

Submission

by



to the

**Finance and Expenditure Select
Committee**

on

**'Climate Change Response (Moderated
Emissions Trading) Amendment Bill'**

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**‘CLIMATE CHANGE RESPONSE (MODERATED EMISSIONS TRADING)
AMENDMENT BILL’**

SUBMISSION BY BUSINESS NEW ZEALAND¹

1. INTRODUCTION

- 1.1 Business New Zealand welcomes the opportunity to comment on the Climate Change Response (Moderated Emissions Trading) Amendment Bill before the Finance and Expenditure Select Committee (the ‘Committee’).
- 1.2 This Bill has been keenly awaited by business and Business New Zealand is pleased it shows the National-led Government has been listening to the needs of business in its redesign of the scheme.
- 1.3 Business New Zealand supports the overall ‘shape’ of the proposed amendments. It reflects a more balanced climate change strategy while retaining the incentive for businesses to reduce their carbon emissions and energy intensity.
- 1.4 However, some residual concerns remain. These concerns relate to the cut-off point of eligibility and its potential affect on trade-exposed businesses, particularly small and medium-sized businesses, whose activities do not qualify for compensation, and are energy, but not carbon-intensive.
- 1.5 Business New Zealand also has some concerns about the haste with which this amending Bill is moving through its legislative process.
- 1.6 Business New Zealand appreciates that the complex package of design features has required trade-offs. Winners and losers are inevitable. However, while features such as the price cap, progressive obligation and adoption of Australian activity and intensity standards soften the transition and make the scheme easier to introduce quickly, they do not absolve policy makers from ensuring the policy framework is fit for New Zealand business circumstances and durable in the long-term. They simply defer the need to address the underlying problems. However, the impact for businesses commences from day one.
- 1.7 In the absence of sufficient time to address such issues and a lack of concerted action by New Zealand’s trade-competitors, it is vital that the Bill ensure the scope of eligibility for protection against a loss of value, is sufficiently broad.
- 1.8 Business New Zealand wishes to appear before the Committee to speak to this written submission.

¹ Background information on Business New Zealand is attached in the Appendix.

2. SUMMARY OF RECOMMENDATIONS

2.1 The following table summarises Business New Zealand’s view of the overall package of amendments set out in the Bill.

<u>Feature</u>	<u>Business New Zealand Position</u>
Overall ‘architecture’ of the proposed amendments	<p>Business New Zealand strongly supports the key proposed design features. These are the:</p> <ol style="list-style-type: none"> 1. transitional features (price cap and progressive obligation); 2. slower phase-out of industry support; 3. intensity-based method of support for trade-exposed businesses; and 4. delayed sector commencement dates. <p>These design features ensure a balanced, more proportionate transition into a full trading scheme than the current Act. But importantly, they retain the marginal incentive to abate in a more comprehensive manner than any other active trading scheme.</p> <p>The availability of other design features (unfettered access to Assigned Amount Units or ‘AAUs’ and borrowing) would further enhance the overall design.</p>
Eligibility for industry support	<p>Business New Zealand considers that the Bill should adopt a more precautionary approach to managing competitiveness-at-risk issues (including, but not solely carbon leakage). While these issues are thought by some to be minor (particularly in light of the above design features) and that compensation should be tightly targeted, Business New Zealand considers that the asymmetric nature of the risk related to under-allocation versus over-allocation warrants a broad-based provision of support.</p> <p>Business New Zealand proposes that the Bill be amended to provide for a single tier at a lower rate of CO₂-e per \$NZD million revenue or value-added <u>and</u> allow for trade-exposed firms who can demonstrate that they have been materially disadvantaged by the introduction of the scheme. Such support is vital to the protection of existing firms’ property rights and the maintenance of New Zealand’s reputation as an investment destination.</p>
Legislative process	<p>Business New Zealand is concerned about the haste with which this amending legislation is being moved through the House. This concern is amplified by the uncertainty surrounding the final form of the Australian Carbon Pollution Reduction Scheme (the ‘CPRS’) and the absence of progress towards the implementation of economy-wide trading schemes in other jurisdictions before Copenhagen.</p> <p>Business New Zealand proposes the issue of sector entry be dealt with separately from the more substantive issues and that more time allowed for businesses to understand the implications for them of the new approach to eligibility and industry support.</p>

- 2.2 Overall, Business New Zealand considers that the changes proposed are positive. They appear to reflect a better understanding of the needs of business in difficult economic circumstances, and the uncertainty that exists regarding the shape of the successor arrangement to the Kyoto Protocol.
- 2.3 There is no free lunch for business. The amendments still reflect the introduction of a price of carbon into the economy. New Zealand is the first country outside of the European Union to have an emissions trading scheme and the only country in the world to have an all sectors, all gases scheme.
- 2.4 The revised scheme temporarily lowers the marginal cost faced by businesses and consumers but does not remove it. Both are appropriate. Some businesses will face a transition from a moderate to increasingly stringent price signal and the incentive, on every unit of production to either abate, or face the cost of carbon. Yet others will face a cost from the outset of the scheme with no regard to their competitive situation.
- 2.5 This Bill will cement in place the process of adaptation to a low carbon economy. It signals that the time is rapidly approaching for those who have already moved to become more carbon efficient to have that effort rewarded, while for others who have not, to face the reaction of their consumers. For others still, it will allow new business opportunities to be realised. Business New Zealand welcomes this evolution.

