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The Right Hon Helen Clark  
Prime Minister

19 October 2007

Dear Prime Minister

### **RE: Process for Introduction of Emissions Trading Scheme in New Zealand**

Climate change is an enormous global challenge. The IPCC reports are conservative and our best scientific minds tell us we may need to prepare for a far more dramatic rate of climate change. We strongly endorse the Government's prudent commitment to an all gases, all sectors approach to address greenhouse gas emissions.

Developing an emissions trading scheme (ETS) that tackles all gases is a very positive step forward and we welcome the Government's initiatives in this direction. We consider that the Government should move forward on its present timetable for introducing and passing the necessary legislation and that any delay in the process should not be considered.

### **Pace of scheme development and transitional assistance**

Recently some business interests have suggested that the development of the ETS has been rushed and that it is ambitious in scope. In our view, the scheme as proposed by the Government is a conservative and gradual scheme and has been well-signalled. Setting the basic framework in place early leaves plenty of time for detailed discussion with stakeholders but avoids endless delays in implementing the scheme itself. There will of course also be significant opportunities for submissions to the appropriate select committee on each stage of the legislation to implement the ETS.

New Zealand needs a business sector that will embrace the opportunities and responsibilities that come with the proposed emissions trading scheme. Fortunately there are a number of innovative businesses that are doing just that.

Some business interests, however, have a history of seeking to delay action on climate change. Emissions-trading has been discussed in New Zealand for over 15 years. These interests have had ample opportunity to engage constructively but have instead chosen to argue for delay and deferral for more than a decade, while the climate problem has worsened.

Claims of widespread industry closures are highly implausible and appear to be simply an attempt to further delay action on this issue. Some business interests would no doubt prefer that the entire first period liability is borne by the taxpayer but this would be corporate welfare of the worst sort.

As it stands the design is extremely generous to large 'trade-exposed' sectors:

1. Agriculture is not required to even enter the scheme until 2013 and will be subsidised with free allocations until 2025.
2. The assistance to other 'trade-exposed' sectors (90% of 2005 emissions, phasing out by 2025) is also generous both up front and in the medium term as it has a very gradual phase out of assistance. The best science available suggests that drastic cuts in global emissions will be required over that period.
3. There is full scope to utilise carbon sinks, unlike for example, the European Trading System that is already in operation.
4. The scheme proposes to allow emitters to purchase so-called "hot air" to meet their commitments up to the end of 2012. These emission units, while legal under Kyoto, are not backed by any real reduction in emissions, and represent a weakening of the New Zealand scheme.

**We believe that further concessions for industry would be wholly unjustified. In particular we strongly oppose:**

- **any relaxation of the proposed phase-out through to 2025;**
- **the use of an intensity-based rather than absolute obligation.**

### **Ensuring Environmental Integrity**

There is a need to ensure that the imperative of short-term legal compliance with Kyoto does not undermine the long-term effectiveness of the scheme, or adversely affect New Zealand's overall environmental performance. There are a number of issues that may require attention in this area and we will communicate separately on these. There are, however, three areas of overall design that we believe need immediate attention:

1. **The lack of quality standards for international emission units that New Zealand companies can buy to meet their obligations under the NZETS.** If the Government can exclude nuclear offsets, it can also exclude low quality AAUs. The Appendix to this letter sets out the case for addressing this issue in some detail.
2. **The need to avoid unintended environmental impacts under the NZETS and NZES.** There is potential for serious, unintended side-effects in terms of biodiversity losses, landscape impacts and loss of wild and scenic rivers. The Government should initiate a parallel process of environmental assessment to identify ways these impacts can be addressed in scheme design and/or in separate measures.

3. **The lack of transparency around gross emissions reductions within New Zealand.** While businesses may prefer to rely largely on buying overseas credits and planting trees, the public understands that solving the climate problem will ultimately depend on achieving emissions reductions within New Zealand. We would like to see the Government maintain a policy focus on this issue by having a target for gross domestic emissions reductions, monitoring performance against this target, and if necessary, identifying further measures to ensure a cost-effective supply of NZ Units resulting from reductions in domestic gross emissions.

Please address these important issues. Through scheme design and implementation the Government can strengthen the environmental integrity of its scheme, and help support innovative New Zealand businesses by giving more substance to our “clean, green” image.

The choice is not between business and the environment. The only choice if the world is to have any future chance of a stable climate is a low-carbon economy. We urge you to ensure that the final design of the New Zealand Emission Trading Scheme plays its part in this essential economic transformation.

Yours sincerely

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## **Appendix: Environmental integrity of credits**

Under the current proposal for a New Zealand ETS, there are few restrictions planned on the type of credits allowed into the scheme. At this stage restrictions are planned for temporary credits and credits generated through nuclear projects. No other limitations are planned. We believe that this is problematic with regard to certain types of assigned amount units (AAUs).

For the following discussion it is useful to distinguish between two categories of AAUs.

