



### Minimum time required for a sector to enter the emissions trading scheme

<b>Date:</b>	26 May 2009	<b>MfE Priority:</b>	Urgent
<b>Security Level:</b>		<b>Number of Attachments:</b>	Nil
		<b>MfE Ref No:</b>	09-B-01426

### Action Sought

	Action Sought	Deadline
Minister for Climate Change Issues Hon Dr Nick Smith	<b>Note</b> the contents of this paper.	None.

### Ministry for the Environment Contacts

Name	Position	Telephone		1st Contact
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## Executive Summary

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This paper details the minimum time needed for a sector to enter the emissions trading scheme under the Climate Change Response Act (CCRA), with reference to progress on implementation and the minimum six months notice of sectoral entry provided by the Emissions Trading Sector Entry Bill.

### Requirements for entry into the New Zealand Emissions Trading Scheme

Three conditions are important for a sector to successfully enter the emissions trading scheme: (i) establishment of an emissions return process, (ii) clear rules affecting emissions price and preparation of a strategies to purchase emission units, and (iii) reasonable certainty over free allocations of emission units.

A lead-in time of 12 months before entry is desirable to (i) progress the emissions return process and (ii) and prepare regulations affecting price and purchasing strategies.

In a perfect world, free allocation would be delivered to eligible parties before they experience emission costs, however; this is not strictly necessary. Firms do, however, need reasonable certainty over the quantity and timing of their free allocations before their sector enters the scheme. This takes 10-12 months from the beginning of the allocation process.

### Ability of sectors to enter the scheme as per dates in existing legislation

The major sectors that have not yet entered the scheme are the agriculture, stationary energy and industrial processes (SEIP) and liquid fossil fuel sectors.

The agriculture sector can successfully enter the scheme, given the timeframes in existing legislation, assuming a decision to adopt a processor level of obligation is taken. The liquid fossil fuel sector can successfully enter the scheme given the timeframes in existing legislation as firms are already able to measure their emissions and will be able to submit emissions returns.

The SEIP sectors will be able to measure their emissions and submit emissions returns, as required by legislation. However, it is likely that firms will not receive reasonable certainty over their likely free allocation until well after the sector's entry date (but before the surrender date).

Work cannot begin in earnest on allocation for the SEIP sector until relevant policy decisions have been taken.

### Amount of notice required before sectors enter the scheme

Some notice is essential before bringing sectors into the scheme. The Emissions Trading Sector Entry Bill provides for a minimum of six months.

Six months should be all the notice that is required for the major sectors that are still to enter, by the dates in existing legislation, as progress on the emissions return process, price-relevant rules and allocation plans can occur independently of this notification period, provided relevant policy decisions are made.

The exception to this is the SEIP sector, which may need a longer period of notice for reasonable certainty over allocation to exist before the sector's entry date. However, officials believe that a six month notice period will be sufficient provided:

- work on an allocation plan begins by July/August 2009
- the sector's entry date is no sooner than 1 July 2010
- the approach to allocation is not complex (i.e. no development of benchmarks or firm-by-firm analysis is required).

Recommended Action

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**We recommend that you:**

(a) **Note** the contents of this briefing note **Yes / No**

Stuart Calman  
Acting General Manager  
**Emissions Trading Group** **Date**

Referred to Ministry Communications Staff: Yes/No

Hon Dr Nick Smith  
**Minister for Climate Change Issues** **Date**

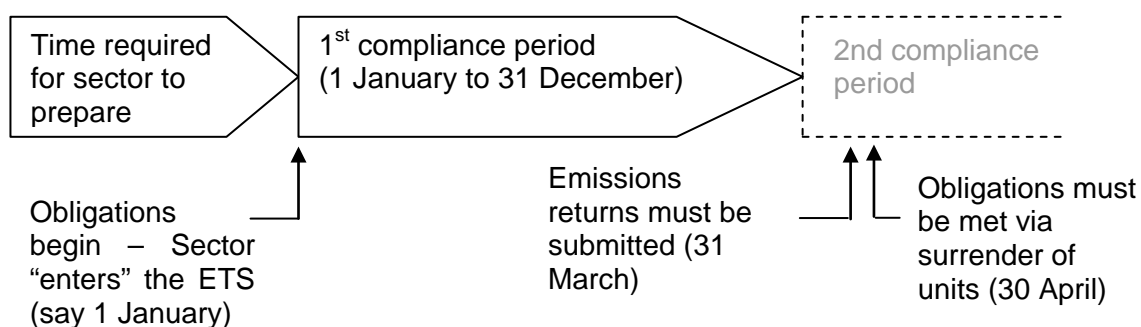
## Purpose of Report

1. This paper details the minimum time needed for a sector to enter the emissions trading scheme under the Climate Change Response Act (CCRA), with reference to progress on implementation and the minimum six months notice of sectoral entry provided by the Emissions Trading Sector Entry Bill.

