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Proposed Restrictions on the use of HFC-23 and N_2O CERs in the NZ ETS

BusinessNZ is pleased to have the opportunity to provide a submission to the Ministry for the Environment on its pamphlet entitled 'Consultation on Proposed Regulations Restricting the Use of HFC-23 and N_2O CERs in the NZ ETS', dated September 2011.[1]

Introduction

The proposal to ban access to some types of certified emission reduction units ('CERs') is flawed policy. Having established a United Nations-centric, internationally-linked market-based mechanism whose price outcomes are, by their very nature unpredictable, the Government is now unwilling to live by the outcomes it delivers in the short-term under the guise that United Nations-approved units now lack 'environmental integrity'.

BusinessNZ supports emission trading as the most effective means of delivering an efficient carbon price into the economy. However, it cannot support the ad hoc consideration of specific market measures in isolation of the wider set of changes that may be made to the design of the scheme. Nor can BusinessNZ support short-term, expedient initiatives whose net effect is to significantly lift carbon prices faced by businesses and households, especially at a time the Government will not face an international obligation beyond 2012.

BusinessNZ has set out below a number of comments to expand on these views. These views are not supported by the BNZ. BusinessNZ's responses to the specific consultation questions are attached to this letter as Appendix Two.

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[1] Background information on BusinessNZ is attached to this letter as Appendix One.

Setting this Proposal within the Broader Context of the NZ ETS Design

Before getting into the specific arguments to support BusinessNZ's position, it is worthwhile considering how the proposal to ban certain units fits within the overall architecture and impact of the scheme going forward. In brief, it is impossible to tell.

The NZ ETS is a complex and inter-linked economic mechanism. Not only do the effects of changes to the scheme's settings in one sector ripple throughout the entire economy, but as noted above, the impacts of the market mechanism are uncertain. The international dimension to the scheme exacerbates this. Despite this complexity, the Ministry for the Environment proposal only focuses on one aspect of the scheme with no consideration as to how the scheme as a whole may evolve going forward.

The review panel made 58 other recommendations, touching on all aspects of scheme design. Before informed decisions about the proposal to ban certain units can be made, the Ministry for the Environment needs to explain how the proposal interfaces with the other design features that may also change as a result of the review panel's other recommendations. No sense of this is provided and as a result, BusinessNZ is unable to determine where the broader set of trade-offs may lie and how the overall balance of the scheme may alter for business.[2] Such uncertainty means that support which may otherwise have been forthcoming is not.

No Unit Supply and Demand Information, or Cost/Benefit Analysis

Contributing to this is the fact that the Ministry for the Environment pamphlet provides no estimates of the impact of its proposal on either the domestic or international supply and demand for units. As a result it is impossible for submitters to understand the impact of the proposal on the level of afforestation (presumably a key driver behind the proposal) and business emissions, the benefits of linking, business and household costs, the impact on the Government's fiscal position or the wider economic impact.

BusinessNZ considers that this is extremely poor regulatory practice.

The Government has recently agreed to proceed with a Regulatory Responsibility Bill. The purpose of such a Bill will be to establish a set of principles of responsible regulation, or good law-making. It might also be expected to provide for any incompatibility with the principles to be justified. The complete absence of any cost-benefit information would likely fall foul of the requirements of any future Regulatory Responsibility Bill. The rigors of the Bill provide a good discipline that ought to be applied from the very outset of a regulatory proposal.

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[2] Of all of the factors that are critical to the future operation of the NZ ETS, what will happen to the availability of *all* CERs because of the expiry of the Kyoto Protocol and the absence of a binding global agreement is the most critical. It is unclear how this proposal looks in light of the likelihood that a successor to the Kyoto Protocol might not emerge before, say, 2020.

The Proposal is Anathema to a Least-cost Objective

It's a fundamental principle of emissions trading that emitters are able to find the least cost form of carbon abatement, *where ever it is*. Carbon trading is widely acknowledged as the most efficient form of carbon pricing because it can produce cuts in emissions at the least cost to the economy – to both businesses and consumers.

