Climate Change (Emissions Trading and Renewable Preference) Bill

187—1

Interim report of the Finance and Expenditure Committee

Contents

Recommendation	2
Background	2
Deferral of liquid transport fuels and phasing-out of free allocations	2
Entry of synthetic greenhouse gases	3
Minority view of the National Party	3
Appendix A	4
Appendix B	5

Climate Change (Emissions Trading and Renewable Preference) Bill

Recommendation

The Finance and Expenditure Committee is considering the Climate Change (Emissions Trading and Renewable Preference) Bill, including the entry date for transport fossil fuels to the scheme, the phasing-out of free credits for trade-exposed industry and agriculture, and the inclusion of hydrofluorocarbons (HFCs) in the New Zealand Emissions Trading Scheme, and recommends that the House take note of its interim report.

Background

The Climate Change (Emissions Trading and Renewable Preference) Bill would introduce a greenhouse gas emissions trading scheme in New Zealand. The scheme would include virtually all greenhouse gases (one example of an exception is coal seam methane) and all sectors: forestry, liquid fossil fuels, stationary energy, industrial processes, agriculture and waste. The bill also seeks to create a preference for renewable electricity generation by means of a moratorium on new fossil-fuelled thermal electricity generation, except to the extent necessary to ensure the security of New Zealand's electricity supply. Both parts of the bill are intended to enable New Zealand to meet its obligations under the Kyoto Protocol.

The bill, as introduced, proposes to phase in in stages the entry of all sectors to the scheme from 1 January 2008 to 1 January 2013. Liquid fossil fuels are currently due to enter the emissions trading scheme on 1 January 2009. The bill also proposes to provide assistance to trade-exposed industries and agriculture by allocating free New Zealand units. The free allocation is proposed to be phased out from 2013 to 2025.

The bill proposes to phase in the entry of gases and industrial sectors to the scheme from 1 January 2009 to 1 January 2013. It proposes the entry of hydrofluorocarbons into the emissions trading scheme on 1 January 2010, in the industrial processes sector. HFCs are potent synthetic greenhouse gases used primarily in the refrigeration and air conditioning, aerosol, foam-blowing, and fire protection industries.

Deferral of liquid transport fuels and phasing-out of free allocations

The Prime Minister has announced two changes in Government thinking on the bill. The Minister Responsible for Climate Change Issues informed us that the Government now wishes to defer the introduction of liquid transport fuels into the scheme from 1 January 2009 to 1 January 2011, and to defer the start of the phasing-out of free allocations from 2013 to 2018.

While we do not intend to invite submissions on these proposals we would like to discuss these issues publicly and consider them further. A copy of the Minister's letter is attached as Appendix B.

Entry of synthetic greenhouse gases

There are a number of significant issues yet to be resolved in respect of the proposed entry of HFCs on 1 January 2010. We are considering a report entitled "Synthetic Greenhouse Gases and the Emissions Trading Scheme", which outlines various approaches to the entry of HFCs into the scheme. We intend to consult submitters from the refrigeration industry on the various possible approaches.

Minority view of the New Zealand National Party

The National Party views this emissions trading legislation in response to climate change as the most significant bill in the term of this Parliament, with very significant and long-term implications for every sector of the New Zealand economy.

National has long supported an emissions trading system as the most efficient way for New Zealand to respond to climate change, but wants to ensure such a scheme is well designed to ensure it achieves the environmental objective of constraining emissions at least cost.

National has major concerns about the select committee process of consideration of this bill, with 96 submissions being crammed into a week and with some submitters getting only ten minutes to raise substantive concerns. We only received notice of the major changes in timing over the entry of liquid fuels and the phasing of allocation of credits to trade-exposed industries after they were announced publicly. We are also concerned that the Climate Change Leadership Forum was consulted over these latest changes, but not the select committee, bringing into question the relevance of the select committee process.

National wants to be constructive in ensuring New Zealand has a well designed emissions trading system but this is being compromised by a process that risks getting critical detail wrong.

Appendix A

Committee procedure

The committee called for public submissions on the bill. The closing date for submissions was 29 February 2008. The committee has received 259 submissions from various organisations and individuals.

