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THE TREASURY
Kaitohutohu Kaupapa Rawa

# Treasury Report: Emissions Trading Scheme: Policy decisions for Ministers

| Date: | 8 June 2012 | Report No: | T2012/1129 |
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## Action Sought

| | Action Sought | Deadline |
|---|---|---|
| Minister of Finance (Hon Bill English) | **Note** the contents of this report | Monday 11 June, 8:00pm Ministers meeting |
| Associate Minister of Finance (Hon Steven Joyce) | **Note** the contents of this report | Monday 11 June, 8:00pm Ministers meeting |

## Contact for Telephone Discussion (if required)

| Name | Position | Telephone | | 1st Contact |
|---|---|---|---|---|
| [s9(2)(a)] | Analyst | [Withheld under Section 9(2)(a)] | | ✓ |
| Melody Guy | Manager | (04) 917 6059 (wk) | (021) 155 3342 | |

## Minister of Finance's Office Actions (if required)

| |
|---|
| Forward a copy of this report to the Minister for Climate Change Issues, and the Associate Minister for Climate Change Issues. |

**Enclosure:** No

8 June 2012

**Treasury Report:** Emissions Trading Scheme: Policy decisions for Ministers

## Executive Summary

1. You are scheduled to discuss possible packages of Emissions Trading Scheme (ETS) decisions on Monday 11 June with the Prime Minister and relevant Ministers, to inform the development of proposals for Cabinet's consideration in July.

2. This report provides Treasury recommendations on the most significant changes proposed, taking account of the results of the public consultation process. This advice supplements previous detailed advice on the various policy options [T2012/207 refers]. The most significant changes proposed include:

    a. *Extending the one-for-two surrender obligation.* The Treasury supports slowing the implementation of the ETS, by phasing out the one-for-two between 2013-15 for all ETS participants except emissions-intensive and trade-exposed firms, which would receive additional support to maintain the one-for-two through to 2020.

    b. *The cancellation of the second tranche of compensation to pre-1990 forest owners.* As the introduction of offsetting provides flexibility to those landowners most negatively impacted by the deforestation liability in the ETS, Treasury considers that there remains a principled case for cancelling the whole second tranche. [ Withheld under Section 9(2)(h) ]

    c. *The entry of Agriculture into the ETS.* The Government consulted on reviewing the entry of agriculture in 2014. Treasury considers that it will be necessary for the agricultural sector to face obligations under the ETS in the future, both in order to ensure New Zealand is able to meet international obligations which will include agricultural emissions and to provide for equal treatment across sectors. We do not consider that a decision should be made at this time on whether to defer the planned entry of agriculture in 2015, as a sufficient case for deferral or inclusion has yet to be presented.

    d. *Introducing auctioning into the ETS.* Auctioning enables the Crown to align the volume of international carbon units (asset) collected by the ETS with any future international commitment (liability). Treasury recommends that the enabling provisions agreed in-principle by Cabinet be confirmed, to enable Cabinet to consider detailed design proposals for auctioning at a later stage.

3. The report also details the fiscal implications of all proposed ETS decisions, with potential packages ranging from fiscal savings of $96 million to costs of $385 million over the forecast period, attached as Appendix 2. The Treasury's recommended package realises savings of $77 million across the forecast period.

4. Cabinet has agreed that the package of decisions will be fiscally neutral or positive across the forecast period [CAB Min (11) 37/16 refers]. Potential impacts vary within the forecast period and will largely be driven by Cabinet's decisions on extending the one-for-two, and the cancellation of the second tranche of compensation to pre-1990 forest owners.

## Recommended Action

We recommend that you:

a **note** that you are scheduled to meet with the Prime Minister and other Ministers on Monday 11 June to discuss proposed ETS changes, to guide advice for final Cabinet decisions in July in response to the 2011 ETS Review,

b **consider** the Treasury's advice on the package, including a proposed package of decisions attached as Appendix 2 that seeks to balance economic growth, fiscal and environmental objectives.

Melody Guy
**Manager, Natural Resources**

Hon Bill English
**Minister of Finance**

# Treasury Report: Emissions Trading Scheme: Policy decisions for Ministers

## Introduction

1. Ministers are scheduled to discuss possible packages of ETS decisions on Monday 11 June, to inform the development of these proposals for Cabinet. The Minister for Climate Change Issues is scheduled to report to Cabinet by July 2012 with proposed changes to the ETS, taking into account feedback from a public consultation conducted between April and May 2012.