## Requirements for entry into the ETS

2. The requirements for a sector to successfully enter the emissions trading scheme are:
  - Emission returns: firms in that sector who are points of obligation are able to register and monitor, and report data relating to activities that make them points of obligation
  - Purchasing: firms in that sector who are points of obligation<sup>1</sup> can purchase emission units to the extent required
  - Allocation: firms in that sector have reasonable certainty over the quantity and timing of any free allocation.
3. Sectors enter the scheme as shown in Figure 1. The time required for a sector to prepare for entry into the scheme depends on how long it takes for the above conditions to be met.

**Figure 1: Defining entry of a sector into the emissions trading scheme**



4. This paper focuses on the major sectors that have not yet entered the scheme; stationary energy and industrial processes (SEIP), liquid fossil fuels and agriculture.
5. The entry dates that exist in current legislation for these sectors are as follows<sup>2</sup>:

**Table 1 Entry dates in existing legislation**

SEIP	Liquid fossil fuels	Agriculture
1 January 2010	1 January 2011	1 January 2013

6. In addition to these entry dates, voluntary and mandatory reporting is provided for in the legislation as follows:

**Table 2 Reporting dates in existing legislation**

	Liquid fossil fuels	Stationary Energy	Agriculture
Voluntary reporting	1 January 2009	none	1 January 2011
Mandatory reporting	1 January 2010	1 January 2010	1 January 2012

<sup>1</sup> Obligations are liabilities to surrender emission units

<sup>2</sup> Noting the intention of the government to introduce the Emissions Trading Sector Entry Bill

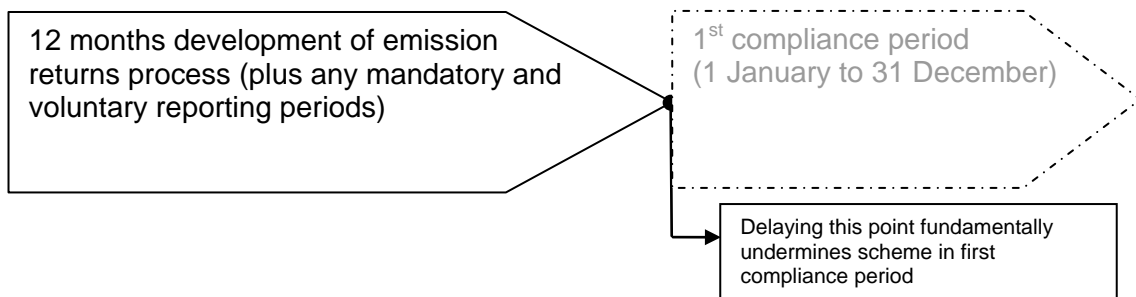
## Emission returns

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### Desirable minimum timeframe

7. In order for firms to submit emissions returns the following must occur<sup>3</sup>:
  - Regulations must be developed that establish the methodologies for calculating emissions/obligations (6-9 months)
  - Guidance material, forms, registry infrastructure and government business systems developed (6-9 months)
  - Points of obligation develop monitoring/reporting systems (3 months).
8. There can be some overlap between these activities and, while not ideal, some aspects can be completed during the first compliance period. As shown in Figure 2, a minimum 12 months is needed to progress the emissions return process before a sector begins to incur obligations; otherwise participants will not know which data to collect in order to prepare an emissions return or have the systems to collect it.
9. The same process must also be complete before firms can participate in either mandatory or voluntary reporting.<sup>4</sup> If a year's mandatory reporting is required before obligations begin, another year must be added to this timeframe.

**Figure 2: Desired timeframes for preparing emissions return process before sectors enter**



10. Measurement of emissions is the most basic step in establishing the scheme and it is critical that the emissions return process is sufficiently progressed before the sector's entry date.

