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Ministry for the
Environment
Manatū Mō Te Taiao

To: Hon Dr Nick Smith, Minister for Climate Change Issues

Fiscal implications of proposed changes to the New Zealand Emissions Trading Scheme

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Executive Summary

1. As per your request, this briefing informs you of the potential fiscal implications of the proposed changes to the New Zealand Emissions Trading Scheme (ETS). These proposals relate to the Government response to the 2011 ETS Review. Officials have provided you with a separate briefing on these proposals on 21 December [11-B-02179 refers].

2. Officials note that a number of these costs and savings are contingent on your preferences on the policy proposals that are to be included in the Cabinet paper [11-B-02179 refers]. The key policy options affecting the overall fiscal neutrality of the entire package of the ETS policy proposals are those relating to the transition phase and the cancellation of the second tranche pre-1990 forestry allocation.

3. The fiscal impact associated with the policy proposals resulting in costs is estimated to be 15 million units or $168 million in total (assuming that carbon price is $10.91 per unit). Excluded from these estimates are the fiscal risks associated with introducing offsetting for pre-1990 forests (from 2013), averaging in the ETS for post-1989 forest owners, and extending the price cap until 2015. Officials are still quantifying these risks at this stage.

4. On the other hand, the fiscal savings associated with the other policy proposals are estimated to be between 200,000 units and 31 million units or between $4 million and $340 million in total. These savings are mainly attributed to the cancellation of the second tranche pre-1990 forestry allocation.

5. It should also be noted that these estimates will change, based on updates to the carbon price and forecast emissions. There are also several potential cost areas that have not yet been quantified. Therefore, the implications should be treated as indicative. Given the urgency of your request, the estimates in this briefing have not been reviewed by other agencies, including the Treasury.

Situation Analysis

6. On 18 July 2011, Cabinet invited you to report to Cabinet by February 2012 with proposed changes to the ETS. To facilitate your discussions with colleagues prior to the submission of the February 2012 Cabinet paper, you requested a briefing on the fiscal impacts of the proposed changes. Accordingly, officials have prepared this briefing, which provides information on the relevant estimates and the assumptions underlying these estimates.

Advice

7. As requested, the fiscal costs or savings associated with individual policy proposals are expressed primarily in terms of units, except for those policy proposals that do not relate directly to unit flows. Totals are provided for costs and savings at the prevailing carbon price, $10.91 per emission unit, the average Certified Emissions Reduction (CER) price for the month of December 2011.[1]

8. The fiscal estimates provided in this briefing will be revised in the February 2012 Cabinet paper because:

    a. The fiscal estimates in the February 2012 Cabinet paper will be based on the assumption that carbon price throughout the forecast period will be the average CER price for the month of January 2012.

    b. The emissions projections underlying the fiscal estimates will need to be updated in the next two weeks so that the fiscal estimates in the Cabinet paper and the ETS fiscal estimates in the March Budget Update will be based on the same emissions projections. Officials are currently in the process of updating the emissions projections for the purpose of preparing the March Budget Update. Officials note that the revised emissions projections could be significantly different from the emissions projections on which the fiscal estimates in this briefing are based, because of updates to Global Warming Potentials.[2]

Fiscal impact of auctioning

9. One of the key policy proposals is introducing auctioning, where a fixed amount (i.e. a cap) of NZUs will be auctioned, while international units will continue to be permitted (with or without a cap). Auctioning would provide the Government with cash at the time of auction, rather than the surrender of eligible overseas units by participants with obligation. This would have an impact on debt, but not on the operating balance. As a result, auctioning would not generate additional fiscal revenue and would therefore be fiscally neutral (excluding operating costs).

10. Officials are still in the process of estimating the operating costs associated with auctioning, and will provide the estimates later in the February 2012 Cabinet paper.

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[1] The use of the prevailing carbon price for forecasting ensures consistency between the Cabinet paper fiscal costs and the treatment of those costings in Budget forecasts. However, for appropriations, the carbon price will continue to be assumed to be $25 per emission unit, given that this acts as a ceiling on expenditure.

