LAWYERS FOR CLIMATE ACTION NZ INC.

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Ministry for the Environment
Wellington
By email: etsconsultation@mfe.govt.nz

Submission on "Reforming the New Zealand Emissions Trading Scheme: Proposed settings"

Introduction

1. Lawyers for Climate Action NZ Inc. (**LCANZI**) is a society comprising over 250 lawyers and an additional number of non-lawyer associate members. Our goals are to:

    a. raise public awareness and understanding of the threat of climate change;

    b. advocate for legislation and policies to ensure New Zealand meets or exceeds its commitment under the Paris Agreement and achieves net zero carbon emissions as soon as possible; and

    c. facilitate free or reduced cost legal assistance to community groups working to fight climate change.

2. LCANZI welcomes the opportunity to provide comments on: *Reforming the New Zealand Emissions Trading Scheme: proposed settings consultation document*.

Summary of submissions

3. New Zealand's emissions trading scheme (**ETS**) is described as "our key policy tool for reducing emissions and meeting our emission reduction targets".[1] However, the ETS suffers from a number of design flaws and limitations that prevent it being effective as a carbon pricing and reduction mechanism.

4. While LCANZI welcomes the present efforts to rehabilitate the ETS, we believe it is very important to be express about its limitations. Even with the proposed changes, the ETS will continue to suffer from major flaws and will not achieve the emissions reductions that are needed to meet New Zealand's commitment under the Paris Agreement.

5. LCANZI considers that carbon pricing can and should play a fundamental role in reducing greenhouse gas emissions and responding to the threat of climate change. To achieve this, either further substantial changes to the ETS are required or else our focus should be on other policy measures, such as a carbon tax.

[1] For example, on the Ministry for the Environment's website.

6. We cannot afford to delay meaningful action on reducing emissions. It is also important that emitters are aware that the present climate response settings are likely to require a major re-set in the near future and can plan accordingly. Unless the scale and rate of change required is communicated clearly and consistently, businesses and investors are at risk of making decisions which may ultimately lead to stranded assets and / or business failure, thereby further increasing the costs of transition to a zero-carbon economy.

7. We therefore urge the Government to acknowledge the limitations of the ETS and to either:

   - undertake more fundamental reform of the ETS framework and settings to ensure that there is a genuine cap on total emissions and a meaningful pricing mechanism; *or*
   - introduce a carbon tax as the main policy tool to reduce emissions (this could be done alongside the existing ETS in order to preserve existing investments in emissions units).[2]

The objectives of the ETS

8. Carbon pricing is intended to implement the "polluter pays" principle and ensure that the full cost of emissions on the environment is taken into account in all carbon emitting activities e.g., when we decide how to travel, what to consume or how land should be used.

9. The International Monetary Fund (**IMF**) has called carbon pricing "the single most powerful and efficient tool to reduce domestic fossil fuel CO2 emissions".[3] An emissions trading scheme (ETS) is one way to implement a carbon price (a carbon tax is the main alternative). If our ETS applied to all our emissions, then (assuming effective monitoring and enforcement) emissions would be capped at a specific annual volume. In this world, supply and demand would produce the right price for emissions and abatement would occur in the most efficient ways possible.

10. According to the IMF, 13 countries have implemented a carbon tax, while a smaller number of countries, states or regional groups (6 in total) have implemented an ETS.[4]

The proposed ETS settings

11. The consultation document proposes various settings for the ETS and seeks submissions on these parameters and the method by which these are set.

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[2] This submission does not attempt to set out a fully developed proposal for a carbon tax and there are a number of issues that would be need to considered, such as the scope of application and the details of how it would work alongside the ETS (assuming that was retained). However, we believe that a carbon tax would have a number of advantages over the ETS, including simplicity, price certainty, and generation of public revenue.

[3] International Monetary Fund: *Fiscal Monitor: How to Mitigate Climate Change*, October 2019 p 3. Available at www.imf.org/en/Publications/FM/Issues/2019/09/12/fiscal-monitor-october-2019

[4] Ibid Table 1.1.

