Submission

by

to the

Emissions Trading Scheme Review Panel

on

‘Issues Statement and Call for Written Submissions’

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ISSUES STATEMENT AND CALL FOR WRITTEN SUBMISSIONS

SUBMISSION BY BUSINESSNZ[1]

1. INTRODUCTION

1.1 BusinessNZ welcomes the opportunity to comment on the emissions trading scheme Review Panel's Issues Paper entitled 'Issues Statement and Call for Written Submissions' dated 11 March 2011 (the 'Issues Paper'). The scheduled stock-take of the appropriateness of New Zealand's emission trading policy settings now and into the future is appropriate and timely. This is the first review of the New Zealand emissions trading scheme (the 'NZETS') and will set the benchmark for future investigations into the effectiveness of it.

1.2 BusinessNZ supports emissions trading, in principle, as the approach most likely to efficiently deliver a carbon price into the economy. The fact that New Zealand has an operational scheme has provided businesses and consumers some clarity about its immediate effects. For a limited number of businesses, new market opportunities may have emerged. However, for most businesses, concerns remain about the impact of climate change policies on their incentives to invest and grow and the opportunities foregone. The review offers an opportunity to re-engage businesses and consumers in a meaningful conversation about what New Zealand is seeking to achieve with the NZETS, and why.

1.3 BusinessNZ considers that the current design of the NZETS will be the best domestic policy solution *if* a deep and liquid global carbon market evolves.

1.4 But the existence of a liquid global carbon market in the near to medium term seems increasingly unlikely. This is mirrored in a lack of progress toward a global climate change agreement with binding emission reduction targets. In the absence of action by others to price carbon in a transparent way and in ways not offset by contradictory subsidy policies, assumptions made even as recently as a year ago concerning the transitory nature of competitive impacts on what are otherwise competitive, trade-exposed businesses, the speed of action by our trade-competitors to price carbon, and the ability to remove the moderating features may no longer hold.

1.5 As more information has come to hand regarding the lack of sufficient international action, it has become clearer that the current design of the NZETS may no longer be fit-for-purpose with regard to New Zealand's economic and environmental circumstances, nor reflect the Government's intent. Changes to the design as embodied in the Climate Change Response Act 2002 ('the Act') are now required to

[1] Background information on Business New Zealand is attached in Appendix One.

deliver a more proportionate and effective scheme and one that better reflects New Zealand's best economic interests.

1.6 BusinessNZ considers that a new equilibrium needs to be reached between the environmental benefits from action and the competitiveness impacts on New Zealand trade-exposed businesses of the NZETS. This new equilibrium needs to be reached in a way that gives greater emphasis to protecting New Zealand's sovereign economic interests, and consistent with a broader strategic desire of both Government and business to transition the economy in a balanced way to a lower carbon intensive future.

2. SUMMARY OF BUSINESSNZ'S VIEWS

2.1 The following table summarises BusinessNZ's view of the overall review package.

Review Issue	**BusinessNZ Position**
Questions 1 – 10 on impacts of the NZETS.	The impact of the NZETS is hard to determine at this early stage, and in the absence of new studies. While most modelling undertaken to date has been helpful in growing the general understanding of where the balance of dependencies lie under a range of scenarios, they are unlikely to be useful for anything other than broad magnitudes. In particular, modelling tends not to have examined sector-specific or regional impacts of climate change mitigation policies, given their emphasis on economy-wide costs and benefits. Regional and sectoral effects will differ considerably from the economy wide results. Therefore, even if demonstrating a small impact, substantial weight should not be placed upon the outcome of assumption dependent modelling done before the 1 July 2010 expansion of the NZETS or from shortly afterwards. In any case, even a relatively limited level of economic sacrifice needs to be viewed in light of policy measures overseas that suggest a limited willingness to pay an economic cost to reduce emissions. At the very least, the review should explicitly consider the level of economic sacrifice that New Zealand is prepared to accept and outline what steps will be taken if the economic sacrifice that results is different. See Section 3 below.

Review Issue	BusinessNZ Position
Questions 11 – 17 on key issues after 2012, and other issues.	The future, both with respect to the international climate change negotiations and action by New Zealand's trade competitors, is highly uncertain. Policy making in an uncertain environment is not new, but neither is the prescription – minimise economic harm and preserve future options by waiting until more, improved information comes to hand before taking definitive action. The trading framework is in place and should be preserved, but the languid pace of international action and the risks of more stringent price signals after 2012 suggest that the NZETS as currently designed should be changed. New Zealand finds itself in a position of early adopter of an economy-wide carbon price and as a result, has shown significant international leadership. Now more action is needed by others to ensure that New Zealand's response remains proportionate to its 'fair share'. The changes proposed by BusinessNZ seek to ensure this. See Sections 4 - 6 below.
Question 18 on synthetic greenhouse gases.	The fundamental purpose of an emissions trading scheme is to allow a market mechanism to discover an efficient price and facilitate the least cost source of abatement to be found. Key to the achievement of this purpose is a scheme that is broad-based, thereby avoiding economic distortions between sectors. In general, exemptions are distortionary. However, synthetic greenhouse gases account for only around 1 percent of New Zealand's total emissions while at the same time they support much of New Zealand's economic prosperity via temperature controlled exports. Therefore, BusinessNZ remains to be convinced that current policy settings are appropriate for synthetic greenhouse gases. Regulatory, or other market options are available, including delayed entry. Failing that, entry with moderating features is a fall-back option that warrants further consideration by the Panel. See Section 7 below.

3. IMPACTS OF THE NZETS

3.1 Responses to the specific questions posed by the Panel on the impact of the NZETS are set out in tabular form in Appendix Two, attached to this report.

The short-term situation is largely as expected…

3.2 Views on the impact of the NZETS from our members are broadly consistent – its effect on reducing emissions has been small in the

short term. There are a number of important contextual reasons behind these low expectations:

a) the level of the price of carbon: this has been fixed until 31 December, 2012, at $25/t CO_2-e. When combined with the 1:2 progressive obligation, it provides for a maximum effective price of carbon of $12.50. This price arrangement reflects an appropriate policy judgement on the inherent tension between the environmental risk of keeping carbon prices too low and the economic risk of unilaterally imposing carbon prices high enough to drive substantial abatement;

b) the significant uncertainty regarding the future path of the international climate change negotiations and, therefore, the future carbon price path: the outcome being observed is consistent with uncertainty – this increases investment risk and therefore the 'hurdle rate'. Lower levels of abatement occur as a result. That abatement which does occur will likely be occurring because it is economic even in the absence of a price on carbon, unless it has a quick payback period (for example, through to 2012) or that the economic life of the equipment being used has expired and reinvestment is required. But even the range of economic abatement opportunities needs to be set in the context of the relatively high level of energy efficiency of New Zealand businesses – New Zealand manufacturing firms already face strong incentives to be as efficient as possible. They face, for example, a price for their energy that is unshielded by subsidies, or productive inefficiencies. Therefore it is reasonable to expect that most 'quick' energy efficiency and associated carbon gains have already been taken. A number of New Zealand's major emitters are already at or below their 1990 level of emissions or operating at world's best practice. In these circumstances, businesses are, as a result, likely to buy units for surrender rather than look to innovative solutions to abate; and

c) the immaturity of the New Zealand carbon market (both in terms of the design and financial market): emitting sectors (liquid fossil fuels, stationary energy and industrial processes) have only been in the NZETS since 1 July 2010. As with the introduction of any major economic reform, there is an inevitable 'settling-in' or 'learning-by-doing' period as businesses wait to see how the incentives have changed and their effect. The current introductory phase of the NZETS is much like Phase I of the EUETS, as companies slowly came to grips with the new financial instrument, the options available and the new incentives being faced. Emissions did not change significantly during Phase I and, in lieu of a liquid market, businesses retained their allocated units for surrender purposes. This too, is being observed in New Zealand.

3.3 On the more positive side of the ledger, BusinessNZ is aware that new forestry investments in land are being made as a direct result of the signals under the NZETS, and that while there has been lag in timing caused by the need to scale up nursery and planting crews etc, new land tree planting is being scheduled. While thought to be low in comparison to planting levels of a decade or so ago, the levels being considered are positive in comparison to recent years. Further, BusinessNZ is aware of much larger land purchases on the East Cape by new players from offshore (United Kingdom ['UK'] & Germany) who are intending to join the NZETS as forestry participants. This could be accelerated if land now in mature forestry could be felled and converted to alternative productive uses without incurring severe financial penalties. This may even become possible under a future international arrangement.

3.4 However, the small impacts offered by the Panel are interesting (for example, "about 1 per cent of revenue", "equivalent to about 0.2 per cent of GDP") but need to be seen in the context outlined in a) to c) above. To a business, all costs add to reduce profitability, which one is the largest is immaterial. These estimates also do not address the real question of whether these increases are appropriate given that they are disconnected from the more strategic consideration of international circumstances. The comparisons to other cost increases are also generally invalid as the markets (for example, carbon and labour markets) and the incentives provided by each increase are quite different. Comparisons of effort implied across jurisdictions, in terms of an equalised cost of abatement, as a percentage of GDP would have been more relevant.

3.5 BusinessNZ notes that low levels of short-term emission reductions do not mean a low cost impact. Characterising the costs as a small proportion of revenue or annual working expenses (as is the case for the on-farm estimates) belies the fact that the cost to those businesses which face elastic demand profiles is reflected in a concomitant reduction in profits. In practical terms, this signifies a reduction in the rate of return for that activity, making the opportunity cost of the next best alternative more attractive, thereby reducing investment opportunities.

3.6 The food processing sector, and energy intensive small-to-medium manufacturers who export or otherwise substitute for imports are also demonstrable of this effect. For example, the costs faced by Masport Foundries, a cast iron foundry, have risen by approximately $52,500 in the nine months from July 2010 to March 2011,[2] while at the other end of the spectrum, Fonterra's processing-related energy costs are expected to rise by around $25m in 2011. All things being equal, both will double with the removal of the moderating features in 2013. In the absence of commercial abatement options and an allocation of units,

[2] Small-to-medium enterprises almost tend to be forgotten as a matter of course, in broader economic analyses.

for both of these companies (and many in-between) this is a cost borne by their shareholders, and not faced by their international competitors.[3] Whether it is a small cost relative to their total revenue, or expenses, is largely irrelevant.

3.7 Indeed, Masport Foundries has advised BusinessNZ that it has not raised its prices for 18 months. We have been similarly advised by other companies.[4] The annualised effect of the NZETS costs under the moderating features equates to a reduction in Masport Foundries profit of between seven and ten percent. Again, this impact would be expected to double under a scenario where the moderating features roll-off. These are not trivial impacts.

3.8 While the NZETS-related costs are a portion of the overall cost increases being faced, the inability to pass costs on is a function of Masport's trade-exposure (despite the fact that it does not receive any units to ameliorate this situation).

3.9 Neither should the 'small' modelled current impacts on households be trivialised. The United States (the 'US') Environmental Protection Agency estimated the Waxman Markey Bill (the emissions trading Bill that only progressed as far as the US House of Representatives) would cost a US family only $USD1.00 per day.

3.10 Nor can the impact be homogenised – it is widely accepted that the cost impact of the NZETS will vary significantly by sector, business size and by location.

3.11 Finally, it is worthwhile observing that an apparently low competitive impact on businesses of the introduction of the NZETS is consistent with an introductory phase – adverse competitive impacts are unlikely to be immediately observable and may, in fact, take some time to become clear, as supply contracts are renewed and new market arrangements entered into.

…..but the longer-term could deliver a high price, low impact outcome.

3.12 In BusinessNZ's view, these factors do not invalidate the proposition that a trading scheme is, if well designed, the best policy response to the existence of a global problem to which New Zealand should contribute (in other words the NZETS is currently so ineffective that it should be scrapped). However, neither on the other hand, do they

[3] BusinessNZ acknowledges that Fonterra receives a small allocation of units for some of its lower value, energy intensive whey products which is expected to reduce its emissions trading scheme cost by between 3 to 4%. However, we understand that its non-energy emissions trading scheme costs (for example, packaging, cleaning chemicals etc will outweigh the value of the allocation.

[4] This is consistent with the business survey outlined in the Ministry of Economic Development's, Occasional Paper 11/04 entitled 'Business Responses to the Introduction of the New Zealand Emissions Trading Scheme, Part I: Baseline', dated March 2011, where 20% of respondents claimed that their response to the cost of carbon would be to absorb the cost, page 39.

validate the proposition that a low modelled long-run economic impact at prices higher than the current effective price of $12.50t/$CO_2$-e justifies removal of the moderating features.

3.13 There is simply insufficient information at this point to make either judgement. In this regard, the Panel's report is notable to the extent that it relies upon:

a) A Ministry of Economic Development paper published on Wednesday 30 March, 2012 which itself acknowledges "It is too soon to judge the effectiveness of the NZ ETS.";[5] and

b) four modelling sources *pre-dating* the entry of the sectors on 1 July 2010, these being:

i. a 2009 joint NZIER/Infometrics paper;

ii. a 2010 Ministry of Economic Development paper entitled 'Impact of Emissions Pricing on New Zealand Manufacturing: A Short-run Analysis' (based in turn on 2006 data); and

iii. a 2010 Ministry for the Environment brochure on the impact of the NZETS on farmers and landowners; and

iv. the Household Economic Survey for the year ended June 2010.

3.14 In the absence of new empirical studies, and at this early stage of the NZETS, the long-term impact of it is therefore hard to determine. While most modelling undertaken to date has been helpful in growing the general understanding of where the balance of key dependencies lie under a range of scenarios, they are unlikely to be useful for anything other than broad magnitudes.

The limitations of Computable General Equilibrium modelling

3.15 This concern is reinforced by the fact that the limitations of CGE modelling, both generic and specific to the modelling of climate change policy, are well known. Indeed, the joint NZIER/Infometrics report devotes two and a half pages to these limitations, and these were, in turn reinforced by a Castalia critique of the approach completed after the release of the joint report. In particular, this critique noted that:

"a) It is almost impossible to test them empirically. There is no way of knowing whether the previous studies have been correct, and hence, no way to assess whether the current study is likely to be empirically significant; and

[5] Ministry of Economic Development Occasional Paper 11/04, op cit, abstract.

b) They generally assume smooth adjustment to economic shocks. Hence, even if CGE model results provide a reasonable representation of where the economy would settle after it has gone through a full adjustment, they provide no useful information on how the transition would unfold." [6]

3.16 In addition, Castalia noted that modelled scenarios also do not reflect the real policy options among which the policymakers must choose. The issue for Castalia is not whether New Zealand should, once and for all, choose a carbon trading scheme or some other regime. Castalia noted that most economists agree that carbon trading is the best solution when all countries participate in it. The real issue, in its view, is how to manage the evolution of New Zealand's policy as the global policy evolves, without causing undue damage to the New Zealand economy during the transition phase. Castalia concluded that the NZIER/Infometrics report appears to provide little information for making such decisions.

3.17 The limitations of such reports are borne out by the fact that an earlier NZIER report in 2008, using different assumptions, substantially based on consideration of the same scheme design, produced very different results. The key long-term conclusions from this report were:

> "In 2025, the combined economic impact of an ETS and the cost of paying for an international emission reduction obligation (in today's prices), is a:
>
> - $5.9 billion reduction in GDP (-2.1%)
> - $3,000 reduction in an average household's spending (-3.0%)
> - reduction in hourly wages equivalent to $2.30 per hour (-6.7%), or $90 a week for someone working 40 hours a week
>
> Of that $5.9 billion reduction in GDP, $4.6 billion is directly attributable to the ETS.
>
> Of course, GDP per capita would still be 42% higher in 2025 than it was in 2007. But that is still less than Australia's GDP per capita today. That highlights that it is critical to seek least cost solutions before committing to any increase in cost on the economy."[7]

[6] Castalia report entitled 'Peer Review of Economic Analysis Prepared for the Regulatory Impact Statement on the Emissions Trading Scheme' dated 25 June, 2009, page 1.

