

6 April 2023

Environment Committee

By email: [en@parliament.govt.nz](mailto:en@parliament.govt.nz)

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

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### **Introduction**

1. Energy Resources Aotearoa is New Zealand's peak energy advocacy organisation. We enable constructive collaboration across the energy sector through and beyond New Zealand's transition to net zero carbon emissions in 2050.
2. This document constitutes our submission on the Climate Change Response (Late Payment Penalties and Industrial Allocation) Amendment Bill (the Bill). It focuses on the industrial allocation elements of the Bill.
3. We wish to speak to the Committee about this submission.

### **Recommendations**

4. To summarise our position on the Bill:
  - we support a one-off review and update of allocative baselines, on the basis that some over-allocation has occurred due to structural market changes;
  - we recommend that the discretionary 5-yearly review and automatic 10-yearly review be lengthened or removed from the Bill, on the basis they disincentivize significant emissions reduction investments that require regulatory predictability over longer time horizons;
  - if these are not lengthened or removed, the Bill could introduce risk-mitigating measures to reduce the disincentive to investment. Therefore, we recommend:
    - requiring the Minister to consider whether a significant emissions reduction project is a material contributing factor when assessing whether over allocation has occurred;

- enabling the industrial allocation calculation to consider operating costs (so that the higher fuel costs of a lower emissions process can be recognised in allocation); and
- providing flexibility for situations where an allocation recipient switches to a new fuel/technology, to ensure allocation is available for these new emissions sources;
- we do not support reducing, from five years to two years, the required period between the publication and the coming into effect of regulations that remove or reclassify an eligible activity in the industrial allocation scheme;
- we support the proposal to use 2016/17 to 2020/21 as base years, with the ability to exclude either 2019/20 or 2020/21 to smooth out distortions from COVID-19;
- we recommend the Bill should specify that any future baseline updates will also use the preceding five years as base years; and
- we recommend the 'new activity' eligibility elements of the Bill could be reviewed to ensure they specifically enable a current recipient to receive allocation for a 'new' activity such as where they change feedstock, fuel, or technology.

## Overarching points

### The purpose of industrial allocation

5. A fundamental purpose of industrial allocation is to compensate incumbent firms for the impact of the emissions trading scheme (ETS) on their existing property rights. These incumbent firms invested in New Zealand on the basis that greenhouse gas emissions were unpriced. Subsequently imposing such a price materially reduced the value of such investment, potentially leading to stranded assets. The industrial allocation regime compensates them for this regulatory taking and minimises the impact of sovereign risk.
6. Industrial allocation also manages the real risk of emissions leakage by reducing the cost impact of the NZ ETS on emissions-intensive, trade-exposed (EITE) firms, and reducing competitive disadvantage with offshore firms subject to weaker climate policy. This is important because the global playing field is far from level. Globally, only 23% of greenhouse gas emissions are covered by a carbon price, with carbon prices varying significantly between jurisdictions. Further, only 4% of

global greenhouse gas emissions face a direct carbon within the range needed by 2030.<sup>1</sup>

