



Who's the Real Cheat Here?

Climate Cheats II: The Dozen Dirty Businesses

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In the first *Climate Cheats* report in April, the Morgan Foundation revealed the full extent of how New Zealand used fraudulent carbon credits to meet its international obligations to reduce carbon emissions.¹ As a country we have done nothing to reduce our emissions thus far, and have instead relied heavily on cheap, fraudulent credits from Russia and the Ukraine. In total we handed over 97 million Emissions Reductions Units – the vast majority of which were likely fraudulent and did not result in any reduction in emissions. These made up some 25% of the units we handed over in the first Kyoto period. The results of engaging in this scam were that some \$200m went into the pockets of foreign criminals, the price of carbon went to virtually zero, our emissions increased, and polluters profited. Finally, the use of these fraudulent units to meet past obligations has allowed the Government to build up a stockpile of units which it is using to meet our future emissions targets, potentially past 2020.

The Government's response to our report was to say that it was not responsible for purchasing the credits, because these were bought by businesses in the course of the operation of the Emissions Trading Scheme. In this follow up report we identify those businesses that traded most heavily in the cheap, fraudulent foreign credits. If the Government continues to duck responsibility, the risk for these businesses is that the mud sticks to them instead.



When Government abdicates responsibility, who does it fall to?

As we made clear in *Climate Cheats*, in our view the New Zealand Government was ultimately responsible for the wholesale importation of fraudulent carbon credits. New Zealand's Emissions Trading Scheme has been the only one to allow the unlimited importation of international credits, and from mid-2013 we were the only country still freely accepting Russia and Ukraine's fraudulent Emissions Reductions Units (ERUs). While the full extent of the problems with ERUs was not confirmed and quantified until 2015, through research by the Stockholm Environment Institute, it was widely known well before that time by people in the market that there were massive doubts about the environmental integrity of ERUs (or anything out of Russia and Ukraine).



Officials and the Climate Change Minister were warned as early as 2011 about the questionable environmental integrity of some international units.² We know from *Climate Cheats* that the European Union was having a robust debate about ERUs in 2012 and finally banned them in 2013 - further evidence the problem was well known at the time. Yet New Zealand didn't act. The fact that the Minister claims not to have been officially informed about the issues until 2015 suggests, at best, negligence on the part of officials.

One of the researchers behind the original Stockholm Environment Institute report, Anja Kollmuss, commented:³

Anyone who had anything to do with Joint Implementation [the mechanism through which ERUs were issued] knew that the market was suddenly swamped by ERUs from Russia and Ukraine and that these were very likely of quite low quality. All our research did was to back up these allegations with detailed research.

Given the price at which they traded, it should be no surprise that rational businesses bought the dirt cheap and environmentally worthless units. The Emissions Trading Scheme is a regulated market, so the regulator (the Government) is ultimately responsible.

The ideal way to resolve the *Climate Cheats* scandal is for the Government to cancel surplus emissions permits in recognition of the junk credits that we have already handed over to meet our 2008-2012 Kyoto commitment. The situation has changed somewhat since *Climate Cheats* was published: the projected surplus remaining in 2020 has reduced from 93 million units to 85.7 million⁴. If the Government were to cancel 97 million permits (the total amount of ERUs it has used), this would now mean a significant shortfall in meeting our 2020 target; the failure to reduce domestic emissions has put us in a difficult position.

What should be beyond dispute, however, is that New Zealand should stop exploiting the legacy of the dodgy credits by 2020 at the very latest. At minimum, the Government should commit to cancelling our remaining surplus in 2020, and make an unequivocal statement that it will not seek to carry any permits over into the next commitment period. Ideally, it would cancel those units now rather than wait until 2020. The international community is unlikely to look favourably on us continuing to hold over emission credits stored up from the past given their dubious origin and the fact that the Paris Agreement was intended to be a fresh start over the Kyoto Protocol.