[7] NZIER report entitled 'The Impacts of the Proposed Emissions Trading Scheme on New Zealand's Economy', NZIER working paper 2008/02, April 2008, pages ii - iii. BusinessNZ believes that the rider applied to the joint NZIER/Informetrics report in footnote 47 of the Panel's 'Issues Paper' that "...it is expected the modelling results would be similar if the modelling work was based on the assumption that the ETS is in its current form, as amended by the 2009 amendment Act." also applies to the 2008 NZIER work.

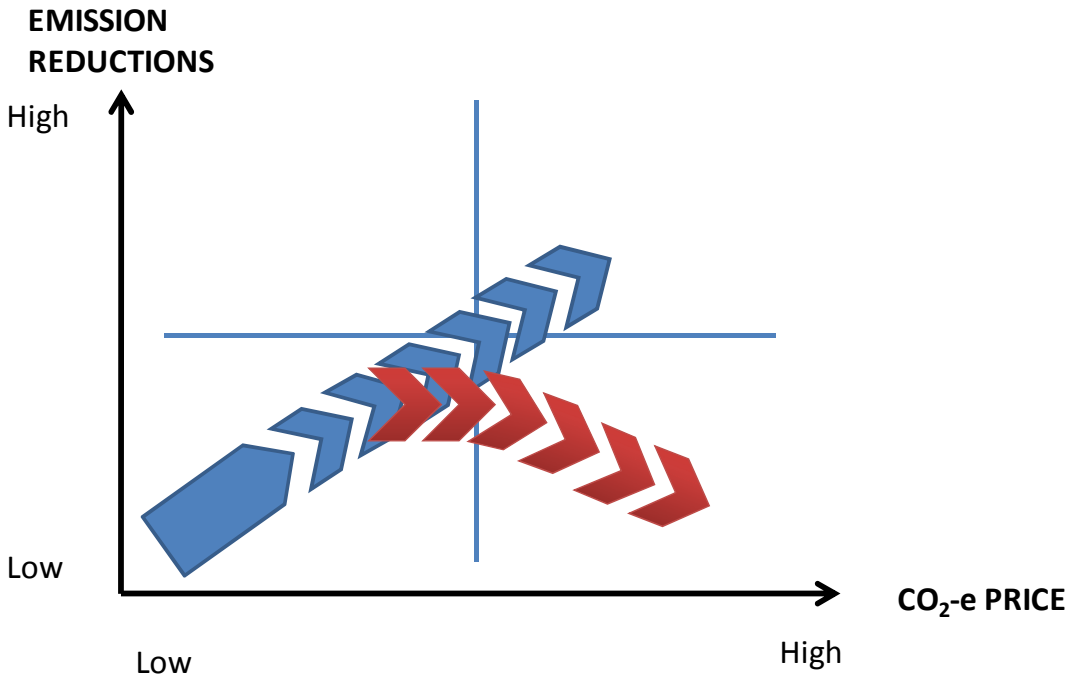
3.18 It is important that the Panel and officials do not simply rely on the most moderate results to continue to justify a policy position reached 18 months ago. Caution must be applied when considering the complex set of arrangements, judgements and incentives that have been set into play with the broadening of the NZETS.

3.19 These issues diminish the usefulness of the modelling in informing future (long-term) policy positions. But this is the very information on which officials and Government relied when establishing the current (then future) policy parameters, especially those concerning the moderating features and their scheduled removal. The key question is therefore:

> "Is there enough new, robust information from the *actual* operation of the NZETS that would verify the modelling, and therefore justify removing the moderating features as scheduled?"

3.20 BusinessNZ does not believe this to be the case, particularly when considered in an international context. Neither does BusinessNZ consider it simply a matter of removing the price restraints to deliver a high price, high emissions reduction scheme as could be inferred from some of the modelling. A new set of informed judgements now need to be made.

3.21 The effect of the NZETS, and two possible transition paths are shown diagrammatically as follows:



3.22 The expectation is for a smooth transition to a higher carbon price, higher emissions reduction scheme (as indicated by the blue arrows).

However, as we move from the short, into the medium and longer term, other factors come into play. BusinessNZ considers that New Zealand's relatively unique factors are as likely as not to transition the scheme into a high price, low emission reduction scheme (as indicated by the red arrows).

3.23 It is widely accepted that the impact of the NZETS in terms of costs and emissions is dependent on the following key factors:

a) the ease with which firms can substitute away from emission-intensive activities;

b) the availability and cost of abatement technology; and

c) action by the rest of the world to price carbon.

3.24 In Section 4 below, BusinessNZ outlines its view on action by the rest of the world (point (c) above). With respect to points (a) and (b):

a) it is clear that due to the make-up of New Zealand's emission profile (export-centric, ~70% from transport and agriculture, ~70% renewable electricity generation), that substitution away from emissions-intensive activities is extremely difficult at a moderate cost of carbon. Many emitters are already operating at or near their 1990 levels of emissions or world's best practice. Abatement opportunities in the agricultural sector are highly uncertain;

b) it is not always clear from the modelling that regardless of the price of carbon, a substantial reduction in emissions at a moderate cost follows. For example:

i. depending on the range and mix of assumptions used (for example, size of carbon price, action by the rest of the world, whether Government as opposed to businesses face the cost, free allocation, technology availability, etc), long-term expectations of emission reductions vary markedly from 0.0% (no reduction) through to minus 21.3%; and

ii. the 2008 NZIER report found that the reduction in emissions do not increase at the same rate as the reduction in GDP, indicating diminishing marginal returns to emission reductions. In other words, as the price for carbon and emissions reductions increases, the cost of further reductions also increases. This result is intuitive given New Zealand's emission profile;

c) as noted above, it is a reasonable working assumption to assume that most profitable energy and emissions reducing technology options have been adopted. It is therefore likely that trade-exposed businesses would be forced to address the long-term effects of the NZETS on their profitability by reducing

output and ultimately the number of people they employ. This is undesirable at a time when the New Zealand economy is at its most fragile; and

d) New Zealand is a technology taker. This gives rise to two observations:

   i. new abatement technologies are unlikely to have a significant impact in the short to medium-term (and even if assumed in the longer-term, the availability of such technologies is uncertain, particularly with respect to on-farm emissions); and

   ii. a high carbon price in New Zealand, in the absence of a carbon price in other large emitting countries, is unlikely to elicit a technological response from technology developers. For example, car manufacturers are unlikely to develop a low emissions car solely because New Zealand has a carbon price. While a carbon price in New Zealand would enable an opportunity to 'hot-house' new technology, technology developers are likely to need the new technology to be commercial in the larger emitting countries, for reasons of scope and scale. The domestic development of innovative emissions reducing technology is likely to be no different (for example, Lanzatech).

3.25 Another relevant factor is New Zealand's rate of population growth. New Zealand has had the second highest rate of population growth of all Annex 1 parties since 1990. While inwards migration trends have dipped from the highs of the early 2000's in light of the global financial crisis, the levels of inward migration are likely to return to the pre-global financial crisis trends as growth returns to the New Zealand economy. This makes reducing emissions more difficult.

3.26 Put plainly, not enough is known about the impact of the NZETS (either positive or negative), particularly on specific sectors, or regions of the country. The just released Ministry of Economic Development occasional paper is a start in this direction, but its analysis is too tentative to substantially inform the current review.[8]

3.27 BusinessNZ agrees that the NZETS should be relied upon to do a reasonable proportion of the climate-change policy 'heavy-lifting'. However, having a scheme which will have a limited long-term impact on gross emissions[9] with current technology except via the purchase of

[8] Ministry of Economic Development Occasional Paper 11/04, ibid.

[9] It is apparent from Figure 3.4 on page 23 of the Panel's 'Issues Paper' that New Zealand's emissions profile is dominated by forestry deforestration/afforestration assumptions. This is unsurprising given that forestry is likely to be a cheaper source of abatement than other sources. Figure 3.4 therefore reinforces BusinessNZ's expectation that non-forestry sources of emission reductions will only play a small role going forward (particularly in the absence of new technology). As an aside, BusinessNZ also notes the substantial gap (of ~ 30mt/CO_2-e) between the 'with ETS' and the recently proposed 2050 emissions reduction target of a 50% reduction by that date). This graph would have been informative (although not a surprise) had it been available for the recent 2050 target consultation process.

high-priced overseas emission reduction units or reduced production is unlikely to be in New Zealand's best long-term economic interests.

Administrative efficiency can always be improved…

3.28 Administration of the NZETS needs to reflect the importance of cost-effectiveness, seeking ways to achieve our climate change goals, without needlessly sacrificing economic or social welfare. This principle should be central to policymaking, because the more cost-effectively we administer the process associated with reducing emissions, the further and faster we are likely to proceed. In the very challenging economic circumstances we now face, delivering administrative efficiency has become even more important.

3.29 Experiences of the administration of the NZETS have been mixed – for both businesses and officials. This is largely a function of the introduction of what is a new and complex economic policy instrument that requires on-going monitoring and reporting, trading and surrendering of units.

3.30 Anecdotal advice suggests that not all business-official interactions went smoothly. Feedback is that in some instances, officials appeared over-zealous in their desire to ensure that every last tonne of carbon was captured in the reporting, eligibility and allocation processes. While laudable, it gave an outward appearance of trying to exclude, rather than include businesses. This was reflected in the processes associated with defining activities, defining eligibility (more specifically, in defining the allocation of costs and revenues), and the design of the monitoring and reporting processes. More flexibility is needed around the eligibility and allocation process (for example, more flexible provisions for the eligibility tests, such as the choice of base years for data assessment and the risks of missing data provision dates).

...and two suggestions for advancing administrative improvement are made.

3.31 The review provides an ideal opportunity to stand-back (at least momentarily) from the detail of the scheme's operation and to ensure that both the administrative detail, and how it is implemented is appropriate in light of the experiences of both business and officials over the previous year.

3.32 Two suggestions can be made in this regard, these being:

a) an independent review of the efficacy of the monitoring and reporting regime, as well as the regulations associated with the establishment and implementation of the allocative baselines. The focus of this review would be to determine the extent to which these regulations can be simplified and stream-lined without materially adversely affecting the overall integrity of the

NZETS. In BusinessNZ's view, this is substantially more than simply asking NZETS participants whether they are satisfied or not with the current regulations. This review could be recommended by the Panel, and could be completed in the period between the delivery of its final report and the Parliamentary process associated with implementing the changes proposed by the Panel. The outcome of this review could be expected to re-balance the costs and benefit of participation in the NZETS for small-to-medium enterprises ('SMEs'); and

b) further consideration of the establishment of an independent Crown-entity responsible for all functions under the Act, including administration of the NZETS and the United Nations Framework Convention on Climate Change (the 'UNFCCC') reporting (including forecasting future emissions trends). We note the current proposal for the New Zealand Environmental Protection Agency to take on a number of administrative functions related to the NZETS, but do not think that this goes far enough. BusinessNZ recognises the critical importance of the economic transition the NZETS is trying to spur, and considers a single *independent* administrator desirable. The NZETS has a complex administrative structure, with multiple Ministerial responsibilities and agencies involved. We suggest that a single, focused agency at arms-length from Ministers would increase confidence of the business sector that functions are being undertaken objectively and aid with the objective of greater scheme predictability (for more on this point see Section 5 below). A single administrator will, in BusinessNZ's view, aid accountability and consistency. The administrator should be well-resourced, especially now, in the early years of the scheme's operation, with a focus being on assisting firms to comply with what is a new and complex piece of legislation.

   However, having said that, BusinessNZ also recognises that the establishment of such an entity now cannot over-ride the desire of future Parliaments to limit such independence. This suggests a relatively high threshold to moving from the current proposal of the New Zealand Environmental Protection Agency (an already established entity) simply taking on more functions. Should the desire for greater independence not be sufficient to breach this threshold, BusinessNZ suggests that at a minimum, the EPA take on *all* NZETS-related administrative functions including those from the Ministry of Agriculture and Forestry (there is, for example, only one agency responsible for the administration of GST).

Re-orientating the compliance regime

3.33 BusinessNZ continues to believe that the compliance regime is heavy-handed for this stage of the scheme's introduction with businesses facing the double jeopardy of having to purchase the missing units on the open market as well as pay a penalty, and potentially criminal convictions.

3.34 But the key issue with compliance regime is not so much its stringency *per se* but the combination of the complexity of the monitoring and reporting regime with the newness, or novelty of the arrangement. BusinessNZ believes that we are likely to see this played out around the first surrender period in May this year, with the expectation being that the majority of breaches will be caused by mistakes, rather than deliberate attempts to defraud the Crown.

3.35 Viewed in this context, the New Zealand penalty regime is extremely tough from its outset, effectively loading all measurement risk on to businesses. By contrast, at the outset of the EUETS, businesses which did not have sufficient units on settlement date paid a high default price per tonne of CO_2, but did not face the double jeopardy of having to 'make-good' the missing units on the open market.

3.36 As noted above, the establishment of an independent entity, with a focus on assisting businesses to comply, would go some way towards ameliorating the issues associated with the stringent compliance regime, as would a review of the monitoring and reporting regulations that is focused on simplification.

3.37 Despite this, the NZETS, while well-integrated and comprehensive, remains a new, largely untested and complex scheme whose actual effect cannot possibly have been fully accommodated in its provisions. Other means are therefore needed to dampen, at least initially, the effect of the compliance regime.

3.38 In order to manage the risks of unintended outcomes, BusinessNZ's preference is that, with respect to the implementation of the compliance regime, that it will be better if businesses have a period of grace within which they have a greater ability to 'learn-by-doing' and transition to the full compliance regime for the 2013 compliance year and beyond. The intention of such a period would be to emulate the effect of Phase I of the EUETS, where participants were able to get to grips with the new trading scheme and its monitoring, reporting and surrender requirements in a relatively low risk way.

3.39 The key objection to such an approach has been removed with the implementation of the $25.00 price cap (at least through to the end of 2012 at this point). In the absence of a price cap, the risk is that simply making good a short-fall at a high default price without a 'make-good' provision means that the default price becomes a price cap, with the

potential for inappropriate incentives to arise. With a price cap, this risk is eliminated so long as the default price is higher than the price cap.

3.40 A delay in the application of the full stringency of the compliance regime (the 'make-good' provision and a penalty) under the Act could potentially reduce reductions in emissions and commensurately increase the burden to be met by taxpayers at the end of the compliance period. However, BusinessNZ considers that the retention of the basic incentives embodied in the Act as currently outlined, including the price cap, will ensure that the cost of any lost emissions reduction opportunities should be extremely small.

3.41 BusinessNZ also considers it highly unlikely that firms, if given the opportunity, would simply decide to eschew their surrender responsibilities. Therefore, the fiscal exposure is likely to be relatively limited, and represents a sensible sharing of economic risks between the Crown and the business sector. It is also BusinessNZ's expectation that a more staggered introduction of the compliance regime will provide participants with a degree of comfort that they will be able to participate in the NZETS in a measured way.

3.42 It is important to point out, however, that it would not be the intention of such a regime to exempt any participant that knowingly fails to report their activities and emissions, or surrender the required number of units. Should this occur, a participant should face full penalties.

4. KEY ISSUES FOR THE NZETS AFTER 2012

4.1 New Zealand's climate change policy settings are inextricably entwined with what is happening internationally. The international environment – both the state of international climate change negotiations and the extent to which New Zealand's trade competitors are taking action – are key strategic factors in determining the future shape of the NZETS.

4.2 Fundamentally, therefore, the review of the NZETS boils down to an assessment of how it can contribute to an international objective of reducing global emissions in a way that maximises New Zealand's opportunities and minimises its costs.

The international context is beset with uncertainties…

4.3 But the international environment is highly uncertain. A long-term trend may be discernable but experience shows that transition paths matter in the size, distribution and duration of costs. The magnitude of the costs and benefits will depend on how the international environment evolves.

