



# Generation Zero

## ETS Review 2015/2016 consultation – other issues

### Contact information

Name	Paul Young
Organisation	Generation Zero
Address	[REDACTED]
Telephone	[REDACTED]
Email	[REDACTED]

## Introduction

We thank the Ministry for the Environment for the opportunity to comment.

It is hard to have a conversation about ETS design and settings without more clarity and consensus around tangible outcomes New Zealand is trying to achieve. How much should we aim to reduce emissions domestically? How much should we aim to reduce gross emissions specifically? We believe goals like this are needed, informed by a long-term transformation pathway to a zero carbon economy. We already discussed the need for a legislated carbon budgeting process in our submission on the priority issues. ETS design should be a part of this process.

We note that in California, their ETS is described as the 'backstop' to ensure overall emissions targets are met. It is part of a whole portfolio of measures under the Global Warming Solutions Act. It is expected to do some of the lifting and 'mop up' the emissions reductions not achieved by other measures (a robust scheme with a binding cap should ensure this occurs). The context has been similar in Europe where in some countries it has been renewable energy policies that have done more of the heavy lifting than the ETS (one contributor to low EUA unit prices).

So while we want to see the focus shift to the bigger, broader picture, the ETS is an important tool and it needs to work. Right now, its credibility is in tatters as a result of the way it has been run to date. The Government has a lot of work to do to restore the faith that the ETS can be made to work. In this light, we suggest two guiding principles for decisions about future design:

- **Make it simple.** Ordinary people have a hard time understanding the ETS, and generally speaking do not trust something they do not understand. Changes that will add further complexity to an already complex scheme should be avoided as much as possible. That might be a trade-off in some cases with sending all the desired price signals to participants (e.g. with forestry rules), but a simpler scheme is likely to result in greater participation, and other targeted interventions could be applied instead.
- **Make it safe.** The Government must not allow the ETS to be rorted again as it has in the past. This would be a final nail in the coffin, and we do not have time for more mistakes. Utmost care must be taken to avoid perverse incentives, profiteering, and other unintended outcomes. Generally this will align with keeping the rules simple.

We now comment on specific issues and questions in the discussion document. Main recommendations are highlighted in bold text.

## Free allocation

(Questions 11-12)

We have three key technical points to make in relation to free allocation:

1. Total free allocation volume has been *increasing* at an average rate of 3.5% p/a (stated by MFE officials at the stage two consultation meeting).

2. Graphs presented at the consultation meeting (presentation slide “Domestic alignment (4)”) show that under current settings, projected free allocation volume plus non-ETS emissions volumes (agriculture + other) will exceed the carbon budget (based on the current 2030 target) by 2030. In other words, the taxpayer will be fully subsidising emissions in excess of our national carbon budget.
3. It is our understanding that the allocative baseline factors are fixed based on historic emissions intensity calculations which are likely now outdated and excessive. The Government’s original plan to reduce the free allocation level by 1.3% p/a was we understand deliberately set to roughly the historic average rate of intensity improvements. That should mean that, under business-as-usual improvements, companies would in fact face no additional burden. Conversely, by not reducing the free allocation level (or updating allocative baseline factors), free allocation will in fact be getting more generous over time, delivering windfall profits to polluters a completely perverse outcome. This seems to be borne out by analysis of NZ Steel in a recent *hot Topic* blog post.<sup>2</sup>

**It is clear to us from these points that free allocation needs to be reduced under *any* conditions, starting as soon as possible.**

**We support the Parliamentary Commissioner for the Environment’s call for a schedule to be (re-) established for phasing out free allocation. We suggest a thorough independent review of the free allocation settings is needed as a first step.**

Such a review should take note of new evidence, including research from the OECD, which found:<sup>3</sup>

*“Environmental policies are not a major driver of international trade patterns, even if they still have some significant effects on specialisation. Increasing the stringency of domestic environmental policies does not have a significant effect on overall trade in manufactured goods, but tilts the comparative advantage away from pollution intensive industries. It provides a corresponding advantage in “cleaner” industries. Less stringent policies give an advantage to more pollution intensive production, but at the expense of less polluting industries. Still, the effects are small compared to overall trade developments.”*

While Generation Zero supports the principle of government assistance being provided in the transition to a low carbon economy, the government should not be protecting and subsidizing emissions intensive industries when that support would be better directed to cleaner industries with sustainable growth potential.

We also note that the second point above highlights the need to revisit the decision to entirely exclude agriculture from the ETS, which increasingly “squeezes” other sectors harder.

## International units

(Question 16)

---

<sup>2</sup> <http://hot-top.c.co.nz/d-d-nz-steel-make-w-ndfa-arb-trage-prof-ts-from-the-ets/>

<sup>3</sup> <http://www.oecd.org/eco/greeneco/do-structure-env-ronmenta-po-c-es-hurt-export-compet-t-veness.htm>

The unrestricted use of international units in the past has been the biggest problem – it has completely undermined the ETS and almost destroyed its credibility in the eyes of much of the public. More fundamentally, New Zealand’s near-exclusive reliance on buying international units (regardless of their integrity) will be damaging to our reputation and economically costly in the long-term (if not already so now).

We recommend that:

**The ETS should remain closed to foreign credits until we can ensure that these have environmental integrity, do not cause other forms of harm, and are subject to a high level of transparency and oversight.**

**If foreign credits of assured environmental integrity do become available, there should be firm quantitative limits on their use to ensure we are transitioning the New Zealand economy towards a zero carbon future.**

We question the assumption that New Zealand will need to use international units in order to meet the current 2030 target. We believe New Zealand can and should aim to meet this target domestically, as the upcoming “Yes We Can” conference will investigate. We believe a more ambitious target would then be accessible through offshore investments (however those are made).

