

Carbon Management Policy

**Wellington City Council
February 2011**

Introduction

The Emissions Trading Scheme (the NZETS) is a key measure in New Zealand's response to climate change.

The NZETS will put a cost on emissions of greenhouse gases; sometimes called a 'carbon price'. This will have direct and indirect effects on the Council.

Direct effects include: liabilities for methane emissions from the Council's landfill operations; potential liabilities for deforesting pre-1990 exotic forest; and receiving credits (and associated potential liabilities) for forests planted after 1989.

Indirect effects include increased energy costs, increased costs for some services and perhaps greater incentives to develop renewable energy on Council-owned land.

This Carbon Management Policy (CMP) provides a framework to aid the Council's decision-making where the future carbon price is, or may, be a material consideration. It will also help ensure that the Council meets its legal obligations and is fiscally prudent when managing carbon-related assets and liabilities.

A key challenge is to manage the considerable uncertainty that surrounds climate change policy, including the future carbon price in New Zealand.

The CMP addresses the effects of the NZETS. It is a sub-set of the Council's wider Climate Change Action Plan (CCAP). It does not address mitigation of climate change or adaptation to climate change directly, as these issues are covered under the CCAP.

Objectives

The objectives of the Carbon Management Policy are:

1. to provide a framework to aid decision-making where the future cost of greenhouse gas emissions (sometimes referred to as the carbon price) is, or may, be a material consideration;
2. to ensure the Council meets its legal obligations and is fiscally prudent when managing carbon-related assets and liabilities; and
3. to identify opportunities to minimise liabilities and/or maximise assets created under the NZETS, where this is economically efficient and fiscally prudent.

Scope and Application

The CMP addresses assets, liabilities, costs and opportunities arising from the NZETS. It applies across all Council activities.

The Council will engage with its Council Controlled Organisations on the CMP, particularly through the Statement of Intent process.

Overarching Principles

These principles will help guide decision-making in an uncertain environment.

The key principles are:

- **Meeting legal obligations** – the Council will meet all its legal obligations required under the NZETS and related legislation and regulations.
- **Conservative approach** – the Council will adopt a conservative approach to managing assets and liabilities arising under the NZETS. The Council does not have a major strategic exposure to carbon pricing nor does it have core competencies in this area. Exposing a large amount of the Council's balance sheet to carbon pricing is therefore not justified. For example, the Council will not become a major carbon trader nor a speculator on future prices on carbon. Nor will the Council take aggressively short or long positions on emissions units relative to its liabilities. Assumptions about future carbon prices will also be conservative.
- **'No regrets' decisions where possible** – Future carbon prices are highly uncertain, yet assumptions about them can have a major impact on the assessed costs and benefits of a particular proposal. Ideally, proposals will have a rationale and net benefit (albeit a diminished benefit) even if the price of carbon changed dramatically in the future.
- **Buy units locally when prices allow** – the Council has aspirations to see forest re-established on private land throughout the district. It may help achieve these objectives by acquiring units from local suppliers. The Council will not, however, pay significantly above market rates for local units.
- **Acquire least-cost units** – in cases where the Council cannot acquire enough units locally or where local units are significantly above market rates, the Council will acquire units at least cost. The Council will not require units to have any additional characteristics beyond those set by Government under the NZETS rules.

APPENDIX ONE

- **Investigate opportunities for economies of scale in the purchase and sale of units** – the Council will consider cooperating, where appropriate, with other local authorities or private entities to achieve economies of scale in the acquisition and/or sale of emission units. In doing so the Council will generally not take on the performance risk of any entities with which it cooperates.
- **Consider overall interests of Wellingtonians not just Council's direct costs** – the Council should consider the overall interests of Wellingtonians when making decisions, even though this may mean investing in new technologies rather than simply passing on cost increases by way of rates or fees.
- **Carbon responsibility** - the Council will consciously consider the effects of its decisions on carbon emissions and storage, and the need for the city to make a positive contribution to avoiding future climate change where this is affordable.

Monitoring and Evaluating a Changing Policy and Market Environment

The policy and market environment for carbon pricing is changing constantly. Good decision-making requires good information.

