



Submission on the Climate Change Response (Emissions Trading Reform) Amendment Bill

To the Environment Committee
16 January 2020

Submitter details

- 1 This submission is from the Parliamentary Commissioner for the Environment, Simon Upton.
- 2 The Parliamentary Commissioner for the Environment is an independent Officer of Parliament established under the Environment Act 1986. The Commissioner has broad powers to investigate environmental concerns and is wholly independent of the government of the day.
- 3 I wish to appear before the Environment Committee to present my submission.
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Summary of Submission

- 5 This submission focusses on the proposals to continue to provide 'free allocation' in relation to:
 - a. Emissions-intensive trade-exposed eligible industrial activities (**EITE activities**); and,
 - b. Agriculture.
- 6 It seeks changes to ensure that:
 - a. Free allocation is only provided to EITE activities where there is a demonstrable risk of relocation of the activity overseas, and the relocation would result in an increase in global emissions;
 - b. The allocative baselines for EITE activities drive the uptake of less emissions-intensive production methods;
 - c. Alternatively, the allocative baselines for EITE activities are required to be adjusted as and when EITE activities reduce their emissions intensity to prevent over-allocation (and the Government has the information-gathering powers it needs to do so);
 - d. Appropriate adjustments are required to be made to phase out rates for the level of assistance to avoid over-allocation; and,



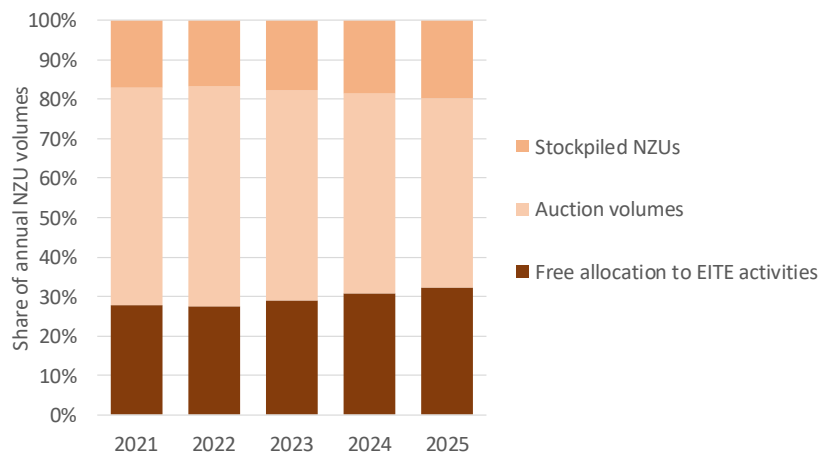
- e. Any free allocation provided for agricultural activities is based on a clear rationale that is consistent with the 2050 target and New Zealand's obligations under the Paris Agreement, and is reviewed as necessary.
- 7 The submission also submits that the Select Committee should recommend to the Government that it explore alternative ways of mitigating risks of emission leakage, such as the use of a border emissions adjustment. Notably, that mechanism is being actively considered by the European Union (EU) and could be more effective and efficient than the provision of free allocation going forward.

New Zealand's overuse of free allocation

- 8 Free allocation is a subsidy. It shifts a share of the costs of the pollution generated by EITE activities onto other emitters and taxpayers and undermines the effectiveness of the New Zealand Emissions Trading Scheme (NZ ETS).
- 9 To date New Zealand has overused these subsidies. The principal Act established a particularly lax free allocation regime, which:
- a. Provides subsidies to activities that have no demonstrable risk of emissions leakage;
 - b. Fails to require EITE activities to adopt less emissions intensive production methods as and when they become available; and,
 - c. Potentially awards windfall gains to such activities in the event that their production becomes less emissions intensive.
- 10 Unfortunately, the proposals in this Bill do not adequately address these defects and would not ensure that EITE activities undertake their fair share of the burden of meeting the 2050 target and New Zealand's obligations under the Paris Agreement.
- 11 Figure 1 shows how the proportion of annual NZU volumes taken up by free allocations to EITE activities is expected to reach around a third by 2025, based on the proposed ETS supply settings that have been published by the Government. This share is likely to continue to rise as the ETS cap is reduced but output-based free allocation continues.
- 12 If the free allocation regime is not tightened, agriculture and EITE activities will eventually consume most, if not all, of New Zealand's entire emissions budget, placing considerable pressure on the rest of the economy. If the necessary emissions reductions cannot be achieved by the rest of the economy, the New Zealand government will need to address the shortfall through the purchase of international units.