3. DESIGN CHANGES REFLECT A MORE BALANCED, PROPORTIONATE APPROACH

- 3.1 This section outlines Business New Zealand's views on the overall shape of the proposed amendments.
- 3.2 Business New Zealand welcomes the Bill as a more balanced, proportionate approach to the introduction of a price of carbon than the current scheme. In Business New Zealand's view, the overall architecture of the revised scheme provides, relative to the status quo, a more considered balance of the costs and opportunities that arise from the introduction of a price of carbon.
- 3.3 While emitters should not be expected to bear full responsibility for New Zealand's emissions simply because it is easy to do so, it is however, important that businesses do their fair share and contribute to the evolution of the economy. Business New Zealand considers that the proposed amendments better reflect this.

- 3.4 In Business New Zealand's view, the design changes proposed in Bill:
- a) recognise the importance of introducing the scheme in a more measured, proportionate way;
 - b) better balance the need to take action on climate change and the need to continue to encourage businesses and the economy to grow. The burdens and benefits of action appear to be fairly allocated across the sectors; and
 - c) seek to protect businesses that are already close to world's best practice in carbon intensity which encourages industry to remain in New Zealand, and new businesses to invest.

Intensity-based Allocation within an Absolute Cap is Unworkable

3.5 Of the range of proposals contained in the Bill, the one that best reflects a more measured judgement in terms of the balance between taxpayers, businesses and consumers is the intensity-based based method of providing compensation. Business New Zealand strongly supports this proposal.

3.6 An intensity-based model without an absolute cap:

- a) retains the marginal incentive to abate (even with 100% compensation, the emission units have an opportunity cost that will incentivise efficient decisions around production or abatement);
 - b) focuses business effort on abatement opportunities and not on penalising existing business for increased production;
 - c) can accommodate (indeed, benefit) new entrants, and in doing so, encourage the use of new lower-emissions technology;
 - d) better manage price volatility (as emission unit volumes adjust up or down according to output, avoiding supply-driven price shocks such as that recently seen in the EUETS); and
 - e) recognises early action (to the extent that businesses are performing better than the representative activity allocative baseline).
- 3.7 However, an absolute cap on the total available number of units able to be allocated to businesses is preferred by some parties. They see the absence of an absolute cap as an 'open-cheque' for business to emit at will.

3.8 The points set out immediately above should show that an intensity-based model without an absolute cap is to be preferred. It is also worthwhile noting that:

- a) an intensity-based allocation within an absolute cap is unworkable from a practical point of view (unless the cap is sufficiently high so as not to bite). Within an absolute cap, every businesses allocation would be dependent upon what is happening to the production levels of all other businesses. In other words, as each businesses output grows or shrinks, the allocation available to every other business also grows or shrinks. Putting aside the matter of sheer administrative complexity in managing this, such an approach would create significant out-year allocation uncertainty and would be likely to damage New Zealand's investment prospects relative to the Australian CPRS;² and
- b) New Zealand's industrial output is not growing strongly. The use of an intensity-basis without an absolute cap is unlikely to expose the Government to a significant fiscal risk in the short term.

3.9 As is true of most aspects of the design of a complex economic instrument, the arguments about intensity within, or without an absolute cap boil down to an argument about the stringency of the carbon price signal that is preferable for business to face.

3.10 Business New Zealand's view is that in the absence of concerted action by our trade-competitors to price carbon, a more measured initial price signal is appropriate. More information on the degree of concerted action will be known by the time of the scheme's first scheduled review and this information can be used to inform whether different judgements are preferable at that time.

Changes to Other Scheme Features will Yield a Least-cost Design

3.11 However, there are in Business New Zealand's view, additional design elements that if amended, would ensure that New Zealand complies with its Kyoto commitments at least-cost to the New Zealand community.

3.12 Business New Zealand considers that compliance costs could be lowered further by:

- a) *freeing up the use of Assigned Amount Units*: the effect of the existing provisions is to ban all foreign AAUs (irrespective of

² Evidence of a cap on emission units in the Australian CPRS is often cited as the reason for the workability of an intensity-based method of allocation within an absolute cap. However, the cap in the CPRS is a total scheme cap, and it is accepted that the level of units to be allocated to industry will grow under the intensity-based method of allocation to business.

country of origin) for use by participants to meet their NZETS compliance obligations unless regulations are drafted which specify that certain ones can be used. While the intention of the regulations is apparently to specify which AAUs are sufficiently 'greened' in order to make them eligible for use, Business New Zealand understands that there is currently no intention to develop such regulations. In any case, irrespective of the development of regulations, the practical effect of section 18CB is to act as a complete ban on AAUs.

So long as AAUs remain legitimate Kyoto units, Business New Zealand considers that their use should be a matter of choice by each business in how it wishes to meet its obligation. Business New Zealand also notes that:

- i) despite the restrictions placed on business, and associated additional costs, the Government is still able to use all sources of AAUs to meet its Kyoto obligations; and
 - ii) concerns with the use of AAUs as potentially damaging the prospects of scheme linking have clearly dissipated with the use of a price cap and limits on export of units;
- b) *allowing borrowing against future emissions liabilities*: the trading of emission units between years and between commitment periods can help manage price volatility and limit compliance costs. While banking allows any surplus emission units to be credited to future years to offset future liabilities, borrowing allows the debiting of future allocations or the addition/extension of future liabilities. Both forms of borrowing help manage price volatility and limit compliance costs because it enables participants to manage their carbon costs across compliance periods and smooth out fluctuations in costs. The benefits of borrowing are recognised by Australia where borrowing will take the form of allowing liable entities to discharge up to a certain percentage of their obligations by surrendering carbon pollution emission units dated from the following year.