12. The proposed overall emissions budget for 2021-25 is 354 Mt CO2-e. As discussed further below, this budget appears to be too high and, in our view, is inconsistent with New Zealand's commitment under the Paris Agreement.

13. After allowing for emissions outside the ETS (203 Mt CO2-e) and free NZU allocations (44 Mt CO2-e), it is proposed that 107 Mt CO2-e worth of NZUs should be available for surrender over this period (2021-25). In order to reduce the current stockpile of NZUs (by 27 Mt CO2-e), it is proposed that the Government should make available 80 Mt CO2-e worth of NZUs for auction over this period. In addition, a $35 fixed price option is proposed for 2020 emissions, and a price floor of $20 and a cost containment reserve price ceiling of $50 throughout this period.

14. While LCANZI supports the broad direction of the proposals, we are concerned that:

    a. the budget is too generous;

    b. international transport emissions should be accounted for; and

    c. the price parameters are too low to induce the necessary abatement levels.

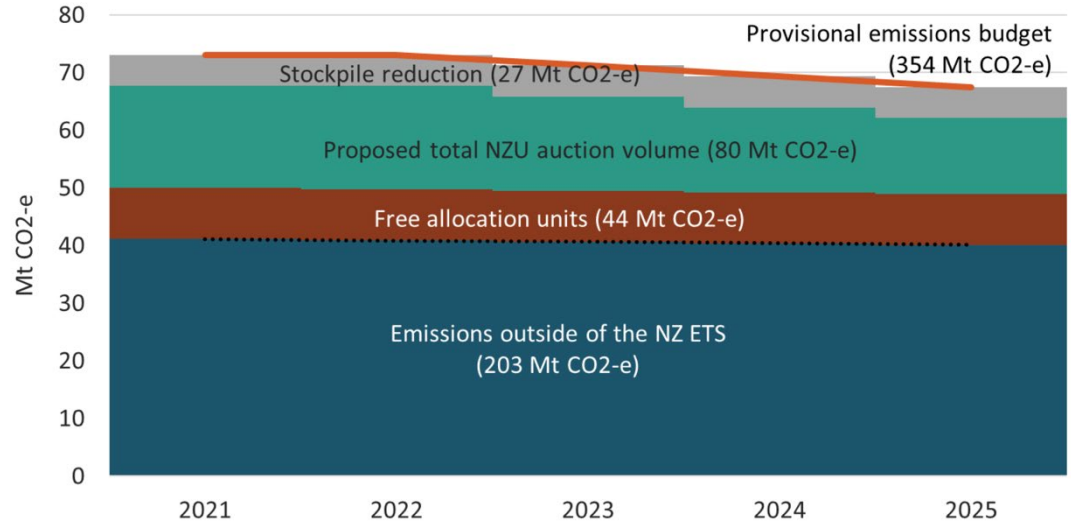
15. More fundamentally, the underlying assumption that there is a linkage between these settings and the total emissions that New Zealand will generate going forward is questionable. Given only 40% of New Zealand's total emissions are covered by the ETS and given the size of the current stockpile of NZUs (132m), the reality is that the ETS as currently envisaged has no ability to significantly influence our total emissions over the next five years, let alone cap them.

16. The next section of our submission focuses on these underlying issues, followed by our comments on the specific settings proposed.

Only 40% of our territorial emissions are covered by the ETS

17. We set out below figure 2 from the consultation paper which shows the proposed emissions budget of 354 Mt CO2-e for 2021-2025, and the factors taken into account in proposing that 80 Mt CO2-e will be auctioned over this period.

Figure 2: Final proposed NZU auction volume within the provisional emissions budget



18. The bottom layer of the chart represents emissions from agriculture (and some waste emissions). Since no units need to be surrendered in relation to these emissions, the ETS and the price of NZUs has no impact. So, although the provisional budget has been determined on the basis of a slight decline in these emissions over the period, the ETS scheme has no control over this component.

