8 August 2023

Ministry for the Environment
Manatū mō te Taiao
PO Box 10362, Wellington 6143, New Zealand

Via: Citizen Space.

Dear Ministry for the Environment,

Re: Review of the New Zealand Emissions Trading Scheme

We welcome the opportunity to make a submission in relation to the four proposals for reviewing the New Zealand Emissions Trading Scheme (NZ ETS).

This submission was written on the traditional lands of the Worimi and Awabakal people, and to that end, we acknowledge the Traditional Custodians and pay our respects to Elders past, present and emerging.

This submission is intended to be made public. Below we address questions: 3.1, 3.2, 3.3, 5.1, 5.2, 5.3, 6.1, 6.3, 6.5.

3.1 Do you agree with the case for driving gross emissions reductions through the NZ ETS? Why/why not? In your answer, please provide information on the costs of emissions reductions.

Yes. The New Zealand Emissions Trading Scheme (NZ ETS) offers significant advantages over alternative instruments for driving gross emissions reductions. While the current design of NZ ETS contains elements that are not sustainable, through a careful review, the NZ ETS has the potential to not only deliver cost-efficient greenhouse gas emissions reductions but also take social and climate justice requirements into account, becoming a truly sustainable scheme (Sven Rudolph and Elena Aydos, *Carbon Markets Around the Globe: Sustainability and Political Feasibility,* Edward Elgar, 2021).

In fact, cost-efficient gross emissions reductions are the main object of cap-and-trade instruments, also known as Emissions Trading Schemes (ETS). By capping emissions and allowing trading of allowances, industries are incentivized to find the most economical ways to reduce their emissions, resulting in overall emission reductions without imposing excessive financial burdens. Experiences in North America and Europe have shown that cost-savings of up to 50% are achievable compared to a traditional command-and-control approach to climate mitigation. Cost-efficiency not only is an economic prerequisite for sustainable climate policy, but it also increases political acceptability and fosters social justice by not overburdening current generations.

The crediting of NZUs to forests is an unusual – and, in its current form, unsustainable – feature of the NZ ETS. Removal activities are typically incentivised through separate carbon offset schemes, such as the Emissions Reduction Fund in Australia and the national forestry offsets in California.

Where removal activities are regulated through separate carbon offset schemes, the ETS design can then determine whether participants are allowed to surrender offset credits to satisfy their liability. The Government may impose qualitative limits to the use of offset credits, e.g. only offset credits generated through certain types of projects or activities are eligible, as well as quantitative limits such as only a certain percentage of covered entities' compliance obligations can be fulfilled by offset credit surrendering (*Rudolph and Aydos, 2021*).

In theory, the eligibility of reliable offsets does not compromise overall environmental effectiveness of an ETS and might even reduce emissions leakage, enabling ETS participants to exploit marginal abatement cost differences between themselves and non-participants. However, the unlimited use of offsets can weaken domestic innovation incentives if prices drop significantly due to an influx of cheap offset credits (*Rudolph and Aydos, 2021*).

In the case of the NZ ETS, the unlimited crediting and use of removal NZUs is not only lessening innovation incentives in the traditional emitting sectors, but also impairing the Government's capacity to control the overall limit of actual emissions through the cap.

3.2 Do you agree with our assessment of the cost impacts of a higher emissions price? Why/why not?

Partially agree.

Emissions Leakage Assessment:

We do not agree with the Government's assessment of the cost impacts of a higher emissions price on emissions leakage. While coverage of energy-intensive trade exposed industries (EITE) can in theory lead to emissions leakage, significant leakage rates resulting from existing ETS, including the NZ ETS, have so far not been demonstrated empirically. In reality, carbon leakage exposure rates have been historically overestimated by industry and governments (Elena Aydos, *Paying the Carbon Price: The Subsidisation of Heavy Polluters under Emissions Trading Schemes*, Edward Elgar, 2017).

The NZ ETS adopted the concept of "potential trade", that is, the notion that industries "something could be trade exposed even if it is not traded currently". While participants under other ETS have to pass a "trade-exposure" test, in the NZ ETS the "potential" for international competition has been assumed (*Aydos,* 2017). This concept has led to an overly generous eligibility threshold to determine a participant's eligibility to receive free industrial allocation (*Aydos,* 2017).