Thus far our Government has refused to take any action, although the Minister is receiving advice from officials on this issue. We eagerly await her announcement.

However, when governments abdicate responsibility, the associated risks don't disappear. Instead the management of those risks is passed on to the businesses involved. This excerpt is taken from the Parliamentary Commissioner for the Environment's submission to the recent Emissions Trading Scheme review:⁵

In a speech last year Mark Carney,⁵ the Governor of the Bank of England, identified three ways in which climate change can affect financial stability – physical risks, liability risks, and transition risks.⁶

Physical risks are the impacts of events like floods and storms that are expected to become more frequent and more damaging as the climate changes. These will decrease the value of assets and make them more expensive and difficult to insure. One certain physical change is the rising level of the sea – around the New Zealand coast several billion dollars of buildings and infrastructure are less than 50 centimetres above the spring high tide mark.⁷

Liability risks are the impacts that could arise when those suffering loss or damage attributable to climate change seek compensation. In the future, large companies that extract or burn fossil fuels could find themselves sued by those hit hard by climate change. In New Zealand, people given consent to build on low-lying land close to the sea might seek compensation from councils.

Transition risks could arise if the adjustment to a lower carbon economy does not begin early enough and does not follow a predictable path. Abrupt changes in policy, for

4 - Ministry for the Environment: Latest net position – July 2016 update. <http://www.mfe.govt.nz/climate-change/reporting-greenhouse-gas-emissions/latest-2020-net-position>

example, could trigger big changes in the values of assets. This is why the protective settings in New Zealand's ETS might begin to damage the very companies they protect and hence the New Zealand economy.

This quote makes it perfectly clear that when Government abdicates responsibility for effective climate policy, that responsibility passes to business leaders in a variety of ways. The risk discussed in this document does not include physical risks, but the other two issues – liability and transition - are worth exploring.

Liability Risk

What liability do corporates bear? When the Government refuses to take responsibility for effective action on climate change the liability risk falls to businesses in two ways – reputational and legal risk.

Firstly, there is the reputational risk – the risk to their brand from being associated with greenwashing. Through buying Emissions Reductions Units, the companies were meeting their obligations on paper in the cheapest way possible, while doing absolutely nothing to protect against climate change. Like most major players in carbon markets the large companies involved in the Emissions Trading Scheme would have been aware of the poor quality of the Emissions Reductions Units. In fact, one major player in the market, Mobil, chose not to buy or hold any ERUs:



Mobil does not hold (and has never held) ERUs. ExxonMobil has a Corporate policy which guides the purchase of carbon credits globally, including by affiliates such as Mobil Oil New Zealand, which goes beyond the restrictions prescribed by the New Zealand Government. (We are fully compliant with our obligations under New Zealand law in relation to the ETS).⁹

So Mobil had corporate standards that prevented them from purchasing ERUs. This indicates two things – firstly that Mobil knew ERUs were of questionable value, and by that

logic other companies should have known this also. Secondly, it tells us that Mobil had the courage to turn down an opportunity for greenwashing, even when it cost them a bit more to do so. Did Mobil have this policy because they knew to protect themselves from the liability risk?

There is also a risk to our businesses from the damage to our international reputation. We trade on our clean, green, corruption-free reputation. However, in this respect New Zealand's reputation is getting decidedly grubby. Here is Anja Kolmuss again³:

It does not reflect well on a small rich country if it allows for the purchase of offsets that are known to be of questionable integrity. If the same country then keeps pushing for lax rules at the international negotiations you have to wonder if the policy makers of that country have truly grasp the urgency and severity we face with the climate crisis.

And then there is the legal risk. In the long term there is a risk that those affected by climate change will sue the companies that have been instrumental in the creation of the problem. We have seen this in the past with cigarettes and could well see it in the future with climate change. Knowingly buying ERUs that have no environmental value could increase this future legal risk for the companies involved. Perhaps this is playing into Mobil's long term thinking also?

