighed by the cost.

Businesses should disclose actual carbon cost
The Panel expressed concern that the price cap should not be used as a proxy for the actual carbon price, or as an excuse to pass on excessive carbon costs to end-consumers. The Panel noted the existence of market mechanisms that disclose trade prices for NZUs (such as Carbon Match) and supported transparency as a matter of principle.

Government to assess the use of new forestry "offsets" against pre-1990 deforestation liabilities
Currently the effect of the ETS is to lock pre-1990 forest land permanently into forestry use. This is driven by international rules which are currently being challenged by the Government and the panel strongly supports seeking change and noted the potential for New Zealand to get more flexibility under any future international framework. Pre-1990 forestry offset planting should be introduced if possible.

Clawback of the second tranche of Pre-1990 allocations, if offsetting introduced.
The Panel recommends that the second tranche of NZUs allocated to compensate pre-1990 land-owners for loss of flexibility be clawed back if offsetting is available as an option instead. This would amount to some 34 million units not coming to market in the post-2013 timeframe.

Consider averaging as a method of managing post-89 liabilities
The options available to sellers of post-89 NZUs wishing to hedge the value of potential harvest liabilities are limited. Long dated options over eligible units are not readily available and as a result post-89 forest owners selling NZUs have an unquantifiable contingent liability. Some do not recognise this and some are deterred from selling as a result. The Panel recommended that the Government consider averaging and retention of a proportion of NZUs as a solution. It also requested that the International Accounting Standards Board look into treatment of the post-89 actual and contingent liabilities in financial accounts.

A range of other forestry- and ownership-related recommendations
• Field measurement should be available as an option for owners of less than 100 Hectares, but not necessarily required.
• The pre-1990 tree weed exemption should be available beyond 2012
• Government should consider strengthening the existing afforestation schemes to encourage greater participation by Maori in post-1989 forestry.
• Government to development amendments to the Act which address the problems associated with Maori land in multiple or trustee ownership, and which ensure that the Maori Trustee can apply for the 50 Ha exemption on the basis of individual Maori trusts'

ownership rather than on the basis of total landholding.
• Government to explore whether temporary extensions to the exemption and allocation deadlines for Maori owners are necessary.

The Panel also made a series of recommendations on the Synthetic greenhouse gas and Waste sectors. See Chapters 7 and 8 of the report for the specific detail on these.

You can read the full report and the accompanying press release here

Supplied from Carbon Match www.carbonmatch.co.nz

South Africa a Significant Beneficiary of the Kyoto Protocol

South Africa has benefited more than any other African nation from carbon investment facilitated by the Kyoto Protocol's Clean Development Mechanism (CDM). However, carbon market investment in South Africa has been driven primarily by the European Union's Emission Trading Scheme (EU ETS) and as this programme enters its third phase, European policy makers are floating the possibility to restrict, from entry into the EU ETS, carbon credits from all but the least developed nations (LDCs).

In a recent interview aired on *CNBC Africa*, Evolution Markets' head of African Markets, Brett Jordaan, and EcoMetrix's African director, Lodewijk Nell, discuss the challenges facing South Africa should the European Union restrict CDM investment to LDCs.

Brett, Lodewijk, and Andrew Gilder of IMBEWU's Climate Change and CDM legal consultancy unit also highlight the opportunities and challenges for clean energy investment using alternative market mechanisms being developed under the Kyoto Protocol in an article published today in South Africa's *Business Day*.

New Zealand ETS review Further Comments

At this stage we note that it is not yet policy which limits the ability to assess how it may affect the NZETS.

The initial impression is that it has taken into account and is following the proposed Australian scheme to allow integration at some future date. Progressive increasing of the price cap and the requirements to surrender 100% of emissions are all positive but in our view being implemented too slowly given the Australia plan. A sudden phase out in 2012 is arguably too radical.

However there have been some perverse outcomes of the current cap of $25. The reported charging at the cap by emitters and then purchasing at a lower rate has created unintended profit opportunities from the NZETS. Whilst there is no specific evidence of this there are reports of second tier emitters becoming points of obligation to avoid paying $25. If we have an increasing cap the regulator should look carefully at what people are paying for costs that are attributed to the carbon charge.

For pre 1990 forest owners I cannot see any relief for them as the report would recommend changes but notes this is not possible due to the international rules.

One issue we are following which may change the landscape for forest owners is the classification of carbon credits as a financial product in Australia. The report considers linking to the Australian scheme and the question that is not addressed is how the New Zealand regulatory environment would need to change.

What flows from this is the current perception of risk by forest owners. The majority of advice has been from forest managers and this has failed to promote the awareness of risks. The panel recommends in its report this be addressed. The reality is this must in EITG view is via proper advice from properly qualified people.

The choice to opt into the FMA with less than 100ha is a sensible recommendation. Increasing the threshold however is not without risk and no empirical data has been supplied to argue increasing the threshold. Once data is available from 2012 measurements it may be this risk can be assessed and the threshold reviewed.

