He Pou a Rangi
Climate Change Commission

Hon Eugenie Sage
Chair, Environment Committee
Parliament Buildings
Wellington

6 April 2023

To the Environment Committee,

Submission on the Climate Change Response (Late Payment Penalties and Industrial Allocation) Amendment Bill

Context

1. Industrial allocation is a tool to manage the risk of emissions leakage: the shifting of production and emissions from firms subject to the New Zealand Emissions Trading Scheme (NZ ETS) to jurisdictions with less stringent measures at no overall gain to the climate. Recipients of industrial allocation are protected from a portion of the costs of their greenhouse gas emissions. Currently, industrial allocation is provided as a temporary measure only to eligible emissions-intensive and trade-exposed producers on the grounds they have less ability to pass on emissions costs than other producers.
2. It is important that the levels of industrial allocation are commensurate to the risk of emissions leakage. If allocation rates are too low, it will not be sufficient to manage the risk of emissions leakage, leading to firms (or production) relocating overseas. If industrial allocation levels are too high, this imposes inequitable costs on other emitters within the NZ ETS who pay for the right to emit. It also imposes a direct fiscal cost on the Government, and thereby to taxpayers, and places additional pressure on meeting emissions reduction targets.
3. There is evidence that industrial allocation rates are higher than they need to be to manage the risk of emissions leakage. By amending current industrial allocation settings, this Bill seeks to ensure the level of allocation to emissions-intensive and trade-exposed industrial producers is more commensurate with the risk of emissions leakage. Our submission addresses only Part Two of the Bill, as it relates more directly to the Commission's functions under the Climate Change Response Act 2002 (the Act).
4. The Commission requests to appear before the Environment Committee to speak to this submission.

Key points

5. **The current wording in the Bill to improve allocative baselines could prevent some instances of over-allocation being corrected, allowing firms to keep receiving more units than they need, which raises equity and target issues.** The Bill sets out a process for allocative baselines to be regularly updated to ensure industries are not receiving significantly more units than they need to manage the risk of emissions leakage. One of the conditions proposed in the Bill before allocative baselines can be changed is that they must lead to allocations being higher than emissions costs. We recommend that this condition should be clarified to explicitly exclude the impact of the level of assistance in this assessment

so that allocative baselines are assessed on their own merits. Without this change, there may be cases where the Act maintains allocative baselines that allow higher allocation than is necessary to manage the risk of emissions leakage.

6. **The proposed change to existing eligibility thresholds risks giving more units to firms than they need, raising costs for other emitters and taxpayers, and again raising equity and target issues**. The risk of emissions leakage changes over time. The context in which the original eligibility thresholds were set in 2009 has changed substantially. The Bill proposes to adjust eligibility thresholds in response to changes in emissions prices alone. This approach – that excludes any evaluation of changes in other drivers of emissions leakage – risks redistributing and likely expanding the pool of recipients unnecessarily. On its own it is also likely to increase the total volume of allocation. These changes could increase costs to taxpayers, raise equity considerations for NZ ETS participants, and place greater pressure on achieving emissions targets. We recommend that any update to the eligibility criteria for receiving industrial allocation is based on a more holistic assessment of emissions leakage risk.

7. **The additional eligibility criterion proposed for new activities to receive industrial allocation is subjective and risks politicising the process.** The Bill would require the Minister to determine whether the risk of emissions leakage from a new activity outweighs any relevant domestic emissions reduction commitments and international climate change obligations. It is not clear how this determination would operate in practice or how it would interact with decisions on changes to the phase-out of industrial allocation. While the introduction of an additional eligibility criterion does present a barrier to widening allocation, the introduction of a more subjective assessment could make the process vulnerable to politicisation and inconsistent decisions. We advise that it would be better to thoroughly review the basis for the existing eligibility criteria – including the original thresholds and the specific electricity allocation factor (EAF) for testing eligibility – and apply them evenly and transparently.

8. **The proposed extensions to information sharing between the Environmental Protection Authority (EPA), the Ministry for the Environment (MfE) and the Commission will support the Commission to provide expert advice.** The Bill proposes that, upon request, the EPA will be required to share information submitted in industrial allocation applications with MfE and the Commission. This will assist the Commission in giving advice on industrial allocation and unit limit and price control settings.

9. **The proposed new approach for calculating the EAF will reduce over-allocation and improve transparency and certainty.** By requiring the EAF to be updated regularly by the Electricity Authority, it will better align the EAF with actual emissions costs. The Bill also requires that the model and the inputs used are made publicly available, providing greater transparency.