19. Putting it around the other way, the ETS scheme only impacts on 151 Mt CO2-e of the provisional budget for 2021-25 (42.7%). Furthermore, this actually overstates its potential impact since the free allocation of 44 Mt CO2-e means that, in simple terms, a further 12.4% of emissions are indifferent to the price of NZUs. In other words, the price of NZUs over the five-year period only has the potential to impact 107 Mt CO2-e (30.2%) of the budget emissions.

20. If the actual outcome is that agricultural emissions exceed the budget by say 20% (243.6 Mt CO2-e) this will not result in additional competition for NZUs or put price pressure on NZUs as would be the case if all territorial emissions were included. Furthermore, the framework does not provide for the volume of NZUs being auctioned to be reduced to accommodate these excess emissions. Accordingly, all other things being equal, we would simply exceed the budget by 40.4 Mt CO2-e.

21. The exclusion of such a large share of our territorial emissions from the ETS is also likely to give rise to fairness and efficiency issues going forward.

22. In terms of fairness, suppose that agriculture was on track to exceed its budget by 20% (40.4 Mt CO2-e) and that the Government attempted to meet the overall 2021-25 budget by reducing the number of NZUs that were available to those emitters whose decisions were affected by the price of NZUs. In this example, that would mean reducing the overall volume available to this group from 107 Mt CO2-e to 66.6 Mt CO2-e. If this were to occur, this group would face a disproportionate burden and a very significant price level would likely be required to induce that degree of abatement.

23. In terms of efficiency, one effect of excluding agriculture from the ETS and omitting a price for emissions in this sector is that some of the least cost abatement opportunities for New Zealand are unlikely to be realised.

24. The recent Ministry for the Environment report on *Marginal abatement cost curves analysis for New Zealand* (January 2020) makes this point very starkly. The graphs on the following page show 2030 marginal abatement costs for energy and industry (fig 3) and for land use (figure 4).

