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Dear Phil

### **Ministerial Review of PM10 Regulations in the Air Quality Standards**

Business New Zealand welcomes the opportunity to provide a submission to the recently announced Ministerial Review of PM<sub>10</sub> Regulations in the Air Quality Standards.

The particular issues under review are whether the air quality standard has the right cost/benefit balance, whether the disallowing of industry consents is appropriate when industry contribute a small proportion of pollutants, and whether the 2013 timeline is reliable.

Business New Zealand welcomes the review. It has significant concerns regarding the efficacy of the current regulations as they apply to business, particularly post 2013. These concerns primarily relate to the disproportionate impact (relative to the contribution to the problem) of the regulations on the business sector, and the inefficient economic signals being faced by business as a result.

#### **Business New Zealand's Interest in this Issue**

Business New Zealand has a strong interest in the regulation of businesses and the quality of regulation. This interest is underpinned by a desire to avoid unnecessary (and therefore inefficient) regulation and to ensure that the:

- a. regulation of businesses is efficient, and in the best long-term interests of end-consumers; and

- b. practical implementation of any regulatory framework is, as a whole, cost-effective and does not impose any undue or unexpected transaction costs on those being regulated.

Bad, or even just poorly targeted, regulations introduce unnecessary delays, uncertainties and costs, stifle innovation, and dampen the incentive to invest. The New Zealand economy will grow quicker, be more productive and New Zealanders will be wealthier, if such regulations are avoided.

### **The Justification for Intervention**

It is easy to get lost in a 'mechanism versus mechanism' debate on policy options for dealing with externality issues such as air quality. What is often not fully considered is the nature of the problem underlying any policy response, and consequently, the justification for the extent or nature of intervention.

The market failure associated with externalities is often seen as a justification for Government intervention. Governments will often intervene to encourage the production of output that creates beneficial externalities and in some cases (such as the case for air quality) will intervene to discourage production of output that creates detrimental externalities. Subsidies and taxes are common interventions used to influence a market price so as to efficiently allocate resources but so are non-price (i.e. quantity) interventions such as the air quality regulations.

Given the potential impacts associated with intervention though, the onus is on Government to identify the marginal social costs and benefits associated with particular activities. Particularly where taxes or discouragements to production are seen as a response to detrimental externalities, affected parties will obviously be keen to ensure that appropriate weight has been given to the assumed costs and benefits of the particular activity. The justification for a particular intervention needs to be clearly identified and possible solutions transparent in terms of all their costs and benefits.

In Business New Zealand's view, it is important to first examine "what are the economic characteristics of the problem that we are trying to solve here?" Without a proper assessment of the extent of any problem, it is difficult to justify *any* intervention.

Business New Zealand considers that the public policy rationale for intervention is, in this case, relatively clear – a good theoretical case can be made for the causers of poor air quality to bear the cost of pollution. But it is important not to rush head-long from theory to practice. Business New Zealand is heartened, in this regard, with the review. Time needs to be taken to understand the specific nature and size of the policy problem and its causes. This does not mean inaction. It is, however, important to fully understand 'what is' before moving on to shaping solutions. Businesses operating in a world of uncertainty need to be assured that regulatory

interventions are robust. Policy also needs to be enduring and the review provides Government with the ability to satisfy both of these conditions.

### **Considerations for the Review Team**

Bearing in mind these factors, there are a number of subsequent considerations for addressing the problem of environmental impacts from certain economic activities and how to address them. These are:

- a. it would seem reasonable to expect that the magnitude/scope of a market failure is relatively observable or identifiable. It would be difficult to justify intervention without this, as any response would need to be well suited to the particular market failure and the specific type and characteristics of the market in which the failure is supposedly occurring for it to be efficient and effective;
- b. a key consideration is the derivation of an appropriate methodology for identifying just what level of detriment is acceptable in terms of the public interest. This follows closely from the previous point, in that there needs to be a way to measure and weight the costs and benefits of various parties;<sup>1</sup> and
- c. if clear cases can be identified where the market is failing, it would seem reasonable to expect that measures to reduce the externalities should be coupled with increases in total social welfare. Unless this occurs, the incentives to act on eliminating externalities (or allowing their pricing into the market) won't create a socially optimal maximisation of welfare.

