

Ministry for the Environment:

Reforming the Emissions Trading Scheme: Proposed Settings

Response to Public Consultation

By Wollemi Consulting Limited and LWCM Limited

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About Wollemi Consulting Limited:



Formed in 2017, Wollemi is an Auckland-based management consultancy mostly focusing on strategic planning in areas such as digital technology and sustainability.

About LWCM:



LWCM is a New Zealand-based investment manager. It is the manager of venture capital fund Punakaiki Fund, which has grown since its inception in 2014 to an asset value now exceeding \$50 million. LWCM is looking at developing an additional fund in the socially responsible investment space.

Summary:

We are grateful for the opportunity to provide this brief submission in relation to proposed reforms to the Emissions Trading Scheme (ETS) in Aotearoa New Zealand.

We believe this is a fundamental and critical reform, with ramifications for every New Zealander and indeed the whole world. This is a pivotal opportunity to ensure the goals of the Zero Carbon Act can be delivered and New Zealand's commitment to limit global warming to 1.5 degrees Celsius can be met.

New Zealand implemented a high-quality Goods and Services Tax regime in 1986. It was simple, broad-based and transparent. It achieved the policy goals set out for it of simplifying the tax regime, avoiding double taxation and deriving Government revenue from consumption rather than production.

We should aspire to do something similar with the ETS, taking up those same principles of simplicity, a broad base and delivering to policy objectives.

By contrast, the current ETS has delivered the opposite: it is complex, narrowly targeted, and has not delivered the stated policy goal of reducing emissions. Worse still, the current ETS is so opaque that it is very poorly understood by the general public. This has served to retard public awareness of climate change issues and the response to them since it was introduced.

New Zealand already has a world-leading policy on climate change, as we are the first country with a legislated goal of keeping climate change to within a 1.5 degree temperature increase. The IPCC's updated 2018 Special Report on "Global Warming of 1.5 °C" presents with increased scientific confidence the frightening predicted trajectory of climate change and the impacts of that change. For instance, eighteen of the past twenty warmest years have occurred in the last two decades. The difference between 1.5 °C and 2

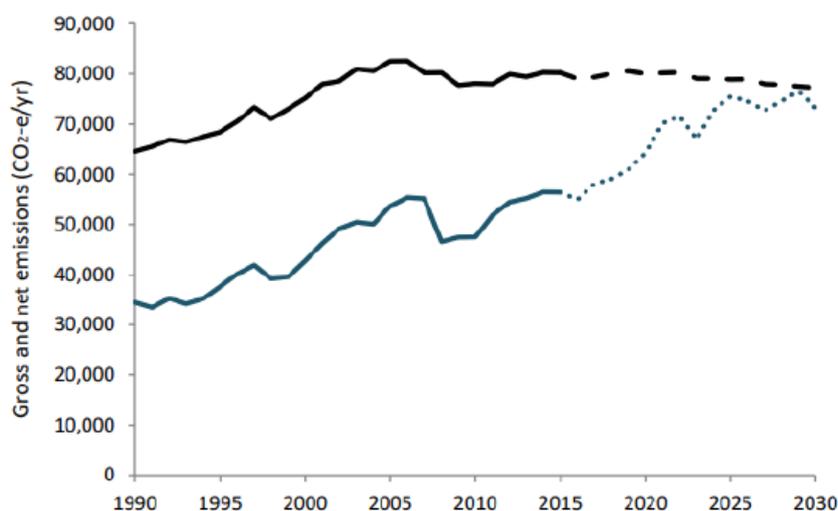
°C means more droughts, more extreme rainfall and storms, higher sea level rise and more instability in ice sheets, irreversible collapses of fisheries and coral reefs, threats to food and water supply, and direct deaths from heatwaves. This more rapid change will stretch our ability to adapt and to afford that adaptation. Without an effective ETS, this policy cannot be successfully implemented.

However, with the right ETS settings, we can deliver the policy at minimum cost - and do so fairly and transparently with a pricing regime which rewards the right behaviours.