Figure 1: Summary of proposed NZ ETS unit supply settings, 2021-25



Source: Based on MfE, 2019. *Reforming the New Zealand Emissions Trading Scheme: Proposed settings*. <https://www.mfe.govt.nz/consultations/nzets-proposed-settings>.

- 13 For these reasons, this Bill requires extensive changes, including the addition of a clear purpose statement to state that free allocations should only be available where the risk of emissions leakage can be clearly demonstrated through much more rigorous eligibility requirements.

When can free allocation be justified?

- 14 Historically, free allocation has been justified on the basis that it is needed to avoid 'emissions leakage'.¹
- 15 In theory, emissions leakage will occur if New Zealand EITE activities are required to pay more for their emissions than their overseas competitors, and the cost difference is enough to result in production moving offshore.²

¹ See for example the Cabinet Paper entitled *New Zealand Emissions Trading Scheme tranche two: a phase-down of industrial allocation* (<https://www.mfe.govt.nz/sites/default/files/media/Climate%20Change/industrial-allocation-cabinet-paper.pdf>), which states (at paragraph 11):

Industrial allocation is the provision of free New Zealand Units (NZUs) to entities that carry out 'eligible activities' whose competitiveness is considered at risk due to costs placed on the activity by the NZ ETS. These costs create a risk of emission leakage if these entities were exposed to the full cost of NZ ETS surrender obligations. The purpose of industrial allocation is to mitigate this risk.

² A theoretical risk of emissions leakage is widely acknowledged around the world. It has been managed in various ways in different jurisdictions, including in the EU, as described below. However, there is no hard evidence that the EITE activities we are subsidising are at risk. The 2018 report, *Countervailing forces: Climate targets and implications for competitiveness, leakage and innovation*, that was commissioned by the Government, indicates that there may well be a risk in relation to some EITE activities. For example, it noted that if New Zealand production of steel and cement was displaced by imports, they would be likely to come from countries such as Australia and Indonesia, where electricity is currently 5-6 times more emissions intensive than in New Zealand (see page 60). However, the report concluded that the likelihood of negative impacts if EITE activities were not subsidised is 'highly speculative' (see page 74).



- 16 From a climate perspective, emissions leakage is only a concern if it results in an increase in global emissions. If production moves offshore and is taken over by a producer who is equally or more efficient than the New Zealand producer, there would not be an adverse impact on the climate.
- 17 New Zealand's free allocation regime conveniently overlooks this distinction. It is set up to subsidise EITE activities regardless of whether they are facing a demonstrable risk of emissions leakage, and regardless of whether they are operating as (or more) efficiently as their overseas competitors.
- 18 Under section 161A of the principal Act (which is not proposed to be amended by the Bill), a New Zealand based industrial³ activity is made eligible for free allocation if it is simply:
 - a. Moderately emissions-intensive or highly emissions-intensive; and,
 - b. Trade-exposed.⁴
- 19 There is no requirement to undertake **any** analysis to establish that there is a risk of emissions leakage, let alone that the leakage could result in an increase in global emissions. For example, the Minister does not need to consider whether overseas competitors are:
 - a. Subject to a comparable emissions price; and/or,
 - b. Producing the relevant goods or services in a more emissions-intensive way.
- 20 As such, the criteria make EITE activities eligible for free allocation even where they do not face a realistic prospect of emissions leakage⁵ and their emissions intensity is inferior to offshore producers. They are even protected where emissions leakage would reduce global emissions.
- 21 A cynic might well conclude that the regime is partly driven by unacknowledged considerations, such as the employment opportunities EITE activities create.⁶ It is, of course, open to Parliament to decide that such considerations should be taken into

³ This part of my submission does not discuss the existing settings for free allocation to agriculture in any detail since they have not yet been 'activated', but the same principles apply in that context.

