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[In Confidence]

Office of the Minister for Climate Change Issues

Chair

Cabinet

Release of the Emissions Trading Scheme Review 2011 Panel's Final Report

Proposal

1. This paper provides you with the New Zealand Emissions Trading Scheme (ETS) Review 2011 Panel's final report and seeks agreement to the release of this report on 1 August 2011.

Executive summary

2. As required by the Climate Change Response Act 2002 (the Act), an independent panel (the Panel) has reviewed the ETS. The Panel provided its final report on 30 June 2011. The Panel was asked to focus specifically on the high-level design aspects of the ETS. The need for an ETS and wider climate change policy was outside its terms of reference.
3. The review took place over the first six months of 2011. The Panel's consultation included a public call for written submissions and a series of stakeholder meetings. It received submissions from 162 organisations and individuals.
4. The Panel reached a number of conclusions on which it based its recommendations. The Panel believes that it is in New Zealand's long-term economic interests to continue to change our behaviour and that the incentives to do so will increase over time.
5. The Panel recommends removing the transition phase more gradually over a slightly longer timeframe in order to help minimise the short-term impact of the ETS on the economy. In addition, it recommends that the agriculture sector continue to enter the ETS in 2015 but that a transition phase be applied, so that it can make a smoother transition into the ETS. In the Panel's view, an increase in fiscal costs in the short term is justified as its recommended changes will protect long-term economic resilience, reduce short term costs for households and businesses, and provide a smoother transition into the ETS for agriculture.
6. The Panel also recommends changing some of the rules for the treatment of forestry in the ETS, the most significant (in terms of fiscal cost) being the introduction of 'offsetting' for pre-1990 forests. These recommended changes are subject to an assessment of a range of factors, including the international position. A number of the Panel's recommendations have fiscal implications, which have not all been costed within its report.
7. Further work is needed to assess the feasibility and risks of the recommendations and options for mitigating the fiscal risks associated with

them. In broad terms, however, I believe the Panel's recommendations are sensible and strike an appropriate balance between short-term costs and long-term economic resilience. The Panel's recommendations provide a more gradual transition for businesses, reducing costs in the short term, while still sending clear long-term investment signals.

8. I propose to release the report on 1 August 2011. I have directed officials to undertake further work on both the Panel's recommendations and other related issues, over the next 6 months. I intend to submit a paper by February 2012, seeking agreement to proposed changes to the ETS based on the Review recommendations and further analysis.

Background

9. The Act requires a review of the ETS to be completed before the end of 2011. In December 2010, I appointed a seven-member review Panel (the Panel), chaired by David Caygill, and asked them to report back to me by 30 June 2011 [Cab Min (10) 44/11 refers].
10. The Panel was asked to focus on the high-level design of the ETS, giving particular attention to the following issues:
 - a. priority issues and questions for key ETS design settings arising from possible international frameworks post 2012, and considerations that government might apply in developing a response to these priority issues and questions
 - b. whether the ETS should continue to scale up to a full obligation and whether new sectors should incur surrender obligations on current legislated timetables after 2012, taking into account the domestic actions of key competitors, or what conditions should be met before proceeding with further sectors entering into the ETS
 - c. the inclusion of synthetic greenhouse gases within the ETS, taking into account alternative approaches to reducing such emissions.
11. The Panel was asked to give particular consideration to a number of factors including:
 - short-term costs, competition and competitiveness impacts
 - impacts on long term economic resilience
 - environmental integrity
 - international efforts to reduce greenhouse gas emissions;
 - equity between sectors and groups, including the distribution of costs and benefits between sectors and groups (including iwi).
12. The Panel met 14 times from February to June 2011. It released an Issues Statement and consulted with stakeholders during March and April 2011. The Panel received 162 written submissions from a range of stakeholders including ETS participants, businesses, agricultural groups, non government organisations and individuals. In addition, it met with a number of selected stakeholders over this period to discuss the impacts of the ETS to date, and options for the future design and the level of ambition for the ETS after 2012.

13. Although the Panel's consultation did not ask whether New Zealand should have an ETS, there was general support for or acceptance of the ETS. For example, 63 per cent of businesses who responded to the Panel's consultation supported or accepted the ETS. The Panel will release a summary of submissions and its working papers once the final report is published.