4.4 Critically, BusinessNZ considers that this uncertainty is unlikely to dissipate anytime in the near future. Use of the term 'gap' implies that at some point a successor arrangement to the Kyoto Protocol will

emerge that provides greater certainty. BusinessNZ considers that this is unlikely to be the case. There is unlikely to be a break-through moment or event which causes the policy uncertainty to seriously abate. In other words, the expectation was that we would move through a period of uncertainty and get to a more settled situation that would enable the moderating features to be removed. But instead, the on-going uncertainty which gave rise to the need for the moderating features is likely to be a permanent feature.

4.5 Central to this on-going uncertainty, and most relevant for New Zealand future domestic policy settings, are whether our trade competitors have:

a) agreed to take on an emissions reduction target; and

b) priced carbon into their economy in a transparent way.

…but even international progress is unlikely to alleviate it.

4.6 Even the most optimistic of the Panel's 2012 – 2020 scenarios (Scenario 1) does not envisage this outcome by 2013. In BusinessNZ's view, the future international framework will have the following characteristics:

a) there will not be a second Kyoto Protocol commitment period. This is likely for two reasons:

i. its coverage of global emissions is incomplete. Its binding emission reduction obligation only covers a subset of developed countries (the US is not currently a signatory and will not be a signatory to a second commitment period); and

ii. the compliance regime, including the use of financial penalties is widely acknowledged as a high-water mark of centralised emission reduction accountability.

Japan, Russia and Canada have also said that they will not agree to a second commitment period. This leaves the Protocol covering only around 16% of global emissions;

b) the demise of the Kyoto Protocol does not necessarily imply the demise of the Clean Development Mechanism (the 'CDM'). The CDM is likely to continue approving projects that will create new tradable units. A range of new market mechanisms will emerge, based on sectoral crediting schemes, carbon farming, REDD+ etc);

c) AAUs as the core Kyoto currency are no longer likely to be available. Those countries that have, or may develop, trading schemes will issue and trade in their own domestic emission unit currency (New Zealand Units [NZUs] in the case of the NZETS).

These currencies will not be backed by AAUs but rather will be tradable based on the merit of their underlying fundamentals (in this case, verifiability or integrity and 'fair value' [in terms of price and delivery of emission reductions]);

d) countries will take on domestically binding (that is, legislative) emission reduction targets. Targets inscribed in any international arrangement will not be legally binding at an international level.[10] Countries will be free to decide how they meet their targets. Countries will submit their actions towards the targets for international scrutiny but there will not be any legally enforceable penalties;

e) the role for the United Nations (the 'UN') is reducing back from the high-tide watermark that is the Kyoto Protocol, but it is unlikely to retreat back to the general obligations set out in the UNFCCC. This can be seen from the progress that was made in the set of decisions from the long-term co-operative action ad hoc working group ('LCA-AWG') at Cancun. This outlines the beginnings of a common set of monitoring, reporting and verification ('MRV') rules and, when combined with some elements of the Kyoto Protocol (for example the land-use, land-use change and forestry ('LULUCF') rules, have the makings of a new multilateral framework. Common verification rules will be critical to the development of new market mechanisms. In addition, it is likely that the UN will continue to be a central point for the communication of domestic action, the collation of views on the effectiveness of that action, and a focal point for on-going discussion about the required level of international ambition.

4.7 While this can be construed as positive progress, significant uncertainty around the finalisation of a new arrangement, the timeframe, and the extent of the adoption of domestic targets and actual action taken, will continue to exist for some time. Rather than eliminate competitive disadvantage, an outcome based on a domestic willingness to take action could, of course, simply entrench it.

4.8 A hard look at the geo-political calendar suggests a comprehensive climate treaty before 2014 or 2015 is unlikely. It is unlikely, for example, that the US will be able to pass domestic legislation entrenching its non-binding international target into domestic law anytime soon.

4.9 Increasingly, while the UN will continue to have some important roles (particularly around MRV), these begin to take the form more akin to the role of a cheer-leader, than a play-maker. Rather than leading efforts to reduce emissions, in BusinessNZ's view, international negotiations are more likely to follow behind and essentially

[10] In this regard, the key question is not whether there will be a legally binding arrangement, but what the nature of the legally binding arrangement will be (or put another way, what it will or will not cover).

'collectivise' domestic actions. This is, in large part, recognition of the difficulty of concluding a new comprehensive arrangement and the recognition that it is important not to let the slow pace of the international negotiations interfere with the need to take action now.

4.10 As noted above, it is increasingly apparent that the emphasis of the international negotiations has shifted towards the attainment of domestically inscribed emission reduction targets. In the aftermath of the Copenhagen and Cancun conferences, it is clearer than ever that forging ahead with climate change policy will be a complex process in which different parts of the world move at different speeds, in an evolving web of domestic actions.

4.11 Actions to reduce global emissions will, therefore, continue in a piecemeal fashion but in a different manner as the world now enters a new form of transition to a new form of global arrangement. This new transition raises some real issues that the Panel needs to consider. These relate to the need to address:

a) the appropriate level of economic burden that New Zealand is willing to accept through the NZETS, including the:

i. lack of comparable action by others; and
ii. on-going absence of a deep and liquid carbon market

b) how to de-couple the current design of the NZETS from its links to the Kyoto Protocol.

4.12 These points are addressed in the following sections.

On-going uncertainty reinforces the need for clarity about the appropriate level of economic burden

4.13 The Issues Paper states, in the context of New Zealand facing a period of uncertainty or 'gap' following the end of the Kyoto Protocol commitments in 2012 that:

> "*In that situation*, the Government would need to consider how much cost it is prepared for the New Zealand economy to bear until the uncertainty abates."[11] (emphasis added)

4.14 The points made above are intended to reinforce the view that the period of uncertainty is unlikely to be time-bound. A transition from internationally binding targets to domestic targets is unlikely to materially reduce the level of uncertainty faced by New Zealand businesses on the passage of the Act into law, for both those who wish to pursue new opportunities that may arise from a price of carbon, as well as emitters who face a new cost. In this case it is imperative that,

[11] Paper by the Ministry for the Environment entitled 'Issues Statement and Call for Written Submissions' dated 11 March 2011, page 29, paragraph 86.

as a matter of course, the Panel explicitly considers what the appropriate level of long-term economic burden is appropriate for New Zealand. This is critical because it:

a) enables the Panel to carefully consider the economic context in which the Review is taking place. New information has come to hand. The New Zealand economy is, relative to 2008, facing some serious challenges. Not only is productivity growth weak and unemployment high as a result of the global financial crisis, but this will be exacerbated by the Christchurch earthquakes. Consideration must also be given to how the NZETS contributes towards the Government's aspiration to catch up with Australia; and

b) should inform any emission reduction target eventually settled on in the context of the on-going international negotiations. The NZETS, as designed, is capable of delivering any target by manipulating its settings. But BusinessNZ considers this to be a wrong-footed way of looking at the relationship between the NZETS and emission reduction targets. To drive the NZETS to deliver a target, without an assessment of economic burden, would likely be extremely damaging to the New Zealand economy. Instead, the level of economic burden should inform the targets with the NZETS being calibrated accordingly. Figure 3.4 of the Issues Paper should provide New Zealand's negotiators with a sobering picture of the deliverability of substantial emission reductions from the NZETS, especially in the medium-term. This suggests that the New Zealand's negotiators need to be actively managing international expectations downwards with respect to New Zealand's ability to seriously reduce emissions, either by domestic action or the purchase of international units.[12]

4.15 Fundamentally, this assessment of economic burden could be expected to set the strategic economic framework within which changes to the design of the NZETS can be considered.

The extent of economic burden is inextricably linked to actions by others...

4.16 All of the modelling undertaken regarding the NZETS shows a strong dependency upon action taken by the rest of the world. It is, therefore, appropriate to try to understand how comparable the efforts of other jurisdictions are.

4.17 However, the upsurge in action by our trade competitors anticipated at the time of the passage of the moderated Act in 2009 has failed to

[12] In the context of targets, BusinessNZ considers that for New Zealand, reliance on domestic targets and a peer review system of 'international consultation and analysis' provides it with a greater degree of flexibility to demonstrate the extent of effort to which it has gone in trying to achieve its target.

eventuate despite the lengthy list set out in Table 4.2 on pages 32-33 of the Issues Paper. BusinessNZ suggests that had such a table been prepared at the time of the passage of the Act in 2009, it would have been even more fulsome (for example, at that time Australia was on the verge of passing the Carbon Pollution Reduction Scheme [the 'CPRS'] into law and the US had the Waxman Markey Bill with promise of its passage into law).

4.18 At face value, the actions appear substantive but in the absence of any supporting analysis, it is simply too difficult to determine what Table 4.2 means for the future design of the NZETS. Indeed, the Panel seems to agree, with the Issues Paper stating:

> " ..... the relative ambition and cost impact of these measures is unclear to the Panel."[13]

4.19 Rather than a siren song of international action, Table 4.2 simply appears to reflect the most recent gyrations in international climate change policy setting. The fact that other countries are taking some action, irrespective of its nature, is positive for New Zealand businesses who if given sufficient domestic support, could participate more actively in those markets as the originators of new low carbon technologies. However, it does not appear to be a solid basis on which to proceed with the removal of the moderating features.

4.20 There are a number of factors that are relevant in this regard, these being:

a) it is difficult to determine the usefulness of the examples provided. For example, it is difficult to:

   i. establish the extent to which *actual* action is being taken, or if it is future expected action. If the latter, then this in turn raises the questions of how credible its is (for example, BusinessNZ notes that Singapore has merely signalled support for carbon pricing conditional on an international climate agreement); and

   ii. determine whether the cost of the policy is being internalised by businesses or being smeared as a shadow price across taxpayers;

b) there is no common metric applied across all of the policies in order to determine whether it is comparable in terms of effort (as, for example, an equalised cost of abatement as a percentage of GDP.). A shadow carbon price is not necessarily a good proxy. As Warwick McKibbin recently showed, a carbon price of around $USD17/tCO$_2$-e in Australia has at least as big an impact on

[13] Issues Paper, ibid, page 31, paragraph 95.

Australian GDP and GNI as a $USD50 price in the European Union.[14] This type of analysis would have been helpful and would have informed a better understanding of the nature and magnitude of the action by others;

c) it is hard to even determine whether the items listed are primarily climate change measures, or motivated by some other primary policy concern such as energy security (with a climate change co-benefit). For example, in China's case it is arguable that the 'Large Substitute for Small' program is a climate change policy since it was introduced both as a means of reducing local pollution and to make the electricity system work more efficiently (under old system rules, small generators were dispatched first);

d) as outlined in recently released BusinessNZ booklet entitled '*Raising the Profile: Comparing New Zealand's Emission Trends Against Other Countries*'), it is clear that each country's action is shaped by its particular emissions profile. The relative ease with which it can reduce emissions without reducing growth generally determines its willingness to agree to ambitious targets for emissions reductions. Therefore, the ability to abate is not uniform across jurisdictions and tends to reflect the strong link between economic fundamentals and climate change policy. As can be seen from Table 4.2, actions tend to focus on electricity and industrial process emissions where reductions have been possible by switching from coal to gas, as opposed to agriculture and transport, where emission reductions are more costly;

e) the economic sacrifice implied by the listed policy measures needs to be considered in light of other policies designed to protect local industries. In many countries, fundamental policy inconsistencies exist between climate change policies and other sector policies, which need to be taken into account when considering the actual economic impact of climate change policy overseas. Policies throughout Europe that provide direct subsidies for coal production are likely to be extended until 2023 "to allow for the continued restructuring of the coal industry", according to recent press announcements.[15] These policies include annual support of more than €2 billion ($USD2.6 billion) in Germany, and €1 million ($USD1.3 billion) in Spain—two of the largest proponents of renewable energy. A 2001 paper that reviewed the research on the magnitude of fossil fuel subsidies in the US found that somewhere between $USD2-10 billion (in 1999 dollars) was spent, depending on how subsides are

[14] Warwick J McKibbin paper entitled 'Comparing Climate Commitments: A Model-Based Analysis of the Copenhagen Accord', Brookings Institute, May 27, 2010.

[15] See Financial Times "Aid to European Coal Industry Held Up" 5 July 2010. Available online at http://www.ft.com/cms/s/0/23c52a7c-884d-11df-aade-00144feabdc0.html?ftcamp=rss.

defined.[16] Research into transport and energy subsidies in Australia found that subsidies for oil, coal, and gas in 2005-2006 totalled approximately $AUD9.5 billion ($USD8.3 billion).[17] These examples highlight the complicated policy environment in which climate change measures are determined in order to strike a balance between economic and environmental objectives. The subsidies that are maintained overseas clearly need to be taken into account in developing a proportionate response in New Zealand; and

f) finally, there is a need to keep some of these 'actions' in context. For example, China has been increasing its carbon dioxide emissions by an average of 12 per cent every year this century. By 2020, China will be emitting nearly 500 per cent above its 1990 levels, even after their highly publicised emissions reduction efforts.

4.21 The Australian Government has asked the Australian Productivity Commission (the 'Commission') to undertake a study on the effective carbon prices that result from emissions and energy reduction policies in Australia and other key economies. The report is expected by the end of May. Effective carbon prices include both explicit carbon prices from emission taxes and tradable permits, and the implicit prices of other measures, such as direct regulation of technologies, renewable energy targets, or subsidies for low emissions technology. The Commission is to:

a) examine and detail key emissions reduction policies either in place or committed to in Australia and other key economies, such as the UK, US, Germany, New Zealand, China, India, Japan and South Korea;

b) estimate the effective carbon price per tonne of carbon dioxide equivalent (CO2-e) faced by the electricity generation sectors in these economies, and selected industries drawn from manufacturing and transport sectors in these and other countries where relevant and data permitting; and

c) report on the methodology, assumptions and data sources used, so as to inform further analysis in this area.

4.22 This will be an important piece of work, and BusinessNZ hopes that the Panel will look to the work of the Commission to inform its assessment of whether action in other countries is comparable in effort with that being taken in New Zealand. Of particular interest to BusinessNZ will

[16] Koplow and Dernbech paper entitled 'Federal Fossil Fuel Subsidies and Greenhouse Gas Emissions: A Case Study of Increasing Transparency for Fiscal Policy', Annual Review of Energy and the Environment, 2001 26:361-389. Available online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1090718.

[17] University of Technology Sydney "Energy and Transport Subsidies in Australia: 2007 Update". Available online at http://www.isf.uts.edu.au/publications/riedy2007subsidies.pdf.

be the extent to which the Commission's report not only assists in the conversation about comparable effort, but also other conversations about the relative efficiency of policies in other countries as well as an understanding of the differential effects of different carbon policies between countries on competing traded industries within those countries.

...whose inaction gives rise to the on-going high risk of carbon leakage...

4.23 By making an early start compared to other countries on emissions trading, we have put New Zealand export businesses in a vulnerable position – they now have to compete against companies overseas that in the most part, do not pay any carbon charges. Allocating carbon credits is simply a way of reducing that vulnerability, and is in the interests of all New Zealanders. Once other countries – specifically our trade-competitors – adopt emissions trading that vulnerability will cease.

4.24 But the risk of carbon leakage, and therefore the need to protect vulnerable businesses, is often down-played with many instead preferring to focus on the opportunities that might arise from a more stringent carbon price.

4.25 While a balance between the costs and benefits of the NZETS need to be carefully considered, BusinessNZ believes that the on-going risk of carbon leakage is real and will be heightened with the removal of the moderating features. The concern is that entrenched asymmetric environmental policies will reshape the pattern of international comparative advantages, incentivising New Zealand businesses to move from countries where environmental measures are stricter, to countries that are not subject to the same requirements.

4.26 Importantly, leakage occurs not only when businesses physically relocate, but also if consumption and investment trends shift toward markets without carbon prices. Some businesses may relocate production, but it is more likely that leakage will occur by new entrants or the expansion of existing foreign competitors as they satisfy the demand that is currently met domestically.

