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Ministry for the Environment

via email: [etsconsultation@mfe.govt.nz](mailto:etsconsultation@mfe.govt.nz)

## Submission on Reforming Industrial Allocation in the New Zealand Emissions Trading Scheme

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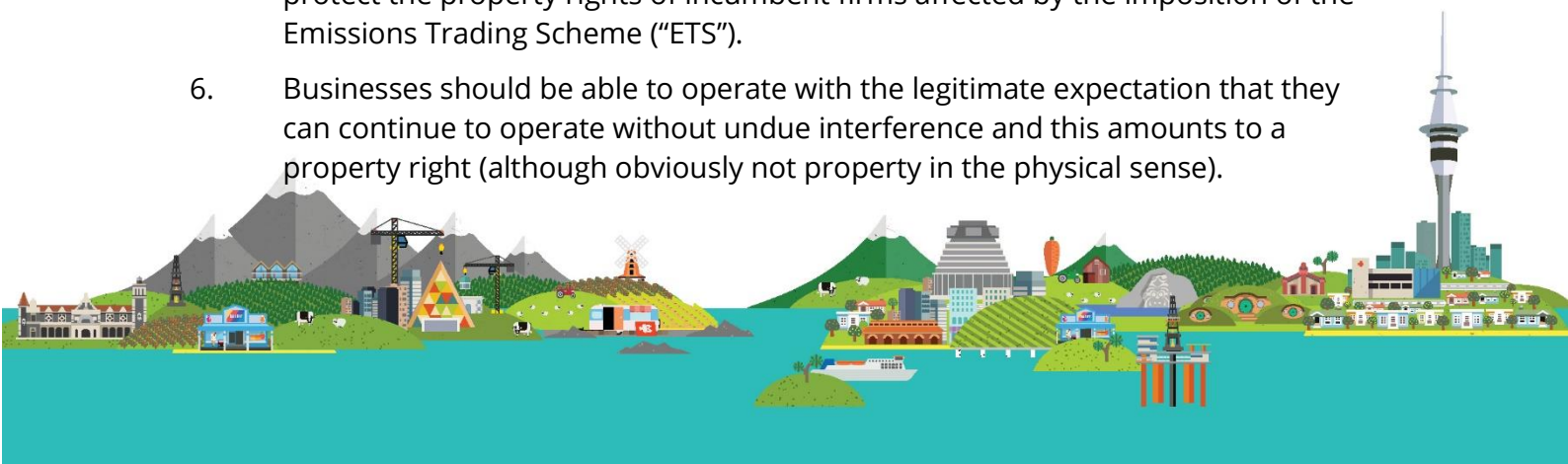
### Introduction

1. Energy Resources Aotearoa represents people and firms in the energy resources sector, from explorers and producers to distributors and users of natural resources like oil, LPG, natural gas and hydrogen.
2. This document constitutes Energy Resources Aotearoa's submission to the Ministry for the Environment on its *Reforming Industrial Allocation in the New Zealand Emissions Trading Scheme* discussion document.
3. We greatly appreciate the extension granted to us and are pleased to be able to comment on the discussion document.
4. We unequivocally support the objective of transitioning to a low emissions economy. The question is not about the 'what' but the 'how', and free allocation is an important part of this consideration.

### Submission

#### *The fundamental underpinnings of free allocation*

5. At its most fundamental, the conceptual underpinning for free allocation is to protect the property rights of incumbent firms affected by the imposition of the Emissions Trading Scheme ("ETS").
6. Businesses should be able to operate with the legitimate expectation that they can continue to operate without undue interference and this amounts to a property right (although obviously not property in the physical sense).



7. It is a widely accepted core principle of good public policy that the appropriation of physical property (through eminent domain) must be compensated, and that certain other property rights are similar enough to physical property so as to warrant a similar compensation approach. Below those two tiers, other general regulation that affects business may not be compensated. As was recognised at the time, the imposition of the ETS was such a ground-breaking and game-changing regulation so as to warrant compensation. The practical means by which this was acknowledged was through the free allocation regime.
8. This is important as prior to that, businesses invested on the basis that greenhouse gas emissions were unpriced. Subsequently imposing a price on emissions materially reduced the value of such investments, potentially leading to stranded assets. The free allocation regime compensates them, overtime, for a regulatory taking and to minimise the impact of sovereign risk.
9. We acknowledge that the prevailing narrative has generally shifted to explaining free allocation on the basis that it mitigates the risk of carbon leakage. This is indeed an important consideration and co-benefit, but is not the fundamental reason for free allocation. The Climate Change Response Act 2002 and the ETS regime established a framework for mitigating greenhouse gas emissions, but it is not the tool to deliver industry policy or subsidies to business.