Restricting the importation of CERs is anathema to this often repeated Government objective.

While the Ministry for the Environment simply repeats the 'concern' that price separation between excluded CERs and other CERs may occur between now and 2013, no effort is made to explain the comparative risks and benefits of the low price relative to that of a higher price.[3] This is important as reports suggest that if access to some CERs were banned, the price of allowable units available to New Zealand businesses could rise significantly, imposing additional cost to businesses and households.

Restricting the importation of lower cost overseas carbon units would force NZ ETS participants to seek out higher cost domestic abatement opportunities for an uncertain environmental benefit. Domestic abatement is more expensive because New Zealand already has around 74% renewable power generation and many of our major industrials are operating at or below their 1990 emission levels or at world's-best practice.

Trade-exposed businesses, already at a disadvantage because their competitors do not face a similar price on carbon, will have their international competitiveness further undermined if they face a higher than necessary cost through the restricted access to units.

The story is no more comforting for consumers particularly those who are harder off. At NZ$30/t CO_2-e, the average cost per household could rise from $125 to $265pa. Compare this to the cost anticipated to be faced by the average American family under its now defunct climate change bill of $1 a day at most by 2020, and the Government's current commitment of $3 per week ($156pa).

A higher price may well encourage greater planting but these benefits need to be enumerated and then set against the greater costs faced by emitters. It's not immediately obvious that the benefits of a higher price will outweigh these costs and no attempt is made by the Ministry for the Environment to demonstrate whether this is true or not. Arrangements such as the ability to sell forestry units into the Australian carbon market from 2015 will boost

[3] Given that there will continue to be European demand for those units set to be excluded from use in the EU ETS for the 2012 compliance year, through to May 2013, it is unlikely that price separation will occur before the 2012 surrender date.

demand for those units and lift the price for them. This will, in turn, lift the domestic price. Patience is required, not short-term tinkering.[4]

Why HFC-23 and N_2O CERs should not be Banned

While the factors above are sufficient reasons in themselves not to proceed with the ban, a number of other compelling reasons exist in support of continued access to the units concerned. These are set out below.

<u>It's all about Europe</u>

Europe, and the design of the EU ETS, is increasingly dominating the impact of the New Zealand scheme. Changing domestic policy settings based on Europe and the design of its scheme is inappropriate for the following reasons:

1. concerns with access to CERs generated from projects that destroy the waste gas HFC-23 as well as those generated through the destruction of N_2O at adipic acid plants appear to be motivated as much if not more by geo-political concerns than environmental as the EU seeks to pressure China (the source for the majority of these units) into an international climate change deal by limiting the inflow of finance associated with them to less developed countries. New Zealand's participation in applying such pressure could lead to an interesting dynamic in light of New Zealand's growing trade relationship with China and would appear to be counter-productive given the desire to encourage them, in the absence of a binding global agreement, to participate in a regional trading arrangement with New Zealand;

2. constant European tinkering with its scheme risks turning the design of the New Zealand scheme into a moving feast. This factor raises two issues:

    a. linking changes to the New Zealand scheme to changes in other schemes will import the worst sort of uncertainty into the New Zealand scheme – it will expose New Zealand businesses to the vagaries of policy changes in other jurisdictions and make the New Zealand scheme a 'hostage to fortune' to future EU changes. The EU has already signalled that it is likely to ban more types of UN-backed carbon units from its emissions trading scheme. Such uncertainty, if flowing through into the New Zealand scheme, is ultimately self-defeating because it:

        i. is likely to have an undesirable chilling effect on investment as businesses incorporate a higher than necessary risk factor into its investment and employment

[4] Interestingly, because foresters face a liability on deforestation, a low international price of carbon would help to manage that risk. And in light of the ability of the forestry sector to sell their units on the international market, continued access to all types of CERs would also potentially provide that sector with an arbitrage opportunity.

