

# **Submission**

By



To the

## **Finance & Expenditure Committee**

On the

## **Climate Change (Emissions Trading and Renewable Preference) Bill**

**29 February 2008**

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**SUBMISSION BY BUSINESS NEW ZEALAND<sup>1</sup> ON THE CLIMATE CHANGE  
(EMISSIONS TRADING AND RENEWABLE PREFERENCE) BILL  
FEBRUARY 2008**

**1. INTRODUCTION**

- 1.1. Business New Zealand welcomes the opportunity to comment on the Climate Change (Emissions Trading and Renewable Preference) Bill [hereafter referred to as 'the Bill']
- 1.2. This submission has been kept short and simple because Business NZ is deeply involved in the establishment of the emissions trading scheme and we are aware that many technical aspects of the bill are under discussion. For this reason our submission offers comment about the more general nature of the bill and some alternative options for the Select Committee to consider.
- 1.3. Last year, Business NZ sponsored a comprehensive study into an emissions trading scheme, which recommends an emission trading market covering all sectors and gasses– post 2012 - as the best way to minimise greenhouse gas emissions in the long term.<sup>2</sup> The report recommends emissions trading should not be introduced before New Zealand's major trading partners and competitors.
- 1.4. Climate change is recognised by governments in developed and developing nations as one of the most serious threats to future generations. However, the Kyoto Protocol CP1 only involves 30% of global emissions and the target is to reduce those emissions to 5% below 1990 levels. It appears that even if this target was met it would have very little impact on climate change.
- 1.5. Because climate change is a global issue, it requires a global solution. Isolated efforts by individual countries are unlikely to achieve the required levels of reduction in greenhouse gas emissions. Until the United States and developing countries make a commitment to reduce their emissions, there is little possibility of achieving the target set by the Intergovernmental Panel on Climate Change (IPCC). This does not mean New Zealand should do nothing, but that we should be aware our efforts alone will not achieve very much in the global context.
- 1.6. It is generally accepted that a major initiative to help reduce greenhouse gas emissions is to place a price on carbon. For this to operate effectively a common global price of carbon is needed,

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<sup>1</sup> Background information about Business New Zealand is attached as Appendix 1

<sup>2</sup> NZIER report '*Emissions Trading Scheme for New Zealand*', March 2007, attached as Appendix 2

however this is not currently achievable because all countries in the world are not prepared to accept the constraints of Kyoto.

- 1.7. For any emissions trading scheme to work we anticipate the international price for carbon would be slightly higher than the lowest cost to abate one tonne of greenhouse gas. At this time, there is no international price for carbon and the level of Clean Development Mechanism (CDM) credits is insufficient to meet the needs of Annex One countries.
- 1.8. The emissions trading scheme proposed for New Zealand is comprehensive and will include all greenhouse gases and all sectors of the economy within a five year timeframe, commencing January 1, 2008. There is no other country in the world attempting this level of coverage in this time frame.
- 1.9. Business New Zealand supports emissions trading as the most cost effective way of establishing an international price for carbon and thereby reducing emission levels. However, we believe that being the first to introduce a comprehensive emissions trading scheme will put our economy at significant risk and could result in the loss of tens of thousands of jobs.
- 1.10. When launching the framework document in September 2007 the Government assured consumers and businesses that the international price for carbon would be in the region of NZ\$15/tonne and that the economic impact of introducing the scheme ahead of our trading partners would therefore be insignificant. The current EUETS price for carbon is NZ\$39.99 and the current secondary market price for CER's is NZ\$32.10. Government needs to reassess the economic cost of the emissions trading scheme in light of this real world price and inform the public accordingly.
- 1.11. Since the Bill was introduced into the House, a number of international studies have been carried out, indicating the cost to abate one tonne of greenhouse gas, between now and 2020, is likely to be between NZ\$112 and NZ\$170 if a 20% reduction in 1990 levels is to be achieved.<sup>3</sup>
- 1.12. It is noted that this level of reduction is at the low end of what scientists tell us is required to avoid serious harm to our global climate.