There are many sources of such information available which the Council will analyse and summarise to aid decision-makers. Information will also be assessed to ensure its relevance to the Council and the NZETS¹.

Financial information, in particular information on the cost of emissions units, will be monitored and evaluated.

Developments in the wider political environment, including internationally, will also be monitored and evaluated.

The information and intelligence gathered will be used to inform decision-making and annual planning processes, including the setting of fees and rates and the assessment of new initiative proposals.

¹ For example, much of the information on carbon pricing relates to the European Trading Scheme which is often not relevant to New Zealand.

Framework for assessing cost and benefits of decisions

The degree of uncertainty over carbon prices challenges typical models and assumptions for making investment decisions where a future cost on carbon is a significant consideration.

This section provides standardised assumptions and other guidance when undertaking cost benefit analysis for carbon-related investment decisions.

Key issues covered are:

- the discount rate to apply for future costs and benefits of carbon
- carbon price assumptions
- scenarios to be modelled
- treatment of implications beyond the Council for cost benefit analysis
- relationship to other relevant policies and plans

Discount rates

The selection of discount rates is one of the most critical assumptions when undertaking discount cashflow analysis as part of any assessment of investment opportunities. Where future cashflows (either incomes or costs) depend on an ongoing carbon price, the uncertainty associated with that future price should be reflected in the discount rate used.

Higher discount rates reduce the net present value of future incomes or costs. As a general rule the more uncertain a cost or benefit is, the higher that cost or benefit should be discounted.

Given the uncertainty over the future of carbon pricing, a premium will be applied to Council's normal discount rates when assessing cashflows dependant on a future price of carbon.

Carbon prices assumptions

The New Zealand Treasury publishes regular updates of the carbon price used to calculate New Zealand's position under the Kyoto Protocol as reported in the financial statements of the Government of New Zealand.

Where the Treasury continues to publish such information, the most recent relevant carbon price published by the Treasury will be used in all "base-case"

APPENDIX ONE

scenarios for financial analysis. Where Treasury does not publish this information, Council officers, using the best market information available, will develop carbon price estimates to be used in financial analysis.

Future carbon prices for “base-case” scenarios will be assumed to be the current carbon price, unless there are exceptional circumstances to modify the current carbon price.

Scenarios to be modelled

All analysis of investment proposals should include scenarios in which future carbon prices are significantly higher (twice) and lower (half) than the current carbon price.

One scenario should also analyse a carbon price of zero in the mid-term (five years from present) to assess the implications of an investment where there are no costs or benefits arising from carbon pricing beyond five years.

Treatment of implications beyond the Council for cost benefit analysis

For some of its activities and services, the Council might be in a position to fully pass on costs of emissions liabilities without loss of competitive advantage. However, in some cases simply passing on costs may be economically inefficient and detrimental overall to Wellington ratepayers compared to investing in technologies to reduce emissions.

The Council will take a broader view of costs and benefits into consideration when assessing investment opportunities and will make decisions in the overall interests of Wellingtonians.

This may mean investing in new technologies rather than simply passing on cost increases.

All analysis should, nonetheless, still identify where costs and benefits lie, including financial implications for the Council.

In some cases analysis may include a hypothetical scenario in which the effect on fees or rates is estimated in the absence of the Council investment in a certain technology or service.

Relationship to other relevant policies and plans

All analysis of investment proposals must consider and assess consistency with other relevant policies and plans. This will be particularly relevant to decisions affecting the management of regenerating or established indigenous forest.

Meeting legal obligations - emission returns and responsibilities

The Council has/will have legal obligations to furnish emission returns for its post-1989 forests under the NZETS and/or PFSI and its operating landfills. There are also statutory obligations to maintain records and report certain transactions.

For landfills and pre-1990 deforestation activities, reporting must be carried out annually between 1 January and 31 March in the year following the year to which the emissions relate (reporting is carried out based on calendar years). Any obligations to surrender emission units must be met by 31 May in the year following the year to which the emissions return relates.

