



Consultation on Proposed Regulations Restricting the use of HFC-23 and N₂O CERs in the NZ ETS

Submission by Z Energy Limited

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Z Energy submission

This is a submission by Z Energy Limited.

Z Energy welcomes the opportunity to comment on the Government's consultation document titled "*Consultation on Proposed Regulations Restricting the use of HFC-23 and N₂O CERs in the NZ ETS*".

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Glossary

CCRA	Climate Change Response Act 2002
CDM	clean development mechanism
CERs	certified emissions reductions
ETS	emissions trading scheme
EU	European Union
EUR	emissions unit register
IG CERs	industrial gas CERs i.e. HFC-23 CERs and N ₂ O CERs from adipic acid production
MfE	Ministry for the Environment
NZU	New Zealand Unit
Z	Z Energy Limited

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Key message

Z supports the Government's proposal to ban IG CERs under the New Zealand ETS at some point in the future. But Z submits that the timing of the ban should be aligned with the timing of the EU ETS ban. This will enable participants to surrender IG CERs for the 2011 and 2012 compliance periods but not for the 2013 and subsequent compliance years. Aligning the timing of the ban in this way will:

- meet the Government's objectives for the ban (protect environmental integrity, avoid risk of oversupply and facilitate linking)
- be administratively simpler to implement than an earlier ban
- avoid the significant financial costs that participants may incur if the ban is imposed earlier, and
- avoid the risk of undermining participants' confidence in carbon trading and the New Zealand ETS.

Z and its emissions liability

Z owns and manages over 300 service stations and truck stops throughout New Zealand and directly employs over 240 New Zealanders. Z supplies fuel to retail customers and large commercial customers like airlines, trucking companies, mines, shipping companies, and vehicle fleet operators.

Z believes in the science of climate change, and that human activity contributes to the rate of climate change. As a local company, Z wants to be a part of the solution to climate change rather than a part of the problem.

With this context, and for the purposes of this consultation document, Z believes the following commitments should underpin the decisions that flow from it:

- Promote a working carbon market that will facilitate behavioural change
- Build a market based on environmental integrity
- Ensure participant confidence in the operation and integrity of the market.

Z is a participant in the NZ ETS under part 2 of schedule 3 of the Climate Change Response Act 2002 as an owner of obligation fuel.

Z is responsible for approximately 5.0 million tonnes of carbon dioxide equivalent emissions per annum. To illustrate the magnitude of this liability, with the 2 for 1 transitional surrender obligation in place at a notional carbon price of \$20 per tonne, this equates to a \$50 million liability. When the 2 for 1 obligation lapses, at a notional carbon price of \$30 per tonne, Z's liability would be approximately \$150 million.

Z intends to meet its 2011 and 2012 emissions liability with a mix of NZUs and CERs. Z has purchased NZUs and has entered into forward contracts for the future delivery of CERs, which are likely to include a large proportion of IG CERs because the majority of CERs issued to date are IG CERs. Under the terms of these forward contracts, CERs are due for delivery to Z in May 2012 and April 2013. The units due for delivery in May 2012 will be surrendered in May 2012 in respect of Z's 2011 emissions liability. The units due for delivery in April 2013 will be surrendered in April or May 2013 in respect of Z's 2012 emissions liability.

The proposed ban and its timing

Z supports the introduction of a ban on the use of IG CERs in the NZ ETS for one of the reasons given by the Government – namely that this will be required to ensure the future environmental integrity of the ETS. However, Z disagrees with the proposed timing of the ban and submits that, for the reasons of protecting and preserving confidence in the market, a ban should be aligned with the timing of the EU ban.

Before turning to a discussion of the disadvantages of the proposed ban timing and the advantages of aligning with the EU ETS ban timing, it is important to understand the timing of the EU ETS ban. This is important because, contrary to the assumption in question 10b in the consultation document, introducing the ban on 1 January 2013 would not be "in line with the EU ETS ban".

