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Submission on *Reforming the New Zealand Emissions Trading Scheme: Proposed Settings*
Ministry for the Environment

Submitted via email to etsconsultation@mfe.govt.nz

PEPANZ Submission: Reforming the New Zealand Emissions Trading Scheme: Proposed Settings

Introduction

1. The Petroleum Exploration and Production Association of New Zealand ("PEPANZ") represents private sector companies holding petroleum exploration and mining permits, service companies and individuals working in the industry.
2. This document constitutes PEPANZ's submission to the Ministry for the Environment on its discussion document *Reforming the New Zealand Emissions Trading Scheme: Proposed Settings*.

Key points

3. The temporary nature of the provisional emissions budget carries risk, by either:
    a. embedding short-term instability if the official budgets differ, or (on the flipside); or
    b. prejudicing and locking in the trajectory that the Climate Change Commission will set after it conducts its own comprehensive analysis.
4. Greater evidence must be provided in relation to two assumptions that underpin current policy direction, which are that:
    a. action and fast-paced changed is presumed to be the best choice, but this is not a certainty. Later action may be a better choice especially as the cost of technology decreases over time; and
    b. the ETS is seen as inadequate and complementary measures are viewed as necessary. We do not accept this view and, consider that because the ETS is currently being strengthened it should be given the chance to do its job before assuming that other mechanisms are also needed. Multiple interventions also make *ex-post* analysis of effectiveness difficult.
5. Least cost abatement is critical to maintain the competitiveness of firms and to maintain durable political support for emission reductions. We therefore observe that:
    a. marginal abatement cost curves must be treated with great caution as they only work at a static sectoral level and not at the dynamic level of the firm; and

international units are important, and especially as method to 'back up' units released under the cost containment reserve.

Policy process and the need for predictability

6. The Zero Carbon Bill and the Ministry for the Environment's consultation document on "Improvements to the New Zealand Emissions Trading Scheme"[1] (which preceded the introduction of this Bill) went through reasonable policy processes which we supported. However, we are concerned that the recent launch of concurrent policy proposals will compromise policy coherence and coordination which in turn creates unpredictability and reduces confidence that reasonable assumptions about the future are broadly likely to hold.
7. We note that in addition to the *Proposed Settings* consultation, other recent emissions policy includes consultation on the:
    a) Climate Change Response (Emissions Trading Reform) Amendment Bill;
    b) "New Zealand Emissions Trading Scheme: Modelling the electricity allocation factor: Issues paper"[2]; and
    c) "Reforming the New Zealand Emissions Trading Scheme: Rules for auctioning technical consultation document"[3].
8. In addition, we now understand that in late 2019 Cabinet agreed to a two-year review of the industrial allocation regime.

The provisional emissions budget

9. The temporary nature of the provisional emissions budget carries risk, either in terms of embedding short-term instability or (other flipside) prejudicing and locking in the trajectory that the Climate Change Commission will set after it conducts its own comprehensive analysis.
10. We note that the current discussion document:

    "proposes provisional settings for NZ ETS price controls between 2020–25. However, the Commission will provide advice to the Government in early 2021 that may include different price floor and ceiling settings."

11. This process, with its short interval between potential policy changes, may risk embedding short-term instability into the regime, as the provisional price controls may well not endure for more than a year or two. Given the multitude of policy work and forthcoming commencement of emission budget development from the Climate Change Commission, we recommend a cautious provisional budget be established at the less restrictive end of the spectrum. This comment is made relative to the discussion documents' proposal to set the Provisional 2021-25 Emissions Budget on a straight-line basis from 2022 to 2050.
12. Too ambitious a budget (especially on an arbitrary straight-line basis) implies a belief that early action is more appropriate than delayed action, as indicated in the discussion document's statement (p25) that:

    "Making emissions reductions more slowly than this straight-line approach would risk us having to make a more abrupt and potentially disruptive transition further into the future

[1] https://www.mfe.govt.nz/publications/climate-change/improvements-new-zealand-emissions-trading-scheme

[2] https://www.mfe.govt.nz/publications/climate-change/new-zealand-emissions-trading-scheme-modelling-electricity-allocation

[3] https://www.mfe.govt.nz/publications/climate-change/reforming-new-zealand-emissions-trading-scheme-rules-auctioning

13. We do not accept that early action is true simply as a matter of fact, and consider that reality is more complex and uncertain. Early action *may* be less costly than later action, but also may be more costly than later action, especially as later action allows the adoption of newly proven and commercially viable technology for which prices are widely expected to decrease. Assertions in the discussion document need to be grounded in evidence.
14. A budget that is less restrictive at the outset (but offset later in the period to get to the same straight-line point) gives time for technology to develop and become more commercially viable.

Complementary policy measures

15. The discussion document states (p28) that:

> "…ensuring that the cost-effective opportunities to reduce emissions are taken up will require more than just the NZ ETS alone – it will also require a package of suitable complementary policies.