### Ability to meet existing entry dates

11. Work is underway on preparing the emissions return process for the SEIP and liquid fossil fuel sectors. Officials are confident that the process will be sufficiently complete by the entry date in existing legislation.
12. Officials are confident that the emissions return process can be completed in time for the agricultural sector to begin reporting by the voluntary reporting date in legislation assuming a processor level point of obligation is adopted.
13. While all three sectors will be able to prepare and submit emission returns in line with dates in existing legislation, this may not be the case if the option of a farm level point of obligation is decided upon for agriculture.

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<sup>3</sup> Very approximate timeframes are noted

<sup>4</sup> Reporting is equivalent to submitting an emissions return but whilst voluntary and mandatory reporting apply under the transitional provisions of the CCRA there is no requirement to surrender emission units.

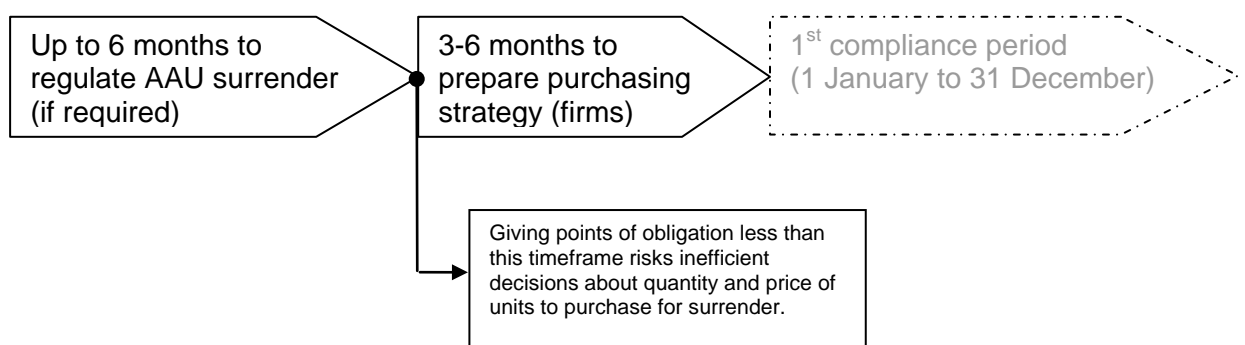
## Purchasing units to meet obligations

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### Desirable minimum timeframe

14. Participants that have obligations that exceed the number of units they hold will need to purchase extra emission units in order to comply with the scheme.
15. These firms will need to develop a strategy for purchasing emission units that takes into account a number of factors including their anticipated production, expected prices for their products and expected prices for emission units. While every firm will be different, as a guide, officials expect that it will take firms 3-6 months to prepare and implement such a strategy.
16. Although firms do not need to surrender emission units until 30 April the following year for which they submit a return, the firms should complete this strategy before they begin to incur obligations. This will allow points of obligation to make optimal decisions about prices to pay for emission units (and hence prices to pass through to their customers) and/or output levels.
17. Before firms can begin to prepare a purchasing strategy, it is desirable for scheme rules that impact on emission price to be clear. Under current legislation, the key rule that has not been finalised is the issuing of any regulations covering the surrender of foreign Assigned Amount Units (AAU) issued by foreign countries under section 18CB of the CCRA<sup>5</sup>.
18. These regulations could take up to 6 months to prepare from the time a decision was taken to begin development. However, the government could give firms clarity significantly faster than this by issuing a statement about its intentions with regards to which (if any) foreign AAUs can be surrendered.
19. The desired timing of the preparation of purchasing strategies and completing AAU regulations is shown in Figure 3.

**Figure 3: Desired timeframes for efficient purchasing decisions to occur**



20. In an ideal scenario, there would also be certainty over free allocation before firms in the agricultural and SEIP sectors prepared their purchasing strategy:

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<sup>5</sup> A price cap is another example of a rule that would impact on price. The current legislation does not explicitly contain provisions to create a price cap.

- Agricultural entities that receive free allocation will probably be those who have an obligation to surrender emission units<sup>6</sup>. Ideally, their purchasing strategies could take their anticipated allocation into account.
- Officials expect that there may well be a significant amount of intra-sector trading in the SEIP sector, as downstream energy intensive firms will receive free allocation but purchasers will often be upstream energy suppliers.