#### *Stable settings are crucial*

10. Stable and predictable settings are crucial for investor confidence, and major regulatory takings without compensation increase risk and dissuade investment. Materially reducing the allocation of free units at a pace misaligned with trade competitors would represent bad faith on government's part and would signal to investors a willingness to change the rules of the game halfway through.

#### *Free allocation still incentivises abatement opportunities*

11. We occasionally see the claim made that free allocation of units leads to inaction, but even with the free allocation of units, emitters face the price at the margin and therefore receive the signal to lower emissions. This is because units have a market value so emitting beyond free allocation limits means purchasing more units and abating emissions means the units can be kept or sold. In addition, free units were never guaranteed for the long-term, so no firm would rely on perpetually free units as a reason to do nothing by way of emissions abatement.<sup>1</sup>

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<sup>1</sup> We see numerous positive examples of firms with free allocation still choosing to invest in domestic abatement such as Ballance Agri-Nutrients investment in renewably generated hydrogen, Golden Bay Cement's investment to replace coal with chipped tyres, and Methanex's consideration of recycling carbon.

*Free allocation is only achieved through the ETS, so “complementary measures” undermine the goals of free allocation*

12. It is important that the ETS is employed as the primary instrument for achieving emission reductions. The ETS best achieves efficient allocation of resources, and is also the mechanism that can manage the adverse consequences of emission prices (such as carbon leakage and impacts on competitiveness) due to the industrial allocation regime being tied to it. That is, if there is an increased reliance on complementary measures, then the associated economic costs of those measures cannot be compensated as only the ETS delivers free units. The complementary measures can (and are more likely to) simply become an impost.
13. One cannot assume that competitiveness of firms is protected by free allocation if the ETS is undermined by an increased reliance on other measures.

*Mitigation of the impacts of high carbon prices will remain important as domestic carbon prices increase*

14. Carbon prices hit \$65.80/NZU earlier in September this year. We would anticipate adverse economic consequences and a lumpy transition if New Zealand’s carbon price continues to increase faster than substitutes fuels become affordable and available at scale. If too severe, we will see job losses and the closure of firms.
15. Should exporting firms close, the risk of carbon leakage arises. Although dependent on circumstances, this cannot be disregarded as a serious unintended consequence of aggressive emissions policies.
16. Not all countries have enforced domestic emission caps. This has direct implications for the likelihood of leakage from firms that we work with in the energy resources sector.<sup>2</sup>

*The role and purpose of compensation*

17. Drawing the previous sections together, compensation (ultimately whether through a cash payment or the stable provision of free units) is important for emissions-intensive, trade-exposed firms. It is needed in order to:
  - a. protect the property rights of incumbent firms at the time of the ETS’s inception;
  - b. preserve the international competitiveness of firms, reducing the risk of economic activity and jobs being lost prematurely; and
  - c. prevent carbon leakage.

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<sup>2</sup> For example, in the scenario of New Zealand methanol no longer being produced by Methanex here due to emission pricing imposts, it is most likely that production will simply shift to China. It is likely that any reduction in the amount of Methanol produced will be picked up by other producers (potentially China). New Zealand methanol is the swing producer in the region so its closure would immediately be felt and other participants would be able to seize the opportunity to fill the supply gap.

18. We now make some specific remarks on the issues raised in the discussion document.

*We prefer that settings, especially allocation baselines, not be regularly tinkered with*

19. The discussion document proposes revision to the allocation baselines. We understand the conceptual interest in updating these baselines, given the Ministry's view that businesses profiting from sale of surplus units implies that the baselines are out of date. However, going beyond the superficial, if baselines are higher than current *actual* emissions intensities, this is because firms have reduced their emissions intensity over time. The allocation regime has *contributed* to these efficiency gains as it provides the incentive to become less emissions intensive than the benchmark (as 'surplus' units can be sold). This is an analogous to the general point we make in paragraph 11 above where we explain how free allocation does not lead to inaction.
20. Given the importance of private property rights, and because investments were made based on previous assumptions, we prefer the baselines not be amended further.
21. If the baselines are changed, the incentive to invest in emission reductions should not be unduly undermined. Should they be amended, we prefer changes at the more gradual end, such as every ten years as per the Technical Advisory Groups' recommendation (as opposed to every year as floated in the discussion document).

*If the free allocation is to be undermined with constant change, a one-off cash payment is more efficient*

22. We prefer to continue to see the ongoing use of industrial allocation. However, if property rights and the incentive to invest efficiently in emission abatement are undermined by constant tinkering with the free allocation regime, then a one-off lump sum cash payment emerges as a credible and principled alternative to ongoing (although steadily phased down) stable free allocation.
23. This is because a lump sum payment cannot be amended in future and provides compensation for the regulatory taking associated with the imposition of the ETS. In principle, this is in line with Infometrics' 2007 report which considered that compensation via free allocation should be via a once-only allocation of emission permits equal in value to the change in asset value.<sup>3</sup>
24. A lump sum could be calculated as the net present value of the residual rights that have been affected through the imposition of the ETS. With compensation, firms can decide whether to continue to operate or not, but continued operation

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<sup>3</sup> *General Equilibrium Analysis of Options for Meeting New Zealand's International Emissions Obligations*. Infometrics. This was prepared for the Emissions Trading Group and is dated October 2007.

is rendered economically viable by the cash payment which offsets losses imposed by regulation.

