Lumley House
3-11 Hunter Street
PO Box 1925
Wellington 6001
New Zealand

Tel: 04 496-6555
Fax: 04 496-6550
www.businessnz.org.nz

28 March 2013

ETS Carry-over
Ministry for the Environment
PO Box 10362
WELLINGTON 6143

via e-mail: etsconsultation@climatechange.govt.nz

Proposed Options for the Carry-over of Kyoto Units under the ETS

BusinessNZ is pleased to have the opportunity to provide a submission to the Ministry for the Environment on its consultation factsheet entitled 'Proposed Options for the Carry-over of Kyoto Units under the ETS', dated February 2013.[1]

Introduction

This issue boils down to one of legitimate expectations. Regardless of the complexion Government might attempt to give this issue, business has the legitimate expectation that based on the information to hand, the government will not impose arbitrary conditions upon them that undermine the business decisions that they have taken. Devolution of the carry-over rule to business should therefore occur unless good reason can be found not to.

This approach has not appeared to have played a part in determining the outcome. In preferring option A (no carry-over of certified emissions reductions (CERs) and emission reduction units (ERUs) by business) over option B (devolution of the carry-over rules to business), officials signal the apparent willingness of the government, as a participant in a multi-faceted market to continue to take a position that suits its own needs over those of other participants.

No concern or consideration is evident in the shedding of all transaction costs and risks associated with this issue on to private sector with disregard of property rights. This risk holds true even if a business has no desire to

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

carry-over units. Neither is it clear how this option is consistent with the scheme's objective of business being able to find the least cost form of carbon abatement. Business and government needs to liaise more closely to work these issues through.

Unfortunately these are not new concerns. Looking across the range of decisions made by government around the operation of the scheme since it was amended in 2009 the government increasingly needs to demonstrate due care and diligence in its regulatory approach. In regulating the operation of a complex and inter-linked economic mechanism, the government must show that its decisions are not capricious and self-interested, and instead, minimise uncertainty and regulatory instability and enable participants to plan investments with confidence.

BusinessNZ's comments below are framed by these concerns. Unless otherwise stated, the comments below primarily relate to consultation issue one – the entitlement to carry-over CERs and ERUs.

Comments

Before getting into the specifics of the BusinessNZ position on it, we wish to first set out two inter-related position statements that inform its response, these being:

1. it is the role of government to protect legitimately held property rights of businesses who have, under the rules set by government, purchased units on the reasonable expectation of their use beyond the 'true-up' period. Any derogation of property rights in the form of regulatory taking should be compensated for; and

2. there needs to be an efficient allocation of risk and opportunity between the various participants of the scheme.

These statements suggest that the preferred solution needs to strike a reasonable balance between costs and benefits and the legitimate expectations of business that their rights will not be unreasonably taken by regulatory fiat without compensation. BusinessNZ does not believe that this balance has been appropriately struck with option A. Indeed, it is unclear how option A is better than the status quo, as claimed, with both option A and the status quo involving the total transfer of price and volume risk on to business, and ultimately, consumers while fully preserving the government's options.[2]

[2] There are at least two dimensions of price risk – the first relating to the need to buy more expensive units (as mentioned in the factsheet), but also a second dimension, relating to the risk associated with the need to dispose of surplus units that are no longer eligible to be surrendered after 2015 into a more depressed international market (in other words, forcing business into the position of having bought dear and now selling cheap). These dimensions crystallise the value of the potential impact on private property rights and value of compensation payable, and renders any suggestion that a suitably lengthy notice period in which to trade out of a long position is costless as highly dubious.