Figure 3: Summary MACC for energy and industry sectors in 2030

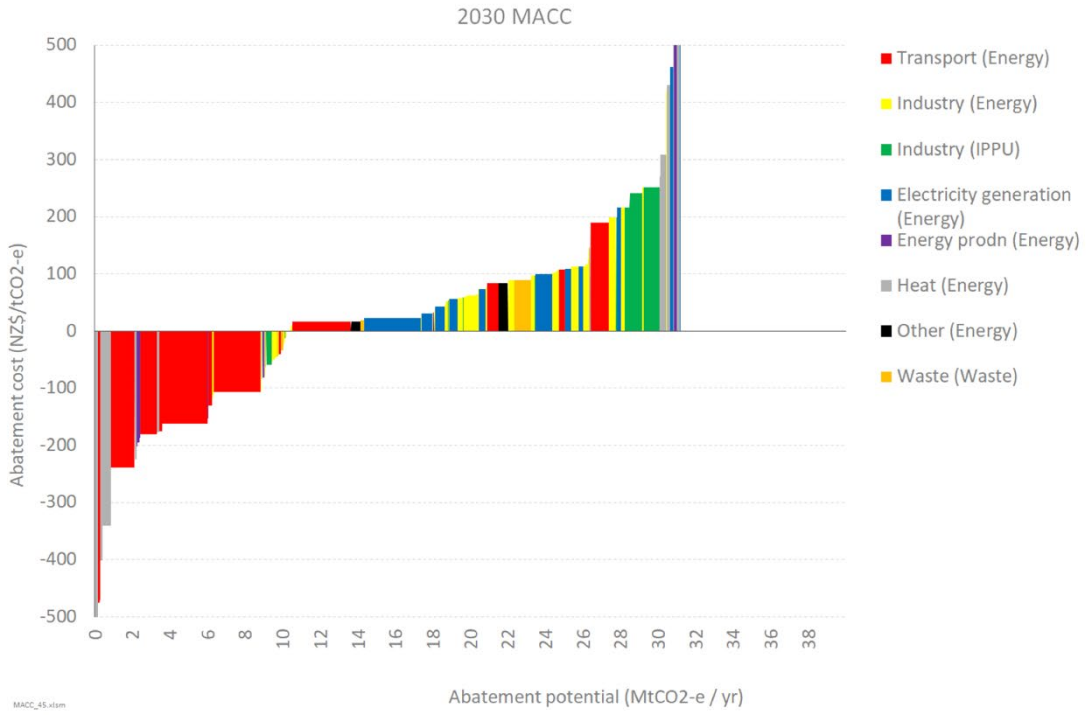
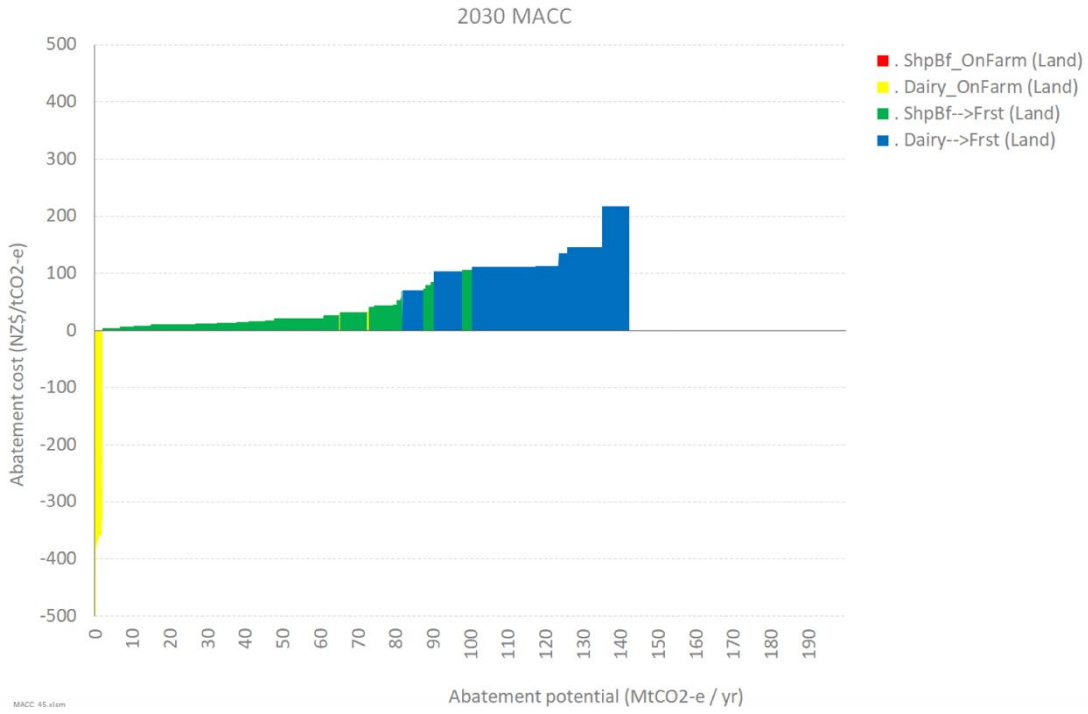


Figure 4: Summary MACC for the land sector (agriculture and forestry) in 2030



25. What this shows is that there is significant abatement potential at a low cost from the conversion of land use from sheep/beef to forestry. In order to see such shifts

occurring, it is important that carbon pricing is applied to sheep/beef so the proper price signal is apparent.