3.13 A summary of Business New Zealand's position on the post amendment design of the emissions trading scheme is shown in the Table One below.

Table One: Business New Zealand Position on Design Features

Design Features	Business New Zealand support
Delay of sector entry dates	☑
Progressive obligation	☑
Price cap option	☑
Intensive-based allocation with no absolute cap ³	☑ ☑
Compensation transition path	☑
Unlimited banking	☑
No borrowing	☒
Constrained use of Assigned Amount Units (AAUs)	☒

KEY ☑☑ Strong support ☑ Support ☒ Do not support

4. PROTECTING THE PROPERTY RIGHTS OF SMALL AND MEDIUM SIZED ENTERPRISES

4.1 It is clear from the section above that Business New Zealand strongly supports the new approach to eligibility and industry support. However Business New Zealand has some residual concerns about its application. In this section Business New Zealand provides the Committee with a brief recap on why compensation is provided *per se*, and what implications that has for the design of the provisions relating to who should receive compensation.

A Recap – Why Compensation is Provided to Businesses

4.2 The concept of property rights of existing emitters and their protection lies at the heart of the rationale for compensation by way of the allocation of free emissions units.

4.3 In short, compensation is generally owed to all businesses who suffer a loss of value as a result of a new policy. A failure to compensate firms suffering a loss because of the emissions trading scheme is tantamount to an expropriation of their property rights, and likely to be damaging to New Zealand. International evidence is clear that any perceived risk of expropriation is a major influence on the location decisions of investors and on the cost of capital.

³ Business New Zealand's support for the intensity-based approach should not be interpreted as support for the way in which it has been applied. See section 4 below for a discussion on its application.

- 4.4 The introduction of the emissions trading scheme will increase existing firms' costs of production and in some cases lower asset values substantially, in a way that shareholders could not have anticipated at the time of investment. Firms may close or reduce New Zealand production due to the imposition of a price on emissions.
- 4.5 Existing emitters have a legitimate expectation that they should retain their 'first-use' rights, even in the face of a (new) need to constrain carbon emissions.⁴ Expropriation of the rights to emit without compensation would be:
- a) inconsistent with the approach taken by the New Zealand government to other natural resource issues (such as fisheries⁵); and
 - b) unnecessary to achieve the objectives of the emissions trading scheme.

Is Compensation a Subsidy from Taxpayers to Business?

- 4.6 The argument that taxpayers are subsidising big emitters is put forward by those who wish the level of compensation (under any method) to be as little as possible. More recently, it is being used to argue against the use of an intensity-based measure without a cap.
- 4.7 Such claims are without foundation, for the following reasons:
- a) the Kyoto obligation was, and remains, a national responsibility. The issue of how the costs and benefits of meeting this obligation are to be apportioned is up to the informed judgement of New Zealand policy makers;
 - b) a subsidy involves Government provision of financial assistance to individuals or firms with the intention of encouraging production or consumption. Compensation is not a subsidy;

⁴ The rule of first possession grants an ownership claim to the party that gains control before other potential claimants. The rule of first possession is deeply entrenched in Anglo-American understanding of property rights. In instances where the allocation of property rights is not yet codified, firms and individuals will have a general expectation that property rights can be established through first possession. First possession has been applied widely in both common and statute law in such varied settings as abandoned property, adverse possession, bona fide purchaser, groundwater, intellectual property, land, non-bankruptcy debt collection, nuisance law, oil and gas, pollution units, the radio spectrum, satellite orbits, seabed minerals, treasure trove, and water rights. Under the rule of first possession, existing emitters have a clear claim over rights to emit. Existing emitters own emission rights. These rights are equivalent to any other property right, and uncompensated constraint or cancellation of these rights on behalf of Government constitutes expropriation.

⁵ This 'first-right' rule has been applied in several instances where the Government has been required to establish rights to a previously open-access resource in order to manage scarcity. Examples of this include the allocation of Individual Transferable Quota (ITQ) under the fisheries management system and the first-come-first-served approach to freshwater allocation. The establishment of the ITQ fisheries management system clearly illustrates the Government's previous preference for consistency with the rule of first possession. When the New Zealand Government established privatised rights over fish stocks with the implementation of the ITQ system, it explicitly recognised the importance of use-rights established through first possession. Quotas were initially allocated on the basis of historical take, with allocations to each vessel based on the vessel's catch history.

- c) compensation is not a transfer from taxpayers to emitters. Because the right to emit resides with existing emitters, free allocation does not represent a transfer from the taxpayer to the emitter but a means of avoiding the expropriation of returns. The existing possession of rights is being respected only if compensation is provided (indeed, any uncompensated restriction of emission rights represents a transfer from the emitter to the taxpayer); and
- d) under the Kyoto Protocol, New Zealand has been assigned a level of free AAU's equal to a five year allocation of its 1990 level of gross emissions (61.9m pa). It is these free units that are being allocated by the Government in order to protect the property rights of business.