[2] From April 2015 (when the 2013 greenhouse gas Inventory is submitted), parties to the UNFCCC and the Kyoto Protocol are required to use updated Global Warming Potentials (GWPs) from the IPCC 4th Assessment Report for national greenhouse gas inventories and accounting under the Kyoto Protocol during the second commitment period. GWPs assess the relative impact of each gas, to enable non-CO_2 gases to be converted into CO_2-equivalent quantities for common accounting purposes. The new GWPs (known as AR4) will be used to update the historical, current and future projections of New Zealand's greenhouse gas emissions profile, and will have the effect of increasing the relative contribution of methane to New Zealand's greenhouse gas emissions profile by approximately 19%, and reducing the impact of N_2O by about 4%.

Proposals with fiscal costs

11. The policy proposals that would result in fiscal costs include:
    - Gradual phase-out of the one-for-two surrender obligation — as per National Party's election manifesto, the one-for-two surrender obligation for the liquid fossil fuels, stationary energy and industrial processes sectors is to be scaled up to a full surrender obligation progressively from 2013 to 2015, increasing at equal intervals per annum, that is to 67 percent in 2013, 83 percent in 2014, and 100 percent in 2015. The discounted surrender obligation will also apply to the waste and synthetic greenhouse gases sectors in 2013 and 2014.
    - Users of sulphur hexafluoride (SF_6) in electrical switchgear would become the point of obligation.
    - Exempting certain landfill operators by defining eligibility criteria using section 60 — the exemption criteria would be a combination of landfill size, distance from other facility, and economic resilience of the community it services. To avoid creating an incentive to open new landfills, the exemption would be limited to those already operating.
    - Removal of layer hens from the ETS — egg producers (i.e. layer hens) would be removed from the ETS.
    - Inclusion of DCD as a removal activity — farmers would be able to access credits for on-farm DCD use.

12. The fiscal costs associated with the above policy proposals are estimated to be 15 million units or $168 million in total. These estimates do not include the fiscal costs associated with the inclusion of DCD as a removal activity, as officials are still quantifying them. These estimates also do not include the fiscal risks associated with extending the $25 price cap until 2015, offsetting for pre-1990 forests (from 2013), and averaging in the ETS for post-1989 forest owners. These fiscal risks will be discussed later in this briefing.

13. The table below shows the fiscal costs associated with various policy proposals.

Policy proposals	Unit of measurement for fiscal cost	2011/12	2012/13	2013/14	2014/15	2015/16	Total
Transition phase—gradual phase-out of 2:1 surrender obligation	units	-	3,611,340	8,126,822	3,224,129	-	14,962,292
SGG — users of SF6 in electrical switchgear are points of obligation	units	-	62,282	124,681	124,897	125,058	436,917
Waste — exempting certain landfill operators by defining eligibility criteria using section 60	units	-	2,123	4,245	4,245	4,245	14,859
Agriculture — removal of layer hens from the ETS	units	-	-	-	1,300	2,700	4,000
Total	units	-	3,675,744	8,255,748	3,354,572	132,003	15,418,068
	$	-	$40,102,377	$90,070,211	$36,598,193	$1,439,698	$168,210,479

Proposals resulting in fiscal savings

14. The policy proposals that would result in fiscal savings include:
    - Cancellation of the second tranche pre-1990 forestry allocation — regarding this, the following three options are being considered:
        - Option 1 (total cancellation) — the entire second tranche for all pre-1990 forest owners would be cancelled.

- Option 2 (partial cancellation) — 60 percent of the second tranche for all pre-1990 forest owners would be cancelled.
- Option 3 (ETS Review Panel's recommendation) — this would entail cancelling second tranche only for the pre-1990 forest owners who offset.

- SGG levy on motor vehicle imports — a mandatory levy would be imposed on motor vehicles when they are registered for on-road use. It would have a fiscal benefit because of the removal of threshold and 100tCO_2-e allowance.

15. The fiscal savings associated with the above policy proposals are estimated to be between 200,000 units and 31 million units or between $4 million and $340 million in total, depending on which option Ministers decide to adopt in relation to the cancellation of the second tranche pre-1990 forestry allocation.

