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Ministry for the
Environment
Manatū Mō Te Taiao

ETS Review Panel recommendations

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|-----------------|---------------|------------------------|------------|
| Date: | 8 June 2011 | MfE Priority: | Non-urgent |
| Security Level: | IN CONFIDENCE | Number of Attachments: | 2 |
| | | MfE Ref No: | 11-B-01022 |

Purpose

| | Action Sought | Deadline |
|---|---|--------------|
| Minister for Climate Change Issues Hon Dr Nick Smith | Discuss draft ETS review report and next steps with Ministerial colleagues and officials. | 20 June 2011 |

Ministry for the Environment Contacts

| Name | Position | Telephone | | 1st Contact |
|-----------------------------|---|--|--------------|-------------|
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Executive Summary

The ETS Review Panel provided you with a draft of their final report on 3 June 2011, as required under their terms of reference. You have until 20 June to provide any comments. The Panel Chair, David Caygill, has offered to meet with you should you wish to discuss the draft. The Panel's completed final report is due to you on 30th June. This brief provides recommendations on next steps in terms of discussing the Panel's emerging thinking with your Ministerial colleagues and with officials.

A summary of the Panel's draft recommendations and official's initial reactions is set out in Appendix 1. The Panel has aimed to strike a balance between mitigating additional short-term costs from the scheme in a period of international uncertainty and increasing incentives to change behaviour over time.

You were provided with options for the post review timing of consideration of the Panel's report in the 23 May Status report. The Climate Change Response Act requires you to publish the Panel's final report. It also requires you to publish a report that responds to any substantive recommendations the Panel makes on allocation. No time limit is specified for publication of the Panel report or response. We are assuming that the government's response will cover the broader suite of Panel recommendations.

You indicated that you would like a single Cabinet discussion that seeks agreement to both the release date of the Panel's report and to your proposed response. Assuming that you would prefer a detailed response to the Panel's report, the earliest officials could produce this would be mid August. Discussion in August would also allow for at least a high level Regulatory Impact Statement to be prepared, which would be required if Cabinet were asked to make decisions on legislative changes to the ETS.

If you wished to take this to Cabinet earlier we note that 13 July will be the last opportunity in July to take the Panel report to Cabinet committee. As the Panel will not finalise their report until 30 June, it will be difficult to do more than provide a reaction in July, in which case a further meeting would be needed to support any decision making that would result in legislative change, supported by a RIS.

Officials recommend that you meet with ministerial colleagues in June, prior to the Cabinet discussion, to discuss the Panel's draft recommendation and the timing of government consideration and response. To aid your discussions officials have prepared an A3, attached at **Appendix 2** that provides:

- A summary of the context for the Panel's recommendations.
- Indicative fiscal and economic impacts of the Panel's draft recommendations compared to the status quo (as currently legislated) and the option of 'freezing' the current settings in place (transition phase continues beyond 2012, new sectors deferred).
- Initial reactions to the Panel's draft recommendations and matters that Ministers need to decide on now.

MfE officials have consulted with officials in Treasury, MAF, MFAT and MED in preparing this material, though it does not necessarily reflect a joint agency view at this time (given limited time and the fact that the Panel's report is still in draft).

We recommend that a meeting in June would include Hon Bill English, Hon David Carter, Hon Tim Groser, Hon Gerry Brownlee and Hon Steven Joyce. We recommend you circulate the draft Panel report to these Ministers in advance of the meeting. We also recommend that you send a copy of the draft report to the Prime Minister.

Officials have scheduled a meeting with you on Thursday 9 June to discuss the information you would like to prepare to support your discussions with colleagues, and the Cabinet process following receipt of the Panel's final report on 30 June.

Recommended Action

We recommend that you:

- a) **Note** that the ETS Review Panel provided you with a draft of their final report on 3 June 2011.
- b) **Note** that you have the option of responding to the Panel's draft report by 20th June 2011.
- c) **Note** the summary of the Panel's key recommendations and their impacts at **Appendix 1**.
- d) **Indicate** whether you would like to meet with David Caygill, chair of the Panel, prior to finalisation of their final report.

Yes / No
- e) **Circulate** the Panel's draft report to your Ministerial colleagues (Hon English, Hon Carter, Hon Groser, Hon Brownlee and Hon Joyce), and to the Prime Minister.

Yes / No
- f) **Meet** with your Ministerial colleagues to discuss the Panel's draft recommendations and the timing of government consideration and response.

Yes / No

- g) **Note** that officials have drafted an A3 that provides a summary of the Panel's recommendations and their expected impacts to support your discussions with Ministerial colleagues, at **Appendix 2**.
- h) **Note** that officials have scheduled a meeting with you on Thursday 9 June, to discuss the information you would like to present to your colleagues and the timing for Cabinet decision making once the report is finalised.