26. We comment briefly on potential solutions:

- *Increase coverage of the ETS and remove free allocations*. This is the obvious solution. It would mean all emitters were on an even playing field and addresses the unfairness and efficiency concerns discussed above. It would also help with the stockpile problem referred to below since the stockpile would become a smaller proportion of the five-year budget.
- *Dynamically adjust volumes.* Within the five-year period, if uncovered areas are above their budget, then the volumes for covered areas should reduce to ensure the overall budget is met. The position is no different to a family budget: if you overspend in one area you need to compensate somewhere else. This would bring out the fairness and efficiency issues discussed above, but would be honest about the impact of the current exemption for agriculture. However, it still relies on the stockpile problem being solved in some way so the budget does actually work as a cap.
- *Reliance on other policy measures and the waterbed effect.*
    - If neither of the above solutions are adopted then other policy measures will be required to ensure emissions are reduced to the budgeted levels.
    - But, care needs to be taken to co-ordinate the ETS and other policies. There is a real risk of a "waterbed effect" where successful measures (in transport and heat for example) could be negated by the operation of the ETS.
    - In particular, the emissions budget assumes certain levels of abatement. If policies outside the ETS are successful and produce higher levels of abatement in relation to activities covered by the ETS coverage, then the NZU volumes being made available should be reduced within the budget period. If not, then the additional abatement will merely result in a combination of NZU price reductions and an increase in emissions elsewhere.
    - Treatment of NZU earning activity gives rise to similar issues. The 354 Mt CO2-e is a net budget. So, if NZUs are earned in addition to those included in the budget, then this will permit additional gross emissions on top of the current budget.

The stockpile of existing units means that the volumes that the Government brings to auction do not create a cap

27. The second reason that the ETS does not presently create a cap on emissions is the existence of a stockpile of 132 million NZUs.

28. The plan to auction 80m NZUs is assumed to be accompanied by a stockpile reduction of 27m NZUs to reach the magic number of 107m NZUs to be surrendered in addition to the free allocation.

29. However, the extent to which stockpiled NZUs are used over the period is not governed by the emissions budget and nor does the volume of NZUs being brought to auction reduce if more than 27m are surrendered.

30. So, there is nothing to prevent covered emissions using say 50m stockpiled NZUs between 2021-25 which would see the budget exceeded by 23m.

31. The combination of the limited coverage of our ETS and the scale of the stockpile relative to the five-year budget means that it is entirely plausible that our actual emissions will greatly exceed the 354 Mt CO2-e "budget". At any rate, the existence of the ETS will have little impact on whether this occurs or not.

32. Furthermore, while the consultation document envisages a 27m reduction in the stockpile in 2021-25 there are reasons to think that this will be partially or wholly offset by further stockpiling. For example:

    - *The $35 fixed-price option (for 2020 only) will result in stockpiling if people think the price will be higher in the future*: We could see increased stockpiling if people choose to use the $35 fixed price option rather than surrendering existing NZUs or their 2020 free allocation. This would be rational if the market expects price to be greater than $35 going forward.
    - *The cost containment reserve may also contribute to the stockpile*: If the market expects a price greater than $50 going forward, the cost containment mechanism might be triggered by speculators taking advantage of the arbitrage opportunity. The proposed cost containment reserve consists of 37.4m NZUs with a trigger price of $50. If these units are purchased to be held in the future, then emitters seeking units to surrender would have to purchase those units on the secondary market at a higher price. While such a price level may be welcome in itself, it will have resulted in the stockpile being increased and emitters who expected the $50 limit to act like a price cap would complain that the regime is not working.

33. We comment briefly on potential solutions to the stockpile issue:

    - *Increase coverage of ETS*. As noted above, the stockpile would become a smaller share of covered emissions and its impact would therefore be diluted.
    - *Nationalise or buyback some of the stockpile.* We acknowledge that nationalisation would be highly controversial and that a buyback would carry an upfront cost. However, the prospect of speculators making huge windfall gains from increases in the price of NZUs is also unattractive.
    - *Require advance notification of use of stockpiled units*: If advanced notification of the use of stockpiled units was mandatory, then this could be taken into account in setting annual additional auction volumes made available by the Government.
    - *A temporary freeze on the stockpile*: Another option would be to freeze the units that are currently in the stockpile as an interim measure while the ETS is being reset. This would increase its prospects of working in the 2021-25 budget period.

- *Limit year of use of units:* There is no reason why NZUs need to be perpetual. Given the size of the existing stockpile, it would make more sense to have a date expiry (e.g. year of issue only) on NZUs that are provided through the free allocation or auction (longer expiry dates could be allowed for forestry NZUs).