25. The next few sections make comments about the importance of a compensation framework to manage risks.

*We do not consider the industrial allocation regime or compensation should necessarily be open to new entrants*

26. The discussion document asks whether new entrants should be able to access units under industrial allocation. We do not consider it should be.
27. As stated upfront, the underlying conceptual reason for free allocation is to protect the property rights of incumbent firms affected by the imposition of the ETS when it was introduced.
28. It is completely appropriate to use such a regime to transition incumbents into the new economic settings under an ETS. But new entrants from henceforth have knowledge of the rules of the game so can factor the ETS into their commercial plans.
29. Free allocation to new firms effectively amounts to *industry policy* to support the competitiveness of new entrants. This could potentially be viewed as a legitimate policy decision, but if achieving an industry policy objective is the goal then this should be made explicit and delivered through the appropriate policy vehicle. We do not consider that the ETS is the right mechanism to deliver that objective should it be one that is sought.

*We oppose Border Carbon Tax Adjustments*

30. The discussion document floats the ideas of Border Carbon Tax Adjustments. We oppose the use of border tax adjustments as an alternative to free allocation. Such a regime would be administratively difficult to administer, anachronistic, and completely 'out of character' for New Zealand given our position as an early remover of tariffs and promoter of free trade. There is a risk of tit-for-tat retaliation and may therefore leave New Zealand as a net-loser from the implementation of such a policy. This risk is now amplified in a world looking to better manage the risks associated with global supply chains.
31. The case for border carbon tax adjustment in fact implicitly relies on the assumption that carbon leakage is indeed a risk (a problem that free allocation indirectly but already effectively manages). This is because it would apply to imports (to prevent domestic production/import substitution from being rendered uneconomic because of the carbon costs faced by New Zealand firms). Apart from preventing *import* substitution, a border tax adjustment does not address the issue of leakage from New Zealand firms operating solely as *exporters* such as Methanex.

32. Without free allocation to protect exporters, alternatives such as general tax relief would be required, meaning a new regime must be developed which would lead us into a complicated tax rabbit hole.

*International carbon units should be brought into the policy mix*

33. We recognise that a discussion on international units is not part of the current consultation, but consider this to be a significant gap. We consider that international units as a 'pressure relief valve' should be included in the policy mix as another legitimate tool to address the underlying issue of competitiveness that much of the discussion on free allocation seeks to address.
34. International units are a legitimate and important mitigation option, especially to avoid unreasonable domestic costs and impacts on firms. As discussions relating to Article 6 of the Paris Agreement and/or bilateral or multilateral agreements advance, we hope that New Zealand will be able to take advantage of offshore mitigation.
35. International units are also important so that emitters have an alternative source of units should foresters seek to deliberately hold back the supply of units to increase their price.
36. In considering access to international units, it is also important to recognise the mutually beneficial nature of trade. If the New Zealand Government or firms purchase units from offshore, there is a finance transfer meaning that the counterparty can use that money for domestic decarbonisation, and technologies can be deployed which might not otherwise be accessible.

*Impact of premature closure of firms on skills transfer can compromise the energy transition*

37. Before concluding, we also note the importance of considering jobs and skills when looking at changes to emissions policy. Skills retention and transfer are important for the energy transition. In terms of skills transfer to the low emission energy sector, it is important that existing skills in the energy resources sector are not prematurely ended through the effects of carbon pricing before new jobs are available in alternate firms and sectors. If a 'gap' emerges, this is adverse not only for workers between employment but also for firms in the low emissions energy sector.
38. The skills in the petroleum sector (such as those related to drilling and pipelines) will have a critical role in supporting other industries such as geothermal, hydrogen or biogas. These skills can also support increased importation of refined petroleum products which will be important as the Marsden Point refinery is set to cease. A vibrant ecosystem of service providers is vital both to the current sector but also to the transference of skills and capabilities to adjacent sectors. If such firms cannot access skills then they will struggle to profitably operate.

## Conclusion

39. We are increasingly concerned at the increasing regularity of changes to the industrial allocation regime. The changes undermine the property rights of firms that were meant to be protected through the implementation of the free allocation regime. Constant tinkering not only weakens the incentive to invest efficiently in emission reduction opportunities going forward, but it also undermines the investments of those who have already taken early action to reduce emissions.