



Summary Paper Outlining Your Emerging Preferred Design for the Moderated ETS

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|------------------------|-------------|-------------------------------|------------|
| Date: | 6 July 2009 | MfE Priority: | Non-urgent |
| Security Level: | | Number of Attachments: | One |
| | | MfE Ref No: | 09-B-01887 |

Action Sought

| | Action Sought | Deadline |
|---|---|-----------------|
| Minister for Climate Change Issues Hon Dr Nick Smith | Indicate whether you wish to propose an intensity-based approach to allocation for agriculture. Forward the attached paper to your colleagues prior to your meeting at 8pm on 21 July. | 14 July |
| Associate Minister for Climate Change Issues (International Negotiations) Hon Tim Groser | Note for information | None |

Ministry for the Environment Contacts [if required]

| Name | Position | Telephone | | 1st Contact |
|---------------|------------------------------------|------------------|---------------|--------------------|
| | | (cell) | (work) | |
| [withheld] | Senior Operator, Emissions Trading | [withheld] | [withheld] | ✓ |
| John Scott | Acting Manager, Emissions Trading | [withheld] | 439 7573 | |
| Stuart Calman | Director, Climate and Risk Policy | [withheld] | 439 7571 | |

Executive Summary

You requested a brief summary of your emerging preferred position for the design of a moderated NZ ETS to provide a basis for further discussion with your colleagues. That summary is attached.

The paper currently proposes an intensity-based allocation approach for industry and agriculture, and has been written in the first person. These aspects can be easily amended if you wish.

Recommended Action

We recommend that you:

- (a) **Indicate** any amendments you would like made to the paper.

- (b) **Forward** the finalised paper to your colleagues in advance of your **Yes / No** meeting scheduled for 8pm on 21 July.

Stuart Calman
Director, Climate and Risk Policy

Date

Hon Dr Nick Smith
Minister for Climate Change Issues

Date

Hon Tim Groser
Associate Minister for Climate Change Issues (International Negotiations)

Date

Summary of Emerging Preferred Design of a Moderated Emissions Trading Scheme

This paper sets out my emerging preferred position on how the Emissions Trading Scheme (ETS) should be modified to deliver the objectives previously discussed at Cabinet Strategy Committee. The purpose of the paper is to provide a basis for further discussion of my preferred approach at the upcoming meeting of those Ministers with an involvement in ETS issues at 8pm on 21 July.

Overarching Objectives

As discussed previously at Cabinet Strategy Committee, my key objectives in proposing changes to the ETS are:

- reducing competitiveness impacts / providing greater certainty for economic growth
- providing a smoother transition for participants / protecting against price volatility in early years
- ensuring affordability within current fiscal constraints
- maintaining flexibility to respond to possible changes in the post-2012 international framework
- maximising the degree of harmonisation with the proposed Australian Carbon Pollution Reduction Scheme (CPRS); and
- fulfilling National Party Manifesto commitments.

Reduced Price Until 2013

I propose that the stationary energy and industrial process (SEIP) and liquid fossil fuel (LFF) sectors now both be brought into the scheme on 1 July 2010.

The first of the three key modifications to the ETS I am proposing is the introduction of a reduced price for the period from the entry of those two sectors through to 31 December 2012. For those 2 ½ years, the price of carbon in the ETS will be moderated through the combination of two design changes:

- a revised core scheme obligation, with participants required to surrender only 1 unit for every 2 tonnes of CO₂ emitted (effectively providing a 50% discount); and
- a price cap of NZ\$25 per tonne initially, increasing on 1 January 2013 to \$50 and then rising gradually over time prior to its removal in 2016.

In order to prevent arbitrage occurring while the price cap is in place, bans on the export and banking of NZUs may be needed.

Together, these two changes would ensure that the *effective* price of carbon facing participants in these sectors would never exceed \$12.50 per tonne before 1 January 2013, and could be lower if the international carbon price fell below NZ\$25 over that period.

These changes will substantially lessen the impact of the ETS on participants in these two sectors until the end of 2012, providing a far smoother transition for industry and the economy as a whole. In turn this will help to ensure that households do not face large price increases. The changes will therefore provide a significant improvement for the important first years of the scheme's operation, when participants are becoming familiar with their obligations and the operation of carbon markets. Given this, I consider that it is no longer necessary to provide an additional package of consumer assistance measures (beyond the usual inflation adjustment of benefits). I also proposed to remove the current innovation fund from the Act.

Note that in keeping with the reduced core scheme obligation, allocation levels would be reduced by 50% over the period that the price cap is in place. Note also that forestry, the

only other sector that will be covered by the scheme before 1 January 2013, would only be covered by the \$25 price cap; the reduced 1:2 core obligation would not apply to either pre 1990 or post 1989 forests. These issues are discussed in more detail below.