4.8 The argument about how much of 'subsidy' there will be in the out-years of the compensation profile out to 2050, also misses the point. There are two levels to this:

- a) figures recently released by the government show that while the new design does have a fiscal impact, the counterfactual against which it is being measured is the scheme designed by the previous government. Overall, the figures show that the introduction of the amended scheme is still expected to be fiscally positive. In addition, the emissions trading scheme income foregone has to be considered in the context of the quality of the spend that might have otherwise occurred and the benefits associated with the competitiveness-at-risk avoided in the revised scheme; and
- b) if there is widespread global agreement of the need to take action and the development of a global price of carbon, the level of compensation can be phased out as competitiveness-at-risk concerns diminish. But the reverse is also true. If there is no global action, then it is also highly unlikely that a domestic trading scheme would be warranted. Again, in this scenario, compensation would not be required.

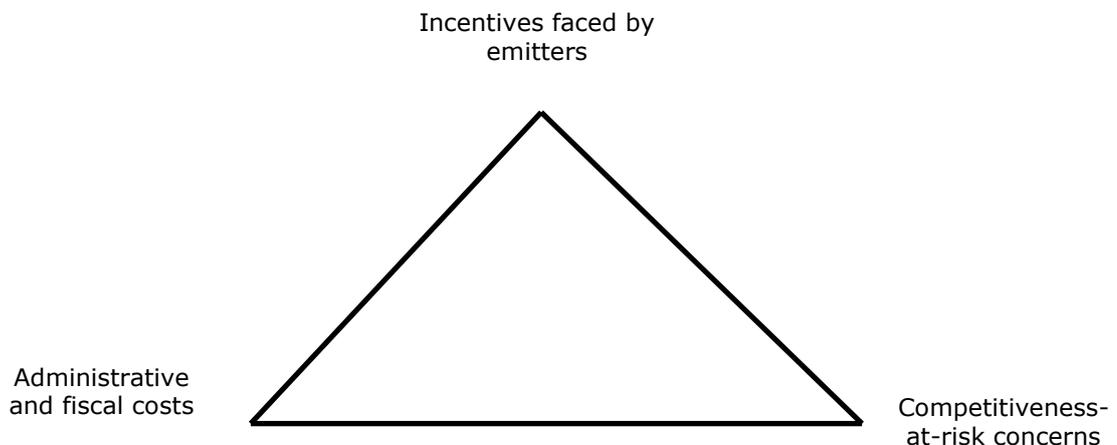
4.9 Fundamentally, the rhetoric of "it's either taxpayers or businesses" is not particularly helpful to the debate on climate change strategy. Any benefit to taxpayers of avoiding the cost of the obligation by increasing the cost faced by business is ultimately likely to be borne by them anyway as employees, as businesses reduce or defer production, permanently defer investment and/or close to manage the exposure.

Considerations on the Issue of Eligibility Thresholds

4.10 On the basis of the property rights arguments made above, all firms who suffer a loss of value as a result of the introduction of the scheme

should be entitled to receive full compensation. However, Business New Zealand appreciates that this would be expensive and substantially dampen the incentive to become more carbon efficient.

- 4.11 By linking the provision of compensation for loss of property rights to production, this both enables compensation to be targeted and helps achieve the policy objective of avoiding competitiveness-at-risk (of which carbon leakage is a specific example).
- 4.12 As is true of other aspects of scheme design, Business New Zealand also recognises that informed judgements need to be made as to where the 'line' should be drawn. Business New Zealand characterises the particular elements of the judgement required as follows:



- 4.13 While by necessity, this characterisation is overly simplistic, the point is that trade-offs between each of these elements is required and pressure applied to one element has an impact on the other two. For example, placing greater emphasis on avoiding competitiveness-at-risk concerns comes at the trade-off of *reducing* the incentives faced by emitters and *increasing* administrative and fiscal costs.
- 4.14 Ultimately where this trade-off should be balanced is an extremely difficult policy judgement. The Report of the Emissions Trading Scheme Review Committee outlined its view of the trade-off as follows:

“The provision of assistance to the wrong firms (those not significantly at risk or those that would not be viable in the end) could increase the overall cost to the economy. It is difficult to determine exactly how firms would be affected by the introduction of a price on carbon, and how they would respond. An assistance package would probably involve a trade-off between providing broad assistance only to the firms that New Zealand wishes to retain in the long term, and providing very targeted assistance, which risks misjudging which firms will be more beneficial to New Zealand in the future.”⁶

⁶ Report of the Emissions Trading Scheme Review Select Committee report entitled 'Review of the Emissions Trading Scheme and Related Matters', page 56.