Background

10. This is a submission from the Climate Change Commission. The Commission is an independent Crown entity established under the Climate Change Response Act 2002 (the Act), whose purpose is "to provide independent, expert advice to the Government on mitigating climate change (including through reducing emissions of greenhouse gases) and adapting to the effects of climate change; and to monitor and review the Government's progress towards its emissions reduction and adaptation goals" (section 5B of the Act).

11. In line with our role, we wish to provide the Environment Committee our advice on the Climate Change Response (Late Payment Penalties and Industrial Allocation) Amendment Bill – in particular the provisions relating to industrial allocation. We have no specific comments on the provisions in the Bill amending penalties for small forestry participants.
12. The issue of industrial allocation is of fundamental importance to the proper functioning of the NZ ETS and is one that interacts with several of the Commission's functions. The Commission has made recommendations to the Government in the past on industrial allocation through our advisory report *Ināia tonu nei* in 2021. The Commission also has a requirement under the Act to regularly consider industrial allocation through our annual advice on NZ ETS unit supply and price control settings. In addition, the Act specifies that when the Minister requests it, the Commission must provide recommendations on changes to phase-out rates of industrial allocation.

It is important to regularly calibrate the levels of industrial allocation to effectively manage the risk of emissions leakage in an equitable way

13. Overall, the high-level intention of the Bill to address existing over-allocation will help Aotearoa New Zealand to better manage the risk of emissions leakage and ensure greater consistency of industrial allocation provisions with domestic emissions reduction commitments and international climate change obligations.
14. However, we have several concerns we wish to discuss in further detail.

The current wording in the Bill to improve allocative baselines could prevent some instances of over-allocation being corrected, allowing firms to keep receiving more units than they need, which raises equity and target issues

15. The regular review and updating of allocative baselines proposed in Clause 14 is necessary to keep industrial allocation fit for purpose and avoid over-allocation. It is also important that the method and frequency for updating allocative baselines do not create perverse incentives for firms to defer improvements that would lower their emissions.
16. The Bill proposes a five-year minimum (Clause 14) and 10-year maximum (Clause 16) period for conducting reviews of allocative baselines. Our assessment is that this is appropriate, but we have identified one issue with how the provisions on reviewing allocative baselines are worded.
17. There are two components to calculating the rate of allocation given for an activity per unit of product produced. The first is the allocative baseline for the activity – this is intended to describe how emissions-intensive the activity is. The second component is the level of assistance.
18. Industrial allocation is not intended to meet all of emitters' emissions costs. The levels of assistance are designed to ensure that emitters still face some costs for their emissions. These are currently set at 87% and 57% for highly and moderately emissions-intensive activities, respectively, and are set to decline over time.

19. Under the proposed approach in the Bill (Clause 14(1)(3A)(c)), the Minister can only amend allocative baselines if "the effect of the existing baseline is that the activity's allocations are equal to or greater than the activity's emissions costs" (also see Clause 16(1)). This drafting is ambiguous; it could imply that the level of assistance would be factored into determining the effect of the existing baseline.

20. To support effective decision making, we advise that the validity of allocative baselines should be assessed independently from the level of assistance that applies at any given time. The situation could arise where an allocative baseline is set too high, but because of the level of assistance, allocations are still less than emissions costs. For example, if an allocative baseline for a moderately intensive activity is too high by 40%, its recipients would receive 80% of their emissions costs (1.4 x 0.57) instead of the 57% intended by the level of assistance. The current drafting could prevent this allocative baseline from being corrected allowing over-allocation to continue.

21. We recommend redrafting Clause 14(1)(3A)(c) to explicitly exclude consideration of the level of assistance. Here is an example: "the Minister is satisfied that the effect of the existing baseline is that the activity's allocations are equal to or greater than the activity's emissions costs *before the level of assistance is applied*." Consequential changes would be needed to Clause 16(1).

The proposed change to existing eligibility thresholds risks giving more units to firms than they need, raising costs for other emitters and taxpayers and again raising equity and target issues

22. As described above, the Act currently sets two categories for levels of assistance: a highly emissions-intensive category that receives 87% of emissions costs, and a moderately emissions-intensive category that receives 57% of emissions costs. The Act currently classifies activities as moderately emissions-intensive if their emissions are at least 800 and less than 1,600 tonnes of CO_2e per $1 million of revenue, and highly emissions-intensive if their emissions are at least 1,600 tonnes of CO_2e per $1 million of revenue.