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<sup>3</sup> 'Climate Change: Everyone's Business' A report from the CBI climate change task force, November 2007

1.13. Recent economic studies carried out in New Zealand confirm that even if carbon was priced at NZ\$300/tonne, we would be unable to achieve the aspirational target proposed by our government for 2025.<sup>4</sup>

## 2. DESIGN OBJECTIVE

The Bill is intended to deliver on the following design objective:

*That the New Zealand Emissions Trading Scheme support and encourage global efforts to reduce greenhouse gas emissions by:*

- *reducing New Zealand's net emissions below business-as-usual levels; and*
- *complying with our international obligations, including our Kyoto Protocol obligations;*

*While maintaining economic flexibility, equity and environmental integrity at least cost in the long term.*

## 3. MAJOR DESIGN FEATURES

3.1. A number of world leading design features are included in the proposed emissions trading scheme. While Business NZ agrees that in a truly international trading scheme most of these features will deliver the desired results, there is serious concern that the economic cost of being a leader has not been properly analysed.

3.2. **Transfer of liability to consumers:** The Government's obligation in the Kyoto first commitment period is to reduce our internal emissions to our 1990 levels or to use the mechanisms available under Kyoto to secure carbon credits to offset the excess emissions quantity. On this basis, Treasury is charged with determining our level of liability by estimating the level of emissions each year from January 1, 2008 through to December 31, 2012 and comparing that with our 1990 levels. Based on an independent valuation of the cost of available carbon credits of NZ\$21, the total liability is determined. In December 2007 Treasury estimated the liability at just under NZ\$1 billion<sup>5</sup>. The

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<sup>4</sup> New Zealand Business Roundtable and Petroleum Exploration and Production Association of NZ: 'Carbon Mitigation Scenarios' – February 2008

<sup>5</sup> Calculation of the provision for the Kyoto liability

introduction of the proposed emissions trading scheme will progressively transfer this liability, and any future liability, to consumers. Initially due to the staged nature of the scheme, the taxpayer will be liable for some of the burden.

- 3.3. **Burden on liquid transport fuels sector:** The first sector to assume its share of the Kyoto liability will be the liquid transport fuels sector. Although the government liability under Kyoto is only for the difference between our current and our 1990 levels, the proposed emissions trading scheme makes the oil companies liable for the total emissions from every unit of liquid transport fuel. The burden for this sector is therefore far greater than that imposed by Kyoto. Other fuels will be placed in the same situation as they are progressively joined to the scheme. In addition, the Bill does not discriminate between liquid fuel used for transport and liquid fuel used as part of a process. This means industry will face the full cost of carbon with no protection, even if they can prove they have competitiveness at risk issues.
- 3.4. **Limited and partial protection for business:** Business NZ believes it is likely that all sectors of business will be adversely affected as carbon is priced into the New Zealand economy ahead of other countries, as every input into their business will be affected by increased energy costs. However, the methodology proposed to protect these businesses is limited and will provide partial protection only for a limited time as it is intended to phase out protection completely by 2025. As stated above, the Bill does not discriminate between liquid fossil fuels and similarly there is no protection offered for increases in the cost of liquid fossil fuels resulting from the introduction of a price for carbon. For example, this will impact on our largest fishing company, where 60% of their input costs are for diesel to power their fishing process. Similar impacts will be felt by other large companies with large energy costs.
- 3.5. **Narrow point of obligation:** On the basis of minimising administration costs to government and transaction costs to participants, it is proposed that the point of obligation for emissions will be as far upstream as possible. For example, in the liquid fuels sector, the five main oil companies will become the points of obligation with responsibility to surrender carbon credits for every tonne of greenhouse gases resulting from the use of liquid fuels. Currently there are few exceptions to this.
- 3.6. **International trade of credit units essential to maximise protection:** Unless there is significant advantage to becoming a point of obligation it is unlikely that even our large businesses will actively participate in the scheme, except for their industrial emissions.