Stuart Calman
Director, Climate and Risk Policy

8/6/11
Date

Hon Dr Nick Smith
Minister for Climate Change Issues

Date

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Appendix 1: Summary of the Panel's conclusions and recommendations

High level conclusions on the wider context and implications for the ETS

The Panel reached a number of high level conclusions on the wider context relating to its advice on the overall level of ambition for the ETS post 2012. These included:

- Even in the absence of a new international obligation to reduce emissions in the short-term, it is likely New Zealand will continue to face such obligations into the longer term, which is likely to require it to take responsibility for its emissions. New Zealand is also likely to face other drivers to reduce emissions. Therefore it is in our long-term economic interests to continue to change our behaviour and that the incentives to do so increase over time.
- It is not correct to say that our international competitors are not taking any action to reduce their emissions. The Panel has heard about the action that a range of countries, including Australia, China and the US, are taking or are planning to take despite the current international uncertainty.
- It is important to send a clear signal for the future development of the ETS so that firms and households have greater certainty and confidence in their investment and purchasing decisions today.
- Increasing incentives over time will increase the costs imposed on the economy in the short-term. There needs to be an appropriate balance between these short-term costs and clearly signalling the long-term direction we will take. This means there should be measures in place that introduces additional costs gradually.
- All emissions sources should ideally face a price on emissions over time.

For agriculture, the Panel has noted concerns that the sector lacks abatement options. However, based on evidence it has heard from stakeholders, it is of the view that the options available to the sector are sufficient to enable surrender obligations to begin in 2015, as currently legislated. Under the current allocation regime, the Panel notes that the obligation on agriculture will essentially be intensity based (emissions per unit of product), and that the agriculture sector has shown an ability to improve emissions intensity year on year.

On balance, the Panel has sought to steer a moderate course, introducing ETS costs into the economy gradually and balancing additional fiscal costs with additional costs for participants.

The Panel's recommendations

Transition measures The Panel recommends that the current obligation for firms to surrender one emissions unit for every two tonnes of emissions be phased-out over three years such that in 2015 firms will have to surrender one emissions unit for each tonne of emissions. The Panel also recommends that the price cap, currently set at \$25 per emission unit, should be increased by \$5 per annum in 2013 and beyond.

Allocation: The Panel recommends no fundamental changes to the allocation regime for industry and agriculture, but recommends that the phase-out of allocation at 1.3 per cent per annum is on a straight-line, rather than asymptotic, basis (the effect of which would be minimal in the next 50 years). The Panel also recommends Government explore a wider range of issues relating to allocation settings raised by stakeholders that the Panel has been unable to address in the time available to it.

Inclusion of Agriculture: the Panel recommends that the agriculture sector enters the scheme on the current legislative timetables (i.e. mandatory reporting from 2013 and surrender obligations from 2015). However, to give the sector further time to adjust to a carbon price and take up abatement options, the Panel recommends that the sector benefits from a one-for-two obligation for the first two years after it enters the scheme (i.e. 2015 and 2016). This surrender obligation should then be phased-out over the subsequent three years.

Synthetic greenhouse gases and waste: the Panel recommends that the waste and synthetic greenhouse gases sectors enter the scheme on current legislative timescales (i.e. surrender obligations from 2013). However, to reduce short-term administration and compliance costs the Panel recommends that a power of exemption be explicitly provided for small, isolated landfill sites and that the treatment of synthetic greenhouse gases installed in equipment that is imported into New Zealand be simplified through the imposition of a fixed levy at the border.

Forestry rules: the Panel recommends that government make a number of changes to the domestic ETS forestry accounting rules, consistent with the changes that New Zealand has been advocating for internationally. This includes introducing offsetting for pre-1990 forestry and averaging for post-1989 forestry. The Panel is conscious of the fiscal and other implications of diverging from the international rules, but recommends that the government make a 'hard headed national interest assessment', taking into account the international position, the potential fiscal impacts and impacts on foresters and other sectors.

Maori issues: the Panel heard in particular about the challenges faced by Maori Land Trustees in applying for allocations and exemptions. It recommends that government pursue a range of legislative solutions that will address these issues. The Panel also notes the need for government to monitor the capacity of Maori land trusts to engage on ETS issues, and provide support where necessary.

Operational and other recommendations: the Panel had few concerns relating to the administrative efficiency of the scheme, and did not make any significant recommendations in this regard. Due to time constraints the Panel did not comment on all of the operational issues raised by stakeholders. The Panel did consider the evolution of the international carbon market beyond 2012, and recommends that government does more to facilitate bilateral, regional and other arrangements that will enhance its development. The Panel also recommends that government consider placing a time limit on the eligibility of certain kinds of CERs generated from projects reducing HFCs, given decisions made to ban these units in the EU, and the risk that the NZ ETS could therefore be swamped with large volumes of cheap units (with negative impacts on the forestry sector in particular).