Current status:

The legacy ETS introduced in 2008 is not working effectively. The ETS was set up with the stated objective to reduce emissions of greenhouse gases (GHGs). It was the principal Government initiative of the last decade to address climate change. Yet it has failed to reduce emissions. In fact, emissions increased materially in the period from 2008 to the present.

Accordingly, New Zealand’s climate risk has increased while the ETS has been in place. This trend is set to continue according to the Government’s own forecasts (see Figure 1). Importantly, as the consultation notes, New Zealand is currently not tracking to achieve the goals it committed to in the Paris Agreement of 2015.



Note: CO₂-e/yr = carbon dioxide equivalent per year. The black lines represent gross emissions, while the blue lines represent net emissions.

Figure 1: NZ actual and forecasted GHG emissions.

Feedback on proposed reforms:

Emissions cap:

It is critical that New Zealand sets an overall cap on emissions that is consistent with meeting our Paris Agreement goal of limiting warming to 2 °C and pursuing efforts towards a 1.5 °C target. This was a key defect of the legacy scheme, and a main feature of the new scheme. Together with the Climate Change Commission and the overall targets in the Zero Carbon Act, these are the main planks of the overall framework to achieve net zero emissions by 2050.

Timeframe of regulation:

The consultation correctly suggests that more regulatory certainty on emissions is needed urgently, before the Climate Change Commission provides its first recommended emissions budget for the period 2022–25, in 2021. Thus, we support the recommended approach of having a provisional emissions budget for the period 2021 to 2025, to be superseded in 2022 once the Climate Change Commission’s advice has been received by the Government.

We note also that some parties in New Zealand want to see action towards net zero emissions happening much faster than a 2050 target. Dunedin City Council, for example, has set an objective of net zero by 2030. If the first emissions budget does not come into effect until 2022, this would make it much more difficult for Dunedin to meet its ambitious goal. Faster action is likely to lower costs overall.

Responses to Consultation Questions:

1. Do you agree with the proposal to set a provisional emissions budget of 354 Mt CO₂-e for the 2021 –25 period? If not, why not?

We support the recommended approach to set the provisional emissions budget using a straight-line approach towards the 2050 target.

We therefore agree with the suggested provisional budget of 354 Mt CO₂e for the period 2021-2025.

We anticipate many stakeholders will seek a slower pathway and/ or special concessions so that they are exempt from the impact of the ETS. Noting that the lack of an emissions cap, a narrow base, and extensive exemptions have been some of the major flaws of the current ETS, we would like to see these submissions politely rejected! Rent-seekers will naturally seek special treatment, and that has got New Zealand into the position of having some of the highest GHG emissions per capita in the world despite having an ETS in place for 12 years.

2. Do you support the decisions made regarding the technical volume adjustment decisions? If not, why not?

We support the proposal that technical volume adjustments may be necessary.

We expect voluntary markets to grow rapidly, spurred by high international demand and high international prices for credible offsets. We expect that many foresters will look to sell offsets into these voluntary markets, so the ETS needs a mechanism to account for this and to avoid double counting. This mechanism should balance two competing goals – to allow foresters to sell their sequestration at the highest price and to allow afforestation to reduce NZ's emissions inventory. Voluntary markets will cause these goals to clash. Technical volume adjustments are only a limited tool to allow adjustments to the inventory, whereas what will be needed is a comprehensive policy on how New Zealand will make best use of both the voluntary market and the inventory.

We suspect that forestry accounting will change dramatically as more is learnt about the rate of uptake from native plantings. Hence the mechanism for technical volume and forestry adjustments will need to be future-proofed against these changes.

We would like to see consideration of differentiated treatment in the ETS of exotic vs native plantings. This could recognise the additional values that native planting brings for biodiversity, cultural health, and risk-reduction through the avoidance of monoculture plantations. This could be in the form of a price multiple for native planting over exotics, or different regulations such as recognising the carbon sequestered by native trees at an earlier stage than exotics.

3. Are there other adjustments that need to be considered?

Generally speaking, the fraction of emissions that are subject to price-setting through the ETS is too low. This dilutes the price signal, creates division between included and non-included sectors of the economy, and increases price fluctuations.