Transition Risk

The other issue facing businesses is that they need to move to being net zero carbon by the end of the century at the very latest – ideally by around 2050. Prior to the collapse in carbon prices – which was in part caused by the ERU rort – there was a reasonably strong carbon price of around \$20 per tonne. Some five years after the rort began the price still hasn't recovered to those levels. This has had a major negative impact on the Emissions Trading Scheme. Indeed, this is the main driver behind why the Ministry for the Environment's recent evaluation of the Emissions Trading Scheme showed it to have had little impact on reducing emissions.¹⁰

Participants interviewed from non-forestry sectors, and evidence from surveys, have indicated that because of the low carbon price over most of CPI, the NZ ETS has not significantly influenced domestic emissions or business decisions. Almost all of those interviewed considered that regulatory certainty and stable long-term policy settings would increase the influence of the NZ ETS on business decisions.

It is more difficult to know what the impact of this rort will be on the confidence in the scheme over the longer term. When asked whether 'the Government has provided sufficient regulatory certainty about the NZ ETS', 80% of people involved in the ETS either disagreed or strongly disagreed. Only half were confident that the ETS would survive past 2020.¹¹ That is a pretty damning assessment of what the Government describes as:

New Zealand's primary policy tool for addressing domestic greenhouse gas emissions and removals, and international commitments on climate change.¹²

In their report Our Forest Future,¹³ Pure Advantage pointed out that:

New Zealand's Emissions Trading Scheme is a notoriously complicated policy instrument. It has also been notoriously ineffective...

Clearly, the Emissions Trading Scheme suffers from a lack of credibility. Its complexity hides its unfairness and its failures from the public. Meanwhile, participants in the ETS have seen too many avoidably poor outcomes to continue believing that those outcomes were entirely unintended. This adds to an already challenging context for forestry, which involves investments that take decades to reach maturity and are vulnerable to natural hazards like fire, disease, and weather events. An unpredictable policy framework, decoupled from its function and purpose, intensifies the uncertainty.

The science is clear - we need to transition to a zero carbon global economy before the end of this century at the absolute latest. The drop in carbon prices as a result of allowing an unfettered trade in cheap, fraudulent foreign credits has set back New Zealand's transition to a low carbon economy by at least five years. This is a short-sighted approach that will increase costs on businesses in the long run. The IPCC has found that delaying action will only increase the costs of reducing emissions over the long term.¹⁴ Government inaction is increasing the long-term risks faced by our businesses.



Who are the Dirty Dozen?

Time to reveal the dirty dozen – the 12 biggest users of Emissions Reductions Units.

But first, a caveat. This is based on data from the Emission Unit Register, in particular the Kyoto Unit Holdings by Account.¹⁵ This is a publicly available dataset that tallies ERUs held at the end of each calendar year. Importantly, it doesn't tell us how many ERUs the companies handed over to the Government – these data are impossible to get hold of due to commercial sensitivity. So the numbers here should be taken as indicative of scale, rather than precise. However, given the volumes involved, the annual changes in their accounts, and the fact that these are generally the major emitters under the Emissions Trading Scheme, the Dirty Dozen list stacks up. We offer our sincere apologies to any companies that missed out on this honour due to the insufficient data! To check, we offered all the companies a chance to comment, and their responses are available at the end of this report. None of the corporates named have questioned their inclusion.

Here's the Dirty Dozen:

COMPANY	TOTAL 2013-14*
BP Energy Asia	6,122,287
New Zealand Forest Leasing Limited 	3,684,239
Z Energy Limited	2,768,610
Wairakei Pastoral Limited 	2,058,465
New Zealand Steel Limited	2,024,241
Matariki Forests 	2,009,317
Contact Energy Limited	1,536,697
Chevron New Zealand	1,489,717
Genesis Energy Limited	1,318,132
Fonterra Limited	1,238,340
Ngai Tahu Forest Estates Limited 	1,076,276
China Forestry Group New Zealand Company Ltd 	858,097

 = Foresters

* Total obtained by summing ERUs in company's holding account at the end of 2013 and 2014 calendar years.

