
CLIMATE CHANGE

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NEW EMISSIONS TRADING SCHEME:
THE REALITY NOW FOR BUSINESS



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New mechanisms to combat climate change mean the cost of carbon has now become a commercial reality for New Zealand business.

The Government yesterday unveiled its framework for a New Zealand Emissions Trading Scheme (NZ ETS) and although it directly impacts on a relatively small number of entities, it will have economy-wide repercussions. While details of the scheme are still being digested, there are some clear implications arising for business.

Business with “obligations”

Under the NZ ETS, certain businesses will carry specific obligations. The Government has yet to confirm which entities will be “points of obligation” under the scheme, but these businesses will have an obligation to surrender tradable emission units, which will be known as New Zealand Units or NZUs, to cover their direct emissions or emissions associated with their product. For economic efficiency reasons, a point of obligation will generally be an entity at the upstream point of the sector (e.g. fuel companies as compared to motorists). It is anticipated that there will be just over 200 points of obligation (plus any foresters who opt in to the scheme) who will be obliged to participate in the NZ ETS. Those with these obligations can expect to be allocated NZUs and the Government has indicated that in many sectors NZUs will be freely allocated. However, where an entity with obligations is capable of passing on the cost of carbon, such as electricity generators and fuel companies, the Government will not freely allocate NZUs as it would result in those entities receiving a windfall gain. The

Government has applied the principle that where carbon costs can be “passed through” or on, NZUs will be auctioned rather than given freely.

The wider business impact

While many businesses will have no obligations under the scheme, its financial ramifications will still reach them. The cost of carbon arising from the NZ ETS will affect businesses as the costs flow down and through the economy. For example, we may expect to see an increase in transport and energy costs, and in the costs of products arising from industrial processes. The costs for a business with NZ ETS obligations will depend on the extent to which it is able to reduce or offset its emissions and reduce the cost of having to hold NZUs. Entities which try to pass straight on the entire cost of NZUs, which they are originally required to hold, may face resistance from their customers. Consumers will no doubt want to know whether the business or organisation could have reasonably mitigated their costs in other ways before passing on any unavoidable carbon costs.

Credits grow on post-1989 trees

The Government has reversed its position on the forestry sector. It will no longer refuse to part with carbon credits associated with post-1989 forests but instead will now freely allocate NZUs to foresters who own post-1989 forests and who opt to join the NZ ETS. Providing credits to foresters will contribute significantly to the trading volume and liquidity of the NZ ETS. The Government

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has also ensured that the timing of including the forestry and transport sectors in the scheme will encourage trading between them. Although opting into the NZ ETS may result in a post-1989 forest owner making a significant financial gain, there will be liabilities associated with being a "point of obligation" in the forestry sector, in particular when it comes to deforestation. Foresters will need to consider the scale of their activities and their long-term plans when considering the benefits and implications of being part of the NZ ETS, in comparison to benefits arising from opting into the Afforestation Grant Scheme. This scheme encourages forest plantings on unforested land by people who do not want to join the NZ ETS, whereby in exchange for a grant to owners for the initial planning, the Government retains the credits and liabilities of these forests.

Wide market carbon trading

Businesses without obligations under the NZ ETS can choose to participate in the trading of NZUs. Our experience with the European Union emissions trading scheme suggests that there would be wide market participation in New Zealand. We expect to see traders such as banks, entities with offset projects, and potential points of obligation such as electricity generators, enter the market relatively early on to capitalise on the opportunities including:

- potential points of obligation acquiring NZUs during the early stages of the scheme in order to hold NZUs for future surrender obligations – for example, if they consider the price for NZUs will rise over time as it did in the EU;
- businesses who carry the passed-on cost of carbon and who will be looking to profit through their trading activities to offset those costs; and
- use of futures and other derivative products by businesses seeking certainty over their future carbon costs.

We have already seen significant interest from foreign players in acquiring emission units from offset projects in New Zealand and expect that they will also be interested in acquiring NZUs (backed by Kyoto-compliant units) through the NZ ETS. The Government envisages that the NZ ETS will be able to link internationally with other emissions trading schemes.

Investing in offset projects

A significant amount of investment by New Zealand entities is expected to be generated in carbon offset projects, including renewable energy resources such as wind farms and landfill gas projects, or projects to capture or reduce carbon emissions. Although the NZ ETS will act as the primary incentive to invest in these projects, incentives also arise under the Government's Sustainable Land Management and Climate Change Plan of Action, and are also anticipated under the soon to be released Energy Strategy and National Energy Efficiency and Conservation Strategy. We also expect to see New Zealand entities with obligations under the NZ ETS investing in offset projects or acquiring Kyoto-compliant units arising from offset projects overseas to help meet their surrender obligations. Similarly businesses to whom the costs of carbon are passed are likely to look to do the same in order to make a profit by trading units to offset those costs.

Carbon neutrality still worthwhile?

For some entities the new scheme may mean that the incentive to become certified carbon neutral falls away. Those meeting the direct or indirect costs of carbon arising from the NZ ETS and also paying for non Kyoto-compliant units in order to be certified carbon neutral, will in effect be paying twice for their carbon footprint. Where this is the case, those businesses will need to consider carefully the benefits of being certified carbon neutral against the increased financial costs they are facing. For some entities, such as those battling against the concept of food miles, certified carbon neutrality may make financial sense, but for others it may simply be a financial drain.

For more detail on the Government's climate change solutions and the NZ ETS visit www.climatechange.govt.nz.

* Bell Gully is advising the Government on legal issues involved in the design and implementation of the NZ ETS. We also advised the Government in 2000 on the potential legal framework for an emissions trading scheme, and emissions trading aspects of the Climate Change Response Act. Bell Gully also advised on New Zealand's first transaction on the Chicago Climate Exchange, the sale of emissions units from New Zealand projects under the Kyoto Protocol, offset projects and contracts dealing with the passing through of carbon costs.