From a total emissions budget of 354 Mt CO₂-e for 2021-2025, only 80 Mt will be auctioned. The majority of emissions are not subject to that price or involved in price-setting, being outside the ETS, freely allocated, or stockpiled at a previous price.

Having only 23% of any market subject to a transparent price-setting mechanism, with the rest set by fiat, interferes with the effective operation of that market. This has two impacts:

- It increases the price fluctuations within the small portion of the market covered by the scheme; and
- It dilutes the incentives for emissions reductions.

As an ideal, all emissions should be priced as the atmosphere does not differentiate between emission sources.

An initial step towards this ideal should be a change in the rules regarding free allocation. Currently, the goal is that: "The purpose of industrial allocation is to reduce the risk of emissions leakage." Pre-empting the risk without confirmation that it exists is overly generous. Emissions leakage is a theoretical risk, but whether it occurs in practice depends upon the nature of each good or service.

Emissions intensive trade exposed industries should have credibly to prove they are affected, and that leakage is a real risk, before they receive any free allocations. The amount of free allocations should be tied to the amount of actual leakage.

4. Do you agree with the proposal to address the NZ ETS unit stockpile by reducing the annual volume of NZUs available for auction? If not, why not?

No. We believe the stockpile should be cancelled.

The ETS was broken by allowing the purchase of international units of dubious and fraudulent quality. In 2013, the price reached \$1.45 in 2013. Many of the stockpiled units were purchased at those broken prices. Around 132 million NZUs were purchased in that period. If the holders were to sell them at the new price of \$35, then those holders will make a potential profit of over \$4 billion.

Participants in the ETS should not be allowed to make such windfalls from a broken system.

5. Do you agree with 27 million NZUs being removed from auction volume between 2021–25? If not, why not?

No. We think all the stockpiled units should simply be cancelled.

6. Do you agree with the steps and calculations taken to reach the proposed annual auction volumes?

Noting our previous comments, we agree with the process for reaching the proposed annual auction volumes.

7. Do you support the proposal to auction 80 million NZUs over the 2021–25 period plus 2 million NZUs for auctioning trial in 2020? If not, why not? Please include your views on the process for adjusting auction volumes.

Noting our previous comments, we do not support this proposal. The stockpiled units should be cancelled and the whole of the emissions budget should be auctioned.

8. Do you agree with the proposal to set an auction reserve price floor at \$20 for 2020–25? If not, why not?

No. Prices compatible with reaching New Zealand's Paris Agreement targets are well in excess of \$50. Prices compatible with a 1.5 degree target are even higher. The current price of \$25 should be considered a minimum with a rising floor being set each year towards prices that drive a shift in the economy towards a low-carbon, high-innovation economy.

Accordingly, we do not see that \$20 is an appropriate price floor and would like to see a much higher floor.

9. Do you agree with the proposal to increase the fixed price option to \$35 for obligations arising from activities over 2020?

We agree with the proposal to increase the fixed price option for obligations arising from activities over 2020.

However, as noted above we believe the price of \$35 is insufficient to drive the rapid transition to a zero-carbon economy and is inconsistent with New Zealand meeting Paris commitments or a 1.5 degree future.

10. Do you agree with the proposal to set the price ceiling trigger of the cost containment reserve at \$50 for the 2020–25 period? If not, why not?

We understand and support the reasons for having a price cap on future emissions in a reformed ETS. This will provide more certainty to the market as they price emissions into their businesses, and crucially, the proposed price cap of \$50/ t-CO₂e is much higher than the previous cap of \$25. However, we believe the price of emissions will naturally rise over time. If the price were uncapped, it might well exceed \$50 within a few years. We see that a price of over \$50 will actually start to drive the require changes in investment and consumption. Putting a cap on the price is creating economic distortion that prevents that low-carbon behaviour from occurring. Government should set the ETS rules, police them and let the market clear.