- 4.15 Information distributed at the time of the release of the government policy positions indicate that around 65 trade-exposed, carbon intensive companies will be eligible for compensation (up from approximately 21 under the current scheme).
- 4.16 In terms of business demographics, Business New Zealand notes that:
- a) New Zealand has 230 private sector businesses that employ 500 employees or more;
 - b) there are 12,127 private sector businesses that employ 20 employees or more;
 - c) businesses that employ 20 employees or more account for approximately 60% of the economy's total output; and
 - d) while not all businesses are trade-exposed, or carbon intensive, the results of the 2008 Business Operations Survey showed that 29% percent of respondents with staff of 100 or more indicated that they exported goods or services.⁷
- 4.17 Business New Zealand acknowledges that the combined effect of the price cap and progressive obligation are intended (at least in the short term) to act as mechanisms to provide all businesses with a level of protection, even before compensation.
- 4.18 Even with the price cap and progressive obligation there is a significant lack of understanding regarding how the effect of this new intensity-based economic instrument on businesses will actually play out in practice, particularly when done ahead of trade-competitors.
- 4.19 Therefore, Business New Zealand is not convinced that the right balance has been reached between all trade-exposed firms who will suffer a loss from the introduction of the emissions trading scheme on the one hand, and trade-exposed, carbon intensive firms on the other hand (as reflected in the two CO₂-e thresholds).
- 4.20 Despite the absence of sufficient information regarding who undertakes an eligible activity and therefore is eligible for compensation, and who will, by definition not be eligible, the Bill contains no flexible mechanism that would allow the Minister to provide compensation to any business other than one that undertakes an eligible activity (either in New Zealand or Australia).
- 4.21 The absence of a definitive view of the impact of the new intensity thresholds is supported by work undertaken for the Emissions Trading Scheme Review Select Committee. NZIER and Infometrics noted that

⁷ Ministry for Economic Development report entitled 'SMEs in New Zealand: Structure and Dynamics 2009', dated August 2009. The Business Operations Survey had a response rate of 81.1%, representing approximately 36,000 businesses.

it is difficult to “assess the degree to which the competitiveness of any particular industry in New Zealand is truly at risk, or for how long a period of time.”⁸

- 4.22 While this sentiment has apparently been relied upon by policy makers to narrow the availability of compensation, Business New Zealand argues that it is this very difficulty that suggests that policy makers should take a more precautionary approach to the provision of compensation, especially in the scheme’s first few years of operation.
- 4.23 This view is reinforced by the asymmetrical nature of the risks associated with the provision of compensation. 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 (the competitiveness-at-risk concern).
- 4.24 Trade-exposed businesses are likely to be extremely vulnerable to minor increases in costs that they are unable to pass on. The closure of businesses, or the loss of the marginal investment dollar to a jurisdiction that does not price carbon, is likely to be extremely difficult to reverse even once there is widespread carbon pricing.
- 4.25 This too suggests that the allocation methodology should err on the point of being too generous rather than less generous in the scheme’s early years, or at least until there is an even adoption of a global price on emissions. This point, in turn, is supported by the current projections of New Zealand’s net position as at 2012. From a policy perspective, the intention should be to ensure that sufficient units are being allocated to prevent competitiveness-at-risk issues arising, as that is the point of the exercise – you can not have exposure to the price of carbon *and* prevent competitiveness-at-risk concerns.
- 4.26 While not relevant to the detail of the Bill, two other inter-related arguments have been brought to bear in an effort to narrow the scope of compensation even further than that envisaged in the Bill, these being limiting the use of compensation:
- a) as a tool to speed the introduction of new, low carbon technology; and
 - b) to aid in the process of economic adjustment (references to the removal of supplementary minimum prices and trade-liberalisation are used in support). This is reflected in the Select Committee report quoted above, where it says:

“An assistance package would probably involve a trade-off between providing broad assistance only to the firms that New Zealand wishes to retain in the long term,....”

⁸ NZIER and Infometrics report to the Minister for Climate Change Issues entitled ‘Final Report, Economic Modelling of New Zealand Climate Change Policy’, dated 28 May 2009, page 18.

and

“It is in New Zealand’s interests to optimise its economic structure for the international environment, regardless of whether that environment is “fair” “⁹

4.27 Both ignore the protection of existing private property rights that lies at the heart of the rationale to compensation. More specifically:

- a) to move to a low-carbon economy, a major step-change in technology is required in order to make significant emission reductions. While new, low carbon technologies do exist, much of it is years, if not decades from commercialisation. Forcing businesses to face a high carbon price signal may make this technology commercial in New Zealand but does not change behaviour in other jurisdictions where it will be business-as-usual and where local production will shift to in order to avoid the cost. This is not consistent with encouraging an efficient evolution to a low carbon economy. This needs to be seen against the back-drop of New Zealand industries already operating at or about world’s best practice and the high proportion of electricity being generated from renewable sources. These factors make the prospect of easy gains from low-hanging fruit from the low-cost application of new technology unlikely and substantially increase the risk of competitiveness-at-risk concerns arising; and
- b) there are a couple of aspects to the ‘economic adjustment’ argument:
 - i) compensation should not be used as a tool to determine which business sectors should, or should not survive but about the protection of private property rights and New Zealand’s reputation as a sound investment destination. Who receives compensation should be even-handed with the market (and not officials) working through the impact of a carbon price signal; and
 - ii) forcing business to face a cost not being faced by their competitors means that you could lose exports from sectors that would still be competitive if all countries faced the same price of carbon. This is not about whether the introduction of a carbon price is fair, but about whether the introduction of a carbon price ahead of New Zealand’s trade-competitors does in fact “optimise its economic structure for the international environment”.

⁹ Ibid, Report of the Emissions Trading Scheme Review , page 56.