Comments on the proposed budget

34. New Zealand is committed under the Paris Agreement to contribute to the global effort to limit the global average temperature to 1.5°C above pre-industrial levels.

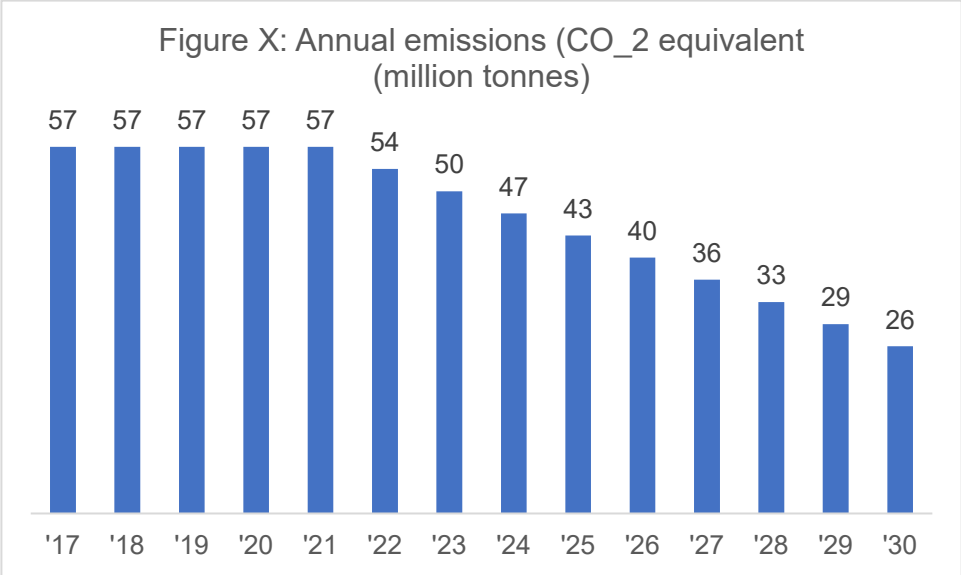
35. The 2018 IPCC Special Report: Global Warming of 1.5°C states,

> "In model pathways with no or limited overshoot of 1.5°C, global net anthropogenic CO2 emissions decline by about 45% from 2010 levels by 2030 (40–60% interquartile range), reaching net zero around 2050 (2045–2055 interquartile range)."

36. Based on this, to limit global warming to 1.5°C, New Zealand needs to target a 45% reduction from its 2010 emissions by 2030. Because the effect of CO2 in the atmosphere is cumulative and persists over time, it is vital that we achieve the 2030 target, as well as the target of net zero by 2050, to avoid global warming above 1.5°C.

37. Net emissions in 2010 for New Zealand were ~48 million tonnes of CO2 equivalent.[5] Therefore, New Zealand should target annualised net emissions of ~26 million tonnes of CO2 equivalent in 2030 to meet the target inferred above in the 2018 IPCC report.

38. If one assumes 2021 net emissions to be similar to 2017 emissions (the latest available data) at 57 million tonnes of CO2 equivalent,[6] then the cumulative budget implied for 2021-2025 inclusive is 251 million tonnes. This is illustrated using annual net emissions data in Figure X below.



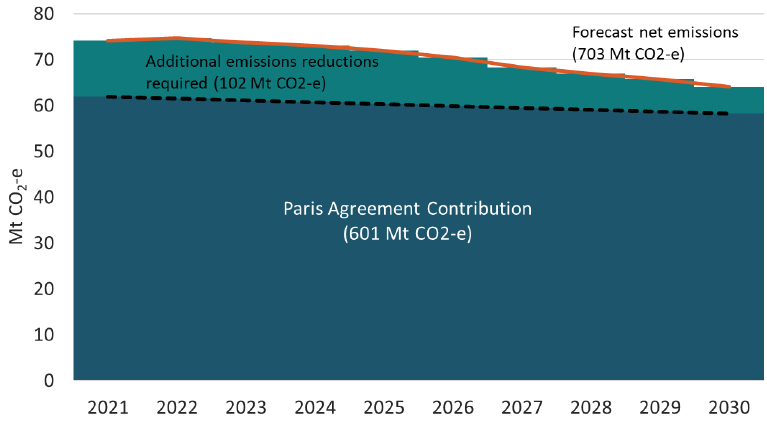
[5] See emissionstracker.mfe.govt.nz.
[6] Ibid.