⁴ Under section 161C(1)(c) of the principal Act, an activity is trade exposed unless, in the Minister's opinion:

- a. there is no international trade of the output of the activity across oceans; or
- b. it is not economically viable to import or export the output of the activity.

⁵ Notably, New Zealand has taken a more rigorous approach in the past. The Negotiated Greenhouse Agreements (NGA) scheme included measures designed to ensure that relief was only provided where a producer was making reasonable efforts to move towards 'world's best practice' (modified to what is technically and economically feasible in the New Zealand context) as forecast over the duration of the agreement (see for example the Cabinet paper *Review of operation of Negotiated Greenhouse Agreement policy* at <https://www.mfe.govt.nz/sites/default/files/cab-05-164.pdf>).

⁶ See for example the recent Business New Zealand paper, *Emissions Intensive Trade Exposed Businesses' Contribution to New Zealand's Low Emissions Economy* (2019), available at: https://www.businessnz.org.nz/__data/assets/pdf_file/0003/169194/EITE-Report-Final.pdf.



account. In that case, their inclusion should be transparently provided for. In my view, such an approach would amount to being blatantly protectionist at the expense of the world's environment which New Zealand professes to be concerned about. As such it is not an amendment I could support.

- 22 What the Bill *should* include, is a purpose statement that makes it clear that free allocations will only be provided where there is a demonstrable and substantial risk of emissions leakage resulting in an increase in global emissions. Further, it should:
- a. require the Government to review the existing regulations to ensure that only those activities which are, in fact, at risk of emissions leakage continue to be prescribed as eligible industrial activities; and,
 - b. amend the eligibility criteria that will apply going forward, to prevent new activities from obtaining unwarranted subsidies.

Changes sought

1. Add a new provision which requires the Government to review the regulations made under section 161A(1)(a) of the principal Act, and to remove any activities that do not meet the criteria set out in recommendation 3 below, within three years of the date when the amendment Act comes into force.
2. Add a new purpose provision which makes it clear that free allocation should only be provided where necessary to manage a demonstrable risk of emissions leakage which would result in an increase in global emissions.
3. Add new provisions that amend the eligibility criteria set out in section 161A(3) of the principal Act, to require the Minister to be satisfied that the following additional criteria are met before recommending the making of regulations that prescribe an activity as an eligible industrial activity:
 - a. there is a substantial and demonstrable risk of emissions leakage (being an increase in 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; and
 - b. the emissions leakage is likely to result in the activity being carried out in a more emissions-intensive manner.
4. Add a new provision allowing the Minister to refuse EITE activity status where the New Zealand-based activity falls significantly short of international best practice in terms of its emissions intensity.



The failure to incentivise the uptake of less emissions-intensive production methods

23 Another defect in our free allocation regime is that it fails to incentivise EITE activities to adopt industry best practice. Allocative baselines are not set by reference to the levels of emissions that would be produced using best or even 'good' practice.

24 By contrast the European Union takes a 'benchmarking' approach to free allocation, which helps to drive continuous improvement. In summary, the regime operates as follows:

The total amount of free allocation each installation should receive is determined by product-related GHG emission benchmarks, to the extent feasible... Those benchmarks are set at the average emission level of the 10% most efficient installations within each sector. In this way, installations that are highly efficient should receive all or almost all of the allowances they need to comply with EU ETS obligations. Inefficient installations have to make a greater effort to cover their emissions with allowances, either by reducing emissions or by purchasing more allowances...⁷

25 The Bill should include proposals to set allocative baselines by reference to either:

- a. any applicable New Zealand-specific Best Available Techniques;⁸ or,
- b. the average emission level of the most efficient ten per cent of installations within New Zealand, where there are enough installations to facilitate that approach; or,
- c. the benchmarks used by the EU (which are based on the ten per cent most efficient installations in the EU) or another reputable international organisation.

Changes sought

5. Add a new provision requiring allocative baselines to be set by reference to the emissions generated by operators using best practice and require them to be updated at appropriate intervals.

The failure to ensure subsidies remain aligned with changes in EITE activities' emissions intensities over time

26 If allocative baselines are not linked to best practice, they should, at least, be adjusted when the emissions produced by the EITE activities fall. The failure to do so will result in over-allocation.