Timing of EU ETS ban

The EU ETS ban is provided for in Commission Regulation (EU) No 550/2011. Article 1 of the Regulation states that:

"From 1 January 2013, the use of international credits from projects involving the destruction of trifluoromethane (HFC-23) and nitrous oxide (N₂O) from adipic acid production for the purposes of Article 11a of Directive 2003/87/EC is prohibited, except for the use of credits in respect of emission reductions before 2013 from existing projects of these types for use in respect of emissions from EU ETS installations that took place during 2012 which shall be allowed until 30 April 2013 inclusive."

This means that IG CERs are eligible for compliance in the EU ETS up to and including the 2012 compliance year (i.e. for emissions up to 31 December 2012) and are banned from the 2013 compliance year onward (i.e. for emissions from 1 January 2013).

If the New Zealand ETS ban on IG CERs were to be introduced on 1 January 2013 it would prevent IG CERs being surrendered in respect of the 2012 compliance year because of course surrender for 2012 would occur in 2013, after the ban comes into force).

Disadvantages of proposed ban timing

Imposing a ban on either of the dates proposed by the Government, namely 1 January 2012 or 1 January 2013, has two main disadvantages:

1. Financial loss

Imposing the ban on either of these dates will cause significant financial loss for Z and (Z understands) many other participants in the New Zealand ETS if participants have to swap IG CERs for non-IG CERs. As mentioned, Z has purchased CERs under forward contracts for delivery in May 2012 and April 2013, and these are likely to include a large proportion of IG CERs because the majority of CERs issued to date are IG CERs. Z plans to surrender these for compliance in respect of its 2011 and 2012 emissions. Other participants are in a similar position.

If the ban were imposed before May 2013, participants will have to renegotiate some of these contracts to ensure that non-IG CERs are delivered. This would come at a potentially substantial cost for Z and the NZ market in aggregate. If participants incur these costs, they would be passed on to customers in the form of higher prices. An exemption for such forward contracts could avoid this loss, however an exemption process would impose an additional administrative burden on participants and MfE.

2. Loss of confidence in New Zealand ETS and carbon market

Imposing the ban on either of the proposed dates will undermine participants' confidence in the New Zealand ETS and carbon market. Z and other participants have entered into forward contracts on the legitimate and reasonable expectation that the New Zealand ETS rules for the period up to the end of 2012 (and including the surrender period ending on 31 May 2013) would be stable. Changing the rules at short notice, where no benefits of doing so have been shown, will undermine participants' confidence in the New Zealand ETS.

In addition, if the ban is imposed in a way that cuts across existing forward contracts for 2011 and 2012 compliance, whether or not an exemption is granted, participants' will be wary of entering into forward contracts in the future. This will hamper participants' ability to comply with the New Zealand ETS at least cost, which will ultimately increase costs to consumers without any environmental benefit.

The timing proposed in the consultation document would also favour those participants who have acted early to secure CERs while others, not unreasonably, have been slower to respond but with the legitimate and reasonable expectation that the opportunity to obtain and surrender units for the 2011 and 2012 compliance years would remain as currently legislated.

Advantages of alignment with EU ETS ban timing

As mentioned, under the EU ETS ban, IG CERs are eligible for compliance in respect of 2011 and 2012 emissions liability, but ineligible for compliance in respect of 2013 and subsequent years' emissions liability.

There are three main reasons why the timing of the ban should be aligned with the EU ETS ban:

1. Objectives of the ban will be met

The Government has identified three reasons for banning IG CERs¹:

- maintaining the environmental integrity of the New Zealand ETS
- mitigating the risk of a global oversupply of these units impacting on the price in the New Zealand ETS, and
- improving the prospects for future links between the New Zealand ETS and other emissions trading schemes that prohibit these units.

Each of these reasons is equally addressed by aligning the ban timing to that of the EU ETS:

- Environmental integrity: Banning IG CERs from either of the dates proposed in the consultation document is not necessary to protect the environmental integrity of the New Zealand ETS. Concerns over the integrity of CDM projects producing IG CERs have existed for some years now. IG CERs are UN approved emissions units and the CDM Executive Board is taking steps to address the environmental integrity concerns relating to them, as the consultation

¹ Consultation document, page 1.

document notes. Aligning with the EU ETS ban timing will ensure the New Zealand ETS keeps pace with the world's largest emissions trading scheme in terms of environmental integrity.

