

Submission to the Finance and Expenditure Select Committee on the Climate Change Response (Moderated Emissions Trading) Amendment Bill

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1. Introduction

1.1 Thank you for the opportunity to make a submission on the Climate Change Response (Moderated Emissions Trading) Amendment Bill. If the opportunity is available, I wish to appear before the committee to speak to this submission.

1.2 I am a consultant who has worked on climate change and energy policy issues for the Ministry for the Environment, the Victoria University Institute of Policy Studies and Ministers of the Crown. I am currently employed by Kapiti Coast District Council. This submission represents my views and not those of the Council.

1.3 I oppose this Bill. My primary concern is with the proposal to allocate free units to industry and agriculture on an uncapped intensity basis, and with the slow 1.3% per annum “phase-out” of this free allocation. This proposal is analysed in some detail in this submission, with the finding that it could lead to an increase in subsidy of \$105 billion to polluting industries out to 2050.

1.4 This analysis is an estimate only. The government has not released officials’ analysis of the expected number of units that would be allocated for free under the Bill’s methodology, so the figures in this submission are inferred from the little data that is available. As part of its considerations of this Bill, I urge the Committee to request from officials:

- projections of the number of units expected to be allocated for free to industry and agriculture out to 2050 under low, medium and high scenarios
- projections for the fiscal costs of these free allocations under low, medium and high scenarios
- information on how significant new entrant activity such as expanded Methanex production, a coal to urea plant, or a coal to liquid fuels plant would change these estimates
- information on how the number of units allocated is likely to compare to New Zealand’s international allocation of units under Kyoto or successor agreements.

1.5 As a secondary issue, I also oppose the transition period price cap and “2 for 1” policy. These measures simply shift the cost of emissions from fuel bills to taxpayers, so do not result in any real savings for consumers.

1.6 I also oppose the further delay in introduction of the agriculture sector, as it further shifts costs onto taxpayers.

1.7 I support the inclusion of an emissions target in legislation. However the target will not be effective unless it drives decisions on allocation within the ETS. I submit that as part of each five yearly review of the legislation, there should be a requirement that the level of free allocation of units be set to give effect to achieving the stated emissions reduction target.

1.8 I also seek the following changes which are not part of the current Bill:

- To ensure that the scheme is fiscally neutral, include a requirement that any ETS revenue be recycled to
 - compensate consumers and small businesses for the increased costs they face
 - assist with adjustment to a low carbon future, and
 - fund climate change adaptation work.
- I support the Parliamentary Commissioner for the Environment's call for the full and transparent publication by the Auditor General of the number and value of all allocations (free or otherwise) distributed under the scheme.

2. Analysis of Issues Surrounding Free Allocation of Units

2.1 The government has stated that its intention with this Bill is to create an emissions trading scheme that is fiscally neutral, consistent with a "50 by 50" target, and aligned with Australia's proposed CPRS. I submit that the current proposal for an uncapped intensity-based allocation does not achieve these objectives satisfactorily, as will be analysed below.

Fiscal Neutrality

2.2 Under the existing legislation, free allocation of units to industry and agriculture phases out between 2018 and 2030, leaving the government with surplus units that it will be able to sell. This is shown in Figure 1 below. Treasury's mid-range estimate¹ is that the resulting revenue could be \$21 billion total to 2030.

¹ MfE/Treasury 09-B-003 63: Joint ETG Report: Emissions Trading Scheme Legislative Review: Fiscal Neutrality, <http://www.mfe.govt.nz/cabinet-papers/09-b-00363.pdf>

