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ETS REVIEW (FULL SURRENDER)

NZAA submission

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NEW ZEALAND

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NOTE TO REQUESTOR

This submission constitutes the first half of the AA's submission on this issue

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Background on the New Zealand Automobile Association

The NZAA is an incorporated society with 1.5 million Members. Originally founded in 1903 as an automobile users advocacy group today it represents the interests of road users who collectively pay over \$2 billion in taxes each year through fuel excise, road user charges, registration fees, ACC levies, and GST. The NZAA's advocacy and policy work mainly focuses on protecting the freedom of choice and rights of motorists, keeping the cost of motoring fair and reasonable, and enhancing the safety of all road users.

In terms of the NZ ETS the AA does not represent a legally obligated party to surrender NZU's. However its Members, like all motorists, are affected by the passing on of NZ ETS costs by the liquid fuel marketing companies who are obligated parties. While the convenience of the market and the scheme participants is the main reason for this arrangement the AA wishes to the point that millions of liquid fuel customers are the ultimate emitters of greenhouse gases and meet the NZ ETS costs imposed on the obligated parties

Executive Summary

The effective domestication of the NZ ETS since July last year creates a turning point in the history of the carbon trade in New Zealand. While the market is currently over supplied with imported four years' worth of NZUs this is a temporary situation which the introduction of full surrender could rapidly reverse.

Currently Forestry is the sole source of commercial NZUs but can only cover one third of current demand at full surrender value. It is unlikely that the carbon market will increase the supply of forestry credits to cover domestic demand as this market is primarily driven by log prices, not NZU demand.

The AA therefore recommends that as a matter of urgency officials seek to expand the source of NZUs available to ETS participants beyond New Zealand forestry. The AA believes that this market expansion should, like other financial markets, be managed transparently with full disclosure so that prices and expectations are predictable to all obligated parties and potential suppliers. The plan to achieve this should be complete before full surrender is enacted.

The AA supports the introduction of full surrender dependent on these disclosure conditions being met for the March 2018 year end. However as a safeguard the current cap of \$25 per tonne should be retained until such time as the international market supply is available at reasonable New Zealand prices.

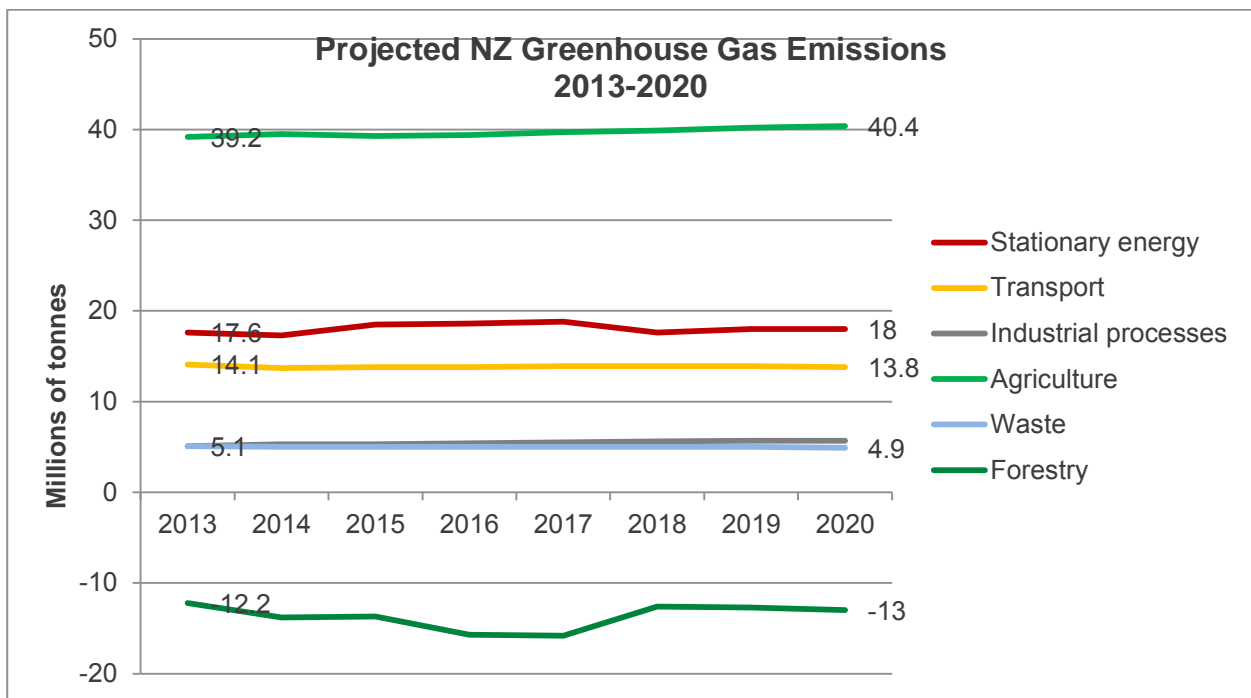
1. Should the NZ ETS move to a full surrender obligation for the liquid fossil fuels, industrial processes, stationary energy and waste sectors?