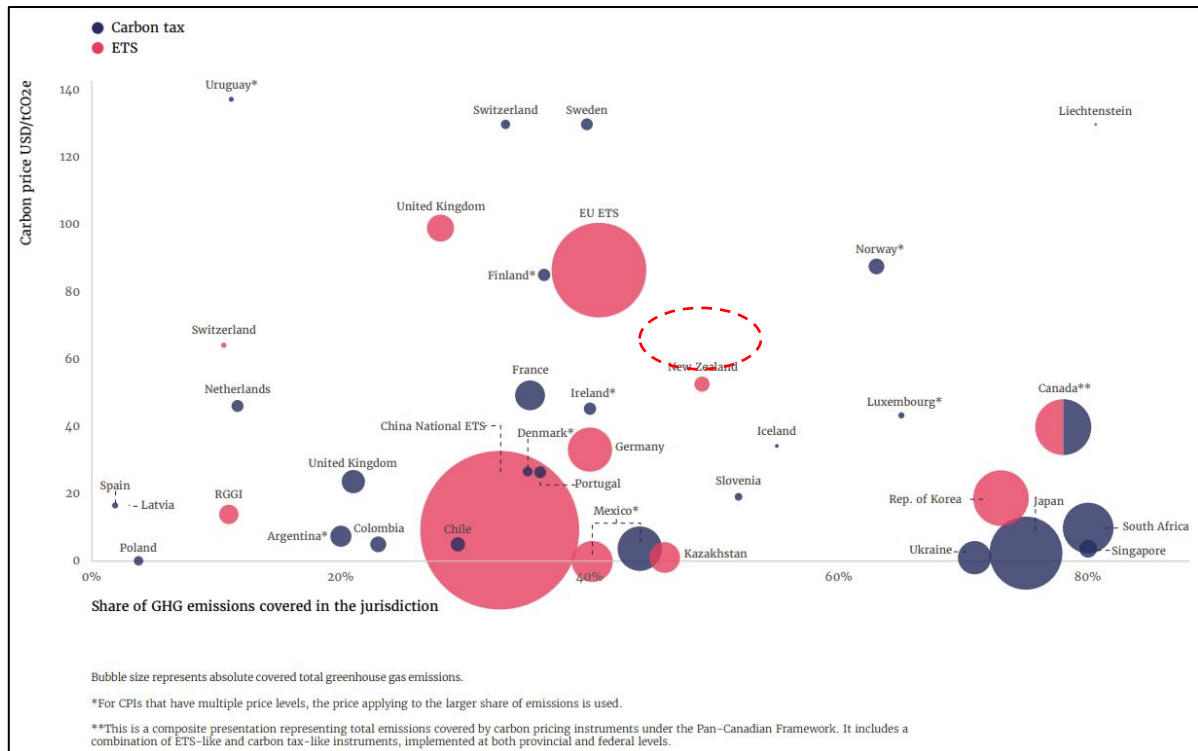


Figure 1: Absolute emissions coverage, share of emissions covered, and prices for carbon pricing instruments across jurisdictions (World Bank, *State and Trends of Carbon Pricing 2022*). New Zealand circled for emphasis.

7. The risk of emissions leakage has likely increased in New Zealand. As the Regulatory Impact Statement (RIS) supporting the Bill states, since 2015 there has been significant increase in the net emissions costs faced by eligible industrial activities, driven by:
  - a significant increase in the NZU price over time (from \$15 in May 2015 to nearly \$90 in November 2022, currently around \$60 in April 2023);
  - the removal of the two-for-one surrender obligation; and
  - the beginning of the phase-out of industrial allocation.
8. The credibility of New Zealand's NZ ETS scheme is not enhanced if it incentivises the shifting of emissions to jurisdictions with no, or lower, carbon prices for no global emissions benefit. New Zealand has made a firm *national* commitment to achieve net zero emissions by 2050, and we support this.
9. But it must pursue this in a way that recognises climate change is a *global* problem. The Climate Change Response Act 2002 is clear on this point – its

1 See the World Bank's *State and Trends of Carbon Pricing 2022* here: [https://openknowledge.worldbank.org/bitstream/handle/10986/37455/9781464818950\\_Executive\\_Summary.pdf?sequence=11&isAllowed=y](https://openknowledge.worldbank.org/bitstream/handle/10986/37455/9781464818950_Executive_Summary.pdf?sequence=11&isAllowed=y)

purpose is to “provide a framework by which New Zealand can [...] contribute to the global effort under the Paris Agreement to limit the global average temperature to 1.5°C above preindustrial levels” (emphasis added).