decisions to accommodate it (in other words, it is dynamically inefficient);

ii. New Zealand does not, for example, import tax laws from other jurisdictions and it should not do so for environmental policy; and

iii. the additional risk makes it more difficult to encourage project originators to finance such investments; and

b. policy-makers in Europe have no regard for New Zealand's economic and environmental circumstances. The European emissions profile is very different to New Zealand's with industrial and power emissions rather than agricultural emissions being its focus. Where policy changes in Europe aimed at increasing the price of carbon could bring forth the next tranche of low-hanging industrial emissions, particularly from Eastern European countries, this is not true in New Zealand. Because of New Zealand's limited opportunities to secure low cost abatement opportunities (because of New Zealand's agricultural and renewables profile), a ban on units is likely to impose higher costs on businesses and households for an uncertain environmental benefit.

BusinessNZ understands from its European counterpart, Business Europe that the constant tinkering in Europe has led some businesses to increasingly look to the predictability created by a carbon tax. This would be a bad outcome for New Zealand; and

3. the European economies are extremely weak and will continue to be so for some considerable time. Italy and Spain have recently received rating agency downgrades while the Greeks have only just managed to fend off technical bankruptcy with the passage of their latest austerity bill. A weak Euro and a strong New Zealand dollar have combined to push the price of *all* CERs to historic lows. In addition, economic output is down significantly and with it the demand for units. Combined with an absolute, rather than an intensity-based method of allocating free units, substantial levels of surplus units have been available to be sold to assist with cash flows. The carbon price will, over time, fluctuate up and down in response to market fundamentals and New Zealand design settings should not be manipulated to address general dissatisfaction with the short-term outcomes being delivered by the market such as cross-rates or temporary circumstances (for example, the EU scheme moves to a sectoral average basis of allocation more akin to New Zealand's).

<u>Myth-busting</u>

Two myths have gained some traction in the course of the debate as to whether or not ban units from the New Zealand scheme. These are that the ban is necessary to enable the New Zealand scheme to be linked with other

schemes (that is, the EU and Australian schemes), and that a failure to ban these units will see their sale in New Zealand collapse the price to close to zero. Neither is true, and in this section BusinessNZ outlines why.

Scheme linking is unlikely to happen anytime soon

Bans in the EU and Australia do not require them to be banned in New Zealand due to linking reasons. Scheme linking is unlikely to happen regardless of New Zealand's policy with respect to access to certain types of CERs.

The risk to the formal linking of the New Zealand scheme with any other scheme is extremely small given the presence of a range of other pre-conditions that would create more substantive hurdles to the formal linking of scheme than the trade in such units (such as, for example, the absence of a 'hard' emissions reduction caps as in the EU and Australian schemes. It is also probable that the Australian scheme will never emerge from its tax form into the form of an emissions trading scheme). The 'emissions problem' in each scheme is simply too different to justify formal linking. In this case, linking will only ever extend to the exchange of mutually acceptable units rather than the copying of design features.

Nor will continued access in the New Zealand scheme to units banned in the EU and Australian schemes prevent the exchange of other mutually acceptable units. Neither Australia, nor the EU have signalled that they would prohibit the importation of other units traded in the New Zealand scheme that remain allowed for importation into those schemes. As recognised by the Ministry for the Environment, all CERs generated hold information as to the CDM project they were generated from. Some units (for example, nuclear) are already ineligible for use in the New Zealand ETS and so it is practically possible to separately identify and exclude other units should the ability for the mutual exchange of units actually ever arise.

The effect of the EU ban will result in the availability of exchange products that differentiate between the various types of units enabling ease of on-selling. New Zealand purchasers who attempt to sell banned units into Australia or the EU will do so at their own risk.

