

## 27 March 2024 Meeting Briefing

**Hon Simon Watts**  
**Minister of Climate Change**

### **Key messages**

*We wish to discuss with you the following points:*

- **a strength of the ETS is that it is technology neutral** based on economy-wide net emissions reductions targets for 2030 and 2050, with a falling quantity cap. Price volatility from annual policy changes must be brought under control, but volatility of itself is not a bad thing because it sends needed signals for investment decisions;
- **the ETS favours the least-cost pathway** to reducing **net** emissions in the economy. Removals and offsets are key in mitigating the hardest-to-abate activities. Focusing on gross reductions at source using complementary policies poses serious risks of deindustrialisation and reduced energy security;
- **the ERP and 2030 NDC target distract us from pursuing the least-cost pathway to 2050.** Suboptimal outcomes are being driven by the demonstration pathways and sectoral approaches to carbon budgets and emissions reduction plans. This approach also minimises the role for gas in providing energy security;
- **free industrial allocation for EITE firms is not a subsidy and should remain under current settings.** If changes are desired, property rights, market exposure and emissions leakage risks need to be carefully managed to avoid an increase in global emissions at high cost to New Zealand;
- **reducing the role of exotic forestry NZUs will significantly increase the costs of getting to net zero by 2050,** raising the need to purchase offshore units in 2030, leaving households worse off and more debt for future generations to pay; and
- **Carbon Capture, Utilisation and Storage (CCUS) will be an essential tool** in the global transition to net zero emissions.<sup>1</sup> In New Zealand it could play a key role in addressing hard-to-abate emissions in the medium term, and net-negative emissions through direct air capture in the long term.

<sup>1</sup> Note that CCUS **is not** an offset or removal, rather it is an abatement technology that eliminates emissions before they enter the atmosphere.

## ***Who are we: Our organisational strategy and how we can help you***

1. Energy Resources Aotearoa has been progressively pivoting to represent the full energy value chain through and beyond the low emissions journey. We now represent over 40 members covering the production, transport, and sale of oil and gas, electricity, refined fuels, and future fuels.
2. We provide a strategic sector perspective on energy and climate change issues. We will give you access to insights from energy sector participants. We will work with you and your department constructively to deliver pragmatic responses to the challenges of your portfolio.

## ***Emissions Trading Scheme needs to stay focused on reducing net emissions***

3. You have publicly stated that, despite warnings from the Climate Change Commission (the Commission), the Government remains committed to no significant changes to the Emissions Trading Scheme (ETS). We applaud this refocus on the ETS away from complementary policies and would welcome discussion on aspects of the ETS design that have been subject to some confusion over the past few years.
4. The Commission is consulting on advice this year to refine ETS policy and says two major problems exist – a surplus of NZ units, and incentives for over-planting forests. We disagree that these are the fundamental problems.
5. The problem of climate change lies with the *accumulation* of greenhouse gases in the atmosphere and is a function of net emissions.<sup>2</sup> The design of the ETS with a falling quantity cap will get New Zealand to the 2050 target, and possibly sooner.
6. We cautiously support the Commission's potential options for reducing the cap sooner, but only slightly. Any reduction in surplus has a corresponding effect on the value of units. Current consultation questions on unit limits and price control settings are focusing on reducing the volume of forestry credits. These inherently reduce emissions. We question why the government would consider policies that reduce the incentives and value of investing in emissions reducing activities that help us achieve net zero by 2050.
7. We prefer the focus on net emissions because it is the only effective way of tackling climate change, and it helps us retain optionality and encourages innovation. There are many fuels and technologies available today and new ones entering the market all the time. The ETS doesn't discriminate by picking a technology, it co-ordinates the preferences and decisions of millions of actors every day to find an efficient, least-cost trajectory toward net zero by 2050.

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<sup>2</sup> The Climate Commission describes the problem as existing at the many points of combustion – however there are technologies to abate emissions (such as CCUS) and remove or offset emissions.