4.27 In response to the recent Ministry of Economic Development business survey, just over 5% of respondents claimed that they would exit, or scale down their business.[18]

4.28 Recent research from the UK suggests that contrary to claims that the EU is decarbonising its economies, there is increasing evidence that the EU is simply off-shoring its emissions. The growth of off-shored emissions appears to highlight that in the absence of a strong global deal on carbon reduction, there is in fact a significant risk of carbon

[18] Ministry of Economic Development Occasional Paper 11/04, ibid, page 39.

leakage, as more carbon intensive industries relocate from carbon-restricted economies to less restricted ones.[19]

4.29 The Business Industry Advisory Council ('BIAC', the business organisation affiliated to the OECD) has consistently raised concerns about carbon leakage, for example:

> "BIAC has on many occasions expressed strong concerns about general statements downplaying impacts on competitiveness of certain sectors, which play and must continue to play an important role in both developed and developing countries' economies. In increasingly globalised markets, the competitiveness of heavily internationally exposed industries would be challenged by their inability to pass through the higher production costs into their final prices, which would have serious implications for countries, regions and jobs. These industries are, in most cases, internationally competitive, but for the carbon price."[20]

4.30 Given New Zealand's relatively unique factors (as outlined in paragraphs 3.24 – 3.25, in Section 3 above), New Zealand is particularly susceptible to high levels of carbon leakage. For example, NZIER states that:

> " ... if an ETS causes the cost of dairy production in New Zealand to rise, and therefore reduces the amount of dairy exports, there will be a reduction in New Zealand's emissions. However, another country will increase their production of dairy to compensate. Because New Zealand production is efficient, global levels of emissions will not fall. This is a particularly poor result, because New Zealand suffers from reduced economic activity, but global emissions are not reduced" [21]

4.31 While the NZIER 2008 does suffer from the same pitfalls as outlined above, BusinessNZ considers this insight regarding dairy processing is particularly relevant as it was based on the then NZETS design of no price protection and an allocation of units to dairy processing (essentially a better situation for dairy processors than is currently legislated for after 2012). However, NZIERs insight is not novel, being broadly consistent with the conclusions reached by others:

> "It can be concluded that the mega and large emitters from the food, beverage and tobacco sector, the petroleum, coal and chemicals sector and machinery and equipment sectors, where they are involved in export activities, are at the most risk of losing

[19] Policy Exchange research note entitled 'Carbon Omissions: Consumption-based Accounting for International Carbon Emissions', dated October 2010.

[20] BIAC Paper entitled 'Carbon Leakage and Competitiveness Impacts' dated October 2010, page 2.

[21] NZIER report entitled "The Impacts of the Proposed Emissions Trading Scheme: Summary Report' dated April 2008, page 2

competitiveness if emissions prices are imposed in New Zealand ahead of other countries."[22]

4.32 While an early, tentative result, these conclusions are supported by the results of the Ministry of Economic Development's recent business survey which found that a business that is in the Food & Beverage industry is relatively unlikely to raise prices and especially likely to absorb the ETS costs.[23]

4.33 Yet despite this, the food processing sector has been deemed to be insufficiently carbon-intensive to warrant protections against the risk of carbon leakage.

4.34 However, it is also important to place food processing, along with other major New Zealand businesses, into a broader economic context. The point of the following graphic should be immediately clear – the top 667 New Zealand businesses earn 92.62% of total export earnings. This highlights:

a) the high dependence on exports (based on New Zealand's unique geography and domestic market size), produced by a small number of businesses; and

b) the potential vulnerability of the prosperity of the New Zealand economy should only a small number of businesses be adversely affected by the extension of the NZETS.

Source: David McLeish, Operations Manager - Regions & Business Intelligence, New Zealand Trade and Enterprise presentation to Export New Zealand

[22] Ministry of Economic Development Occasional Paper 10/2, entitled 'Impact of Emissions Pricing on New Zealand Manufacturing: a Short-Run Analysis', dated March 2010, page 44.

[23] Ministry of Economic Development Occasional Paper 11/04, ibid, page 50.

4.35 New Zealand is significantly more dependent on international trade compared to other countries experimenting with emissions trading schemes. Accordingly, it can be expected that the economic cost will be higher still if the moderating features are removed without more careful consideration of the need to protect all vulnerable sectors of the economy from competitiveness risk, including SMEs (for more on this see paragraphs 4.46 – 4.52 below).

4.36 A trade to GDP ratio measures the volume of international trade as a percentage of a country's total domestic production. New Zealand's trade to GDP ratio is just under 60 percent. By contrast, the trade to GDP ratio for the EU (as a whole) and the US is just over 25 percent.[24]

4.37 The following figure, prepared by Castalia Strategic Advisors for the Australian Chamber of Commerce in June 2009 shows a comparison of the trade to GDP ratios for the EU, the US, New Zealand and Australia.

Figure 0.1: Trade to GDP Ratios for European Union, United States, New Zealand and Australia

Source: World Trade Organization "2007 Country Trade Profiles" and Castalia.

4.38 The greater reliance on internal trade among EU member states and within the US borders dramatically reduces the economic vulnerability of those countries to the cost disadvantages and uncertainty that carbon prices impose. Essentially, the EU and the US are like large free-trade zones. When they implement carbon pricing policies, it applies uniformly to all of their member countries and states. Because New Zealand's trade necessarily occurs beyond its borders, to be equally as effective without the risk of substantial carbon leakage, protection by way of allocation is imperative.

[24] World Trade Organisation. 2007 Country Trade Profiles.: http://www.wto.org/english/res_e/statis_e/statis_e.htm.

4.39 The economic incentives that drive carbon leakage are strong and many arguments that suggest carbon costs will create minimal leakage - like the comparison to exchange rate fluctuations - are not economically sound.[25] The four primary consequences if the NZETS does not avoid carbon leakage are:

a) adding carbon costs will reduce New Zealand's comparative advantage and reduce economic production as activity moves offshore;

b) the movement of activity offshore will displace workers and create high transitional costs;

c) the NZETS will generate limited environmental benefits; and

d) no momentum will be gained toward encouraging emissions abatement internationally.

4.40 Adding even small carbon costs to the production process can have the effect of seriously disadvantaging domestic producers and driving economic activity offshore. Some strong advocates for emissions trading have argued that the cost of carbon is too small to shift trading patterns. Such an expectation does not acknowledge the dynamism of the global economy. In reality, there is a high probability that leakage will occur either in the short-run through price competition or in the longer run through a change in the flow of investment.

4.41 In today's highly integrated global economy, the price elasticity of demand for merchandise is relatively high, on average, and particularly high for some very competitive goods. Moreover, in trade-exposed markets that are characterised by global price-taking, profit margins are often thin and even small reductions in profitability can force businesses to shut down. Even if the additional carbon costs do not push operators to shut their doors in the short-term, the reduction in profitability will reduce the return on domestic investment. Less incentive to invest translates into lower levels of economic growth, employment, and innovation. Dynamic manufacturing industries require continued re-investment, and it is likely that such re-investment would occur outside New Zealand.

4.42 BusinessNZ is not seeking permanent protection – BusinessNZ understands that competition will be distorted and, even if in the short run some domestic companies might benefit from the extra protection provided by trade measures, this initial advantage will over time turn into a competitive disadvantage, due to the disincentive for companies that are temporarily protected to invest in innovation, seek new business opportunities and be more efficient.

[25] In a nutshell, exchange rate uncertainty is already built into prices but the expected value of carbon costs is a new cost, which will not be faced by international competitors unless other countries adopt similar policies.

4.43 Rather, BusinessNZ is mindful of the asymmetrical nature of the risks associated with under, or over allocation. While over-allocation risks a wealth transfer there is no adverse impact on economic efficiency. However, under allocation risks reduced investment and loss of production overseas. This suggests that the allocation methodology should err on the point of being too generous rather than less generous.

4.44 As such, BusinessNZ is concerned that the NZETS is designed to create incentives appropriate to New Zealand's best economic interest. This is, in BusinessNZ's view, unlikely to involve increasing the risk of carbon leakage in the face of on-going inaction by our trade-competitors.

4.45 The retention of a policy which heightens the risks of damaging the viability of New Zealand businesses, increasingly unemployment and reducing wages is clearly contrary to the Government's strategy for securing New Zealand's economy recovery, and other goals, such as catching Australia.

...with a yet-to-be-determined impact on SME manufacturing exporters

4.46 Smaller businesses are particularly vulnerable to the ramping up of the NZETS, as they are more likely to be price-takers.

4.47 While the majority of export receipts are earned by larger businesses, New Zealand is predominantly a nation of small businesses. As at February 2009, New Zealand had 476,558 enterprises, 97.2% of which employed 19 staff or less. In contrast, 339 or 0.1% of New Zealand enterprises employed more than 500 staff.

4.48 In terms of contribution to the economy, while firms with 100-499 employees recorded the highest average value-added output per rolling mean employment of $60,233 in 2008, they were followed by firms with 1-5 employees ($57,599) and 6-9 employees ($45,601).[26]

4.49 However, limited attention has been given to how the NZETS will affect SME manufacturing exporters or what specific measures need to be taken to deal with the loss of competitiveness in that sector.

4.50 Interestingly, the Ministry of Economic Development's recent business survey identified that small businesses (0-5 FTE's) are just as likely to be energy intensive as larger businesses. However, the survey did not reveal how many of those would receive allocations.[27] BusinessNZ understands that the total approximate number of all New Zealand

[26] Value-added is a measure of the contribution to total output by businesses in the economy. It is calculated as gross output minus intermediate consumption. Ministry of Economic Development publication entitled 'SMEs in New Zealand: Structure and Dynamics 2010', dated July 2010, page 19.

[27] Ministry of Economic Development Occasional Paper 11/04, page 70.

businesses to receive an allocation is likely to be as low as 300 businesses.

4.51 While Australian-based research, Castalia found that:

> "Our findings show that the CPRS will generate additional costs that would erode [SME] profitability at marked levels of between 4 to 7 percent on average. In some cases, we found that the impact of additional carbon costs could erode firm profitability entirely. Erosion of firm profitability at these average levels could be significant enough to change investment incentives."[28]

4.52 While there are differences between the pre-2012 design settings and the CPRS, the schemes were more similar with regard to the post-2012 settings and on that basis there is no reason to think that this conclusion would not be broadly applicable to New Zealand.

...and the absence of a deep and liquid carbon market.

4.53 The key uncertainty facing business arising from a lack of international action is the future price of carbon. The Act has the moderating features scheduled to be removed on 1 January, 2013 and businesses to face the full international price of carbon. The expectation, at the time of the passage of the Act, was that international action would be forthcoming and that this would be accompanied by the development of a deep and liquid carbon market that would allow businesses to manage their remaining risks (as in this scenario carbon leakage would be greatly diminished).

4.54 The reality is somewhat different. Even a staunch supporter of carbon trading notes that:

> "Global adoption of carbon pricing is unlikely to be politically or even administratively feasible during the next decade....."[29]

4.55 The slow speed of the international climate change negotiations has been matched by the slow pace of carbon market developments. This means that the only international reference price available to New Zealand businesses is the Certified Emission Reduction Unit, or CER. Secondary CERs for December 2011 delivery closed at €13.00 ($NZD24.55) in Europe on Wednesday 23 March – almost level with the price cap of $NZD25.00. As a result of design dynamics, NZUs will trade at a slight discount to the price cap. With the 1:2 progressive obligation, the effective price of carbon can be no higher than $NZD12.50.

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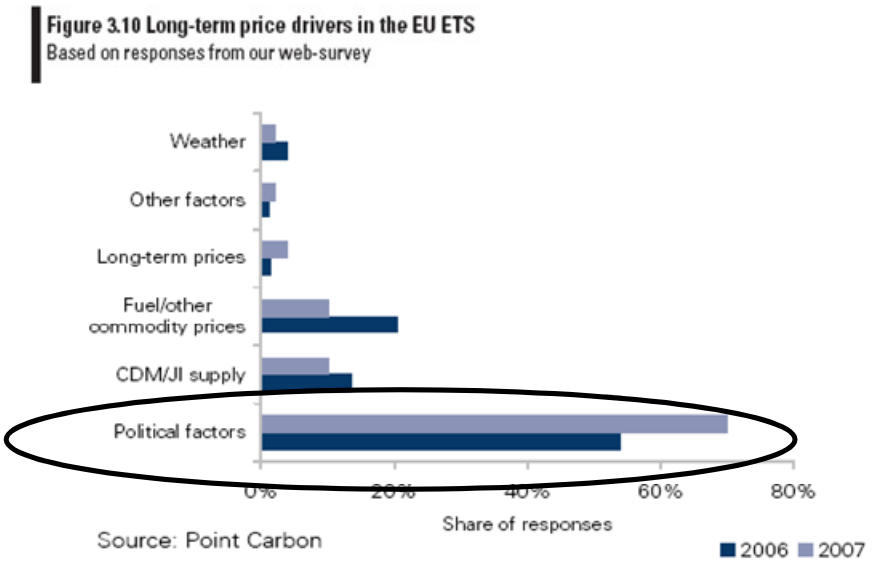
[28] Report by Castalia Strategic Advisors to the Australian Chamber of Commerce and Industry entitled "Securing SMEs in Australia's Low Carbon Future: The Cost of the Carbon Pollution Reduction Scheme for Australia's Small and Medium Sized Businesses" dated June 2009, page i.

[29] Carbon Trust report entitled 'Tackling Carbon Leakage: Sector –specific Solutions for a World of Unequal Carbon Prices' dated March 2010, page 5.

4.56 The international carbon market is unlike most other markets. It is dominated by EU factors – for example, weather patterns and energy markets have a significant role to play (for example, the recent closure of the German nuclear power plants caused the price of carbon to spike). In many ways this is an unremarkable market feature. For example, New Zealand will always be subject to the whims of the global oil market, over whose fundamentals it has no control. However, the key point here is that this is acceptable so long as the market is stable and well-functioning and delivering an efficient price.

4.57 However, importantly, the international carbon market is also driven by EU climate change politics. The relative dominance of these factors is reflected in the following Point Carbon graph from its 2007 survey.



4.58 While all markets are influenced to some extent by politics, this survey showed that respondents expected EU politics to be *the* determinative (and growing) factor by some considerable distance. BusinessNZ does not see any reason why this would have changed in the intervening period, with on-going moves by the European Commission to manipulate the price of CERs by deciding to limit the acceptability of some unit types (for reasons of overall emissions stability and source country), and looking to hold back the level of units to be auctioned to effectively withdraw the level of banked units created by lower than anticipated production levels.[30]

4.59 This makes the carbon market not just volatile (which can be managed) but unpredictable. This is a serious flaw.

4.60 None of these factors reflect New Zealand carbon market fundamentals or the domestic ability to abate. Importantly, it is extremely difficult to argue that this single international price point reflects in any way

[30] In a twist of irony, BusinessNZ understands that Point Carbon was pressured into removing the question about the long-term price drivers in the EUETS by the European Commission.

whatsoever *the efficient cost of abatement.* The purpose of carbon trading is, after all, to have a market that establishes an optimal or efficient price of abatement. A thin or narrow market is extremely unlikely to do this. In which case, it is highly likely that if the current market arrangements are sustained, New Zealand purchasers will as a matter of market design, forego lower cost sources of abatement.

4.61 In the absence of other international markets post-2012, New Zealand compliance purchasers will have no other international price point comparison.

4.62 Given the wide range of factors likely to influence the international demand and supply of carbon units, it is simply too hard to predict where the price of carbon will head. However, in the absence of other market mechanisms, and the likely continued dominant influence of the EUETS, the expectation is that it will rise, and possibly rise dramatically.

4.63 While CERs are currently trading in the $NZD25.00 range, it is important not to forget that in July 2008, CERs peaked at around $NZD45.00, and there is no reason to think that such levels will not be reached again with tightening quality requirements for CERs allowed to be traded in the EUETS and a tightening EUETS cap, not to mention once serious economic growth returns to Europe.