16. We ask *why* the ETS is seen as inadequate, are needed, and consider this must be answered before going down the route of complementary measures. Our view is that decentralised, competitive energy markets are the most flexible and responsive mechanism for delivering efficient outcomes (relative to centralised control and/ or interventions. We are therefore concerned about preferences for complementary measures, as this implies that market mechanisms are longer relied upon to deliver lowest marginal cost abatement of emissions.
17. We also note that when contemplating complementary measures and interventions, it is important to consider the risk of 'government failure', whereby the cost of dealing with a market failure can exceed the cost of the failure itself[4].
18. A risk of complementary measures is that, being discrete (rather than economy-wide as the ETS is), incorrect signals are sent leading to duplication or unintended consequences.
19. With direct interventions comes costs which are imposed on consumers in a hidden manner (compared to the explicit price associated with the Emissions Trading Scheme "ETS")). We are especially opposed to bans and interventions that foreclose options or which seek to engineer specific outcomes. Lowest-marginal cost abatement cannot be achieved if imposed regulatory barriers or interventions preclude least-cost pathways from being discovered and implemented by firms.
20. Lastly, the preference to employ complementary measures does not appear to engage with the fact that recent and current proposals to strengthen the ETS, including removal of price limits and introducing a cap on the number of units available. Presupposing that further measures are needed, ahead of judging the outcomes of the ETS changes, is premature policy.

Marginal Abatement Cost Curves

21. The discussion document refers to work on marginal abatement cost curves (MACCs), and does a reasonable job of noting their limitations and usefulness. We would add that although MACCs provide static information about *sectors'* abatement costs, MACCs do not provide information at the level of the *individual firm*. Each firm will have its own MACC and the goal of the ETS is to help discover that.

[4] Sources of government failure include market distortions, welfare impacts, disincentive effects, short-termism, electoral pressure, regulatory capture and imperfect knowledge.

22. MACCs also do not account for the dynamic effects of choices as they throughout the economy. For example, the MACCs put a marginal abatement cost on reducing emissions from electricity generation, but (as well identified by the Interim Climate Change Committee), if electricity becomes too expensive due to abatement then the desirability of electrifying transport and process heat diminishes.
23. Where abatement areas of interest are present, it may be worth conducting Computable General Equilibrium modelling to look at the flow on effects throughout the economy. Given the short timeframe for the provisional emissions budget, CGE modelling is well-placed to give an accurate indication of effects on prices.
24. We are also not aware of any ground-truthing of the MACCs with relevant industry players, so unless this has happened then care should be taken before making substantive plans based upon them.
25. On the whole, decision-makers should be highly cautious of relying on MACCs to inform policy.

Costs to households

26. In addition to using CGE modelling, we note that the analysis of cost to households is just based upon specified carbon prices. However, complementary measures will have their own costs (albeit more well-hidden) and, on a best endeavours basis, we consider that the impacts of these should be included in the analysis.

International units

27. We acknowledge that the presumption against the use of international units (aka offshore mitigation) is driven by settings in the *Climate Change Response (Zero Carbon) Amendment Act 2019*. Aware of this constraint, we are still concerned about the presumption in the discussion document that "purchasing international units could delay the domestic transition".[5] Firms will look for domestic abatement opportunities in their business and then to domestic credits, so international units will only be used when cheaper domestic opportunities are not available. Domestic abatement could be achieved at lower cost as technologies develop, which is a sound reason for allowing access to international units.
28. The cost-containment reserve allows new units (beyond the capped sum) to be released when a trigger price is reached, but these units must be backed by the New Zealand Government. It is unclear where those units will come from or how they will be sourced, but we strongly consider that international units are likely to be the most cost-effective source. In the event that the cost containment reserve is triggered, the economy will likely be in a tight situation where both domestic abatement opportunities are low and where demand for units is high. If units released must be backed by domestic units then one can imagine this exacerbating the pressure on units, which may mean the pressure on price cannot be adequately released. Lower cost international units seem the obvious solution, and we therefore recommend they be allowed under the provisional budget.

Fixed Price Option

[5] As an aside, if the presumption is that domestic abatement is the priority (and offshore mitigation is therefore not preferred) then for consistency's sake, domestic offsets through trees do not make sense either. We do not make this point to suggest that trees should not be used, but they are (depending on end-use) only a temporary solution to emissions and not representative of gross reductions.

29. The discussion document proposes to increase the Fixed Price Option from $25 a unit to $35, as prices increased on the secondary market towards the proposed new limit. Even the announcement of this consideration has had a market impact which affects participants. ETS participants are, however, unable to surrender units at $25, i.e. the level of the Fixed Price Option in place when the emissions actually happened. Costs cannot be passed through as clearly contracts are forward looking and not retrospective. In short, the proposal has adversely affected current participants by having a retrospective effect on parties operating under different previous settings. Although discourse in public policy has rightly promoted predictability in settings, we do not believe this has adhered to in relation to the Fixed Price Option proposal, and we recommend that it be retained at $25 in 2021.