

**Comments from the Office of the Parliamentary Commissioner for the Environment  
on the  
Departmental Report on the Emissions Trading Select Committee Review  
Confidential Consultation Draft v2.1 - 3 June 2009**

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This document describes our specific comments on the content of the Department Report Draft v2.1 - 3 June 2009. Overall the Departmental Report is well written and balanced. However reservations remain, for example broader environmental concerns are not sufficiently discussed.

This review is a continuation from earlier discussions with officials regarding the content of the Departmental Report. We are pleased to see our earlier comments have been incorporated and present here further remarks. In this document we consider the Executive Summary and the Analysis sections of Chapter 2 - 5. Our comments are not intended to be exhaustive; we mainly focus on substantive points of difference, but in some cases we address other issues if they have cumulative effects that could be misleading.

**General comments**

1. The environment is not just atmospheric greenhouse gases and their impact on the climate. Also, the ETS will have broad environmental impacts beyond the impact of GHG emission reductions on the climate. While there is an argument for succinctness, wording should reflect these two points. For example, when referring specifically to GHG emissions, the wording “greenhouse gas emission reductions” should be used instead of “environmental outcomes”, “environmental integrity” should, in many places, be replaced by something like “effectiveness in reducing greenhouse gas emissions”.
2. The important issue of carbon leakage (i.e. increased net global GHG emissions caused by industry moving from New Zealand to countries there is an effectively lower, or no, price on carbon) seems entirely omitted. Decisions made about protecting competitiveness must also consider carbon leakage. Carbon leakage should be explicitly described, and referred to, throughout this report.
3. The requirement for integrated science and economic research to inform effective climate change policy is not mentioned. It should be.
4. Text should generally refer to greenhouse gas emissions, not just emissions

1	Pg vii, para 4 “The fundamental difference....”	This paragraph should mention the difference in the degree of risk to the government/tax payers between an ETS and tax.
2	Pg x, para 2 “From an environmental...”	Should reword to “To mitigate human-induced changes to the climate, it matters that total global emissions are reduced, and not whether these emission reductions occur in New Zealand or elsewhere.”
3	Pg xi End of Managing the	Add paragraph: “An ETS will also have broad environmental impacts, both positive and negative, on

	transition through assistance	for example, water quality and indigenous land cover. The extent of negative environmental impacts will depend on the details of ETS rules and regulations.” This paragraph should be expanded to include the main points of the section “Other non-greenhouse gas environmental impacts”
4	Pg xi, Cost impact on industry	This section fails to mention the risk of carbon leakage. It should.
5	Pg xii bullet points	Add bullet point: “preventing carbon leakage”
6	Pg xv, bullet points	This list is incomplete. Should also mention insufficient price incentive, capital constraints, externalities, and an incomplete ETS.
7	Pg 19, 2 <sup>nd</sup> bullet “Measures to deal with carbon...”	This bullet point should mention that carbon leakage could cause a net increase in global GHG emissions – as well as being a trade issue, it is environmental.
8	Pg 25, para 2 or elsewhere Agricultural issues	Consider referring to the question of whether the current GWP of methane is the most appropriate measure of CO <sub>2</sub> equivalence, the international context of this issue, and its importance for New Zealand.
9	Pg 27, para 1 “..managing a changing climate...”	Domestic policy can’t manage changing climate. Suggest changing to “managing the anthropogenic impact on the climate” and, since adaptation is in the terms of reference, “managing the impacts of the changing climate”
10	Pg 29, para 4 “...In addition to the reasons...”	This needs better description. Neglects to mention the potential for environmental <i>damage</i> due to poorly designed or implemented mitigation policy, e.g. increasing dairy farming in water catchment areas already over-burdened with farm runoff, as a result of forestry offsetting. Suggest text “Policy designed to mitigate greenhouse gas emissions, taking into account a broader environmental perspective, could produce valuable environmental co-benefits.”
11	Pg 29, para 6 “Climate change is already...”	The climate has always changed. The issue is the impact of anthropogenic GHG emissions on climate. Suggest wording change to: “Human-induced climate change is already evident”
12	Pg 30, 1 <sup>st</sup> set of bullets, 4 <sup>th</sup> bullet point	Given the potential impacts on tourism mentioned below, suggest edit to: “change in rain and snowfall patterns”
13	Pg 30, 2 <sup>nd</sup> set of bullets	This list would benefit from including economic threats such as a) the impact of changing precipitation patterns on e.g. hydroelectric power generation, tourism/alpine industry, b) the risk to plantation forestry, especially to monocultures, of spreading pests, wind damage. etc

