



Greater Alignment of the NZ ETS and Australian CPRS

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Security Level:		Number of Attachments:	One
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Action Sought

	Action Sought	Deadline
Minister of Finance Hon Bill English	Note	None
Minister for Climate Change Issues Hon Dr Nick Smith	<p>Indicate your preferred approach to further integrating the NZ ETS with the Australian CPRS</p> <p>Forward a copy to the following Ministers for their information:</p> <ul style="list-style-type: none"> • Prime Minister • Minister of Energy and Resources • Minister of Transport • Minister of Maori Affairs 	None
Minister of Forestry Hon David Carter	Note	None
Associate Minister for Climate Change Issues (International Negotiations) Hon Tim Groser	Note	None

Ministry for the Environment Contacts [if required]

Name	Position	Telephone		1st Contact
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Executive Summary

This brief considers whether, and if so in what ways, New Zealand should pursue greater alignment of the design of the NZ Emissions Trading Scheme (ETS) with the Australian Carbon Pollution Reduction Scheme (CPRS).

The NZ ETS is already strongly linked to other ETSs internationally as it allows for both the import and export of Kyoto compliant units. However, the further alignment of the NZ ETS with the schemes of one or more of our key trading partners, such as Australia, may offer a number of additional benefits. In particular, further alignment of the NZ ETS with the Australian CPRS would provide greater protection of the competitiveness of NZ firms relative to their trans-Tasman rivals. In addition, it would help to reduce trans-Tasman transaction costs and protect against the possibility of New Zealand facing a period where the international trade in Kyoto compliant units is not possible.

However, a greater degree of alignment would also impose costs on New Zealand if it saw us adopt ETS policies that were not in our national interest. For example, a New Zealand decision to follow Australia and ban the import of all AAUs would increase the price of carbon in our domestic market.

Officials therefore consider that where our objectives in ETS design differ, it is not likely to be sensible to move away from New Zealand's first-best policy approach. As a result, it is too early to conclude that complete or significant alignment of the two schemes is in New Zealand's interests. However, we see benefits in New Zealand attempting to initiate a dialog with Australia promptly, and carry out the further domestic analysis needed to identify the areas where further alignment is likely to be in New Zealand's interests.

Degree of Integration

Note that it would be possible for the two schemes to be more closely aligned in some areas of design than others. A range of options around the level of integration exist, including:

- voluntary adoption of key CPRS design elements
- non-binding agreement on key design elements
- mutual recognition of each other's domestic units and binding agreement on key design elements
- full harmonisation

Timing of Integration

[withheld].

Note also that it is not likely to be possible for the NZ Government to further align the two schemes through its current legislative review of the NZ ETS. Under the current Australian timelines changes to the design of the CPRS are almost certain to occur *after* September 2009, when NZ Ministers are intending to pass the amendment to the Climate Change Response Act (CCRA) arising from the legislative review. A subsequent amendment to the CCRA after September 2009 is therefore almost certain to be needed as NZ Ministers will not know what design rules New Zealand should align with until later in 2009 or early 2010.

Possible Areas for Further Alignment

With regard to the areas where alignment could occur, the two schemes currently differ in a number of ways. We recommend that priority be given to consideration of those areas where change would help to maintain or improve our relative competitiveness with respect to Australia, but not impose unreasonable economic or fiscal costs on New Zealand. The areas

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where we consider that investigation of the possible benefits of alignment should be given priority are:

- Allocation policy (for emissions intensive trade exposed (EITE) industry and agriculture participants)
- Whether to stipulate a national emissions reduction target, and if so at what level
- Whether to establish a temporary price cap at a similar level to Australia's (the Australian cap is due to cease on 30 June 2015)
- Whether to ban the import of all AAUs and the export of NZUs
- Whether to recognise CPRS permits as a valid unit under the NZ ETS (and seek equivalent treatment of NZUs in the CPRS)

Note that we recommend against alignment with the Australian approach to deforestation, where emissions from the deforestation of exotic pre-1990 forests are excluded from the CPRS. Adoption of the Australian approach in this area would impose significant economic and fiscal costs on New Zealand. With regard to agricultural emissions, the Australian government intends to take a final decision on the sector's inclusion in 2013, with an entry date of 2015 at the earliest. The costs and benefits of alignment of this entry date will be addressed in an upcoming brief from the Ministry of Agriculture and Forestry within the next two weeks.