The Commission has recently supported this conclusion, finding evidence that some eligible activities are receiving over-allocations that fully compensates EITE firms for their NZ ETS costs (Ministry for the Environment. 2021. Reforming industrial allocation in the New Zealand Emissions Trading Scheme: Consultation document. Wellington: Ministry for the Environment).

Free industrial allocation impacts the revenue-raising capability of the NZ ETS, which as we discuss below, is crucial for compensating low-income households and disadvantaged communities for the distributional effects of higher energy prices. Particularly relevant to the current review of the NZ ETS, free allocation neutralises the desired market signal from the carbon price, mitigating incentives for assisted sectors to invest in cleaner means of production and undermining the incentives for less carbon intensive industries (Elena Aydos, 'Emissions Trading Schemes and the WTO', *Elgar Encyclopedia of Environmental Law*, Edward Elgar, 2021).

We have previously maintained that the risk of emissions leakage is best dealt with through carbon border adjustments and/or by adding flexibility mechanisms to the ETS, such as the use of banking, reliable offsets, a sufficiently high price ceiling, and linking (*Aydos*, 2017; *Rudolph and Aydos*, 2021).

Household Cost Assessment:

We agree with the Government's assessment of the cost impacts of a higher emissions price on household costs. Distributional effects of higher energy prices are regressive and hurt low-income households disproportionately. A well-targeted redistribution of allowance auction revenues, however, can be an effective remedy (*Rudolph and Aydos*, 2021).

We strongly encourage that to serve social justice as well as climate justice, detrimental social effects caused domestically by the ETS should be primarily mitigated by earmarking auction revenues (*Rudolph and Aydos*, 2021). In other words, intra-generational justice will be best served by using NZU auction revenues for compensating low-income households and disadvantaged communities in New Zealand for the regressivity of higher energy prices. This approach is also in line with redistributional welfare-based justice concepts.

In line with current practices in California and proposals for the new European ETS2, we recommend a combination of an equal per capita redistribution (carbon dividend) for the most part and a small-share targeted regressivity compensation for the poorest which is squarely in line with the options suggested by the Government in the Discussion Document (p. 41). Recent studies in Germany have shown that a per capita equal climate dividend is already capable of mitigating the biggest part of the ETS regressivity.

3.3 How important do you think it is that we maintain incentives for removals? Why?

As stated in the Discussion Document, one of the key considerations for assessing the consultation proposal is that the "The NZ ETS helps Aotearoa achieve the 2030 NDC and future NDCs, as much as possible, through domestic actions". Forestry removals have an important role in supporting New Zealand to meet their domestic emissions budgets and 2050 target, as well as successive NDCs.

However, the unlimited crediting and use of NZUs under the NZ ETS is not sustainable. It is removing an important aspect of the ETS, which is the Government's control over the levels of actual pollution through the cap, attributing emission costs to polluters and incentivising gross emissions reduction.

Therefore, we believe that sustainable forestry and other removal activities should be predominantly incentivised by a separate scheme, which may be linked to the NZ ETS.

5.1 Do you agree with the Government's primary objective for the NZ ETS review to consider whether to prioritise gross emissions reductions in the NZ ETS, while maintaining support for removals? Why/why not?

We partially agree with this statement. Data shows that forestry removals have an important role in supporting New Zealand to meet their domestic emissions budgets and 2050 target, as well as successive NDCs. However, the crediting of large volumes of forestry NZUs under the NZ ETS is deteriorating the incentives to reduce gross emissions from traditional polluting sectors and impairing the Government's capacity to control the overall limit of industrial emissions through the cap. We believe that the Government must prioritise gross emissions reductions in such sectors in the NZ ETS, while supporting removals thorough a separate scheme. Alternatively, and at the very least, gross emissions reductions must be the primary goal of the NZ ETS, with support for removals becoming a secondary feature.

5.2 Do you agree that the NZ ETS should support more gross emissions reductions by incentivising the uptake of low-emissions technology, energy efficiency measures, and other abatement opportunities as quickly as real-world supply constraints allow? Why/why not?

Yes. As mentioned above, the NZ ETS is the right instrument for achieving cost-efficient gross emissions reductions in the covered sectors. By capping emissions and allowing trading of allowances, industries and the transport sector are incentivized to find the most economical ways to reduce their emissions, resulting in overall emission reductions without imposing excessive financial burdens.