The pooling to create an insurance risk pool matching the Australian scheme whilst noble fails to consider the Australian scheme excludes plantation forest. Forest owners have access to and can fund private insurance. This should tie into foresters receiving proper advice.

Exclusion of industrial gas CER from the NZETS has been raised but no real recommendation made on the impact of this on the costs of carbon and on the ETS. An urgent recommendation for review is therefore appropriate.

No real comment has been made on the operation of the ETS. The timing of allocation and surrender, currently on fixed dates, is in our view counterproductive and creates distortions in the market. There is little in the way of recommendations on the structure and operation of the ETS. Adding

9000 farmers of points of obligation as the report suggests would put further significant pressure on the regulator all during one time period during the year.

On the operation of the EUR there is some suggestion that information be released so as to preserve commercial confidentiality in relation to specific transactions.

Given the purpose of the ETS is provide a readily discoverable price of emissions we question this advice. The stock market is open and subject to disclosure rules to protect parties from people miss using information.

The review panel suggests that commercial confidentially is above the need for transparency in the market. To date we believe one of the flaws in the ETS has been the lack of credible and reliable information to buyers and sellers. The market is essentially bilateral trades which are unreported. Carbon Match offers a bid/ask service but this lacks depth and potential transparency.

The concept of averaging for post 1989 forests to deal with liabilities at harvest is raised the proposal suggests the Government use a scheme to limit credit issuance to the long term post 2008 average carbon stocks and in turn it supplies the credits to meet harvest liabilities. We don't think this is practical as the majority of post 1989 forests will be harvested from 2020 onwards (the so called wall of wood) and the average carbon stock approach fails to address the fact that ALL units issued under the ETS will need to be surrendered at harvest. In our view averaging will only assist those with new plantations post 2008 of which there are few.

NZETS – the Concept of a Participant

Stephen Ladányi is a subject matter expert on the operational design and implementation of the forestry sector aspects of the NZ ETS. He worked for MAF as ETS Implementation Manager from the first introduction of the ETS legislation in late 2007 until late 2010.

Stephen has kindly contributed an explanation of the concept of a participant as it applies to the New Zealand Emissions trading scheme.

The concept of "Participant" is one of the key design features of the New Zealand. Undertaking particular activities described in the ETS legislation determines who is a Participant.

For most sectors, these activities have been described high up the supply chain to minimise the number of Participants and thus reduce ETS administration. The forestry sector is the exception as the activity descriptions potentially result in many thousands of Participants.

The following table gives some examples of ETS activities:

Activity	Type of Participant
Importing coal.	Mandatory Participant
Producing iron or steel.	Mandatory Participant
Deforesting more than 2 hectares of non- exempt pre-1990 forest land in the 5 year period commencing on 1 January 2008 (or any subsequent 5 year period).	Mandatory Participant
Owning post-1989 forest land (not subject to a forest sink covenant under the Forest Act 1949).	Voluntary Participant

The term Participant is a singular concept even though multiple parties may be involved. In each of the following examples there is only one Participant:

Example A. John Smith

Example B. John Smith, Mary Smith

Example C. Carbon Credits Limited, John Smith, Bernice Bloggs (a partnership)

Example D. Your Company Limited, My Company Limited (a joint venture)

It is the Participant as a singular entity (and not the component parties individually) that has entitlements and obligations under the ETS. For example, it is the Participant that:

- Must have a holding account at the NZ Emission Unit Register (NZ EUR)
- Is entitled to apply for carbon credits
- Is obliged to surrender carbon credits
- Must make keep certain records
- Must make certain declarations

There are no "associated persons" rules for Participants in relation to post-1989 forest land in the ETS. Take the following example:

- John Smith, Mary Smith and Bill Bloggs together own 90 hectares of post 1989 forest land that is registered in the ETS. Collectively, they are the Participant in relation to the 90 hectares and must have an NZ EUR holding account

- Bill Bloggs also owns an additional 75 hectares of post-1989 forest land by himself. He is the Participant in relation to the 75 hectares and must have a separate NZ EUR holding account
- For the purposes of determining whether or not either of these two Participants exceeds the Field Measurement Approach 100 hectare threshold, no account is taken of the fact that Bill has an ownership interest in both of the forests. From the perspective of the ETS, these are two completely unrelated Participants neither of which exceeds the FMA 100 hectare threshold

Of course, there are associated persons rules in relation to pre-1990 forest land exemptions and allocations. But that's another story.

Stephen can be contacted via email at zoltan@paradise.net.nz

Our 'Silly Fool' Reacts to the NZETS Review and the Self Insurance Pool

This "silly fool" has been caught again by the Governments "independent review panel" announcement that 5% of carbon grown by foresters would be retained for "self-insurance pool" and/or to cover any liability at harvest that the owner may be unable to pay.

This so called "self-insurance pool" sounds like the Government Accident Compensation Scheme to me…. Very expensive.