All of this is heavily dependent on forestry accounting rules, and we are still yet to see what New Zealand’s emissions projections to 2030 look like under different rules. Until the necessary analysis has been done and properly scrutinised, and New Zealand’s target adjusted accordingly, we can’t really say anything more specific about limits on international units. Government needs to provide the analysis so that New Zealand is able to have a proper debate.

## Auctioning

(Questions 17-19)

First, it is only worth discussing auctioning in the context of an actual cap – in other words a quantity restriction on international units.

**Timing:** **Unless the Government takes action to clear the bank of NZUs faster (such as suspending free allocation for a year as has been suggested), auctioning should not be introduced before 2020, as this will add to an already oversupplied market.** An exception to this could be the auctioning of a very small quantity of units as a sort of trial to get systems up and running for the post-2020 period.

**Purpose:** We see that auctioning could play a useful role in aligning supply with international targets, managing NZU prices (through a floor price), and generating revenue (which can be used for compensation to low income households and/or investing in low carbon projects and infrastructure). However, this depends on a number of other design factors so we do not have a firmly held view at this stage.

## Managing price stability

(Questions 21-23)

The most important thing to us is a clear expectation of steadily increasing carbon prices over time, so that businesses have more certainty around low carbon investments and strong disincentives

against high carbon investments (e.g. new coal boilers). Given the track record of price instability (on the down side), the Government needs to take extra steps to deliver certainty going forward.

**For this reason, we think there should be a steadily rising price floor, similar to the California ETS.**

We do not see the need for a price ceiling, however if a price floor was in place then a ceiling would be acceptable as long it was sufficiently high and rationally determined. For example, we suggested in our previous submission that a ceiling could be benchmarked to the social cost of carbon. The current fixed price option, which we understand operates effectively as a simple charge, seems to operate fine as a mechanism.

## Possible scheme design

Here is an outline of one possible ETS design, which we are intending as food for thought rather than a recommendation.

- Viable international markets with assured integrity are not developed by 2020, and we keep the ETS closed as a domestic scheme.
- Free allocation is reduced according to a clear schedule.
- Auctioning is introduced with a total supply cap aligned with the carbon budget (accounting for non-ETS sectors).
- A floor price is set with an auction reserve, rising with a clear schedule.
- A price ceiling is maintained as a simple charge emitters can pay, rising with a clear schedule.
- Government chooses how to use auction revenue, from options including: recycling to citizens/households, low carbon investments in New Zealand, purchase of international units at a time they become available, or direct bilateral climate change investments.

While this idea needs scrutiny, there are several positive attributes in our view:

- A single currency keeps the scheme simpler and less prone to manipulation and perverse outcomes.
- Maintain flexibility for the government to strategically use the proceeds from unit purchasing.
- Can better ensure oversight of integrity of international units and make government more directly accountable, and add additional purchasing criteria beyond least cost compliance.
- Allows government easy control over price floor.

We would like to see this idea explored further, rather than jumping to the conclusion that we must have an open or linked ETS by 2020.

## Operational matters

Over the years there have been repeated allegations and concerns raised about price gouging (i.e. companies charging consumers more than they are actually paying to cover their emissions) which have not been satisfactorily addressed.<sup>4</sup> This is another issue potentially affecting public trust and buy-in. Worse, it could be creating perverse incentives where companies are profiting from pollution.

---

<sup>4</sup> See the Morgan Foundat on's *Climate Cheats* report.

**We recommend that the Government investigate this matter and explore options for public disclosure of carbon prices paid by companies.**

Relatedly, public trust and buy-in could be improved by regular reporting focusing on tangible outcomes achieved by the ETS (not just the technical details). So far there have not been tangible positive outcomes to speak of, but in the future this could include: estimated gross emissions reductions; estimated area of tree plantings; what auction revenue was used for; a breakdown of overseas projects invested in.

## **Addressing barriers to the uptake of low emissions technologies**

This is a huge area where more work is needed and we find the question here is too narrow, framed only in terms of technologies (not behaviours or practices), and only “barriers and market failures”. These are of course important to address, but given the rate of change needed we need to look beyond to actively supporting low carbon solutions, including with public money. New Zealand is rare amongst developed countries in its low level of regulations and public investment to drive the transition to a low carbon economy. Again, this is where a comprehensive carbon budgeting process is needed.

Within the limited scope, here are a few suggestions:

- Electric vehicles need social proof of concept and opportunities for people to try them out, which could be helped along by an ambitious government fleet electrification programme.
- Bioenergy uptake seems to be hindered by a lack of coordination, information and resourcing, which the government could support.
- In several countries (most notably Germany and Denmark) community-owned wind farms are very common and successful. Why is this not occurring in New Zealand? Are there market barriers to small-scale electricity generators?
- In some cases there is a low price elasticity because people do not have access to decent alternatives particularly in transport.
- Access to sufficient capital and the need for a very high rate of return is a barrier to a wide range of cost-effective low carbon investments. Ideas such as low-cost loans and government-backed “green bonds” could be pursued.
- Split incentives for household/building insulation and efficient heating mean regulation is required.
- Uncertainty about future carbon prices is another cross-cutting issue, which the Government could address with, for example, a rising price floor as discussed above.