### **Industrial allocation still incentivises emissions reduction**

10. It is periodically argued that industrial allocation is a subsidy for recipients, insulating them from the emissions price and weakening incentives to reduce emissions. We disagree with this for two reasons:
  - NZETS units – even those allocated for free – have a market value, so emitting beyond the industrial allocation means purchasing additional units, and conversely, abating emissions below the industrial allocation means surplus units can be kept or sold. This means recipients still face an incentive at the margin to invest in emissions reduction; and
  - industrial allocation was never guaranteed in the long term (and indeed is now legislated to gradually phase down over time), so recipients cannot rely on the regime in perpetuity to justify doing nothing on the emissions reduction front.<sup>2</sup>
11. Provided NZ ETS settings and parameters remain stable over the medium-long term, we expect it will continue to drive efficient emissions reduction investments among EITE firms. Much of our more specific commentary later in this submission is in the spirit of ensuring EITE firms are still incentivised to undertake significant emissions reduction investments.
12. It bears noting that significant rolling changes have been made to the overall NZ ETS regime over the past few years, all placing upward pressure on NZU prices and contributing to increased volatility and uncertainty about regulatory settings for obligated firms. This has included the developments listed in paragraph 7 above, as well as changes to the auction price floor and cost-containment reserve.
13. In our view, over-allocation should be addressed where structural changes in manufacturing sectors have occurred (for example, the departure of some participants in an activity leading to inherited overallocation for those that remain). Over-allocation should be addressed in a way that also preserves investment confidence and the incentive to reduce emissions.

### **Industrial allocation settings should preserve the incentive to reduce emissions**

14. As noted above, we consider that industrial allocation does provide an incentive to recipients to reduce their emissions (i.e., it is not a ‘free ride’). However, settings are important here – industrial allocation should preserve investment confidence

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2 The Climate Change Response (Emissions Trading Reform) Amendment Act 2020 introduced a phase-out of the level of assistance, which will see industrial allocation for highly emissions intensive businesses fall from 90% in 2020 to about 30% in 2050.

and avoid unduly undermining the case for significant emissions reduction and/or energy efficiency investments.

15. This point underpins our strong preference for:
  - infrequent changes/reviews/updates, justified by a high evidential threshold;
  - stable settings in terms of the allocation calculation (including the allocative baseline and level of assistance, i.e., phase-out rate).
16. Paragraph 100 of the RIS for the Bill specifically rejects emissions reduction as an objective of industrial allocation on the basis that “while this is an implicit purpose of an output and intensity-based method of allocation, the Government does not consider this to be the purpose of New Zealand’s IA policy and there are other policies to achieve this more effectively”.
17. We strongly argue to the contrary. The implicit price signal sent by allocation of units with market value is a highly effective incentive to decarbonise. The NZETS regime is our central pillar to incentivise emissions reductions in line with our 2050 targets. Industrial allocation is about balancing this necessary price incentive with the risk of emissions leakage. Regarding the claim that “there are other policies to achieve this more effectively”, we refer readers to our previous public commentary about the waterbed effect and the high threshold this creates for non-ETS complementary measures.<sup>3</sup>
18. We also note that the RIS prepared in support of the Bill relegates regulatory certainty and predictability to a secondary criterion. This enables short-term tinkering that could undermine recipients’ incentives to decarbonise. Significant emissions reduction investments will likely require payback periods exceeding ten years.

## Specific comments on proposals

### Updating allocative baselines to address over-allocation

19. The Bill establishes an immediate review and update of all allocative baselines. Given over-allocation has occurred due to structural changes in some manufacturing sectors, we support a one-off update to allocative baselines to re-establish integrity in the industrial allocation regime.
20. Beyond this immediate review and update, we consider the existing phase-out of industrial allocation will generally address further over-allocation over the long term. Any residual risk of over-allocation will be low, so subsequent periodic review and/or update – if any – should be infrequent, subject to high thresholds for action, and generally undertaken only in response to further structural sector changes if any.

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3 <https://www.energyresources.org.nz/dmsdocument/202>

21. The Bill also enables the Minister, where there is evidence of over-allocation, to review and update an activity-specific baseline after 5 years and requires review of all baselines every ten years.
22. Here we reiterate our concern that regular changes – particularly exercise of the discretionary 5-yearly review – may undermine future investment in emissions reductions, which conflicts with the purpose of the NZ ETS. If emitters expect their allocative baseline to quickly be reduced in response to significant emissions reduction investments, their incentive to make these investments is moderated.
23. Timeframes such as these may have the unintended consequence of incentivising only incremental improvements in recipients' emissions efficiency, as the rational response may be to reduce their emissions only to their allocative baseline and no further (or to seek subsidies to compensate for this diminished commercial incentive). This could undermine the case for more significant 'step-change' scale investments in emissions reductions. Significant emissions reduction investments often have payback periods beyond ten years, so the prospect of an allocative update within this window may, perversely, deter emissions reduction investment.
24. Our first preference is therefore that the five-year discretionary review, and ten-year automatic review of baselines, are removed from the Bill. Alternatively, they could be lengthened significantly.
25. In lieu of removal from the Bill or lengthening of these periods, the risks that periodic reviews pose to investment incentives could be mitigated to some extent by introducing further flexibility into the regime. This could include:
  - requiring the Minister to consider whether a significant emissions reduction project is a material contributing factor when assessing whether over-allocation has occurred;
  - enabling the industrial allocation calculation to consider operating costs (so that the higher fuel costs of a lower-emissions process can be recognised in allocation); and
  - providing flexibility for situations where an allocation recipient switches to a new fuel/technology, to ensure allocation is available for this new emissions source.

