



## The New Zealand Emissions Trading Scheme

# Consultation on proposed regulations restricting the use of certain international units in the NZ ETS

## Purpose

The Government is considering restricting the following international emission units from surrender in the New Zealand Emissions Trading Scheme (NZ ETS) due to concerns over their environmental integrity:

- Emission Reduction Units (ERUs) generated from HFC-23 and N<sub>2</sub>O industrial gas destruction projects
- Certified Emission Reduction units (CERs) and ERUs generated from large-scale hydropower projects (greater than 20 MW capacity) that do not meet the guidelines in the World Commission on Dams' final report: *Dams and Development: A Framework for Decision Making*.

This document seeks your feedback on the proposed restriction of units, when this restriction should come into effect and the application of the restriction to forward contracts.

## Making a submission

Submissions are welcomed from parties who may be affected by the proposed change and from other interested people. The consultation questions at the end of this document are for guidance only. Submissions on all aspects of the proposals are welcome.

Please send your submissions to [climatechange@mfe.govt.nz](mailto:climatechange@mfe.govt.nz) or Ministry for the Environment, PO Box 10362, Wellington 6143.

The deadline for submissions is **5.00pm on Friday 30 November 2012.**

## Definitions

**Emission Reduction Unit (ERU):** ERUs are generated for emission reductions or emission removals from joint implementation projects, eg, Projects to Reduce Emissions (PRE) such as landfill methane capture.

**Certified Emission Reductions (CER):** CERs are issued for emission reductions from Clean Development Mechanism (CDM) project activities. For example, renewable energy, wind farms, hydropower and landfill gas.

**Joint Implementation (JI) projects:** A mechanism under the Kyoto Protocol through which a developed country can receive 'emissions reduction units' when it helps to finance projects that reduce net greenhouse gas emissions in another developed country. An Annex I Party must meet specific eligibility requirements to participate in joint implementation.

**Clean Development Mechanism (CDM):** A mechanism under the Kyoto Protocol through which developed countries may finance greenhouse gas emission reduction or removal projects in developing countries, and receive credits for doing so which they may apply towards meeting mandatory limits on their own emissions.

## Background

Participants in the NZ ETS currently may import international units generated by the Kyoto Protocol flexible mechanisms, subject to some restrictions,<sup>1</sup> to meet their surrender obligations under the NZ ETS.

<sup>1</sup> For example, the NZ ETS does not accept CERs from nuclear or forestry CDM project activities.

Two of the unit types permitted for use in the NZ ETS are ERUs and CERs (see unit definitions above).

In December 2011, the Government introduced a restriction on the use of CERs generated from HFC-23 and N<sub>2</sub>O industrial gas destruction activities in the NZ ETS. This was in response to growing concerns that the destruction of these gases provides limited environmental benefits and may be associated with adverse environmental outcomes.

## What's the issue?

Significant issues have been raised internationally about the environmental integrity of two types of projects:

- destruction of industrial gases
- large-scale hydropower projects (greater than 20 MW capacity) that do not meet the guidelines in the World Commission on Dams' final report: *Dams and Development: A Framework for Decision Making* (see box below).

### ERUs derived from industrial gas destruction projects

CERs generated from industrial projects that destroy HFC-23 and N<sub>2</sub>O industrial gases are banned from the NZ ETS due to a lack of environmental integrity. Banning ERUs derived from the same activities ensures a consistent approach is taken.

There is a further concern that the profitability of HFC-23 destruction projects may create a perverse incentive to increase production of HCFC-22, a precursor of HFC-23. HCFC-22 is an ozone-depleting gas which also has a high Global Warming Potential, and is being phased out under the Montreal Protocol.

Under the Kyoto Protocol, ERUs may be issued only for projects which lead to emission reductions that are additional to what would have happened anyway. Given the perverse incentives described above, there is concern that this criterion may not be met.

These concerns have led other jurisdictions (eg, EU and Australia) to ban these units from use in their domestic emissions trading schemes.

### ERUs and CERs generated from large-scale hydropower projects

Concerns have also been raised about some large hydropower projects (with a capacity exceeding 20 MW) supported under the wider CDM and JI. Issues frequently raised with respect to the sustainability of these projects include:

- loss of biodiversity

- the displacement of local communities
- contribution to land-use change.