Adoption of an Intensity-Based Allocation Approach for Industry

The second of the three key modifications I am proposing is the adoption of an intensity-based approach to the free allocation of units to emissions intensive, trade exposed (EITE) industry. While the detailed aspects of our two schemes may differ, this would see New Zealand adopting a similar approach to allocation to that we expect to be put in place in Australia.

Under an intensity-based approach to allocation the number of units each firm receives will be updated each year to reflect changes in their output levels, effectively reducing the price of carbon faced by those firms eligible to receive assistance. The key elements of the intensity-based approach to allocation I am proposing include that:

- firms will only be eligible to receive assistance if they meet trade exposure and emissions intensity tests (with similar thresholds to those proposed in Australia)
- more emissions intensive firms will receive a higher rate of assistance than less intensive ones (most likely at the rates of 90% and 60% respectively, although we could also adopt the proposed Australian temporary buffer taking the rates initially to 94.5% and 66%)
- consideration will be given to the possibility of providing an allocation to very large emitters whose emissions-intensity falls below the threshold rates
- during the period that the reduced core obligation is in place (see above) the amount of assistance will be reduced by 50%
- the number of units each firm is eligible to receive will be calculated on the basis of the average emissions-intensity for each industry, not each firm's actual intensity (to ensure that firms with higher than average emissions per unit of output are not rewarded for being less efficient)
- new entrants, or firms that are expanding, will automatically see their allocation increased, while shrinking firms will see their allocation decreased; and
- the rates of assistance provided will be reduced over time at a rate around 1.5% per annum from 2018, with a 5 yearly review (with any changes to the phase out also requiring a 5 year notice period).

This adoption of an intensity-based approach to allocation will provide ongoing protection for the subset of New Zealand firms that would otherwise be most at risk of suffering a substantial loss of competitiveness under the ETS. An intensity-based approach to allocation will therefore help to avoid undue disruption to the economy, and maintain the ability of businesses in sectors where New Zealand currently has a clear competitive advantage to continue to grow. This change would provide savings over the early years of the scheme's operation, but impose increasingly large fiscal costs over the long term.

In order to implement an intensity-based allocation approach in the limited time available, I intend to adopt as much of the operational detail of the Australian allocation approach as sensible.

Treatment of Forestry

I propose to make only minor changes to the treatment of the forestry sector under the modified ETS:

- the reduced 1:2 core obligation will not apply to either pre 1990 or post 1989 forests
- the NZ\$25 price cap will apply to any emission liabilities from pre 1990 or post 1989 forests (that accrue before 1 January 2013)

- the current policy of providing for domestic offsetting after 2012 subject to New Zealand securing the right internationally will be retained
- the forestry allocation plan process will be continued, with the first phase of 21m units allocated for CP1;
- the treatment of post 1989 forests will be unchanged initially, and then reviewed for effectiveness in the early stages of the second commitment period; and
- consideration will be given to excluding units earned from post 1989 forests from the export ban required while the price cap is in place.

This proposed package recognises the need for the moderated ETS to remain affordable. The \$25 price cap will provide a modest benefit, providing greater certainty to those owners wishing to deforest in CP1.

A key decision for Cabinet will be whether to cancel the second phase of the forestry allocation package (34m units out of the 55m total) if offsetting is introduced after 2012. The current legislation only allows for these units to be cancelled if emissions from the deforestation of pre-1990 forests are removed from the ETS entirely. Arguments can be made for expanding this provision to also allow for the second tranche of units to be cancelled if offsetting is introduced from 2013, as offsetting would significantly reduce the impact of the ETS on land values. Cancelling these units would also provide a significant fiscal saving in CP2 (assuming a price of carbon of \$25 per tonne, these units have a value of \$850m).

However, any attempt to cancel these units would most likely be met with significant resistance from stakeholders, and therefore pose stakeholder management challenges. The Act currently requires that the total allocation package of 55m units be reduced by the number of units needed to meet the cost of the 'under 50 hectare' and ongoing '2 hectare' exemptions, and then be distributed as follows:

- 18 units per hectare of CFL land yet to be transferred under a Treaty settlement
- 39 units per hectare for owners of pre 1990 land bought after 31 October 2002; and
- the remaining units be allocated on a pro rata basis to all owners of pre 1990 land bought prior to 1 November 2002 (estimated to provide around 60 units per hectare).

[withheld].

Note that I initially intended to introduce changes to allow greater land use flexibility for pre-1990 forest participants for the 2008-2012 period. However, largely due to the fiscal and economic cost I have decided not to pursue this further. When communicating with stakeholders on this issue I intend to emphasise the large fiscal and economic implications of introducing offsetting domestically before it is allowed for internationally, and note that participants wishing to deforest can wait several years at little cost and then hopefully take advantage of offsetting arrangements introduced from 2013.

With regard to post 1989 forests, I remain concerned about the current low levels of new planting. But it is difficult at this stage to be clear what is driving those low planting levels. I believe that the most prudent approach is to leave the current post 1989 provisions unchanged for now, and review their effectiveness in the early stages of the second commitment period.

