NEW ZEALAND
BusinessROUNDTABLE
PROMOTING POLICIES FOR A BETTER NEW ZEALAND

1 July 2009

Hon Peter Dunne
Chair
Emissions Trading Scheme Review Committee
Parliament Buildings
WELLINGTON

Dear Mr Dunne

NZIER/Infometrics Report on Climate Change Policy

1. Introduction

1.0 When the Business Roundtable appeared before your committee on 19 June 2009, we emphasised the importance of a Regulatory Impact Statement being available to affected parties and policy makers in order to inform sound decisions on climate change measures.

1.1 We sought the Committee's agreement, which was granted, to submit and appear before it again on an RIS when it was available.

1.2 This supplementary submission focuses on the economic analysis prepared by the New Zealand Institute of Economic Research and Infometrics for the RIS on the Emissions Trading Scheme.

2. Background

2.1. The terms of reference of the select committee require:

> "A high quality, quantified, regulatory impact analysis to be produced to indentify the net benefits and costs to New Zealand of any policy action, including international relations and commercial benefits and costs."

2.2. The committee provided the consultants with terms of reference (attached for ease of reference as Annex I) which required:

> "a fully quantified economic cost benefit analysis that identifies the net benefits or costs of the following options:
>
> (i) the least-cost option for meeting any Kyoto liability
>
> (ii) the proposed emissions trading scheme
>
> (iii) a revenue-neutral tax on carbon or carbon equivalents, coupled with an equivalent subsidy for carbon sinks, or a tax on energy."

3. General comments

3.1. We regard the NZIER and Infometrics as reputable consultancy organisations. Moreover, we regard computable general equilibrium modelling, which is the analytical tool used in the report, as capable of providing useful insights on climate change policies. Indeed we have used Infometrics ourselves for that purpose. However, they do no more than provide insights: a range of quantitative and qualitative methods of analysis ought to be applied.

3.2. Having said that, we cannot emphasise too strongly that the NZIER/Infometrics report is not a Regulatory Impact Statement.

Three points are relevant here:

(i) It was always understood by the consultants and interested parties that the study would cover only the costs side of the equation. It does not cover the benefits side (eg international relations and commercial benefits, as required in the committee's terms of reference).

(ii) With respect to costs, it does not model "The proposed emissions trading scheme". The report models it as if it were a carbon tax. This is not necessarily a criticism of the modellers; with a CGE model there may be no other option. However, the report makes no attempt to analyse the differences between a carbon tax and an ETS. These are significant (see below).

(iii) The report does not provide anything like an adequate basis for policy conclusions. The first draft of the study did not have any policy recommendations. We understand that these were 'bolted on' at the request of officials. We regard such interference with the committee's terms of reference as highly inappropriate. Much more analysis than that undertaken by the consultants is needed to evaluate policy options. A glance at the RIS accompanying the Australian government's climate change legislation, which runs to well over 200 pages, will indicate the difference (leaving aside any judgment on its quality).

4. Specific comments on the report

– ***The analysis is not consistent with the government's goal of catching up with Australian income levels by 2025***

This is a major deficiency. Government policies across all domains should be consistent. The implicit modelling assumption is a trend per capita GDP growth rate of 2.4 percent per annum. A per capita growth rate in the region of 3.5 – 4 percent (say 4.5 – 5 percent in terms of GDP) is likely to be necessary to meet the government's objective and be consistent with action to reduce emissions. Infometrics modelled such a scenario for the Business Roundtable and the Petroleum Exploration and Production Association of New Zealand, in combination with a carbon neutrality goal, in a report released in February 2008. A media release summarising the findings is attached as Annex II.

– ***The study does not consider transitional costs***

It is one thing to conduct modelling on the basis that in the long term, full employment of all resources will occur despite the imposition of climate change measures. However, the transitional costs could be large, as we saw with New Zealand's economic reforms of the 1980s and early 1990s. By changing the assumptions of the model it is possible to get a feel for these transitional effects, as was done in the Business Roundtable/PEPANZ study. Such an analysis should have been undertaken.