14	Pg 32, para 3 Last sentence	Remove the word “ideally”
15	Pg 33, para 2 “It is difficult to quantify...”	Should mention the potential impact of changes to the ETS rules, particularly those regarding forestry, on harvest and replanting decisions and timing.
16	Pg 31, para 4 “...as well as the practical challenge of reducing ...”	Suggested wording change “... challenge of reducing New Zealand’s emissions without undue negative impacts on the broader environment”.
17	Pg 35, para 3 “...the use of incentives does not..”	Suggested change to “does not guarantee greenhouse gas emission reductions”
18	Pg 36, para 2, last sentence	Suggest change to “There is a strong case for other policies and measures to be applied alongside a broad price-based measure”
19	Pg 40, 1 <sup>st</sup> bullet point, Pg 44, para 4, Pg 59, para 1, and elsewhere	Should replace “environmental outcomes” with “greenhouse gas emission reductions” in the main text, not added as a footnote or in brackets.
20	Pg 43, para 5 Competitiveness impacts	This paragraph should mention and describe carbon leakage as being a possible negative result from competitiveness impacts.
21	Pg 47 Price based mechanism design	On Pg 123, the report lists reasons impacting forestry rules including: “Delivery outcomes sought by government at a level above (or below) that which would be provided by considering climate change drivers alone. For example, should the government seek to increase forest planting beyond its climate change benefits (say to improve water quality or reduce erosion) then the NZ ETS might be changed to reduce costs and risks to investors or increase benefits” While not an objective specific to the ETS, the ETS does provide opportunities to move towards other environmental goals. The above paragraph or similar should be included somewhere in the section on price-based mechanism design.
22	Pg 48, para 3 “Competitiveness concerns...”	Should be “Competitiveness and carbon leakage concerns....”
23	Pg 51, footnote 64	Removals that can not be counted towards NZ’s CP1 commitments should be identified and quantified/estimated.
24	Pg 52 -53 Analysis of coverage	This section should describe the risks of not including all sectors, for example competition between agriculture and forestry for land. The related risk of perverse environmental outcomes as a result of this competition for land (including increased GHG emissions, risks to water quality etc) should be

		described.
25	Pg 58, para 4 “Environmental and...”	This section only describes the risk to certainty of greenhouse gas emission reductions, and no other environmental considerations – the title should reflect this.
26	Pg 67-70 Independent governance	Issues of governance, and the potential role of independent agency to implement the ETS, needs more consideration in this report, particularly given overseas precedent. A comparison of the organizational structures of other countries which have, or are intending to have, an ETS should be provided, including the UK.
27	Pg 69, para 3 and Pg 70, para 3. Timing	While it may be difficult to completely analyse governance structures before the ETS design has been finalized, consideration of organization structure is required now. Functions cannot be defined without some idea of what agency will be undertaking them.
28	Pg 73, para 3, Pg 74, para 2 and elsewhere Pgs 71-84	Carbon leakage should be mentioned throughout this section relating to the impacts of competitiveness issues. Indeed , the threat of carbon leakage should be included as one of the “main concerns” (e.g. Pg 81, para 6) of the impact of pricing carbon.
29	Pg 84, last para	Decision makers should also consider the impact on net global emissions (carbon leakage).
30	Pg 86	Suggest calling this section “ Broader environmental Impacts”
31	Pg 86, para 1	Replace paragraph with: “Introducing a price on carbon is likely to have unintended broader environmental impacts.”
32	Pg 86, para 3	New paragraph: “The Cawthron Report identified many ways in which the ETS may impact the environment, both positive and negative. The potential impact of greatest concern is the threat to high value biodiversity from incentivizing the planting of exotic forests. Another significant and likely effect is the increased risk of wilding trees on areas of high landscape or conservation value, including much of New Zealand indigenous grasslands. Other potential impacts include risks to water and soil quality in certain regions.”
33	Pg 86, last paragraph	Consider: “Although outside its core intent, the broader environmental impacts of the ETS should be considered.”
34	Pg 91, 1 <sup>st</sup> bullet point	Suggest add sentence “An example of a measure to remove an information barrier is the introduction of