⁷Refer page 40 of the EU ETS Handbook (2015) at:

https://ec.europa.eu/clima/sites/clima/files/docs/ets_handbook_en.pdf

⁸See the 'Discussion Document: Accelerating renewable energy and energy efficiency' at p43 for an explanation of this concept (<https://www.mbie.govt.nz/have-your-say/accelerating-renewable-energy-and-energy-efficiency/>).



- 27 As matters presently stand, there is no requirement to monitor changes in the emissions profiles of EITE activities. The allocative baselines⁹ used to calculate each EITE activity's free allocation are based largely on the level of emissions that were being produced at the time when activities were first made eligible for free allocation (refer sections 161D and 161E(3)).
- 28 It should be acknowledged that the Bill makes some positive changes in this regard. While allocative baselines are not specifically dealt with, the Minister will be able to increase the phase out rates of the level of assistance for specific EITE activities in a range of circumstances, including a situation in which there is a 'risk that the value of the allocation for the activity will exceed the cost of meeting the emissions trading scheme obligations in relation to the activity' (refer proposed section 84C(3)(d)) and where an operator has access to 'the availability of low-emission technologies related to the activity' (refer proposed section 84C(3)(f)).
- 29 However, the Minister should be required, rather than being merely permitted, to make appropriate adjustments, particularly given that we are being overly generous already. (The Regulatory Impact Analysis, *A phase-down of industrial allocation*¹⁰ (RIA IA), indicates that only "some" of the EITE activities that are currently receiving free allocations face a "credible" threat if those allocations were phased out too fast.¹¹ In fact it concludes that the "risk is small for most activities").¹²
- 30 It is my understanding that the Government is currently prevented from requiring up-to-date information on EITE activities on account of a shortcoming in its information gathering powers. Specifically, the Minister can only require information relating to the financial years 2006/07, 2007/08, and 2008/09 for any activity that was being carried out in those years (which, as I understand it, is the case for all EITE activities that are currently receiving free allocations).¹³
- 31 The Bill should amend the existing information-gathering powers to enable the Minister to gather up-to-date information on the emissions intensities of EITE activities.

Changes sought

6. (Unless above change 5 is made) add provisions to require the Minister to review the emissions profiles of every EITE activity, and make any appropriate changes to the allocative baselines, at least every three years
7. Repeal existing section 161E(3) to remove any restrictions on the time period to which the Minister's information-gathering powers apply.

⁹ Allocative baselines reflect the level of emissions expected to be produced per unit of output.

¹⁰ <https://www.mfe.govt.nz/sites/default/files/media/Climate%20Change/industrial-allocation-impact-statement.pdf>

¹¹ Above at note 10 at page 9.

¹² Above at note 10 at page 21.

¹³ See section 161E(3).



The need to adjust phase out rates to avoid over-allocation

- 32 When the free allocation regime was first developed the Government intended to phase out free allocation altogether by 2025.¹⁴ With just five years to go, no progress has been made. The Bill's default phase out rates will not be sufficient to reduce free allocation to zero by 2050,¹⁵ despite the 2050 target in the same piece of legislation envisaging a level of emissions equivalent to net zero long-lived gases in that year.
- 33 The RIA IA acknowledges that the information used to determine the default phase out rates in the Bill was, "used for assessing activities when they were [first] made eligible for allocation", being data that is on average twelve years old.¹⁶
- 34 Notably, the default phase out rates that are being proposed in the Bill appear to be low in comparison to the phase out rates that have been implemented in other jurisdictions.¹⁷
- 35 This suggests that we are being much too generous with these subsidies, and that the default phase out rates need to be significantly more stringent. Accordingly, the Bill should require, rather than merely enable, the Minister to review them.
- 36 Further, the Bill needs to do more to ensure that any adjustments are soundly based. For example, it is currently proposed that the Minister only be required to "consider" the risk of over-allocation (both in relation to the level of risk of leakage and the extent of the ETS obligations) in making decisions. The Minister should instead be required to recommend phase out rates designed to avoid over-allocation.
- 37 I am also concerned that the Minister is empowered to consider any other matters he or she considers relevant (refer proposed section 84(3)(k)). In the absence of a purpose provision, this creates the potential for decisions to be driven by political expediency, rather than the need to avoid an increase in global emissions.
- 38 Finally, the regulation-making powers should enable the Minister to both increase and decrease the general and specific phase out rates for the level of assistance. The Bill currently provides that the Minister can only:
- a. Reduce (but not increase) the phase out rate that applies to all EITE activities 'across the board'; or,
 - b. Increase (but not reduce) the phase out rate that applies to specific activities.
- 39 In my view, there is no reason to constrain the Minister in this way. The Minister should also be able to increase the default phase out rate for all activities (if, for example, the science shows we need to reduce overall emissions faster than we