Committee members

Charles Chauvel (Chairperson)
Hon Bill English
Jeanette Fitzsimons
Craig Foss
Hon Mark Gosche
Hone Harawira
Rodney Hide
Moana Mackey
Dr the Hon Lockwood Smith (Deputy Chairperson)
Hon Paul Swain
Chris Tremain
Judy Turner
R Doug Woolerton

Hon Dr Nick Smith replaced Chris Tremain and Hon David Carter replaced Craig Foss for this item of business.

Appendix B

ET/GEN/20

Office of Hon David Parker
Minister of State Services
Minister of Energy
Minister for Land Information
Minister Responsible for Climate Change Issues

6 May 2008

Charles Chauvel MP
Chairperson
Finance and Expenditure Select Committee
Parliament Buildings
WELLINGTON

Dear Charles

Prime Minister Helen Clark will this evening address the Canterbury Manufacturers' Association.

In her speech the Prime Minister will outline changes in government thinking on the design of the New Zealand Emissions Trading Scheme (NZ ETS).

The proposals are the subject of FEC deliberations and relate to :

- Deferral of the introduction of liquid transport fuels into the NZ ETS from 1 January 2009 to 1 January 2011
- Deferral of the beginning of the phase out of free allocations by five years to 2018 (subject to five year review)

Transport Fossil Fuels

Changing the date for introducing the liquid fossil fuels sector into the NZ ETS would ease macro-economic pressures in the economy as well as reducing pressures on household finances – especially important now given the recent increases in fuel prices at the pump. Of course, given these higher fuel prices, we are already seeing behavioural changes that are leading to lower levels of fuel use.

Phase Out Of Free Allocation

The issue of phase out of free allocation has been one of the most discussed and debated issues in the design of the NZ ETS.

The Bill currently includes a provision to phase out the allocation on a linear basis from 2013 to 2025 – for both trade-exposed industry and agriculture.

The proposed delay in this phase out has received particular attention in the work undertaken by the Climate Change Leadership Forum, and is supported by the Forum.

Parliament Buildings, Wellington, New Zealand. Telephone: 64 4 470 6559, Facsimile: 64 4 472 3617
Email: dparker@ministers.govt.nz Website: www.beehive.govt.nz

The benefits of such an approach are that it gives industry more certainty around current investments, and allows the economy a more gentle transition to a lower carbon future.

The change is designed to avoid unnecessary economic disruption (and emissions leakage to countries without emissions pricing), while still providing an incentive to reduce emissions by ensuring that the marginal cost for emissions increases, and reward for decreases, is preserved.

I would encourage the Committee to consider a longer phase out in your deliberations.

The NZ ETS will be a critical policy instrument for New Zealand for at least the next 20 years in adjusting the economy to a carbon-constrained future and in tackling climate change both locally and globally.

Changes in Net Position

The Prime Minister will also announce the latest projections for New Zealand's Kyoto Liability. They show the provisional net position is now projected to be a deficit of 21.7 million units during the first commitment period of the Kyoto Protocol (2008-2012). This compares with the projected deficit reported in May 2007 of 45.5 million units, and is a drop of 52 per cent.

Further Information

Further information relating to these announcements is attached:

- Phase Out of Assistance: a paper prepared by the Emissions Trading Group for the Climate Change Leadership Forum
- A powerpoint presentation given by Jonathan Ling of Fletcher Building at the Climate Change Leadership Forum meeting on 17 April

Thank you for your ongoing work on these important issues.

Yours sincerely

Hon David Parker
Minister Responsible for Climate Change Issues

2

IN-CONFIDENCE

Climate Change Leadership Forum report number: 11

Phase Out of Assistance

Briefing for the Climate Change Leadership Forum
Prepared by the Emissions Trading Group
Date: 9 April 2008

Executive Summary

Attached is the paper went to Cluster 3 for discussion at their meeting on Monday 7 April. The paper incorporates their comments and feedback.

Phase out of Free Allocation
Further analysis for Cluster B – 7 April 2008

Background

At the Cluster B meeting of 15 February and the Climate Change Leadership Forum meeting on 21 February papers on phase out options were considered. Further work was commissioned on a possible alternative option.

This paper looks at the objective of a phase-out approach, develops the possible alternative option further and then considers what the pros and cons of this option are. This paper is designed to generate further discussion.