Quote: *"The two predominant recommendations for post-1989 forestry are around the methods of collecting deforestation liabilities*
• Averaging ……. and
• A self-insurance pool: Under this scenario, a pre-determined percentage of post-1989 NZU allocations would be retained by the Government for future liabilities caused by natural disasters.

Neither of these recommendations should have market moving implications, however on balance they appear practical approaches to protecting retail forestry investors who are the predominant player (by volume of participants) in this space."

On a forest, say of age 12 years, works out at $62.58 ha (based on the price I sold my NZU at in February 2011) BUT it only covers the carbon liability! I still have to insure for re-establishment costs, plus fire fighting and possibly loss of future earnings plus there is a carbon fund coming to market where people can borrow credits to cover harvest liabilities.

I am already paying for FULL forest AND carbon liability insurance, from NZ Carbon Insurance, that covers everything, all of the above plus fire, storm, clearing, replanting and especially the carbon NZU that I have liability for in the event of disaster…..the cost of this comprehensive cover is half at $31.25 Ha.

AND if I have "foolishly" sold all of my NZU, not taken steps to plant more offset forest or invested the carbon returns in another saleable asset and at the time for harvest, my liability is greater than the harvest returns plus the saleable asset ….. why would I harvest at all?

Have they allowed a way for me to opt out of this 5% retention if I desire and for the insurance industry to continue to be effective? There is a carbon fund coming to market where people can borrow credits to cover harvest liabilities.

The decision makers need more information and we foresters and others in the industry will do our bit to try to educate them and leave the most of the solutions to the private market.

The Act allows the government to go after any forest owners and directors, if they can't meet their obligations and commitments, they are all personally liable. They cannot do a runner!

Why does the government place levies on every product, I, as a primary producer have been forced to pay over my thirty year farming experience on maize, wool, meat etc and never had any significant benefit from because those who manage it are salaried and never put out any personal financial risk.... I stopped growing maize in 1979 (never did get a penny of the stabilisation fund I had paid into), because the return was equal to 5 sheep per acre, on 11 sheep per acre land, stopped wool farming in 1987 the last time the price for crossbred wool was $6.80 the level it finally got back to earlier this year but it needed to be at $11.50 to be equal to inflation. Went for bull beef and stopped that in 1989 when the schedule was $3.30kg, which it finally got back to a few years ago…….. I planted trees because the forestry returns, averaged over the 60 years prior to 1990, were +3% (positive to) of inflation and no levies. All forms of animal based commodities were below inflation, dairy at just under inflation, for meat and wool farm returns (minus) -3% and had levies.

When I returned from my OE, in the mid '70's, shearing and building a bit of capital to get started farming for myself I had found a market for NZ lamb, "great I am going to be an exporter and make some serious farming money", went to the meat board in wellington to get started, I had a market for 2 containers a month.

Market 1, the front of the lamb to the end of ribs in Kenya to a big Kenyan family I had met. The Kenyans could not afford the prime end.
Market 2, for the rear half of the lambs, prime chops and back legs to a friend who owned butcher shops in Ulster, who I used to bone out NZ lamb with, for sausages!

The good old NZ Meat board said "give us the details and we will do it". They didn't even offer to pay me for the market that I had secured.....

So what has that got to do with the "self-insurance pool"? Everything. The point is it costs twice as much for a quasi- government levy collecting organisation to do anything, its not performance based as my business is. The cream gets licked off by this system. None of the levies or other donations that I have been forced to pay over the years have had an impact anywhere near even keeping up with inflation or being price beneficial or market beneficial in my experience.

Contact Details

Terry Quilty	p: 64 21 250 6789 f: 64 9 920 1093 skype terryquilty e: terry.quilty@eitg.co.nz
Richard Hayes	p: 64 9 920 1092 m: 64 21 310 301 m: 61 45 223 0232 (Australia) f: 64 9 920 1093 skype richardshayes e: richard.hayes@eitg.co.nz
Simon Baillieu	p: 27 82 558 9616 skype sbaillieu e: simon.baillieu@eitg.co.nz
Martin Albrecht	m: 64 21 565 682 e: martin.albrecht@eitg.co.nz skype goodground
Iain MacDonald	m: 64 27 438 2544 iain.macdonald@eitg.co.nz

'Carbon Monitor' is a client service of EITG.
EITG develops, facilitates and engineers Carbon Mitigation projects and strategies. Terms of use of this information are set out on our web site.

EITG corporate advisory provides high-level briefings and advice on building robust responses to emerging regulatory structures.

EITG Carbon Pool provides forest owners with a robust platform to access markets while dealing with harvest and other liabilities.

EITG provides trading platforms and strategies based on extensive mitigation and avoidance platforms under JI and CDM, with matched offset packages for emitters.

EITG is part of an international consortium with representation in Asia/Pacific, UK, Europe, USA and South Africa

To subscribe go to our web site and enter your details

Let your thoughts be known on our blog at www.ghgemissionstrading.wordpress.com

Join twitter for updates from EITG www.twitter.com/eitg

Like us on Facebook Environmental Intermediaries & Trading Group Limited

www.eitg.co.nz