16. The table below shows the fiscal savings associated with various policy proposals.

Policy proposals	Unit of measurement for fiscal cost	2011/12	2012/13	2013/14	2014/15	2015/16	Total
Second tranche — option 1 (total cancellation)	units	30,900,000	-	-	-	-	30900000
Second tranche — option 2 (partial cancellation)	units	18,500,000	-	-	-	-	18500000
Second tranche — option 3 (Panel's recommendation)	units	200,000 – 5,900,000	-	-	-	-	200,000 – 5,900,000
SGG — SGG levy on motor vehicle imports	$	$0	$300,025	$600,050	$600,050	$600,050	$2,100,175
Total	units	200,000 – 30,900,000	-	-	-	-	200,000 – 30,900,000
	$	$2,000,000 – $337,000,000	$300,025	$600,050	$600,050	$600,050	$4,100,175– $339,100,175

Note:

- It is assumed that the savings associated with cancelling the second tranche pre-1990 forestry allocation would be accounted for in the 2011/12 financial year.
- It is assumed that the SGG levies on importing motor vehicles would be set at a level identical to prevailing carbon price.

Proposals with fiscal risks

17. Some of the policy proposals may present fiscal risks, which might or might not eventuate depending on the circumstances.

18. One of these proposals is extending the $25 price cap until 2015, as per the National Party's election manifesto. This proposal would not result in any fiscal cost if the international carbon price were below the price cap until 2015. However, the Government would incur a significant fiscal cost if the international carbon price rose above a price cap, and the Government was subject to an international obligation or the Government backed domestic units (NZUs) by international units. Officials are working with the Treasury on estimating the fiscal risk associated with the $25 price cap.

19. The proposal to introduce offsetting for pre-1990 forests (from 2013) would also present fiscal risks. As officials are still working on the policy development and assessing the accounting impacts of the Flexible Land Use agreed at Durban, an analysis of the fiscal costs/risks of this policy will be provided later.

20. In relation to averaging in the ETS for post-1989 forest owners, the fiscal risks associated with it will depend on Ministers' decisions about design and implementation. A relatively simple design and longer implementation timeframes will minimise administration costs. However, averaging could involve significant fiscal costs if New Zealand was subject to an

international obligation, although officials are exploring ways that could minimise fiscal risks if New Zealand is a party to an international agreement. Officials will provide detailed costings in the February 2012 Cabinet paper reflecting Ministers' decisions.

Conclusion

21. The fiscal costs and savings of all the policy proposals are still to be confirmed because:
    a. Officials are currently updating emission projections and the unit price.
    b. The fiscal impacts of certain policy proposals, such as inclusion of DCD as a removal activity, are still being estimated by officials.
    c. The total operating costs associated with the proposed changes to the ETS are still to be confirmed, as officials are still in the process of calculating the operating costs associated with auctioning, offsetting and averaging. The total operating costs could be in the order of tens of millions of dollars for the next five years.
    d. There may also be fiscal costs or savings associated with technical amendments, but these technical amendments are still to be confirmed.
22. The fiscal neutrality or otherwise of the entire package of the ETS policy proposals will depend on decisions on key issues, such as the transition phase settings and the cancellation of the second tranche pre-1990 forestry allocation.

Risks and Mitigations

23. There are risks associated with making decisions on the ETS on the basis of the information in this briefing note, as the estimates on the fiscal impacts of the policy proposals will be revised in the next two weeks due to updates in emissions projections and carbon price assumption. To mitigate these risks, officials recommend that Ministers rely on the fiscal estimates in the February 2012 Cabinet paper to make decisions on amendments to the ETS.

Next steps

24. Given the uncertain nature of the fiscal estimates in this briefing, officials recommend you not to discuss them with your colleagues at a detailed level at this stage.
25. Officials will provide you with a draft Cabinet paper on the proposed changes to the ETS in early February. The draft Cabinet paper may contain the same fiscal estimates as those stated in this briefing. However, the final Cabinet paper will contain revised fiscal estimates that are based on the most up-to-date emission projections.

Recommended Action

We recommend that you:

a) **Note** the contents of this briefing
b) **Note** that the fiscal estimates contained in this briefing are indicative only and will be revised in the February 2012 Cabinet paper on proposed changes to the ETS.

Director
Climate and Risk Directorate **Date**

Hon Dr Nick Smith
Minister for Climate Change Issues **Date**