21. This is not overwhelmingly important, however, because of the ability of buyers to access the international emissions market and to bank any excess units for the next compliance period.

#### Ability to meet existing entry dates

22. Work cannot begin on developing the AAU surrender regulations until policy is developed. Assuming a policy decision on AAU surrender is eventually taken, regulations would be in place in time for agricultural sector and liquid fossil fuel sectors to prepare a purchasing strategy to meet their existing obligations in an efficient way.

23. There is probably the bare minimum time required remaining for any AAU regulations to be finalised in time for SEIP sector buyers to make optimal purchasing decisions to meet their obligations by dates in existing legislation, if work on regulations began now. Government could choose to give firms certainty earlier by issuing a statement about its intentions regarding AAU surrender.

## Allocation and trading

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#### Desirable minimum timeframe

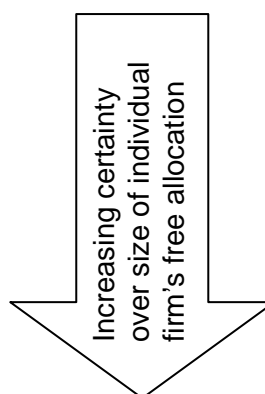
24. The current legislation provides for free allocation of emission units to certain parties in the agriculture and SEIP sectors. The purpose of this free allocation is to provide partial relief, to those parties that need it, from the impacts of emissions pricing. In the liquid fossil fuels sector, no allocation is given to any parties except for a relatively small amount given to fishing vessel operators<sup>7</sup>.

25. The current legislation stipulates a process for making free allocations that applies to the SEIP, agriculture and fisheries sectors. Key steps required by this process include:

- Preparation of a draft allocation plan
- Consultation on draft allocation plan
- Preparation of a final allocation plan
- Consideration of final allocation plan by Parliament
- Applications for free allocation
- Draft determinations
- Final determinations
- Transfer of emission units to eligible parties (Allocation is received)

Minimum  
10-12 months

Minimum 4  
months

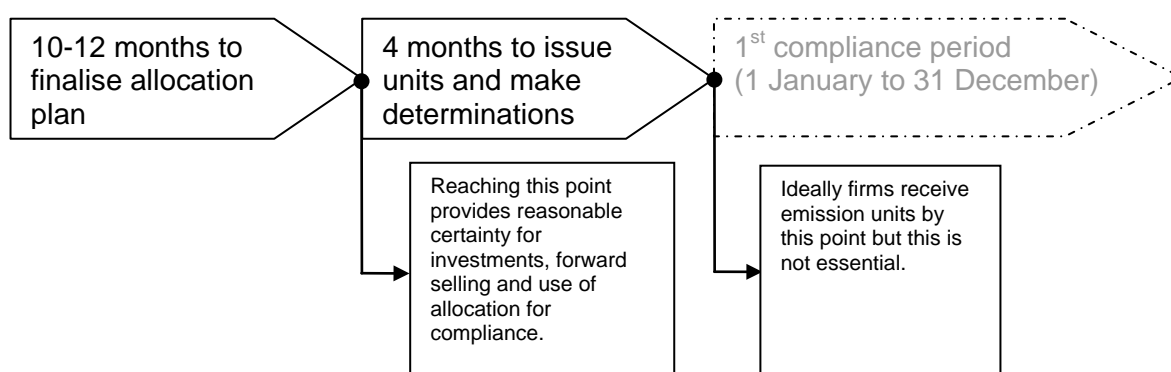


<sup>6</sup> A significant amount of data needs to be collected to determine emissions from agricultural firms. It is logical to make allocations to those same entities using that data as the basis (e.g. in the creation of benchmarks and thresholds) in order to avoid collecting another large set of data.

<sup>7</sup> The government has signalled it wishes to increase the quantity of allocation to the fisheries sector. This does not impact on the desired timing of allocation discussed in this paper.