Continued access to all CERs may not cause the price of NZUs to collapse

As profit maximisers, the sellers of these units have no economic incentive to collapse the price of NZUs, but would rather see the domestic market reach a new price equilibrium relative to the other price points of forestry NZUs and the price cap.

It is interesting to observe that the substantial number of units allocated to New Zealand forest-owners have not all been dumped on to the domestic market, collapsing the price, but rather they have been held until a suitable price point has been reached.

Finally, it is unclear what the position is regarding unit acceptability in other emerging markets. No evidence is presented by the Ministry for the

Environment to suggest that the Chinese domestic pilot trading schemes will not accept these units, or other schemes such as those being planned in Japan and Korea. Instead, New Zealand is portrayed as the sole likely recipient of these units. This is unlikely to be true with Point Carbon stating that Japan is likely to be the biggest buyer of excluded CERs.

Reliance on UN approval processes

CERs are only issued after due investigation by the body created to do this job under the Kyoto Protocol (the Clean Development Mechanism, or 'CDM' and its Executive Board). It is clear to all concerned that this process has been fraught with difficulty, but steps are being taken by the UN to improve its authorisation process and methodologies. As noted by the Ministry for the Environment:

> "The Board is taking steps to revise the methodology which governs the generation of CERs from HFC-23 destruction projects."[5]

BusinessNZ considers that this is where the focus of New Zealand's effort should be applied – within the multi-lateral process upon which it has previously placed such considerable weight. New Zealand has, to date, relied upon the international framework established by the UNFCCC to determine additionality and other aspects of eligibility under the Kyoto rules, rather than determining its own arbitrary rules and standards. It should continue to take this approach. To do otherwise risks the integrity of *all* CERs being called into question. This would undermine the key market mechanism which underpins the future development of a liquid international carbon market.

Unilateral action is not justified simply because:

> " ….the impact of the new methodology is uncertain … ".[6]

Indeed, taking unilateral action risks damage to the chances of securing future international agreements as doing so demonstrates a willingness to undertake opportunistic behaviour when their domestic interests deviate from the goal of global co-ordination. So long as an imported unit represents a tonne of CO_2-equivalent genuinely removed from the atmosphere or from an industrial process (having been approved, for example, by the Executive Board), it should be allowed into the NZ ETS. Reliance on this process will enable the Government to manage any supposed reputational risks and allow businesses the flexibility to decide themselves whether any particular type of CERs should be used by them in meeting their obligations.

If a Ban is Imposed

BusinessNZ considers that the arguments outlined above are sufficient to warrant the Government moving cautiously to ban certain types of CERs from

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[5] Ministry for the Environment pamphlet entitled 'Consultation on Proposed Regulations Restricting the Use of HFC-23 and N20 CERs in the NZ ETS', dated September 2011, page 2.

[6] Ministry for the Environment pamphlet, op cit, page 2.

the NZ ETS. However, if despite the above information, the Minister for the Environment still wishes to proceed with the ban, we would urge the Minister to consider the following:

1. get the unit demand and supply information, along with supporting unit price information done before a final decision is made. Supporting cost-benefit analysis should also be completed, and subject to scrutiny from stakeholders. This is consistent with good regulatory practice;

2. continue with the moderating features (the price cap and the progressive obligation) for either 10 years or until there has been more substantive international action to price carbon. As signalled above, excluding CERs is likely to place significant upward pressure on the carbon price faced by New Zealand businesses and households at a time when international action is modest and poor economic conditions are set to continue. This impact would be compounded by lifting the price cap and removing the progressive obligation. In the current circumstances, such action would be inconsistent with the Government's well stated position that stepping up of the New Zealand scheme in 2013 and the addition of further sectors will be conditional on substantive progress being made in other countries, particularly our major trading partners like Australia.