No prizes for guessing #1 - it is our old friend, the clean, green environmentally sustainable BP. This scandal isn't quite on the scale of the Gulf of Mexico, but they were intent on buying their way out of carbon obligations at the cheapest price possible. Up there in the top 12 are also the other big gas-guzzlers Z Energy and Chevron. As noted previously, another petrol retailer, Mobil, did not purchase any ERUs to cover their emissions obligations. This was a conscious choice, and one that would have hurt their bottom line given that ERUs were the slightly cheaper unit to buy. Who ever thought that we'd be giving environmental kudos to Mobil?



Power companies operating coal, gas and geothermal generation are in the Dirty Dozen too; namely Contact and Genesis Energy. As we saw in *Climate Cheats* there are allegations that petrol and electricity suppliers didn't drop prices to match the collapse in the carbon price. If this is the case then these companies have profited from the use of cheap fraudulent foreign credits, at the expense of ordinary New Zealanders.

No dirty dozen would be complete without New Zealand's biggest industrial coal users – New Zealand Steel and Fonterra. As we saw in *Climate Cheats* these companies continued to receive free credits (NZUs) from the Government while they bought ERUs for virtually nothing. It is worth noting that due to the regulations around these free units, New Zealand Steel has received far more than Fonterra. They were either able to sell these NZUs for a much higher price than they bought ERUs (benefiting from arbitrage), or hang on to them to cover their emissions well into the future.

Either way, both these companies have clearly profited from the use of these cheap, fraudulent credits; New Zealand Steel in particular. Blogger Simon Johnson¹⁶ pointed out that in 2014/15 the Australian parent of NZ Steel (Bluescope) booked \$A4.4m of income from carbon permits linked to the New Zealand Emissions Trading Scheme.¹⁷ The price of carbon has more than quadrupled since then - if NZ Steel banked those units, their total would have grown commensurately.

All of the companies named above are big enough and ugly enough to have known that they were buying cheap and very dodgy foreign credits. They likely all have teams that are engaged in the carbon trading market. As we know from Mobil's example, if they didn't know they were buying fraudulent junk credits, then they didn't do sufficient due diligence.

The surprising thing is the inclusion of five companies associated with forestry and farming in the Dirty Dozen. Some of these were true forestry companies, others land owners who happened to have some forest. Forests soak up carbon while they are growing, and new forests planted after 1989 can earn New Zealand Units through the Emissions Trading Scheme. However, harvesting or deforesting incurs a carbon liability; the owner must surrender credits to the government. For pre-1990 forests, they cannot earn any credits and can harvest and replant without issue, but must surrender credits if they permanently deforest the land (for conversion to dairy, say). While international rules have since been amended to try to account for the temporary storage of carbon in harvested wood products, all forestry emissions are still treated as instant under the current rules of the Emissions Trading Scheme.

So deforestation counts, under current rules, as a carbon emission like any other. That puts these companies on a par with the fossil fuel burners; they have created emissions, and used fraudulent foreign credits to pay for their liability. Like the fossil fuel companies, the ones that have permanent carbon trading teams (such as the #2 ERU purchaser listed above - New Zealand Forest Leasing Limited¹⁸) should have known better.)

However, there are more mitigating factors in the forestry space. Some of these companies are less culpable, while others engaged in a nice little rort of the Emissions Trading Scheme that is on a par with that perpetrated by NZ Steel.