23. Under the methodology proposed by the Bill (Clause 15), these thresholds would be updated to reflect increases in the emissions prices that have occurred since the thresholds were originally developed. The Bill would scale the current thresholds by the ratio of 25 divided by the "specified price of carbon" (calculated under section 30W based on emissions prices in the previous 12 months). Using a hypothetical specified price of carbon of $75, the eligibility thresholds would drop from 800 to 267 tonnes per $1m for moderately intensive producers and from 1,600 to 533 tonnes for highly intensive producers.

24. Under Clause 21 (introducing new Clause 19 to Schedule 1AA), the Government would conduct a one-off review of existing eligible activities using the amended eligibility thresholds and updated base years. The notice requesting the necessary information would be issued no later than 31 December 2026.

25. Based on data available on current intensity measures, we consider it likely that under this approach all activities currently considered moderately intensive would be reclassified as highly intensive, increasing their level of assistance accordingly.

26. The rationale provided is that that these reductions in eligibility thresholds are justified by the increase in the emissions price from $25 per tonne when the intensity thresholds were set in 2009 to a much higher

price today.[1] When the thresholds were originally set, they equated to between 2% and 4% of revenue for moderately intensive producers and at least 4% of revenue for highly intensive producers.[2] The Government has stated that these ratios need to be preserved to avoid "significant risk of emissions leakage."[3]

27. We question the case for preserving these ratios and suggest that further evidence and analysis would be needed to support their use. We discuss our reasoning below.

Leakage risk is more complex than emissions price impact

28. The risk of emissions leakage is driven by the extent to which a trade-exposed firm is able to avoid, pass on, or absorb emissions costs, and the degree to which overseas competitors would likely increase their production and overseas emissions would rise if the volume of production in Aotearoa New Zealand decreases as a result of domestic climate policies. This is highly specific to activities, mitigation options, competitors, and markets. The risk of leakage is also a matter of degrees and is not a binary matter.

    Notably, other parts of the Act recognise this nuance. When making regulations to adjust phase-out rates for industrial allocation, one of the matters the Minister must consider under section 84C(3) is the risk of emissions leakage. That section describes this consideration as:

    (c) the level of risk of emissions leakage (increased emissions overseas as a result of emissions reductions in New Zealand, for example, an activity being relocated outside of New Zealand to reduce the emissions-related costs for the activity), based on—

    (i) *the emissions-related costs and policies in competing jurisdictions; and*
    (ii) *the markets for international trade in the products produced by the activity; and*
    (iii) *the ability of affected eligible persons to pass on increased costs to customers;*

29. The current proposal in the Bill would scale the eligibility thresholds only for the increase in emissions price and its effect on emissions leakage risk – making more activities eligible for higher rates of allocation. However, many of the wider factors affecting emissions leakage will also have changed, potentially making such a change unnecessary. Section 84C(3)(c) provides a much more comprehensive scope for evaluating emissions leakage risk (in the context of adjusting phase-out rates) than underpins the proposal in the Bill. We suggest that a more effective assessment of leakage risk be done than is proposed in this Bill before any adjustment to the eligibility thresholds is made.

[1] The Government's Regulatory Impact Statement for the Bill refers to an emissions price of NZ$75 per tonne in April 2022. Emissions prices surpassed $85 per tonne at some points in 2022. At the end of March 2023, emissions prices were under $60 per tonne.

[2] As discussed further below, the eligibility assessment applied the Australian electricity allocation factor which was (and remains) significantly higher than appropriate for New Zealand and artificially inflated the presumed impact of emissions pricing as a percentage of revenue.

[3] Refer to the Cabinet paper "Reform of industrial allocation policy in the New Zealand Emissions Trading Scheme," paragraph 47.

The global landscape for climate change policies has changed since 2009, reducing the risk of leakage