Comment

The Panel's considerations

14. The Panel considered that, even without an international obligation to reduce emissions in the short term, New Zealand will eventually face an obligation which is likely to require significant emission reductions. In any case, New Zealand is likely to face other strong drivers to reduce emissions, for instance from trading partners. The Panel concluded that it is in New Zealand's long-term economic interests to continue to change behaviour and that the incentives to do so should increase over time through a cost on emissions.
15. The Panel agreed that there needs to be an appropriate balance between managing short-term uncertainties and competitiveness risks faced by New Zealand, with the need to provide certainty about the long term direction. This means there should be measures in place to allow gradual rather than abrupt introduction of ETS obligations.
16. The Panel also noted that it is not correct that our international competitors are not taking action to reduce emissions, nor that some sectors have no options for abatement (for example, for the agriculture sector).
17. On balance, the Panel sought to steer a moderate course, introducing ETS costs into the economy gradually and balancing the additional fiscal costs for Government with the additional costs for business.

The Panel's key recommendations

18. The Panel made 59 recommendations. Its key recommendations are summarised below.
19. In relation to the **transition phase**, the Panel recommends that:
 - for the liquid fossil fuel, stationary energy and industrial processes sectors, the current surrender obligation of one emission unit for every two tonnes of emissions, which is due to end on 31 December 2012, be phased out over three years from 2013 to 2015
 - the price cap, currently set at \$25 per emission unit to 31 December 2012, should be increased by \$5 per annum between 2013 and 2017.
20. In relation to **allocation**, the Panel recommends that:
 - the phase-out of allocation at 1.3 per cent per annum is on a straight-line, rather than as a percentage of the previous year's allocation¹ (the effect of which would be minimal in the next 50 years)

¹ The Panel notes current settings produce a smaller annual decrease each year, causing allocation to continue indefinitely

- the Government examines further the potential inclusion of additional emissions sources, such as liquid fossil fuels and recycled materials, for the purposes of determining eligibility and/or allocative baselines.
21. In relation to **agriculture**, the Panel recommends that:
- the agriculture sector enters the ETS on the current legislative timetables (i.e. with surrender obligations from 1 January 2015). The Panel sets out a number of reasons for this and further, believes that the available abatement options are sufficient to reduce on-farm emissions
 - the sector benefits from a one-for-two surrender obligation for the first two years after it enters the scheme (i.e. 2015 and 2016) which is then phased out over the subsequent three years (consistent with the Panel's recommendation above)
22. In relation to **synthetic greenhouse gases and waste**, the Panel recommends that:
- these sectors enter the ETS on current legislative timescales (i.e. with surrender obligations from 1 January 2013)
 - a discretionary power be provided to enable waste landfills to be exempted from obligations where the landfills are small, isolated and do not have alternative disposal options
 - goods imported containing synthetic greenhouse gases should face a levy, equivalent to the market price for emission units, rather than have obligations under the ETS.
23. On **forestry**, the Panel recommends the Government make a hard-headed assessment of domestic forestry rules beyond 2012 by taking into account the international position, fiscal impacts and the impact on stakeholders. Key areas recommend for change include introducing forestry offsetting for pre-1990 forests, the treatment of retained carbon in harvested wood products (if international rules change). It also recommends allowing averaging for post-1988 forests.
24. The Panel's terms of reference required them to consider the principles of the Treaty of Waitangi when under taking its review. It makes a number of recommendations in relation to **Māori**, in particular, on issues faced by Māori trusts and the Māori Trustee, including establishing a working group with the Māori Trustee to address pre-1990 forestry exemption and allocation application issues.
25. The Panel also made recommendations in relation to other matters. For example, the Panel recommends the Government urgently consider whether HFC CERs should continue to be eligible emission units under the ETS.

Impact of the Panel's recommendations

26. The Panel provided some initial cost estimates of its recommended changes to the ETS compared to the current legislated ETS. However, the costs arising from the Panel's recommended changes to the domestic forestry rules are not included.

27. Table 1 below shows the estimated change in the Government's net fiscal position. As can be seen, the bulk of the additional fiscal costs associated with the Panel's recommendations fall in 2013 and 2014. This is primarily due to the Panel's recommended changes to the transition phase.

Table 1: Estimated change in the Government's net fiscal position (based on a carbon price \$25 and excluding the Panel's forestry related recommendations)

	2013	2014	2015	2016	2017	2018	2019	2020
Change in net fiscal position (\$ million)	-265	-140	-50	-55	-40	-25	0	0

28. In the Panel's view, the increase in fiscal costs in the short term is justified as its recommended changes will protect long-term economic resilience, reduce short term costs for households and businesses, and provide a smoother transition into the ETS for agriculture. Its estimates of cost savings for households, businesses and farmers are presented in table 2.