A number of NZ Ministers have meetings scheduled with their Australian counterparts over the next few months (in particular, Prime Ministers are due to meet on 1 March and climate change Ministers later in March). If Ministers wish to pursue greater alignment of the NZ ETS and CPRS further, we recommend that the Prime Minister propose this at his bilateral meeting, and suggest that both countries' officials be directed to initiate preliminary talks on the subject in 2009. However, we recommend that NZ Ministers and officials initially avoid making any commitments about the design areas where the greater policy alignment should occur, and the date it should occur from, until further analysis has been undertaken.

If you agree to this approach we will provide more detailed recommendations and background information in the briefing material for your respective bilateral meetings.

Recommended Action

We recommend that you:

- (a) **Note** that officials see potential benefit in the pursuit of greater alignment between the NZ ETS and Australian CPRS, in particular through improved protection of the competitiveness of NZ firms relative to their Australian counterparts.
- (b) **Note** that further alignment could also impose costs on New Zealand if it resulted in the Government adopting ETS policies that are less suited to our domestic circumstances and objectives.
- (c) **Note** that it is therefore too early for officials to conclude that substantial alignment of the two schemes is in New Zealand's interests.
- (d) **Invite** the Prime Minister to propose to his Australian counterpart (at their meeting on 1 March) that a joint officials process be established to **Yes / No**

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investigate possibilities for further alignment of the two countries' schemes, with preliminary talks on the subject held in 2009.

- (e) **Note** that if you agree to recommendation c) above, officials will provide more detailed recommendations and background information in the briefing material for the Prime Minister's bilateral meeting
- (f) **[withheld]**.
- (g) **Note** that officials advise against changing the current NZ ETS rules in relation to deforestation, and that the Ministry of Agriculture and Forestry will provide further advice on the costs and benefits of aligning the entry date for agricultural emissions.
- (h) **Agree** that New Zealand Ministers and officials should initially avoid making any commitments about the design areas where the greater policy alignment should occur, and the date(s) it should occur from. **Yes / No**
- (i) **Note** that areas for possible alignment that NZ officials see as a priority and intend to prepare further advice on include:
 - a. allocation to EITE industry and agriculture **Yes / No**
 - b. inclusion of an emissions targets in the NZ ETS **Yes / No**
 - c. adoption of a price cap **Yes / No**
 - d. import and export rules **Yes / No**
 - e. acceptance of CPRS permits under the NZ ETS (and vice versa) **Yes / No**
- (j) **Direct** officials to include an assessment of the impact of any proposed changes to the NZ ETS on possible alignment with the CPRS in all future papers prepared under for the ETS Legislative Review. **Yes / No**

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(k) **Refer** this report to:

Yes / No

- a. The Prime Minister
- b. The Minister of Energy and Resources
- c. The Minister of Transport
- d. The Minister of Maori Affairs

Stuart Calman
Acting General Manager, Emissions Trading Group

Date

Hon Dr Nick Smith
Minister for Climate Change Issues

Date

Purpose of Report

1. This brief considers whether, and if so in what ways, New Zealand should pursue greater alignment of the design of the NZ ETS with the Australian CPRS.