- **Global oversupply:** A ban on IG CERs before the EU ETS ban is not required to prevent New Zealand becoming a dumping ground for IG CERs. Until the EU ETS ban takes effect, IG CERs are eligible in the EU ETS and will be sought after by EU ETS participants to meet their emissions liability, so the price between IG CERs and 'green' CERs should not materially diverge. Based on available market information, the price difference between IG CERs and other EU ETS compliant CERs is between 0 and 35 Euro cents. Forward prices out to April 2013 reflect a similar price difference. This shows that there is no expectation in the market that prices will significantly diverge before the IG CER ban begins in the EU ETS. This being the case, there is no basis for assuming that New Zealand would become a dumping ground for IG CERs before the ban begins in the EU.
- **Linking:** A ban on IG CERs before the EU ETS ban is not required to improve prospects for future links between the New Zealand ETS and other emissions trading schemes that prohibit these units. There is no prospect of linking with such schemes before 2013. In respect of the period from 2013, the ban timing proposed by the Government and by Z have the same effect, i.e. IG CERs will not be eligible in the New Zealand ETS (except those that entered the New Zealand EUR before the regulations came into force).

2. Administratively simpler

Aligning the ban timing to the EU would be administratively simpler because it will avoid the need for exemptions for forward contracts. In particular, any forward contract for delivery on or before 30 April 2013 would not need to be exempted because any IG CERs delivered under that contract would be eligible for compliance with 2011 or 2012 emissions liability but would be ineligible for compliance with 2013 and subsequent years' emissions liability.

It is possible that some participants have entered into forward contracts for delivery after 30 April 2013. If so, an exemption would be required for these contracts. However, based on market information, Z understands that if there are any such forward contracts they are few in number and likely to be EU compliant (i.e. excluding IG CER's) so few if any exemptions would be required.

3. Disadvantages avoided

Aligning the timing of the ban to the EU ETS ban would avoid the financial loss and loss of confidence in the carbon market discussed above that would result from an earlier ban.

Aligning with the EU ETS ban will not enable greater 'stockpiling' of IG CERs

It is important to note that alignment with EU ETS ban timing would not allow any more time for 'stockpiling' IG CERs than under MfE's first option (i.e. a ban from 1 January 2012). That is, the Government could bring the regulations into force on or before 1 January 2012 and any IG CERs imported after the regulations come into force would be subject to the ban, i.e. those IG CERs could only be used for 2011 and 2012 compliance.

Only IG CERs imported before the regulations come into force would be protected by section 30G(3) of the CCRA (which provides that regulations restricting eligibility of units do not apply to units in the registry before the regulations come into force).

Proposed ban drafting

Z proposes the following drafting for the ban:

- (1) *No participant may surrender, or permit to be surrendered, a certified emission reduction unit from a project involving the destruction of trifluoromethane (HFC-23) or nitrous oxide (N₂O) from adipic acid to meet the participant's obligations under section 63 of the Act in respect of any emissions from any activities listed in Schedule 3 or 4 of the Act carried out by the participant after 31 December 2012.*
- (2) *No participant may surrender, or permit to be surrendered, a certified emission reduction unit from a project involving the destruction of trifluoromethane (HFC-23) or nitrous oxide (N₂O) from adipic acid to meet the participant's obligations under section 63 of the Act in respect of any emissions from any activities listed in Schedule 3 or 4 of the Act carried out by the participant during 2012 unless the unit was held in an account in the Registry on 30 April 2013.*
- (3) *Nothing in regulation (1) or (2) applies to a certified emission reduction unit held in an account in the Registry at the time regulation (1) and (2) came into force.*

Drafting notes:

- The drafting of (1) and (2) is based on section 18CC of the CCRA and draws on wording from the EU ETS regulation set out on page [4] above. In the case of (2), the drafting also draws on wording from section 30G(3) of the CCRA.