The Case of Low Carbon, High Energy-intensive SMEs

- 4.28 The analysis above seeks to make a case for policy makers to err on the side of more generous compensation *per se*. This is important when considering eligibility for compensation for trade-exposed carbon-intensive businesses that do not meet the emissions intensity test or have no equivalent activity specified in the Australian scheme.
- 4.29 However, other than the new design features, no explicit regard is given in the Bill of the impact of the eligibility provisions on low carbon, but high energy intensive, trade-exposed businesses. As noted above, the Bill contains no scope to include in the list of specified activities any that are not intensive (as defined). These are likely to be SMEs in the manufacturing sector such as sawmillers, iron foundries, textile manufacturers, large engineering shops and food processors. This impact seems counter-intuitive at a time when significant policy emphasis is being placed on how to enhance growth opportunities from high-value manufacturing services.
- 4.30 A low carbon, high energy-intensive trade-exposed business that uses, for example, 8GWh electricity pa faces an additional cost of around \$80,000 pa (based on an increase of 1c/KWh). This cost potentially doubles once the price cap and progressive obligation roll-off at the end of 2012.
- 4.31 Whether low carbon businesses were also ineligible for compensation under the Act as currently in place, is largely irrelevant in Business New Zealand's view. The Select Committee now has an opportunity to rectify a bad policy outcome for these energy-intensive businesses.
- 4.32 Similar to lower carbon intensive businesses, there appears to be no public policy case to not compensate these trade-exposed firms as they also suffer a loss of property rights. However, quite apart from concerns over property rights, Business New Zealand maintains that the likely impact of the Bill's proposed eligibility criteria on these firms will be inequitable.
- 4.33 In fact, any climate change related public policy rationale for excluding these businesses from compensation rests on extremely shaky foundations. Being low carbon intensive, their exposure comes from the higher costs they will face from their upstream energy (electricity, gas and fuel) providers. The presumption of carbon-cost pass through from the upstream providers implies that the burden of adjustment fully falls on these businesses as their trade-exposed status means that they are unable to pass these costs through to their consumers.
- 4.34 However, the nature of these businesses limits their options to respond. Increasing their energy efficiency will help but this option is subject to capital constraints and plant age considerations. Reduced production or closure, are real options. The effect of such a policy is to penalise

firms who invested at a time when climate change was neither known, nor understood, while delivering the worst possible outcome at the worst possible time of job losses, wealth destruction and local community collateral damage for no direct material carbon reduction benefit.

A More Measured Approach to Protecting Trade-exposed Businesses

4.35 In light of the analysis set out above, Business New Zealand considers that a better, more measured approach to eligibility for compensation would be as follows:

- a) the use of a single tier emissions intensity threshold of say 500 tonnes of CO₂-e per \$NZD1million revenue or a suitably calibrated value-add metric (with the actual thresholds in tonnes being based on the outcome of analysis of officials which has been subject to scrutiny). Use of both a lower carbon-intensity and value-add metric would better reflect the emission profile of New Zealand's trade-exposed industry relative to Australia's (which has a larger number of higher carbon-intensive businesses), and avoid exclusion of some of New Zealand's largest trade-exposed businesses.

Activities that qualify should receive assistance commencing at 90% of the allocative baseline, declining thereafter at the rate of 1.3% from 2013. This approach would better reflect the lower average carbon intensity of New Zealand businesses relative to that of Australia and is consistent with the recommendation for a single tier of the Stationary Energy and Industrial Process Technical Advisory Group (the 'SEIP TAG')¹⁰; and

- b) given the pervasive nature of this economic reform, and the uncertainty of its effect on existing businesses, some form of broader safety-net is appropriate. Business New Zealand proposes the inclusion of a provision that allows for all other existing trade-exposed firms to apply for compensation should they be able to demonstrate that their costs have risen over a specified monetary threshold as a direct result of the commencement of the trading scheme. Under Business New Zealand's approach, a business able to apply for the safety-net assistance would be one that:
 - i) carried out a trade-exposed activity at any time in 2009; and
 - ii) undertook an activity that was trade-exposed in 2009, unless in the Minister's opinion:
 - there was no international trade of the output of the activity across oceans; or

¹⁰ Report of the Stationary Energy and Industrial Process Component of the New Zealand Emissions Trading Scheme, Technical Advisory Group Final Report, dated October 2008, page 11, recommendation 9.

- it was not economically viable to export or import the output of the activities, and
- iii) carries out the same trade-exposed activity in the year in respect of which it requests safety-net assistance; and
- iv) the cost increases caused by the emissions trading scheme (defined below) incurred in carrying out the activity in the relevant year exceeds \$50,000 (the threshold cost increase).

Compensation could be applied for in any year in which the person carries out the same trade-exposed activity. In order to provide an efficiency driver, the amount of assistance to which the person is entitled would be calculated as 90% (declining in each year after 2012, by 1.3%) of the carbon intensity of their energy use.

- 4.36 More generous compensation is not intended to imply that businesses do not need to adjust to a carbon constrained economy. Quite the reverse. Firms who can adapt their businesses are already active at doing this. A more generous compensation simply protects the property rights of those who are unable to adjust as rapidly as others while protecting jobs and local communities.
- 4.37 Business New Zealand recognises that its proposal may result in a short term increase in fiscal cost but considers that this is likely to be out-weighed by its long term economic benefits. On balance, Business New Zealand considers that more generous allocation provisions are warranted until more information about the state of the global trading market, and the degree of concerted action by New Zealand's trade-competitors is known. This is reinforced by the state of the current economic circumstances.
- 4.38 Finally, Business New Zealand notes that a review of the scheme is intended in 2011. This review would appear to provide a good opportunity to reassess the proposed alternative basis of allocation should it be found to be overly generous in light of action by our trade-competitors.