Analysis

2. The NZ ETS is already strongly linked to other ETSs internationally as it allows for both the import and export of Kyoto compliant units. Under the NZ ETS rules there is no quantitative limitation on the import and surrender of a number of types of Kyoto compliant units (such as Certified Emissions Reduction (CER) units created under the Clean Development Mechanism). However, subject to the finalisation of regulations (to be covered by a future briefing) the Climate Change Response Act currently bans the import and surrender of some or all AAUs. Similarly, NZ ETS participants have the right to convert NZUs into AAUs and sell them to buyers in other countries, subject to the quantitative constraints of New Zealand's commitment period reserve. This relatively liberal approach to linking was adopted in the design of the NZ ETS to maximise liquidity in the domestic market, reduce price volatility, and stop prices in the domestic market exceeding those in international markets.
3. Notwithstanding this existing high degree of linking, the further alignment of the NZ ETS with the domestic emissions trading schemes of one or more of our key trading partners offers a number of additional benefits. However, to the extent that such alignment involves New Zealand adopting ETS design rules that are not optimal from a New Zealand perspective, it also involves potential costs.
4. Australia, due to its proximity, importance as a trading partner, and importance as a source and destination for investment, is an obvious choice of country for New Zealand to consider further alignment with. This is recognised in the existing work being carried out under the Single Economic Market concept to remove regulatory barriers to trans-Tasman trade and firms operating in both markets.
5. The New Zealand and Australian schemes are in practice already very similar. However, there are a small number of potentially important areas where differences exist, or may eventuate. The key benefits offered by further alignment with Australia include:
 - Greater protection of the competitiveness of NZ firms and relative attractiveness of New Zealand as a place to do business (and therefore a reduction in distortions in trans-Tasman trade and investment flows)
 - Reductions in trans-Tasman transaction costs
 - Shared competencies for professional services
 - Larger economies of scale in terms of interactions with the international carbon market
 - Protection against the possibility of New Zealand facing a period where the international trade in Kyoto compliant units is not possible, such as due to a failure in the international negotiations (in which case the ability to trade with Australia would become significantly more important)
6. Of these benefits, we consider that the protection of the competitiveness of New Zealand firms is the most important.
7. **[withheld]**.

8. Officials therefore consider that the level of alignment ultimately achieved should reflect the circumstances and objectives of both nations. Where our objectives in ETS design differ, it is not likely to be sensible to move away from New Zealand's first-best policy approach. It is therefore too early to conclude that substantial alignment of the two schemes is in New Zealand's interests. However, we see benefits in New Zealand attempting to initiate a dialog with Australia promptly, and initiate the further domestic analysis that is needed.

Levels of Alignment

9. Many levels of alignment of ETSs are possible, ranging from total policy harmonisation and mutual acceptance of each other's units (resulting in a single trans-Tasman ETS) through to the existing situation where Kyoto compliant units are traded under separately developed schemes. The key most likely options along that spectrum include:
 - A. *Voluntary adoption of key CPRS design elements*: the NZ Government would unilaterally opt to adopt the same policy settings as Australia in key areas, but without entering into formal discussions and without committing to maintain those policy settings in the future.
 - B. *Non-binding agreement on key design elements*: the two governments would negotiate and agree on policy settings in key areas, but neither would commit to maintaining those settings in the future.
 - C. *Mutual recognition of each other's domestic units and binding agreement on key design elements*: the two governments would negotiate and agree to adopt the same policy approaches in key areas, agree to accept each other's units for surrender in their schemes, and commit to maintaining the agreed policy settings
 - D. *Full harmonisation*: The two schemes would in practice become one. Both countries would accept the other's units for surrender in their scheme, and adopt the same policy settings across most, if not all, design areas. In practice, firms in NZ would therefore be treated identically to those in Australia.
10. Note that for options A-C, it would be possible for the two schemes to be more closely aligned in some areas of design than others. Note also that it is unlikely to ever be possible to have full institutional harmonisation. For example, New Zealand is likely to always be required to operate its own registry under future international agreements.

Timing Issues

11. New Zealand also faces choices around when to further align the two schemes.
12. [withheld].
13. [withheld].
14. [withheld].
15. We therefore recommend that NZ Ministers indicate a general interest in further alignment of the two schemes to their Australian counterparts, and suggest that officials be directed to initiate talks in 2009. (We understand from Australian officials that this suggestion is likely to be well received). However, we recommend that the question of when any further alignment would come into effect, and how significant any alignment

might be, be left open at this stage. Further, we recommend that you direct officials to include an analysis of the potential impact on the ability to further align the NZ ETS and CPRS in all future papers on ETS design prepared as part of the ongoing Legislative Review.