Fiscal and economic impacts

The Panel provide some initial modelling on the fiscal and economic impacts of their proposals, as compared to the status quo (transition phase ends in 2013, Synthetic Gases and Waste enter in 2013, Agriculture enters in 2015). Note that these figures are indicative only and subject to further work. Further detail is provided in **Appendix 2**.

Impacts on the Fiscal position: The fiscal impact of the Panel's recommendations falls primarily in 2013 and 2014. This is because of their recommendation to phase out the transition phase measures gradually from 2013, rather than removing them completely at the end of 2012. There are also some fiscal implications from their proposal to provide transitional arrangements to support the entry of Agriculture from 2015. The fiscal costs of the Panel's proposal are approximately \$270million per annum in 2013 and \$50million per annum in 2015.

Impact on existing participants and on energy bills for businesses and consumers: the end of the transition phase means that ETS costs are effectively doubled for participants, and for businesses and consumers facing increased energy prices. The removal of the transition

phase means business costs increasing from \$351million (approximately 0.25% GDP) to \$702million (approximately 0.4% GDP). Household costs increase from \$133 per annum to \$266 per annum for the average household. The Panel's recommendations graduate these increases over 3 years (rather than 1 under status quo) and defer the full cost increases to 2015.

Impact on farmers: the Panel's recommendations similar spread the cost increases for farmers over a number of years. The average dairy farm will expect to see total costs (energy and agricultural biological emissions) of \$8,300 per annum in 2015 under the Panel's proposals, compared to \$9,900 under status quo.

Initial reaction from officials

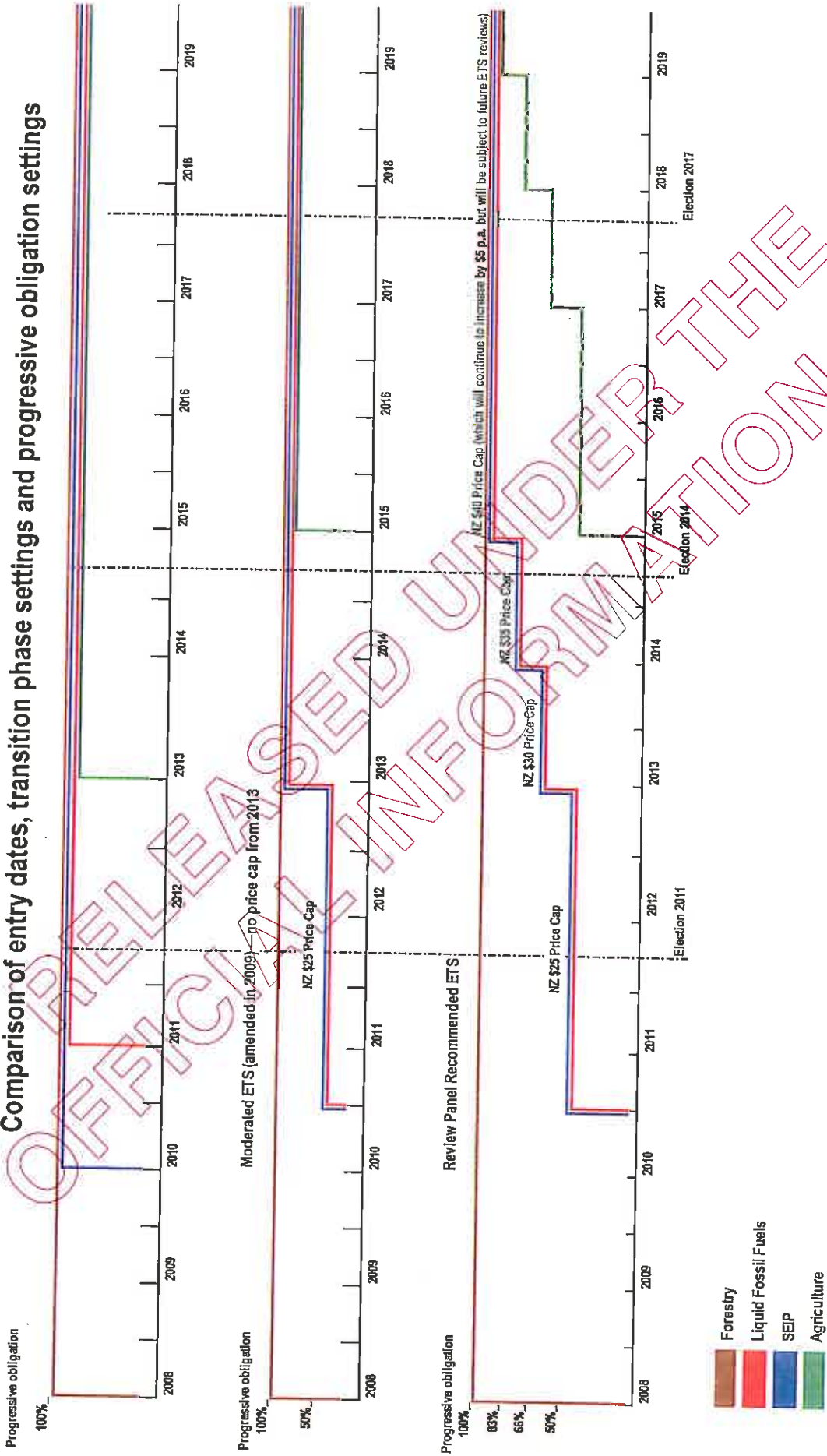
As the Panel has not yet provided their final report, it is too early for officials to provide definitive advice on their recommendations.