Assisting SMEs to Improve their Energy Efficiency

- 4.39 Irrespective of the degree to which the Select Committee finds the arguments above for a broader eligibility for compensation compelling, Business New Zealand considers that greater policy emphasis needs to be given to supporting SMEs to become more energy efficient. Such an emphasis would merely be heightened were eligibility for compensation not be extended to low carbon, high energy-intensive SMEs.

- 4.40 Business New Zealand notes that as a part of the Ministerial Review of the Electricity Market that EECA is to be reviewed. With the addition of the Budget 2009 four year funding of \$323.3 million to fit homes with insulation and clean heating devices such as heat pumps and approved wood burners, EECA becomes a \$100 million per annum plus entity and it is appropriate to undertake a strategic reassessment of it.
- 4.41 While outside the immediate scope of the Bill before the Select Committee, Business New Zealand would support targeted assistance aimed at supporting trade-exposed SMEs as they adjust to the new incentives they will face.

5. PROCESS CONCERNS NEED TO BE ADDRESSED

- 5.1 This section outlines Business New Zealand's views on the process surrounding the passage of the Bill through the House.
- 5.2 Business New Zealand is concerned about the speed with which the proposals – which represent major design changes to the scheme, particularly around unit allocation – are being moved through the legislative process. Business New Zealand's particular concern is the lack of a suitable opportunity for businesses to review and understand how the new eligibility and allocation provisions will work in general, and for individual businesses more specifically. The fact that businesses have had a number of years to understand the implications of the introduction of a carbon price *per se* does not detract from this point.
- 5.3 Relying on the CPRS provides Business New Zealand with no comfort in this regard. While undoubtedly the framework set out in the CPRS is an improvement on that set out in the current Act, this does not mean that it is going to be appropriate to the circumstances of our domestic business. Mitigating the risk of 'jurisdiction shopping' by investors is desirable, but care needs to be taken in tying the future of New Zealand businesses into a scheme clearly designed for Australian conditions. Doing so risks the dilution of New Zealand's economic sovereignty.
- 5.4 But this appears to be the reality. Emissions trading bulletin No 12 states that:

“In practice, it is unlikely that a New Zealand-specific activity definition will be developed unless a corresponding CPRS activity definition has not been developed or the inputs, outputs, or chemical/physical transformation described in the CPRS definition is materially different from the relevant New Zealand activity.

In the short run (up to 2013), given the focus on establishing the systems necessary to operate the free allocation provisions and improving data quality and the transition phase, activities in New

Zealand would need to differ in a very substantial way from those in Australia for this to be considered material.”¹¹

5.5 The expectation is that firms who initially are not eligible for compensation or eligible at the 60% level, will simply need to wait for the outcome of the review in 2011. This may be too late for some businesses that in the meantime have had to compete with overseas businesses that have not faced similar costs.

5.6 Nor does reliance on the CPRS provide a good rationale for rushing consideration of the Bill. As noted by the Treasury in the Regulatory Adequacy Statement:

“there is no discussion of the risks of harmonising with an overseas scheme that has not yet been finalised or agreed and may yet be subject to significant revision. Such risks may include the potential impacts on business certainty and investment decisions, and the overall credibility, sustainability and effectiveness of the NZ ETS”¹²

5.7 Business New Zealand shares these concerns.

5.8 A desire to have a scheme in place before Copenhagen also now seems of less vital in light of international developments. Neither the CPRS nor the American proposed scheme is likely to be passed into law by that time. In concert with these two schemes, a revised New Zealand scheme may have gained some recognition. Without them, it is harder to discern the benefit.

5.9 Given the current uncertain state-of-play with respect to international developments, the advantages of waiting until after Copenhagen before finalising the amended scheme may well outweigh the disadvantages.

5.10 Finally, Business New Zealand understands that a number of drafting changes are already in the pipeline, with more likely to follow as a result of the select committee submission process. It would be Business New Zealand’s strong preference that the process that occurred in the last stages of the current Act, with a substantial number of amendments made by Supplementary Order Papers, be avoided. This process is neither transparent, nor conducive to good policy outcomes.

A Suggested Alternate Process

5.11 The concerns around eligibility for compensation and adoption of CPRS activity definitions and a desire for a more transparent process leads Business New Zealand to suggest an alternative process path to that on which the Bill is currently set.

¹¹ Emissions Trading Bulletin entitled ‘Industrial Allocation Update’, No 12 dated September 2009, page 3.

¹² Climate Change Response (Moderated Emissions Trading) Amendment Bill, Explanatory note, page 12.

