



The New Zealand Emissions Trading Scheme

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

What's happening?

Participants in the New Zealand Emissions Trading Scheme (NZ ETS) can use some international Kyoto units to meet their obligations. The Government is proposing to restrict the Kyoto units permitted for surrender in the scheme, consistent with restrictions in other major schemes internationally, as there is a concern that continuing to allow certain Kyoto units will pose reputational risks to the NZ ETS and impact on the New Zealand carbon market.

The Government is consulting on a proposal to ban the surrender of Certified Emission Reduction units (CERs) generated from HFC-23 and N₂O industrial gas destruction projects, by participants in the NZ ETS.

We are also seeking views on two options for the timing of the proposed ban:

- applied to surrendered units that enter the New Zealand Emission Unit Register (NZEUR) from 1 January 2012
- applied to surrendered units that enter the NZEUR from 1 January 2013.

This consultation document will assist affected participants and other interested parties who wish to make a submission on this proposal. Specific questions to guide your submission are included at the end of the document.

Purpose of the change

The proposed change is intended to:

- support the environmental integrity of the NZ ETS amidst growing concern that units generated from HFC-23 and N₂O industrial gas destruction projects provide limited environmental benefits and may be

associated with adverse environmental outcomes

- mitigate the risk of a global oversupply of these units impacting on the price in the NZ ETS
- improve prospects for future links between the NZ ETS and other emissions trading schemes that prohibit these units.

Who may be affected?

The proposed change 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.
- Allocation recipients.
- New Zealand carbon traders and others intending to sell units into the NZ ETS.

HFC-23 (Trifluoromethane) and N₂O (Nitrous Oxide) are powerful greenhouse gases with high global warming potentials. HFC-23 is a by-product produced during the manufacture of the refrigerant HCFC-22. Projects in developing countries that destroy these gases are able to earn CERs under the Kyoto Protocol's Clean Development Mechanism.

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.

Submissions can be sent to climatechange@mfe.govt.nz, with 'HFC/CERs submission' in the subject line or Ministry for the Environment, PO Box 10362, Wellington 6143.

The deadline for submissions is **5pm on Monday 31 October 2011**.

Description of the issue

Participants in the NZ ETS currently have the ability to import international units generated by the Kyoto Protocol flexible mechanisms, subject to some restrictions, for surrender as part of their domestic compliance.

One of the unit types permitted for use in the NZ ETS are CERs produced by Clean Development Mechanism (CDM) projects. Under the CDM certified emissions reductions resulting from project activities in developing countries (non-Annex I countries) may be used to assist developing countries in achieving sustainable development and assist developed countries (Annex 1 countries) in achieving their emission reduction commitments under the Kyoto Protocol.

The decision to allow international Kyoto units into the NZ ETS was made to:

- reflect consistency with New Zealand's obligations under the international Kyoto framework
- provide NZ ETS participants with access to the lower cost form of abatement
- provide liquidity and reduce price volatility in the small New Zealand carbon market.

There are some restrictions on the types of international units that can be surrendered for domestic compliance. For example, the NZ ETS does not accept CERs from nuclear or forestry CDM project activities. Participants are also restricted from surrendering imported Assigned Amounts Units (AAUs) until such time as this is permitted under regulation.

Currently, the most common types of CERs in the global market are those generated from industrial gas destruction projects, in particular those which destroy HFC-23 and N₂O gasses. It has been

estimated that such projects account for around 67 per cent of all CERs issued to date.

Other examples of CDM projects for which CERs are generated include (but are not limited to):

- renewable energy: wind farms, hydroelectric power and landfill gas
- electricity and fuel efficiency for households and industries
- reducing emissions in industrial and manufacturing processes e.g. cement production
- reducing fugitive emissions from production and consumption of fossil fuels, halocarbons and sulphur hexafluoride.

Concerns about environmental integrity

Concern has been raised about the environmental integrity of CERs from HFC-23 and N₂O industrial gas destruction projects. Some sources have suggested the economics of these projects may create incentives to increase production of these gases in non-Annex I Countries.

Under the Kyoto Protocol, CERs may be issued only for projects which lead to emission reductions that are additional to what would have happened anyway. There is concern that HFC-23 and N₂O industrial gas destruction projects may not meet this criterion.

There is a further concern that profitability from HFC-23 destruction projects creates 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.

Changes to CDM methodologies from 2012

Approval of CDM projects is governed by the CDM Executive Board. The Board is taking steps to revise the methodology which governs the generation of CERs from HFC-23 destruction projects. A new methodology could be applied post-2012 to projects as they reach the end of their current crediting period – so it would apply to future units issued in relation to existing projects as well as new ones.

A change in the methodology may significantly reduce the number of CERs from industrial gas projects in the medium term. However the impact of a new methodology is uncertain and a large number of CERs generated from projects before any new methodology entered into force would remain in circulation.

Overseas action

The concerns mentioned have led the European Union to ban the surrender of CERs and Emissions Reduction Units from HFC-23 and N₂O industrial gas destruction projects in Phase 3 (2013-2020) of the European Union Emissions Trading Scheme (EU ETS). The recently announced Australian Carbon Pricing Mechanism will also prohibit the surrender of these units for domestic compliance when the scheme enters its flexible price period in 2015.

