



Further Information: Capped intensity-based allocation and Agriculture Advisory Body

Date:	8 September 2009	MfE Priority:	Non-urgent
Security Level:		Number of Attachments:	Two
		MfE Ref No:	09-B-02720

	Description	Relevant dates
Minister for Climate Change issues	Note the attached advice.	None.
Hon Dr Nick Smith	Forward the attached advice on an Agriculture Advisory Body to the Minister of Agriculture and Forestry.	

Ministry for the Environment Contacts

Name	Position	Telephone		1st Contact
		(cell)	(work)	
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Purpose

You have requested advice on how to implement the following proposals (as well as risks associated with them):

- Capped intensity-based allocation to industry.
- An Agriculture Advisory Body to review treatment of agriculture under the NZ ETS.

Advice on each of these proposals is attached.

Advice on the Agriculture Advisory Body has been written by officials from the Ministry of Agriculture and Forestry.

We recommend that you forward the attached advice on an Agriculture Advisory Body to the Minister of Agriculture and Forestry.

Stuart Calman
Director, Climate and Risk

Date

Capped Intensity-Based Allocation to Industry

Introduction

1. A capped intensity-based allocation approach generally means that a firm's allocation is based on its output, but the overall pool of allocation to eligible firms is capped. Under this approach, new entrants and firms growing output receive the same allocation per unit of output as incumbents.
2. The primary purpose of a cap is that it limits the overall cost to the wider economy of providing allocation. It also provides fiscal certainty. In general, a cap is likely to accelerate industry exposure to a full price on emissions, relative to a straight intensity-based approach.
3. In designing a capped intensity-based approach there are two main issues to consider:
 - The level and process for setting a cap.
 - The nature of the cap and consequences of breaching it.

Setting a cap

4. The level at which a cap is set and process for setting it depend on the purpose of the cap.
5. One option is to set a cap in legislation based on historic emissions that does not cater for growth. This approach represents a more stringent limit on the overall cost to the wider economy of providing free allocation. The existing allocation provisions under the Climate Change Response Act represent this approach.
6. Alternatively, a cap could be set under regulations having regard to certain factors, such as total existing emissions from eligible firms, the expected growth rate and desired phase-out rate. It may be desirable to defer the introduction of such a cap in order to draw from data collected during the initial operation of intensity-based allocation.
7. Under either of these options it is unlikely that the cap would be breached prior to 2012.

Nature of cap and consequences of breach

8. The cap may operate either as a 'hard' cap or a 'soft cap'.
9. Under a hard cap approach the cap could not be breached and upon reaching the cap, allocation to individual firms would be subject to a pro rata mechanism. When the cap has been reached, a firm's allocation would be calculated as follows:

$$\text{Firm X's intensity entitlement} \times \text{Cap} / \text{Sum of all firms' intensity entitlements}$$

10. Under this approach there is a risk of misalignment between the level of assistance provided to New Zealand firms and those of New Zealand's trading partners and competitors, particularly Australia.
11. A capped intensity-based approach of this type was considered by the Stationary Energy and Industrial Processes Technical Advisory Group (SEIP TAG). Industry members of the SEIP TAG considered a capped intensity-based approach of this type would be unworkable.

12. Under a soft cap approach the cap could be breached, but the breach of the cap would trigger the review of the provision of allocation to industry. The review could include factors such as the level of the cap, levels of assistance and phase-out.

Uncertainty over individual firms' allocation

13. The primary concern with a hard cap approach is that it leads to uncertainty over an individual firm's allocation. An individual firm's allocation is potentially volatile if the sum of firms' intensity based entitlements is volatile. Consequently, there are arguably equity concerns associated with this approach in addition to uncertainty concerns.

14. The risk of volatility is exacerbated in a small market such as New Zealand, where a single new entrant (or increase in capacity) or closure could significantly impact on other firm's allocation. **[withheld]**.

15. **[withheld]**.

16. The risk of volatility could be mitigated through a cap which excludes allocation to certain types of firms. Allocation for excluded types of firms would be provided for under separate reserve pools of units, which may be capped or uncapped. The separate reserve pools could provide for any level of assistance relative to the level of assistance to firms within the main capped allocation pool. In particular, it would be possible to determine that firms operating under a separate reserve pool receive the same level of assistance as firms within the main capped allocation pool. Types of firms for which a separate reserve pool may be desirable include:

- Significant new entrants (or increases in capacity) or closure.
- Firms with significant variability of output.
- Firms which have had a Negotiated Greenhouse Agreement.