Other reasons for not supporting option A are:

1. it would show the Government's multiple and consistent statements over the past year about why access to low cost international units was good for business, consumers and the economy to be nothing more than rhetoric, by requiring businesses to swap out any excess low priced units for the next more expensive unit.[3] The proposal seems to forget that much of what the government has done since 2009 has been targeted at maintaining unlimited access to low cost international units - but seems targeted instead at expunging this ability at the earliest opportunity;

2. it is unclear where the next, more expensive international unit is going to come from should option A be implemented. Since the Minister advised the market that the Government needed to address the issue of carry-over last October, the trading context has changed dramatically.[4] At the time, limits on access to second commitment period units were not expected. Continued and unfettered access to such units would have ameliorated a zero carry-over. But given the decisions made at Doha CoP 18, and that:

    a. no New Zealand businesses to date undertake primary CERs origination;
    b. there is still substantial uncertainty as to where the boundary between primary and secondary unit trading lies with the risks sufficient to preclude only the most risk insensitive;
    c. participation in primary CER trades involves the acceptance by the purchaser of project credit risk (of a price movement in the wrong direction causing a financial loss); and
    d. no-one, in any case, will invest in primary CERs while the price is expected to remain at or around current levels

    second commitment period units are likely to be rare in the New Zealand scheme, leaving the sellers of NZUs to set the benchmark price;

3. concerns about complexity and the administrative costs of option B are over-blown. For example:

    a. it is difficult to conceive in New Zealand's small market with its small number of account holders that it would be too difficult to develop an efficient allocation method (for example, a pro-rata amount based on the closing balance of the previous compliance year's account). This is all the more difficult to believe given that advice prepared for the Australian Department

[3] In fact, a forced requirement on those who might carry excess units held to sell them down has all of the hallmarks of a quantitative restriction which the Government just last year resiled from implementing.

[4] Ministerial press release dated 17 October, 2012.

of Climate Change in the run up to the implementation of the New Zealand scheme look-alike, the Climate Pollution Reduction Scheme, advised that the carry-over rule should be devolved to scheme participants; and

b. in terms of the consideration of administration costs, given the 'sunk' nature of the costs incurred by officials (in other words, the cost exists regardless of the type of solution implemented), they are by even the most cursory of consideration, irrelevant to the assessment of the costs associated with implementing the solution, complex or otherwise;

4. the period of time that has elapsed since the passage of the Climate Change Response Act in 2008, including section 16, Carry-over of certain Kyoto units. This section states that:

> (1) An account holder may, *subject to regulations made under this Act,* apply to the Registrar to carry-over assigned amount units, certified emission reduction units, or emission reduction units held in that account holder's holding account. (emphasis added)

In failing to develop the regulations at an earlier stage, businesses have proceeded according to their own best commercial judgement. Therefore, it is not the absence of carry-over rules that is creating uncertainty about the post true-up period but rather the fact that the rules to be written now, at this late stage, will cut across legitimate commercial decisions made by businesses in their absence since 2010. What wasn't a business problem in 2010 has been made one by the delay to act.

Is this all just a Storm-in-a Flue-stack?

BusinessNZ is aware of some businesses that have a 'long' position relative to the expected true-up date. However, it would come as no surprise to BusinessNZ that many (if not the majority of) businesses have managed the risk of trading first commitment period units beyond the true-up conservatively.

Before reaching to policy conclusions based on this observation, it is important to understand what has caused it. In BusinessNZ's view, this conservatism has little to do with the absence of carry-over rules but can be largely attributed to previous government operational policy decisions about unit acceptability and its willingness to trammel property rights. The best (or worst) example of this was the government's decision last year, in the context of restricting access to 'green' ERUs by placing an arbitrary 18 month cut-off date on existing forward contracts. As predicted by BusinessNZ at the time, in an environment already filled with regulatory risk surrounding unit acceptability, buyers would rely on spot market trades, rather than the futures market, and would not risk entering into futures unless they were for NZUs. This trend is readily observable.

Legitimate expectations, and the respect of property rights, *do* matter. Forcing business to sell units cheaply, or purchase units that are not the lowest cost has real implications in terms of deferred investment and jobs.

This is relevant to *all* participants, regardless of their likely trading position at the true-up, in terms of how future changes may be implemented and their impact on business. The downstream risk of this particular proposal is also relevant to all participants given the likely higher future cost of compliance.