¹⁴ MfE. 2007. *Allocation in the New Zealand Emissions Trading Scheme*.

<https://www.mfe.govt.nz/sites/default/files/allocation-nz-ets-dec07.pdf>.

¹⁵ If the default phase out rates were applied, the level of assistance in 2050 would be 0.3 for highly emissions intensive activities and zero for moderately emissions-intensive activities. Free allocation for highly emissions-intensive activities would be phased out altogether by 2060.

¹⁶ Above at note 10 at page 25.

¹⁷ For example, in the EU ETS the average phase down rate for manufacturing industries 0.038 between 2013 and 2030 (the level of assistance is decreasing from 80% to 30% over this period).



thought), and to decrease the phase out rate for a specific EITE activity (if proof can be provided that it would still face a demonstrable and substantial risk of emissions leakage otherwise).

Changes sought

8. Add provisions requiring, rather than merely enabling, the Minister to review the general and specific phase out rates. The first set of reviews should all be completed within five years of the date when the new Act comes into force, and further reviews should be required to be undertaken whenever the Minister becomes aware of significant changes to one or more of the specified considerations. (Note that I do not propose removing the provisions which prevent changes being made to a phase out rate during an emissions budget period).
 9. Replace proposed section 84C with provisions that require the Minister to recommend phase out rates which are:
 - a. Consistent with delivering the 2050 target and New Zealand's obligations under the Paris Agreement; and,
 - b. Unlikely to result in the value of the allocation for the activity exceeding:
 - i. the value necessary to offset the level of risk of emission leakage that would increase global emissions; or,
 - ii. the cost of meeting the emissions trading scheme obligations in relation to the activity;
- (The matters for consideration in paragraphs (a), (e), (f), (g), (h), (i) and (j) can remain.)
10. Add a further matter for consideration, being, 'the availability of substitutable goods and services that can be produced with lower emissions'
 11. Remove proposed section 84C(3)(k).

The phase out rate for agriculture should also be reviewed

- 40 I note at the outset that my preference is for biological emissions to be priced via a levy, rather than the ETS. However, if the Government pursues the option of having these emissions enter the ETS, the following matters should be addressed.
- 41 Clause 78 of the Bill amends section 85 to increase the rate of the 'level of assistance' for eligible agricultural activities from 0.9 to 0.95.
- 42 The Explanatory Note to the Bill does not provide any substantive rationale for the proposed change. It is simply stated that the change is designed:

To reflect the Labour-New Zealand First Coalition Agreement...

- 43 The relevant Regulatory Impact Assessment, 'Reducing greenhouse gas emissions from



the agriculture sector'¹⁸ (RIA AA), describes the effect of the proposed change as follows (at page 2):

The agriculture sector will...only face five per cent of the cost of its biological emissions for at least the next five years.