- The drafting achieves alignment with the EU ban because (under (1)) IG CERs would not be eligible for compliance for emissions after 31 December 2012, but (under (2)) as long as an IG CER was imported by 30 April 2013, it would be eligible for compliance for 2012 emissions (and the ban does not affect eligibility of IG CERs for 2011 compliance).
- The drafting is also consistent with the annual surrender deadline in the New Zealand ETS, namely 31 May (which of course is a month later than the annual surrender deadline in the EU ETS, namely 30 April). That is, as long as an IG CER was imported before 1 May 2013 when the EU ETS ban takes effect, the IG CER could be submitted during May 2013 for 2012 compliance.
- Regulation (3) reflects section 30G(3) of the CCRA.

N₂O CERs

Z understands from the consultation document that the intention is to ban all CERs derived from projects involving the destruction of N₂O. This is not consistent with the ban in the EU ETS. The EU ETS ban only applies to N₂O CERs from adipic acid production. It does not apply to all N₂O CERs, in particular those from nitric acid production (see wording of ban on page [4] above). Similarly, the ban on N₂O CERs in the Australian ETS will only apply to N₂O CERs from adipic acid production².

It is Z's view that only those N₂O CERs that are subject to the EU ETS ban should be banned in the New Zealand ETS. The Government's reasons for banning IG CERs do not apply to CERs that are not banned under the EU ETS. There are no environmental concerns with these CERs and no risk of an oversupply because they continue to be eligible in the EU ETS and will be sought after by EU participants.

If all N₂O CERs are banned in the New Zealand ETS, this will affect participants' ability to trade spot and futures under the standard European Climate Exchange contracts from 2013, because they would need to separately exclude all other N₂O projects (not only adipic acid). This would increase participants' cost of compliance for no good reason, which would then be passed on to consumers.

Consultation on drafting of ban and any exemption

Z requests that the Government consults on the draft text of the ban and any exemption to ensure that they operate as intended. Consultation on draft regulations is an increasingly common step in the regulatory process. For example MfE and the Ministry of

² See Appendix A of "Securing a Clean Energy Future", Commonwealth of Australia 2011.

Agriculture and Forestry have both consulted on draft New Zealand ETS related regulations on many occasions and made substantive corrections and improvements as a result of feedback from participants. That is all the more important here where the implementation of the ban and any exemption is complex and may have serious adverse unintended consequences if not worded accurately.

Future changes to the New Zealand ETS

Z also wishes to make three points arising out of the proposed ban of IG CERs; namely a request for robust consultation in future, a proposal to protect forward contracts in future and observations on how the Government should view future CER eligibility restrictions in the EU ETS.

Adequate consultation required

The consultation document is very brief. Given the complexity of the issues and the potential costs of the proposal to NZ ETS participants and consumers, Z would have expected more detailed analysis to support the proposal. For example, the consultation document contains little or no analysis of matters such as why it is thought necessary to ban IG CERs earlier than the EU ETS, the point in time at which the EU ETS ban would be likely to impact on the carbon price in the NZ ETS, or the costs and benefits (including economic impact) of a ban and the proposed timing options.

Z appreciates that officials may have been under time constraints and it agrees that there is a clear case for banning IG CERs. However, it hopes that more time and analysis is given to proposed changes to the NZ ETS in future. Section 30H of the CCRA recognises the need for quality consultation by making it mandatory to consult on certain regulations under section 30G, including giving adequate notice and reasons for proposals. More broadly, Z recommends that the Government develop a process for consulting with NZ ETS participants before changes to the scheme are proposed, including any changes required as a result of the gap in international agreements from the end of 2012.

Amendment to section 30G(3) of the CCRA

Z proposes a change to section 30G(3) of the Act to give participants more certainty that the Government will not cut across forward contracts in future.

As currently drafted, section 30G(3) of the CCRA provides that if regulations are made under section 30G(1)(b)(i) or (c) which restrict unit eligibility in the New Zealand ETS, the restriction will not apply to units held in the New Zealand EUR at the time the regulations come into force.

While section 30G(3) provides protection for those who have purchased units and hold those units in their New Zealand EUR account, it does not provide any protection for those who entered into forward contracts to purchase units and have them delivered at a later date.