Moving Beyond Principled Concerns to Practical Ones

The concerns outlined above suggest that a more targeted conversation with business would be appropriate in order to work the issues through. BusinessNZ recommends the establishment of a joint business-government group to do this.

Two key pieces of information will be required as the basis of such a conversation in order to achieve a robust, well-informed outcome, these being establishing:

1. whether there will be more or less than 15,478,000 CERs and ERUs held in the New Zealand registry at the true-up. This is important as if less than that amount, all of those units will be eligible to be carried-over into the second commitment period. If, however, the holdings of international units exceed this limit, there will be a need for clear rules to delineate which units are capable of being carried-over (volume) and the basis for the distribution (allocation); and

2. which participant (i.e. government or business) is expected to hold units that are eligible to be carried-over into the second commitment period, and on what basis (i.e. does government automatically have a preferential right over business to carry-over, and if so, would this be the most efficient outcome).[5]

It is difficult to determine which pathway forward is the most efficient with any clarity without better understanding the Government's objectives, and the risks it perceives. Greater transparency is needed around this and other matters in order to have the more productive, informed conversation sought by BusinessNZ about how to share the risks and opportunities in the most efficient manner.

[5] Our initial, high-level assessment of who will hold the units that are eligible to be carried-over on true-up is that if it is the Government's strategy to first submit RMUs, then CERs and ERUs, followed by AAUs, then it is unlikely that the Government will hold any excess of CERs and ERUs that have been surrendered to it that can be carried-over into the second commitment period. If this assumption is correct, then this would essentially make the devolution of the right to carry-over units to business costless for government and low risk.

However, having said that, based on the information to hand, *if*:

1. it is unlikely that the Government will hold any excess of CERs and ERUs that have been surrendered to it that can be carried-over into the second commitment period, and

2. there is limited demand from business to carry-over units into the second commitment period,

then it is unclear why there could not be an automatic presumption in favour of devolving the carry-over rules to business, and why a simple queuing method of allocation would not work.

As noted above, if officials' concern is about a flood of low cost units being brought into New Zealand that results in more than the carry-over rules allow, then constraints could be placed on trading to avoid this. For example, this could involve simply accepting *all* existing contracts struck regardless of their end date, or alternatively not accepting new forward contracts with an end date beyond the true-up.[6]

If the Government is serious about continuing to provide access to low cost units then the Government should be willing to offer to exchange *all* CERs and ERUs held on a certain date into NZUs at a given rate, regardless of whether the total volume of units held in the registry exceeded the carry-over limit. This would relieve any pressure to introduce auctioning, and provide a smooth landing into what will eventually become a purely domestic higher-priced scheme after the true-up. Given that New Zealand has no international obligation to meet a specified emission reduction target after 2012 (but will have a domestic, politically-binding target), and the low likelihood of international linking, undertaking an exchange would seem to be of little or no financial or environmental risk to the Government (for example, the units would still represent an avoided tonne of carbon, and therefore, an environmentally sound outcome would still result).

A Note about the Evaluation Criteria

Finally, in order to ensure a durable outcome, it is important to have clear objectives and robust evaluation criteria. The consultation factsheet states that:

> "The proposed carry-over regulations have the following objectives:
>
> 1. To increase certainty for the eligibility of CP1 Kyoto units in the ETS. This will provide market participants with the necessary information to make long-term business decisions, maximise efficiency, and minimise the risk of financial loss; and

[6] However, given the government's stated desire not to limit access to low cost units, the absence of any concerns about the environmental integrity of these units, and the risk to the buyers of units that some proportion of units they purchase becoming ineligible by forced scaling back, it is unclear why this would be a concern to officials.

2. The carry-over regulations must be written so they can be applied equitably, in a manner which is transparent and which maintains the environmental integrity of the ETS."[7]

However, these 'objectives' overlap with the evaluation criteria of efficiency, effectiveness, transparency, clarity, equity, environmental integrity, consistency with international obligations and maintenance of international reputation, making for confusion between what is being sought from the initiative and how officials will know whether it has been achieved.