2. This report examines the key proposals for determining the final package of decisions, by assessing the fiscal and economic implications of the options presented.

## Proposed changes: Analysis and Treasury recommendations

### Extension of the transition settings

3. The Government has consulted on progressively phasing out the one-for-two obligation for non-forestry ETS sectors[1] over 2013-15 to a full obligation (67%, 83%, 100%), as recommended by the 2011 ETS Review. The one-for-two is currently legislated to end on 31 December 2012.

4. Taking into account the results of the consultation, officials have identified three options for the ETS transition settings:

   a. Maintaining the one-for-two obligation until 2020,

   b. Progressively phasing out the one-for-two obligation over 2013-15 to a full obligation (67%, 83%, 100%), but adjusting the industrial allocation so that effectively a one-for-two obligation is maintained for emissions intensive and trade-exposed companies, or

   c. Progressively phasing out the one-for-two obligation over 2013-15 to a full obligation (67%, 83%, 100%) as proposed in consultation and recommended by the ETS Review.

5. These options involve a direct trade-off between the reduction in fiscal revenues the Government is willing to incur against a reduction in economic costs for households and businesses. These are detailed in the table below:

**Table 2: Estimates Fiscal and Economic Impacts of ETS transition settings[2]**

| Option | Forecast period fiscal cost compared with status quo | Economic – Household fuel and electricity saving over status quo |
|---|---|---|
| **Phase out the one-for-two between 2013-15** | $81 million | $33 between 2013-15. |
| **Maintain the one-for-two to 2020** | $266 million | $96 between 2013-15. |
| **Phase out the one-for-two between 2013-15, but maintain for most intensive industries until 2020** | $103 million | $33 between 2013-15. |

[1] Stationary Energy, Liquid Fossil Fuels, Industrial Processes, Waste, Synthetic Gases.

[2] MfE analysis based on MED Energy Data File (2010). It should be noted that estimated household and electricity costs assume a direct pass through of all price increases, which may not occur due to market competition dynamics and the methods for incorporating ETS costs into price-setting.

6. This decision will largely determine the maximum revenue (carbon units) collected by the ETS through to 2020, and therefore the extent to which the ETS pays for any future international climate change commitments taken on by the Government.

7. By effectively reducing unit revenue to 2020, an extension of the one-for-two through to 2020 would increase the risk of the Crown paying for emissions increases above current best-estimate projections (which are broadly in line with 1990 levels through to 2020). The extent of this potential cost depends on actual emissions and ETS revenue projections under the various ETS policy options.

8. On balance, the Treasury recommends extending the transition settings as proposed by the ETS Review Panel and as per consultation, but to adjust the industrial allocation so that emissions-intensive and trade-exposed industries effectively face a one-for-two obligation through to 2020.

9. This approach would provide targeted relief to those companies most exposed to ETS costs and international competitiveness impacts. The phase-out of the transitional allocation for these firms would then occur from 2020 onwards, to coincide with the scheduled entry into force of a global agreement for reducing emissions. The Treasury notes that this proposal was not part of the changes proposed during consultation, but views that a principled argument can be made for mitigating competitiveness impacts on firms while other major emitters are not facing an equivalent cost on carbon.

**Cancellation of the second tranche of allocation for pre-1990 forestry**

10. The Government has consulted on three options for adjusting the second-tranche of forestry compensation, in light of the introduction of offsetting for pre-1990 forests:

    a full removal of the second tranche of pre-1990 forestry compensation for all previously eligible landowners,

    b a flat-line or pro-rata reduction of the second tranche of pre-1990 forestry compensation for all eligible landowners, and

    c full removal of the second tranche of pre-1990 forestry compensation only for those landowners who take up offsetting.

11. As previously advised, Treasury considers that there is a principled policy argument for cancelling the second tranche of compensation for pre-1990 forest owners in full.

12. Offsetting provides an option for pre-1990 forest owners which confers greater flexibility in land use and allows foresters to significantly reduce the costs of deforestation. The original allocation plan was a blunt mechanism that would have distributed benefits unequally among forest owners.