1.0 Observations on the general effect of market systems

The NZ ETS, like all market based systems, seeks to establish an equilibrium between supply and demand through a price mechanism. When supply is plentiful and demand is low prices will also be low. When supply is constrained and demand is high, prices too, will be high.

In the case of greenhouse gas emission trading schemes the good being traded is the right to emit a tonne unit of carbon dioxide (or equivalent warming potential) gas – an NZU. Liquid fuel distributors carry the burden for their customers and must cover their legal responsibility for the greenhouse gases their customers emit when their fuel is burned by surrendering NZUs to the NZ Emission Unit Registry on 31 March each year.

The demand for units therefore comes from those obligated parties who need to surrender units. Obligated parties need to surrender units to cover New Zealand's emissions which are about 18.5m tonnes of stationary energy (power) 13.5m tonnes of transport energy, 5m tonnes of industrial processes and 5 million tonnes of waste. Not all of this falls under the ETS as some may be exempt, like agriculture which emits 39m tonnes. Transport accounts for roughly one third of non-agriculture emissions.



The supply of NZUs has changed significantly over the life of the ETS. The sources of NZUs include: 1) free allocations from the New Zealand government of NZUs to trade exposed industries 2) Forestry sink credits created by forests absorbing carbon from the atmosphere (projected to be 15m tonnes this year) 3) units created by other authorities such as the United Nations and imported into the ETS. In 2014 94% of units surrendered entered the ETS from United Nations mechanisms.

New Zealand stopped accepting most UN authorised removal units from July 2015. However market participants had already bought over 140 million very low priced units from these

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sources by the time this door was closed and the integrity of the market requires that these units continue to be honoured.

From January 2013 the price of NZUs was nominal (around \$4) but has lately recovered to around \$9.50.

1.1 Origin of the two-for-one surrender concession

When legislation (Climate Change Response Act 2002 section 63A) was amended in 2009 transition measures including a “surrender one unit for every two tonnes emitted” clause was introduced as a “transitional” measure.

As required under legislation this Act was reviewed in 2011 and the review panel concluded the one for two offer should be retired. The government disagreed and extended it to 2015 pending a new review (this one), arguing the effects of the global financial crisis meant the transitional measure was still needed.

This means that under current rules obligated parties currently need to surrender 19.2 million market sourced units per year instead of 38.4 million units. Forestry can cover around 14m units. This is 70% of the market under two-for one but only 35% under full surrender.

Obviously any cessation of the two-for-one deal will have the effect of eroding the stockpile of 140 million of cheap UN originated units out of the ETS twice as quickly as it would if the two for one deal was continued.

This view seems to have reversed following the Paris agreement at 21st Conference of the Parties of the UNFCCC where New Zealand committed to reduce GHG emissions to 30% below 2005 levels by 2030.

1.2 View in principle

The whole ETS system is based on the expectation that the provision of NZUs from those removing carbon from the atmosphere will equal or exceed the emissions from those who emit. However because of the two for one unit measure in the case of liquid fuels this means that 16.74 million tonnes of CO2 equivalent were emitted in 2014 but only 8.37 NZUs were surrendered. Obviously under two for one New Zealand is most unlikely to achieve a greenhouse gas balance.

If the ETS is in complete balance then New Zealand as a nation achieves carbon neutrality *except for agricultural emissions* (mostly from animal methane) which is currently excluded from the ETS. Agriculture emits 39.2 million tonnes which is 48% of national emissions and has remained fairly constant since 2005.

However the target for the government is not to achieve carbon neutrality. The target is to achieve a reduction of net greenhouse gas emissions *including agriculture*.

This implies that if the ETS is to be New Zealand’s main mechanism to achieve a 30% reduction over peak 2005 emission levels (and agriculture continues to be excluded) then the cost of reduction must fall on non-agricultural sectors. That is to say that the value of NZUs must ultimately rise to a point where the price is so high emitters choose to forgo emission or there is sufficient market incentive for forest sink growers to expand their operations to such a point that carbon absorption is 30% greater than carbon emission.

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Officials have stated that modelling shows that even at a price of \$300 NZUs (35 cents per litre) New Zealand cannot domestically achieve a reduction of emissions either by abatement or sinks to meet the 30% target and that the importation of abatement or sink credits from other jurisdictions will be essential. However at the present time officials admit the NZ ETS does not recognise any other carbon units.

In the short term economic modelling by NZIER shows that switching to one-for-one surrender with a low carbon price will not have much economic impact. However once the banked credits are used up prices could rise quickly depending on log prices which are the main driver of afforestation rates according to Professor Manley's technical note on forestry responses to NZU prices.

1.2 Conclusion

In principle the AA agrees that the transitional two for one measure enshrined in section 63A of the Climate Response Act 2002 should be removed and the market be allowed to function.