However, most businesses that receive protection in the form of allocated New Zealand carbon credits will have to engage in carbon credit trading to ensure they maximise the level of financial protection on offer. To date, all credits issued by government under the now defunct Project to Reduce Emissions Scheme have been sold off-shore. For this to occur, New Zealand units are converted into Kyoto 'Assigned Amount Units' (AAU's) which can be traded internationally. This means a significant number of the AAU's issued to the government will find their way off-shore. We are already in a deficit position, given that our current emissions levels exceed our 1990 levels, and this will simply exacerbate the situation.

**3.7. Consumers will bear the ultimate cost of carbon as thermal generators pass on the increased costs resulting from their obligations:** Our electricity market is based on a generator pool where the marginal or last generator dispatched sets the spot price for electricity. The introduction of a price for carbon will see every unit of electricity attracting that spot price. It will not matter that a hydro generator is on the margin as they will have offered a price greater than the price of thermally generated electricity which will include a price for carbon. As hydro generators use the price of thermal generation to set their price for water, we are unlikely to see any reduction in thermal generation as a result of introducing a price for carbon. What we will see, however, is an additional cost to consumers of what we estimate to be about three times what it actually costs thermal generators to meet their obligations.

**3.8. Protection from international competitors likely to be inadequate:** Where companies are unable to pass on the increased costs resulting from the obligations of the NZETS, they will be exposed to unfair competition from similar businesses located in countries with no obligation or an internalised price for carbon. The Bill proposes to provide protection for these businesses by allocating carbon credits equivalent to 90% of their 2005 emissions, over a yet to be determined threshold level, phased out to zero between 2013 and 2025.

This level of protection is likely to prove inadequate for most businesses as it:

- excludes liquid fossil fuels used in manufacturing processes;
- will result in protection for less than 90% of 2005 levels for large businesses, dependant on the level of threshold adopted;
- will deny smaller businesses protection even if they are energy intensive and trade exposed;

- does not take account of the measures adopted by other countries when phasing out protection; and
- is likely to result in leakage as production is cut back in New Zealand and picked up in countries that have less stringent climate change policies.

**3.9. The lack of provision to protect new entrants and to protect growth in existing business will be detrimental to the New Zealand economy as a whole.** Trading schemes in other countries, in particular the EUETS, have new entrant allowances and accommodate growth in existing businesses. The aspirational goal of a low carbon economy (and in some cases carbon neutrality) for New Zealand will prove extremely difficult to achieve while retaining the government's target level of growth in GDP. In particular the fact that 50% of our greenhouse gas emissions are generated by the agricultural sector – a burgeoning export sector making a significant contribution to our GDP, with virtually no way to reduce its emissions levels in the medium term – will make it impossible to achieve a low carbon economy any time soon.

#### 4. COMMENTS

**4.1. Proposed design falls short of objectives:** Comparing the design features with the design objective it would appear that the proposed design falls short in a number of important areas and significant change will be needed in order to deliver on the design objective. It is extremely unlikely that an emissions trading scheme that does not reflect a truly international price for the abatement of green house gases will deliver a reduction in net emissions below business as usual.

**4.2. The scheme appears to have been designed to minimise government's liability during Kyoto CP1 to the extent that it actually makes the government revenue.** In so doing, we calculate it will impose an additional cost of NZ\$3.5 billion onto the economy while maintaining government's liability at NZ\$1 billion during CP1. As the phase out of protection commences in 2013 it becomes a revenue gathering mechanism which, by 2020, will be delivering NZ\$1 billion p.a. into the government coffers. There is no indication in the legislation of how this surplus will be recycled into the economy as was the case with the proposed carbon tax. It is hard to see under the circumstances how this will maintain economic flexibility, equity and environmental integrity at least cost in the long term in accordance with the design objective.