The main forestry related ERU trick was the old in-and-out tactic. We discussed this in *Climate Cheats* – foresters could arbitrage the system by buying and surrendering ERUs to leave the ETS, then re-entering and banking the more valuable New Zealand Units they were issued:

... the cheap foreign credits exposed another arbitrage loophole, which many foresters exploited to get their own back. Post-1989 foresters, who voluntarily join the ETS, can also decide to opt out by paying back all the credits they received upon registering. However, the rules allowed them too to use 100% foreign credits when they deregistered. So just like the polluters, they could simply hang on to the NZUs and pay the bill with ERUs at a few cents per tonne. Many decided to give up on the ETS and get out while it was cheap, with some moving to deforest their land, as discussed in the previous section. But here's the kicker: having exited the scheme, foresters could then reregister, receive a new payment of NZUs, deregister again with a payment of ERUs, and so forth, stockpiling those NZUs for future sale. They were literally printing money...

As pointed out by Mark Belton in an August 2015 article on Carbon Pulse¹⁸:

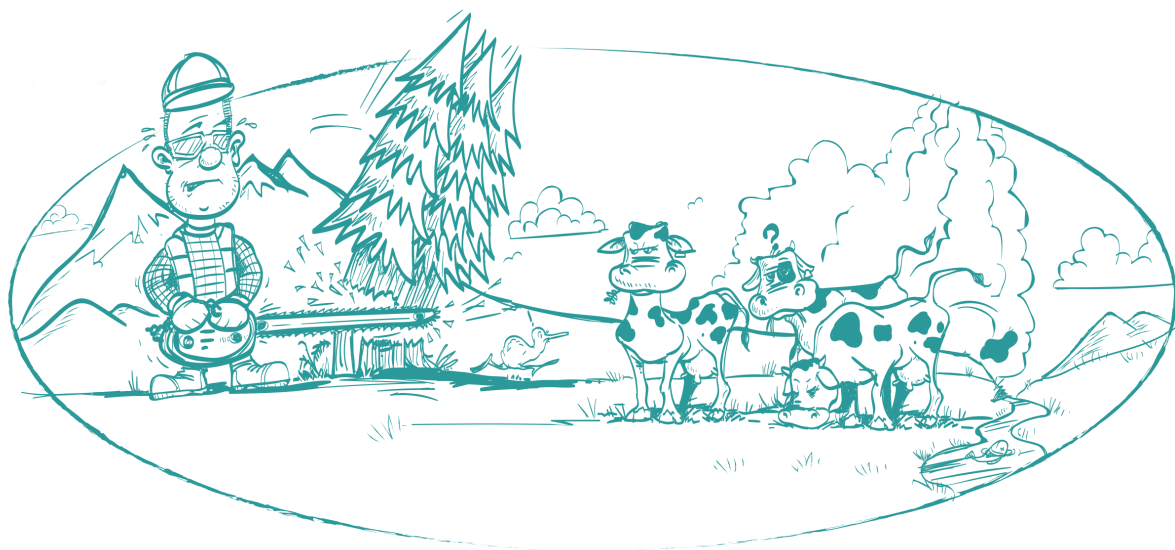
Owners of timber forests were able to play the market and make millions in windfall profits. About 80% of NZ's plantation forests are foreign-owned with their parent companies domiciled in offshore tax havens.

While Treasury didn't deign to clamp down on NZ Steel's ETS rort, they did get hold of this one and shut it down in Budget 2014. Given trading details are not public, it is difficult to know exactly which companies engaged in this rort.

However, not all of the land-based companies trading in ERUs were doing it for nefarious money making reasons. As discussed in *Climate Cheats* and reiterated above, foresters have been worst hit by the Government's mismanagement of the ETS. Some just wanted to exit the scheme, and after having their profits hammered by the low carbon price, they wanted to do so in the cheapest way possible. The purchase of ERUs may simply have been a way out of the scheme for them. To add insult to injury, some of these operators were even stranded with ERUs they were suddenly unable to use after the surprise change in Budget 2014.