4.64 Marcelo Labre, Visiting Fellow, London Business School in a presentation at Carbon Forum Asia, in November 2011, referenced forecast CER prices of between €38-€45 (~$NZD70.00 - $NZD83.00) under a 20 or 30 per cent reduction target and limits on the acceptability of certain types of CERs.[31]

4.65 A carbon price of $NZD100t/ CO_2-e is not an unreasonable assumption in the period after 2012. In the absence of New Zealand's trade-competitors participating in carbon markets, and moderating features, such prices would have disastrous economic consequences for the New Zealand economy for little environmental benefit.

4.66 The absence of a clear, unambiguous international reference price of carbon raises some critical issues to be addressed by the Panel for the post-2012 period. For example:

a) what is an appropriate price of carbon to be faced by New Zealand businesses?

b) from what year should businesses face that price?

c) will access to international markets deliver that, or some other price?

[31] Source: Societe Generale Orbeo, European CO_2 Market, Carbon Specials, October 25, 2010.

4.67 An assessment of these questions needs to be underpinned by an analysis of the appropriate level of economic burden for New Zealand.

4.68 Some might consider if Australia ever passes a trading scheme into federal law that the Australian carbon price would be appropriate to use at least as a reference price, in the New Zealand carbon market. This argument is addressed (albeit in reverse) in the following recent quote. It captures the New Zealand situation nicely:

> "In any case, matching the carbon price of other countries would not be efficient because it costs more to cut emissions in Australia's carbon-intensive economy. Without a genuine global trading scheme, Australia would have to "sacrifice" more if our carbon price matched that in other less carbon-intensive economies." [32]

4.69 Price is the best means to equilibrate economic impact across schemes, but this requires a deep and liquid carbon market. In the absence of such a market, prices set in other markets are set according to their specific economic, technological and political circumstances, and do not reflect a price that is appropriate to the New Zealand economy.

4.70 BusinessNZ considers that the price to be faced by New Zealand businesses needs to reflect the following:

a) the ability to abate. Many emitters are already operating at or near their 1990 levels of emissions. Abatement opportunities in the agricultural sector are highly uncertain. The ability to abate is not uniform across countries;

b) that New Zealand is generally a technology-taker. Abatement technology developed overseas is unlikely to be driven by a New Zealand carbon price, irrespective of its level (the small size of the domestic market also means that any new technology developed in New Zealand is also likely to be for overseas markets); and

c) access to the least cost sources of abatement. In the absence of a deep and liquid international market, prices set in other countries (such as Australia and the EU) do not represent an efficient price of carbon that exhausts all available opportunities for New Zealand emitters to gain access to the least cost sources of abatement (for example, as emitters swap to lower carbon intensive technologies).

[32] The Australian, March 25, 2011.

De-coupling the NZETS from elements of the Kyoto Protocol

4.71 The NZETS is different to, but not entirely distinguishable from, New Zealand's obligations to reduce greenhouse gas emissions under the UN Framework and the Kyoto Protocol. In the likely absence of a successor arrangement to the Kyoto Protocol, the very practical need arises to effectively de-couple the NZETS from the links in the Act to it. The requirement to do this will not be optional in the event that a successor arrangement to the Kyoto Protocol has not been agreed by 31 December, 2012.

4.72 Careful consideration would need to be given by the Panel as to how to go about this as parts of the Kyoto Protocol are likely to still retain their relevance. The key aspects that are likely to fall away relate to:

a) any future (that is, post 2012) binding obligations with respect to emission reduction targets (BusinessNZ assumes that the obligations associated with the first commitment period, even though they may not crystallise until after 2012, will still be honoured); and

b) the tools associated with the binding target from the first commitment period, such as the allocation of Assigned Amount Units (as noted above, it is possible that other mechanisms such as CERs, and removal units (RMUs) may still retain their relevance, though this is unknown).

4.73 De-coupling will in some measure be the ultimate test of the durability of the NZETS. With no recourse to AAUs, the NZETS must stand or fall on the quality of its unit, the NZU. In the short-term, retention of the price cap and the ban on exporting units (should this be the case), will diminish this risk as with the exception of the forestry sector, and CERs, the NZETS will have limited external links. However, in the on-going absence of RMUs, specific arrangements may be required for the forestry sector.

4.74 De-coupling from the intricacies of the Kyoto Protocol could also allow for more flexible arrangements. For example, the upsurge in new forest plantings could be accelerated if land now in mature forestry could be felled and converted to alternative productive uses without incurring severe financial penalties as these are driven by the Kyoto arrangements.

4.75 The price impact on the forest sector of reliance on NZUs is unknown but it could be expected that the New Zealand pedigree could be sufficient for there to be on-going interest especially if they are produced in a way that is consistent with the LULUCF forestry rules relating to permanence, additionality, measurability etc. In fact the absence of competing AAUs could increase their value (in any case a

reduction in value would be matched by a reduction in deforestation liability).

4.76 But this becomes more of an issue, in the event that the moderating features are rolled-off as scheduled, as emitters will also wish to have unfettered access to the international market. Should this not occur for some time, this risk is likely to be diminished with the evolution of the international consultation and analysis (the 'ICA' processes and procedures) and common verification standards would be expected to remediate any risks associated with the integrity of New Zealand units.

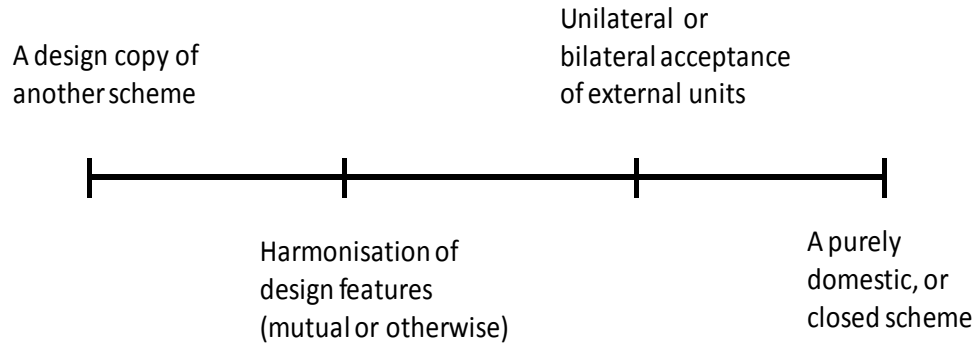
4.77 The level of emission reduction ambition and other characteristics such as the extent of free allocation (for example, if over-allocating to deliberately dampen the scheme's impact) and the extent of domestic action may also implicitly become factors of relevance as other markets determine the acceptability of New Zealand's units.

4.78 The implications of such changes, and their effects on the incentives for New Zealand businesses to abate or to seize new market opportunities would need to be very carefully worked through.

Linking – a wolf in sheep's clothing?

4.79 Linking is a means to reduce transaction costs and provide access to a broader carbon market, thereby facilitating access to the least cost form of abatement. BusinessNZ agrees with the objective of linking as a matter of principle.

4.80 However, linking can mean any one of a number of possible scenarios. A spectrum of these scenarios is set out below.



4.81 In addition, a number of descriptors are used, for example, "mirroring", and "harmonisation", including "linking". These descriptors are as likely to be used interchangeably, or with specific implied meaning.

4.82 Putting aside the obvious issue that there is only one other scheme to which linking (in whatever form) is possible at the moment, it is unclear to BusinessNZ why New Zealand would wish to formally link (that is, moving along the left-hand side of the spectrum) with another scheme, at least at this point.

4.83 Formal linking (the adoption of another scheme's rules on emission caps, sectors and allocations) isn't required in order to reduce emissions most efficiently but access to a choice of market mechanisms is. A common price can be used to equilibrate economic impact.

4.84 Formal linking would be likely to involve too much sovereign risk and should only be actively pursued if unequivocally in New Zealand's best economic interests. What may be appropriate and drive abatement in one country may, because of the other country's particular emissions profile, require a level of economic burden that it cannot afford.

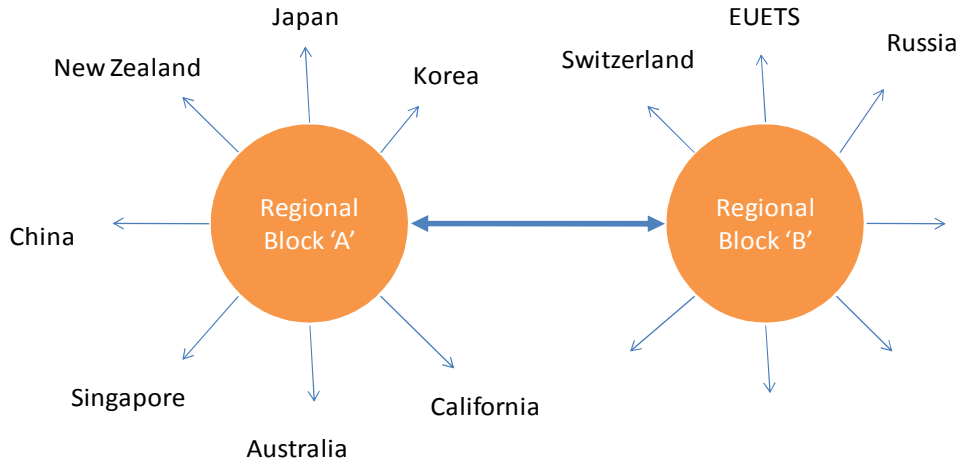
4.85 Formal linking is likely to impose unacceptable constraints on scheme design. For example, the NZETS would require a 'hard' emissions cap before being able to link with the EUETS. In light of our emissions profile, and a desire to play a role globally that is commensurate with our size and willingness to 'do our fair share', a hard cap would be unlikely to be in New Zealand's best economic interests.

4.86 Linking is also unlikely to assist the reduction in the risk of carbon leakage. Asymmetric scheme coverage means that linking with a specific set of other schemes is likely to be ineffective in addressing the risks associated with carbon leakage. Unless linking has occurred with a substantial number of other schemes, there will remain other countries to which capital and job flight can occur.

4.87 In BusinessNZ's view, the active pursuit of access to other market mechanisms is preferable to more formal linking at this stage. Linking (or even harmonisation) with other schemes should only be a long-term goal. BusinessNZ considers that given the relative immaturity of carbon pricing and carbon markets, that there is too much sovereign risk involved in moving to formally link with other schemes.

4.88 In light of the nature of the international progress outlined above, and the absence of a deep and liquid carbon market that would allow for the price of carbon to equilibrate impact across schemes, BusinessNZ considers that even access to other market mechanisms is unlikely to occur in the short-term. Instead, the more realistic outcome is the progressive development over the next decade of a patchwork of markets and market mechanisms that are linked via the exchange of fungible units that meet a commonly accepted verification framework.

4.89 Over time these markets and market mechanisms could be expected to coalesce into broader regional arrangements as confidence with each country's individual arrangements grows. Eventually links will be formed between individual participants in each of the various regional arrangements and efforts to drive out unnecessary transaction costs will eventually create even larger combined markets. A hypothetical model of such an arrangement is shown diagrammatically, below.



4.90 Subject to meeting a common verification standard, BusinessNZ sees no reason in principle why New Zealand businesses should not be allowed to sell into or buy units from the schemes in the US (particularly since they have been put forward as examples of action to reduce emissions in Table 4.2 of the Issues Paper) or any other scheme, for example, the anticipated Japanese power sector scheme.

4.91 Depending again, on the definition of "linking" being used, this approach seems to be consistent with the Panel's thinking, as the Issues Paper says:

> "In a continuing period of uncertainty, progress may depend on linking between domestic schemes."[33]

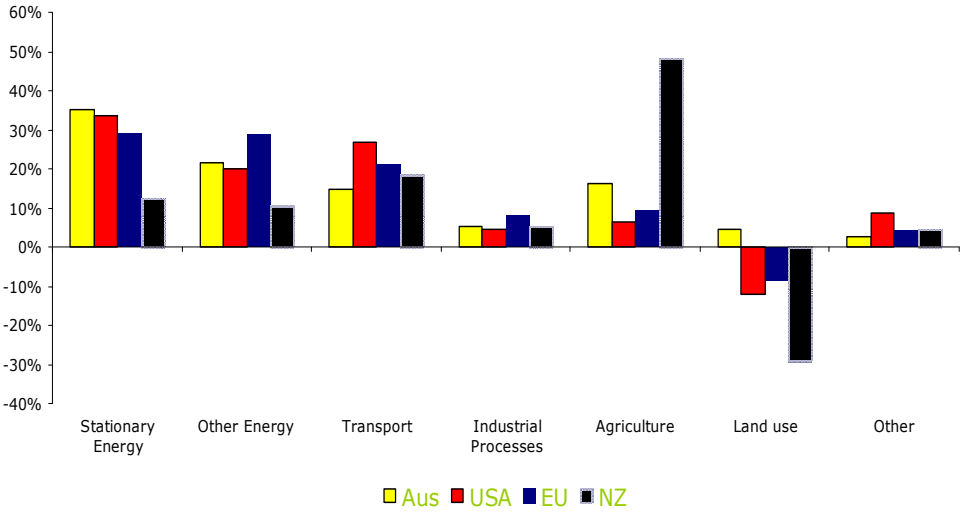
4.92 If "linking" in this context means mutual arrangements to trade emission reduction units in other countries, irrespective of whether those countries have national schemes, then BusinessNZ would strongly support such a sentiment.

4.93 This approach can contrast with the desire to 'harmonise' with the now defunct Australian CPRS when its prospects of being passed into law looked somewhat better. 'Harmonisation' went some distance beyond market access.

4.94 BusinessNZ agrees that New Zealand needs to look at the policies of its closest major trade competitor, and the experiences - both positive and negative - of other countries in setting their policies. However, care is needed to ensure that New Zealand does not simply import policies that are directed at solving problems that do not exist here. This was not always the case, particularly around the protection of sectors that are more important in New Zealand (for example, food processing), than Australia (for example, coal-fired power generation).

[33] Issues Paper, ibid, page 30, paragraph 93.

4.95 The following graph showing the emission profiles of a set of Annex I countries, including Australia and New Zealand, highlighting their differences.



Source: UNFCCC

4.96 BusinessNZ considers that the effort to harmonise with the then CPRS was a failed experiment in mutual recognition and lessons must be learnt from it. Fundamentally, the policy drivers were (and remain) different, with Australian policy directed at different issues than in New Zealand. In Australia, the challenge is to maintain the current level of emissions, while in New Zealand, the requirement is to reduce net emissions or import offsetting units.

4.97 Minimising cross-border compliance costs is an important goal, but not one that should over ride domestic economic factors.

4.98 The NZETS needs to be refocused on protecting New Zealand's economic sovereignty, and de-coupled from the CPRS. An ideal scheme design is one that adopts the best features of other schemes but not features that are not in New Zealand's best economic interests.

4.99 As the initial focus should be on gaining access to a greater range of international emission reduction units, more emphasis could be placed on linking in the next review when it may be more relevant.

Considerations on sector entry - agriculture

4.100 BusinessNZ supports the adoption of an all sectors, all gases scheme. As a matter of principle, that includes those sectors currently scheduled, but yet to have obligations under the Act to surrender units (waste, synthetic greenhouse gases and agriculture).

4.101 As a matter of overall scheme efficiency (bearing in mind that the fundamental purpose of a trading scheme is to have a market

mechanism that determines where the abatement opportunities are) to act as a proxy to the market would be tantamount to the Government picking winners, with all of its attendant (and well-known) risks and foibles.

4.102 The conversation around the inclusion of on-farm emissions is highly charged. Much of the debate has been in black and white terms, of either needing to be in the NZETS and sooner (Labour, for example, had agriculture scheduled to enter the NZETS in 2013, and maintained that position throughout the development of the moderated NZETS), or out of it indefinitely.