The decision to purchase on spot or under a forward contract is a purely financial one. Purchasing forward can save on interest costs because the purchaser does not have to pay for the units until delivery. Participants who purchase units under forward contracts should be entitled to rely on the rules in place at the time of entering into the forward contract. As mentioned above, without such protection, participants will be wary of entering into forward contracts in future. This will increase participants' cost of complying with the NZ ETS, which will ultimately increase costs to consumers without any environmental benefit.

Accordingly, Z submits that the Government should extend section 30G(3). It should exempt from any regulations restricting unit eligibility under section 30G(1)(b)(i) or (c) any units purchased under forward contracts that are entered into before, and provide for delivery of units within three years of, the regulations coming into force.

Future CER eligibility restrictions in the EU ETS

There will soon be other CER restrictions in the EU ETS. For example, in relation to CDM projects registered after 2012, only CERs from projects in least developed countries will be eligible.³ Other restrictions are being considered by EU officials.

New Zealand should not automatically mirror such restrictions. The EU has imposed such restrictions for political reasons, namely to close the EU ETS market to CERs from countries like China and thereby exert pressure on these countries to adopt emission reduction commitments. The EU ETS is also a very different scheme to the NZ ETS. It is more narrowly based (for example it does not include transport) and has typically been a higher priced scheme than the NZ ETS.

Z supports the New Zealand ETS review panel's view that:

- It is in New Zealand's interests for the New Zealand ETS to be as open as possible to international carbon markets as this will minimise the cost impact on the economy.
- It does not automatically follow that just because certain types of emission units are ineligible under one emission trading scheme then they should also be ineligible under the NZ ETS.⁴

³ See EC Memo/10/614 (25 November 2010)

Responses to questions

Question 1: *What are your thoughts on the Government's assessment of the risks of allowing CERs generated from HFC-23 and N₂O industrial gas destruction projects in the NZ ETS?*

Z agrees that there are risks to the environmental integrity of the New Zealand ETS and oversupply of IG CERs if IG CERs are not prohibited from use in the New Zealand ETS in the future. However, Z disagrees with the Government's assessments of when those risks will materialise. Z believes that those risks will only materialise when the EU ETS ban on IG CERs commences on 1 May 2013. Z also agrees that there are benefits in improving prospects of the New Zealand ETS being further linked to other emissions trading schemes in the future, although given the uncertainty around the future shape of other schemes, Z submits that this is a secondary consideration.

As explained in more detail above, each of these risks is addressed equally as well by aligning the timing of the ban with the timing of the EU ETS ban, and such timing is administratively simpler to implement and avoids the financial loss and loss of confidence in the carbon market and New Zealand ETS that would result from an earlier ban.

Question 2: *Should there be a ban on using these CERs for compliance in the New Zealand Emissions Trading Scheme (NZ ETS)?*

Yes. However, as set out above, Z submits that the timing of the ban should be aligned with the timing of the EU ETS ban.

Question 3: *What effect do you think the ban would have on:*

a. *you or your organisation*

If the ban is imposed as proposed in the consultation documents with no exemption for Z's forward contracts, Z would be prevented from using any IG CERs delivered in May 2012 (if the ban is imposed from 1 January 2012) and in April 2013. Accordingly, Z could stand to lose substantial value under these contracts. These costs would ultimately be passed on to consumers in the form of higher fuel prices.

If the ban is imposed as per Z's recommendations however, the effect will be minimal, with continued confidence in the integrity of the evolution and operation of the market.

b. *the NZ ETS*

⁴ Final report of the Emissions Trading Scheme Review 2011 (30 June 2011), page 77.

In addition, if the ban is imposed from 1 January 2012 or 1 January 2013 and no exemption is made for forward contracts, the ban will undermine participants' confidence in the New Zealand ETS, carbon markets and carbon trading. It will also work contrary to the goals of supporting the development of a global market which drives behavioural change. The New Zealand ETS is a regulatory instrument with significant financial implications for participants. Commercial decisions are made on the legitimate expectation that the rules will be stable. Changing the rules in a way that cuts across existing contracts will undermine confidence in the New Zealand ETS and participants' ability to participate in it at least cost.

Question 4: *Are you currently holding CERs generated from HFC-23 and N₂O industrial gas destruction projects? If so are these units held in the NZEUR or an overseas registry?*

No.