Options

17. The table on the next page sets out the main options for designing a capped intensity-based approach to allocation.

1. Type of Cap?	2. How is Cap Set?	3. Review of Cap?	4. Other options	Risks/ Benefits:
<p>Option 1: 'Fixed' Cap</p> <p><i>Cap cannot be breached. Level of assistance to participants must be adjusted year by year to fit cap.</i></p>	<p>On face of legislation. Likely based on a % of a base year (e.g. 90% 2005 emissions)</p> <p>OR</p> <p>In regulations – having regard to specific factors & with 5 years notice of any change in the level of the cap (like other allocation provisions).</p>	<p>Either no change possible without amending legislation.</p> <p>OR</p> <p>As part of 2011 review, as with other aspects of allocation.</p>	<p>Single cap for all participants.</p> <p>OR</p> <p>Separate 'reserve' pool for:</p> <ul style="list-style-type: none"> - significant new entrants. - firms with significant variability of output, - firms with NGAs. 	<ul style="list-style-type: none"> - Greatest fiscal certainty (about total level of allocation). - Significant risk of volatility in level of allocation to participants - could be mitigated to an extent by setting cap in Regulations and use of separate 'reserve' pool for certain participants.
<p>Option2: 'Soft' Cap</p> <p><i>Cap can be breached. Level of assistance to participants not immediately affected. If cap breached, review of some/ all allocation provisions triggered.</i></p>	<p>On face of legislation. Likely based on a % of a base year (e.g. 90% 2005 emissions)</p>	<p>Required whenever cap is breached. Review could be of either:</p> <p>All aspects of allocation.</p> <p>OR</p> <p>Just the cap.</p>	<p>Single cap for all participants.</p>	<ul style="list-style-type: none"> - Less fiscal certainty (about total level of allocation). - Less risk of volatility in level of allocation to participants (almost identical to uncapped model).

Agriculture Advisory Body

Background

You requested advice on the possible design of an independent Agriculture Advisory Body¹ (AAB) to provide the Government with expert advice on when and/or how the agriculture sector should be included in the NZ ETS. Officials understand that under this scenario, no significant changes would be made to the existing legislation in respect of agriculture in the short term. Rather the legislation would be implemented as currently drafted and the AAB would report back to Government in the context of the legislative review of the NZ ETS in 2011.

Analysis

The key design features of the AAB are its role and membership. To a large extent the membership should reflect the role of the Body and there are two main options described below. These options only represent initial thoughts.

A High level design role

The context in which the AAB would be working implies that it would be providing high level advice on when agriculture should enter the NZ ETS. The AAB could work with the government to either perform or oversee an in-depth economic analysis of bringing agriculture into the scheme in both the short term and longer term. The analysis would focus on “scenario building” using various assumptions with respect to carbon prices, availability of mitigation technologies, and farmer responses.

Based on this work the AAB would provide the government with advice as to the entry date, the nature of the allocation phase-out, and the total quantum of assistance.

B Technical role

There are also opportunities for the AAB to play a technical role. The Ministry of Agriculture and Forestry (MAF) established an Agriculture Technical Advisory Group (agTAG) in December 2007 which reported back to MAF in April 2009. The agTAG’s role was to provide advice on possible design options for the point of obligation and methodologies for allocating units.

This agTAG’s report provides a very useful framework for understanding the practical design of the point of obligation options and the technical detail involved in bringing agriculture into the NZ ETS. However, the report by its own admission only represents “*a first stage of a formidable design task*”.

The agTAG report indicated that more work is needed in a number of areas including:

- Quantifying the relative benefits of a farm level point of obligation;
- Understanding the distributional impacts of different allocation methodologies; and
- Understanding the legal issues that might arise between legal participants and associated persons (eg. lessees).

These tasks could represent a useful starting point for an AAB, but it should be noted that they relate primarily to a farm level point of obligation. This is because the agTAG was of the firm view that the obligation should be at farm level (in spite of unknown benefits and unresolved

¹ This is a generic term for the proposed body.

information verification issues at farm level) and therefore did not consider how a processor level obligation could be improved to provide a better price signal to farmers.

Given the government's preference is for the point of obligation to be at processor level initially and transition to the farm level later, then it is logical for the AAB to focus initially on ensuring the best possible design for processor level. Things that the AAB could consider include:

- The regulations including the emission factors for the obligation;
- Recognition of farm level mitigation behaviour;
- How a transition to the farm level might work in practice.

The AAB's role could potentially be phased according to the short term and long term objectives. During Phase 1, the AAB could focus on design of the processor level obligation including regulations and mitigation. Phase 2 could focus more closely on the outstanding issues related to a farm level point of obligation.

A strong signal that the government intended to implement at processor level initially would be necessary to focus the Body's attention.

Membership

The technical role would require individuals with a high degree of in-depth knowledge and understanding of agricultural systems at both farm level and industry level. The agTAG membership could provide a starting point for this group. Its members include policy analysts from the main agricultural industry groups and associations, scientists, and other agricultural specialists. It would be useful to revise the makeup of this group in light of the new role.

The high level advisory role, on the other hand, would be better suited to individuals with a greater level of independence from the agriculture sector. A number of options could be explored (for example, MAF's Climate Change Peak Group).

The two different roles described above are not likely to be able to be performed by the same group. One of the key learnings from the agTAG was that it is challenging for industry personnel to focus on technical detail while there are outstanding policy design issues; the point of obligation in the case of the agTAG. People inevitably begin to represent their own interests rather than pursue broader objectives and consensus becomes difficult to achieve.

Conclusions

The risk in either of the approaches above is that it creates an environment of ongoing uncertainty for the sector and is likely to reduce the incentive to invest in mitigation technology and innovation in the short term. Other risks include that the AAB becomes a tool for political lobby rather than independent advice and analysis. A strong independent Chair backed by sufficient departmental resourcing will be critical under either scenario.