BusinessNZ suggests that before choosing the best option, a clearer distinction is made between the objective (what is sought from the initiative), the evaluation criteria (how to know that the preferred option for achieving the objective has been obtained), and the design criteria (the set of desirable attributes the best option needs to demonstrate, in order to be the best preferred option). BusinessNZ suggests that the following distinction is appropriate:

The Objective

To provide market participants (including the Government) with the necessary information to make long-term business decisions, maximise efficiency, and minimise the risk of financial loss

The Evaluation Criteria

When considering public policy interventions, it is standard practice to use the orthodox economic efficiency criteria of productive (least cost), allocative (highest value use) and dynamic (innovation and investment) efficiency as the test. The use of this test is designed to establish whether the proposal is welfare enhancing (in other words, it improves overall efficiency relative to the status quo). Consideration of distributional issues such as fairness or equity, to the extent that they are not accommodated in the economic efficiency criteria, are generally excluded because they 'net off' among participants (in other words, that such effects redistribute wealth rather than grow the size of the pie).[8]

Where possible, the preferred option (the one that achieves the most efficient outcome) should then be subject to an economic cost-benefit analysis.[9]

Design Criteria

Factors such as transparency, clarity, environmental integrity, consistency with international obligations and maintenance of international reputation are

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[7] Ministry for the Environment consultation factsheet entitled 'Proposed Options for the Carry-over of Kyoto Units under the ETS', dated February 2013, page 3.

[8] In light of the above information it is likely that option A would deliver a worse dynamic efficiency outcome (in terms of a dampened incentive to innovate and invest) than option B.

[9] For information on the types of costs (including sunk costs) and benefits fto be included in such an analysis, a good starting-point is The Treasury document entitled 'Cost Benefit Analysis Primer', dated December 2005. This can be found at http://www.treasury.govt.nz/publications/guidance/planning/costbenefitanalysis/primer/cba-primer-v12.pdf.

relevant in this regard. While only tangential to the degree to with the preferred option is welfare enhancing, they are useful 'touchstones' that can be used in a qualitative sense to ensure that the preferred option is in fact the best overall option.

Summary

It is easy to imply from this proposal, when combined with earlier decisions, that virtually no transaction, past or future, by business participants in the trading scheme is safe from regulatory interference. This is unfortunate and the Government needs to work hard to demonstrate to business that it will not act solely to its own advantage and in doing so, trammel property rights of other market participants, and impose higher future costs on to the economy at a time of economic fragility. From the information to hand, it is unclear why market participants should not be afforded the opportunity to access fifteen million more low cost units to use in the second commitment period for little or no apparent risk to the government.

Instead, the proposal purports difficulty and cost where none need be. This is compounded by the fact that officials have apparently borrowed from the Australian analysis of the options but not their conclusion to prefer devolution of the carry-over rules.

BusinessNZ proposes that a more targeted conversation between officials and business is required in order to work through the outstanding issues. This is needed to reach an outcome that respects property rights and allocates the risks and opportunities in an efficient manner.

Yours sincerely

John A Carnegie
Manager, Energy, Environment and Infrastructure
BusinessNZ

APPENDIX ONE: ABOUT BUSINESSNZ

Encompassing four regional business organisations (Employers' & Manufacturers' Association (Northern), Business Central, Canterbury Employers' Chamber of Commerce, and the Otago-Southland Employers' Association), BusinessNZ is New Zealand's largest business advocacy body. Together with its 73 strong Major Companies Group, and the 70-member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, BusinessNZ is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

In addition to advocacy on behalf of enterprise, BusinessNZ contributes to Governmental and tripartite working parties and international bodies including the ILO, the International Organisation of Employers and the Business and Industry Advisory Council to the OECD.

BusinessNZ's key goal is the implementation of policies that would see New Zealand retain a first world national income and regain a place in the top ten of the OECD (a high comparative OECD growth ranking is the most robust indicator of a country's ability to deliver quality health, education, superannuation and other social services). It is widely acknowledged that consistent, sustainable growth well in excess of 4% per capita per year would be required to achieve this goal in the medium term.