   At this stage in the journey, New Zealand's emissions trading scheme should be based around the development of a stable long-term trading framework. That is, one that provides business with predictability so that it can invest in both abatement opportunities and new technologies with confidence and that can be made more stringent when circumstances warrant it;

3. not implement the ban until 31 May 2015. This is the date by which New Zealand participants must surrender units for the preceding compliance year. It precedes the date on which the Australian scheme is to transfer into a trading scheme, and that date (1 July 2015) is therefore the earliest date by which New Zealand units could be traded into the Australian scheme. As linking is more likely with the Australian, rather than the European scheme, this should be the operative date for the ban. This approach would:

   a. continue to minimise the impact of the scheme on the New Zealand economy at a time of on-going economic fragility;

   b. enable further, new information about the state of progress towards the conclusion of a new binding global agreement to come to hand; and

   c. provide compliance purchasers with sufficient warning to those who may enter forward and future contracts to not procure such contracts beyond that date, thereby avoiding the need for exemptions and minimising the overall cost of a ban; and

4. ban the same gases as those being banned in Europe. The discussion in the pamphlet of which CERs are to be banned is loose with the focus being N_2O CERs generally. This could cover CERs from a variety of sources such as adipic acid, nitric acid or caprolactam. The Ministry for the Environment needs to clarify this. Only adipic acid – not nitric acid or caprolactam - CDM projects (44% of N_2O CER supply) are being banned from use in the EU ETS.

Finally, BusinessNZ urges the Ministry for the Environment to consider the establishment of an informal group of technical experts to assist it work through the correct use of trading techniques (for example, futures and forwards), and market-based terminology. At a minimum, such a group should be used to peer-review draft regulations before they are put out for consultation.

Summary

BusinessNZ considers that the restrictions proposed challenge the underlying least-cost design principle of the NZ ETS. Proposals that increase the costs of compliance without providing any meaningful global environmental benefits are likely to further reduce the public acceptability of the scheme.

This, combined with the dubious rationale for the proposal, is likely to undermine the nascent New Zealand trading market. Opportunistic design changes aimed at delivering short-term, non-market outcomes will only create uncertainty. More worryingly, it risks causing businesses to lose confidence in a market whose design settings will become unpredictable and subject to the vagaries of changes to distant markets that are inappropriate for New Zealand economic and environmental circumstances.

BusinessNZ asks that the Ministry for the Environment consider these views carefully.

Yours sincerely

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BusinessNZ

APPENDIX ONE: ABOUT BUSINESSNZ

Encompassing four regional business organisations (Employers' & Manufacturers' Association (Northern), Employers' Chamber of Commerce Central, Canterbury Employers' Chamber of Commerce, and the Otago-Southland Employers' Association), BusinessNZ is New Zealand's largest business advocacy body. Together with its 73 strong Major Companies Group, and the 70-member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, BusinessNZ is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

In addition to advocacy on behalf of enterprise, BusinessNZ contributes to Governmental and tripartite working parties and international bodies including the ILO, the International Organisation of Employers and the Business and Industry Advisory Council to the OECD.

BusinessNZ's key goal is the implementation of policies that would see New Zealand retain a first world national income and regain a place in the top ten of the OECD (a high comparative OECD growth ranking is the most robust indicator of a country's ability to deliver quality health, education, superannuation and other social services). It is widely acknowledged that consistent, sustainable growth well in excess of 4% per capita per year would be required to achieve this goal in the medium term.