Returns for post-1989 forest land must be carried out over the same months of the year, but there is flexibility as to what years returns are made. The only compulsory return for post-1989 forests is once every 5 years (or the end of 2012 in the case of the first commitment period of the NZETS).

The provisions for filing returns for forests can be complex where post-1989 forest land is bought or sold.

To ensure the Council meets its legal obligations, specific legal requirements will be identified, including those noted above, and assigned to particular business units.

Some key tasks to be assigned include:

- completing accurate draft emissions returns
- notifying relevant government agencies when specified activities or transactions occur as required under any relevant legislation
- keeping records
- filing emissions returns
- surrendering emission units
- applying for a free allocation of units for pre-1990 exotic forests owned by the Council.

Managing the Council's NZETS-related Landfill Liabilities

The Council will actively consider opportunities, including new technologies and investment, to reduce greenhouse gas emissions and liabilities from its wholly-owned landfill operations.

Such opportunities will be coordinated with and/or included in the Council's Waste Management and Minimisation Plans as appropriate.

Any new initiatives identified will be considered by Council along with all other new initiative proposals, either as part of the Draft Annual Plan process or LTCCP processes. Analysis of the costs and benefits of such initiatives will follow the framework discussed above.

In general, the Council will recover the costs of any such initiatives by way of user fees and costs on refuse bags.

Despite initiatives to reduce emissions, some emission liabilities will almost certainly remain. The costs of these will be fully recovered from users by way of landfill fees and costs on refuse bags. Where emission units are sourced internally from forest-related activities, the transfer cost of such units will be estimated using the market carbon price at the day the units are transferred, and this transfer price will be recovered by way of landfill user fees.

Council officers will ensure that appropriate forecasting is done so that fee setting under the Draft Annual Plan and LTCCP processes has accurate information upon which to base cost recovery.

Spicer landfill

Wellington City Council owns a minority share of Spicer landfill. Key decisions on Spicer are made by a Joint Venture Committee that is structured to represent Wellington City's interest. The Joint Venture Committee is the appropriate vehicle for influencing and proposing investment decisions and pricing for Spicer, including NZETS liabilities.

Managing the Council's NZETS-related Forest Assets and Liabilities

Post-1989 Forests and PFSI Forests

The carbon management issues arising from post-1989 forests (including PFSI forests) are more complex than those arising from landfill management. This is because forests can be both sources of liabilities and generators of assets. They also create contingent liabilities that will need to be managed.

The Council will actively consider opportunities to increase carbon sequestration in its post-1989 forests. It will also carefully consider the costs and benefits of any forestry operations that reduce the amount of carbon stored in its forests.

Management of post-1989 forests will be in accordance with specific forest or land management plans which include expected forest operations and the carbon sequestration and emission implications of those operations.

Where forests are expected to be harvested at some future point, future emission liabilities will be estimated and the Council will ensure that adequate emission units are available - from (in no particular order) the forest in question, other forests within the Council's portfolio, or the purchase of units - to cover those estimated future emission liabilities.

Where a forest management plan does not propose harvesting (for example where indigenous forest is being regenerated) up to 90 percent of emission units generated from those forests will be available for sale (including for transfer to other parts of the Council to cover emission liabilities). A reserve of 10 percent of credits generated will be retained to cover unforeseen losses through such things as fires. The level of retained credits will be reviewed 5 years after the adoption of this Policy and adjusted as appropriate.

The Council will seek to optimise its returns from units generated from post-1989 forests. This may mean the Council will sell such units on the open market (as opposed to using them to cover its own landfill liabilities), where the Council can receive a premium for those units given the significant biodiversity attributes they have.

Any new initiatives identified to increase carbon sequestration, such as control of browsing animals or enhancement planting, will be considered by Council along with all other new initiative proposals, either as part of the Draft Annual Plan process or LTCCP processes.

Analysis of the costs and benefits of such proposals will follow the framework discussed above.

APPENDIX ONE

Pre-1990 Forest Deforestation

Under the NZETS deforestation of pre-1990 exotic forests creates liabilities. The Council does not anticipate any significant deforestation activities involving any of its forests.

