

## Seeking the Aroma of Error ... In Place of the Real Thing

### *Rebuttal to Business New Zealand's document "The Subsidy Myth"*<sup>1</sup>

While purporting to be very concerned about “unnecessary confusion ... around emissions trading”, Business New Zealand’s document mainly relies on inferring error in place of identifying the real thing when critiquing the Sustainability Council’s analysis of the ETS.<sup>2</sup> The document seeks to construct the aroma of error rather than provide genuine critical analysis. This approach, combined with the propensity for actual error in the Business NZ document, undermine its potential as the credible communications tool it was intended to be.

Business NZ has three lines of critique that are highlighted in boxed sections of its document. The following rebuts each of these in order of appearance.

### 1. Value of the Subsidies

Business NZ infers that the assumptions used to calculate the subsidies are wrong, while completely failing to mention that each of the assumptions it criticises is in fact used by the Government when making such calculations. The Council generally used assumptions that parallel the Government’s to minimise the scope for confusion – something Business NZ says it is concerned about. Yet what does Business NZ list as its three charges in this regard:

a) ***That the Council uses a linear phase out rate of 1.3% per annum – exactly that used in a series of Government documents.***<sup>3</sup> The alternative interpretation of the Bill is an asymptotic decline based on the 1.3% figure, which would result in even higher subsidy estimates – something not mentioned by Business NZ. Business NZ relies on a cheap inference while the selection of this assumption in fact demonstrates a conservative approach by the Council.

b) ***That the Council runs the estimates for a full 76 years – which again is the result of using the 1.3% linear phase out*** and is the period the Government estimates would run to if not truncated to varying periods the Government seeks to focus on.<sup>4</sup> Business NZ tries to argue that because there is a requirement in the Bill for periodic review, that somehow it is invalid to estimate the value of the subsidies as

<sup>1</sup> Business New Zealand, *The Subsidy Myth*, November 2009.

[http://www.businessnz.org.nz/file/1772/The\\_subsidy\\_myth.pdf](http://www.businessnz.org.nz/file/1772/The_subsidy_myth.pdf)

<sup>2</sup> Sustainability Council, *ETS: Bill to a Future Generation*, 12 November 2009.

[www.sustainabilitynz.org/docs/ETSBillToAFutureGenerationNov09.pdf](http://www.sustainabilitynz.org/docs/ETSBillToAFutureGenerationNov09.pdf)

<sup>3</sup> See: Hon Dr Nick Smith, *ETS Briefing*, 9 Oct 2009; Hon Nick Smith, figures Rio Tinto/Comalco smelter tabled in the House, 23 September 2009.

<sup>4</sup> See documents in the above reference and MFE and Treasury, *Emissions Trading Scheme Legislative Review: Fiscal Neutrality*, 13 February 2009 and related updates.

provided for in the Bill now. The Government estimates them well beyond a series of review dates (with estimates going out to 2018, 2030 and 2050 in various instances) because it is recognised that the Bill, if passed, would generate costs over the full transition period unless and until the legislation were altered. The “near-perpetual” subsidies are a function of the formula set out in the Bill until Parliament amends it.

c) *That the Council nonetheless failed to mention the review provisions – when they are a key focus of subsection 3.3 in its report.* Business NZ is simply wrong when it states in respect of the review provisions that: “The Sustainability Council has omitted to mention this critical section of the Bill”. Not only is the existence of the review provisions identified and the clause named on page 12 of the Council’s report, that subsection focuses on why in spite of Parliament’s ability to change law, the level of subsidies proposed may be difficult to unwind.

## 2. Carbon Price Used

The Business NZ document ironically reveals of itself exactly the failing it levels in its second claim: “lacks an understanding of the state of the carbon market”.

The Council uses values of \$30/t (roughly today’s carbon price) and \$25/t (the value of the price cap), as appropriate, to value all subsidies. Business NZ raises no specific objection to the use of these values or the estimates resulting from them. Its press release that cites “flawed assumptions regarding ... carbon prices” instead relies on identifying what it believes is a technical error of interpretation to infer that the carbon prices used are somehow wrong.

The technical point Business NZ relies on is that a nation’s Kyoto obligations can only be met with Kyoto instruments issued during the Kyoto period (ending in 2012). It says that when the Council lists a range of possible values for the Kyoto liability, and one of these is based on a possible carbon price for 2015 of \$100/t, that the Council is mixing up prices between periods – and so does not understand the carbon markets.

It is Business NZ’s document however that has not thought through how the market operates. Just because units must be created in the Kyoto period to be valid, it does not mean that they cannot be traded in 2015 when Kyoto obligations must be settled by. If the supply of credits available to settle up is tight, prices could go very high. They will in any case be strongly influenced by then prevailing prices for credits created in the second commitment period. This is for the simple reason that many credits from the Kyoto period (such as AAUs) can be banked to the second period. Thus, why would anyone sell such a Kyoto credit in 2015 for less than the amount they could avoid paying for a credit made in the second commitment period?

What is billed as “flawed assumptions regarding ... carbon prices” turns out to be a point completely unrelated to the subsidy estimates the Council makes, and on analysis of the point, Business NZ’s document is hoisted by its own petard.

### **3. Accounting for Kyoto Forests**

Business NZ accepts that it is appropriate to place a contingent liability on the Government's accounts for the future felling of forests currently earning credits – the Kyoto forests. It also implicitly concedes that the owners of those forests intend to harvest them, and that unless there are changes to the current regulatory landscape, the full value of the credits now being counted towards the Kyoto net position will ultimately need to be repaid. (This is also the Treasury's assumption, as Business NZ quotes.)

Yet Business NZ accuses the Council of a “misleading” approach for insisting that this expected future debt be counted in today's assessment of the Kyoto position. Business NZ's document implies that this multi-billion dollar expected cost should be passed as a debt for a future generation to pick up rather than recognize today that the Kyoto forests are, as the Treasury states, ultimately “a zero sum game”.

The Council's approach to the issue is based on economic analysis – which makes abundantly clear that for the purpose of policy setting, the future deforestation costs must be matched to the credits being earned today. Both must be counted in the Kyoto period. The net position report for the Kyoto period needs to be updated and corrected to show the contingent liability of future deforestation costs. The Crown accounts have also been in error right up to and including the May 2009 budget documents through having failed to record any such contingent liability, and this has only been corrected online very recently.

Even if the frame is narrowed right down to accounting policy as Business NZ suggests, the end result is the same. If there is a very high chance that a contingent liability will eventuate, then the amount that a buyer would be prepared to pay for an entity is the balance sheet value, less the contingent liability. In this case, the New Zealand Government fully expects the Kyoto forests to be felled and unless and until there are changes that would materially alter the risk, effectively all the Kyoto forest credits must be replaced in future (as the Treasury now assumes). Thus if the note on the Crown accounts is properly interpreted for the Kyoto period, there is a multi-billion dollar future cost as a result of the Kyoto obligations that reduces the Government's wealth accordingly. That reduction in wealth cancels out the value of the forest credits such that New Zealand faces a Kyoto liability effectively equal to its excess emissions.

In summary, far from “distracting efforts from the real task of getting a durable emissions trading policy in place”, the Council has been endeavoring to make clear the real costs of the ETS and the need for a change of approach that will ensure today's polluters pay today's emission bills.