		smart electricity meters (which provide real-time information on price and consumption of electricity in the home.)”
35	Pg 91, para 2	This list is not exhaustive, suggest amend to emphasize this, eg: “Some market failures that may warrant the use of non priced-based measures include:”
36	Pg 91, bullet 5	Suggest adding to this point: “For example, inefficient electric resistance heaters are much cheaper than more efficient heat pumps or wood burners.”
37	Pg 91	This list should include these other reasons for market failure: <ul style="list-style-type: none"> <li>- Externalities. Decisions may be made based on reasons external to the ETS. For example, the decision to build a plant that converts lignite to liquid fuel, with significant CO<sub>2</sub> emission implications, may be strongly influenced by National Strategic Issues such as a desire for independence of fuel supply.</li> <li>- Incomplete ETS. As discussed below, where the ETS is incomplete, that is not all sectors are included, or there is free allocation, the strength of the price signal is weakened.</li> </ul>
38	Pg 93, para 3 “However, these arguments....”	Suggest removing this paragraph altogether. Otherwise reword to read “Arguments (i) and (ii) are based on a lack of confidence in agreed international frameworks for trading. This concern must be balanced against the importance of supporting global agreements. In the case of (iii)....”
39	Pg 97	Should add “The New Zealand Climate Change Research Centre submits research into agricultural mitigation is required that is coupled with analysis of the related economics and policy options.”
40	Pg 99 Analysis	This section needs to better represent the need for research into economics and policy of climate change in the New Zealand context.
41	Pg 99 Analysis	This section fails to respond to the relevant Terms of Reference, which is to “consider the case for increasing resources devoted to New Zealand specific climate change research”. An integrated and strategic overview including a plan for all government funded climate change research should be described here. Analysis of whether the government investment in climate change research is being optimally spent should be presented, as well as any holes identified where research is needed to aid effective decision making on the ETS. In

		addition, any structural barriers which impede progress of climate change research in New Zealand, or the clear transmission of its findings to decision makers, should be identified. If this analysis is not available now, high priority should be given to this assessment.
42	Pg 99 Analysis	This section should pull together research needs identified in other parts of this report and identify the extent to which they are being carried out. For example those described in the RIA chapter and agricultural section.
43	Pg 99, bullet points	Add another bullet: “Inform effective policy and decision making.”
44	Pg 100, para 2	The issue of the CO <sub>2</sub> equivalence measure of methane and the science, economic and policy implications should be mentioned here specifically (i.e. the question for New Zealand is not just trying to reduce methane emissions, but ensuring New Zealand pays a fair price internationally for the methane that is emitted).
45	Pg 106, para 7	Motu’s contribution is greater than just the model development. Alter sentence to read “They seek to inform climate change policy incorporating understanding from both natural science and economic analysis”.
46	Pg 106, para 8 Last sentence	Include a justification for this statement. More info is needed, e.g. \$\$, and how is research defined as being adaptation or mitigation.
47	Pg 106, para 8-9	Should mention the need for integrated science, economic and policy research to inform New Zealand’s climate change response (e.g. New Zealand Climate Change Centre’s submission).
48	Pg 112 Agriculture analysis	This section should mention somewhere the issue of whether the current GWP of methane is the most appropriate measure of CO <sub>2</sub> equivalence. If this changes, it could significantly increase or decrease the incentives to reduce methane emissions.
49	Pg 113, para 3 “Some submitters....”	For report cohesiveness and because it would aid the reader, suggest the words “carbon leakage” were used in this sentence.
50	Pg 113, para 3 “There are good economic...”	Should read “There are good economic and environmental reasons to continue to improve the efficiency of production...”
51	Pg 114, para 7	Need to define what a “hybrid option” is.
52	Pg 114, para 8	What is the default option for the point of obligation? If it is the processor this should be explicitly stated.
53	Pg 120, 2 <sup>nd</sup> set of bullets	Another bullet point is required, suggest: “broader environmental impacts including those