- 4.3. **Lack of long term economic flexibility:** Neither will the scheme, as designed, maintain economic flexibility at least cost in the long term when it adheres rigidly to 100% liability for all current and future emissions from fossil fuel, yet only offers protection to at risk businesses at somewhere less than 90% of their 2005 emission levels phasing out to zero by 2025. Energy intensive businesses would be much better protected by a scheme based on intensity measures.
- 4.4. **Insufficient analysis of economic costs:** To date the economic analysis undertaken by the designers of the scheme has failed to quantify the significant adjustment costs that will occur in specific sectors of the economy. Instead, equilibrium models have been relied on to demonstrate little economic impact to New Zealand over time. The latest modelling undertaken by Infometrics<sup>6</sup> confirmed a minimal impact on GDP but in so doing it assumed a 40% reduction in the level of our current dairy industry. It is difficult to comprehend that such a massive reduction in one of our fastest growing export sectors would not have significant economic impact in the long term. Infometrics are also predicting that with a NZ\$25/tonne price on carbon, 52,000 jobs will be lost as a result of introducing the NZETS. The higher the price of carbon, the greater the number of job losses.
- 4.5. **Renewable preference requirement a sign of no confidence in the ETS:** The fact this Bill has tagged on to it a renewable preference requirement in the form of a ten-year moratorium on building thermal generation is an indication of how poorly government thinks the emissions trading scheme will deliver on its design objective. To introduce a high cost market mechanism designed to promote the use of renewable energy sources over traditional fossil fuels and, at the same time, to regulate to ensure that renewable generation is built before thermal, is a sign that the government has no confidence in their emissions trading system delivering the desired outcomes.
- 4.6. **Short timeframe poses risk to economy:** As stated in the introduction, Business New Zealand supports the use of market mechanisms and believes that a properly designed emissions trading scheme would deliver on the design objective. However, we have continually expressed concern that Government is attempting to introduce a highly complex and as yet untested scheme in an extremely short timeframe. We believe this is being dictated more by politics than sound economics. Another point is that our major industrial companies have international owners and the opportunities they are being offered by our competitor nations to invest internationally and to relocate and grow offshore are such that we are

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<sup>6</sup> 'General Equilibrium Analysis of Options for Meeting New Zealand's International Emissions Obligations' Report prepared by Infometrics for 'Emissions Trading Group', October 2007

likely to see no further investment in New Zealand. This would be of major consequence to the health of the NZ economy and our communities. If the real outcome of the NZETS is to reduce our dairy industry by 40% and force large manufacturers to move the bulk of their production off-shore, we will be failing to deliver on our international obligations and in particular our Kyoto obligations.

#### **4.7. Land use issues:**

The current problems with deforestation of post 1989 forests and the slow down in planting of new forests result from the government's decision to use carbon absorption in trees to shelter emitting activities without compensating forest owners. This approach conflicted with what the industry understood to be government plans when they originally ratified the Kyoto Protocol. This change of position reduced the incentive to invest in forests and the problem was further exacerbated when the government indicated their intention to stop foresters from converting land to dairying or other uses by imposing a cost of carbon on deforestation during the first commitment period. This action infringed property rights and was the main cause of the large-scale deforestation of recent years.

The Bill goes some way to rectifying the problem for post-1989 forests. However, there is still a real problem with proposals in respect of other forests. The owners of the land on which pre-1990 forests stand who opt not to replant following harvest, but instead switch to another land use such as dairying, will be liable for the full cost of the emissions involved. This is a substantial penalty and reduces land use flexibility. Land-based industries are an extremely important part of the New Zealand economy. It is vital that they are able to continue to respond flexibly to changes in world prices, technological developments and competition for resources. Any attempt to erect a barrier to exit from forestry will deter people getting into it in the first place, which is also undesirable on environmental grounds. Moreover, what are in effect retrospective tax changes are bad policy, affecting domestic and international investors in New Zealand and Maori forest owners, and would send poor signals about New Zealand's investment climate.