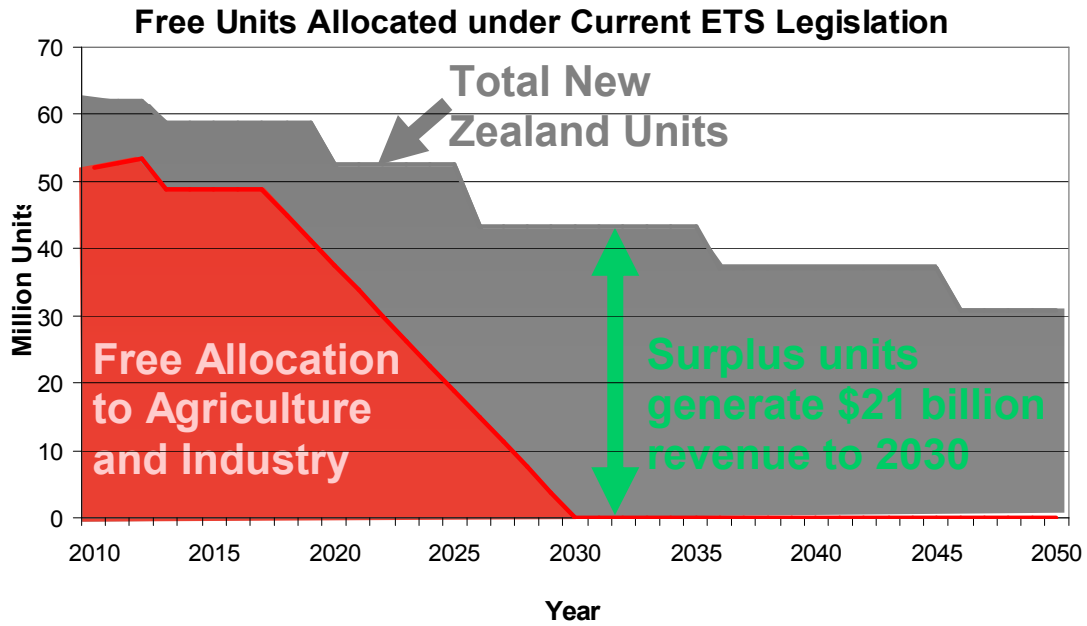


Figure 1. In the existing legislation, free allocation phases out by 2030 leaving the government with surplus units to sell².

2.3 In my view it is a significant flaw of the current ETS that it does not specify how this revenue should be directed. This has led to valid concerns that the government will pocket these funds rather than returning them to taxpayers and consumers or using them for climate change purposes. This concern has been echoed by the Prime Minister and government Ministers:

“ It should be fiscally neutral rather than providing billions of dollars in windfall gains to the government accounts at the expense of businesses and consumers. National does not think it's responsible for government to use green initiatives to pad the Crown coffers while thinning out Kiwis' wallets.”
 (John Key “National won't cut corners on ETS at kiwis' expense” 18 May 2008)

2.4 The question then is how this excess revenue should be directed to achieve fiscal neutrality: should there be further subsidies for industry and agriculture? Should it be returned directly to consumers and taxpayers? Should it fund climate change adaptation work?

2.5 With this Bill, the government has chosen to allocate 100% of the surplus units as increased free subsidies to industry and agriculture. To 2030, this amounts to a \$21 billion wealth transfer from taxpayers to these subsidised sectors. After 2030, the scheme is not fiscally neutral but is in deficit: the government would have to purchase units offshore to maintain the level of subsidy specified in the Bill. This is shown in Figure 2 below, where the blue line has been derived directly from the fiscal costs table in the

² Treasury's mid-range estimate of total units available runs to 2030. I have extrapolated this assuming a “50 by 50” target.

explanatory note to the Bill to 2030, then extrapolated linearly to 2050 (See Appendix A for further details on this analysis).