		resulting from incentivizing the planting of exotic species over indigenous, risks to water quality and threats to existing indigenous land cover including grasslands.”
54	Pg 122, para 4 “There is also the incorrect.....”	The second part of this statement will depend on the rules and is not necessarily accurate. Later (pg 102) the report does describe estimates for costs to the crown but this is based on some big assumptions which should be made explicit. The potential fiscal impacts of deviating from Kyoto rules should be expanded upon.
55	Pg 123, bullet points	Add another bullet point: “Mitigating the potentially negative impacts of the Kyoto forestry rules on the broader New Zealand environment. For example, removing incentives to allow wilding pines to become establish on indigenous grasslands.”
56	Pg 123, para 5 “There is no provision...”	There are potentially large differences between an area replacement versus a carbon replacement requirement in offset forests. For an equivalent area to sequester equivalent amounts of carbon, it would require equivalent soil quality etc, reducing the net benefits to the landowner of offsetting. This is an important distinction and should be discussed.
57	Pg 126 Other Environmental considerations	Should be renamed “ Broader environmental costs” and moved next to, or to be part of the “Costs of Offsetting” section.
58	Pg 126, para 3 “Officials understand...”	This sentence is misleading. Despite regulation, in practice dairy conversions lead to higher nutrient loadings in runoff and correspondingly poorer water quality, particularly in areas already under pressure. Remove this sentence altogether.
59	Pg 126, para 3 “However the water quality in.....water quality issues”	Weak and misleading. Replace these two sentences with “Conversions of existing forest to dairy farming use, facilitated by offsetting, will generally exacerbate water quality issues.”
60	Pg 126, para 4 “Concerns have also...”	This sentence should also mention the significant threat to indigenous grasslands from offset planting of exotics species.
61	Pg 126, para 4 “However, the degree....”	Remove the word “However”.
62	Pg 126, para 4 “It should also be noted...”	Misleading. For significant areas of indigenous scrubland, referred to in the opening sentence of this paragraph, the ETS <b>does not</b> provide any positives. The sentence should be removed or amended to read “It should also be noted that under the NZ ETS there are some positives for indigenous scrubland that can

		qualify as forest.”
63	Pg 126, para 4 “However, the NZ ETS (and complimentary .....”	Incomplete. Additional sentence needed at end of paragraph: “However, the financial reward for retaining indigenous scrub is considerably lower than the reward for planting the same land in exotic tree species.
64	Pg 139, bottom of page. Pg 140, para 4, bullet 5. Pg 140, para 4, bullet 6. Pg 140, para 6, 2 <sup>nd</sup> sent. Pg 141, para 3	The terms of reference imply that the modeling will compare the proposed ETS with a tax. This is not what the report modeled – in fact it modeled an ETS <i>as</i> a tax.  This needs to be explicitly pointed out. This point is acknowledged in the text at one point. Nevertheless, referring to scenarios as “ETS” or “narrow tax” will still be misleading, as it implies the defining difference between these scenarios is the type of pricing instrument – which is incorrect. For example, the difference between the “ETS” and the “narrow tax” appears to be sectoral coverage. Both types of pricing instruments can have narrow sectoral coverage. Another example is a carbon “tax” scenario where the defining feature is that the domestic price is different to the world price. However, in this modeling framework, the results would be equivalent to an ETS with price controls (e.g. price ceiling or floor).  Consider referring to the scenarios as a something along the lines of “carbon pricing”, “carbon price with narrow sectoral coverage”, “domestic carbon price different from international price” instead of “tax” or “ETS”.  The point could then be made that both a tax and an ETS can be designed in this way.
65	Pg 140, para 2, “The specification of various...of the contractors”	Remove this sentence - doesn't add anything.
66	Pg 140, para 5	It is acknowledged that Business-as-usual (BAU ) scenario has no impact on the relative impacts of policies, and consequently the real substance of the report. <b>However, the BAU does impact the magnitude of all policies modeled, which leaves the report open to interpretation in a misleading way.</b>