– ***An ETS is not a carbon tax***

A key difference is that under an ETS, prices for carbon could be high and volatile. This could introduce major uncertainty into business decision making and deter investment, with larger economic costs. Such effects were modelled in the Business Roundtable/PEPANZ study and should have been investigated in the current exercise.

– ***No investigation was conducted into sectoral or regional effects***

Earlier studies included such effects, which were in some cases dramatic, eg in the dairy industry. They should have been included in this study to ensure policy makers are aware of possible outcomes.

– ***The estimated economic costs of the ETS as modelled are large***

An impact of 0.1 percent of GDP, the lower end of the range of estimates, may appear small but is in fact large. It is incurred every year and, added up and discounted back to today's dollars at the discount rates used by authorities such as Stern and Garnaut, it is broadly equivalent to our entire GDP. The benefits of introducing climate change policies need to be large to outweigh such costs.

– ***Other comments***

The Castalia critique of the report has been made available to the committee although we do not necessarily endorse all its findings.

We reiterate that many of the above criticisms are not necessarily levelled at the consultants or the report. Our point is that they were not commissioned to explore many vitally important issues, apply other methods of analysis, and address policy issues in other than a superficial way.

5. Policy implications

5.1. For the reasons outlined, the NZIER/Infometrics report is far too limited a basis on which to form policy conclusions.

5.2. We consider that on the costs side further work should be undertaken to remedy the gaps and weaknesses identified above and provide a more robust assessment.

5.3. Then an analysis of the possible benefits of climate change action by New Zealand should be undertaken, in particular an assessment of international relations and commercial benefits as required by the committee's terms of reference. These would need to be large to justify incurring significant costs. A 0.1 percent of GDP economic cost is equal to around $180 million annually. A 0.5 percent of GDP cost equates to $900 million. Plausible benefits are highly unlikely to be near the top of this range and may well be below it.

5.4. Finally, a comprehensive RIS evaluating policy options should be undertaken covering the range of options and issues included in the Australian RIS (such as institutional arrangements). The scant amount of research and policy development that has been undertaken in New Zealand compared with Australia should be regarded as embarrassing by the committee and the government. In many respects we are flying blind.

5.5. We reiterate that we support additional action by New Zealand if agreement is reached in Copenhagen on post-2012 measures and if action is taken by Australia and other emitters. New Zealand should await these developments before taking final decisions. An extremely important point emphasised in the NZIER/Infometrics report is that the costs

of policy action by New Zealand are much higher if the rest of the world does not take comparable action. In the meantime, additional work of the kind outlined needs to be undertaken to provide a basis for sound, broadly accepted and politically durable government decisions.

5.6. In this context our preference remains for a low ($5-10/tonne) carbon tax, at least as a transitional measure unless and until a broad international trading regime is in place. This is not currently in prospect. We note that the Australian government is proposing an A$10/tonne fixed charge in the initial period. This will limit international trading.

5.7. The NZIER/Infometrics report correctly states that it is feasible for a country to be part of an international cap-and-trade scheme but for its domestic policy to be a carbon tax (p13). The tax could be adjusted periodically according to well-defined rules that would give reasonable certainty to businesses and households. (We disagree, incidentally, with the contention of the minister for climate change issues that an advantage of an ETS is that it fluctuates according to whether the economy is growing strongly or in recession. This may well not be the case because the international price of carbon will not be determined by the state of the New Zealand economy. In addition, a carbon tax could be adjusted to take account of the same factors if this was considered desirable – which it may well not be, given the importance of a relatively stable carbon price signal.)

6. Conclusion

We request the opportunity to appear before the committee to elaborate on this supplementary submission.

Yours sincerely

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Regulatory Impact Analysis
Terms of Reference
for NZIER/ Infometrics Joint Venture

The Government has established a special select committee to review the Emissions Trading Scheme and related matters as provided for in the National-Act Confidence and Supply agreement. The terms of reference of the select committee require:

> *"a high quality, quantified, regulatory impact analysis to be produced to identify the net benefits or costs to New Zealand of any policy action, including international relations and commercial benefits and costs"*

Desired Output

To provide the select committee with sound policy advice, the Government requires a high quality regulatory impact analysis of policies aimed at addressing climate change.