These projects are also arguably more likely to have occurred regardless of carbon financing.

The EU has policies that ban the use of emission units from large hydropower projects (with a capacity exceeding 20 MW) which do not comply with guidelines contained in the World Commission on Dam's 2000 report. This is to ensure hydropower projects are developed along the options least damaging to the environment.

## World Commission on Dams (WCD)

The [World Commission on Dams](#) points out five core values that must be met when planning, carrying out and running dam projects. These are:

- equity
- sustainability
- efficiency
- participatory decision-making
- accountability.

The WCD sets out guidelines to ensure compliance with these criteria. Factsheets will be prepared if the restriction goes ahead to provide more information on how the restriction would be implemented.

## Objectives

To assess how to approach this issue, the Government has focused on the following objectives:

- ensuring environmental integrity is maintained in the NZ ETS
- ensuring the NZ ETS continues to deliver emission reductions at least cost
- upholding the international reputation of the NZ ETS
- improving prospects for future international links.

## Proposals: Unit restrictions

Options available to the Government regarding ERUs from HFC-23 and N<sub>2</sub>O industrial gas destruction projects include:

- banning the surrender of ERUs from HFC-23 and N<sub>2</sub>O industrial gas destruction projects

- maintaining status quo: Continue to allow ERUs from HFC-23 and N<sub>2</sub>O industrial gas destruction projects.

Options available to the Government regarding CERs and ERUs from hydropower projects include:

- banning the surrender of all hydropower project CERs and ERUs
- banning the surrender of ERUs and CERs from hydropower projects that exceed 20 MW of installed capacity
- banning the surrender of ERUs and CERs from hydropower projects that exceed 20 MW of installed capacity and do not meet the guidelines in the final report of the World Commission on Dams
- maintaining the status quo ie, continue to allow hydropower CERs and ERUs to be surrendered.

On balance, the Government is proposing to ban the surrender of units from:

- ERUs generated from HFC-23 and N<sub>2</sub>O industrial gas destruction projects
- CERs and ERUs generated from large-scale hydropower projects (greater than 20 MW capacity) that do not meet the guidelines in the World Commission on Dams' final report: *Dams and Development: A Framework for Decision Making*.

These proposals are considered to be consistent with the objectives set out above and reflect the approach taken in other countries.

## Timing

Allowing adequate time for ETS participants to prepare for the changes needs to be balanced against a desire to ensure environmental integrity in the scheme as soon as possible. Two possible options are being consulted on for when units would be banned from surrender in the NZ ETS:

### Option 1: 1 January 2013

Option 1 would mean that relevant units entering the New Zealand Emission Unit Register (NZEUR) after 1 January 2013 could not be used to meet surrender obligations.

This option provides greater protection from New Zealand becoming a dumping ground for ERUs from HFC-23 and N<sub>2</sub>O industrial gas destruction projects and large-scale hydropower ERUs and CERs that do not meet the guidelines in the final report of the World Commission on Dams. It provides greater

mitigation against the risk that participants may stockpile cheap units in the NZEUR.

### Option 2: 1 June 2013

Option 2 would mean relevant units entering the NZEUR after 1 June 2013 could not be used to meet surrender obligations.

This option will provide participants with an additional surrender period to dispose of these types of CERs and ERUs, ie, participants would be able to surrender the units in question to meet their 2012 obligations. It would also mean more banned units could be stockpiled to meet the 2013 surrender obligations.

## Forward contracts

The Government is also consulting on whether the proposed restrictions should be imposed on forward contracts, and if so, under what terms.

Under the previous restriction, an industrial gas CER purchased by an account holder under a forward contract was exempt from the restriction if the forward contract was entered into before the restriction came into effect and units were delivered into a surrender account before a specified date.

Under the CER ban that was introduced in December 2011, banned CERs brought into the NZEUR under forward contracts could be surrendered up to 1 June 2013. This meant units for an additional two surrender periods (calendar 2011 and calendar 2012) could be surrendered after the ban came into effect.