		<p>Consider adding a paragraph that more fully explains the lack of realism regarding the BAU. For example, discuss the fact the BAU excludes any trade sanctions, overseas consumer backlash, impact on international negotiations etc.</p> <p>Also, remove this text “but it does cause some confusion as all scenarios are presented with negative signs” as it is unhelpful.</p>
67	Pg 140, para 6 “The modeling results show ...”	The equity implications of the government purchasing permits from general taxation should be mentioned.
68	Pg 140, para 7 “The report recommends ...”	<p>The main recommendation in the NIZER/Infometrics report: “On balance, our recommendation in the short run is to introduce an ETS with free allocation to competitiveness-at-risk sectors, with agriculture excluded if measurement of its emissions is prohibitively expensive. Free allocation should be output-linked and phased out as our competitors adopt carbon pricing. If agriculture is initially excluded it should be transitioned into the ETS, with free allocation if required, as measurement becomes economic.”</p> <p>In the report it is summarized as recommending a “narrow” policy. This is not our interpretation of the recommendation. NZIER/Infometrics appear to recommend all sectors are included, except possibly agriculture depending on the measurement costs.</p> <p>Consider directly quoting this recommendation, to avoid any doubt. Alternatively, fully define what “narrow” means.</p>
69	Pg 141, para 7. & pg 139 first bullet list.	<p>We agree that many of the issues that were raised in submissions need to be considered. An analysis of distributional impacts, to enable the provision of appropriate transitional assistance, is required.</p> <p>Longer term, considering the environmental costs of climate change, with a view to adaptation, will also be extremely important. However, “comparing the impacts of climate change with the costs of response” will add little to policy debate, given the uncertainties and risks and the fact that NZ is a signatory to Kyoto.</p>
70	Pg 141, para 7.	This sentence relates to international backlash resulting

	“The fact that these ...”	from New Zealand not introducing domestic policy. It states that excluding costs of the backlash will not affect the relative costs of the scenarios. However, we argue that excluding this factor <b>will</b> affect the relative costs, because the likelihood and extent of any backlash or sanction depends on the domestic policy.
71	Pg 141, para 2 “As the carbon price rises above a certain level ... “	What does the modeling suggests this level would be? Should be included/mentioned.
72	Pg 141, para 7. “Factors that are not captured ...”	For clarity instead of referring to consumers, refer to overseas consumers and other governments
73	Pg 142, para 1 “The study does not ...”	Remove the second part of this sentence: “as this was not explicitly ...reference”
74	Pg 142, para 3 “A number of ...”	<p>This paragraph outlines the assumptions/modeling difficulties that would cause the costs from the modeling results to be overstated. For balance, a list of assumptions/ modeling difficulties that could lead to <b>understating</b> the cost should be added.</p> <p>Following this, a discussion could be added regarding the fact that forecasts of regulation costs are often overestimated. As a supporting example, the sulphur dioxide market in the US could be referred to. Also, a paper has analysed 25 cost estimates of environmental regulations (including the sulphur dioxide market), and found that 12 cases over estimated where as 6 underestimated costs. Much of the overestimation was attributed to unanticipated technical innovations. The reference is Harrington, W, Morgenstern, D, &amp; Nelson P. 1999. “On the Accuracy of Regulatory Cost Estimates.” <i>Discussion Paper 99-18</i>. Resources for the Future.</p> <p>We suggest that these findings are discussed here.</p>