



THE TREASURY

Kaitohutohu Kaupapa Rawa

Treasury Report: Climate Change: Scene-Setter for 2012 Policy Decisions

Date:	3 February 2012	Report No:	T2012/165
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Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Note the contents of this report	Friday 10 February 2012
Associate Minister of Finance (Hon Steven Joyce)	Note the contents of this report	Friday 10 February 2012
Associate Minister of Finance (Hon Dr Jonathan Coleman)	Note the contents of this report	Friday 10 February 2012

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
<input type="checkbox"/> S9(a)(e)	Analyst, Natural Resources	<input type="checkbox"/> Withheld under Section 9(2)(e)	✓
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Minister of Finance's Office Actions (if required)

Following the Minister's agreement, forward a copy of this report to the Minister for Climate Change Issues, and the Minister responsible for International Climate Change Negotiations.

Enclosure: No

3 February 2012

SH-10-8

Treasury Report: Climate Change: Scene-Setter for 2012 Policy Decisions

Executive Summary

Cabinet is scheduled to consider a number of linked climate change decisions in coming months. These decisions will set the direction for climate change policy in the short-to medium-term:

- a A suite of decisions on the Emissions Trading Scheme (ETS) scheduled to be taken by Cabinet on Monday 5 March, including whether to:
 - i. reduce the volume of international carbon units imported through the ETS, and the exposure of the ETS to international carbon market fluctuations
 - ii. slow the implementation of the ETS to reduce costs for some sectors, with a corresponding reduction in fiscal revenue from 2013/14 onwards, and
 - iii. cancel compensation to pre-1990 foresters, with a corresponding one-off decrease in fiscal costs, to accompany the introduction of 'offsetting' into the ETS and to make the ETS package fiscally neutral.
- b Whether to take an international emissions reduction target, including under the Kyoto Protocol, ahead of any decisions on Kyoto later in 2012.

Out of scope

The report also outlines some of the key fiscal components of the proposed ETS decisions, which respond to the 2011 ETS review.


Treasury is preparing further detailed analysis on these issues to discuss with you on Monday 13 February, ahead of ETS Cabinet decisions scheduled for Monday 5 March.

Recommended Action

We recommend that you:

- a **note** that in 2012 Cabinet will take connected decisions on climate change, including ETS policy decisions and whether to submit a target for a second Kyoto Protocol commitment period starting in 2013

b **note** that the Treasury is preparing advice on the following topics to discuss with you on Monday 16 January, ahead of the first suite of ETS Cabinet decisions scheduled for Monday 5 March:

- i. ETS design changes that reduce the volume international carbon units imported, including either increasing domestic supply through auctioning or banning international units
- ii. decisions in response to the 2011 ETS Review, including fiscal implications, and
- iii.  Out of scope

Melody Guy
Manager, Natural Resources

Hon Bill English
Minister of Finance

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Introduction

1. Cabinet's ETS policy decisions in March will shape the conversation on an emission reduction target, and potential participation in future international agreements.
2. ETS decisions will influence domestic emissions, by determining the effective carbon price faced by ETS participants. They will also set parameters for the volume of international carbon units imported through the ETS. These two factors will determine New Zealand's ability to meet a future emissions reduction target, and the distribution of costs across the economy.
3. This report outlines the high-level linkages between an international commitment and ETS decisions, and outlines the main fiscal components of ETS decisions that will be considered by Cabinet on Monday 5 March.

Analysis – key issues for consideration

Out of scope

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Out of scope

How the ETS links to an international target – projections & decisions

Out of scope

15. In addition to reducing obligations on emitters, Cabinet could either:
- a auction domestic units to reduce international unit purchasing, or
 - b transition the ETS to a domestic trading scheme by banning the import and export of units.
16. Both of these options replace international unit importing with ETS participants buying domestic units from the Government, and replace the Crown's carbon unit asset with a cash asset.

Out of scope

17. Auctioning can be introduced in a number of variations, with most options retaining a link to international markets and in particular international carbon prices. At one extreme a small volume of units auctioned would result in a similar situation to the status quo. At the other extreme a large volume auctioned would reduce importing, and coupled with a tight regulatory restriction on imports would be similar to a domestic scheme. An auctioning approach would require investment in a sophisticated auctioning platform and a very considered approach to the volume of units to be auctioned by the Government.
18. A domestic scheme, where obligations are met in cash, maximises the cash asset collected through the ETS. This asset could subsequently be used to reduce the general tax burden and/or support efforts to reduce domestic emissions. This option would involve the Government effectively setting the price, either by fixing the price or pegging it to an international carbon price. In this scenario, there would be no international units imported and the Crown would be responsible for purchasing any emissions reductions required to meet an international target. This option is likely to be perceived as akin to a carbon tax.
19. An overarching design consideration is the extent to which the ETS is linked to international carbon markets. International unit importing via the ETS protects the Crown from being exposed to carbon price increases when meeting an international target, as any carbon price increases are instead met by ETS participants. However, linking the ETS to international markets also subjects the ETS to international carbon prices and regulatory uncertainty. The rationale for importing carbon units via the ETS over a domestic scheme (c) is weakened if the Government does not face an emissions reduction target.

ETS Review decisions – main fiscal implications

20. There are two main fiscal components to the ETS package of advice being prepared by officials, in response to the 2011 ETS Review. The package is being designed to be fiscally neutral across the forecast period. However, within the forecast period these two initiatives have differing impacts.

Slowing the implementation of the ETS

21. Slowing the implementation of the ETS for the liquid fossil fuels, stationary energy and the industrial processes sectors between 2013-15, as per the National Party's election policy, will result in a reduction in ETS revenues. This will have a negative impact on the operating balance across the 2012/13-2015/16 years.

Cancelling compensation for pre-1990 foresters

22. Cancellation of the second tranche of forestry compensation is proposed to make the package fiscally neutral, and will accompany the introduction of 'offsetting' into the ETS. Offsetting can reduce the costs of deforestation for foresters.

23. Cancellation will result in a reduction in ETS expenses and a positive impact on the operating balance when the decision takes effect – at this stage proposed for the 2011/12 fiscal year. The extent of this impact would depend on whether the Government cancels all or some of the compensation.

24. Officials are analysing the economic and fiscal implications of these proposals in order to develop advice for Ministerial consideration, informed by updated carbon price and emissions forecast information. Withheld under section 9(2)(h) There are also a number of other decisions that will impact on ETS forecast revenues and expenses to

a lesser extent, within the overall package. The Treasury will brief you in more detail on these impacts, for discussion on Monday 13 February.

Next steps

25. Treasury officials are preparing more detailed advice for a discussion with you on Monday 13 February. This discussion is proposed to focus on the ETS, ahead of Cabinet decisions scheduled for Monday 5 March.

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