### **Reassessing eligibility to ensure appropriate levels of support to EITE emitters**

*Reviewing eligibility using new base years and recalibrated thresholds to reflect a higher carbon price*

26. We support a one-off reassessment of eligibility using new base years, with existing thresholds recalibrated for the significant rise in the carbon price since initial eligibility decisions were made.

### *Reducing the five-year transition period*

27. We do not support the Bill's reducing, from five years to two years, the required period between the publication and the coming into effect of regulations that remove or reclassify an eligible activity in the industrial allocation scheme.
28. Rapid increases to an emitter's net exposure to NZ ETS costs increases the risk of emissions leakage and we consider the existing 5-year transition period appropriately manages this. There is a material risk that a change in eligibility undermines a recent or pending investment in emissions reduction and/or energy efficiency. Even more significantly, the RIS for the phase-down in industrial allocation concluded that rapid reduction in allocations could result in a credible threat to the competitiveness of some eligible activities (i.e., risk leakage).
29. In contrast, the corresponding benefits of reducing the transition period are small. The RIS itself states that the expected magnitude of eligibility changes in terms of allocation volume is small, so the impact on meeting our national emissions targets is negligible. We suggest this measure is removed from the Bill.

### **New base years for updating allocative baselines and reassessing eligibility**

30. On the basis allocative baselines are updated, we support the proposal to use 2016/17 to 2020/21 as base years, with the ability to exclude either 2019/20 or 2020/21 to smooth out distortions from COVID-19.
31. The Bill is not clear on how baseline years for future allocative baseline updates will be set. Presuming periodic review is retained, the Bill should specify this to remove the uncertainty this creates. We recommend future updates, if any, should also use the preceding five-year period.

### **Technical adjustments**

#### *New activity eligibility*

32. We support the new activity eligibility elements of the Bill, particularly on the basis that it could be used to facilitate existing recipients changing their technology, feedstock, or location while retaining access to industrial allocation for their activity. We recommend that the eligibility criteria should be specifically enabling in this regard. Some activity definitions are tightly worded, so a 'new' activity may be required for some emissions reduction projects.
33. Genuinely new entrants can factor the NZ ETS into their commercial plans. Industrial allocation to new entrants effectively amounts to industry policy to support their competitiveness (indeed, regional economic benefits are cited as a core benefit in the RIS). We suggest if this is the policy intent, this be made explicit, and do not consider the NZ ETS is the right mechanism to deliver that objective.

## Conclusion

34. The NZ ETS is the central pillar of New Zealand's low-emissions transition, and this should remain the case. However, many of our large industries operate in a competitive global environment, subject to varying carbon prices in each market. We therefore support ongoing industrial allocation as a critical element of the regime to ensure that it compensates regulatory takings and mitigates the very real risk of emissions leakage.
35. Premature departure of large industrials could mean New Zealand suffers significant economic costs and forgoes future opportunities to transition these industries to lower-emissions operations as technologies mature. Once these industries are gone it will be exceedingly difficult to bring them back.
36. We favour infrequent changes over frequent material tinkering to the industrial allocation regime. This provides the confidence and predictability that large industries need to invest. To the extent possible, the industrial allocation regime's settings should be specifically mindful of the need to provide flexibility and certainty that supports recipients implementing emissions reduction projects beyond their allocative baseline.
37. We appreciate the opportunity to provide input on this Bill and wish to engage directly on the details of this submission with the Committee.