The fundamental failure of carbon pricing is that prices have been too low to reduce emissions. Whether delivered through carbon trading markets or through carbon taxes, only 20% of global emissions face any price and only 1% of global emissions face prices consistent with achieving the Paris Agreement targets of limiting temperature rise. Around 10% of global emissions face prices of less than US\$10 per tonne. Some 80% face of global emissions are entirely unpriced at present.

We think having a cap on emissions (a sinking lid), administered by the Climate Change Commission, and a price cap, for more than an interim period would tend to distort market behaviour. Firms will know they are liable for costs of \$50/ tonne at most and will naturally avoid reducing emissions if the costs of doing so are more than the annualised value of ETS costs.

Therefore, we are in favour of removal of the price cap.

11. Do you agree with the proposed annual cost containment reserve volumes to be released if the price ceiling trigger is hit? If not, why not?

We agree that reserves should be released at the price trigger. However, this must only happen if these reserves come from "legitimate equivalent emissions reductions". It is hard to foresee where these reductions will come from. If emissions reductions existed at, for example, a \$50 cost then emitters would have already purchased those reductions. This implies that the emissions reductions making up the cost-containment reserve will come at a higher cost than the price ceiling and will likely be purchased overseas.

Thus, the cost-containment reserve exposes New Zealand as a nation to the international carbon price while insulating New Zealand companies from this risk. This is the intention of the policy, but again firms will know they are liable for costs of \$50/ tonne at most and will avoid reducing emissions if the costs exceed \$50, knowing that the government will pay a higher price.

12. Do you agree with the proposed approach for release of NZ ETS settings information? If not, why not?

Yes. As we have noted, a transparent regime is in the interests of investors and all of the community in Aotearoa New Zealand, and we see the proposed information release as supporting this transparency.

13. Do you have any further comments?

Another area of concern for us is the international market. We should stop or at least discourage international investors from buying up cheap NZ credits. For example, the current NZ price of ~\$29 is well below the prevailing European price per tonne CO₂-e of ~25 euros (~\$42). The ETS must ensure it cannot be “gamed” by international investors for whom the prevailing price may be a discount to their own jurisdiction. Equally, if international buyers are willing to pay more than the NZ price for emissions reductions, New Zealand producers of high-quality credible emissions reductions should be able to benefit from that high price. This will drive us towards a single global market in emissions reductions that matches the single global atmosphere, delivering emissions reductions for all at the lowest-possible price. NZ should follow, when possible, international prices that are consistent with effective and sufficient climate action.

We also wish to note that the ETS is being reformed in a context of broader environmental, economic and social policy in New Zealand. In future we would do well to take a whole-of-system approach which tries to end the “take, make, waste” model of the industrial revolution in its entirety. This model has produced the GHG pollution which we are now grappling to deal with through the Zero Carbon Act, the ETS and many other measures.

An improved model would include:

- A Government capital allocation model which addresses climate change risk, for example through reducing investment in high emissions industries, government procurement rules supporting lower-emissions goods and services, and requirements to track and publish emissions, as well as investing in resilient infrastructure, partnering with local Government, and increasing the funds available to the Green Investment Fund;
- Supporting investment by private firms in complementary activities including green bonds, allocation of corporate capital towards sustainability programmes, and “climate tech” venture capital;
- Appropriate price signals for the environmental costs of waste, including water pollution, impact on biodiversity and climate change impact, incorporated in the Emissions Trading Scheme;
- As part of this, a higher levy on waste going to landfill, with more Government funding accordingly available through the Waste Minimisation Fund to help industries clean up their waste streams;
- Stronger price signals and non-price measures where appropriate to support the use of lower-waste materials, designs, and products with the goal of enabling a truly circular economy; and
- Taking a well-being framework rather than a purely economic approach, as suggested by the Living Standards Framework, the UN Sustainable Development Goals, the OECD Better Life Index and so forth.

Should the ETS continue to fail to reduce emissions, then all options should be on the table for a replacement. A simpler model would be a carbon tax system, akin to the GST system we have. This tax will need to be large and rising over time to deliver the necessary emission reductions.