APPENDIX TWO: RESPONSES TO SPECIFIC CONSULTATION QUESTIONS

Consultation Question	BusinessNZ Response
1. What are your thoughts on the Government's assessment of the risks of allowing CERs generated from HFC-23 and N_2O industrial gas destruction projects in the NZ ETS?	While there are some risks from the importation of these units into the NZ ETS, these risks are greatly exaggerated and, in any case, are likely to be out-weighed by the risks created by banning such units and the benefits of not banning them. See the cover letter for further detail.
2. Should there be a ban on using these CERs for compliance in the New Zealand Emissions Trading Scheme (NZ ETS)?	No. Please see the reasons outlined in the cover letter.
3. What effect do you think the ban would have on: a. you or your organisation b. the NZ ETS	As outlined in its submission the ETS Review Panel, BusinessNZ considers that New Zealand's relatively unique factors (such as its emissions profile and abundance of renewable sources of electricity) are as likely as not to see the scheme without careful management, transition into a high price, low emission reduction scheme. Banning units is likely to contribute to this.
4. Are you currently holding CERs generated from HFC-23 and N_2O industrial gas destruction projects? If so are these units held in the NZEUR or an overseas registry?	N/a
5. Have you entered into a contract to purchase CERs generated from HFC-23 and N_2O industrial gas destruction projects in the future? If so, what is the term of the contract?	N/a
6. What are your views on how an exemption for holders of forward contracts for CERs could be implemented?	Without a ban, exemptions are not required. As a matter of principle, should a ban be introduced, private property rights should not be overridden without compensation. The net effect of the proposal is the probable derogation of private property rights for which no compensation is proposed. The Government has recently agreed to proceed with a Regulatory Standards Bill. The purpose of this Bill is to establish a set of principles of responsible regulation, or good law-making. BusinessNZ considers this proposal would likely fall foul of the requirements of this Bill, in particular, of the third principle set out in Part 2 of the Bill (Principles of responsible regulation and their effect): **7. Principles** 1. The principles of responsible regulation are that, except as provided in subsection (2), legislation should—

Consultation Question	BusinessNZ Response
	Rule of law (a) ……. *Liberties* (b) …… *Taking of property* (c) not take or impair, or authorise the taking or impairment of, property without the consent of the owner unless— (i) the taking or impairment is necessary in the public interest; and (ii) full compensation for the taking or impairment is provided to the owner; and (iii) that compensation is provided, to the extent practicable, by or on behalf of the persons who obtain the benefit of the taking or impairment: Irrespective of one's view of the Bill, the economic significance of the proposal is such that it warrants being required to meet such a stringent standard of quality and associated requirements, as intended in the Bill. In lieu of compensation, the Government must outwardly demonstrate to the business community the desire to protect private property rights. This can be done in a number of ways, for example: 1. contracts that run beyond the date chosen should automatically be exempt. In other words, there should be a blanket exemption for all contracts struck before the effective ban date irrespective of their forward delivery date. Evidence for this should be able to be easily demonstrated by presentation of the contract. Blanket exemptions are most likely to be the lowest cost method; or 2. by provision of a suitably lengthy notice period that would ensure that very few holders of forwards contracts are affected. For example, as set out in the cover letter, BusinessNZ proposes that a 1 May 2015 commencement date for a ban would serve this purpose.

Consultation Question	BusinessNZ Response
7. What support would the government need to provide to ensure participants were able to identify banned CER and avoid purchasing or surrendering them?	While BusinessNZ does not agree with a ban, BusinessNZ considers that should such a ban be implemented, the risk should fall to the business purchasing the units. There are already other units that cannot be surrendered in the New Zealand scheme (such as nuclear-based CERs), and a similar approach should be used for the units that are the focus of this proposal.
8. If banned CERs were surrendered after the regulation entered into force, should there be the potential for penalties?	See response to Q7 above. As a matter of general principle, banned CERs if surrendered, should be treated the same as for other banned units.
9. If banned CERs were surrendered, how long should the participant have to surrender eligible units to replace them?	See responses to Q7 and 8 above.
10. If the government goes ahead, do you think any ban should be implemented: a. from 1 January 2012 b. from 1 January 2013, in line with the EU ETS ban, or c. Some other date (please specify).	From 1 July 2015, the date on which the Australian scheme becomes a trading scheme. See the cover letter attached for further details.
11. Do you consider that there any alternative options to the proposed ban?	Don't ban them. In lieu of this, a range of other potential approaches are set out in the cover letter attached.