Considerations such as these would ideally form the basis of any justification for intervention because of market failure – regardless of the particular method for intervention. Business New Zealand looks forward to seeing this sort of rigour being applied by the review team, as it forms the platform on which an economically efficient solution (or set of solutions) will be based.

### **Matching the Solution to the Problem**

Given these thoughts around the nature of the problem being contemplated, and the possible considerations in assessing the need for any type of intervention to remedy the problem, it is useful to set out Business New Zealand's view of the extent of the problem as identified by the Government.

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<sup>1</sup> For example, are the weights of the various parties' marginal costs/benefits assumed to be equal? While net public benefit and net consumer benefit-type welfare tests are commonplace, they may not be entirely suited to examine the weight of various parties' welfare effects. They are probably more suited to measuring marginal private costs, rather than the incidental costs associated with externalities. It is difficult to apply monetary values to effectively subjective factors. The difficulties are likely to be equally material in terms of identifying (and weighting) benefits to society.

The fact that policy responses to the externality problem have been developed and are already in place, and that the review is not a complete reassessment of whether a problem does exist, indicates that the Government has at least implicitly assessed that a market failure of some material nature does exist. Business New Zealand has no information (subject to the consideration of the matters raised above) that would suggest otherwise, but it expects that more light will be shed on this by the health modelling being undertaken by the review team.

A key issue left to be addressed is how to ensure that the solution, and who the burden of cost falls to, matches the size and nature of the problem. While the work being undertaken by the review team in fulfilling its terms of reference will shed more light on this matter, Business New Zealand has some practical observations to make in this regard.

### The Current Policy Response and Associated Pitfalls

If PM<sub>10</sub> levels track on or above the straight or curved line path, councils will not grant resource consents for any process that makes the levels worse. However, the resource consent can be granted if the proposed emissions are offset by reductions elsewhere in the airshed (in other words where the net result of all activities in the airshed results in an improvement in air quality). After 2013, no resource consents to discharge PM<sub>10</sub> will be granted if the air quality standard is still being breached.

This directly impacts on both existing and new business. However, the Ministry for the Environment's own information on the regulations states:

“PM<sub>10</sub> comes from the burning of fuels such as coal, wood, oil, petrol and diesel. *The main sources in the urban environment are home heating and vehicles, as well as some industrial processes.*”<sup>2</sup> (emphasis added)

Without prejudging the work of the review team, particularly in its consideration of the matters raised by Business New Zealand above, Business New Zealand fails to see how it is appropriate for business to face a potentially significant cost for a problem that is largely not of its making. Such a potential outcome has the strong appearance of being inefficient with households and vehicle users able to externalise their costs on to the productive sector. This means that all sectors are likely to produce a suboptimal level of pollution – business are likely to produce less than is efficient while households and vehicle users are likely to produce more.

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<sup>2</sup> Ministry for the Environment website <http://www.mfe.govt.nz/laws/standards/airsheds/index.html>

Business facing an inefficient signal has a number of undesirable effects.<sup>3</sup> These are:

- a. it may appropriate the property rights of existing businesses. In other words, the rights of existing businesses to pollute has become *more* constrained, and in the process asset values would be lowered in a way that shareholders could not have anticipated at the time of the investment. Existing polluters have a legitimate expectation that they should retain their use rights, even in the face of a new need to constrain emissions;
- b. imposing new regulatory measures on businesses without regard for the impact on property rights potentially undermines New Zealand's reputation as a place to invest. At a time where the marginal foreign direct investment dollar is at a premium (and indeed at the very time when the Overseas Investment Act is being reviewed to encourage such investment), the integrity of the New Zealand investment climate will be better sustained if the review team gives greater consideration to these issues;
- c. the blunt nature of the regulatory solution for business (an absolute cap on emissions and the inability to gain a consent if breached) has no regard for the relative performance of businesses within an airshed. Despite a business having invested in the best practicable option, it may still not gain a consent in an area because of the actions of other polluters.<sup>4</sup> It could penalise those businesses who have taken early action to reduce their emissions and reduces decisions to abate to guesswork; and
- d. there is no transparent market price on the cost of avoidance/abatement. Businesses have no ability, via mutually beneficial trading, to discover who most values the ability to emit or who can efficiently abate at least cost.

