New Zealand Emissions Trading Scheme Review 2015/16

Priority Issues

Submission by the Investor Group on Climate Change

February 2016

[redacted]
www.igcc.org.au

1. Introduction and overview

The Investor Group on Climate Change (IGCC) represents Australian and New Zealand institutional investors with over $1 trillion of funds under management, along with members of the investment community focused on the impacts of climate and energy issues.

IGCC members are invested across the economy and are part owners of most of New Zealand's large companies. As managers of retirement savings and pooled investments we are concerned with the evident and increasing impacts of climate change on the global and New Zealand economies and the flow through impacts for future investment returns.

It is increasingly apparent that there is a global economic transition underway, focused on the reduction of the emissions intensity of economic activity in order to stabilize global warming at two degrees Celsius below pre-industrial levels at most and move towards a net zero emissions economy by the second half of the century. To protect existing investments and invest in future low carbon opportunities, investors are seeking to reduce their exposure to the risks of climate change, including through a reduction in emission-intensity of the investments they currently hold and, where practicable, through allocation of investment capital to new low carbon investment opportunities.

The policy settings which New Zealand establishes to support our fair share in the global task of tackling global warming will determine whether this process of decarbonisation is smooth and efficient or abrupt and disruptive.

Engagement in the public policy discussion on the most appropriate policy framework for New Zealand is a key way in which investors can positively support the development of an economically efficient and environmentally effective policy response. We therefore welcome the opportunity to contribute to the review of the New Zealand Emissions Trading Scheme (NZETS).

2. This submission

Given that IGCC is not a direct market participant or a liable entity under the scheme, we have sought to comment on selective aspects of the discussion paper on priority issues to be considered under the review and focus primarily on the investment implications. These include:

- Context and drivers for the review
- Moving to full surrender obligations and managing the costs
- Protecting competitiveness through free allocation
- Managing price stability
- Addressing barriers to the uptake of low carbon technologies

Feedback draws upon the experience and views of IGCC members.

Context and drivers for the review

This review is both timely and necessary, as New Zealand moves to respond to the new global climate change agreement of December 2015 and address structural issues within the current NZETS design.

The recently-finalised Paris Agreement is highly significant in that it delivers a process and pathway for ambition which increases over time. Both the commitment to target a limit to global warming of 1.5/2.00 degrees Celsius and ultimately achieve a net zero emissions economy by the second half of the century, as well as the fixed review and ratchet provisions, mean that New Zealand's policy response will need to build in the ability to scale up emission reductions over time in line with the agreed international process.

IGCC notes that the NZETS Review Discussion Paper itself acknowledges the need to strengthen the application of the NZ ETS, stating that "*Projections indicate that New Zealand's current policy measures, of which the NZ ETS is the main instrument, will have little impact on gross emissions in the future if current settings continue*[1]*.*"

As investors, IGCC remains supportive of the principal role of the NZ ETS in New Zealand's policy framework. This has been our historical position, and remains our preferred policy response. The IGCC supports robust, investment-grade policies to reduce emissions. IGCC members have long supported putting a price on emissions as the most effective and efficient way to provide a long-term, transparent and certain regulatory framework to address carbon risks in investment portfolios. Clear policy signals and frameworks deliver greater investment certainty, allowing the market to move ahead of fixed policy processes and ultimately smooth the path and reduce the cost of transition.

While recognizing that the NZETS is currently a domestic market, IGCC believes that the Government should continue to actively participate in international negotiations focusing on the post-2020 framework and design of future international market architecture, as set out in the Paris Agreement.

Finally, the need to address economic competitiveness implications should be incorporated into policy design, not seen as the basis for implementing a shallow or unambitious policy response. Failure to adequately position business for the global low carbon economy of the future by being over-protectionist is just as likely to result in diminished economic competitiveness for New Zealand business as an excessively onerous policy response. This is a question of policy balance and transitional pathways which incorporate a full and frank acknowledgement of the direction and pace of decarbonisation in the future.

Moving to full surrender obligations and managing the costs

Transitional measures which accompanied the introduction of the NZETS served a number of useful purposes, including assisting business to manage the introduction of a new cost impost, managing flow through price impacts for the wider community and ensuring the introduction of the scheme was measured and reasonable.

Ultimately, however, the primary intent of a market based carbon pricing mechanism is for the market to generate a price signal which flows through the economy and incentivize the tilting of economic behavior towards less carbon intensive forms of activity. While the transition to a low carbon economy can be smoothed out with additional transitional measures, at some point the price has to act as a reasonable signal for the policy to be environmentally effective overall.

Research conducted for this review on the impacts for entities liable under the NZ ETS have indicated that the price signal has not been sufficient to significantly change behavior or incentivize investment in technological or structural change. This has been as a result of a number of factors, including policy changes and price movements in international markets impacting the NZ ETS price. In summary, it would appear that a low price combined with underlying structural and design dimensions have weakened the ability of the ETS to deliver on the overarching policy objective.