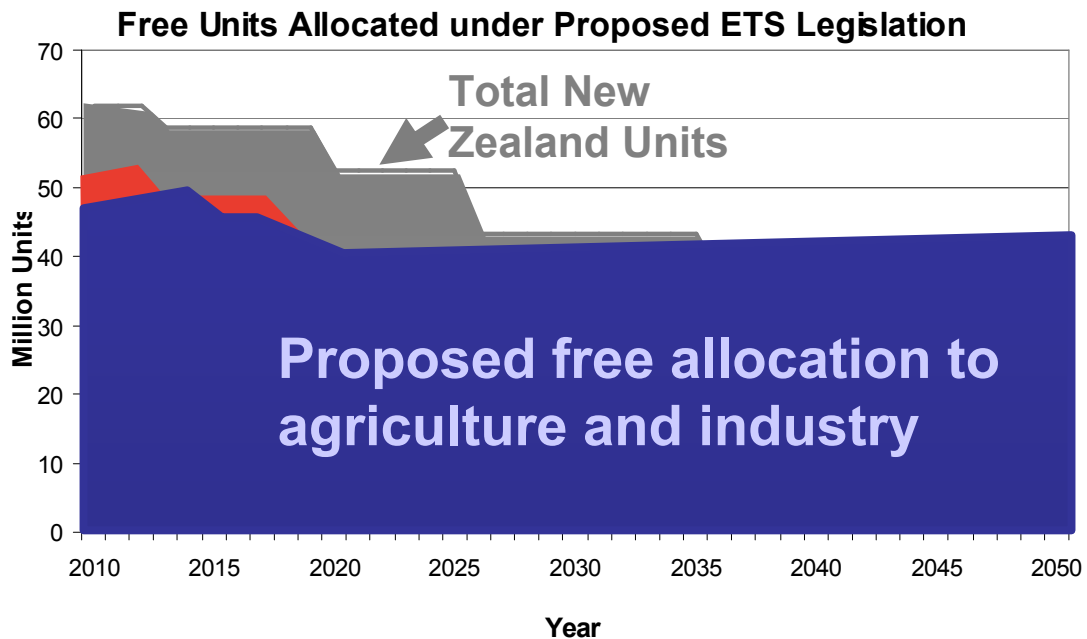


Figure 2. The proposed uncapped intensity-based allocation of units is expected to mean that no surplus units are available to 2030. This amounts to a \$21 billion wealth transfer from taxpayers to polluting sectors. After 2030, the government would need to purchase units offshore to continue funding the subsidy.

2.6 You may wonder why the blue line in Figure 2 is increasing, when the subsidy level in the Bill supposedly “phases out” at 1.3% per annum. This is because the Bill proposes an intensity-based approach to allocation. If industry output increases faster than 1.3% per annum, the total number of units allocated will increase, not decrease with time. In calculating the fiscal costs presented in the Bill’s explanatory note, government officials must have assumed an increasing level of free allocation. These assumptions have not been released publicly by the government.

2.7 Note that the blue line assumes that the “phase-out” rate remains unchanged at 1.3% per annum. To 2030 this is officials’ assumption, not mine, as the line is derived from the fiscal costs in the explanatory note. The government’s own graph presenting the Bill (Appendix A, Figure A1) shows the 1.3% rate continuing to 2050 and claims that this is consistent with a “50 by 50” target. It is therefore reasonable to extrapolate the line to 2050 assuming that the allocation parameters remain unchanged.

2.8 Figure 3 breaks this allocation down into the free allocations expected to be provided to Agriculture and Industry, again by directly translating the fiscal costs from the Bill’s explanatory note into numbers of units. From this, it is clear that it is subsidy to agriculture, not industry, that is the dominant factor.

Free Units Allocated to Industry and Agriculture

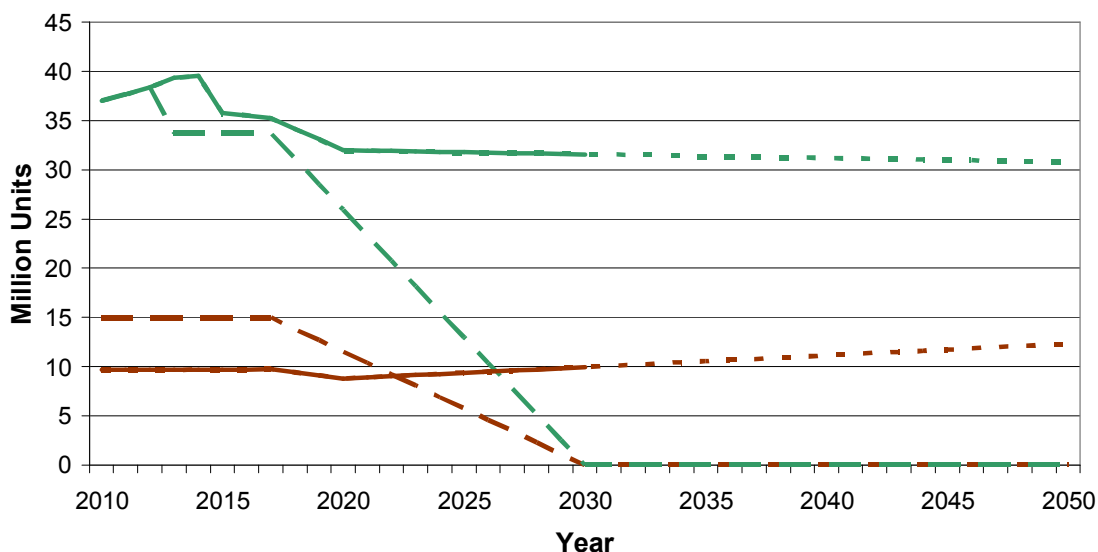


Figure 3. Free allocations under current (dashed) and proposed (solid) legislation for the agriculture (green) and industry (brown) sectors.