### **Moving the Issue Forward**

In practical terms, the current operation of the regulations insofar as they apply to businesses appears to be relatively muted. Emissions from business have generally not been assessed as being significant and so the effect of the regulations on consenting has been modest. While this outcome has probably been appropriate, the validity of the approach taken by some Councils is open to question. In addition, the effect of the regulations is set to become more stringent after August 2013.

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<sup>3</sup> The precise nature or magnitude of some of these effects vary depending upon the date (pre or post 1 September 2013), contaminant of concern, status of airshed, significance of discharge, approach to compliance (projected) and status of compliance (observed).

<sup>4</sup> Offsets are allowed if the increase in PM10 concentrations is significant. An example would be an industrial development helping to reduce emissions from a hospital boiler located nearby. However, the use of offsets appears to be a tool by which businesses are able to subsidise action in the sector most responsible for the problem – households.

Therefore, Business New Zealand prefers that the intended effect of the regulations on business be addressed at its root. The review team needs to demonstrate a clear linear relationship between the nature, size and net public benefit, and well targeted, proportionate solutions. To this end, Business New Zealand expects issues such as the number of exceedances, the implementation timeframe (2013 or some other later date) and who should implement the solutions to fall out of the review team's work.

However, given the issues raised above, Business New Zealand considers that the review team faces an extremely high burden of proof to show that the current regulations, insofar as they will or may impact on business, is not inefficient and need to be changed.

Without prejudicing the outcomes of the review team, Business New Zealand would expect the solution-set for business to rest somewhere in the realm of:

- a. the complete removal of the regulations as they apply to businesses with a solution better targeted at households and/or vehicles; or
- b. their application to new businesses only (as a means of transitioning in their application); or
- c. the application of carefully targeted regulations to specific new businesses; or
- d. the gathering of more emission data on which to base future regulatory intervention.

Irrespective of where the eventual solution lies, regional councils and territorial authorities in airsheds affected by PM<sub>10</sub> targets should be required to draw up a strategy for how the targets are going to be met and to demonstrate compliance with that strategy or face sanctions. This will put some tension on the councils to target the specific problems in their airshed, be they domestic, vehicles or industrial. The strategic plans prepared should be reviewed and signed off by the soon to be established EPA to ensure that costs are fairly shared among those who are responsible for the problem or at least the sector that is responsible.

Finally, if the eventual solution does involve business, and the compliance timeline is extended then serious consideration should be given to either:

1. a mechanism to compensate businesses who have recently consented and have been required, as a part of the consenting process to incur material expenditure on meeting new, more stringent air quality standards based on the current regulations; or
2. the ability to change the compliance timelines (and therefore cost) that have been built into the consents.

## **A Point on Process**

Business New Zealand notes that the last step in the review team's process is to report back to Cabinet on the outcomes of review in February 2010. Consistent with good public policy development processes, it is Business New Zealand's expectation that there will be a subsequent process in which to provide comment on the revised draft regulations that emerge from the review.

## **Summary**

Inefficient (i.e. poorly targeted) regulations act as a drain on the economy by distorting resource allocation and reducing overall economic welfare. Therefore Business New Zealand welcomes the review of the air quality regulations. Such a review, while warranted on its own merits, is even more vital in the current economic environment, when many businesses are simply struggling to survive.

While the provision of certainty for business across New Zealand was a factor motivating policy makers in the design of the regulatory approach to address the problem, its application is blunt and ill-conceived.

Business New Zealand urges the review team to think more carefully about the issues in terms of the nature and size of the market failing. This approach is likely to result in an appropriate regulatory response to business emissions that is better directed at the source of the problem, measured in its application, and proportionate (both to the size of the problem, and to its source).

Business New Zealand looks forward to working with the review team and Ministry for the Environment to ensure that an appropriate outcome is reached.

Yours sincerely



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Business New Zealand

## **APPENDIX: Background Information on Business New Zealand**

Business New Zealand is New Zealand's largest business advocacy organisation.

Through its four founding member organisations – EMA Northern, EMA Central, Canterbury Employers' Chamber of Commerce and the Otago-Southland Employers' Association – and 70 affiliated trade and industry associations, Business NZ represents 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 NZ contributes to Governmental and tripartite working parties and international bodies including the International Labour Organisation, the International Organisation of Employers and the Business and Industry Advisory Council to the Organisation for Economic Cooperation and Development.