4.103 At a minimum, BusinessNZ considers that a date should continue to be specified for inclusion of the agriculture compliance obligation. The precise date could vary depending on a number of factors relating to a clear transition path based on practical sectoral considerations.

4.104 The purpose of a date is intended to signal a credible commitment by Government to include the agriculture sector. The expectation is (so long as the signal was credible) that it can spur action prior to the actual inclusion of the sector into the NZETS and make the actual entry of the sector more managed. In addition, the specification of an entry date will minimise the risk that assets being invested in now could become stranded after a decision to include agriculture.

4.105 In reaching its decision with respect to agriculture, the Panel needs to take a number of factors into account, for example:

a) need to recognise the difficulties of addressing a biological problem rather than a technological one. Ruminant emissions are very hard to control and limit;

b) the extent to which introducing agriculture to the NZETS poses significant practical administrative difficulties because of the complexities of measuring, monitoring, reporting and the number of industry participants;

c) the rationale for a trading scheme - a trading scheme can only operate efficiently if it is as broad as possible. The idea of a trading scheme is that those with obligations under the scheme have the widest possible opportunity to source the lowest cost units;

d) any inconsistency issues between arguing for the creation of a deep and liquid international carbon market if New Zealand excludes from its scheme ~50% of its emissions;

e) the credibility of arguing for the inclusion of agriculture only if it has been included in the schemes of other countries. The Panel needs to take a principled approach to this issue, bearing in

mind that the broader application of this rules would see only a sub-set of our industrials would be covered (as only a small set of industrials are captured in the EUETS). Liquid fossil fuels would also be out on that basis, and the benefits of an emissions trading scheme would quickly evaporate, becoming a tax on energy, fuels and industry;

f) the extent to which industrials that are already at, or below their 1990 levels of emissions can be expected to find it much easier to abate at a reasonable cost than the agricultural sector; and

g) the ability of a market-based instrument to test whether emissions reductions are possible in agriculture or not (for example, nitrogen inhibitors) and the consistency in treatment between sectors with regard to the current availability of commercial abatement options.

4.106 Having considered these factors, the Panel could well determine that there are ways of thinking about agriculture other than in simple black and white terms of 'in or out'. For example:

a) while the current level of allocation has been set at 90%, this level could be raised to say, 95%; and/or

b) rather than bring all agricultural gases in, their entry could be staggered, with nitrous oxide entering the NZETS first (as the use of inhibitors is increasingly possible), followed at some later date by methane; and/or

c) to more equitably share the burden across all sectors and be consistent with the objective of a trading scheme – to enable the market to find the cheapest source of domestic or international units – include agriculture but reduce the $12.50/tonne fixed price (in other words, lower the rate on a broader base).

4.107 See Section 7 below for a discussion on the issues associated with the inclusion of synthetic greenhouse gases.

5 WHAT DOES ALL THIS MEAN – A CALL TO GREATER ACTION OR TIME FOR A CUP OF TEA AND A LIE DOWN?

5.1 Section 4 canvassed a range of issues associated with the operation of an efficient emissions trading scheme. Uncertainty is the key defining characteristic of the environment in which the NZETS operates. The purpose of this section is to round out the analysis outlined in the preceding sections of this submission, and to chart a course of action required to ensure that the NZETS is 'fit-for-purpose' and continues to prepare New Zealand businesses and consumers for an increasingly carbon constrained future.

"Do no harm"

5.2 This well-known exhortation underpins the Hippocratic Oath. While initially incongruent, it bears some relevance in this context.

5.3 BusinessNZ considers that it will be extremely difficult for the Panel to say that the moderating features should be removed, as scheduled, in light of the information presented above. Therefore, we should not be proceeding on the basis that we have a binary choice (comprehensive, fully international emission trading scheme or not), but how to make decisions in the face of extreme uncertainty around potentially diverse outcomes.

5.4 BusinessNZ agrees that supporting actions that address the long term risks of climate change is worthwhile - but not at any cost.

5.5 As with the 'do no harm' requirement, the Panel should be cautious about the aggressiveness with which future actions are taken. As described below, BusinessNZ's view is that a single intervention, that is the introduction of a carbon price, is adequate to achieve a shift to a lower carbon pathway.

5.6 Accordingly, while global climate change policy settings are unclear, and the costs and benefits are uncertain, adding additional aggressive policy interventions to force greater action risks creating unwarranted market distortions and imposing otherwise avoidable price shocks on to both businesses and consumers.

5.7 The Panel and public policy makers in general face the unavoidable fact that they operate in a world of uncertainty. Moreover, an incorrect decision by policy makers may potentially impose very large costs on businesses and the economy. Such costs occur through distorted resource use and reduced investment and innovation (that is, they impair allocative and dynamic efficiency). Reduced investment results in a compounding loss of value that may become quite substantial over a long period.

5.8 BusinessNZ's advice is that small steps be used initially so that their effectiveness can be assessed. If responses are inadequate, the original intervention can be intensified or additional measures can be deployed. If instead aggressive interventions are applied now to the same problem, then it will not be possible to assess which intervention to intensify if responses are inadequate because the effects of the different measures will not be separable.

5.9 Where interventions cause market changes that are uncertain but irreversible, policy design should set a higher cost benefit threshold. Holding off intervention until there is this higher level of benefit is often

referred to as recognising the option value of waiting in making irreversible interventions.

5.10 Climate change is a slowly evolving problem. The Government has time on its side to progressively introduce more and more aggressive measures should it be shown that the previous ones are failing to deliver the policy outcomes sought.

Business needs long-term policy predictability

5.11 Businesses rarely act without a clear understanding of costs, risks and benefits. If market uncertainties grow too large, it is difficult for businesses to justify major investment. Business understands that even under the best of circumstances, perfect certainty is not a realistic outcome. Predictability is a much more reasonable expectation. For an increased likelihood that the objectives of the NZETS are achieved, business needs clarity not unpredictability of the policy settings that will underpin the pathway.

5.12 New Zealand is a small, open, export-oriented economy, which is ultimately reliant on its export sector to support improvements in economic well-being. To compete effectively, business needs long-term policy predictability in order to have the confidence to invest and create jobs. Without this long-term focus, policies which are short-term or stop and start over an investment's lifetime will act as a source of increased unpredictability that would be deeply unhelpful to businesses considering large, long-term investments.

5.13 This issue is neatly summarised in an OECD report on New Zealand:

> "New Zealand is to be commended for taking its Kyoto Protocol commitment seriously, including by being the first country to introduce an all-gas, all-sector emissions trading scheme. However, because of the importance of export-oriented, emissions-intensive industries, firms and citizens at large are unlikely to accept and continue to support environmental policies that are perceived to unfairly hurt their prosperity, unless similar efforts are made in other countries. To reduce the impact of pricing greenhouse gas emissions, the trading scheme gives temporary free allocations to the most affected industries. *However, it still creates uncertainty because investment is long-lived and the price of emissions when these free allocations expire is impossible to predict*... .[34] (emphasis added)

5.14 Technology choices and investment plans, particularly in the energy sector, reach across decades and so politicians and policy makers need to create the right frameworks and systems that will facilitate more active business participation in the development and deployment of

[34] OECD Economic Survey of New Zealand, 2009, page 8.

useful solutions and try to avoid the lock-in of current higher emissions technologies.

5.15 Predictable long-term policies in this area are vital to ensure New Zealand's economic resilience over the long-term. Under the right conditions, businesses will respond to the commercial opportunities that arise to satisfy consumers' demands. But to make the most of these opportunities, the Government needs to provide a policy regime that provides certainty to potential investors.

5.16 It is, after all, business that will be making investments and adjusting to different market circumstances at various stages along the way.

Design change recommendations

5.17 The need for long-term, not short-term predictability has heavily influenced BusinessNZ's recommended changes to the NZETS.

5.18 BusinessNZ believes that in light of the information set out in Section 4 above, the emphasis at this stage in the journey of emissions trading should be based around the development of a stable trading framework, one that provides business with predictability so that it can invest in both abatement opportunities and new technologies with confidence.

5.19 BusinessNZ's key recommendations are set out in the following table:

Issue	Recommendation
1. The price cap	Expectations about the durability of the policy and confidence that the settings are robust will directly influence the decisions businesses take in responding and therefore the dynamic efficiency of the policy. A short term retention of a price cap does not give business – either emitters or those who want to take advantage of a carbon price – any long term predictability. **<u>BusinessNZ recommends that the Panel</u>**: 1. Retain the current price cap (combined with the 1:2 progressive obligation[35]) for a period of ten years or until appropriate metrics – based around the extent of global emissions covered by a carbon pricing in other jurisdictions (at an economy or sectoral level) and comparable effort, in terms of GDP – are reached that would trigger making the NZETS more or less stringent.[36] The price cap mechanism could also be combined with the penalty regime in order to moderate its effects.

[35] This feature retains desirable incentives to access international markets.

Issue	Recommendation
2. Trading scheme links to the Kyoto Protocol	**<u>BusinessNZ recommends that the Panel</u>**: 2. De-couple the NZETS from the trading elements of the Kyoto Protocol. De-coupling the NZETS from the intricacies of the Kyoto Protocol will need to be carefully managed but could provide for greater flexibility for foresters and emitters.
3. The inclusion of other sectors	**<u>BusinessNZ recommends that the Panel:</u>** 3. Retain a date for the entry of agriculture into the NZETS in order to signal Government's commitment; 4. Consider a range of innovative design responses in terms of gases and levels of protection to accommodate practical sectoral issues and competitive impacts; and 5. Consider, if the NZETS is broadened to include the new sectors, the merits of a lower overall price cap over the broader base to maintain comparable effort across sectors.
4. The allocation regime	**<u>BusinessNZ recommends that the Panel:</u>** 6. Change the allocation to be fit-for-purpose for New Zealand business circumstances, assist smaller businesses, and de-couple from the defunct Australian scheme; 7. Ensure that the eligibility thresholds are appropriate for NZ (as opposed to Australia) and that all of New Zealand's key export sectors are covered; 8. Consider the merits of a sliding scale of thresholds to avoid major breakpoints while preserving the integrity of the overall amount of allocation (this would assist smaller businesses); 9. Make the eligibility tests (such as the base years for data assessment) more flexible (this issue was considered by the Stationary Energy and Industrial Process Technical Advisory Group, who supported the use of a mix of recent and historical base years); and 10. Defer the commencement of the phase out of the allocated units until 2018 as it is generally the case that New Zealand's trade competitors are not facing a price of carbon.

[36] Consideration was given to the alternative means of providing long-term predictability of setting an emissions cap. On balance, BusinessNZ considers that setting an emissions cap would be problematic given our emissions profile and would require greater design change and add complexity to the scheme. For example, it is likely that you would need to abandon the output-based allocation feature (as intensity allocation within a hard cap would be extremely problematic in terms of long term certainty of allocation profile and therefore investment), move to auctioning, and limit access to international units (that is, move away from having a 'responsibility' target to a predominantly domestic one).

Issue	Recommendation
5. Linking with other schemes	**BusinessNZ recommends that the Panel:** 11. Afford priority to facilitating access to fungible units from other schemes that meet minimum acceptability standards by explicitly focusing on providing a wider set of units from a broader range of jurisdictions (for example, Carbon Farming Initiative units from Australia, Californian units, sectoral offsets, REDD+, etc); 12. Ensure that businesses have clarity about unit acceptability from a wider range of emission reduction markets; and 13. De-link the NZETS from the now defunct Australian scheme.

5.20 Combined with the administrative and compliance regime recommendations set out in Section 4 above (paragraphs 3.28 – 3.42) and the other proposals set out in Section 6 below, BusinessNZ considers that it has provided the Panel with a robust and comprehensive set of suggestions that warrants close consideration.

5.21 As an aside, the Ministry of Economic Development occasional paper floats an idea that a price floor may be appropriate as a part of the scheme's design. We strongly advocate against this. Other policy options to support the developers of innovative solutions would be preferable (for more on this see below). BusinessNZ also notes that the Grattan Institute reference is not credible in the New Zealand context where the development of low emissions power generation is not an issue.[37]

6. OTHER ISSUES FOR THE PANEL'S CONSIDERATION

6.1 In addition to the recommendations above, BusinessNZ considers that there are six other issues that warrant the Panel's attention. These relate to:

a) the need to improve the uptake of new low carbon technologies by greater use of the offset mechanism;

b) the inclusion of liquid fossil fuels in the allocation eligibility criteria;

c) retaining access to the range of units currently available to compliance buyers;

[37] Ministry of Economic Development, Occasional Paper 11/04, ibid, page 72.

d) look to the wider use of complementary measures where they stand on their own merits;

e) removal of the scheduled five-yearly reviews; and

f) the Panel's process through to delivery of the final report.

6.2 Each of these issues is canvassed briefly, below.

Improving the uptake of 'clean-tech' by greater use of offsets

6.3 The design of the NZETS is intended to fully incentivise participants to achieve emission reductions below business-as-usual. However, as recognised as long ago as the 2007 'Framework' document, "an ETS does not incentivise all activities that reduce emissions". While the 'Framework' document recognised that "….the design of the ETS may not be sufficiently detailed to capture the activity" it also acknowledged that "an ETS framework can be augmented by the use of offsets."[38]

6.4 At the moment, the use of the offsets mechanism is carefully prescribed (covering synthetic greenhouse gases and carbon capture and storage), and is only available to NZETS participants.

6.5 BusinessNZ recognises the difficulty associated with the design of an offset mechanism with an all sectors, all gases scheme. However, having said that, BusinessNZ considers that the more effective use of the offsets mechanism would help contribute towards the development of a more vibrant technology sector, targeted specifically at the introduction of low carbon technologies. Trading in offset credits can also help to encourage emission reductions from sectors that are not as well suited to the trading scheme. This would align well with Government objectives in both the climate change and technology innovation areas.

6.6 Two particular features need to change to deliver a more effective offset mechanism:

a) the expansion of the mechanism to include both NZETS participants and non-participants; and

b) the ability for NZETS participants to invest in technology outside of their core sector (for example, an electricity generator investing in bio-sequestration would not currently receive credits for that investment).

6.7 Therefore, BusinessNZ recommends that the Act be amended to allow for either:

a) a downward adjustment of liability for a participant where emissions are not actually released into the atmosphere; or

[38] The Framework for a New Zealand Emissions Trading Scheme', section 4.9.1, page 48.

b) the ability of non-participants to earn emission units for each tonne of emissions that is avoided.

The inclusion of liquid fossil fuels in the allocation eligibility criteria

6.8 In the process of applying the New Zealand-specific allocation rules in the absence of the CPRS it appears that some inconsistencies emerged that should be addressed. As the Panel knows, the expectation was that when making decisions about allocation, that New Zealand firms would be able to use an 'Australian track'. In a nutshell, this meant that New Zealand businesses that delivered an activity that had been defined as eligible in Australia, would be able to use the Australian allocative baseline. The Australian baselines included use of liquid fossil fuels in the allocation. However, when the Australian track was not available, it was decided not to allow an allowance for liquid fossil fuels in determining the New Zealand allocative baselines. This seems inconsistent and for some businesses, has lowered their allocation, or not enabled them to become eligible.

6.9 This inconsistency should be rectified by allowing for the use of heavy fuel oil for allocation purposes when used in the provision of industrial heat (similar to the acceptability of gas and coal in the same circumstance).

Retaining access to the range of units currently available to compliance buyers

6.10 In January this year, the EU decided that from May 2013 it would ban the use offsets sourced from cutting emissions at HCFC 22 and adipic acid CDM projects due to concerns over their environmental integrity. This was despite the acceptance of such projects by the CDM Executive Board as legitimate.

6.11 The Panel may also be giving consideration to a similar proposal. BusinessNZ understands that the EUETS limited access for geopolitical rather than economic reasons and does not believe that these reasons apply in the New Zealand context.

6.12 Some consider that the continued use of these units poses risks to the ability of the NZETS to link with other schemes. The risk to linking is nominal given the presence of a range of other pre-conditions that would create more substantive hurdles to linking (such as, for example, the absence of a 'hard' cap).