Question 5: *Have you entered into a contract to purchase CERs generated from HFC-23 and N₂O industrial gas destruction projects in the future? If so, what is the term of the contract?*

Yes. In addition to purchasing NZUs, Z has entered into forward contracts for the future delivery of CERs. Under the terms of these contracts, CERs are due for delivery to Z in May 2012 and April 2013. The May 2012 delivery will be surrendered in May 2012 in respect of Z's 2011 emissions liability. The April 2013 delivery will be surrendered in April or May 2013 in respect of Z's 2012 emissions liability. Due to the volume of IG CERs that have been issued by the CDM Executive Board and the introduction of the EU ETS ban on IG CERs from May 2013, it is inevitable that most if not all of the CERs delivered under these contracts will be IG CERs.

Question 6: *What are your views on how an exemption for holders of forward contracts for CERs could be implemented?*

If the Government decides to ban IG CERs in line with the timing of the EU ETS ban an exemption for Z's forward contracts would not be necessary.

If the ban is imposed at an earlier date, an exemption for Z's forward contracts would be essential. Z, and other participants, have entered into forward contracts in good faith, according to the NZ ETS rules in force at the time the contracts were entered into. A decision not to provide exemptions for these contracts would severely undermine participants' confidence in the NZ ETS and could cause financial loss to participants without gaining any environmental benefit.

If it becomes necessary to include an exemption for futures contracts in regulations banning the use of IG CERs, as noted above, Z requests that the Government consults on the draft text of the regulation to ensure that participants' contracts will be caught by the exemption. Given the importance of this issue for participants, and the potential financial implications, it is imperative the regulations are carefully crafted to ensure they operate as intended.

Z submits that the Government consider the following drafting as the means of exempting futures contracts:

(1) [Ban]

(2) Subparagraph (1) does not apply to the surrender of a unit by a participant to meet the participant's obligations under section 63 in respect of any emissions from any activities listed in Schedule 3 or 4 carried out by the participant before 1 January 2013, provided that the unit was acquired by the participant under an agreement entered into before the time that this regulation came into force but was not held in an account in the Registry at the time that this regulation came into force.

Question 7: *What support would the government need to provide to ensure participants were able to identify banned CERs and avoid purchasing or surrendering them?*

Z considers that the New Zealand EUR should include an ability to search CERs by project type (e.g. hydro, industrial gas). This added search functionality would enable participants to easily self audit their holdings and the types of units being offered for sale by others.

Question 8: *If banned CERs were surrendered after the regulation entered into force, should there be the potential for penalties?*

Z considers that in the majority of cases banned CERs would not be surrendered and that it would be rare for a participant to knowingly surrender banned units. Accordingly participants should be given the opportunity to self-correct their error. It would only be after the participant has failed to self-correct its error that penalties should be considered as an option.

Question 9: *If banned CERs were surrendered, how long should the participant have to surrender eligible units to replace them?*



If banned CERs were surrendered, Z considers that 90 business days would be reasonable for a participant to surrender eligible units.

Question 10: *If the government goes ahead, do you think any ban should be implemented:*

- a.** *from 1 January 2012*
- b.** *from 1 January 2013, in line with the EU ETS ban, or*
- c.** *some other date (please specify)?*

For the reasons set out above, Z submits that the ban should not be imposed on either of the dates in a. or b. above. Instead, Z submits that the timing of the ban should be aligned with the timing of the EU ban. Z also notes in relation to b. above that the EU ETS ban effectively starts on 1 May 2013, not 1 January 2013 as the question appears to assume.

Question 11: *Do you consider that there any alternative options to the proposed ban?*

No.

Conclusion

Z supports the New Zealand ETS and the development of a robust carbon market which influence behaviour and begin to reduce carbon emissions. Z has filed this submission in the hope that it will contribute to the on-going development of the New Zealand ETS in such a way that protects both the environmental integrity of the scheme and participants' confidence in it, as well as its connectedness with international markets.

Z would be pleased to answer any questions on any element of this submission and proposes to publish the document on the company's website in the hope of continuing to stimulate discussion and debate about the evolution of the New Zealand ETS.