Objective of phase-out

Any options for phasing-out of free allocation need to align with the objective(s) for the provision of free allocation and with the resulting allocation plan. Allocation could cover a variety of objectives; prominent amongst those are reducing adjustment costs, addressing equity concerns and maintaining New Zealand's reputation as a sound country to invest in by compensating for stranded assets, and minimising economic leakage and economic regrets.

Clarity about the objective for free allocation is critically important for selection the appropriate phase out approach. The phase out of free allocation over time is mainly relevant in the situation where the objective of free allocation is economic regress. It is not relevant where the objective is compensating for stranded assets. And by addressing economic regress, adjustments costs will also be reduced.

Economic regrets concerns the risk production shifting overseas when there is an expectation that this production would be viable in the medium term once the next international agreement is known. Avoiding economic regrets is a time-limited concept. It should be tied to avoiding decisions that would be regretted once it is clear what the next international agreement is.

However, it is not about protecting industry from the behaviour of other countries in response to that international agreement (competitiveness at risk). It is inevitable that imposing a cost of emissions will accelerate some decisions that result in relocating manufacturing/production overseas. Simply striving for prevention of all economic leakage could result in subsidies for industries that may not have a long term future in (a low carbon) New Zealand.

While a key objective for the phase out of free allocation has been expressed as economic regrets, it is worth noting that this is concept can be considered a sub-set of environmental leakage and through addressing economic regrets the phase out of free allocation will also address an element of environmental leakage.

Environmental leakage arguments have two facets. Firstly, if emissions that are currently occurring in New Zealand transfer to a country that does not have Kyoto Protocol quantified commitments (the Kyoto "bubble"), then global emissions will increase (other things being equal). Secondly, it may be that production of certain products is more carbon efficient in New Zealand than elsewhere. As such from a long-term global carbon efficiency viewpoint, avoiding leakage is desirable because it will minimise, in the long-run, the global cost of meeting emission reduction targets.

However, continuing to allocate free emission units to private entities to avoid all environmental leakage involves New Zealand taking on an additional environmental responsibility (over and above its Kyoto commitments) at economic cost to the country. Further to this, leakage must (ultimately) be dealt with through improved international agreements – and it can be argued that New Zealand should focus its efforts on improving those international agreements.

It is for these reasons that the relevant objective of any phase out approach can be considered to be avoiding economic leakage. The key issue to consider in the development of phase out approaches is the cost to the taxpayer of providing free allocation in relation to the cost of any economic regrets. The costs relating to economic regrets are generally one-off (resulting from the shift in production) and should fall over time as more countries come within international agreements.

Analysis of a possible alternative option

Description of option

The possible alternative option is:

- Free allocation of 90% of 2005 continues until 2018;
- Move to zero free allocation in 2030;
- Review every five years;
- Clear review criteria and process.

As noted above it would be useful to provide more certainty on the criteria and process for those reviews. This could be achieved by having a separate review clause in the bill in regard to the phase out of free allocation. This would build on the relevant criteria and process already in the Bill.

The relevant review criteria in the Bill include:

- The emissions pricing policies of New Zealand's major trading partners; and
- The implications of any future international obligations with respect to its emissions and removals that New Zealand had undertaken.

These criteria might not be the right criteria and could be clarified.

Possible criteria for the review of the phase out approach include:

- Fairness between business sectors, taxpayers and consumers;
- The number of countries facing binding emissions targets and the extent to which these countries are New Zealand's competitors for imports and exports;
- The implications of any future international obligations on New Zealand's emissions target;
- Significant changes in emissions mitigation technology; and
- Other ways available for addressing economic regrets.

With regards to certainty on the process the bill currently sets out the timing, timeframe, responsibility, consultation requirements, issues for consideration and publication of these reviews. Further certainty could be provided by expanding the description of who must be consulted and how.

It is also recommended that further certainty on the outcome of any review also be provided for. Additional certainty could be achieved by specifying the features of phase out that can be amended as a result of any review. For example, through specifying that free allocation of 90% of 2005 cannot continue beyond a certain period and that the end date for free allocation must be no later than a specified date. This also sends a clear signal that an ultimate objective is for New Zealand firms to be facing the full price of carbon and that the reviews are not intended to move away from this objective. Another specification would be that the government will not allocate more units than it receives under any post-Kyoto obligation.