2.9 The cost of the total subsidy from 2010 to 2050 is shown in Figure 4, where the number of free units has been multiplied by Treasury’s mid-range estimate³ for the carbon price. Because the carbon price is expected to increase with time, long-term free allocation becomes increasingly costly.

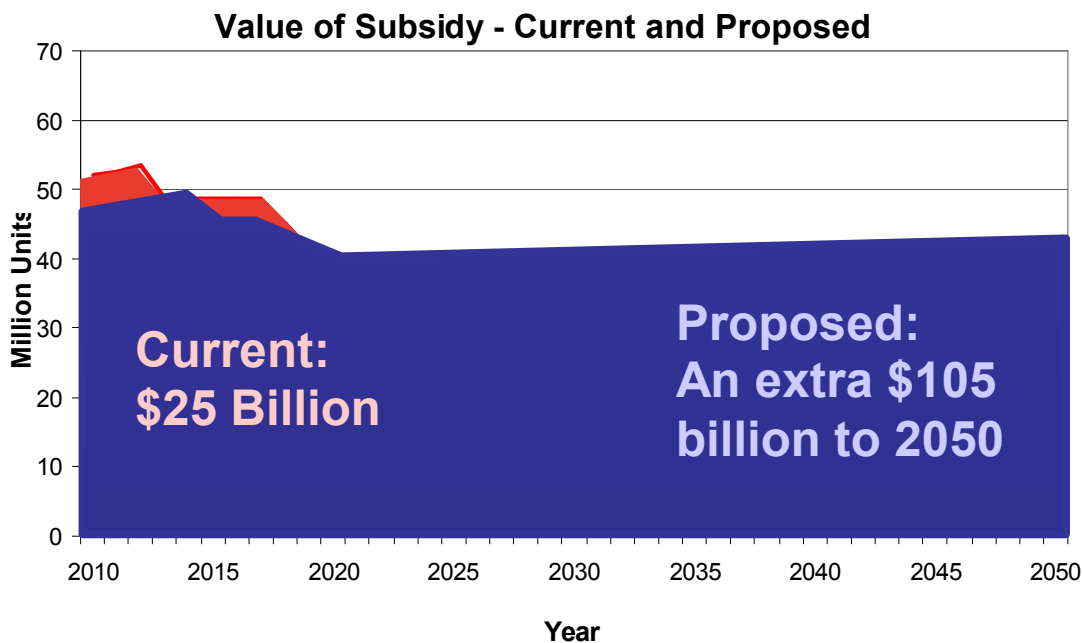


Figure 4. The Bill proposes to increase free allocation to industry and agriculture from around \$25 billion to around \$130 billion cumulative to 2050.

³ MfE/Treasury 09-B-003 63: Joint ETG Report: Emissions Trading Scheme Legislative Review: Fiscal Neutrality, <http://www.mfe.govt.nz/cabinet-papers/09-b-00363.pdf>

2.10 Clearly, this level of subsidy is fiscally unsustainable in the long term. If the Bill is passed as drafted, future governments will be forced to radically reduce the level of subsidy to keep the scheme viable.

2.11 Leaving it to future governments to amend the scheme on an ad-hoc basis creates enormous uncertainty for long-term investors. It would be better to put in place a framework now that sets the principles for how allocations will be determined in future. I submit that any free allocation should

- be capped, to limit emissions and limit the risk to the taxpayer;
- be linked to New Zealand's international allocation of units under Kyoto or successor agreements, to ensure fiscal neutrality. If New Zealand's international allocation falls, the cap on subsidy to industry must fall in line with this; and
- reduce to zero over a reasonable timeframe.

2.12 I also believe that is unfair and untenable for 100% of ETS revenue to be directed solely to polluting industries. I submit that the Bill should require a proportion of units (say 20%) be reserved for auctioning, with proceeds used to:

- compensate consumers and small businesses for the increased costs they face
- assist with adjustment to a low carbon future, and
- fund climate change adaptation work.

2.13 To ensure that the scheme is fiscally neutral, the Bill should also include a new section that requires that any ETS revenue be recycled for these purposes.

Consistency with "50 by 50" target

2.14 Returning to Figure 2, the grey area shows the total number of units that would be available if New Zealand's international target reduced to 50% of 1990 levels (31 million tonnes) by 2050. Clearly, subsidising industry to emit for free at a higher level than this is not consistent with the target!