However, the initial reaction of officials is that the Panel's draft report strikes a reasonable balance between the short term uncertainty that New Zealand faces and the long term signals the ETS needs to send. The broad thrust of the Panel's recommendations that the transition measures phase out gradually, and that SGGs and Waste face a carbon price from 2013 seem sensible. Similarly, the Panel's reasoning on agriculture seems broadly sound (availability of abatement options, importance of encouraging technology take up in the longer term, fiscal risks and equity).

However, officials note that further analysis will be needed on a range of issues, including detailed options for transitional settings (considering the balance between price, overseas purchasing of units and ambition in the medium term). The costs of implementing changes to forestry rules and deviating from international rules are also an area for concern, given their potential scale. The ability of government to implement some proposals (particularly the proposed Synthetic Gases levy) would also need consideration.

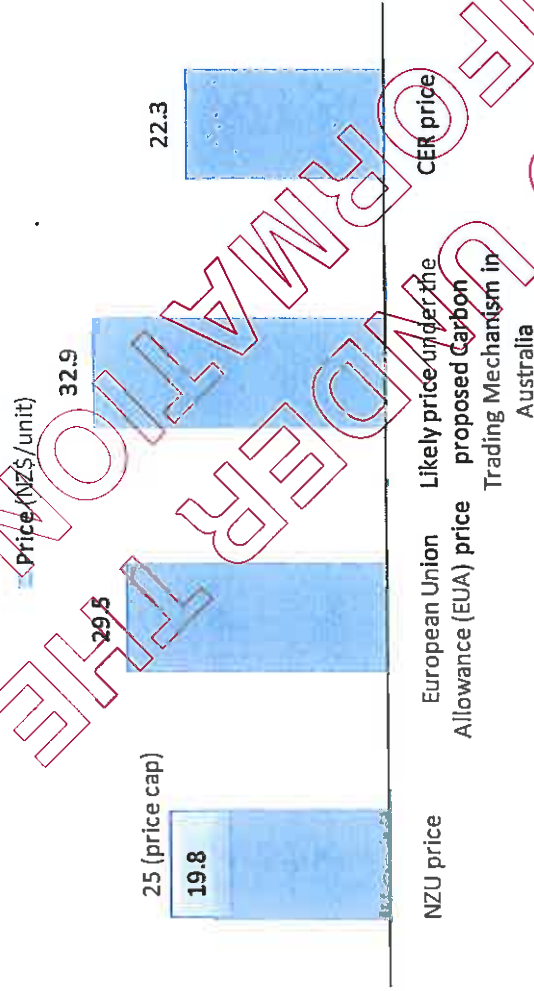
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Comparison of entry dates, transition phase settings and progressive obligation settings



Note: The lines in the above diagram show how the progressive obligation steps up for different sectors over the transition phase.

Comparison of carbon prices



Note:

- The NZU price is the NZU spot price, which was reported by the New Zealand Carbon Market to be NZ\$19.80 on 8 June 2011. There is currently a \$25 fixed price option, but the NZU has been traded within a price range of NZ\$19 to NZ\$20 in recent months.
- The EUA price is the EUA spot price, which was reported by Point Carbon to be €16.46/tonne on 7 June 2011.
- The carbon price in Australia, if the proposed Carbon Trading Mechanism in Australia were implemented, is expected to be between Aus\$20 (NZ\$26.3)/tonne and Aus\$30 (NZ\$39.5/tonne).
- The CER price is the CER spot price, which was reported by Point Carbon to be €12.48/tonne on 7 June 2011.