Framework for Considering Greater Alignment

16. As noted, officials see both potential costs and benefits from further alignment of the NZ ETS and Australian CPRS. When considering where, and to what extent, it is in New Zealand's interests to further align the two schemes we recommend that Ministers consider the following factors:

Economic

- *Impacts on the competitiveness of New Zealand firms:* In some cases (but not all) differences in design between the two schemes will impact on the competitiveness of NZ firms relative to their Australian counterparts. Sustained differences in competitiveness will impact on trade and investment flows and could disadvantage NZ industry.
- *Fiscal impacts:* ETS design changes can have potentially large fiscal implications.
- *Impacts on NZ's economic development:* It is in New Zealand's interests to see our economy evolve over time to become more carbon efficient in the businesses we currently operate, and/or specialise more heavily in business activities that are less emissions intensive. A balance must be struck between avoiding significant economic disruption, and encouraging the economy to evolve.
- *Transaction costs:* It is important that NZ firms have cost effective access to international carbon markets. There would be benefits in ensuring that New Zealand firms can particularly easily access Australian markets and specialist professional services.
- *Impacts on the price of carbon:* The adoption of some of Australia's current design rules could see an increase in the price of carbon in the NZ ETS.

Political / Strategic

- *Protection against a breakdown in international negotiations:* The ability to trade Kyoto compliant units internationally is a key 'safety valve' in the design of the current international framework. If this right was removed for a period of time, such as due to a breakdown in international negotiations, the ability to trade with Australia (and potentially other countries) would become substantially more important.
- *Impacts on NZ's international reputation:* Some aspects of ETS design have the potential to affect NZ's international reputation (both positively and negatively). In some areas a balance may need to be struck between pursuing New Zealand's interests, and avoiding adversely impacting on New Zealand's reputation (which could in turn impact on our ability to negotiate appropriate emissions targets, and pursue changes to international rules that are in New Zealand's interests).
- *Equality of treatment with key trading partners:* Not all aspects of ETS design will affect competitiveness (see discussion below). For example, as electricity is not tradable between our two countries the Australian proposal to provide a free allocation of units to electricity generators under the CPRS will not impact on the competitiveness of generators here. However, the government may face pressure to provide equal treatment even where competitiveness is not affected.

- *Sovereignty issues:* A binding commitment to maintain certain ETS policies could reduce the NZ Government's ability to modify the NZ ETS in the future in response to changes in our economic circumstances.

17. Of the key considerations discussed above, competitiveness impacts are likely to be particularly important. It is therefore important to recognise that not all differences in ETS design will lead to competitiveness impacts. As discussed above, differences in the treatment of non-tradable products, such as electricity, will by definition not have a direct impact on the competitiveness of NZ businesses. However, even where tradable goods are involved, competitiveness impacts will not always result from differences in design.
18. The key factor that determines whether competitiveness impacts will result from differences in ETS design is whether those differences will result in firms in the two countries facing a different effective price for their emissions. If differences in design do not impact on the effective price firms pay for their emissions, they will not affect competitiveness. For example, the proposed approach under the CPRS for providing a free allocation of units to emissions-intensive, trade-exposed (EITE) industry *will* affect competitiveness, as recipient firms will effectively face lower emissions charges than they otherwise would have. In contrast the current NZ ETS pre-1990 forestry allocation policies will *not* affect competitiveness. Under those forestry allocation policies pre-1990 landowners will receive units regardless of whether or not they ultimately choose to deforest. In other words, any decision by landowners to deforest will see them facing the full international price of carbon on their emissions. (This reflects the fact that the goal of the forestry allocation policy was to provide compensation to existing landowners, rather than reduce the impact of the ETS on their land management decisions).

Potential Design Areas for Greater Alignment

19. The NZ ETS and CPRS currently differ in a number of design areas (see Appendix I for a comprehensive summary).
20. However, many of these differences will not have any real impact on the considerations discussed above. For example, the CPRS uses a 1 July – 30 June compliance year, where the NZ ETS uses calendar years. Similarly, there are differences in the level and nature of the penalties that can be levied under the two schemes when participants fail to meet their legal obligations.
21. The areas where officials consider that further alignment between the NZ ETS and CPRS is likely to be most desirable are those that will have a significant impact on trans-Tasman competitiveness, but will not see New Zealand facing an unreasonable increase in costs. Our preliminary analysis suggests that this includes the following aspects of NZ ETS design:

Allocation to Emissions Intensive Trade Exposed Industry and Agriculture

- The rate(s) of allocation assistance provided per unit of output (and choice of thresholds where assistance is varied)
- The approach to reducing rates of assistance over time (phase out)
- The level at which eligibility is assessed and an allocation provided (i.e. firm vs plant vs activity)
- The eligibility of new entrants, or expansion of output by incumbents, to receive a free allocation
- Whether to place a binding cap on the overall levels of assistance provided, or use indicative rolling targets
- Whether to use eligibility thresholds, and if so how to define them and what level to set them at

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- The nature and timing of the process used for reviewing allocation policies over time

Sectoral Coverage and Treatment

- Whether to exempt emissions where the carbon has been transferred to an approved carbon capture and storage facility.