5.3 Do you agree that the NZ ETS should drive levels of emissions removals that are sufficient to help meet Aotearoa New Zealand's climate change goals in the short to medium term and provide a sink for hard- to-abate emissions in the longer term? Why/why not?

We partially agree with this statement. Achieving cost-efficient gross emissions reductions is the main object of an ETS. It is also possible to incentivise emissions removals by accepting the use of offsets in an ETS. Nevertheless, it is important to remember that the cost-efficiency and innovation incentives inherent in an ETS might also create new opportunities for reducing emissions that are commonly referred to as 'hard-to-abate' over the long term.

The crediting of unlimited removal NZUs under the NZ ETS is predominantly incentivising forestry removals, at the cost of achieving emissions reductions. As recommended below, we agree that NZ ETS should be one driver of emissions removals in the short to medium term, but not the main driver. We recommend that quantitative restrictions be put in place on the NZUs allocated for removal activities that can be used for surrender obligations (under Option 3). The quantitative limits should reduce over time, allowing for an adjustment period during the transition towards Option 4.

In the longer term, we believe that forestry and other removal activities should be predominantly incentivised by a separate scheme, which may be linked to the NZ ETS, increasing flexibility in relation to hard- to-abate emissions. Quality standards and quantitative limits must be put in place to safeguard the integrity of the NZ ETS.

6.1 Which option do you believe aligns the best with the primary objectives to prioritise gross emissions reductions while maintaining support for removals outlined in chapter 5?

Option 4 best aligns with the primary objectives of this review. It does so by transitioning the NZ ETS towards sustainability and allowing the Government to support forestry and other sustainable removal activities through a separate carbon offset scheme.

As described in the Discussion Document, Option 4 involves the most comprehensive changes to the NZ ETS, which could be costly and take several years to implement. The early adoption of the following features, carefully selected from Options 1 – 3, would best support the Government's priorities in the short-term and the transition into Option 4:

1. The review of the phase-out rates for free of charge industrial allocation (under Option 1), achieving 100% auction rates by the time Option 4 is fully operational; and
2. As a transitional measure, imposing quantitative restrictions on the NZUs allocated for removal activities that can be used for surrender obligations (under Option 3). The quantitative limits should reduce over time, allowing for an adjustment period; and
3. Vintaging of NZUs allocated for removal activities (under Option 3), including units in the stockpile, would be recommended to ensure a smooth transition towards Option 4.

6.3 Of the four options proposed, which one do you prefer? Why?

For the reasons exposed in our answer to the previous question, we recommend the combination of the following options:

1. Option 4 to be fully implemented, creating a carbon offset scheme for sustainable removal activities separate from the NZ ETS; and
2. The immediate review of the phase-out rates for free of charge industrial allocation (under Option 1), achieving 100% auction rates by the time Option 4 is fully operational; and
3. As a transitional measure, imposing quantitative restrictions on the NZUs allocated for removal activities that can be used for surrender obligations (under Option 3). The quantitative limits could reduce over time, allowing for an adjustment period prior to the exclusion of removal activities from the NZ ETS; and
4. Vintaging of NZUs allocated for removal activities (under Option 3), including units in the stockpile, ensuring a smooth transition towards Option 4.

6.5 Based on your preferred option(s), what other policies do you believe are required to manage any impacts of the proposal?

Strengthening the NZ ETS will have impacts to household costs. We recommend using NZU auction revenues for compensating low-income households and disadvantaged communities in New Zealand for the regressivity of higher energy prices. More specifically, we recommend a **combination** of an equal per capita redistribution (carbon dividend) for the most part and a small-scale targeted regressivity compensation for the poorest . Recent studies for Germany have shown that a per capital equal climate dividend is already capable of mitigating the biggest part of the ETS

regressivity. These recommendations are in line with the options suggested by the Government in page 41 of the Discussion Document.

In terms of industry support, once the NZ ETS has been revised, a Border Carbon Adjustment can be effective in preventing carbon leakage at a sectoral level. The linking of the NZ ETS and the newly created offset scheme, with strict quality standards and quantitative conditions, can add flexibility while ensuring the integrity of the NZ ETS.

Thank you for the opportunity to submit this contribution.

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