Where pre-1990 exotic forests are harvested, it is expected that the affected areas will either be replanted or regenerated into a different forest type, such as an indigenous forest. In either case no emission liabilities are created under the NZETS.

Should deforestation of pre-1990 exotic forests be proposed, the deforestation costs created by such proposals will be considered by the Council as either:

- a new initiative under the Draft Annual Plan process; or
- included in the costs of a project to which the proposed deforestation relates. For example, if an infrastructure project required deforestation of an area of pre-1990 exotic forest, the costs of any deforestation liabilities will be included in the costs of the project.

Revenue from Sales and Cost Recovery

Revenues generated from the sale of emission units or from costs recovered by way of fees and charges will be treated as other revenues received by the Council.

There will be no ring-fenced use of revenues arising from the Council's response to the NZETS.

Policies to manage the indirect effects of the NZETS

The Council incorporates any expected price effects arising from the NZETS as part of its Annual Plan and LTCCP processes.

Any purchasing or investment strategies to reduce the Council's exposure to NZETS-related price increases will be evaluated as part of draft Annual Plan and LTCCP processes.

Purchasing and Trading Strategies for Emission Units

The Council will have obligations to surrender emission units in respect of its landfill operations and any net emissions arising from its forestry activities covered by the NZETS. The Council will also have the opportunity to sell units from its relevant forestry activities.

The Council will develop an appropriate level of expertise, and take expert advice as required, on the acquisition and sale of emission units, including addressing the following key issues:

- ensuring that acquired emission units meet the requirements of the NZETS
- undertaking due diligence on contracting partners, particularly where contracts involve the supply of units in future
- long-term versus spot market purchasing strategies
- managing the Council's overall net position with respect to emission unit assets and liabilities
- cooperating with other purchasers to take advantage of synergies and economies of scale
- minimising costs to Council while ensuring appropriate risk management
- managing accounting and taxation issues, as appropriate.

APPENDIX ONE

The Council may also consider options to acquire emission units by way of investing in post-1989 forest activities in addition to land under its direct control. Consideration of such options will require careful evaluation for risk and value for money.

The Council will give priority to purchasing emission units from local sources, where the generation of those units is consistent with the Council's wider policy objectives (such as establishing indigenous forest on private land). Any such purchases, however, will not be at a price that is significantly above market rates for units.

Financial reporting of carbon-related assets and liabilities

There is currently no International Financial Reporting Standard relating specifically to carbon-related assets and liabilities.

In December 2004 the International Accounting Standards Board (IASB) released *IFRIC 3 – Emission Rights* which specified the accounting for companies participating in government schemes aimed at reducing greenhouse gas emissions. This interpretation was subsequently withdrawn in June 2005. Since then there has been no specific guidance relating to emissions and entities have to apply the current accounting standards to develop an accounting policy for the recognition and measurement of assets and liabilities relating to emission units. The IASB is not expected to release a new draft standard until 2012.

The Council complies with existing New Zealand Generally Accepted Accounting Practice but notes that the current treatment of carbon-related assets and liabilities may change if new guidance is released.

If emission units are held to meet compliance requirements (that is, to surrender to meet an entity's liability relating to emissions) they meet the definition of intangible assets under *NZ IAS 38 – Intangible Assets* and are treated in line with the requirements of this standard. Granted allowances are recognised initially at fair value which is deemed to be the market price on the date of allocation. Purchased allowances are recognised initially at cost.

APPENDIX ONE

Any carbon-related liabilities are recognised when all of the following three conditions can be satisfied:

- There is a present obligation as a result of a past event
- There is a probable outflow of economic benefits
- The amount can be estimated reliably.

Where the Council already holds units to offset its liabilities then the unit price used to determine the value of the liability is the same as the carrying value of the asset. Any liabilities over and above this are recognised at fair value (market price) at the date of recognition of the liability and re-measured at the end of each reporting period.

Explicit information on carbon-related assets and liabilities will be reported in the Council's Annual Report. The nature of the information reported may change if and when new accounting standards are released.

ENDS