The proposal to allocate 55 million tonnes of free carbon credits to be distributed among the pre 1990 forest owners is fraught with problems and would only be a partial solution. The optimal policy would be for agricultural emissions to face the full cost of carbon subject of course to any competitiveness at risk issues and to not impose any land use restrictions on land currently in forest. Any conversions of forest land to dairying or other uses would then be economically sensible as long as the cost of carbon was factored in.

The proposal to delay entry of the agricultural sector into the NZETS until 2013 will create issues with land availability for forestry as the land will retain its higher value while its cost of emissions is subsidised by the tax payer. This in effect will continue to constrain the level of new forest planting until post 2013. It would have been more sensible to have forestry and agriculture enter the NZETS at the same time.

## 5. RECOMMENDATIONS

Summary of Business NZ's recommendations:

- Ensure sufficient carbon credits are allocated to ensure 100 per cent protection in initial years.
- Introduction of the NZETS should not impose any more cost on the economy than that estimated by Treasury.
- Use a progressive obligation methodology in the liquid fossil fuel sector to ensure sectoral liability matches the government's Kyoto liability.
- Separate identification and protection for liquid fossil fuels used for heat generation and propelling machinery.
- Point of obligation selected to deliver emission reductions
- Introduce a one-way trade system with a safety valve to minimise overall cost to the economy.
- Revert back to the dispatch system used by ECNZ to minimise fuel burn in electricity generation.
- Allow technical groups to complete their analysis and report back through the leadership forum.
- Slow the passage of this legislation to allow more detail to be incorporated before it is reported back to the House.

### 5.1. **Ensure sufficient carbon credits are allocated to ensure 100 per cent protection in initial years.**

While it is important for New Zealand to position itself alongside its main trading partners, there is no justification for imposing costs on our manufacturing and production sectors when no other country is imposing such costs on theirs. This issue can be handled by ensuring that sufficient carbon credits are allocated to ensure 100% protection in the initial years. To achieve the proposed allocation of credits up to 90% of 2005 emission levels would require to be amended to provide full protection against all increased costs including liquid fossil fuels.

### 5.2. **Introduction of the NZETS should not impose any more cost on the economy than that estimated by Treasury.**

The cost to the economy is calculated regularly by Treasury and currently sits at around NZ\$1 billion. The introduction of the NZETS

should not impose any more cost on the economy than that estimated by Treasury. To achieve that the proposed NZETS should initially only allow credits to be purchased off-shore and there should be a safety valve capping the cost of credits at the price calculated by Treasury. This could change as we reached bilateral agreements with other countries to link our trading system.

**5.3. Use a progressive obligation methodology in the liquid fossil fuel sector to ensure the sectoral liability matched the government's Kyoto liability.**

While it is understood that where a supplier can pass on costs to consumers there is no justification for allocating carbon credits, the cost difference between the government's Kyoto liability and the cost to consumers in the liquid fossil fuel sector will be disproportionate. It would seem appropriate in the liquid fossil fuel sector to use a progressive obligation methodology to ensure the sectoral liability matched the government's Kyoto liability.

**5.4. Separate identification and protection for liquid fossil fuels used for heat generation and propelling machinery.**

It has been assumed that all liquid fossil fuels are used for transport. Liquid fossil fuels used for heat generation or for propelling machinery as part of a process should be identified separately and protection provided where required.

**5.5. Point of obligation selected to deliver emission reductions.**

Administration costs for the NZETS should be minimal as it is a self reporting electronic system. It has been proposed however, that to minimise administrative costs for government, the point of obligation should be as far up the supply chain as possible. The only exception in the liquid fossil fuel sector is airlines that may opt to become the point of obligation rather than an oil company. This ignores the other very large users of liquid fossil fuels like fishing and mining companies and it is difficult to see why they should not be allowed to opt in should they choose to. It really depends on what the NZETS is designed to achieve. If it is intended to result in a reduction in emissions then the point of obligation should be the party with the greatest incentive to reduce consumption. It is unlikely that the fuel supply company would meet those criteria.