However the AA has considerable concerns about the source of future units available to the ETS which should be addressed at the same time. These are discussed in responses to the other questions.

2. What impact will moving to full surrender obligations have on you or your business?

2.0 Role of AA Members

The 1.5 million Members of the New Zealand Automobile Association emit around half of the 8.2 million tonnes of CO₂e produced by New Zealand's light vehicle fleet. At current prices (\$9.60), and one for two surrender (assuming ETS prices are passed through to the customer the same way oil prices are) they would be collectively charged \$19.8 million for NZUs per year, which would double to \$39.6 million if the one for two option is removed. This comes to roughly \$13.20 each, doubling to \$26.40 per year if full surrender is introduced.

Ministry of Transport figures show that CO₂e emissions from petrol vehicles has remained largely the same since 1990. By contrast diesel emissions have grown from 2 million tonnes to 5.7 million tonnes over the same period. Diesel consumption is strongly correlated with economic activity (construction, fishing, farming and distribution).

2.1 Effects on AA Members

In order to become an AA Member a person must purchase a Membership subscription. As such AA Members tend to have more disposable income than non-AA Members. While rapid changes in fuel prices have impacted on AA Members it would require a very high NZU price for this to occur.

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2.2 Conclusion

In the short term it appears that the effect of full surrender on AA Members will be negligible. However timing is everything and market conditions now may not prevail at the time full surrender comes into effect as very high NZU prices are theoretically possible.

3. If full surrender obligations are applied, when should this be implemented?

3.0 Concerns about full surrender

The AA's main concerns about full surrender are that the market as currently constrained is effectively determined by the price of logs to New Zealand foresters.

According to Professor Manley's technical note the main driver of afforestation is the anticipated log price likely to be gained by foresters. The price of NZUs is a marginal benefit to foresters but is not sufficient in and of itself to warrant being in the forestry business either now, or into the foreseeable future.

While the bulk of surrendered NZUs to date have entered the ETS through the various UN mechanisms and that door is now shut. This means that the only source of NZU credits is either government free allocation or forestry credits.

Professor Manley cannot forecast an afforestation rate based on NZU prices because the afforestation rate is driven by log prices. It is therefore conceivable that the supply of NZUs into the ETS could become constrained by conditions in the timber market rather than anything to do with the carbon market. This could easily create a huge imbalance of NZU supply and demand driving up prices to extreme levels.

3.1 Pre-conditions for full surrender

Therefore before moving to a full surrender the AA would be more comfortable if there were in place alternative sources of NZUs. This is envisaged to come from other markets, ideally where the marginal cost of abatement (or sinks) is lower than New Zealand.

To achieve this we recommend full disclosure of the Ministry's objectives, criteria, timetables and negotiations so that the market's expectations are clear and there is no scope for rumours, insider trading or uncertainty to create unwarranted ETS price fluctuations.

3.2 Time-table

In order to achieve this the AA recommends moving to full surrender by 31 March 2018.

4 If the NZ ETS moves to full surrender obligations, should potential price shocks be managed?

4.0 Market Principles

As discussed the NZ ETS is currently very exposed to the forestry market which is too small to cover the entire demand for NZUs. While the ETS can provide marginal incentives to foresters for afforestation this is a rather poor basis on which to base carbon abatement costs/incentives to achieve public policy outcomes.

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Log prices were at low levels in September 2015 but have since rebounded on the basis of Chinese and Indian demand. In the event of a serious recession in China log prices could collapse again (as stockpiles are reasonable) with a serious inverse effect on the New Zealand reforestation rate and the availability of NZUs to the ETS.

The AA believes that alternative sources of NZUs are required to make the ETS a more reliable market before the banked NZUs are run down. Disclosure rules apply in most financial markets and should also apply to way in which new supply is sourced for this one.

4.1 Market caps

The market is currently capped at \$25 per tonne by the alternative surrender mechanism. For emitters this provides the comfort that the maximum price in the ETS is set. For foresters the cap limits the potential of the ETS to provide earnings over and above log prices. Thus Professor Manley reports foresters take a dim view of lower caps and would prefer a much higher cap (e.g. \$50) or no cap at all.

With the ETS cap of \$25 the maximum the ETS can cost motorists is 3.3 cents per litre. If this was raised to \$40 the maximum is just shy of 5 cents per litre. Typically motorists regard ETS charges as a tax. Government fuel excises increase about 3 cents per litre each July and FED is currently just under half of the total cost of a litre of petrol.

At this time the AA does not have a mandate from its Members to suggest increasing the market cap, however it does not have any demand for reducing it either. The AA therefore strongly recommends retaining the market cap at least until such a time as alternative sources of NZUs are available to the ETS.

4.2 Conclusions

The AA suggests it would be imprudent to rely entirely on log prices as the main determinant of NZU supply in the ETS. We recommend broadening the market over the next two years and retaining the cap of \$25 per tonne for the foreseeable future.

Further submissions

The AA intends to submit on the wider issues before this review at a later date.

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