

## **Why the ETS Should Be Deferred**

Calls are mounting for the next phase of the government's emissions trading scheme, due to commence on 1 July 2010, to be deferred.

There are strong arguments for a temporary suspension of the scheme. The world has changed since the ETS legislation was passed in November last year.

The changes began with the failure of the UN conference in Copenhagen. There is now little chance that a legally binding treaty will succeed the Kyoto Protocol after 2012. The most likely scenario post-2012 is coordinated 'best endeavours' commitments by countries on differential actions to reduce emissions.

Next, it turned out that political support for an ETS in Australia was lacking. The leaders of both main political parties in effect recognised that in present circumstances voters were not prepared to bear the costs. In its budget last month the Australian government stated that it would not reintroduce ETS legislation at least until 2013, and "only when there is clarity on the actions of major economies, including the US, China and India".

The government made much of aligning the New Zealand ETS with Australia's, both as to design and timing. Now there is no Australian scheme with which to align.

The US seems unlikely to adopt a cap-and-trade scheme (ETS) any time soon, and while China and India are increasing energy efficiency with new industrial investment, they are adamant that economic growth to raise living standards takes priority over climate change action.

In Europe governments are scaling back emissions reduction plans as their economies look set for a long period of stagnation, even if they manage to avoid sovereign debt crises.

On top of all this, the IPCC process on which governments have relied for advice on the science has come into disrepute, and polls indicate sharp

falls in the numbers of people who believe global warming is the result of human activities. Whether justified or not, this puts additional political constraints around policy action.

Against this background, it is difficult to understand why the government seems determined to press on. It is resorting to ever-more spurious arguments to defend its position.

Lately, for example, in speeches to National Party conferences climate change minister Nick Smith has argued that the “ETS is not a tax.” He points out that because of forestry carbon credits the ETS will actually cost the government money.

This is nonsense on stilts. As the Australian Liberal Party leader Tony Abbott memorably put it, the ETS is “a great big new tax on everything.” It is similar in many ways to a carbon tax coupled with a subsidy for carbon sinks, a policy that most economists prefer – as does the Business Roundtable, if and when further action by the government is justified.

That policy too could cost the government revenue, depending on factors such as rates of forestry planting. But to maintain that the ETS is not like a tax when it pushes up the prices of electricity and fuel, and the costs of firms that use such inputs, is ludicrous.

Likewise it is spurious to argue that our ETS is justified because Australia is implementing other measures that reduce emissions. That is true but New Zealand also has an enormous (not always well-justified) raft of other measures: energy efficiency programmes, building regulation, incentives for solar water heating systems, home insulation, bio-fuels grants, animal emissions research and the like.

The government seems to have fallen back on just two substantive arguments, both of which are weak.

One is threats to our export trade, especially in Europe. These cannot be significant in the short term: New Zealand has an ETS on the books, and importing countries could hardly discriminate against us in favour of

competing exporters like the United States and Australia which have no comparable policies. In any case, action by individual firms (eg product labelling for carbon content) would be more important to consumers than official country policy, and there is little evidence that they have asked for such information. This argument is largely empty rhetoric.

The second argument is to honour commitments to foresters who stand to gain from carbon credits. But foresters could still sell credits offshore; the amount of additional planting encouraged by the ETS in recent years is quite small; forest rotations are 30-plus years so a temporary suspension would have limited implications; and genuine claims for compensation from foresters who could show they planted trees because of the ETS could be entertained by the government. These would not be large.

Nick Smith's claim that the ETS could cost taxpayers money deserves further analysis. It is based on the provision in the Crown accounts for the cost of emissions units allocated for free, mainly carbon credits to foresters. The amount provided for 2011 is \$1.007 billion, with smaller amounts for succeeding years. But this is hypothetical money, not actual money. It would be an actual liability only if three conditions are satisfied: (1) that New Zealand as a country fails to meet its Kyoto targets, (2) that sanctions are in fact applied (requiring taxpayers to meet the shortfall, for example through the government having to buy international Kyoto units), and (3) that the price of international credits has not collapsed for want of a successor to the Kyoto Protocol.

The reality, however, is that currently New Zealand is on track to meeting its Kyoto obligations, and even if there were a shortfall after sales by foresters of credits, the prospect that financial sanctions would be applied is remote. The Canadian government has stated bluntly that Canada won't meet its Kyoto targets and it won't pay up. This has always been the realpolitik of Kyoto: the idea that US voters, for example, would agree to financial transfers to, say, Russia was fanciful.

The bottom line is that there is no need for precipitate action. Proceeding with the ETS would do nothing for business certainty. There is no solid regulatory analysis underpinning the ETS and hence no cross-party support

that would withstand a change of government; rules could change following the 2011 review; after 2012 there is no limit on carbon prices, which could be much higher; and the government is already talking about possible future modifications.

Some businesses such as renewable electricity generators, accounting firms and carbon traders will benefit from an ETS, but theirs is not a national interest perspective. Others are reconciled to coping with it as best they can.

But the government should be taking a broader view. The last thing New Zealand needs right now, with global economic vulnerabilities and a patchy and unbalanced recovery, is more cost burdens on firms and households on top of increases in GST, ACC levies, electricity prices and interest rates.

The logic is inescapable: if an ETS is to change behaviour, it will hurt; if it doesn't, it is merely tokenism. The public is already seeing the consequences in the form of price increases by power companies and Air New Zealand, and there will be many more. The GST increase on 1 October will be applied to the ETS-induced price increases, adding insult to injury. Federated Farmers has estimated that it will take the profit from 4.7 million lambs to offset the \$40 million (\$1,500 per sheep and beef farm) of ETS costs from 1 July. The annual costs to Fonterra by 2015 have been put at over \$100 million. The Reserve Bank estimates that the ETS will add 0.4 percent to an already sharply rising CPI.

Moreover, it is important not just to take a short-term view. The tax effect of the ETS is expected to be ratcheted up over time; the Labour Party is committed to a more onerous scheme; and if the ETS is activated now, vested interests will be created that will make it harder to modify or remove if the government finds other countries are not taking comparable action.

There are no effective ways of mitigating the impacts of the scheme without legislative action. Business NZ has suggested ministerial discretion could be used to reduce the impacts for firms such as SMEs and food processors. But significant discretion doesn't exist, and nor should it. The

ETS is a tax, and only parliament should authorise taxes and tax concessions.

It follows that by far the most sensible approach would be to suspend the next phase of the scheme on a temporary basis until such time as other countries, notably Australia, take comparable action.

This should not involve any loss of face for the government. Its stated policy has been to move in line with other countries, not ahead of them. There is broad support in the business community for this commonsense approach – nothing New Zealand can do on its own can affect global temperatures. Other governments and, I suggest, most New Zealanders would accept that rationale.

Arguably, most of the political risks lie in the opposite direction. The ETS is an extremely ambitious and complex mechanism which few people understand. There are many unresolved issues around basic issues of administration. The risks of botched implementation and opportunities for carbon fraud are considerable.

All these risks can be avoided. The prudent course for the government is to stay engaged with international negotiations, suspend the 1 July measures on a temporary basis, and move if and when other countries do – as it told the country it would.

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