26. This process is shown in more detail in Annex 1. Officials estimate that this process will take approximately 14-16 months to complete as a minimum, noting that that the process contains steps that may cause delays (for example the disallowance of an allocation plan by Parliament)<sup>8</sup>.
27. An ideal timeframe for the allocation process is shown in Figure 4. Firms would receive their allocation by, or before, the time their sector enters the scheme. Receipt of units before a price is placed on emissions gives firms maximum flexibility to manage cash-flow, but it is not essential. It is much more important that firms have reasonable certainty about the amount and timing of their free allocation as soon as possible. Certainty about their free allocation allows them to consider anticipated units in investment decisions and purchasing strategies and to enter into agreements to “forward sell” units.
28. It will take the allocation process 10-12 months to get a point where allocation is relatively certain, although this depends heavily on the approach to writing the allocation plan and the final shape of the allocation model:
- An allocation model based on historical emissions (i.e. grand-parenting) with some allowance for new entrants will be relatively quick
  - An allocation model based on intensity will take considerably longer to implement because of the time needed to develop benchmarks, unless an existing model is adopted from elsewhere (e.g. Australia) with few modifications

**Figure 4: Ideal timeframe for allocation process**



29. While it is difficult to identify a “minimum” timeframe for the allocation process, officials believe that firms should have reasonable certainty over their likely free allocation before the sector enters the scheme. The longer the allocation process is delayed, the more problematic uncertainty and cash-flow issues will become.

#### Ability to meet existing entry dates

30. While Technical Advisory Groups were established for the Agriculture and SEIP sectors in 2008 and have reported recommendations that will be useful in preparing allocation plans, no further progress has been made on developing allocation plans for these sectors, or for the fisheries sector.
31. Even if work were to begin immediately on preparing an allocation plan for the SEIP sector, firms would not have reasonable certainty over their likely free allocation before being exposed to the price of emissions and would not receive free allocation until well inside the first compliance period (but would receive them before the surrender date) .

<sup>8</sup> It would be possible to shorten this timeframe by amending the legislation.

32. Assuming a decision is taken to adopt a processor level point of obligation in the agriculture sector, there is time for emission units to be allocated before the sector's existing entry date.
33. In the liquid fossil fuels sector, if work began soon on a draft allocation plan for the fishing sector, units could be allocated to the sector before the existing sector entry date. Allocation to fisheries is less of a concern than to the agriculture and SEIP sectors, as the allocation to fishing vessel operators is given largely for equity reasons, is for a shorter duration and is a small amount relative to the obligations of the sector.
34. It is not sensible, however, to begin preparing these allocation plans until the policy direction over allocation is clear.

## Summary

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35. A lead-in time of 12 months before sector entry is desirable to (i) progress the emissions return process and (ii) and establish rules affecting price and purchasing strategies.
36. In a perfect world, free allocation would be delivered to eligible parties before they experience emission costs, however, this is not strictly necessary. There is no easily identifiable minimum timeframe for the allocation process to be complete but firms should have reasonable certainty over free allocation before the sector enters the scheme.
37. The agriculture sector can successfully enter the scheme, given the timeframes in existing legislation, assuming a decision to adopt a processor level of obligation is taken. The liquid fossil fuel sector can successfully enter the scheme given the timeframes in existing legislation. However, to ensure that this remains the case, important decisions will eventually be required on allocation and over the restrictions on the surrender of AAUs.
38. The SEIP sectors will be able to measure their emissions and submit emissions returns, as required by legislation. However, it is likely that firms will not receive free reasonable certainty over their likely free allocation, until well after their sector's entry date.
39. Work cannot begin in earnest on allocation for the SEIP sector until relevant policy decisions have been taken.