Table 2: Estimated cost reductions for households, businesses and farmers² (based on a carbon price \$25 and excluding the Panel's forestry related recommendations)

	2013	2015	2017	2019
Decrease in average household annual expenditure on energy	\$90	No change	No change	No change
Decrease in total business annual expenditure on energy	\$237m	No change	No change	No change
Decrease in average dairy farmer annual expenditure on energy and surrender obligations	\$2,300	\$1,600	\$1,300	No change
Decrease in average sheep and beef farmer annual expenditure on energy and surrender obligations	\$800	\$1,600	\$1,300	No change

Preliminary assessment of the Panel's recommendations

29. In broad terms, I believe the Panel's recommendations are sensible and strike an appropriate balance between short term costs and long term economic resilience. The transition phase recommendations and recommendations for agriculture avoid the more sudden change under current legislation, reducing costs in the short term. However, they still provide a clear long-term investment signal.

30. I note that the Panel's recommendations will have significant short term fiscal costs. The Panel's estimates of fiscal costs (presented above) did not include costs associated with its recommended changes to the domestic forestry rules. An additional fiscal cost would arise in implementing different forestry rules, if the international rules do not match the ETS forestry rules.

31. The panel recommend that pre-1990 offsetting is introduced after the end of the current Kyoto commitment period (2013 onwards). Currently, an immediate cost is incurred by the owner because of the deforestation liability associated with the

² Revised estimates – note that these figures differ slightly from those presented in the Panel's report

land. The Panel proposes that this liability should be allowed to be offset by planting forests elsewhere to sequester the lost carbon, without incurring a cost up front.

32. There may be some fiscal risks from allowing offsetting. Fiscal costs would eventuate if New Zealand ratified a new international agreement that did not allow pre-1990 offsetting. In addition to offsetting, the fiscal costs and feasibility of the other suggested forestry rule changes would need to be assessed.
33. In regard to the short term fiscal costs presented in this paper, these are based on an assumption of a \$25 carbon price post 2012, and a long term international agreement post 2012 that places a liability on New Zealand for emissions. Due to the uncertainty around the international context post 2012, including carbon prices and the value of international units to the Government, the fiscal and cash impacts of the Panel's recommendations are also subject to significant uncertainty.
34. Therefore, whilst I am broadly comfortable with the direction of the Panel's recommendations, more work is required before reaching a final conclusion. Further work is required in relation to:
 - operational issues and the feasibility of implementing a number of the Panel's recommendations, in particular those on pre-1990 offsets, synthetic greenhouse gases and waste
 - the issues that the Panel has recommended the Government give further consideration, such as the eligibility of certain units
 - technical and operational issues that were raised during the Panel's consultation but on which it did not reach a conclusion
 - the impact of international uncertainty post 2012 on broader ETS market design, and how this flows through to fiscal impacts.
35. I have directed officials to analyse these matters further and report back to me by February 2012.

Announcement of Australian carbon pricing mechanism

36. On 10 July 2011 Australian Prime Minister Julia Gillard released details of an Australian carbon pricing mechanism. The scheme will begin with a three year fixed price period which will start at AU\$23³ (NZ\$29.50) per tonne, during which time it will be closed to international trading. Australia will move to a full emissions trading scheme with international linkages from 2015.
37. After 2015 the Australian carbon pricing mechanism will include provisions for linking with other domestic emissions trading schemes, subject to regulation. The Australian announcements note that linking to other credible trading schemes, such as the NZ ETS and the EU ETS, is in Australia's national interest.
38. On 27 July 2011 Prime Ministers John Key and Julia Gillard announced the establishment of a senior officials group to work on ways to link the two

³ Note that fixed price will rise 2.5% in real terms per year. Therefore it will be AU\$24.15 in 2013/14 and AU\$25.40 in 2014/15

countries emissions trading schemes⁴. Informal discussions have begun between New Zealand and Australian officials on establishing this group, with a preliminary meeting set down for early August.

Publication of the Panel's report

39. In the meantime, I propose to publish the Panel's report on 1 August 2011, to coincide with my presentation to the 7th *Australia-New Zealand Climate Change and Business Conference*. As noted above, I am required under the Act to release the Panel's report. In addition, I believe that there will be a high level of public interest in this report and delaying its release would be difficult. Releasing the report will also enable me to gauge public comfort with the Panel's recommendations before making any final policy decisions.
40. I intend to report back to Cabinet by February 2012 with proposed changes to the ETS. Subject to Cabinet agreement, legislation to amend the Act will be introduced towards the second half of 2012.

