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Proposed Regulations Restricting the use of Certain International Units in the NZ ETS

BusinessNZ is pleased to have the opportunity to provide a submission to the Ministry for the Environment on its paper entitled 'Consultation on Proposed Regulations Restricting the use of Certain International Units in the NZ ETS' released on Tuesday 13 November 2012.[1]

Introduction

BusinessNZ supports emission trading as the most effective means of delivering an efficient carbon price into the economy. It, therefore, also supports the development of a deep and liquid international carbon market based on the trade, between schemes, of fungible units.

Key to the successful implementation of a deep and liquid carbon market is the emergence, over time, of a set of units that meet commonly acceptable quality standards that can be traded across borders. This is important to allow those who trade in carbon to transact with confidence and know that their decisions are not subject to undue regulatory risk. BusinessNZ has approached its response to the proposals in this context.

BusinessNZ Supports the Proposals…..

This section sets out BusinessNZ's rationale for its general support of the proposals. Its responses to the specific consultation questions are attached to this letter as Appendix Two.

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

As BusinessNZ stated in its 2011 submission on the proposal to ban certain Certified Emission Reduction Units (CERs)[2], BusinessNZ is unable to support the ad hoc consideration of specific market measures in isolation of the wider design of the scheme. However, now that the overall shape of the scheme is more settled (in fact, it is now more settled than it has been at any point in the last four years), BusinessNZ supports these initiatives as proposals that will:

1. provide consistency with previous policy changes (while BusinessNZ, vigorously opposed the 2011 proposal to ban certain CERs generated from the destruction of industrial gases, having done that there now seems little reason not to also ban the use of other types of unit derived from the same process);

2. provide participants with increased certainty about the eligibility of unit types. Continued speculation about what might be 'grey' or 'green' units is unhelpful;

3. reduce the barriers to cross-border trading, and eventually, scheme linking. While the barriers to linking are likely to be much larger than who accepts which units, acceptance of common units is a basic first step towards eventual linking; and

4. not unduly lifting carbon prices faced by businesses and households at a time of substantial economic insecurity.

Importantly, the current proposals are not predicated on the same drivers for the 2011 proposals. The earlier proposals were a thinly veiled signal that the international carbon price was delivering too low a domestic price and therefore warranted a departure from the least cost compliance principle. Ultimately, however, it was a misguided attempt to bolster demand for New Zealand units under the guise of concerns with 'environmental integrity'. The carbon price has, since 2011 continued to fall, this fundamentally being driven by a lack of international demand, rather than an oversupply of units of doubtful environmental integrity.

…..But BusinessNZ's Fundamental Concerns have not Completely Dissipated

While supporting these two specific proposals, some residual concerns remain. BusinessNZ considers that that while not strong enough to make it reconsider its support for the proposals, these concerns need to be given active consideration by policy makers when giving final shape to the current proposals, and also to the consideration of any future proposals. These are:

1. the signal that New Zealand is willing, when it suits, to act outside the multilateral UN processes to which it otherwise adheres. This was a concern raised in the context of the 2011 proposal. BusinessNZ

[2] BusinessNZ submission to the Ministry for the Environment entitled 'Proposed Restrictions on the use of HFC-23 and N_2O CERs in the NZ ETS', dated 31 October, 2011.

considers that the UN framework should be 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 rules and standards. To do this 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;

2. the importance that New Zealand avoid (either deliberately or inadvertently) signalling to other countries who may be considering taking an obligation under the Ad Hoc Working Party on the Durban Platform (the ADP) or participating in carbon markets that it will be a party to the ex post re-writing of the rules. To this extent, it is conceptually no different to New Zealand's position at CoP18 on the carry-over of AAUs where New Zealand is concerned about inappropriate, or poor incentives being sent from the application of contemporary circumstances to a position agreed some considerable time earlier;