The first category of AAUs for which a market is slowly beginning to appear are AAUs traded in connection with Green Investment Schemes (GIS) which link income from the sale of AAUs to more or less specific and identifiable projects or actions with a positive effect on emissions. These can range from direct investments in projects to implementation of “softer” policies and measures such as raising awareness. The more directly these emission reductions can be monitored and verified, the closer these GIS-based AAUs will be to Joint Implementation (sometimes also labelled “hard-green” AAUs).

The second category of AAUs is different in the sense that they do not reflect emission reductions. A number of countries (Russia, Ukraine, etc.) have a Kyoto Assigned Amount which is above their business as usual emissions (so-called “hot air”). An unknown number of these surplus allowances may be sold as AAUs during the first commitment period.

A variety of reasons have been put forward for why such hot-air credits may be allowed into the NZ ETS, including the following:

1. Hot air AAUs are legitimate under the Kyoto Protocol (and negotiators were aware of their effect).
2. “Hot air” was likely a key factor in Russia’s decision to ratify the Kyoto Protocol. This is important because it was only through the ratification by Russia that the Protocol entered into force in early 2005.
3. “Hot air” can be found in many countries where allocation of credits was more generous than may have been warranted. For instance, Germany was able to “reduce” its emissions very easily because of the collapse of the East German economy in the early 1990s.
4. In order to sell units from other countries they will need to be converted to AAUs. As New Zealand will want to sell its own AAUs, it may be seen as unfair if it does not accept others’ AAUs.
5. If New Zealand does not allow AAUs into our scheme, other countries will buy them anyway.
6. While the government could prohibit private entities from bringing hot-air AAUs into the NZ ETS, there is nothing stopping the government from buying such credits to ensure Kyoto compliance at least cost.
7. Hot air AAUs are likely to be a temporary glitch in the system; it appears less likely that such credits would be allowed in future international agreements.

8. There is some uncertainty as to whether hot air AAUs will actually come onto the market, i.e. whether countries holding these surplus allowances will decide to put them on the market or whether they will bank them.
9. Hot air AAUs will likely reduce the cost of compliance. It is not unlikely that supply could outstrip demand, particularly in light of the fact that the largest potential buyer (apart from the EU) – the US – is not participating in Kyoto. However, it is unlikely that the price of credits will approach zero because then they would be worthless (i.e. relevant countries are likely interested to ration supply and maximise revenue from their sale).
10. Being able to buy hot air AAUs is a risk management strategy for New Zealand which could be used if the price of better quality credits rises too high.

We acknowledge these arguments but feel nevertheless that it is important to consider the arguments against allowing hot-air credits.

1. While hot-air credits are legitimate under the Kyoto Protocol, it is also legitimate for countries to choose for themselves what type and source of credits to purchase in order to meet their obligations under the Protocol. The world has learned a lot since the Kyoto Protocol was signed.
2. While there is some incentive for countries holding hot-air credits not to increase emissions so as not to “use-up” such credits, the environmental integrity of such credits is nevertheless low due to their lack of linkage to emission reduction policies or investments. It appears that by not allowing credits linked to nuclear activities the New Zealand Government wishes to exclude some types of credits based on some notion of environmental integrity. With regard to environmental integrity we argue that the ultimate aim of a NZ ETS should be emission reductions, and thus we believe the Government is inconsistent in its criteria for excluding certain credits and not others.
3. There is a risk to the clean green identity for New Zealand which the Government is endeavouring to foster both domestically and internationally. First, allowing hot-air credits could undermine New Zealand’s reputation as being serious about addressing climate change. The international community may regard it as a cheap way for New Zealand to buy its way out of serious action. More importantly, within New Zealand, people could come to feel that the Government is being hypocritical by asking them to make sacrifices for the sake of moderating climate change, while allowing polluters to take a cheap and dirty way out of meeting their obligations which won’t actually reduce emissions.
4. Excluding those credits could send a welcome signal to the international community that hot air will not be tolerated in later agreements.
5. There are clear opportunities to recognise and purchase “greened” hot air AAUs in which the income from the sale of such AAUs is linked to specific and identifiable projects or actions to reduce emissions.
6. While it is unlikely that countries holding hot-air AAUs will let the price of credits approach zero, it is not unlikely that supply could outstrip demand, particularly in light of the fact that the largest potential buyers – the EU and the US – either do not allow such credits or do not participate in Kyoto. This will lower the price of hot air AAUs. However, in order to prepare New

Zealand for a more carbon-constrained world, earlier exposure to more realistic prices on emissions would be preferable.

7. If the Government wants to retain access to hot air if faced with a serious price spike, it should identify hot air purchases as a last resort strategy and set out the conditions under which they might be used.

We believe that the arguments against the use of hot-air AAUs outweigh the arguments for allowing them. Considering that there are opportunities to improve the environmental integrity of hot-air AAUs by linking the income from the sale of such credits to identifiable projects to reduce emissions, we believe the Government should review its criteria for allowing/excluding certain types of credits. We suggest that criteria be linked to the notion of environmental integrity and actual emission reductions.