2.15 From Figure 2, approximately 110 Million units would need to be purchased between 2035 and 2050 under the proposed allocation. At Treasury's mid-range carbon price of \$100/tonne, the cost of this international purchasing to 2050 would be around \$11 billion.

2.16 So what does it mean for the subsidy to be "consistent" with a 50 by 50 target? The most obvious interpretation is that the subsidy should be reduced to a level that achieves 50% emissions reductions. This implies a complete phase-out of free allocation. I submit that a phase-out of subsidies to zero by 2030 is the best way of being consistent with a "50 by 50" target.

2.17 A much less stringent but still plausible interpretation is that the level of subsidy should decrease by 50% (in absolute terms), so that polluters are responsible for any emission above target levels. In this case the subsidy to polluters phases out at the same rate as New Zealand's total allocation. I do not support this approach, but if the Committee is looking for compromises between the current legislation and the Bill, it could be considered.⁴

Alignment with the Australian CPRS

2.18 It seems odd to be attempting to align New Zealand's legislation with an Australian scheme that has not yet been passed. As Treasury comments in the explanatory note to the Bill:

"there is no discussion of the risks of harmonising with an overseas scheme that has not yet been finalised or agreed and may yet be subject to significant revision. Such risks may include the potential impacts on business certainty and investment decisions, and the overall credibility, sustainability and effectiveness of the NZ ETS."

2.19 However even if we assume that the current Australian proposal will remain unchanged, the Bill fails to align with many important aspects of the Australian scheme because it cannot – our profile of emissions does not allow us to simply adopt the Australian approach. For example, government officials advise that:

At 30% of the total number of permits available, the CPRS would see a much smaller proportion of Australia's permits freely allocated. With agriculture excluded that figure would be 20%.

In contrast, we estimate that under the NZ ETS in 2013 the free allocation to the industry and agriculture sectors would be equal to about 79 per cent of our Kyoto assigned amount (assuming it was the same as in CP1).

(Emissions Trading Group paper 'Australian Carbon Pollution Reduction Scheme Green Paper – Proposed Approach on Allocation' 21 July 2008 Treasury:1129662v1)

2.20 Only a small proportion of units are allocated for free in the Australian scheme. They propose to auction \$11.5 billion of units, instead of these being allocated for free to polluting industries. All revenue raised will be used to help households and business adjust to the scheme, including through:

- Benefit and pension increases, including upfront indexation
- Increased family tax credits
- Low-income tax changes

2.21 This assistance is expected to fully meet the expected increase in the cost of living for low-income Australian households.

⁴ This is curve (b) of Figure 4.

2.22 Contrasting this with the New Zealand approach, the proposed Bill allocates 100% of New Zealand's units to support industry and agriculture, there is nothing left to support consumers. The government has chosen to align with those aspects of the Australian scheme that support polluting industry, and ignore those aspects that support households and small businesses. This is grossly inequitable.

2.23 I submit that the Bill should require a proportion of units (say 20%) be reserved for auctioning, as is the case in the Australian scheme, with proceeds used to:

- compensate consumers and small businesses for the increased costs they face
- assist with adjustment to a low carbon future, and
- fund climate change adaptation work.

2.24 To ensure that the scheme is fiscally neutral, the Bill should include a new section that requires that any ETS revenue be recycled for these purposes.

Conclusion

2.25 The proposal in the Bill for an uncapped intensity-based free allocation to industry and agriculture phasing out at 1.3% is:

- not fiscally neutral in the long term, as the number of units given out for free exceeds New Zealand's total number of units available;
- unaffordable, creating an additional wealth transfer from taxpayers to polluters of \$21 billion to 2030 and \$105 billion to 2050;
- inequitable, with 100% of ETS revenue used to subsidise polluters rather than providing transition assistance to consumers and small business;
- inconsistent with reducing emissions, as the number of free permits allocated is expected to increase not decrease with time; and
- unable to fund essential climate change adaptation work, as there is no revenue generated.

3. A Compromise Way Forward ?

3.1 To provide certainty for the long term, I believe that it is important to articulate now, in legislation, the principles that will guide allocation of permits under the ETS into the future. These principles should be that

- if free allocation is to be on an intensity basis, it must be within a capped pool of units.