30. The risk posed by emissions leakage to climate change and the Aotearoa New Zealand economy is substantially different now than what it was in 2009 when the eligibility thresholds were first set.
31. Since then, the world has moved from the 1997 Kyoto Protocol to the 2015 Paris Agreement. Both developed and developing countries have Nationally Determined Contributions under the Paris Agreement and an increasing number of countries have adopted targets for net zero emissions by 2050. Emissions pricing and more stringent mitigation policies are in place in many countries. Countries with absolute economy-wide emissions reduction targets will need to compensate for any increased emissions due to leakage of production from other countries. In addition, actions and targets by multi-national corporations and sub-national actors further constrain the probability that increased mitigation efforts and costs in Aotearoa New Zealand would simply result in a compensating increase in production and emissions elsewhere. As a result, emissions leakage is generally less likely to occur and poses less threat to the global climate than in the past, with different rates of progress across sectors. These kinds of global shifts will have different impacts on the risk of leakage across different activities and markets.
32. Another important consideration is how firms' operating models and profit structures have changed since the settings were determined. The Government adapted the current eligibility thresholds for the NZ ETS (with adjustments for exchange rates) from those proposed by the Australian Government in 2008 under its Carbon Pollution Reduction Scheme (which evolved into the Carbon Pricing Mechanism). That approach was based on Australia's industrial production data over 2001-2002 and adjusted in the context of Australia's anticipated emissions cap. At the time, the Australian Government concluded that eligible firms should not receive free allocation for 100% of their emissions costs and planned for the phase-out of allocation over time.
33. The eligibility thresholds in the NZ ETS were designed as a gateway to receiving industrial allocation when emissions trading was first introduced. They are artifacts of history specific to the time they were developed. Just as the test did not change when emissions prices plunged in 2011, the test was never designed to be adjusted as emissions prices increased over time. Furthermore, the test has never promised a perpetual entitlement to free allocation if emissions costs were to exceed 2% or 4% of revenue at any future emissions price. Since the inception of the NZ ETS, it has always been the intention in policy and legislation for industrial allocation to be phased out over time.
34. In this context, the suitability of applying the historical eligibility thresholds as the base for an updated assessment of eligibility for today's industrial operations in Aotearoa New Zealand is questionable and merits further testing.

The existing electricity allocation factor for testing eligibility counts more emissions than are actually occurring, leading to more industrial allocation than is needed

35. Electricity allocation factors (EAFs) describe how much emissions from the production and use of electricity are attributed to other activities for the purpose of industrial allocation. The Bill proposes a process for updating the EAF used in setting allocative baselines for eligible industrial activities. The process established under new section 161FA (Clause 18) to update this EAF will better align the EAF with actual emissions costs. By requiring that the model and the inputs used are made publicly available, it will also make the EAF more transparent.

36. However, under the Climate Change (Eligible Industrial Activities) Regulations 2010, a different EAF is used when determining if emissions associated with an activity meet the eligibility threshold for industrial allocation. The Bill does not signal any changes to section 6(b) of the Regulations, so we presume the existing regulated value would continue to apply.

37. The EAF for determining eligibility for industrial allocation is currently set at 1 tonne CO_2e per megawatt hour (MWh), reflecting the value that would have applied in the Australian ETS based on that country's high levels of coal-fired power. This was chosen for reasons of trans-Tasman competitiveness. The Australian ETS was repealed in 2014, but the EAF for assessing eligibility for industrial allocation in Aotearoa New Zealand remains in regulations at 1 tonne CO_2e per MWh. This means that a producer counts much more electricity emissions towards an activity for the purposes of assessing its emission intensity than are actually occurring. For comparison, the EAF currently applied to allocative baselines in the NZ ETS is 0.537 tonnes CO_2e per MWh, and independent analysis commissioned by the Government suggests that even this lower level has contributed to over-allocation.[4]

38. The use of an Australian EAF to determine eligibility for industrial allocation in Aotearoa New Zealand is another historical artifact that if maintained would lead to more firms being eligible than if an EAF specific to Aotearoa New Zealand was used. Our assessment is the Australian EAF for eligibility is not appropriate in today's context. Any decision to amend the eligibility thresholds presents an opportunity to replace the current EAF with an EAF based on Aotearoa New Zealand's electricity system, so it correctly targets industrial allocation at the activities that need it.

Updating eligibility thresholds for existing producers pulls against achieving our domestic emissions reduction targets

39. The proposal to update the eligibility thresholds could see a range of activities already operating in Aotearoa New Zealand become newly eligible for industrial allocation. However, the analysis provided for the Bill put forward no relevant examples of what activities this may apply to and the potential impact on allocation volumes and costs.

40. Emissions-intensive and trade-exposed firms will have been factoring the impact of emissions pricing into their investment decisions since at least 2010 when industrial emissions entered the scheme. At this stage, businesses have had many years to make adjustments and to prepare for the transition to a low-emissions economy. It is therefore hard to justify providing significant new access to allocation.

41. Updating the eligibility thresholds using the approach currently proposed in the Bill expands the potential pool of recipients still receiving free units by 2050 and beyond (given the current phase-out trajectory), which places further pressure on the 2050 target and raises questions of equity across other sectors and for taxpayers.