6.13 BusinessNZ agrees with the sentiment of the Chair of the Panel, who when asked about limiting the use of units such as HFC CERs was quoted as saying:

> "The integrity of the NZ scheme, in particular its openness to other international arrangements, and the fact that parties may

> have already acquired these rights in good faith on the basis that they would be entitled to surrender them in NZ would also have to be considered..."[39]

6.14 Making changes such as these are ultimately self-defeating, as they create uncertainty about future such interventions thereby making it more difficult to raise finance for future investments. BusinessNZ understands from its European counterpart, Business Europe, that such changes have led some businesses to increasingly look at the predictability created by a carbon tax.

Use of complementary measures where they stand on their own merits

6.15 A corollary to maintaining the moderating features in place is the need to think more broadly than the NZETS itself. The Panel has the ability to do this in the exception to the boundaries placed on the breadth of the review by its Terms of Reference. The Panel's Terms of reference says that:

> "The review panel should not focus on:
>
> a. ….
> b …..
> c. climate change measures outside of the NZ ETS (except to the extent that a – c above raise broader issues about the best means of meeting New Zealand's international obligations)."

6.16 The reality is that despite the elegance of a single market solution, experience in other countries suggests that a broad range of complementary measures is emerging in preference to broad-based emissions trading. This is, to a certain extent, borne out by Table 4.2 of the Issues Paper.

6.17 There are a range of other measures that would complement the action being taken under the NZETS, and are likely to stand on their own economic merits – congestion pricing is a case in point. The recently established Advisory Group on Green Growth provides another vehicle in which to define the broader set of sustainable business opportunities and what can be done to maximise them. The changing preferences of consumers of New Zealand's exports will also drive positive change.

6.18 As the prospect of agreeing a comprehensive international approach to mitigation becomes more remote, countries are more likely to push international negotiations to pay greater attention to adaptation measures (as distinct from mitigation measures). This was seen at Cancun, and a greater domestic focus on adaptation measures would be a useful complement to the NZETS.

[39] Point Carbon news, dated 18 March, 2012.

Removal of the scheduled reviews

6.19 Section 160 of the Act requires regular five-yearly reviews of the NZETS. These reviews give rise to the presumption of change, and run counter to the desire to provide participants with greater long-term predictability of policy settings.

6.20 BusinessNZ recommends that the scheduled reviews be removed from the Act. This will not over-ride the Parliament's prerogative to make change at any time it sees fit (as exists for any other issue, such as the tax system, for example) but allows for business to manage the risks associated with a range of different possible outcomes within a stable, long-term framework. BusinessNZ compares this to, for example, the position with respect to the corporate tax rate – it is known that it can be changed at any time, but the consequences of doing so are carefully considered before any such changes are made.

6.21 It will also aid in removing the threat of relatively frequent changes that might make the NZETS seem more unpredictable than it may actually be, thereby dampening the incentives for firms to act upon it.

Building understanding of the Panel's views

6.22 The Panel's terms of reference states "It is important that the outcome of the review is enduring. For the review to be successful, the review process will need to be robust, transparent and credible."40 BusinessNZ strongly agrees with this sentiment.

6.23 However, BusinessNZ understands that after this consultation process, the Panel intends to draft, and submit its report to the Minister as required by its Terms of Reference without first sharing its findings with stakeholders. In this process, stakeholders will not get an opportunity to 'road-test' the positions formed by the Panel prior to their finalisation.

6.24 While we appreciate that the extremely short timeframe set for the Panel has to a certain extent, conspired against a more fulsome process, we urge the Panel to give careful consideration to the suggestion that prior to it issuing its draft report to the Minister, it issue a summary of the conclusions, based on the submissions received, that it has reached. This could be expected to aid with developing an understanding of the changes and why they are being made. At a minimum, if the Panel feels unable to do this, the Panel should recommend to the Government that it consult widely once it has formed a view on the Panel's report.

[40] New Zealand Emissions Trading Scheme (NZ ETS) Review 2011 - Terms of Reference, page 1.

7. SYNTHETIC GREENHOUSE GASES

7.1 BusinessNZ's views on the efficiency attributes of including all sectors and all gases into the NZETS are set out in paragraph 4.100 above. In essence, the overall efficiency of the NZETS depends on it being as broad as possible.

7.2 However, as at 2008, HFCs accounted for just over one percent of total emissions while other synthetic greenhouse gases (PFCs and SF6) accounted for less than 0.1 percent. Synthetic greenhouse gases in absolute terms also declined by just over 11 percent between 2007 and 2008.

7.3 While all gases are to a certain extent "special", and BusinessNZ is loathe to create distortionary exceptions, the sources of synthetic greenhouse gases are disparate and typically small, with long lag times between the import of the gas and eventual emissions. This latter point is significant to the extent that typically, only a very small amount of these gases might leak and be released into the atmosphere. The balance is used in equipment which can in some cases have an installed life of 35 years, and then be recycled or destroyed. The up-front costs associated with these gases are therefore very high.

7.4 This gives rise to significant working capital issues, at a time when capital is either difficult to get or expensive. One company, for example, has advised BusinessNZ of the need to carry an additional $1million of working capital to finance refrigerant gas imported and carried in stock until re-exported in equipment.

7.5 The question is whether the introduction of synthetic greenhouse gases into the NZETS is the most efficient means to deliver an optimal level of synthetic greenhouse gas use. BusinessNZ considers that other tools may be more appropriate.

7.6 To a certain extent, the prescription here is similar to that offered with respect to the agriculture sector – a back-stop entry date should be retained in the Act as a credible commitment to including the sector should other plans either not eventuate or fail to achieve sufficient reductions. BusinessNZ suggests a date of 1 January 2018 (equivalent to the commencement of what would have been the third commitment period). The Government can, of course, at any time review the appropriateness of this date.

Two alternatives and a back-stop

7.7 Two broad alternatives seem appropriate. First, regulatory measures. There are a range of potential regulatory measures, such as:

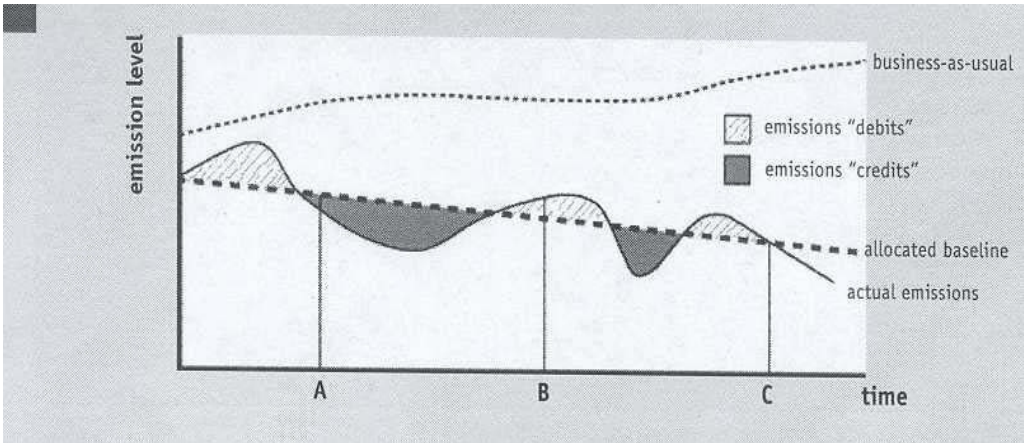
a) the adoption of a set of regulations similar to the EU F-gas regulations. As noted in paragraph 115 of the Issues Paper, the

EU F-gas regulations have provided impetus to alternative refrigerants in mobile air-conditioning and smaller gas charges. BusinessNZ understands that these regulations cover a range of pertinent issues such as containment, recovery and reporting. BusinessNZ considers that the Panel, in conjunction with the sector, should investigate how to adapt the European Regulations to best suit New Zealand; and

b) enforcement of the Australia and New Zealand Refrigerant Handling Code of Practice 2007. The Issues paper raises this as a potential option in paragraph 132. This code of practice applies to all systems which use fluorocarbon refrigerants and covers reducing emissions during refrigerant handling operations, such as installation, maintenance and servicing. While developed with funding from both the Australian and New Zealand Governments, it has not been made legally enforceable in New Zealand.

7.8 A second alternative is the use of a baseline and credit scheme for the sector. Under a baseline and credit scheme, a baseline is set that aims to reduce emissions below business-as-usual. Businesses that have emissions intensities above the baseline have to buy credits. The ability to generate credits from emissions reductions relative to baseline and the pressure to avoid having to buy permits for emissions in excess of the baseline provide incentives for participants to find lower emission production processes.

7.9 A characterisation of a typical baseline and credit scheme is shown below.



Source: Discussion Paper on Measures to Reduce Greenhouse Gas Emissions in New Zealand post-2012[41]

7.10 BusinessNZ acknowledges that there are some practical issues associated with the establishment and implementation of baseline and credit scheme (such as setting the baseline, enforcing it and monitoring

[41] Adapted from Australian Greenhouse Office (1999). "National emissions trading: Designing the market" (Discussion Paper 4).

compliance). However, BusinessNZ does not believe these issues to be insurmountable for such a small sector, particularly if implemented in conjunction with the sector. Regular reviews could ensure that the baseline remains appropriate.

7.11 As a back-stop, if the Panel decides to leave the Act unchanged with respect to this sector it should, at a minimum, provide a range of those protections that have been afforded the other sectors on their entry into the NZETS (for example, a price cap, the 1:2 progressive obligation and an allocation of units) to this sector. These features should be afforded the sector for a period matching that of the other sectors.

7.12 If the Panel decides to extend the moderating features as proposed by BusinessNZ, then that should also apply to this sector.

8. CONCLUSION

8.1 New Zealand is a small, trade-dependent country. It, unlike most other countries, has managed to pass a comprehensive emissions trading scheme into law. In recognition of its trade-dependency, a number of features were implemented that sought to strike a balance between the risks and opportunities that emanate from the NZETS. This balance is reflected in the design features that comprise the current operation of the NZETS (for example, intensity-based obligation and allocation, progressive obligation, price cap).

8.2 The expectation, built into the Act, was that in a short period of time (by the end of 2012), the uncertainty that resulted in the short term application of the moderating features would diminish sufficiently for them to be rolled-off. In other words, that international action would commence a process whereby the risk of carbon leakage was reducing, and that businesses that faced a cost of carbon would be able to manage that risk efficiently in an increasingly deep and liquid carbon market.

8.3 Neither has occurred.

8.4 The Panel, therefore, has a stark choice - to either expose New Zealand businesses to an on-going and heightened risk of carbon leakage and to an unpredictable international reference price (driven by the fact that slow international progress to price carbon has stymied the development of a deep and liquid carbon market), or to continue with the moderating features beyond 2012.

8.5 New Zealand's contribution to total global greenhouse emissions is minuscule and no unilateral efforts will generate significant environmental benefits. Therefore, New Zealand's policy should be designed to primarily signal its commitment to addressing climate change and to encourage others to be similarly committed.

8.6 BusinessNZ considers that the widespread failure of other countries to adopt carbon pricing (which gives rise to the risk of carbon leakage), combined with the absence of a deep and liquid carbon market (which means that businesses cannot efficiently manage their carbon price risks) will create unacceptable economic risks and extend its reach beyond a reasonable level of commitment.

8.7 BusinessNZ suggests that the moderating features be retained beyond 2012. The question is, what is the best way to make the NZETS robust in the absence of a deep and liquid carbon market, and how long will those measures be required? The carbon market is like no other. The nature of the issues faced are, by most standards, unusual.

8.8 Businesses – both emitters and those who see opportunities - want a long-term, predictable pathway which will enable them to invest with confidence. However, the continuation of the moderating features for only a further short-term period is unlikely to deliver this. Instead, it is likely to deliver on-going policy uncertainty.

8.9 This review provides the Panel with an opportunity to provide businesses with the long-term predictability that they seek. It can do this by 'fixing' the level of economic burden that New Zealand is willing to accept until the international environment has crystallised.

8.10 BusinessNZ believes that this, and its other proposals, are a pragmatic response to the enormous difficultly inherent in the trade-off between tackling the issue of carbon market uncertainty while preserving the effectiveness of the approach set out in the NZETS. The recommendations preserve New Zealand as a good place to invest and combined with other policies, New Zealand's commitment remains credible.

APPENDIX ONE: ABOUT BUSINESS NEW ZEALAND

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), Business New Zealand is New Zealand's largest business advocacy body. Together with its 72 strong Major Companies Group, and the 70-member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, Business New Zealand 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, Business New Zealand 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.

Business New Zealand'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

Review Recommendation	Business New Zealand Position
1. Do you agree/disagree with the Panel's assessment of the current impact of the ETS? If not, why not?	The short term impact of the NZETS has been modest in terms of abatement for good reason, not least of which are the Act's moderating features. In any case, it is extremely difficult to draw any firm conclusions in terms of future action from the information provided as it is either extremely tentative, or the future international environment is too uncertain. There is also a tendency to lose sight of the fact that models are tools used to inform the judgement of decision makers, not to predict future behaviour. See Section 3 of the attached submission for a fuller response to this question.
2. What impacts of the ETS have you experienced to date? In your response we would be interested in: a. financial impacts you have experienced and how you have managed these (eg, passed them on to consumers) b. how significant the impact of the ETS has been relative to other changes, such as GST increase, consumer demand changes and oil price increases c. whether the ETS has yet influenced your investment decisions (eg, on low-carbon technologies, and land development) d. whether the ETS has yet influenced your operating decisions (eg, input sourcing, supply chain, choice of energy supply) e. other impacts of the ETS (eg, social, environmental).	Short term impacts are unlikely to have been significant, but this was expected. The period up to 31 December 2012 was always intended to provide a soft introduction into the NZETS. The real question is whether the current carbon price has been high enough to elicit investments in abatement opportunities. A number of factors, not least of which are the state of international negotiations and action by our trade-competitors, have given rise to significant uncertainty as to the future shape of the international carbon market. It is likely that this has had a chilling effect on the early operation of the NZETS. Having said that, it is without doubt that the NZETS has influenced investment and operational decisions, especially by the larger emitters. Indeed it probably started to have an effect from the moment the Labour Government announced that it was going to introduce the NZETS, as businesses factored it in to their future decisions. A carbon price of some variety is, in most cases, being incorporated into major investment decisions, if only as a sensitivity test. See Section 3 of the attached submission for a fuller response to this question.

Review Recommendation	Business New Zealand Position
3. What are your views on the administrative efficiency of the ETS? In your response we would be interested in comments on: a. compliance costs associated with the ETS (including brokerage fees) b. complexities of ETS reporting requirements (such as accounting methodologies) c. penalties for breaching ETS obligations d. the organisation of this administration across government, including the role of the Environmental Protection Authority.	The implementation of the NZETS has been a mammoth task for both businesses and officials. For example, it is easy to overlook the additional administrative burden by the Australians abandoning the CPRS, and the need for officials to pick up the slack without missing the aggressive deadlines set by the Minister. However, lessons can be learnt by both Government/officials and businesses from the experiences to date. It is important that any lessons be used to inform on-going efforts to streamline monitoring and reporting requirements, and the processes for determining eligibility requirements and thereby lower future transaction costs. The establishment of a work programme to independently assess these policies and processes, with a view to simplifying them, would be appropriate. See Section 3 of the attached submission for a fuller response to this question. Specific proposals with regard to b. to d. are set out in paragraphs 3.28 to 3.42.
4. In your opinion, are the modelling results in paragraph 62 (page 21) likely to reflect the actual macroeconomic impacts of the ETS? If not, in your opinion, how will the ETS affect New Zealand in overall economic terms?	No. While the economic models used have a role to play in predicting long term impacts on an economy of pricing carbon, their limitations mean they are not well suited to advising policy makers about the near term adjustment an economy would have to go through. See Section 3 of the attached submission for a fuller response to this question.