- The cap will initially be set at around 80% of New Zealand's Kyoto allocation (i.e. around the same level of allocation as expected in the Bill).
- The cap will decline at least in line with New Zealand's Kyoto (or successor agreement) allocation, to ensure fiscal neutrality.
- Free allocation will reduce to zero over a reasonable timeframe.
- A proportion of units should be set aside to provide ongoing support for consumers and small business, rather than allocating 100% to industry and agriculture.

3.2 I believe that the \$25 billion of subsidy provided in the existing legislation is sufficient, so free allocation should phase out by 2030 as at present.

3.3 However if the Committee is looking for potential compromises between the existing legislation (\$25 billion subsidy to 2050) and the proposal in the Bill (\$130 billion subsidy to 2050), the following could be considered:

OPTION A: Free allocation within a cap, starting at 80% of New Zealand's Kyoto allocation to 2018, then phasing out to zero by 2050 rather than by 2030. I estimate that this would roughly increase the total subsidy to industry and agriculture from \$25 billion to \$41 billion by 2030, and \$25 billion to \$68 billion by 2050. This option is shown in green in Figure 5 below.

OPTION B: Free allocation within a cap, with the cap fixed at 80% of New Zealand's Kyoto allocation. The cap declines with New Zealand's international allocation, but there is no phase-out to zero. I estimate that this would roughly increase the total subsidy to industry and agriculture from \$25 billion to \$44 billion by 2030, and \$25 billion to \$103 billion by 2050. This option is shown in yellow in Figure 5 below.

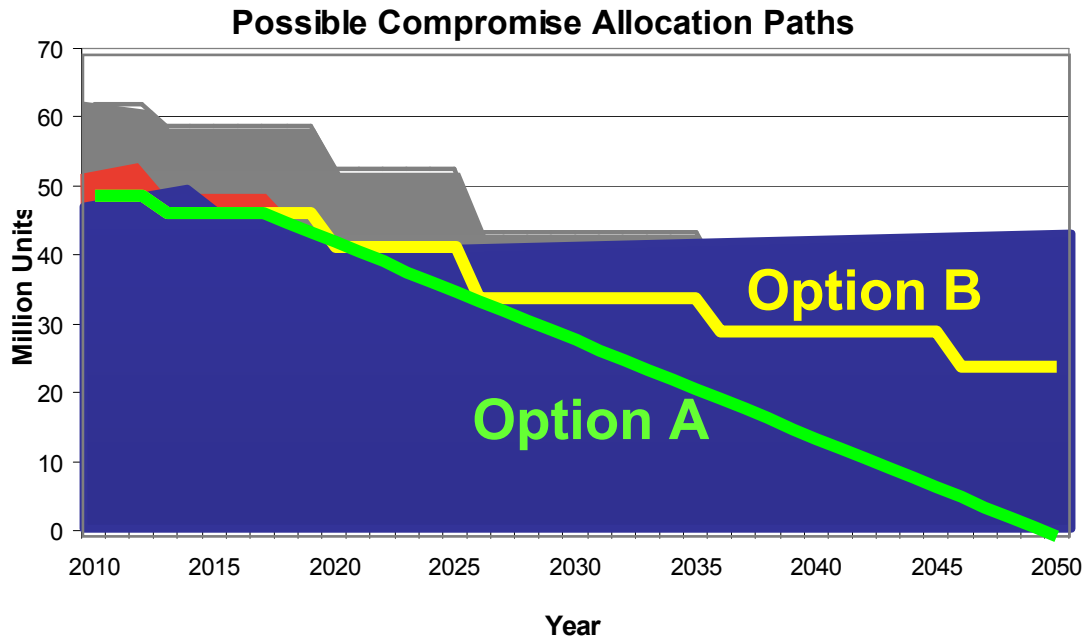


Figure 5. While I submit that free allocation should phase out by 2030, the Committee may wish to consider compromise paths A or B.

4. Summary of Submission

I submit that :

With regard to the Committee's deliberations

4.1 The Committee should request from officials:

- projections of the number of units expected to be allocated for free to industry and agriculture out to 2050 under low, medium and high scenarios
- projections for the fiscal costs of these free allocations under low, medium and high scenarios
- information on how significant new entrant activity such as expanded Methanex production, a coal to urea plant, or a coal to liquid fuels plant would change these estimates
- information on how the number of units allocated is likely to compare to New Zealand's international allocation of units under Kyoto or successor agreements.