39. This 2021-2025 budget of 251 Mt is notably lower than the 354 Mt CO2-e outlined in the consultation document. We understand that the difference is due to the facts that: (a) the budget in the consultation document is based on New Zealand's Nationally Determined Contribution, submitted in 2015 under the Paris Agreement, to reduce greenhouse gas emissions by 30% from 2005 levels by 2030, rather than the more recent 2018 IPCC Report finding that a reduction of 45% from 2010 levels by 2030 is required to stay below 1.5°C; and (b) the budget in the consultation document uses the same "gross-net" accounting methodology used to calculate New Zealand's Nationally Determined Contribution, whereby the 2005 baseline used is a gross figure but the 2030 target is a net figure. This has the effect of making the budget look more ambitious than it actually is. [7]

40. What matters is that we achieve a real reduction in the actual amount of CO2-e being released into the atmosphere. Therefore, we consider that net figures are the most relevant measure. But whichever measure is used, it should be consistent for both the benchmark and the target figures. New Zealand's net emissions in 2005 were 54.5 Mt CO2-e.[8] This would imply a target of annual net emissions of 32.6 Mt CO2-e by 2030, which is around half the figure suggested in the consultation document, as shown in Figure 1 below.

41. Figure X is also notably different to Figure 1 in the consultation document which is included here to ease comparison.

Figure 1: Forecast emissions and Paris Agreement Contribution emissions budget



Mt CO_2-e = million tonnes of carbon dioxide equivalent.

42. If New Zealand is to pursue a 1.5°C compliant path it must adopt a target based on the most up to date data and analysis, which is currently the 2018 IPCC Report. Stepping back from the technical detail, the need for rapid decarbonisation of the New Zealand

[7] We understand that there is also a baseline difference in that the figures used in the consultation document are based on our "target accounting emissions", compared to the data within the emissions tracker which is based on UNFCCC reporting: see https://www.mfe.govt.nz/climate-change/emissions-reduction-targets/about-measuring-and-reporting-emissions. This may affect the scale on the y-axis and explain a significant part of the difference between our proposed 2021-25 budget and that in the consultation paper, but the key point is that the overall profile of the emissions should be sharply downwards, not flat.

[8] See emissionstracker.mfe.govt.nz.

economy is urgent. An essentially flat line budget for the next five years is simply not ambitious enough. Yet, the actual emissions outcome may be even worse if the cost containment reserve of 37.4m NZUs is drawn upon or more than 27m NZUs from the stockpile are surrendered. If these outcomes are consistent with our Nationally Determined Contribution, it simply means that we have the wrong Nationally Determined Contribution.

43. It is important that the scale and rate of change be communicated consistently to New Zealanders including in consultation documents, both in the text and figures. The consultation document fails to do so and therefore fails to convey the urgency of change demanded by the science, as most authoritatively set out by the IPCC. It may lead, amongst other things, to investors making decisions that are not aligned with a 1.5°C path, leading to stranded assets and / or business failure, thereby further increasing the costs of transition to a zero-carbon economy.

International transport emissions

44. While we acknowledge that international transport emissions are difficult to address solely through domestic measures, and that an international solution is ultimately preferable, we are concerned that an international solution is likely to take time to achieve. In the meantime, by leaving them out of the ETS, there is no real incentive for the international travel and freight industries to reduce their emissions.

45. In the absence of international agreement, we consider it is worth considering an interim solution that would bring these emitters within the ETS for a proportion (e.g. 50%) of their emissions related to transport to or from New Zealand.