- 5.12 One way to ameliorate the haste would be to delay the stationary energy and industrial process sectors a further six months, to 1 January 2011. The CPRS is not expected to come into effect until that date and the emissions trading scheme is aligned to the CPRS in most other regards.
- 5.13 However, irrespective of whether a further delay to the sector entry date occurs, Business New Zealand suggests that the issue of sector entry dates be dealt with separately to the more substantive amendments. This would allow extra time in which a revised draft Bill that addresses the substantive changes could be released for a further round of submissions. This could be accompanied by an exposure draft of the supporting regulations. This would enable businesses to see the changes as a package and allow a clearer understanding to emerge for business regarding whether their activities are, or could be eligible and enable them to participate in the process in a more informed way.
- 5.14 It is preferable that businesses are able to understand what their allocations will, or will not be before their entry into the scheme. However, there is a potential trade-off between longer, more informed participation in, and understanding of the eligibility process, versus allocation to businesses by the sector entry date should this be retained at 1 July 2010.
- 5.15 Finally, allowing more time for the consideration of the issues does not mean that the economic evolution is delayed. Two points are pertinent in this regard:
- a) there is a credible political commitment to the introduction of a carbon price into the economy. New business investment decisions are being made now with this commitment in mind. This should be sufficient to ensure that new business opportunities come forward irrespective of a legislated scheme. Absent the price cap, the scheme itself provides no certainty of the long term price of carbon. This, like other factors needs sensitivity analysis; and
 - b) it is important to remember that customers drive business behaviour. It is easy to lose sight of this in the debate about a particular mechanism. Business is being told by its customers now that the greening of business and trade is real (one just needs to think of the recent palm oil example, or on a more positive note, the recent Air New Zealand decision regarding and the investigation of biofuel use and the use of winglets). Both are a reflection of a real and sustained shift in consumers' attitudes and businesses reacting to it. This isn't about carbon pricing and the timing of its introduction – just delivering a better service, that consumers want now.

6. OTHER ISSUES

6.1 This section outlines Business New Zealand's views on a range of residual matters that warrant the Select Committee's attention. These issues are:

- a) *the need for an independent regulator*: the explanatory note to the Bill states that:

"It is intended that certain functions relating to the assessment and processing of individual applications for allocation will be transferred to an Environmental Protection Agency at some point after it is created. It is also likely that other NZ ETS administrative functions will be transferred to that Environmental Protection Agency."

Business New Zealand understands that the Environmental Protection Agency's (the 'EPA's') establishment as part of the Resource Management (Simplifying and Streamlining) Amendment Act that recently came into effect was driven more about concerns with the Ministry for the Environment's focus and the effectiveness of the resource consent process. As such, Business New Zealand is not immediately convinced that the Environmental Protection Agency is the appropriate 'home' for the emissions trading scheme functions. Given the value involved in the allocations, Business New Zealand considers that there is a strong case for placing the emissions trading scheme-related functions into an independent Crown-entity, operating in a transparent manner at arms-length from Ministers now rather than waiting for the review undertaken under clause 160(5)(n). This would increase the confidence of the business sector that the functions are undertaken objectively;

- b) *the choice of baseline years for the provision of information is important*: Business New Zealand notes that the years used for the assessment of eligibility appear to be inconsistent with the CPRS. The CPRS allows for greenhouse data over the period 2006/07, 2007/08 and financial data over the period 2004/05, 2005/06, 2006/07, 2007/08 and the first half 2008/09. Also a single abnormal period can be removed. The Bill, on the other hand, uses the years 2006/07, 2007/08, 2008/09 only [Section 161A(2)(a)-(b)]. The choice of years can have significant implications for eligibility, as can the ability to take account of circumstances in which changes in commodity prices vary significantly from those recorded during this assessment time period. Business New Zealand notes that the SEIP TAG recommended that the financial years between 2005 and 2007 inclusive be used¹³;

¹³ Ibid, Report of the Stationary Energy and Industrial Process Component of the New Zealand Emissions Trading Scheme, page 12, recommendation 11.

- c) *the workability of the opt-in provisions under the new sector entry dates*: on the request of prospective opt-in participants, the 12 month notice period for opt-in was waived to enable those participants to effectively opt-in from the commencement of the scheme (1 January 2010). No such waiver exists in the Bill meaning that the 12 month period is now in force for entities wishing to opt-in for their obligations from the new commencement date (1 July 2011). Business New Zealand recommends that the Bill be amended to accommodate a waiver;
- d) *the timing and terms of the 2011 review*: Business New Zealand suggests that the timing of the first scheduled review be delayed to 2012. This revised timing would allow for the review to be informed by 18 months of trading, including a full compliance year (as opposed to the compliance associated with the first six months operation of the scheme with its inevitable teething problems and anomalies). This timing would also allow information from the initial operation of the CPRS to be included.

In regard to the terms of the review, Business New Zealand notes that clause 160(5)(j)(ii) provides for recommendations on the level of assistance prescribed. However, Business New Zealand recommends that this clause be amended to read:

“(ii) the level of assistance prescribed for eligible activities (with particular reference to the level of international coverage of these activities in other carbon pricing schemes)”

- e) *scope of the five year notice period*: clause 161A(9) provides a five year protection from changes to the eligibility of activities but does not appear to afford similar protection to the allocative baseline or other allocation parameters. This is inconsistent with explanatory note which states:

“ the phase out of free allocation will also be considered through a 5-yearly review, with the first review conducted in 2011. Any significant changes to the provision of free allocation will require a 5 year notice period.”¹⁴

This statement appears to extend the scope of the protection afforded by the five year notice period to the quantitative elements of the allocation process, as well as the eligibility provisions. Business New Zealand considers this to be appropriate.

6.2 Business New Zealand looks forward to working with the Committee on the matters it has covered in this submission.

¹⁴ Ibid, Explanatory note, page 28.

APPENDIX: ABOUT BUSINESS NEW ZEALAND

Encompassing four regional business organisations (Employers' & Manufacturers' Association (Northern), Employers' & Manufacturers' Association (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 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.