### ***Emissions Reduction Plan and 2030 target distract from the goal***

8. Policies that foreclose options, or incentivise options disproportionately with their emissions value, will increase the overall cost of the transition. In that light, we see the Emissions Reduction Plan (the ERP) as a costly path to transition to net zero by 2050. The ERP has been developed with a bottom-up approach with micro level interventionist policies that will circumvent and distort the least-cost transition, but ultimately cannot deliver net zero by 2050 efficiently or even any quicker.
9. Also impeding the least-cost transition and our energy security is our Nationally Determined Contribution (NDC) under the Paris Agreement to reduce net GHG emissions to 50 per cent below gross 2005 levels by 2030. Agreeing to an intermediary target has distracted from the core business of reaching net zero by 2050 using the least-cost policy, the ETS. In our view the 2030 target is neither legally binding on New Zealand nor, in the parlance of accounting, a 'constructive obligation'; under Generally Accepted Accounting Principles (GAAP).
10. Some of the hard-to-abate emissions from energy and industry are just that – hard-to-abate – even at very high carbon prices. Selecting to focus on reducing their gross emissions to meet the 2030 NDC target could incentivise the de-industrialisation of New Zealand's economy, posing risks to energy security by prematurely shutting out supply before sufficient economic renewable alternatives are available.
11. Energy and industry will do the heavy lifting in the next few decades of the decarbonisation journey. These industries need sight of their economic and regulatory lifespan to plan for the needed shifts in emissions profiles and avoid a high-cost disjointed pathway to net zero emissions. Ultimately, demand will condition the future of the sector.

### ***Industrial allocation is not a subsidy and the current phase-out rate should be retained to allow offsets to manage hard-to-abate emissions***

12. Carbon units are property rights. We think the allocation of units to emissions-intensive and trade-exposed (EITE) firms has been wrongly described by some commentators as a direct subsidy to those firms operating in the New Zealand market. We note as recently as 20 March the comments by the Finance and Associate Climate Minister, quoted below, which wrongly describes the nature of free industrial allocation as a subsidy. *"I'm really wary of any policy that, whether upfront or by a backdoor, is subsidising people to pollute"*, said Minister Willis.<sup>3</sup> We have since written to you and Minister Willis in response to this.
13. We have previously argued that industrial allocation is needed out to 2050 for hard-to-abate emitters who operate in international markets to mitigate the competitive impact of emissions pricing. This view was based upon the damage to investment confidence from driving down industrial allocation faster than the signalled phase-out rate and the risk that it could drive emissions offshore. We do

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<sup>3</sup> <https://www.interest.co.nz/public-policy/126901/nicola-willis-says-she-wary-emission-subsidies-there-are-no-plans-change>

not consider this would be a defensible approach to meeting our international commitments.

14. We think the current phase-out rate to 2050 is the most appropriate way to retain investment confidence. The Commission argues that under current settings, free allocation exceeds the NZ ETS cap from 2036. We think this view is short-sighted because it fails to adequately consider the hard-to-abate nature of some of these emissions, even at very high carbon prices. These emissions (if persisting beyond 2036) can be consistent with net zero by 2050 if offset by CCUS or forestry removals.
15. If industrial allocation needs to be revised, we suggest it could be linked to the actual risk of emissions leakage by (e.g., tying it to an index of New Zealand's top trade competitors). This would ensure that any reduction in allocation corresponds with the actual risk of emissions leakage.
16. If you are to consider changes to the nature and magnitude of free industrial allocation we think there are a number of matters to consider:
  - the allocation is a property right, being compensation for a regulatory taking;
  - the extent to which the allocation requires compensation if taken away prematurely;
  - how the compensation should be paid out, e.g., annually;
  - how that links to length of time the EITE firm continues trading on the international market; and
  - whether the compensation payment would be adequate in mitigating the material risks of emissions leakage (if an EITE firm moves offshore, for example).