13. [ Withheld under sections s9(2)(h) and s9(2)(g)(i) ]

*Legal advice*

14. [ Withheld under Section s9(2)(h) and Section s9(2)(g)(i) ]

Withheld under sections
s9(2)(h)
and s9(2)(g)(i)

*Māori issues*

15. Māori submitters to the consultation supported the introduction of offsetting as providing greater flexibility to develop iwi land. However, as all iwi may not be in a position to take up offsetting and/or those iwi able to utilise offsetting
Withheld under section s9(2)(h) and s9(2)(g)(i)

16. Withheld under sections s9(2)(h) and s9(2)(g)(i)

17. Withheld under section s9(2)(g)(i)

*Recommendation*

18.

19. Withheld under sections
s9(2)(g)(i) and s9(2)(h)

20. As part of the public consultation process the Government proposed reviewing the entry of agriculture in 2014, subject to a) there being technologies available to reduce emissions, and b) international competitors are taking action on emissions in general. It has subsequently been proposed that Ministers consider deferring the entry of Agriculture until 2020.

21. Agricultural emissions are accounted for under international climate change commitments and represent approximately half of New Zealand's gross emissions. Therefore, it will be necessary for the sector to undertake efforts to reduce its emissions domestically and/or take responsibility for purchasing sufficient international emissions units to cover international obligations over time. A price signal, no matter how marginal, will incentivise research and development of commercially viable, scalable, low-carbon technologies. Agriculture participants would be liable for ten percent of emissions, if agriculture was to enter the ETS in 2015 as legislated.

22. The Treasury does not consider that sufficient evidence has been presented to make a considered decision now on whether to defer the entry of the agriculture sector into the ETS beyond 2015. Further evidence is required to verify whether agriculture is at a substantial disadvantage to other industries with limited abatement options, e.g., steel, to ensure equity across sectors. Therefore the Treasury recommends that a decision be deferred until the proposed review has been completed in 2014.

**Introducing auctioning into the ETS**

23. The Government consulted on legislative change to allow the auctioning of New Zealand Units (NZUs)[3]. Auctioning would provide flexibility to adjust the volume of international units and cash received through the ETS, i.e. to ensure the Crown's carbon asset is in line with any future domestic or international emissions reduction target.

24. Cabinet has noted the case for reducing the volume of international units imported through the ETS [STR Min (12) 3/1 refers]. A surplus carbon asset held by the Crown would be subject to carbon price volatility, may be difficult to sell, and if not sold would represent a net cash outflow from New Zealand. Auctioning will simply transfer a carbon unit asset to a cash asset, but will not increase net revenue for the Crown.

25. The Treasury recommends that the additional auction powers proposed be confirmed, to enable Cabinet to consider detailed design settings of auctioning at a later stage.

*Restriction on international units*

26. The Government also consulted on explicitly restricting the use of international carbon units by ETS participants to a proportion of their obligations, to encourage the take-up of domestically auctioned units. This change is now no longer proposed by the Ministry for the Environment, noting that a restriction could be used to increase ETS prices and be counter to the principle of allowing market participants to source lowest-cost units.



[3] Section 6 (e) of the Climate Change Response Act currently allows the Minister of Finance to sell or buy carbon units. The proposed changes include explicit settings for a sale process through auction, and extend this power to the Minister for Climate Change Issues.

## Appendix 1: ETS carbon price and the Crown's financial statements

1. It should be noted that the impacts of these policy decisions are calculated at a $6.00 price, rather than the $10.60 price as at the Budget and Fiscal Update 2012. Officials from the Ministry for the Environment, the Treasury and Audit NZ will be discussing a possible change to the methodology for valuing NZU prices in the ETS during June [TSY 2012/1091 refers]. This is because the price of NZUs in the Crown's financial statements now appears to be higher than market ETS prices, and the NZU market is maturing to the extent where an alternate NZU price can be reliably observed.