Holders of forward contracts were required to apply for an exemption by registering their contract with a signed declaration to the Registrar of the NZEUR by a certain date.

It should be noted that at the time of the previous CER ban, the price of carbon was significantly higher and therefore the impact of not allowing forward contracts was considerably higher. There are two options:

### Option 1: Allow forward contracts

Under this option, as with previous restrictions, units purchased under forward contracts would be assessed on a case-by-case basis and would likely be exempt from the ban. This will ensure New Zealand companies with legitimate investments are not disadvantaged by the ban.

The Government wishes to understand the extent of existing forward contracts to purchase the proposed affected ERUs and CERs, including when delivery of units is expected. This will help to inform when units

would need to be delivered into a surrender account in order for the exemption to apply.

### Option 2: Forward contracts not allowed

This option would mean that no units entering the NZEUR after the ban date could be used to meet surrender obligations, regardless of forward contracts.

## Implementation

Consistent with the restriction on CERs from industrial gas destruction projects, participants would be responsible for identifying the restricted units and ensuring these units were not surrendered after the regulations had come into force. If banned CERs or ERUs were found to have been incorrectly surrendered (eg, by the NZEUR's verification process), the participant would be required to replace the units with eligible units and could face penalties.

ERUs and CERs already in the NZEUR at the time the regulations entered into force would remain eligible for surrender. As such, evidence showing when the ERU or CER was imported into the NZEUR is likely to be required when units are surrendered.

## Impacts of the proposals

The proposed changes may affect the following:

- all NZ ETS participants with obligations to surrender emissions units
- all removal (post-1989 forestry and other removal activities) participants who have opted to join the NZ ETS or who are considering opting into the NZ ETS
- New Zealand carbon traders and those intending to sell units into the NZ ETS, including allocation recipients.

ERUs are among the cheapest units available to domestic emitters to meet their compliance obligations (a NZU is currently 2.5 times the value of an ERU). Of the 233 million ERUs issued to date, approximately 34 per cent are derived from industrial gas destruction projects. We would expect that banning these units should not therefore restrict participants' ability to access ERUs.

Large-scale hydropower CERs represent just over 27 per cent of all CERs issued to date. Large-scale hydropower ERUs represent 1.2 per cent of all ERUs. We would expect that banning these units should not therefore restrict the ability of participants' ability to access CERs and ERUs.

The majority of contracts for the delivery of units are tailored to meet the eligibility criteria in the EU ETS. It is likely NZ ETS participants purchasing units through these contracts would, by default, comply with the similar eligibility criteria proposed in the NZ ETS.

We anticipate that the proposed restrictions on the units outlined above are likely to have minimal to no impact on the carbon price because they will not restrict participants' ability to access least-cost compliance options.

## Consultation questions

1. Do you agree with the Government's proposals to ban the surrender of the proposed CERs and ERUs in the NZ ETS? If not, what other options should the Government consider and why?
2. If the Government goes ahead, when should the ban be implemented?
  - a) from 1 January 2013
  - b) from 1 June 2013, or
  - c) some other date (please specify and state reasons why).
3. What effect do you think the ban would have on:
  - a) you or your organisation, including compliance costs associated with identifying these units?
  - b) the NZ ETS?
4. Are you currently holding ERUs generated from HFC-23 and N<sub>2</sub>O industrial gas destruction projects or ERUs/CERs from large-scale hydropower projects that do not meet the guidelines in the final report of the World Commission on Dams? If so, are these units held in the NZEUR or an overseas registry?
5. Do you think units purchased under forward contracts should be assessed on a case-by-case basis to determine their exemption from the ban, as with previous restrictions? If not why not?
6. Have you entered into a contract to purchase ERUs generated from HFC-23 and N<sub>2</sub>O industrial gas destruction projects or ERUs/CERs from large-scale hydropower projects that do not meet the guidelines in the final report of the World Commission on Dams? If so, what is the term of the contract?

*While all information provided to the Government is subject to the Official Information Act 1982 (OIA), in the event of a request any commercially sensitive information will be considered for withholding under s 9(2)(b) of the OIA. Please indicate if any information you provide is sensitive.*

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