Similarly, Ngāi Tahu used ERUs to realize the value of the land they had bought on the Canterbury Plains as part of the Ngāi Tahu Settlement process. They had bought the land at market rates prior to the ETS coming into effect, with the sale price based on the best use of the land (i.e. farming). Suddenly after the advent of the ETS they had to hand over emission units in order to meet the unexpected cost of converting the land to farming. Ngāi Tahu hadn't received any units for growing the trees in the first place, because the forest was planted pre-1990 and therefore they only received a nominal allocation. It is worth noting that Wairakei Pastoral and Matariki also had some pre-1990 forest. Some foresters – particularly those with pre-1990 forests – may not have had permanent carbon trading teams and so may not have known about the environmental problems with ERUs.

Finally, as we noted in *Climate Cheats* cutting down trees to convert land to dairy farming has nasty environmental downsides beyond the release of carbon dioxide. The conversions undertaken by Wairakei Pastoral for example will leach a lot more nitrogen into the Waikato River, which should help boost the growth of algae. These conversions were completely legal, but highlight the weaknesses in current fresh water regulations.



How can companies put this right?

As mentioned earlier (p. 3), we'd like to see Government "dump the junk" by cancelling surplus emissions units it holds to make up for dodgy ones it has exploited so far. At minimum, the Government should commit to cancelling our remaining surplus in 2020, and make an unequivocal statement that it will not seek to carry any permits over into the next commitment period. The international community is unlikely to look favourably on us holding over emission credits stored up from the past to use after 2020. This is particularly the case given their dubious origin and the fact that the Paris Agreement was intended to be a fresh start over the Kyoto Protocol.

There is a simple fix for this problem, and it lies in the hands of the Climate Change Minister. However, thus far her response is that the Government did not purchase these fraudulent units, private companies did. In lieu of the Government taking responsibility for allowing fraudulent units to be purchased, the reputational risk falls upon the private sector. If the companies involved wish to avoid this, they should be lobbying the Government to cancel the surplus units it holds.

Furthermore, for these companies to protect their reputations and not be seen as parties to greenwashing, they could voluntarily cancel an equal sum of New Zealand Units to the ERUs they have handed over. The problem they face is that since the end of this scam, the price of carbon has risen to nearly \$18 per tonne. So repaying these units has become a lot more expensive – 97m tonnes of carbon now has a market value of \$1.7b. It would be far cheaper and simpler for the companies involved to ask the Government to take ownership of this problem and cancel the units it holds in excess of our 2020 target.



Failing that, the different companies in our Dirty Dozen face different reputational risks:

1 – Of all the companies in the Dirty Dozen, NZ Steel, and to a lesser extent Fonterra, face the greatest reputational risk. We know for certain that as exporters these two companies received free New Zealand Units (NZUs) from the Government while they were exploiting the cheap, fraudulent foreign credits. In other words they have profited from their climate pollution. Due to the regulations around the NZUs, New Zealand Steel have benefitted from this far more than Fonterra; last year they banked a \$A4.4m profit from carbon trading and that total may be much higher by now. Both companies should immediately cancel the free units they received between 2013-2015 in recognition of the environmental worthlessness of the ERUs they traded in. If they have sold those units they should surrender an equivalent sum to the price they received.

2 – There have been allegations that the petrol and electricity companies held their prices artificially high even though they were exploiting cheap foreign credits. The Commerce Commission should investigate whether petrol and electricity prices reflected the lower cost of carbon during the period where the price crashed. If it can be proven that prices were kept high, then these companies should be able to afford to buy and cancel equivalent units as compensation for the cheap and fraudulent ERUs.

3 – Lastly we have the forestry and farming companies. The picture here is more complex, and forestry companies need to front up to why they traded in ERUs. Given the way the forestry sector has been treated under the Emissions Trading Scheme, some may argue that trading in fraudulent credits was fair compensation for the way the ETS was set up, or what happened to them when the Government allowed the price of carbon to crash. However, some companies clearly engaged in arbitrage in the same way NZ Steel did above. Those companies that rorted the system by exiting with ERUs and returning to collect NZUs should hand back their ill-gotten profits.