***ETS pricing has recently focused on mitigating the risks of overplanting of exotic trees (afforestation)***

17. We see multiple reasons why the ETS will not drive afforestation at the scale or speed anticipated. Recent extreme carbon price volatility in the secondary market has been driven by decisions that introduced uncertainty (government, Climate Change Commission, and the courts). Other proposals to charge fees, change the Overseas Investment Act, and end the stock change option for forestry, have all reduced investment confidence. Weather events such as Cyclone Gabrielle also weakened confidence.
18. Rather than using the ETS to address such externalities of emissions reductions and removals, we recommend separate dedicated policy tools, such as land use planning and environmental regulations, or a biodiversity credits system to encourage the planting of native species.
19. The cancellation of the ETS Review has come as welcome news. We are aware of evidence revealing the exorbitant costs to consumers, and negative climate outcomes, if forestry was to be taken out of the ETS. If you are interested in

learning about the financial impacts, we would be happy to assist you in connecting with the appropriate people.

### **Role of gas**

20. New Zealand is fortunate to have an indigenous supply of natural gas. It has provided economic and social benefits and has underpinned energy security for many decades. Recent undermining of the gas sector through policy changes has led to significantly lower than expected field life production forecasts. This situation needs to be reversed. At this critical time, we are interested in how the Government proposes to maintain energy security and affordability beyond 2030 if the investment conditions do not turn more favourably toward gas.
21. The retention of natural gas will also support the development of waste-to-energy gases and their introduction to the reticulated gas pipeline network. We oppose the Commission's proposal to ban new gas connections.
22. It is widely recognised internationally that CCUS is essential to reach net zero. We continue to see CCUS as an opportunity to support a circular indigenous energy economy, enabling us to retain key industrial operations while continuing to drive down net emissions.
23. We consider, along with the Intergovernmental Panel on Climate Change (IPCC) AR6 synthesis report and IEA etc., that CCUS is likely a strong contributor towards our future emission reductions potential along with fuel shifting, including use of natural gas. Currently global rates of CCUS deployment are far below those that the IPCC says are required to limit global warming to 1.5-2°C.
24. We are co-ordinating sector efforts to explore the technical and economic feasibility of these technologies. We are also keen to engage with the Government and officials to identify and remove regulatory barriers. We stress the importance of joined up coherent policy settings across government. We see Electrify NZ and a revitalised gas sector as consistent with each other and mutually beneficial.
25. Below are two tangible examples of how natural gas can contribute in a meaningful way towards the new Government's emission reductions goals:
  - **the use of CCUS: report from Castalia**  
(<https://www.energyresources.org.nz/dmsdocument/237>)  
  
This showed we can remove the equivalent of 700,000 cars off the road – so c.15m/t CO<sub>2</sub>-e by 2035 relative to a policy-as-usual baseline, and then 2m/t every year thereafter under the right policy conditions. As mentioned above, CCUS is recognised by the IPCC and the IEA as valuable decarbonisation tools that will be required if we are to remain hopeful of achieving global temperature goals; and
  - **shifting from coal to gas in electricity generation: report from Greg Sise**  
(<https://www.energyresources.org.nz/dmsdocument/243>)

This report showed that if New Zealand switched all coal-fired electricity generation to natural gas from this point on, and half of the North Island's coal-fired industrial process heat was converted to natural gas, New Zealand would avoid 1.8m/t CO<sub>2</sub>-e by 2030. This is the equivalent of taking over 93,000 cars off the road - and avoided emissions could be even higher if the coming years are drier than average.

### ***Conclusion***

26. We are interested in understanding how best to engage and help you to be successful in achieving your objectives as Climate Change Minister.
27. We have significant expertise and experience. There are a number of issues that you are going to grapple with which we can help with, as outlined above.
28. In addition, John is offering to attend UNFCCC COP29 (November 2024) with you. John has attended previously as an observer and a member of the official delegation on multiple occasions. John is currently the Chair of the finance committee of the World Energy Council and represents New Zealand's energy interests internationally in that capacity.