Targets

- Whether to stipulate a national emissions reduction target
- If so:
 - how to define it (domestic emissions only or domestic emissions less the number of Kyoto compliant units imported)
 - What level(s) of target to opt for over time
 - Whether to stipulate an indicative emissions reduction trajectory over time

Price caps

- Whether or not to set a cap on the price for domestic emissions
- If so, what level to set the cap at

Import / Export Rules

- Whether to allow for the import and surrender of AAUs (both in CP1 and in subsequent commitment periods)¹
- Whether to allow NZUs to be converted into international units and exported² (which is likely to be related to the question of whether to establish a price cap)
- Whether to allow for the import and surrender of CPRS permits in the NZ ETS (and seek equivalent treatment of NZUs in the CPRS)

22. **[withheld]**.

23. **[withheld]**.

24. **[withheld]**.

Next Steps

25. A number of NZ Ministers have meetings scheduled with their Australian counterparts over the next few months (in particular, Prime Ministers are due to meet on 1 March and climate change Ministers later in March).

26. If Ministers wish to pursue the alignment of the NZ ETS and CPRS further we recommend that the following process be adopted:

- The Prime Minister propose at his upcoming bilateral meeting that both countries' officials be directed to initiate preliminary talks on possible alignment in 2009.
- The Minister for Climate Change Issues finalise procedural details at his meeting later in March.

¹ The Australian Government has indicated an intention to review its ban on the import of AAUs for the period starting 1/6/12.

² The Australian Government has indicated that the ban on exports from the CPRS will only apply for the 'early years of the scheme's operation').

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- NZ Ministers and officials initially avoid making any commitments about the design areas where the greater policy alignment should occur, and the date it should occur from.
- You provide a preliminary indication of your priority alignment areas, and direct officials to undertake further work on each policy issue.
- You direct officials to include an assessment of the impact of any proposed changes to the NZ ETS on the ability to further align the two countries schemes in all future papers prepared under the Legislative Review.

This approach should ensure that New Zealand retains flexibility over its negotiation position until further analysis has been undertaken, while also ensuring that the necessary collaborative work with Australia begins as soon as practical.

Note that officials also intend to informally sound out our counterparts' views on alignment issues at the next Australia-New Zealand Climate Change Partnership talks scheduled for late February. This forum was established in 2003 to encourage greater cooperation on climate change issues.

If you agree to this approach we will provide more detailed recommendations and background information in the briefing material for your respective bilateral meetings.

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Annex I - List of Design Issues

Topic	Detailed Design Issue
Allocation	Rate of assistance (per unit of output) / and use of thresholds
	Phase out over time
	Level of application (firm, plant, or activity)
	Treatment of new entrants / growth
	Soft or hard cap on overall level of assistance
	Use and level of eligibility thresholds
	Nature and timing of review process
	Allocation to non trade exposed entities (electricity generators)
Sectoral Treatment / Rules	Inclusion of agriculture
	Exclusion of deforestation of pre-1990 forests
	Date of entry of covered sectors
	Levels of reward for sequestration by post 1989 forests
	Allowance of carbon capture and storage activities
	Methodologies used for estimating emissions
Targets	Whether or not to have them
	Make them binding or not
	What level(s) to opt for
	Stipulation of an indicative trajectory
Price caps	Whether or not to introduce one
	What level to set it at
	Administrative arrangements
Import / Export Rules	Ban on import of AAUs (to be reviewed for period from 1/6/12)
	Ban on export of CPRS units (only for the 'early years of the scheme's operation')
	Bilateral acceptance of each other's units
Administrative Procedures	Choice of reporting year (calendar or other)
	Overall scheme participation threshold
	Level and nature of assistance to households
	Compulsory auditing of returns by large emitters
	Size and nature of non-compliance fines and penalties
	Processes used for auctioning of units
	Tax and accounting treatment
	Independence of scheme regulator