Consultation

41. The following agencies were consulted in the preparation of this paper: the Ministry of Agriculture and Forestry, the Treasury, the Ministry of Economic Development, the Department of Prime Minister and Cabinet, the Department of Conservation, Te Puni Kōkiri.

Financial implications

42. There are no direct financial implications arising from this paper as specific changes to the ETS are not being proposed at this stage. However, as noted above, there would be financial implications if the Government accepts any or all of the Panel's recommendations. These will be considered in future Cabinet papers that propose specific changes to the ETS.

Human rights

43. The proposals contained in this Cabinet paper do not appear to be inconsistent with the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993.

Legislative implications

44. There are no direct legislative implications arising from this paper, specific changes to the ETS are not being proposed at this stage. However, there will be legislative implications if the Government accepts any or all of the Panel's recommendations. These will be considered in future Cabinet papers that propose specific changes to the ETS.

Regulatory impact analysis

45. The Regulatory Impact Analysis requirements do not apply, as specific changes to the ETS are not being proposed at this stage. However there will need to be a regulatory impact analysis if the Government accepts any or all of the Panel's

⁴ This could only occur after the Australian scheme moves to the flexible price period in 2015.

recommendations. This will be provided with future Cabinet papers that propose specific changes to the ETS.

Publicity

46. As noted above, I intend to release the Panel's report on 1 August, to coincide with my presentation to the 7th *Australia-New Zealand Climate Change and Business Conference* being held in Wellington on 1-2 August 2011.

Recommendations

47. I recommend that Cabinet:

1. note that an independent panel, appointed in December 2010 to review the Emissions Trading Scheme (ETS), provided the Minister for Climate Change Issues with its final report on 30 June 2011 (refer Appendix 1)
2. note that the Climate Change Response Act 2002 requires that the ETS Review Panel's report be published and tabled in the House
3. note that the Panel has met the requirements set out in its terms of reference and under the Climate Change Response Act 2002
4. note that the Panel makes the following key recommendations:
 - a. the current one-for-two surrender obligation for certain sectors, which is due to end on 31 December 2012, should be phased out over three years from 2013 to 2015
 - b. the price cap, currently set at \$25 per emission unit to 31 December 2012, should be increased by \$5 per annum between 2013 and 2017
 - c. the agriculture sector should enter the ETS on the current legislative timetables (i.e. with surrender obligations from 1 January 2015)
 - d. the agriculture sector should benefit from a one-for-two surrender obligation for the first two years after it enters the scheme (i.e. 2015 and 2016) which is then phased out over the subsequent three years
 - e. the synthetic greenhouse gases and waste sectors should enter the ETS on current legislative timescales (i.e. with surrender obligations from 1 January 2013)
 - f. the Government should assess changes to the current ETS forestry rules, including offset forestry planting for pre-1990 forests, subject to an assessment of the international position, the potential fiscal impact and the impact on stakeholders
 - g. the phase-out of allocation at 1.3 per cent per annum should be on a straight-line, rather than asymptotic, basis
 - h. establishing a working group with the Māori Trustee to address pre-1990 forestry exemption and allocation application issues.

5. agree that the ETS Review Panel's final report be released on 1 August 2011, to coincide with the Minister for Climate Change Issues presentation to the 7th *Australia-New Zealand Climate Change and Business Conference*
6. agree that the ETS Review Panel's summary of submissions, individual submissions to the Panel and working papers be released alongside the final report, in line with the Panel's Terms of Reference
7. note that the Minister for Climate Change Issues has directed officials from the Ministry for the Environment, in consultation with Ministry for Agriculture and Forestry and other relevant agencies, to undertake further analysis of the Panel's recommendations as detailed in their final report
8. note that on 10 July 2011 Australian Prime Minister Julia Gillard released details of an Australian carbon pricing mechanism that begins with a three year fixed carbon price from 1 July 2012, before moving to a full emissions trading scheme with international linkages from 2015
9. note that the Australian carbon pricing mechanism will include provisions for linking with other domestic emissions trading mechanisms, including the NZ ETS, from 2015
10. note that Prime Ministers John Key and Julia Gillard announced the establishment of a senior officials group to work on ways to link the two countries emissions trading schemes in the future
11. invite the Minister for Climate Change Issues to report back to Cabinet by February 2012 with proposed changes to the Emissions Trading Scheme based on the Panel's recommendations, developments in and discussions with Australia and further analysis.

Hon Dr Nick Smith
Minister for Climate Change Issues

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