The regulatory impact analysis shall, as outlined in the Special Select Committee Terms of Reference, provide a fully quantified economic cost benefit analysis that identifies the net benefits or costs of the following options:

- The least-cost option for meeting any Kyoto liability
- The proposed Emissions Trading Scheme
- A revenue-neutral tax on carbon or carbon equivalents, coupled with an equivalent subsidy for carbon links, or a tax on energy

Work Allocation

The fully quantified economic cost benefit analysis will be contracted out to two separate consultancy firms who will form a joint venture to complete the work.

Timing

The regulatory impact analysis is due with the select committee by 9.00 am, 13 April.

Annex II

EMBARGOED UNTIL 11.30 AM TUESDAY 5 FEBRUARY 2008

Carbon Neutrality Goals Costly and Unattainable

Taken alongside the government's goals for economic growth, its goal of achieving carbon neutrality

- could cost New Zealand households around $19,000 a year in current dollars by 2025
- but would leave the country further away from carbon neutrality than it is today.

These are key conclusions of the attached report by Dr Adolf Stroombergen of Infometrics Limited, prepared for the New Zealand Business Roundtable and the Petroleum Exploration and Production Association of New Zealand. The government's Emissions Trading Group engaged Infometrics last year to model effects of the government's proposed emissions trading scheme.

The period to 2025 was chosen for the study because it was used by the government and because it represents a 'milestone' on the path to the government's goal of carbon neutrality by 2050.

The study analyses a target of reducing New Zealand emissions to 1990 levels by 2025. This is a very conservative target in relation to carbon neutrality: at the recent Bali meeting, New Zealand supported a proposal by the Intergovernmental Panel on Climate Change to cut emissions by 25-40% below 1990 levels by 2020.

The study proceeds by modelling three scenarios.

First, a 'high growth' Business as Usual (BAU) scenario of 4.5-5% GDP growth is modelled to 2025. This scenario (Scenario A) serves as a benchmark to measure the economic costs of emissions reductions policies. A key premise of the study is that the impact of such policies does not put in jeopardy the government's priority goal of achieving sustained annual real GDP growth of 4% or more (necessary if New Zealand is to get back into the top half of the OECD per capita income rankings).

Scenario B models the impact of imposing a carbon price on the economy (through an emissions tax or trading scheme). Ideally, the question posed would be what price is necessary to achieve 1990 emissions levels by 2025. However, it turns out that the necessary price would be too high to model realistically. Instead, the question asked was what impact an international price of $100/tonne CO_2e, supplemented by measures such as the quasi-moratorium on new fossil-fuelled thermal generation which would bring the effective (or 'shadow') domestic price up to $300/tonne, would have on emissions relative to 1990 levels.

Scenario B assumes that all economic resources would be reallocated to other activities over time in response to higher carbon prices but does not take account of the effects of investment

uncertainty and transitional costs. Such effects are allowed for in Scenario C which assumes some fall in investment, employment and productivity.

The analysis shows that even with the very high carbon prices assumed, which would lead to a doubling of electricity prices in real terms and a 50% increase in petrol prices, New Zealand would be further away from its carbon neutrality goal than it is today, rather than on a path to achieving it. Moreover, in Scenario C private consumption would fall by 14% relative to BAU, which is about $7,000 per person or $19,000 per household.

In addition, the impact on numerous industries would be devastating – reductions in output of the order of 30-40% are reported in the case of sheep and dairy farming – and major industrial firms could face complete closure.

Commenting on the study, Business Roundtable executive director Roger Kerr and PEPANZ executive officer John Pfahlert said it called into question the consistency of the government's twin goals of faster economic growth and carbon neutrality.

"Businesses and households have to take them seriously – they are surely not intended to be a fraud on the electorate.

"Yet the government is not on track to meet its growth target and it is clear from the study that the economic impact of carbon neutrality policies would be far greater than the government has maintained.

"The reality is that there are currently no low-cost ways for New Zealand to reduce emissions significantly. The business community takes the threat of global warming seriously and is not generally opposed to action to put a low initial price on carbon. However, rhetoric about 'carbon neutrality' and 'leading the world' is fanciful and irresponsible and no basis for sound policy, as the study demonstrates."

5 February 2008

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