With regard to allocation of units

4.2 A proportion of units (say 20%) should be set aside to be auctioned to provide ongoing support for consumers and small business, rather than allocating 100% of units to industry and agriculture.

4.3 If free allocation is to be on an intensity basis, it must be within a capped pool of units.

4.4 The cap should initially be set at around 80% of New Zealand's Kyoto allocation (i.e. around the same level of allocation as expected in the Bill), and phase out to zero by 2030.

4.5 If the Committee wishes to consider a higher level of subsidy than this or a longer timeframe for phase-out, then the cap must at least decline in line with New Zealand's Kyoto (or successor agreement) allocation, to avoid the scheme being in deficit. Two such potential paths are shown in Figure 5.

4.6 The Committee should support the Parliamentary Commissioner for the Environment's call for the full and transparent publication by the Auditor General of the number and value of all allocations (free or otherwise) distributed under the scheme.

4.7 To ensure that the scheme remains fiscally neutral as free allocation to industry and agriculture phases out, include a requirement that any ETS revenue generated be recycled to

- compensate consumers and small businesses for the increased costs they face
- assist with adjustment to a low carbon future, and
- fund climate change adaptation work.

Other Issues

4.8 The transition period price cap and "2 for 1" policy should be removed from the Bill. These measures simply shift the cost of emissions from fuel bills to taxpayers, so do not result in any real savings for consumers.

4.9 Further delay in introduction of the agriculture sector is unnecessary and shifts costs onto taxpayers. The date for entry of agriculture should remain at 2013.

4.10 Provisions relating to setting an emissions target by regulation should be strengthened. As part of each five yearly review of the legislation, there should be a requirement that the level of free allocation of units be set to give effect to achieving the stated emissions reduction target.

Appendix A – Further Details of Costs Analysis

- A1 The explanatory note to the Bill presents a table of fiscal costs to 2030 compared to the current legislation. These can be divided by the carbon price provided (\$25 to Dec 2012, \$50 thereafter) to create a table of how many units are allocated compared to the present legislation.
- A2 For example the current legislation's industry allocation is expected to be around 15MT phasing out to zero⁵. From the table, the new legislation is 3 to 7 MT lower in 2013, and 8 to 12 MT higher than this in 2030. That is, total allocation to industry is expected to be 8-12MT in both 2013 and 2030. The graphs in this submission show the midpoint of this range.
- A3 For agriculture, values relating to the existing ETS are simpler to find: 2008-2012 emissions are available in MfE's 2009 Net Projection report, and 2005 emissions (which set the subsidy level) are included in the latest inventory report.
- A4 The resulting lines to 2030 were then extrapolated linearly to 2050. Effectively, this is an assumption that the allocation parameters (such as the 1.3% "phaseout" do not change. The government's publicity material in relation to this Bill (Figure A1(a) below) shows a 1.3% phaseout continuing to 2050, so clearly this is a reasonable assumption.
- A5 To obtain costs, the numbers of units were then multiplied by a carbon price. I have used Treasury's mid-range scenario⁶ which is for a carbon price of \$25 to 2012, \$30 to 2019, \$50 to 2026, and \$100 thereafter.
- A6 The explanatory note uses a different carbon price: \$25 to 2012 and \$50 thereafter. If these carbon prices are used (with the additional assumption that the price goes to \$100 from 2030) the results are similar: the total subsidy to 2050 calculated is \$96 billion rather than \$103 billion. I have used the Treasury carbon price scenario for internal consistency, as this is the one that was used to provide the much-quoted "\$21 billion" surplus figure shown in Figure 1.

⁵ Officials advice to the Finance and Expenditure Committee, 30 May 2008

⁶ fMfE/Treasury 09-B-003 63: Joint ETG Report: Emissions Trading Scheme Legislative Review: Fiscal Neutrality, <http://www.mfe.govt.nz/cabinet-papers/09-b-00363.pdf>