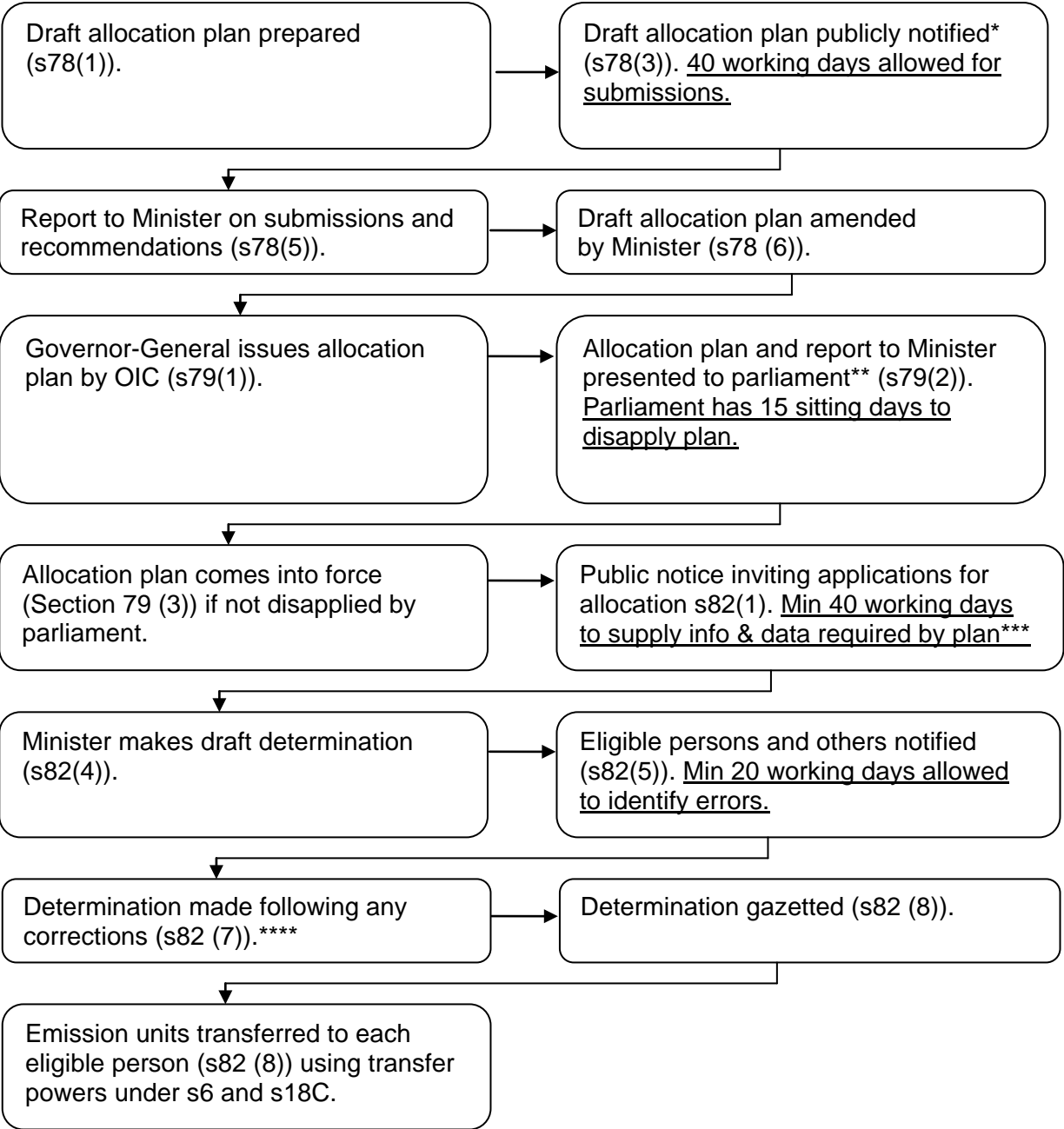
## Conclusion

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40. Some notice is essential before bringing sectors into the scheme. The Emissions Trading Sector Entry Bill provides for a minimum notice period of six months.
41. This should be all the notice that is required in order for firms to enter by the dates in existing legislation, as progress on the emissions return process, price-relevant rules and allocation plans can occur independently of this notification period, provided relevant policy decisions are made.
42. The exception to this is the SEIP sector which may need a longer period of notice in order for reasonable certainty over allocation to exist before the entry date. However, officials believe that a six month notice period will be sufficient provided:
- work on an allocation plan begins by July/August 2009
  - the sector's entry date is no sooner than 1 July 2010
  - the approach to allocation is not complex (i.e. no development of benchmarks or firm-by-firm analysis is required).

**ANNEX 1**

**Summary of Allocation plan process for the Stationary Energy and Industrial Processes Sector, Agriculture Sector and Fisheries Sector**



Consultation is public consultation

Includes targeted consultation with eligible persons and those who consider themselves eligible

\* Available on internet and at relevant Ministry's office.  
 \*\* Note that this applies to industry, agriculture and fisheries sectors but not forestry.  
 \*\*\* A person must respond to be able to receive an allocation.  
 \*\*\*\* Note that after making the initial determination the Minister may request further information (s83) and/or may remake the determination under s84.