Climate Change (Emissions Trading and Renewable Preference) Bill

30 January, 2008

1 Introduction

Late last year, we reviewed the Government's policy announcements with respect to the Emission Trading Scheme. We expressed strong concerns that the scheme—as it was described at the time—was not sustainable, because it did not balance economic and environmental objectives. The concerns that we identify have not been addressed in the Climate Change (Emissions Trading and Renewable Preference) Bill.

2 Concerns Regarding the Policy

Our review of the Government's proposed policy raised a number of concerns regarding the economic impacts and efficacy of the proposed Emissions Trading Scheme.

2.1 Competitiveness Issues

By exposing New Zealand businesses to the relatively high and variable price of emission permits while their competitors did not face similar constraints, the scheme would discourage economic activity in New Zealand. The Government's own modelling indicated significant declines in such exposed sectors as dairying.

2.2 Sustainability of the Policy

We expressed concern that once the economic costs of the proposed scheme began to crystallise, the imperative to protect economic prosperity would force the reversal of emissions policy. The fact that New Zealand has one of the highest emission growth rates in the world, and that successive governments have struggled to introduce viable measures despite the rhetoric of commitment to the Kyoto Protocol shows that the community is not willing to address emissions at any price. The cautious approach adopted by the new Government in Australia—despite its commitment to the Kyoto Protocol—shows that the need to balance economic and environmental objectives is not unique to New Zealand. The Australian Government, for example, has made it clear that environmental measures will not be allowed to undermine economic growth.

2.3 Devolution of Liability

We were also concerned that the Government's move towards delegating emission liabilities arising under international agreements to consumers and businesses would, in

many instances, increase the cost of compliance. While the fiscal costs to the Crown would be reduced, the overall economic and social costs to New Zealand would be raised.

2.4 International Comparison

We compared the proposed New Zealand scheme to the European Union Emissions Trading Scheme and the emissions trading scheme designed by the Howard Task Group in Australia. We concluded that the New Zealand scheme was different from overseas emissions trading schemes in critical respects, and that these differences would increase economic costs under the New Zealand scheme.

Since our report was published, the European Commission announced plans for the 2013—2020 phase of the European Union Emissions Trading Scheme (EUETS). These announcements highlight the seriousness with which economic risks are being taken into consideration in the design of overseas emission trading schemes, and the extent to which New Zealand's proposed scheme increasingly differs from international best practice:

- **The European scheme provides domestic firms with more protection against competition from foreign firms that don't face a carbon price.** Imposing a price of carbon exposes domestic firms to a cost that may not be experienced by competitors. The New Zealand Government plans to cap free allocation of permits to competitiveness-exposed firms at 90% of 2005 emissions, and begin phasing out all free allocation from 2013. New Zealand firms will therefore increasingly face costs that their competitors do not. In contrast, competitiveness exposed firms within the EUETS may be provided with 100% free allocation for the foreseeable future, shielding them from this cost disadvantage
- **The European Scheme will be less ambitious in terms of coverage.** While the New Zealand scheme will include all sectors by 2013, the EUETS will continue to exclude agriculture, forestry, road transport and shipping until at least 2020. New Zealand's leadership position will increase the costs and risks to the New Zealand economy
- **The European scheme will continue to allow for growth in emitting industries.** All emissions from new entrants or expansions in production will immediately face a carbon price under the New Zealand scheme. This will mean that new production faces costs that overseas and existing producers will avoid. In contrast, the European scheme will continue to allow for free allocation to new entrants. During the 2013—2020 period, 5 percent of the total quantity of allowances will be reserved for free allocation to new entrants in the EUETS, allowing for growth in emitting industries and avoiding unfairly advantaging incumbents.

2.5 Recommendations to Improve the NZETS

We proposed a number of changes to the scheme which would have allowed the Government to balance the economic and environmental risks. The main measures included:

- Introducing a "safety valve": a mechanism which would ensure that the price of carbon did not fluctuate too widely, and did not exceed a level which would allow New Zealand producers to remain competitive. Such a safety valve is important as global carbon markets are still in their infancy, and the prices

they produce bear little relation to the marginal benefit of abatement. The safety valve would involve de-linking the New Zealand carbon market from international markets if the prices exceeded an acceptable level. For example, much of the analysis undertaken by the Government was based on a carbon price of around NZ$15, while current international prices are already more than double that. We argued that the Government needed to announce the acceptable price ceiling for the next five years in advance, to ensure certainty for investment planning

- Ensuring that protections for competitiveness at risk are only phased out as the countries with which New Zealand competes introduce the price of carbon into their economies. Moreover, it is important not to confuse compensation for loss of asset value which may arise if past investment becomes unviable as a result of the carbon price, and competitiveness at risk, which relates to new investment decisions and future growth. We argued that allocating permits solely on the basis of historic emissions would not provide adequate protection for competitiveness at risk, as it would fully expose new investments and growth opportunities to the price of carbon. Grandfathering only protects against undue loss of asset value. To protect against competitiveness at risk, it is important to base targets on emission intensity, thus building an allowance for growth into the scheme.
- Ensuring that compliance with Kyoto Protocol is only delegated to businesses and households where and when they are able to achieve compliance at a cost which would be no higher than the cost faced by the Crown.