Treatment of Agriculture

The third key modification I propose to make is to shift to an intensity-based approach to allocation for the agriculture sector, with the same approach to phase out as is adopted for industry. However, in line with the industry allocation provisions, there would be a review of allocation policies every five years.

Until more effective emission abatement technologies have been developed, or the weaknesses in the current international regime's treatment of agricultural emissions are addressed, I believe a relatively generous level of assistance is justified for the agriculture sector. The sector is too important to the New Zealand economy to allow domestic activity to be replaced by less efficient and more polluting operations in other countries.

I also propose to make several other minor changes to the treatment of agriculture under the ETS:

- the entry date of 1 January 2013 will remain unchanged
- a processor level point of obligation will initially be adopted (as the Act currently allows for); and
- a change will be made to allow a shift to a farmer-level point of obligation at a later stage, subject to stakeholder views and a number of key administrative challenges being successfully addressed.

Other Changes

In addition to the key changes discussed above, I am proposing several changes to ensure consistency with the commitments made in the National Party Manifesto prior to the election. These include:

- increasing allocation for the fishing sector from the current level of 50%, to 90% of 2005 emissions for three years (the legislation would continue to stipulate the actual number of units to be allocated); and
- introduction of a '50 by 50' emissions reduction target for New Zealand.

Officials have also identified a number of more minor policy changes and technical amendments they consider would help to ensure the scheme operates smoothly and cost effectively. Cabinet approval of these changes will be sought in due course.

Implication of Proposed Changes

Broader Economic and Social Impacts

I believe that this proposed package of modifications to the current ETS will substantially reduce the scheme's competitiveness impacts, and more generally allow a smoother transition for participants and households in the early years of the scheme. The cost of the package is also consistent with current fiscal constraints.

I would emphasise, however, that a number of participants are likely to be modestly disadvantaged under my proposed changes *relative* to the current scheme design. This was effectively unavoidable, given the fiscal constraints we face. It will be important to address any concerns raised by these key groups:

- less emissions intensive, trade exposed firms
- owners of post 1989 forests; and
- iwi yet to settle Treaty claims that involve crown forest licence (CFL) land.

For participants that are eligible to receive assistance, my proposed shift to an intensity-based approach to free allocation will provide considerable gains over the allocation approach that was favoured (but not prescribed) by the previous government. However, there will inevitably be some firms that will fall below the emissions-intensity thresholds we ultimately put in place. Those firms may have expected to receive a free allocation under the previous proposals, but will prove ineligible to receive any assistance under this new approach. I make no apologies for this; after the first 2 ½ years, when all participants will enjoy a low price, I think it is important to target the available level of assistance more tightly

to those firms with the highest levels of emissions intensity, as they are the firms that will suffer the largest effects. However, the choice of thresholds will clearly be important, especially relative to those ultimately chosen in Australia. I will address the choice of threshold levels and assistance rates in subsequent Cabinet papers.

The ownership of post 1989 forests is currently the only 'net removal activity' currently allowed under the ETS¹. In contrast to the rest of the economy, owners of such forests benefit from a higher price of carbon. Accordingly there may be resistance from the owners of Kyoto forests to the proposal to ban exports while the price cap remains in force, as it may close off a higher priced market for sales. Such owners may also be concerned about an export ban even where the New Zealand price is at the same level as the international price, as we are aware of some instances where post 1989 forests are being funded by international investors who are seeking a source of units to import back to their home jurisdictions. I therefore propose to investigate the possibility of excluding units earned from post 1989 forests from the export ban.

[withheld].

Fiscal Impacts

The table below sets out officials preliminary assessment of the fiscal implications of my proposed changes to the ETS. Further work to refine these estimates will be carried out before our meeting on the July 21.

| | Fiscal Cost before 31 December 2012 (\$m) | Fiscal Cost from 1 January 2013 (\$m) |
|--|---|---|
| Reduced Price until 31 December 2012 (combined with a 1 July 2010 start date for the LFF and SEIP sectors) | \$600m (with risk of increased costs if price goes above \$25) | N/A |
| Price cap of \$50 from 2013 (rising over time to reflect changes in the intl price of carbon) | N/A | \$0 (but moderate risk of increased costs if international price exceeds the cap) |
| Intensity-based approach to allocation for industry | likely <u>saving</u> (size depends on choice of thresholds and rates of assistance) | range from possible <u>saving</u> to possible cost (size depends on choice of thresholds and rates of assistance) |
| Intensity-based approach to allocation for agriculture (with no phase out) | N/A | \$30m per annum in 2013, rising to \$150m in 2020 and \$740m in 2030 (assuming a 90% rate of assistance). |
| Increased fisheries allocation | \$0 | \$0 |
| Total Fiscal Cost | \$600m or less | Uncertain |

¹ Note that forestry net removal activity differs from other removal activities allowed for under Part 2 of Schedule 4, such as in relation to the production of methanol, where the carbon is permanently embedded in the exported product.