Impact of the alternative option on hypothetical firms

Previous analysis has been undertaken to compare the impact of different phase out options with the option outlined in the bill. This analysis was based on a hypothetical firm that emits 1,000,000 tonnes per annum (static) and makes a profit of $100 million per annum before emissions trading is introduced. The Emissions Trading Group compared the impact that different phase-out options could have on the net present value and profits of that firm.

It is proposed that more realistic model firms be used to analyse the impact that the preferred phase out option would have. Cluster 8 will be requested to provide some test cases for this analysis. The information required for each test case includes:

- Emissions;
- Current profit;
- Average asset life;
- The timeframe over which the firm seeks to recover capital investments.

Benefits and costs/risks of the alternative option

The possible benefits and costs/risks of this option are in comparison to the phase out option (base option) in the Bill.

The benefits of this option are:

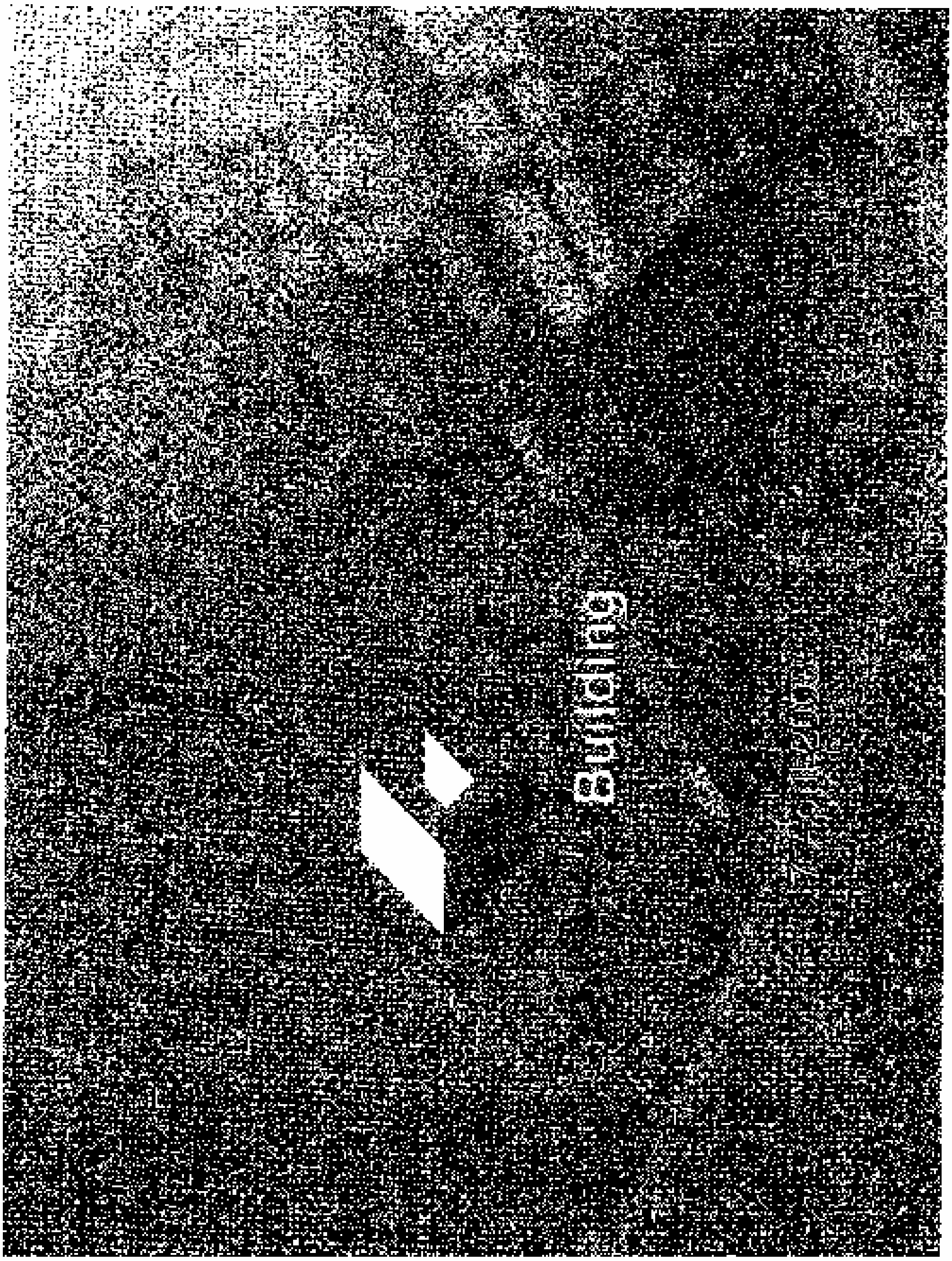
- Ensures that phase out can be refined based on the next international obligation (assuming there is one);