3 Content of the Bill

You have now asked us whether the Bill addresses any of the problems identified in our earlier work. The answer could not be simpler: it does not. While considerable uncertainty remains because most of the detail is to be set out in regulations, it is clear that little thought is given to mechanisms to balance economic and environmental effects.

The overall thrust of the Bill is clear: the Crown wishes to transfer all risks associated with the implementation of climate change policy to businesses and households. The only nod in the opposite direction is relaxation of the penalty regime so that participants will not face full monetary penalties the first time they surrender units for an accidental shortfall (see clause 43, new section 175).

We comment on some aspects of the Bill in more detail below.

3.1 Controlling the Price of Carbon through a Safety Valve

On the face of it, the Government is able to issue as many NZUs as it wishes. This appears to reflect earlier statements by officials that provisions would be made for a possible safety valve of the type discussed in Australia. Under such a safety valve, the Government would feed in the units into the market to prevent the price from going above some acceptable limit.

However, we think that, in practice, there is no safety valve in the legislation. The logic of the safety valve is that it would allow the national market to be de-linked from the international market, if the effects of the prices set through international linkage become too damaging. The Bill does not allow the New Zealand market to be de-linked from the international market: new section 30E creates an automatic right to convert NZUs into

designated assigned amount units and to transfer them to international registries. In other words, if the Government tried to flood the market with NZUs to reduce their price below the international level, there would be an immediate outflow of designated AAUs from New Zealand, until the price equalised again.

To sum up, there is no mechanism in the legislation to allow the NZU price to differ from the international prices of approved units, and hence there is no effective safety valve.

3.2 Free Allocation

The process for the free allocation of units remains pretty open, but what is specified is quite problematic.

Our first concern is about the grounds for free allocation. Free allocation is only possible if companies suffer competitive effects as a result of:

- Carrying out industrial processes in 2005
- Directly using coal, gas or geothermal steam in 2005
- Directly consuming electricity in 2005.

It is odd that there is no possibility of recognition of competitiveness effects resulting from higher transportation costs (direct consumption of liquid fuels). It is not immediately obvious that competitive damage from electricity costs would be worse than competitive damage from higher transport costs.

There is also clearly no opportunity to provide free allocation to new entrants who were not operating in 2005.

It is also odd that the only protection available for competitive damage is free allocation of permits. Most of the businesses which are trade exposed and which may suffer as a result of directly using electricity will not be required to hold permits. To compensate them in the form of permits means that they would immediately need to sell those permits. In other words, they will receive compensation in kind, and will then need to sell permits to derive any value. In effect, this will promote speculative trading, which is exactly what the explanatory note tells us the Bill wants to avoid. More importantly, it will add to the risks faced by trade exposed firms, since the compensation they receive will be of uncertain value.

The focus on trade—exposed businesses is good, but the question is what evidence will be needed to demonstrate that the business will suffer from competition and inability to pass on price increases, and how the Government will respond to that evidence.

The process looks highly politicised and non-transparent. The Bill establishes a stakeholder consultation process to develop an allocation plan and specifies some principles to be applied (see clause 43, new sections 73—74), but then quite explicitly states that the Minister need not take any of the results of the consultation into account.

Finally, as the Bill currently stands, revenue from the sale of NZUs received as free allocation may be taxable. In other words, firms may face a tax wedge between the costs incurred and compensation received.

3.3 Compliance

The ETS adopts a self-assessment approach similar to that used for tax returns. Under the ETS participants will be subject to hefty penalties that may arise for failing to enter the scheme, or to comply with obligations.

Penalties under the proposed Bill include full compensation at market rates for any units that entities fail to surrender, plus heavy penalties which could double or triple an entity's liability.

In order to meet all of the requirements for compliance with the ETS, participants will be required to undertake a number of activities; including the need for firms to calculate their emissions liabilities for the purposes of filing their annual returns.

Cutting and pasting a taxation approach to compliance in order to account for firms' obligations under the ETS imposes an excessive burden on participants. The accounting rules used for tax compliance are pretty well understood (and even then, there are many compliance risks). By contrast, emissions accounting is rudimentary and highly uncertain. Heavy compliance penalties on businesses mean they will be very conservative in their reporting of emissions. In other words, the regime means that whenever there is doubt about the extent of emissions, assumptions must be made to the detriment of New Zealand businesses.

4 Conclusion

The Bill does not reflect the views expressed by the industry participants during consultations, and does not incorporate any of the mechanisms which would have allowed the Government to balance economic and environmental objectives in a sustainable way. If passed in the current form, the legislation will require substantial revisions and amendments over the next few years. The expectation that such amendments would occur will create uncertainty, and create unnecessary economic costs for New Zealand.