**5.6. Introduce a one-way trade system with a safety valve to minimise overall cost to the economy.**

The proposed method of protection offered to businesses who are trade exposed as a result of the introduction of a price for carbon is to issue them with carbon credits equivalent to 90% of their 2005 emission levels for all industrial process emissions, electricity and

direct fuel use with the exception of liquid fossil fuels. These companies will need to engage traders to operate on their behalf or establish in-house trading expertise in order to maximise the value of the carbon credits that are issued. As outlined earlier, if the NZETS was a one way trade system with a safety valve the process would be greatly simplified and overall cost to the economy would be minimised.

**5.7. Revert back to the dispatch system used by ECNZ to minimise fuel burn.**

Our electricity market presents specific problems for New Zealand and without reform it will be unlikely to deliver the desired change in balance between renewable and thermal generation. Given that, in the main, thermal generators provide base load and hydro generators provide peaking, there is little or no discrimination on price and very little possibility of thermal generation being displaced in the merit order. One option would be to revert back to the dispatch system used by ECNZ to minimise fuel burn. This would see a significant change in the way the electricity market operated by ensuring the lowest fuel/operating cost generators were dispatched first and should produce a greater level of emission reductions.

**5.8. Allow technical groups to complete their analysis and report back through the leadership forum.**

Business New Zealand recognises the vast opportunities for business as the international market moves to tackle the global issue of climate change. However, it also recognises that without a strong economy it will be difficult for a country the size of New Zealand to capitalise on these opportunities. If New Zealand extends too far in its desire to be a world leader we will fail to gain any advantage from the vast array of opportunities. We recommend caution when considering the technical details of this Bill and suggest that the various technical groups already established be allowed to complete their analysis and report back through the leadership forum, who in turn will inform the Minister, before this Bill is reported back to the House.

**5.9. Slow the passage of this legislation to allow more detail to be incorporated before it is reported back to the House.**

There is concern at the extent to which regulation will be required to enable this legislation. The Legislation Advisory Committee recommend that as much detail as possible is included in the legislation and as little as possible in regulation. The haste with which this legislation is being introduced will preclude this approach being adopted and we therefore recommend that the passage of this legislation be slowed to allow more detail to be incorporated before it is reported back to the House

## **6. ALTERNATIVE APPROACHES**

- 6.1. The NZETS is not a cap and trade scheme in the true sense as it relies on a global cap under which it can trade. This allows a country and a business, which is increasing its levels of emissions, to meet its obligations by purchasing carbon credits from a country or a business that has reduced its emissions below the level of its assigned amount. The assigned amounts set the global cap and it is that cap which must be reduced if the most serious consequences of climate change are to be avoided. It is inappropriate therefore to consider that in some way the scheme will cap our emissions. It will not, it will simply cost more to maintain business as usual levels of emissions over time. There is no reason not to adopt an intensity based measure for energy intensive businesses as this clearly defines the most efficient producers. If the global cap is to be achieved, production should be moved to the most efficient plant and although the emissions for that plant increase, closure of a less efficient installation reduces global emissions.
- 6.2. The intent of the Bill is to offer protection to a business that meets a threshold limit of emissions but which does not have to become the point of obligation. Removing the need for a threshold to determine who is eligible for protection would not create the administrative problems envisaged, as long as a business receiving protection also had to become the point of obligation, as a company would only be interested in opting in if it made economic sense to do so.

## **APPENDIX 1**

### **BACKGROUND INFORMATION ON BUSINESS NEW ZEALAND**

Business New Zealand is New Zealand's largest business advocacy organisation.

Through its four founding member organisations – EMA Northern, EMA Central, Canterbury Employers' Chamber of Commerce and the Otago-Southland Employers' Association – and 70 affiliated trade and industry associations, Business NZ represents the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

In addition to advocacy on behalf of enterprise, Business NZ contributes to Governmental and tripartite working parties and international bodies including the International Labour Organisation, the International Organisation of Employers and the Business and Industry Advisory Council to the Organisation for Economic Cooperation and Development.

## APPENDIX 2