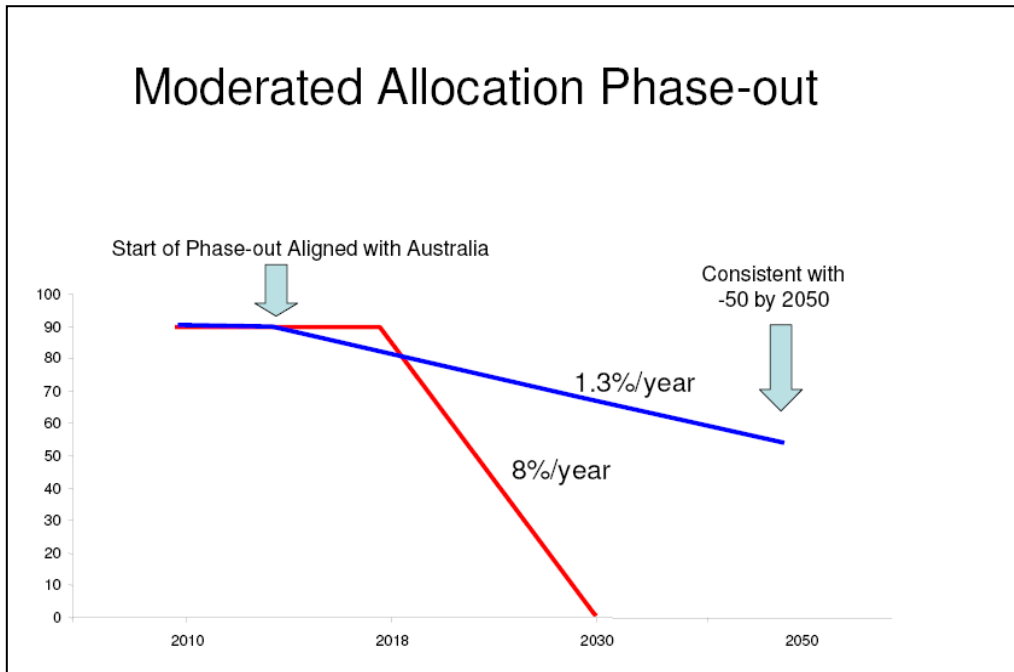


Figure A1 (a) Graph presented by the government to explain the difference in allocation between the existing (red) and proposed (blue) legislation. This graph plots two quite different quantities on the same axis, so is comparing apples with oranges. A like for like comparison is shown in (b) below. Also note that the time axis is skewed so that the graph under-represents later time periods.

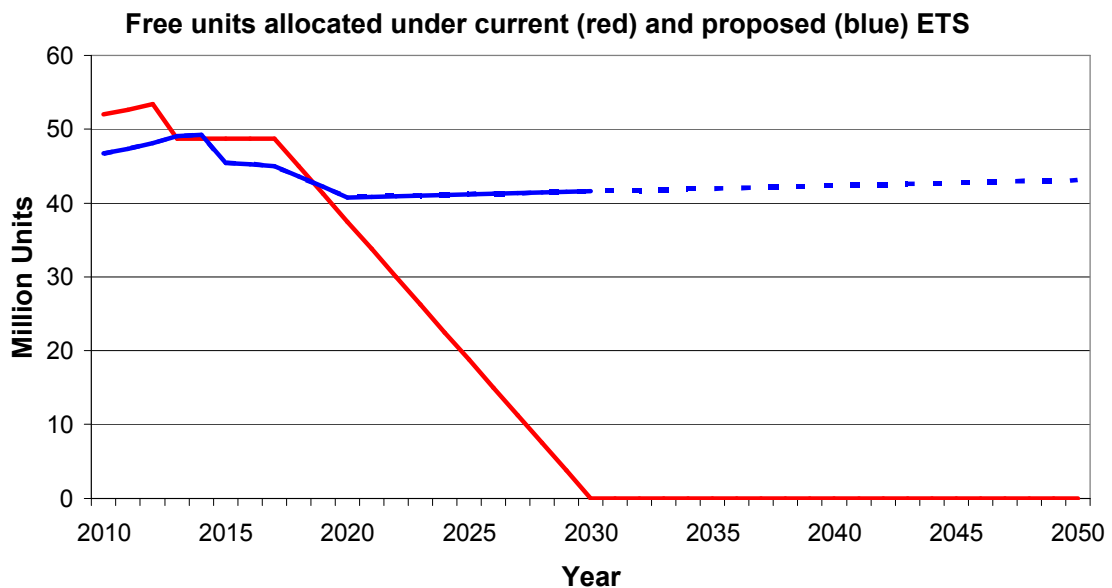


Figure A1 (b) Graph derived from the Bill's explanatory note showing a like for like comparison of the difference in allocation between the existing (red) and proposed (blue) legislation. This graph plots the same quantity for each: the absolute number of units allocated to industry and agriculture. Note that actual levels of allocation go up, not down with time under the Bill's proposal.