Review Recommendation	Business New Zealand Position
5. Do you agree/disagree with the Panel's assessment of the impact of the ETS after 2012? If not, why not?	Paragraph 61 of the Issues Papers says that: "In the panel's view, the impact of the ETS is likely to be more significant in the post-2012 period than in the period up to 2012." It is extremely difficult to disagree with this assessment. If the moderating features are removed, and businesses are exposed to the unpredictable international reference price, the impact post-2012 could be severe. However, it is also extremely difficult to predict what the impact of the NZETS is going to be in the future given the range of complex variables at play. This suggests to BusinessNZ that a cautious approach to assessing the impact of any design changes is likely to be appropriate. Importantly, the analysis in this section of the Issues Paper is disconnected from a broader more strategically orientated analysis of international (in)action that is set out in the following sections of the Issues Paper. Without that 'overlay' (in particular an assessment of what an acceptable level of economic burden is for New Zealand) it is difficult to contextualise the post-2012 impacts that have been put forward. See Section 3 of the attached submission for a fuller response to this question.
6. What impacts do you expect to experience after 2012 (given the current design settings of the ETS)? In your response we would be interested in: a. how impacts will change once the transitional phase ends b. whether any significant business risks are created by uncertain carbon prices, and if so, how these risks could be mitigated c. any competitiveness risks and therefore risks of carbon leakage d. any business opportunities and benefits that may arise e. how you expect abatement technologies to develop by 2015 and beyond f. comparison between carbon prices and abatement costs g. how you expect the ETS to affect New Zealand socially and	Removal of the moderating features of the NZETS as scheduled will expose the New Zealand economy to a set of unpredictable risks for limited environmental benefits. If the moderating features come off as scheduled, in the absence of significant industrial and agricultural abatement opportunities (as it is widely known that the domestic cost of the level of abatement needed to make a substantial contribution to the achievement of New Zealand's 2020 target is substantial – this too is reflected in Figure 3.4), our members expect to find the future much more difficult than it has been to date. However, the extent of the difficulty faced will depend on the degree to which other countries have taken action and whether a deeper and more liquid carbon market than currently exists has emerged. Given the range of predictions concerning international action, it is likely that the risk of carbon leakage will be heightened and businesses will not be able to efficiently manage their price exposure in the carbon market (as it is unlikely to reflect an optimal price of abatement).

Review Recommendation	Business New Zealand Position
environmentally in the long term.	As clarity on these factors emerges, businesses will abate, and innovate with greater confidence. However, in the meantime, business opportunities to abate will arise, but in BusinessNZ's view, these are as likely to be primarily driven by the changing preferences of the consumers or our export products, than an unpredictable future carbon price. See Section 3 of the attached submission for a fuller response to this question.
7. As forestry is New Zealand's largest source of carbon credits and has a significant influence on emissions reduction in New Zealand, do you think the ETS provides enough incentive for forestry investments? If not, why not?	Yes. Forestry-based sequestration, as shown in Figure 3.4, is likely to provide the majority of New Zealand's contribution towards its 2020 emission reduction targets. BusinessNZ considers that the implementation of the moderating features, combined with unfettered access to the international market, created a well-balanced scheme whereby domestic demand could be complemented with international demand should the international price exceed the domestic price cap. Removal of the moderating features might lift domestic demand for forestry units (depending on the international price). However, should the international reference price continue to rise, as expected (and in possibly a dramatic fashion), forestry units are likely to continue to be in demand irrespective of the scheme's domestic settings. While the continuation of the moderating features may limit the domestic market for forestry units, this is unlikely, in BusinessNZ's view to create a situation of a domestic over-supply (thereby depressing prices) as foresters have an incentive to bank units in light of facing a market obligation deforestation liability, and they will have continued unfettered access to the international market. However, a number of other factors are important to the incentive faced by foresters, such as a price on agriculture which can be expected to adjust land prices away from dairy and the export price of logs. Finally, should the NZETS be de-coupled from the strictures of the Kyoto Protocol this could advantage the forestry sector, as issues such as the offset rule would become moot.

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8. Do you agree with the Panel's assessment of the impacts of the ETS on Māori? If not, why not?	Māori are unique to the extent that as businesses, they are over-exposed to the effects of the NZETS on natural resources (for example, agriculture, forestry, fishery). In addition, they have, and will continue to have an enduring interest in the land. This interest, as long-term guardians or kaitiaki leads to an unwillingness or in many instances an inability, to transfer their land interests to other domestic or offshore players. This does, however, have the potential to make Māori ideal, long-term business partners as they are holders of the underlying resource. To this extent, Māori could be considered to be the barometer of the effects of the NZETS and it is important that its effects do not halt the nascent expansion of the Māori economy.
9. In your opinion, what impacts of the ETS have Māori experienced to date?	-
10. In your opinion, how will the ETS affect Māori in the longer term?	-
11. Do the scenarios in table 4.1 (page 28) capture the most likely outcomes for the international framework after 2012? If not, what other scenario(s) do you suggest the Panel should consider?	In most part. The key issue is that there is unlikely to be a successor arrangement of any form in place by 1 January 2013 and that despite on-going incremental progress with the international negotiations, it is unlikely to lead to any substantive diminution of uncertainty (certainly not to the extent anticipated at the time of the passage of the Act into law). See Section 4 of the attached submission for a fuller response to this question.
12. How might the objective(s) of the ETS change under each of these scenarios? In particular: a. what do the different scenarios imply about the costs New Zealand should be imposing on its economy through the ETS in the short term? b. what considerations should influence how the costs of any international obligation New Zealand faces should be shared between different sectors of the economy such as the split between emitters and taxpayers and the relative abilities of different sectors to reduce emissions? c. what is the role of the ETS in	The NZETS has an important role to play in moving the New Zealand economy on to a lower carbon pathway. However, while features such as the price cap, progressive obligation and intensity standards have softened the transition and have made the transition into the NZETS easier, they have not absolved policy makers from continuing to ensure the policy framework is fit for New Zealand business circumstances and durable in the long-term. Efficient and effective policies in this regard are vital to ensure economic resilience over the long-term. The key issue for BusinessNZ is that irrespective of the scenario (even under the most optimistic scenario 1), the risks of carbon leakage and the continued existence of a carbon market that doesn't represent an optimal abatement price will prevail as changes in these two characteristics are in turn dependent on New Zealand's trade competitors accepting emission

Review Recommendation	Business New Zealand Position
preparing New Zealand for the international obligations and other drivers for action it may face in the long term? d. should the ETS design be changed in order to strengthen the incentives for domestic abatement? If so, how? e. how important is continuing access to international carbon markets? f. how do you see domestic and international carbon markets developing beyond 2012?	reduction targets and pricing carbon in a transparent manner. However, it is widely accepted that scenario 1 will not eventuate, but some other, significantly less optimistic outcome will emerge. The likely continued uncertainty, the erratic and generally incomparable action taken by other countries, and the uncertain economic burden that the NZETS, if scaled-up as legislated, will have on the economy are therefore all relevant considerations for the Panel to consider, specifically the costs imposed on the economy. Given the strong likelihood that these uncertainties are going to endure into the future (albeit, in a different form as the international arrangement morphs over time from the Kyoto Protocol into a patchwork of interlinked domestic arrangements), there is an on-going need to continue to carefully balance the effects of the NZETS in an equitable manner across taxpayers, businesses and consumers until circumstances change and the uncertainty abates. This is particularly important as the immediate absence of a successor arrangement to the Kyoto Protocol will not mean, in BusinessNZ's view, that the Government will not continue to pursue an emissions reduction target. International inaction does not mean domestic inaction for reasons of long-term economic resilience and trade and reputational reasons. Costs will, therefore, continue to be borne by market participants. However, as noted in response to Question 5 above, how the NZETS should 'look', and the incentives (both costs and benefits) it will drive into the economy needs to be framed by first determining the level of economic burden that is acceptable to the New Zealand economy in the medium term in order to achieve that long-term economic resilience. The two key factors in this regard are the international carbon price and the level of the emissions reduction target. In light of New Zealand's specific circumstances with respect to emissions and other factors, it is important that New Zealand's response remains proportionate to its contribution to the global problem and the Government's desire for New Zealand "to do its fair share". This suggests that the Panel should adopt a precautionary approach to managing the uncertain risks related to the future price of carbon. While these risks are thought by some to be minor (particularly in light of the moderating design features) and that compensation should be more tightly targeted,

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	BusinessNZ considers that the asymmetric nature of the risk related to under-allocation versus over-allocation warrants the provision of support and where justified, its expansion. Issues such as how the burden should be shared between sectors of the economy, whether some level of domestic abatement should be required and the role of international markets) have been vigorously debated since 2005. BusinessNZ believes that the positions reached in the 2009 amendments (apportioning the cost burden, no requirement for domestic action and the importance of access to international markets) remain appropriate, indeed vital in the on-going journey to a low carbon economy. As such, BusinessNZ sees no utility in re-opening these debates. The positions reached were the outcomes of complex trade-offs and difficult judgements. It is particularly important in BusinessNZ's view that the nature of the conversation around burden sharing moves away from the rhetoric of "it's either taxpayers or businesses." The benefit to taxpayers of avoiding the cost of the obligation may ultimately be borne by them as employees as businesses reduce or defer production, permanently defer investment and/or close to manage the exposure. A more holistic view of compensation for businesses is desirable. See Section 4 of the attached submission for a fuller response to this question.
13. Under what conditions should the ETS scale up to a full obligation? In particular: a. Should the fixed price option of $25 continue beyond the current transition phase (ie, after 2012)? b. Should the one-for-two obligation continue beyond the current transition phase?	BusinessNZ believes that the price cap should continue for 10 years, or up to the point at which it is determined that our trade competitors are taking action of comparable effort (whichever occurs first). The 1:2 progressive obligation should also continue as long as there is a price cap. It should not be used independently of the price cap as to do so would dampen the incentive to access international markets. See Section 4 of the attached submission for a fuller response to this question.

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14. To what extent, if any, should abatement options be relevant in determining the extent of a sector's participation in the ETS?	The key benefit of a market-based instrument is that it provides a set of market signals and incentives to which innovative responses will be made. The intent therefore, of such as instrument is to let the market work out least-cost emissions reduction opportunities. While the availability of abatement options have some relevance to sector entry, to over-weight this characteristic risks placing the Government in the position of second-guessing from where, and when new technologies will come forward. This is the very purpose of the NZETS. The absence of current technology could act as a permanent barrier to sector entry. Long-run elasticity is much larger than the short-run elasticity in terms of driving innovative responses. It is important to acknowledge, however, the specific difficulties around the management of emissions from biological systems. See Section 4 of the attached submission for a fuller response to this question.
15. Under what conditions should new sectors enter the scheme and incur surrender obligations?	As an all-sectors, all-gases scheme, all sectors should in principle, enter the NZETS and face a price signal. This is important for inter-sector equity. At a minimum, it is important for the Government to send sectors a credible signal as to their inclusion in the NZETS in order to spur action prior to actual inclusion and to make the entry of the sector more managed when it occurs. In addition, the specification of an entry date will minimise the risk that assets being invested in now could become stranded after a decision to include the sector. This approach will help provide the sectors with a clear transition path based on sectoral considerations (not 'special' circumstances), and signal the constancy of Governments objectives. Concerns with carbon leakage and access to international carbon markets should be addressed via other design features (such as the allocation regime and price cap etc).
16. Should allocation of NZUs continue as planned under current design settings after 2012? In your response we would be particularly interested in: a. the effectiveness of allocation in reducing competitiveness risks b. the impact of allocation on	No. BusinessNZ suggests that changes be made to the allocation regime in order for it to be fit-for-purpose for New Zealand business circumstances, assist smaller businesses, and de-coupled from the defunct Australian scheme. Other changes to the eligibility criteria (including accounting treatment of revenue and choice of base years) and a delay in the commencement of the phase-out of allocation, also warrant

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incentives to reduce emissions c. whether the allocation thresholds should be amended d. whether the process to determine allocative baselines should be changed e. whether the allocation of units to small and medium sized enterprises (SMEs) is the most administratively efficient way for protecting impacted sectors either for SMEs or government	further consideration. There is much confusion surrounding the role of the allocation regime and whether it dampens the incentive to abate. BusinessNZ notes that abate depends entirely on the incentive effect of the trading obligation (that is, the need to surrender units). The abatement effect is achieved whether companies are given all the necessary NZUs, or has to buy then all, or with any intermediate allocation. Officials have long accepted this point, stating as far back as the 'Framework' document: "Economic theory suggests that the free allocation of emission units (as opposed to auctioning) *will typically not affect firms' decisions on the levels of production*."[42] (emphasis added) However, the same cannot be said of the progressive allocation. Generally with free units product prices rise to cover the new cost and if not recovered, the free permits compensate shareholders for any loss. A progressive obligation on the other hand, is about setting a cap but then saying you only need to surrender 1 permit for every 2 tonnes you emit (or some other ratio). So businesses' costs rise by only 50% of the full cost of emission permits and prices don't have to rise by so much. The effect of this is more like an exemption as it dampens the incentive effects of the NZETS on new investment. Having said that, BusinessNZ supports the use of the progressive obligation, as when combined with the price cap, it provides some clever incentives. Changes to the allocation regime are required, not least as they relate to the need to de-couple the NZETS from the CPRS and therefore offer allocation to sectors that are of critical importance to New Zealand's future prosperity, such as Fonterra and other food processing companies. The fact that these companies do not meet the current eligibility thresholds is a matter of policy choice which is wholly within the control of New Zealand policy makers. BusinessNZ urges the Panel to consider the merits of a sliding scale of thresholds to avoid major breakpoints while preserving the integrity of the overall amount of allocation (this would assist smaller businesses). Finally, it is recognised that the cost of compliance for small businesses risk, in many

[42] The Framework for a New Zealand Emissions Trading Scheme, published by the Ministry for the Environment and the Treasury, September 2007, page 61.

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	cases, outweighing the benefit from the receipt of units. However, BusinessNZ agrees with the principle that allocation should be based on whether or not the activity being undertaken is trade-exposed, rather then on the size of the business. Instead, BusinessNZ suggests that in order to ensure that the costs and benefits are appropriately aligned, that the Panel adopt the proposal to review the administrative and compliance regulations to first ensure that no improvements can be made in those areas. See Section 6 of the attached submission for a fuller response to this question.
17. Are there are any other issues, in particular any related to the matters set out in section 160(5) of the Act as summarised in Chapter 1, you think the Panel should consider? If so, please provide details of your view on them	BusinessNZ considers that there are six other issues that warrant the Panel's attention. These relate to: 1. the need to improve the uptake of new low carbon technologies by greater use of the offset mechanism; 2. the inclusion of liquid fossil fuels in the allocation eligibility criteria; 3. retaining access to the range of units currently available to compliance buyers; 4. look to the wider use of complementary measures where they stand on their own merits; 5. removal of the scheduled five-yearly reviews; and 6. the Panel's process through to delivery of the final report. See Section 6 of the attached submission for a fuller response to this question.

Review Recommendation	Business New Zealand Position
18. Should the ETS cover synthetic greenhouse gases (SGG) from 2013, as currently legislated? a. if no, what other policy tools or what combination of policy tools should be used to encourage reduction in SGG emissions? b. if yes, are there supporting measures or amendments to the ETS that could support implementation and reduce administrative and compliance costs? c. if the ETS should be amended to cover only some SGG-using sectors: which ones, why, and what policies should be developed for the others? In your response we would be interested in d. estimated impacts of the ETS coverage of SGGs (such as compliance costs for direct participants, on rates of gas recovery and recycling or destruction, and on management of leakage) e. arguments for or against alternative policy tools f. estimated impacts, including behavioural impacts in terms of incentives to reduce emissions, of alternative policy tools.	No. There are a range of other tools that a re likely to be more appropriate to apply to this sector that would better balance the costs with the environmental benefits. See Section 7 of the attached submission for a fuller response to this question.