Comments on proposed price parameters

46. In our view, the price parameters are too low to induce the necessary abatement levels. The Government proposes that the fixed price option remain in place in 2020 but is increased to $35, and that a cost containment reserve price ceiling of $50 applies for the period 2020 to 2025.

47. While the $10 increase in the fixed price for 2020 is step in the right direction, our view is the price needs to rapidly increase after 2020 to drive abatement. The New Zealand Productivity Commission stated in its August 2018 report on the Low Emissions Economy that:

> "Just what level of pricing will be required cannot be known precisely. However, specialised modelling and other available evidence suggests that New Zealand's emissions price will need to rise to levels of the order of $75 a tonne of carbon dioxide equivalent (CO2e) and possibly over $200 a tonne over the next few decades to achieve the domestic emissions reductions needed to meet New Zealand's international commitments."[9]

[9] New Zealand Productivity Commission: The Low Emissions Economy, August 2018, p5.

48. This estimate preceded the 2018 IPCC Report, which indicated that emissions cuts needed to be larger than previously estimated to stay within the Paris target of 1.5°C, so is almost certainly too low.

49. Similarly, the IMF stated in a report released on 16 October 2019 that, to limit global warming to 2°C or less, each country would have to immediately introduce a carbon tax rising rapidly to US$75 per ton by 2030.[10]

50. Keeping the cost containment reserve price ceiling at $50 until 2025 will artificially suppress the price and may lead emitters to postpone abatement actions until after 2025. Artificially constraining the price may lead to stockpiling of units, as already discussed. We submit that the price ceiling should ratchet up on an annual basis, to send a clear signal to the market that the carbon price will increase over time and ensure that emitters are motivated to take action sooner rather than later.

51. Similarly, the price floor should also increase on annual basis to provide assurance to participants that investments in carbon reduction will be worthwhile.

Conclusion

52. The harsh reality is that adjustments to the parameters being consulted on cannot deliver the emissions reductions we need to meet our Paris commitment to contribute to keeping global warming within 1.5°C. The extent of emissions outside the regime and the size of our stockpile mean that we will be largely reliant on other policy tools to achieve decarbonisation in the near and medium term.

53. A cap and trade system cannot work when 70% of emissions are either outside the regime or backed by a free allocation. Either coverage needs to become close to universal (and the free allocation phased out), or else we should drop the aim of having the ETS as a major policy tool and look for other solutions.

54. The existing stockpile (and future stockpiling) is a further problem that will prevent the budget acting as a cap. Measures need to be taken to address this, such as introducing NZUs that can only be used in the year of issue, buying back stockpiled units, or the Government selling stockpiled units on behalf of holders rather than issuing new units for auction.

55. Furthermore, our understanding of the 2018 IPCC guidance is that far more aggressive emissions reductions are required by the 1.5°C target than currently proposed.

56. In view of the fundamental issues identified in this submission and the need for more extensive coverage and higher pricing under the ETS, we consider that the Government needs to signal clearly to the market that there is likely to be a major reset of the ETS in 2021/22.

[10] International Monetary Fund: Fiscal Monitor: How to Mitigate Climate Change, October 2019, p7.

57. If the ETS is to be maintained, it will also be important that successful abatement initiatives or NZU earning activities feedback into the volumes of NZUs made available for auction during the budget period. If not, then these successful outcomes will be negated by the ETS.

58. We also consider that the Government should seriously consider abandoning the ETS, at least in the short term, and moving to a simple carbon tax to ensure a clear price signal is achieved quickly, without wasting more years of effort in tinkering with a flawed scheme.

Further assistance

59. Should officials wish to discuss these comments further, please contact James Every-Palmer QC, james.everypalmer@stoutstreet.co.nz or Jenny Cooper QC, jenny.cooper@shortlandchambers.co.nz. LCANZI can also be contacted through LCANZI Law Reform Co-ordinator Emily Sutton on admin@lawyersforclimateaction.nz.

Lawyers for Climate Action NZ Inc.