2. The fiscal impact of changing the methodology is included in the table below. The first line includes the ETS position as at BEFU ($10.60), and the second following a potential change to the methodology ($6.00). This table does not include any proposed policy changes to the ETS, which are detailed in Appendix 2.

| | 2011/12 $m | 2012/13 $m | 2013/14 $m | 2014/15 $m | 2015/16 $m |
|---|---|---|---|---|---|
| **Forecast ETS position at $10.60 price (BEFU)** | **-477** | **74** | **179** | **195** | **207** |
| **Forecast ETS position at $6.00 price** | -270 | 42 | 101 | 110 | 117 |

| | | | | | |
|---|---|---|---|---|---|
| **Impact on OBEGAL** | **207** | **-32** | **-78** | **-85** | **-90** |

## Appendix 2: Summary of Fiscal implications and Treasury advice

1. The table overleaf presents the fiscal implications of each decision within the proposed package and the Treasury's recommendations. The aggregate impact of the recommended Treasury package is included at the bottom of this table. The aggregate fiscal impact is particularly dependant on the proportion of the second tranche of forestry compensation Cabinet decides to cancel, and the one-for-two settings adopted.

2. In December 2011 Cabinet agreed that the ETS package would be fiscally neutral [CAB Min (11) 37/16 refers] across the forecast period. The options below include proposals that would not result in a fiscally neutral package. There are also differing impacts on the operating balance during the forecast period, as shown in the table overleaf.

3. There are interdependencies between some decisions, and therefore there will be slight variances depending on the configuration of options chosen. Officials will have an excel document available during the 11 June meeting to enable Ministers to calculate the implications of the various packages, taking into account any interdependencies between decisions.

| | $ million | 2011/12 | 2012/13 | 2013/14 | 2014/15 | 2015/16 outyears | Total | Treasury Recommendation |
|---|---|---|---|---|---|---|---|---|
| | | increase/(decrease) in operating balance | | | | | | |
| Transition Phase | A - Extend the one-for-two to 2020 | | (28) | (80) | (80) | (78) | (266) | Do not support |
| | B - Phase-out the one-for-two across the ETS with a one-off increase in the allocation for emissions intensive trade exposed industries in 2013 | | (21) | (48) | (22) | (5) | (96) | Support |
| | C - Phase-out the one-for-two between 2013-15 | | (18) | (44) | (18) | 0 | (81) | Do not support |
| Second-Tranche | A - Cancel only for foresters that take-up offsetting | | 1 | 1 | 1 | 1 | 6 | Do not support |
| | B - Pro-rata cancellation | 93 | | | | | 93 | Do not support |
| | C - Flat line allocation of 12 NZUs | 94 | | | | | 94 | Do not support |
| | D - Full cancellation | 185 | | | | | 185 | Support |
| Ag and Forestry | Defer the introduction of Agriculture | | | | (12) | (24) | (36) | Do not support |
| | Return of 1st tranche of pre-1990 forest allocation for forestry exemptions | | 0 | 1 | 0 | 0 | 1 | Support |
| | Extending the Pre-1990 tree weed exemption to 2015/16 | | (1) | (1) | (1) | (1) | (4) | Support |
| Industrial Allocation | Include costs associated with fugitive coal seam methane emissions | | (1) | (1) | (1) | (1) | (6) | Support |
| | Include stationary energy use of liquid fossil fuels | | (4) | (4) | (4) | (4) | (16) | Do not support |
| | Defer the 1.3 percent phase out (maintain one-for-two until 2020 – links to Transition Phase - B). | | (0) | (1) | (2) | (2) | (5) | Support |
| | Include the activity "manufacture of carbon steel from cold ferrous feed" | | (0) | (0) | (0) | (0) | (1) | Do not support |
| Other changes | Synthetic Greenhouse Gas and other technical changes | | (2) | (0) | (0) | (0) | (3) | Support |
| | Update Global Warming Potentials | | 1 | 2 | 4 | 5 | 12 | Support |
| | A $10 per annum low carbon fund | | (5) | (10) | (10) | (10) | (35) | Do not support |
| | ETS Review Implementation Contingency | | (9) | (2) | (2) | (2) | (15) | Cabinet has agreed CAB Min (12) 8/7 |

| | 2011/12 | 2012/13 | 2013/14 | 2014/15 | 2015/16 outyears | Total |
|---|---|---|---|---|---|---|
| Maximum Fiscal Cost | 0 | (51) | (100) | (112) | (121) | (385) |
| Maximum Fiscal Savings | 185 | (28) | (45) | (18) | 1 | 96 |
| Treasury's recommended package | 185 | (49) | (51) | (23) | (5) | 77 |