BusinessNZ
The voice of business

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29 April 2016

NZ ETS Review Consultation
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New Zealand Emissions Trading Scheme Review 2015/16

BusinessNZ is pleased to have the opportunity to provide a second submission to the Ministry for the Environment on its discussion document entitled 'New Zealand Emissions Trading Scheme: Review 2015/16', dated 24 November 2015.[1]

Introduction

Having provided the Ministry for the Environment with a comprehensive submission addressing most facets of the issues canvassed in the discussion document, BusinessNZ wishes to use this submission to share with the Ministry some further thoughts about the ETS and its operation.

Further thoughts

BusinessNZ has the following observations it wishes to make:

- we support the eventual removal of the 1:2 surrender obligation. It was intended as a transitional measure and, in light of the Paris Agreement, it is timely to be considering the conditions surrounding its removal as global action to reduce emissions intensifies. It is, however, important that this is done in a way that maintains the international competitiveness of our business sector (a high proportion of New Zealand businesses are in global supply chains) and the overall economic burden on the economy relative to the pace of change being implemented by our trade competitors;

- it is clear that changes to the ETS cannot be solely justified on needing to meet New Zealand's 2020 target – New Zealand is already going to achieve that. Changes are warranted for other longer term reasons

[1] Background information on BusinessNZ is attached in Appendix One.

(that is, post 2020) but these reasons need to be transparent, with proposed solutions clearly matched to them;

- market mechanisms are complex, and cannot be judged by their end state, because markets are by their very nature a process of discovery. Much of the price movements and volatility officials are concerned about originates in the constant change of rules that carbon markets – both internationally and domestically – have undergone. Constant change or its continually signalled possibility focuses the attention of the market participants on the market regulators rather than the market's underlying fundamentals. Bringing this dynamic to a halt by stipulating a series of durable, static rules is important to decreasing unnecessary risks and therefore volatility. This in turn will encourage efficient investment;

- as an element of the preoccupation with inconstant prices and volatility, officials appear to be looking to manage prices themselves through manipulating the scheme's design settings. Stabilisation reserves and auctions, for example, should not be used to achieve price stability. Economic agents (that is, businesses) are used to dealing with variations in prices and volatility so long as they are based on market fundamentals. Such business-led risk management solutions are also more likely to be effective. If a market needs to be managed, then the market does not work – at least in the perception of its agents – as they will adapt their actions to the actions or signals of the market managers and not to the signals provided by the market process and its underlying fundamentals;

- the price cap was not introduced for price stability reasons, certainly not the 'volatility' observed in the scheme. The cap was introduced as a 'safety-valve' to limit the level of economic burden on the economy as New Zealand moved ahead of its international peers by placing a price of carbon on the economy. Until this concern – that the burden being placed on New Zealand businesses is disproportionate to that being faced by their trade competitors – dissipates, then such a mechanism remains a valid option;

- there is no 'right' or 'wrong' business response to an ETS. Each business has its different individual cost curve, capabilities and preferences and as such will adapt differently to the market. No useful information for policy development purposes can be extracted from a pejorative assessment of how business might or might not be reacting to the ETS;

- in the absence of access to international units, auctions must be available. These are a vital tool to help discover the economy-wide abatement cost curve. BusinessNZ remains uncertain why an auction mechanism has not already been designed, let alone implemented, given that the power to do so has existed for a number of years. A failure to design an auction mechanism quickly for rapid implementation if required could see carbon prices that are not supported by carbon market fundamentals, creating inefficient and distorting price signals, resulting in the misallocation of resources and ultimately policy failure;

- access to international units is a necessary feature of a viable and fully functioning liquid trading scheme. International trading (via either the one-way importation of units or the more complex scheme linking) is a vital economic safety-valve given New Zealand's high domestic cost of abatement. Without access to international units, New Zealand would essentially have a carbon tax (or 'managed price path') with complex trading attributes whose transactions costs would in all likelihood outweigh its benefits;

- the allocation of free units is often confused with creating an incentive not to reduce emissions. Abatement depends entirely on the incentive effect of the trading obligation and is achieved regardless of whether businesses are given 100% of units free, or has to buy them all. With a market price of carbon, businesses with 100% free units still face the incentive to sell units and abate (as the units have a market value), or emit and surrender the units. Maintaining emission rights of existing emitters will meet their legitimate expectations based on investment decisions made when access to the atmospheric resource was unconstrained (that is, prior to the introduction of the scheme), avoid the appropriation of profits and can be achieved without harming the efficacy of the scheme; and

- forestry, along with access to international units (as *both* are offsets), will be important especially in the short-term, to reduce our net emissions profile, but will not reduce our gross emissions. Policies such as averaging seem sensible, but favourable treatment of the forestry sector to encourage afforestation needs to be balanced with policies targeted at supporting reductions in our *gross* emissions profile, especially those that will not be easily reduced due to the need to maintain international competitiveness or inelasticity's of demand. Revenue from auctions should be utilised for this purpose.

Summary

Making changes to a fundamental piece of economic architecture such as the ETS is difficult. It is important to learn from past mistakes not to base policy on wishful thinking about what might emerge out of the international negotiations. Paris delivered a positive outcome, but much of the detail – for example, the actual stringency of action being taken by other jurisdictions and the development of, and access to carbon markets –will take a number of years to establish. This pace of change needs to be a consideration as domestic policy settings are developed as this will impact on the extent to which New Zealand businesses remain internationally competitive.

As the key source of low greenhouse gas solutions, business looks to work collaboratively with government and officials to further unlock a lower greenhouse gas future. But business wants to see any decisions taken on scheme design nested within a more long-term, strategic framing. A tactical focus on scheme features targeted at lifting the carbon price in isolation of a more careful consideration of the full suite of climate change-related initiatives and objectives will raise the likelihood of poor outcomes. Business wants to see evidence of a well thought-through pathway and has commenced work to help inform government policy development in the form of the business-initiated climate change leader's dialogue. The purpose of this dialogue is to bring all stakeholders together to drive long-term systems change to accelerate emissions reduction at a national scale.

Knowing New Zealand is already going to meet its 2020 emissions reduction target provides us with a window of opportunity to develop, and start to implement a long-term, coherent, joined-up and ambitious climate change strategy.

Yours sincerely

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BusinessNZ

APPENDIX ONE: ABOUT BUSINESSNZ

Encompassing four regional business organisations (Employers' & Manufacturers' Association (Northern), Employers' Chamber of Commerce Central, Canterbury Employers' Chamber of Commerce, and the Otago-Southland Employers' Association), BusinessNZ is New Zealand's largest business advocacy body. Together with its 80 strong Major Companies Group, and the 70-member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, BusinessNZ is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

In addition to advocacy on behalf of enterprise, BusinessNZ contributes to Governmental and tripartite working parties and international bodies including the ILO, the International Organisation of Employers and the Business and Industry Advisory Council to the OECD.