

Submission to the Emissions Trading System Review Panel

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5 April 2011

Given the short time since the system was introduced, there is relatively little new information on the broad design. I have one new suggestion to improve the effectiveness of the policy and a few comments on some specific questions raised by the Panel.

New suggestion: Limit future liabilities and induce more efficient short-term investment by buying NZUs forward. (relates to 6b and 16)

Discussions with participants and preliminary review of data (Karpas and Kerr (2011) and Olssen, Brooks and Kerr (draft)) emphasise the severe effects of uncertainty about the continuation of the system and the future level of carbon prices for investments in forestry. Because most carbon returns are earned after the first few years of slow growth, an additional forestry investment that is dependent on the carbon returns is critically vulnerable to uncertainty. This same effect is surely happening in other sectors.

This is always an issue in new environmental markets but is particularly acute in this case and may persist for a long time because the ETS is addressing an international issue. There are two sources of uncertainty:

1. non-continuation of policy or change in effective price through policy change
2. change in price for non-policy reasons – e.g. international carbon price in markets we can access changes

No government can commit not to change policy in a democracy. One way that policy certainty can be increased is through clear, well designed policy. A well designed policy is less likely to need to be changed and hence more certain. I think that we have largely achieved this in the ETS. Policy may still change however because of external circumstances over which we have no control. In response to external circumstances we may still change the effective price through extension of transitional measures or changes in accounting rules. The government can control this but may choose to make changes.

We have limited control over the international process that generates agreements that we participate in (international, multilateral or bilateral) and hence international markets and carbon prices. However government is actively involved in this process and has a better idea than most

private actors of how other countries might behave, who we might link with in a future trading arrangement, and the likely stringency and hence carbon price.

Thus government controls some risks and is better informed about others. At a macroeconomic level, the government is also concerned that private actors respond efficiently to current and expected future carbon prices. Because of harvest cycles and because New Zealand is planning to take on a more stringent responsibility target, New Zealand is likely to face high greenhouse gas liabilities after 2020. Investment in new forests or in emissions reducing technology and capital will serve us well.

Combining this, it seems sensible for the government to enter contracts with private actors to buy NZUs in the future (maybe for the next 10 years) at fixed prices. They could choose to do this only for specified investments that are expected to generate sequestration or emission reductions. This would provide more price certainty and could make efficient investments possible. This would have no short-term fiscal cost. It would expose the government to some risk.

Alternatively, in trade-exposed sectors, rather than contracting to pay cash in the future, the government could invest now in sequestration or emissions reduction projects and in exchange the company could contract to receive fewer free NZUs in future. Even if the allocation of NZUs is output-based, if the firm is making a production-related emissions reduction investment that can't be reversed, the government could be assured that the company will continue to produce reasonable levels of output and hence be eligible for free allocations in future. Thus there would be few enforcement issues. This would involve some short-term fiscal cost and some risk but long-term gain.

Some small firms, such as tomato growers, may prefer to receive their free allocations in the form of an investment in emissions reduction that lowers their marginal production costs, and hence enables them to keep producing even when paying higher carbon costs, than a small, high-transaction-costs stream of free units.

This could generate a win-win. Firms and foresters would make investments that make sense with the government's expectations of future carbon prices. The government would buy future units more cheaply and would reduce New Zealand's overall liability.

Firms that are not directly involved may also regard government's 'investments' as a credible signal of future policy certainty and thus may invest with more confidence.

Other comments and thoughts

My main other comment would be to be very careful about making changes to policy when there is little new information. This only induces policy uncertainty. In particular, the agricultural emissions part of the ETS is an area where the solutions are still not clear and the best path is probably to make no changes until we can make a change with confidence.

Compliance costs

Our interviews in the forestry sector suggest that the regulatory process has mostly been fairly easy and well managed.

Modelling results

The results are misinterpreted. The effects presented are not the effect of the ETS but the effect of taking on the Kyoto (or similar) obligation and then using the ETS to efficiently respond. If we do not have the ETS, the costs to the economy would be much higher unless we also reduce our international responsibility target. The ETS reduces the cost to the economy and also alters the way those costs are distributed – hopefully more fairly.

6 c Emissions leakage from agriculture

A small, but crucial, point on agricultural emissions is that all available empirical evidence suggests that leakage of land and production out of the agricultural sector in response to greenhouse gas costs would be small. This evidence is summarised in Kerr and Zhang (2009). The empirical evidence is not that strong so may be wrong but there is no evidence pointing in the other direction. This does not mean that the farming sector would not be seriously hit by the charges if there were no free allocation. It is clearly a trade-exposed sector which largely faces international prices but it has such a strong comparative advantage that in most places pastoral agriculture will still be a viable activity. This means that output-based allocation may not be the best way to address the agricultural sector in the medium term.

7 Forestry

We should not ‘over-reward’ forestry. If we can address the uncertainty, the international carbon price is almost certainly our best estimate of the appropriate level of reward. In any case, we do not want to become too dependent on forestry for our mitigation for two reasons. The first is that the albedo effect may mean that the rewards for carbon sequestration are lower in future. Second, if our forestry is primarily *pinus radiata* mono-culture we expose ourselves to significant risk of pest invasion.

12 New international agreements

The key issues for New Zealand are the level of stringency of effort of our peers and trade competitors (and the availability of consistent monitoring information so this can be credibly assessed), and the availability of credible international units that we can purchase to make up the difference between our responsibility target and our domestic reductions. We are likely to be a net buyer going forward so while connections to other OECD countries would help us with liquidity, connections to developing countries that might sell to us may be more critical. The CDM is a seriously flawed institution and concept. Many commentators estimate that up to 75% of units are non-additional. This cannot be significantly addressed by more analysis and better processes; it is inherent in the design. We should be considering the potential of bilateral partnerships of the type Norway is developing (for deforestation), but on an appropriate scale for New Zealand. Obviously partners would be in the Pacific or Latin America. We may be able to reduce risks of leakage simultaneously. We should also continue to support efforts to bring developing countries, including the smaller ones, in more generally in the various possible international agreements.

13a Fixed price and banking

If the fixed price is continued the banking provision should be revisited as discussed in my comments to select committee.

14 and 15 mitigation options and entry

If there are some abatement options and the prospect of more, and the administrative cost of inclusion is not high, it makes sense to include the sector particularly in this phase with low effective prices. If however there are few abatement options and the administrative and compliance costs are high, it might be better to use alternative regulations. Thus for agriculture, if the current processor based approach can be implemented in a simple way it might form a useful transition into a longer term policy. It should be designed to facilitate such a transition. However trying to create a more complex system may, at this stage, not be worthwhile particularly if it creates momentum away from a good long run solution.

References

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