- Ensures the number of countries facing binding emissions targets and the extent to which these countries are New Zealand's competitors for imports and exports are taken into account in the review;
- Provides further time for the New Zealand economy to adjust;
- Allows additional time for businesses to adjust while still facing the marginal price of emissions.

The costs/risks of the option are:

- In the long-run it is in New Zealand's overall economic interest to move to zero free allocation (assuming efficient revenue recycling); however, this option further delays the achievement of this;
- There is a risk that, if any future international obligation is set at more than 16% lower than our current cap, extending the phase out until 2018 would have a fiscal cost to the Crown. The extension of the phase out therefore is likely to result in the allocation packages beyond 2012 being percentage based rather than absolute figures;
- The longer that free allocation is provided the less units the Crown has to auction and therefore to use for tax reductions or spending purposes (extending the phase out by five years would cost the Crown around $1.3 billion in lost revenue) – this represents a transfer from taxpayers to firms;
- Firms that are receiving free allocation for long periods of time could be perceived by consumers as avoiding their environmental obligations which might create a consumer back-lash;
- It creates a risk that firms will focus on the review process rather than making the necessary structural adjustments;
- Depending on the original allocation plan, free allocation might become less relevant over time (this is particularly an issue if the original allocation plan is based on historic emissions).

[1] This is based on the current phase out proposal which would see the free allocation reduced by 1/12th each year. Based on an estimated 49 million units allocated for free this means that each year an additional 4 million units would be retained by the Crown. Over five years this adds up to 61 million units. At a carbon price of $21.17 these units are valued at $1.3 billion.


Building

Proposed Phase Out

Treasury has proposed a possible alternative option to that proposed by the Bill :

- *Free allocation of 90% of 2005 continues until 2018;*
- *Move to zero free allocation in 2025 or 2030;*
- *Review every five years;*
- *Clear review criteria and process.*

Proposed Phase Out

We support the alternative proposal from Treasury. We believe the phase out provisions should align with the objective for free allocation which should be to minimise reduced current or future output from trade-exposed firms without reducing their marginal incentive to reduce emissions.

Proposed Phase Out

We believe.

- *The Phase out should be subject to review, preferably by an independent body. The Garnaut Report (Australia) has proposed an independent body to review allocation to trade-exposed firms.*
- *Clear review criteria and process should be set.*
- *Free allocation should continue at 2013 levels until 2020, (These are the same time-frames as the EU scheme).*
- *We should retain the INTENT to move to zero free allocation by 2025, but subject to sector-specific reviews.*

Review of phase out

Criteria for the reviews should include both economic and environmental considerations. For example:

- *The emissions pricing policies of New Zealand's major trading partners.*
- *The implications of any future international obligations with respect to its emissions and removals that New Zealand had undertaken.*
- *Significant changes in emissions mitigation technology.*
- *Fairness between business sectors, taxpayers and consumers.*
- *Ensuring the environmental integrity of the Emissions Trading Scheme is maintained.*
- *That the Government will not allocate more units than it receives under any post-Kyoto obligation.*

Benefits of this Proposal are:

- Provides greater flexibility to accelerate phase-out if there are international policy developments such as sectoral agreements.
- Ensures that phase out can be refined based on future international obligations.
- Ensures that the emissions pricing policies of New Zealand's major trading partners and their effects on competing (or substitute) product prices, are taken into account.
- Provides certainty to firms when making investment decisions that overseas developments will be taken into consideration in determining the phase out path.
- Ensures that firms receive clear signals about both the short-term (still face the marginal price of emissions) and the long-term, (ultimately they will face a full price of carbon).
- Retains the international credibility of the ETS.

Conclusion

This approach significantly reduces the risk of leakage that could occur through reductions in production, plant closure and reduced investment in New Zealand. It improves the environmental integrity of the New Zealand ETS.