Updating eligibility thresholds for only one aspect of leakage risk, without assessing others, risks doing more harm than good

42. To be successful, this Bill should seek to manage the risk of emissions leakage while avoiding overpaying to do so. Adjusting eligibility assessment to account for changes to emissions prices and base years only,

[4] Ministry for the Environment. 2019. "The New Zealand Emissions Trading Scheme: Modelling the electricity allocation factor: Issues paper." Wellington: Ministry for the Environment.

while omitting to review wider aspects of leakage risk or apply an EAF relevant to our own electricity market, is not likely to achieve that goal. Instead, it could contribute to inefficient and unnecessary industrial allocation which could have significant negative impacts on the climate, taxpayer costs and the proper functioning of the NZ ETS market.

43. Our assessment is that the risks of updating the eligibility test based on only one aspect of leakage risk materially outweigh potential gains. There could be merit to improving the eligibility assessment for both existing and new industrial allocation but only if it is grounded in a wider assessment of how leakage risk has changed over time and how eligibility should change in response. It is important that any such assessment also consider how the industrial allocation regime can be made consistent with achieving Aotearoa New Zealand's emission targets as the current regime pre-dates the emissions targets now set in the Act.
44. Under the Act, there are three levers for improving industrial allocation: the eligibility test, allocative baselines, and phase-out rates. Adjusting phase-out rates, which is already enabled through regulations under sections 84A and 84B of the Act with advice from the Commission, could be used to mitigate shortcomings of the existing eligibility test if that test is retained in its current form.

The additional eligibility threshold criterion proposed for new activities to receive industrial allocation is subjective and risks politicising the process

45. The current eligibility thresholds for activities are based on assessment through just two objective tests – emissions intensity and trade exposure. Meeting both these tests automatically results in any activity becoming eligible. Under the proposed changes in the Bill, the emissions intensity test will become easier to meet as the thresholds are updated to account for increases in the carbon price. No changes are proposed to the trade exposure test. The trade exposure test specifies that all activities are considered trade exposed unless, in the Minister's opinion, "they have no international trade of the output of the activity across oceans" or "it is not economically viable to import or export the output of the activity" (section 161C(1)(c)).

46. Clause 14(1)(2) in the Bill adds a third test for new activities to become eligible to receive industrial allocation. This requires that the Minister assesses eligibility under the same criteria defined under section 84C(3), with the exception of recommendations from the Commission. Before a new activity can become eligible the Minister must then "be satisfied that the activity is at risk of emissions leakage and that risk outweighs any relevant domestic emissions reductions commitments and international climate change obligations."

47. This new test requires a subjective judgment by the Minister following a balancing exercise. Requiring the Minister's assessment of eligibility on a case-by-case basis using subjective factors could politicise such decisions across administrations and types of activities and trigger more cause for judicial review. That could damage confidence in the system by the market and the public.

48. Further, the Minister – with advice from the Commission – is required to consider the factors in section 84C(3) when deciding on any changes to phase-out rates, without the specific further direction to weigh the risk of emissions leakage against domestic commitments and international obligations. This inconsistency could be problematic and produce contradictory outcomes.

49. Therefore, we recommend that this requirement be removed. If an additional test is warranted for determining eligibility of new activities, we suggest that an objective test would be better.

Summary

50. In summary, many of the amendments to industrial allocation settings proposed in the Bill will better align levels of industrial allocation to be proportionate to the risk of emissions leakage. However, in some parts of the Bill the current approach could allow for significant perverse outcomes from over-allocation that could interfere with proper functioning of the NZ ETS market, increase costs to Government, and place emissions reduction targets at risk. We recommend that the following changes be made:

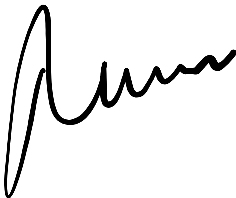
    a. Amend Clause 14(1)(2) to enable a more objective eligibility assessment for new activities to receive industrial allocation (with consequential changes to Clause 15(2))

    b. Amend Clause 14(1)(3A)(c) (with consequential changes to Clause 16(1)) to clarify that it is the effect of the allocative baseline *before the level of assistance is applied*, that needs to be higher than the activity's emissions costs to allow the baseline to be amended.

    c. Either remove Clauses 15(1) and (3) (which relate to recalculating emissions-intensity thresholds for eligibility) or amend them to provide for an effective assessment of leakage risk under updated circumstances.

51. The Commission requests to appear before the Select Committee to speak to these points.

Ngā mihi nui



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