Affects on the New Zealand carbon market

Once the EU ETS ban on CERs from HFC-23 and N₂O industrial gas destruction projects comes into force, there will be a global oversupply of these units and their price will diverge from the price of other CERs. As participants in the NZ ETS are allowed to surrender an unlimited amount of CERs, there is a concern that if New Zealand does not adopt a similar restriction the price in the New Zealand market could be affected as it would become the only domestic trading scheme accepting these units after 2012.

The EU ETS allows HFC-23 and N₂O industrial gas CERs to be surrendered with respect to obligations incurred for the period to 31 December 2012. This means they can still be surrendered during the 2012 compliance period ending in April 2013. As a result there is a possibility that a price divergence between HFC-23 and N₂O industrial gas CERs and other CERs could occur before this date. This has led to a concern that participants in the NZ ETS could stockpile these units while they are inexpensive.

These concerns were raised by submitters during the consultation to the NZ ETS Review earlier this year. The submissions led the NZ ETS Review Panel to recommend in their final report that *“the Government should urgently consider whether HFC CERs pose a significant risk and whether a time limit should be imposed on their eligibility”*.

In addition, the NZ ETS Review Panel noted that *“if the Government decides these units should be ineligible then the Panel believes that a reasonable notice period should be given so that businesses which have already bought these units in good faith have an opportunity to surrender them. In deciding what a reasonable notice period is, consideration should be given to whether other options are available to businesses to dispose of these units”*.

Possible options

There are a range of options available to the Government, including:

- banning the surrender of CERs from HFC-23 and N₂O industrial gas destruction projects
- continue to allow CERs from HFC-23 and N₂O industrial gas destruction projects
- other options that would involve qualitative or quantitative controls on CERs
- banning all international units.

Proposal

On balance, and reflecting the approach taken in other countries, the Minister for Climate Change Issues has decided to focus on banning the surrender of CERs from HFC-23 and N₂O industrial gas destruction projects through regulation under section 30G(1)(c) of the Climate Change Response Act 2002.

The timing of the ban would involve balancing the risk of price instability due to a potential over supply of these units, and providing participants with enough time to prepare for the changes.

Consistent with the Act, the ban on the use of units for surrender would not apply to units already held in the NZEUR at the time the regulation came into force. However it would prevent participants from surrendering units held in overseas registries, or units purchased at a later date under existing forward contracts.

The Government wishes to understand the extent of overseas holdings and forward contracts to purchase CERs that are currently in place. We are seeking participants' views on the following:

- as to whether some provision, such as an exemption, for holders of forward purchasing contracts at the time the regulation comes into force may be necessary
- if an exemption is necessary, how it might be implemented, given the difficulties associated with monitoring compliance for this type of exemption.

Two possible options are being consulted on for the timing of the proposed ban:

- Option 1 – surrendered units entering the NZEUR from 1 January 2012 are banned from use to meet surrender obligations.
- Option 2 – surrendered units entering the NZEUR from 1 January 2013 are banned from use to meet surrender obligations, more in line with the ban of these units from entering the EU ETS.

Option 1 – January 2012

Option 1 provides greater protection from a potential oversupply of CERs from HFC-23 and N₂O industrial gas destruction projects and other CERs from affecting the price in the New Zealand market between January 2012 and January 2013. It provides greater mitigation against the risk that a price divergence in CERs may occur prior to 2013 and that participants may stockpile cheap units in the NZEUR.

Option 2 – January 2013

The option of banning units from 1 January 2013 is in line with the timing of the EU ETS ban. It will provide participants with an additional surrender period to dispose of these types of CERs. However there is a greater risk that a potential price divergence in CERs prior to 2013 could affect the price in the New Zealand market.

Implementation

All CERs generated hold information as to the CDM project they were generated from, and investigations can be made into the nature of the project (i.e. whether it was a HFC-23 and N₂O industrial gas destruction project).

There are two broad options for how a ban could be administered, depending on whether primary responsibility for ensuring banned CERs are not surrendered rests with participants or with the government.

If primary responsibility rests with participants, (in line with the self-assessment principles inherent in the NZ ETS), participants would need to identify the CERs generated from HFC-23 and N₂O industrial gas destruction projects that they hold. Participants would be responsible for identifying these units and ensuring these units are not surrendered after the regulations have come into force. If banned CERs were later found to have been surrendered (e.g. via audits), the participant would need to replace the units with eligible units and could face penalties.

If it was the government's responsibility to ensure that banned CERs are not surrendered (as is currently the case in relation to imported AAUs), the government would need to either block these units from being surrendered or assess CER units after surrender and reject any banned ones. It would still be the participant's responsibility to check the status of any CERs they bring into the NZEUR – the government would not review the eligibility of units until they were surrendered.

CERs already in the NZEUR at the time the regulations entered into force would remain eligible for surrender. As such, evidence showing when the

CER was imported into the NZEUR is likely to be required when units are surrendered.

Consultation questions

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?
2. Should there be a ban on using these CERs for compliance in the New Zealand Emissions Trading Scheme (NZ ETS)?
3. What effect do you think the ban would have on:
 - a. you or your organisation
 - b. the NZ ETS
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?
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?
6. What are your views on how an exemption for holders of forward contracts for CERs could be implemented?
7. What support would the government need to provide to ensure participants were able to identify banned CER and avoid purchasing or surrendering them?
8. If banned CERs were surrendered after the regulation entered into force, should there be the potential for penalties?
9. If banned CERs were surrendered, how long should the participant have to surrender eligible units to replace them?
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).
11. Do you consider that there any alternative options to the proposed ban?