The Subsidy Myth

Analysis of Sustainability Council claims in '*ETS: Bill to a Future Generation*'

In its report on the NZ emissions trading scheme as proposed by the Climate Change Response (Moderated Emissions Trading) Bill, the Sustainability Council makes a series of flawed assertions about the costs and liabilities of the policy.

It asserts that under the terms of this proposed legislation NZ households will in effect be subsidising business, with this subsidy stretching for many decades in the future.

This assertion is incorrect and is best described as a *subsidy myth*.

A review of the report reveals that the analysis is fundamentally flawed with regard to:

1. Allocation to industry and agriculture
2. Carbon pricing assumptions
3. Treatment of the forestry contingent liability

1. Allocation to industry and agriculture

Why is allocation required?

- In common with other emissions trading schemes operating (EU ETS) and in design (Australia, Japan, US) the NZ ETS has provisions to allocate units to address the risk of carbon leakage.
- Many NZ firms are competing in commodity priced world markets (aluminium, steel, cement, pulp, food produce etc.), against firms operating in countries which do not yet place a price on greenhouse gas emissions.
- NZ firms in such markets cannot pass on the cost of carbon in their product price, nor can they simply absorb the cost. Those who are not in such markets do not receive an allocation and will pass the cost that they face on to end consumers.
- In the absence of allocation to firms competing in international markets, this would result in the displacement of economic activity and associated greenhouse gas emissions from New Zealand – 'carbon leakage'.

How long is allocation provided?

- Carbon leakage is a temporary issue until such time as there is wider (if not worldwide) international pricing of greenhouse gas emissions.
- The Bill recognises this in Section 160 where in 2011 and 12 months before the end of each international commitment period (or 5 yearly), a review of the operation of the NZ ETS is carried out by a review panel.
- Specifically each review must consider what changes to the following aspects of allocation (as applicable) to industry and agriculture are necessary or desirable including the phase-out rate, level of assistance, emissions intensity thresholds, determination of trade exposed activities and eligible industries.[1]

[1] Section 160(5)(j) of the Climate Change Response Act 2002 as amended by the Bill

The Sustainability Council has omitted to mention this critical section of the Bill.

Instead it wrongly assumes that allocation continues indefinitely until eroded by the 1.3% allocation reduction rate resulting in what it calculates to be a 76-year transition.

What about international action?

- New Zealand's proposal for the post-2012 international agreement is a 10-20% reduction on 1990 levels conditional on the following:

  i. *the global agreement sets the world on a pathway to limit temperature rise to not more than 2°C;*
  ii. *developed countries make comparable efforts to those of New Zealand;*
  iii. *advanced and major emitting developing countries take action fully commensurate with their respective capabilities;*
  iv. *there is an effective set of rules for land use, land-use change and forestry (LULUCF); and*
  v. *there is full recourse to a broad and efficient international carbon market.*

- As more countries make commitments, they too will introduce a price on carbon, reducing the risk of carbon leakage, negating the need for allocation.

The Sustainability Council's assumption of "near perpetual subsidies" would require New Zealand to sign up to future international agreements unconditionally for the next 70+ years, while our trading competitors take no action.

2. Carbon pricing assumptions

In section 2.5 of the report, the Sustainability Council contemplates a price of $100/t by the Kyoto settlement date of 2015 when covering any Kyoto commitment period liability for 2008-12.

This indicates a lack of understanding of the state of the Kyoto carbon markets:

- While not anticipated, should the Crown have a Kyoto deficit it can meet that through the purchase of Kyoto compliant units. These units must have been generated in the period ending 2012. Although the Crown has until end 2015 to settle up, it must use 2008-12 units to do this.
- Of these the most plentiful are:

  - CERs (Certified Emission Reduction units) which can also be used in the EU ETS;
  - AAUs (Assigned Amount Units) which sell at a discount as there is a significant oversupply of them as:
    - They cannot be used in the EU ETS
    - Demand from the EU15 and Japan is now low due to emissions reductions, the economic recession and prior purchasing
    - Ukraine, Czechoslovakia and other Former Soviet Union nations are now bringing AAUs to the market in increasing numbers.
  - CER pricing from Reuters shows a 2012 CER price of €13 (NZ$26)

- AAU Pricing information from Point Carbon – an international carbon markets information news and analytical service – has a range over the past 12 months from €5 (NZ$10) to €14(NZ$28)

The Sustainability Council's use of NZ$100/t for any 2008-12 Kyoto deficit bears no relationship to carbon market fundamentals.

- Although prices for units generated in a post 2012 commitment period may be higher than those today, those prices are not relevant for the 2008-12 Kyoto calculation.

- For future periods, should a high price exist, this can only be through there being strong international agreements. This in turn also negates the Councils "near-perpetual" allocation assumption as previously covered.

3. Treatment of forestry contingent liability

Throughout the report the Sustainability Council advocates treating any future and uncertain contingent liability as a current Balance Sheet item for the Crown's Kyoto calculation. It is through this assumption that the Council moves the Crown's 2008-12 forecast surplus to a liability of 76 million units.

The report is confusing concepts of balance sheet accounting and contingent liabilities. It is appropriate to note a contingent liability however it should not be brought forward into the calculation of the deficit as proposed. A liability is typically only brought onto the balance sheet as it occurs.

This is confirmed by the response from Treasury to Carbon News:

> "The Sustainability Council's statement is incorrect about liabilities from future harvesting not being included in the accounts. Such 'liabilities' are contingent on future events. The contingent liability from future harvesting is included in Note 32 of the latest set of annual Financial Statements of the Government.
>
> The note states that "*During the first commitment period the Ministry of Agriculture and Fisheries estimate that 92.3 million tonnes of carbon credits will be generated by carbon removals via forests. To the extent that these forests are harvested in subsequent commitments periods there will be an associated liability generated that will need to be repaid (Refer note 22) $1,995 million at 30 June 2009 (not previously quantified).*
>
> There is no need to update or 'correct' the accounts because they already include the correct and necessary information about liabilities and assets as at June 30, 2009, under the Kyoto Protocol, as well as providing information on obligations that are contingent on future international agreements."

Between now and 2020 when the potential contingent liability starts to be realised, there is much that can happen, such as:

- International accounting rules for forestry may change – as advocated by the NZ Government;
- Forecast harvesting and replanting rates will have changed;
- Opt-in levels under the NZ ETS devolving any harvest liability will be known;

- Carbon prices will have changed;
- Carbon leakage concerns could have reduced, freeing up units.

While it is appropriate to recognise contingent liabilities, the treatment of them as a balance sheet item is misleading.

The Sustainability Council's use of a contingent liability for forestry to create a short term Kyoto deficit cost to the country is misleading.

Conclusion

The examples above indicate that the Sustainability Council has applied inappropriate assumptions.

In the complex arena of emissions trading economics, this is distracting efforts from the real task of getting a durable emissions trading policy in place.