3. the need to provide the market with a clear, unequivocal signal that further changes concerning unit eligibility will be rare, or at least infrequent. Constant tinkering (or even the prospect thereof) with unit eligibility is not costless – it gives rise to uncertainty and can result in price separation between unit types that may not be based on market fundamentals but rather participants best guess about the underlying political risk attached to each unit type. In fact, we can see this very outcome in the current price premium between NZUs and the Kyoto units. While the limited supply of NZUs is a factor in this price separation, so too is the uncertainty of continued access to certain Kyoto units. This has a chilling effect on their demand as New Zealand compliance purchasers move instead to hold the 'safer' or less risky NZUs. As the current proposal if implemented will be unlikely to have any discernible impact on the international price of Kyoto units, the cost of regulatory uncertainty can be directly observed as the price difference between NZUs and the Kyoto units. This is an unnecessary cost to the economy which has an undesirable chilling effect on investment as businesses incorporate a higher than necessary carbon price into its investment and employment decisions than it would in a world without the uncertainty (in other words, it is dynamically inefficient);and

4. having set and now reinforced the precedent, New Zealand faces the problem of how to manage the risk of now just following changes made by the EU to suit its circumstances even though such changes may be either irrelevant, or inappropriate to New Zealand circumstances. In essence, the New Zealand scheme (and its participants) becomes a 'hostage-to-fortune'.

Some Practical Considerations

The two key practical implementation issues associated with the proposal relate to two interrelated issues of the timing of the ban's introduction, and what to do about forward contracts. BusinessNZ considers that both of these issues can be dealt with in a relatively straight-forward manner.

Timing of the Ban

As the proposal is not being driven by trying to push up the domestic price or carbon (arising from the acknowledgement that it is likely to have little or no impact on the international price of carbon in any case) - there is no rush to implement a ban. In other words, a delay in implementation of the ban in this instance will not forego any expected behavioural changes on the part of participants.

However, BusinessNZ understands that there is a trade-off in terms of the choice of timing. This trade-off is to either:

a) ban the units effective immediately, while letting all units held in participant's registry accounts at the time of the ban to be honoured, and able to be surrendered at a time of their choosing; or

b) ban the units by some later date, but constrain the use of those units to only be used for surrender in the preceding compliance year (this is different to the presumption set out in the Ministry for the Environment's paper which implies a later ban date but with no such constraint).

Both approaches are intended to avoid the risk that participants buy substantial amounts of the soon-to-be-banned units and have pros and cons. Broadly these relate to the extent to which, and how quickly, the Government wishes to constrain and or eliminate the use of the units in the scheme (in turn related to considerations of the environmental integrity of the scheme), the extent to which private property-rights are respected, the financial risks participants might face from holding what were, prior to the ban, legitimate units, and the degree of flexibility needed by participants to adjust their positions.

BusinessNZ considers that the New Zealand scheme is unlikely to be inundated with units that cannot be used elsewhere. The EUETS, while having banned the use of the industrial gas units from 1 January, 2013, has made an exception until 30 April 2013 for the use of these units from existing projects that are approved before 1 January 2013, for compliance with 2012 commitments (essentially option (b) above).

Similarly, any suggestion that the large hydro ban be implemented quickly to avoid these units from being dumped on to the New Zealand scheme is simply implausible given that they have already been banned in the EUETS for some considerable time with no evidence of dumping already having taken place.

While either approach (i.e. options (a) or (b) above) would work in the New Zealand scheme, on balance, BusinessNZ considers that option (a) is preferred. This suggests that the ban for industrial gas units be introduced from 1 January 2013 with no new industrial gas units being allowed to enter participants' accounts after that date. However, any units already in accounts by that date should be able to be used by participants at their discretion.

With respect to large hydro-dam units, BusinessNZ also proposes that the large hydro dam ban be implemented on a similar basis – that they can only be used after 1 January 2013 if already held in a participants account by that date. Any units already in accounts by that date should be able to be used by participants at their discretion. After 1 January 2013, only units that meet the new higher standard should be eligible to enter participant's accounts.

This approach is 'cleaner' and respects private property-rights while removing progressively removing the units from the system. Participants will, by the time of the ban, have had time in which to adjust their positions.

The Treatment of Forward Contracts

As for the issue of forward contracts, this would appear to be able to be treated in a similar manner. There would appear to be no reason why a ban on the striking of new forward contracts containing both types of units could not be introduced from 1 January 2013.