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[1] New Zealand Emissions Trading Scheme Review Discussion Document, p.8.

IGCC would therefore support the rollback of a number of transitional measures to boost the NZU price and strengthen the efficacy of the NZ ETS as a policy measure intended to drive economy wide decarbonisation.

Specifically, IGCC investors support the proposal to remove the two-for-one surrender provision. This should be clearly signaled to the market and implemented as soon as is practical, rather than phased out over time. IGCC also supports maintaining the fixed price option of $25, but would suggest reviewing options for ratcheting it up over time to ensure that it does not undermine the price incentive for longer term investment in transformative technologies.

At the economic level, IGCC notes that modelling undertaken by the New Zealand Institute of Economic Research (NZIER) found that moving to a full unit obligation at $25 per tonne would impose a cost to GDP growth of 0.1% in 2020[2]. Moving to a full surrender obligation would also address Government concerns over the substantial stockpile of banked NZUs.

Protecting competitiveness through free allocation

IGCC notes that the allocation of units to trade exposed liable entities is not part of the current scope of review. However, it should also be acknowledged that the free unit allocation is currently linked to the two-for-one surrender provision. Therefore, an adjustment or phasing out of this provision would need to be consider implications for supply/demand dynamics. The review should consider whether there is an opportunity to provide greater clarity on a timeline and phase out approach to the free unit allocation as a transitional measure, so that removal of one without the other doesn't undermine the intent and impact supply/demand.

For investors, the critical implication for carbon pricing policy is the delivery of clear market signals, implementation timelines and transitional pathways. Greater clarity on the proposed approach to transitional assistance, including free unit allocation, would assist investors in accurately pricing carbon risk into long term investment decisions. This would also serve to incentivize more investment into low carbon as investors are able to more accurately incorporate the costs and benefits of acting on climate change.

Managing price stability

Market volatility is a function of the impact of unforeseen and sudden changes to market expectations on supply and demand. In a regulatory market such as the NZ ETS, this has included unforeseen domestic policy changes on market design, underlying economic or industrial activity and policy decisions in international markets.

To some extent all markets are limited in their capacity to wholly eliminate price volatility, however there are certain measures which can be implemented to reduce extreme price movements. Efficient price discovery is key.

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2 Table 1 Macroeconomic results of removing the 1 for 2 obligation. (p. i), Economic impacts of removing NZ ETS transitional measures, NZIER final report to Ministry for the Environment December 2015

- Stable, predictable and transparent policy design and decision-making processes, including implementation timeframes, are one of the key levers which Government and regulators can apply to reduce price volatility.
- Price floors and caps can also provide upper and lower limits to price movements, but also have the potential to distort traded behavior.
- Policy levers which allow regulators to adjust unit supply and demand (eg free permit allocation, international linking and auctions) can be used effectively to moderate price swings where they occur.

As stated above, IGCC supports maintaining the fixed price option of $25, but would suggest ratcheting it up over time to ensure that it does not undermine the price incentive for longer term investment in transformative technologies.

However, for the market to function as a market, government or regulatory intervention which has the potential to distort price discovery and/or market behavior, thereby leading to unintended outcomes (eg prices that are too high or too low or which trade at the price cap or the price floor without genuine market movement), should be carefully managed and limited wherever possible.

Given that the Government has signaled that it intends to examine opportunities for re-establishing linkages with international markets at a future date, and with due consideration to current arrangements for free unit allocation, the desire to generate further domestic abatement through the forestry sector and existing stocks of banked units, IGCC would recommend against introducing auctions as an additional avenue for supply until a clear outcome on international discussions on future global market architecture are resolved.

Addressing barriers to the uptake of low carbon technologies

IGCC also believes there is a role for climate change policy to facilitate and accelerate technological and market support for climate change solutions. Policy responses should incorporate the flexibility required to support investment in the innovation, clean energy and CleanTech solutions required to reduce the market costs of transition. Supporting private sector investment and growth opportunities will ultimately reduce public costs and deliver greater cost effectiveness. In addition, the removal of existing subsidies or perverse incentives for emissions intensive activities or practices should be reviewed and considered under the umbrella of direct regulation.

IGCC investors believe that there may be some additional policy opportunities in the areas of transport, energy efficiency and industrial efficiency. The built environment and the property sector is another area where there may be some opportunities for additional direct regulation to facilitate the transition of both new and existing stock to a low carbon operating environment.

6. Conclusion

New Zealand now has a number of years' direct experience in implementing various climate change policy options in response to the changing debate. The time is right to revisit some of the design elements of the NZ ETS, particularly following the finalization of the historic Paris Agreement.

More broadly, New Zealand needs to pursue an integrated climate change policy response which facilitates an economically efficient transition to a low carbon economy, while playing our fair share in the global task of avoiding dangerous global warming. Market based mechanisms have historically proven most effective at delivering policy objectives, coupled with targeted regulatory interventions where necessary and as appropriate.