Company Responses

BP

BP has been a long-standing advocate of taking action to reduce greenhouse gas emissions and of the need to price carbon, however as BP does not set domestic climate change policy in New Zealand, it relies on Government to set the compliance requirements and eligibility criteria with which industry must comply. The Government must lead by providing a clear, stable and effective policy framework if companies are to provide and use energy competitively.

BP NZ operates in compliance with the New Zealand Emissions Trading Scheme (ETS) rules and regulations as set out by Government. BP NZ has taken great care to meet the requirements of the New Zealand ETS since its inception and, during consultation periods and ETS reviews, BP has provided letters of support and recommendation for the NZ ETS and the associated environmental targets.

BP is an energy company that exists to meet the energy needs of its customers. In line with the rules set by Government and where possible, BP NZ will continue to support programmes designed to reduce emissions while delivering cost competitive products to meet customer demand.

Contact Energy

At Contact we've met our carbon obligations under the ETS but more importantly we've reduced our level of carbon emissions by 47% over the past four years while ensuring a secure and reliable supply of electricity for New Zealanders. We've reduced our carbon emissions by investing in new renewable geothermal and more flexible thermal power stations which have allowed us to retire some gas-fired generation. Contact's 2015 obligations were met exclusively with New Zealand Units (NZUs).

We are focused on delivering value for our customers and shareholders and we offer a range of competitively priced products. We operate in a highly competitive retail market which has delivered a reduction in the cost of electricity for customers.*

* <http://business.scoop.co.nz/2016/06/16/decrease-in-household-electricity-costs/>

Z Energy

As we discussed, I think it would be fair to say that over the course of the early days of the ETS we, and I think this is also true for government, have learned a lot about both the operation of the scheme and the broader carbon markets.

We appreciate the opportunity to make the following points, and would be very happy to discuss this with you further at any time:

- The ETS is a market-based tax. The New Zealand Government set the rules, and Z has worked within those rules throughout. Z has complied with meeting its obligation to surrender eligible units each and every year.
- Our customers made it very clear to us that they wanted the lowest cost fuel and expected us to make commercial decisions about that. Z would not be working in the interests of its customers or shareholders if it didn't meet its obligation at least cost. As your report now notes, our competitors also purchased the cheapest units. If Z had not, we could have had the effect of penalising our customers and, ultimately, shareholders.
- It's really important to us to be clear that at no time have we held prices artificially high. Actual costs of whatever the ETS credit may have been are passed through each year. By focusing on least cost abatement within the prescribed rules, Z has spared Kiwi businesses and motorists additional and unnecessary cost.
- Despite all of the above, we acknowledge that the system and the rules under which we were operating had flaws. This goes to my earlier point around people and organisations learning through this process. We have outlined a couple of examples of our public position in this area in two previous Government submissions.

- In Z's [*February 2016 submission*](#) on the Government's ETS consultation, Z called for a much stronger ETS and endorsed restrictions on where units can be sourced from: "Z submits that environmental integrity, measurement reporting and verification standards are vital to maintain the integrity of the NZ ETS".

<http://z.co.nz/assets/NEWS/NZ-ETS-review-submission-Z-Energy.pdf>

- In Z's [*2011 submission*](#) on the consultation of the proposed restrictions of CERs, Z supported the introduction of a ban on the use of IG CERs in the NZ ETS, noting: "this will be required to ensure the future environmental integrity of the ETS". <https://z.co.nz/assets/PDFs/Z-submission-to-MFE-on-CERs-FINAL.pdf>

- Our internal actions have been consistent with our public stance through these submissions. We have advocated for a better framework for emissions trading precisely to avoid the repeat of some of the issues identified in your report.

Z wants to be a company that operates with integrity and transparency in this space. We're very happy to be honest and upfront about any decisions Z has made in the emissions trading space. We're committed to doing what we can to try and ensure the rules and frameworks around emissions trading are as good as they can be.

References

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