However, the need to have the Government signal its desire to protect private property rights is important as contracts that have already been struck might be for future delivery in the 2013 compliance year, or beyond. BusinessNZ suggests that all contracts struck before 1 January 2013, irrespective of the future delivery date, be respected and allowed to be executed. To do otherwise raises the spectre of claims for compensation for what were otherwise perfectly legitimate units on entering into the contract.

Summary

At this stage in the emissions trading 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 act with confidence in the scheme.

BusinessNZ considers that the proposal set out by the Ministry for the Environment - to bring greater certainty and consistency to the trade of units - contributes towards this goal. Therefore it supports the proposals and outlines some views as to how the bans could be effectively implemented. However, despite its support, BusinessNZ continues to have some reservations about the implementation of such proposals and it asks that the Ministry for the Environment give these reservations due regard in finalising its approach, both now and in future cases.

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

Yours sincerely

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APPENDIX ONE: ABOUT BUSINESSNZ

Encompassing four regional business organisations (Employers' & Manufacturers' Association (Northern), Business Central, Canterbury Employers' Chamber of Commerce, and the Otago-Southland Employers' Association), BusinessNZ is New Zealand's largest business advocacy body. Together with its 80 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. Do you agree with the Government's proposals to ban the surrender of the proposed CERs and ERUs in the NZ ETS? If not, what other options should the Government consider and why?	Yes.
2. If the Government goes ahead, when should the ban be implemented? a) from 1 January 2013 b) from 1 June 2013, or c) some other date (please specify and state reasons why).	On balance, option a). However, the ban should not apply to units already held by participants who should be free to surrender the units they already hold at their discretion (i.e. without constraint). Critically to the issue of timing, there is no evidence provided that would support the contention that urgency is required, nor that should a later date be chosen, that the New Zealand scheme will somehow be flooded with these units.
3. What effect do you think the ban would have on: d) you or your organisation, including compliance costs associated with identifying these units? e) the NZ ETS?	It is difficult to assess the effect of the ban on the NZETS in light of the complete absence of cost-benefit information. However, from an economic cost perspective, BusinessNZ would expect the cost to be low, for two reasons: 1. the proposal is seen as consistent with the stated objective of "ensuring the NZ ETS continues to deliver emission reductions at least cost"; and 2. the move to reduce access to a small number of units on the basis of their environmental integrity is (like the initial 2011 proposal to ban certain CERs) unlikely to alter the international carbon price to which the New Zealand scheme is tied, and therefore unlikely to increase the domestic price of carbon.
4. Are you currently holding ERUs generated from HFC-23 and N2O industrial gas destruction projects or ERUs/CERs from large-scale hydropower projects that do not meet the guidelines in the final report of the World Commission on Dams? If so, are these units held in the NZEUR or an overseas registry?	n/a
5. Do you think units purchased under forward contracts should be assessed on a case-by-case basis to determine their exemption from the ban, as with previous	No. In order to avoid the retrospective extinguishing of private property rights, all such units purchased under forward contracts should be automatically exempt on production of evidence of the forward contract.

Consultation Question	BusinessNZ Response
restrictions? If not why not?	In addition, there should not be a specified date after which the forward contracts will not be eligible for an exemption. In BusinessNZ's view, any date cut-off date would be arbitrary and punitive as contracts purchased before the date of the release of the consultation document would have been made in the knowledge that at the time of entering such a contract, the units were eligible for use in the New Zealand scheme. The Government must outwardly demonstrate to the business community the desire to protect private property rights. BusinessNZ sees that officials seem to believe that respect of private property rights is a function of price. On page three, the paper says that: "It should be noted that at the time of the previous CER ban, the price of carbon was significantly higher and therefore the impact of not allowing forward contracts was considerably higher." BusinessNZ considers that the respect of private property rights is fundamental and to imply that they might be able to be extinguished simply because the current price of carbon is low completely mistakes the principle behind the need to protect them and the extremely bad precedent that extinguishing them on this basis would create.
6. Have you entered into a contract to purchase ERUs generated from HFC-23 and N2O industrial gas destruction projects or ERUs/CERs from large scale hydropower projects that do not meet the guidelines in the final report of the World Commission on Dams? If so, what is the term of the contract?	n/a