# INTERNATIONAL ENERGY AGENCY
# AGENCE INTERNATIONALE DE L'ÉNERGIE

The Executive Director
*Le Directeur Exécutif*

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Mr. Stuart Calman
Energy and the Environment Group
Ministry of Economic Development
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Dear Mr. Calman,

We welcome the opportunity given to the IEA Secretariat to comment on New Zealand's *proposed framework for a greenhouse gas emissions trading scheme.* The subject is one in which the IEA has developed expertise over the years, from the analysis of emissions trading in the run-up to the Kyoto Protocol, to the implementation of the Clean Development Mechanism in the energy sector, and the implications of domestic emissions trading systems for the energy intensive sectors. Emissions trading is at the core of some of our Member countries' strategy to drive the energy sector's response to the climate change challenge, and therefore of great interest to the IEA, as a forum for an exchange of best practice among policy-makers.

In their in-depth review of New Zealand's energy policies (released in 2006), the IEA recommended that New Zealand consider "*implementing a carbon tax or emissions trading – or a combination of the two – as quickly as possible.*" The *proposed framework* is a welcome step in this direction. We note, however, the specificity of New Zealand's situation and climate policy debates and the present IEA comments should be viewed in that context.

We compliment the government for a well-integrated strategy in an area – greenhouse gas mitigation – where a piecemeal approach could lead to a less effective, more costly outcome; further, the proposal introduces some flexibility to allow linking with other schemes, enhancing the effectiveness of a possible future international carbon market. The framework also takes a very realistic approach to the New Zealand's climate strategy, recognising its small contribution to global climate change, but its responsibility in setting an example in terms of policy implementation. In so doing, the proposed framework offers some innovative features, including on sectoral coverage – including agriculture and forestry, on which the IEA cannot comment in detail, but also the coverage of fossil fuels used in the economy – and on the distribution of costs among covered sources.

We understand that the framework is a first step towards the establishment of a finalised emissions trading scheme. We nonetheless find some of its intended features of particular interest.

- The scheme would be well integrated in existing Kyoto Protocol's trading mechanisms, offering New Zealand's sources the possibility to meet their emissions obligations at lower cost than if solely based on New Zealand's reduction potential.

- It recognises that cap-and-trade does not adequately address all sectors' emissions and needs to be complemented by policies to overcome market barriers. Some energy end-uses in particular have been noticeably unresponsive to price changes and measures can be taken to make energy prices more visible to actual investors in energy using equipment.

- Nonetheless, the framework seeks to introduce as broad a price signal as possible, including through its allocation of emission obligations to fossil fuel producers and importers, who will pass the cost onto consumers through (higher) fuel prices. This should further encourage adoption of a more rational use of energy. We note that the actual impacts on transport fuel prices may be low initially, as indicated in the proposal. We take good note of the complementary measures introduced in the road transport sector – including the enhanced provision of public transport alternatives that a price of carbon alone would not trigger.

- The framework proposes an innovative treatment of the issue of cost distribution, inherent to a system that seeks to introduce a new cost on economic activities and citizens. The New Zealand government has been a close observer of the EU Emissions Trading Scheme and of the controversy over the electricity sector's profits derived from it, through the pricing of $CO_2$ in electricity prices. In the initial phase, with a free allocation, power generators operating in a free market stand to gain from passing through the cost of $CO_2$ in electricity prices, at the expense of consumers – especially industry purchasing power on wholesale market platforms. New Zealand offers an innovative option for a better distribution of costs, by separating the point of obligation (e.g. fossil-based power generators) from the point of allocation (industrial electricity consumers). Industrial consumers selling the distributed emission allowances on the market would thus be partly compensated for higher electricity costs. The incentive to lower electricity demand would remain, however, which is what is expected from the carbon pricing mechanism.

- The proposed framework pays due attention to the issue of competitiveness, for energy and emission-intensive sectors whose international competitors may not face a cost of carbon. Free allocation of emission allowances is welcome in this respect, as it is combined with a clear transition schedule towards auctioning in the medium term. This should provide a strong signal to investors, while alleviating near term competitiveness problems related to stranded assets.

- The possibility of a "progressive obligation" is also of interest as a means to lower the cost of the constraint in an initial phase: sources could be asked to surrender allowances for only part of their emissions, until they take full obligations.

- Further, the intent to send a strong signal on future allocation, with a clear schedule towards auctioning, should provide adequate visibility to investors in energy-using capital. Our agency's work has shown the importance of extending goals to the medium- and long-term to both trigger investment and lower cost.

Other elements of the proposal raise interrogations with respect to the system's intended effectiveness. While these aspects seem well understood by the authors of the framework, we would like to stress the following.

- The framework's proposed goal is to trigger economic transformation and bring emissions under control. The unit of trade in your system is essentially the same as the Kyoto Protocol's. Granting unrestricted access to the Kyoto Protocol's mechanism may mean that New Zealand's sectors face a low incentive for such modernisation in the near term. Current projections show that the Kyoto market may be oversupplied, especially as Russia and Ukraine become eligible to participate in emissions trading under the Protocol. Free access to all Kyoto mechanisms may limit the willingness of other parties to grant New-Zealand access to their domestic emissions trading system. We understand the political nature of such choices, however, and the downsides of restricting access.

- In principle, sources ought to be allowed to retain their allowances when closing plants. This is especially useful when operators seek to replace old capital with more efficient, less-greenhouse gas intensive processes. We would therefore, at first, cautious against the decision to withdraw allowances upon closure, as it encourages to maintain older, less efficient processes. On the other hand, the intention to move towards full auctioning by 2025 should prove a strong incentive for modernisation, and mitigate the somewhat negative effect of the closure rule.

In light of the above, I would like to encourage the government of New Zealand to pursue work and consultations towards the implementation of its emissions trading scheme. In closing, let me stress that the IEA does not promote particular policy instruments and our comments should be interpreted in the context of New Zealand's *proposed framework* only.

The IEA looks forward to monitoring your progress towards more rational, climate-friendly energy system and society.

Yours sincerely,

Nobuo Tanaka

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