- 44 The RIA AA goes on to state that the Ministry's modelling indicates that the effect of a farm-level¹⁹ pricing scheme for livestock emissions with 95 per cent free allocation would mean that (at page 36):

...sheep and beef farms have an incentive to adopt some additional mitigation options compared to the status quo, such as removing breeding cows and planting woodlots. Dairy farms, however, are unlikely to adopt **any** mitigations even at high GHG prices (\$100/tCO₂-e). [Emphasis added]

- 45 It then acknowledges that the proposed level of assistance would mean that including agriculture in the ETS, "will have only a small effect in making more abatement options economically viable".²⁰ To put it more bluntly, it would largely defeat the purpose of including the sector in the ETS at all.
- 46 The principal Act already specifies a phase out rate of 0.01 per year for agricultural activities (refer section 85(2)). At that rate, free allocation would continue for at least 95 years after it is triggered, which clearly doesn't align with the 2050 target and New Zealand's obligations under the Paris Agreement. Supplementary Order Paper No.413 requires the Minister to consider the advice of the Climate Change Commission before 'reactivating' it, but does not include detailed provisions to guide decision-making.
- 47 In my view, the Bill should include provisions to require the Minister to review the phase out rate and establish a robust framework for doing so.

Change sought

12. Add new provisions which empower the Governor General, on the recommendation of the Minister, to make regulations setting phase out rates for free allocation to agriculture that are consistent with the 2050 target and New Zealand's obligations under the Paris Agreement, and to permit adjustments to the phase out regulations from time-to-time as appropriate.

¹⁸ <https://www.mfe.govt.nz/sites/default/files/media/Legislation/RIS/ria-reducing-greenhouse-gas-emissions-from-agricultural-sector.pdf>

¹⁹ I acknowledge that the RIA AA suggests that a processor level pricing scheme for livestock emissions with 95 per cent free allocation would be marginally preferable. It would mean that (at page 36):

'...sheep and beef farmers have an incentive to adopt mitigation options at all carbon prices. However, this option does not encourage the dairy sector to adopt **many** mitigation options even at the highest GHG price (\$100/tCO₂-e)'. [Emphasis added]

²⁰ Above at note 18 at page 2.



Alternatives to free allocation

- 48 As explained, the provision of free allocation to EITE activities makes sense when there is a significant differential in the emissions prices faced by New Zealand EITE activities and their competitors in other countries. However, currently there is little evidence of emissions leakage occurring.²¹ This is understandable given: (1) the generous provision of free allocation to EITE activities; and (2) emissions prices which have been far too low to incentivise a transition towards the global temperature goals of the Paris Agreement.
- 49 Of course, under the Paris Agreement asymmetry of climate policy effort is likely to continue for some time. Hence, there remain strong grounds to protect EITE activities from emissions leakage. However, free allocation as a regime to address such leakage not only limits exposure of EITE activities to the full emissions price, but continues to be plagued with perverse incentives such as the prospect of windfall profits when EITE activities are over-subsidised and sell their allowances for a profit.
- 50 Accordingly, it is appropriate for New Zealand to consider alternative regimes to free allocation to address emissions leakage, while also ensuring that there are strong incentives for EITE activities to shift their efforts to low-emissions technologies and production.
- 51 One alternative regime I promoted in my 2019 report *Farms, Forests and Fossil Fuels*, is the idea of recycling auction revenue to fund the research, development and deployment of low-emissions technologies relevant to EITE activities.²² Recycling auction revenues to support the transition is also politically expedient. We have learnt from overseas experience that increasing the stringency of climate policies has much less chance of being accepted, if revenue disappears into general Government coffers.
- 52 An alternative approach would be to replace free allocations with the establishment of a border emissions adjustment policy. Such policies are increasingly gaining attention in Europe. It would be timely to explore such policies to ensure that they are not developed uniquely to advance European interests and can be used in a way that is not detrimental to small, open economies like New Zealand's.
- 53 One advantage of border emissions adjustments is that they not only ensure that domestic EITE activities face the full emissions price, but they also provide incentives for other countries to adopt more stringent climate policies to avoid the 'adjustment' required on their exported goods. For example, the adjustment policy could simply

²¹ For example, Arlinghaus (2015; p.23), in reviewing a wide set of papers on emissions leakage and competitiveness, concluded that "most studies reviewed [...] fail to measure any economic meaningful competitiveness effects as a consequence of these [emissions pricing] policies." See Arlinghaus, J., 2015. *Impacts of carbon prices on indicators of competitiveness: a review of empirical findings*. Environment Working Paper 87, Organisation of Economic Cooperation and Development: Paris.

²² Economic analysis for the Tax Working Group indicated that the removal of free allocation and an emissions price rising to \$50 per tonne of carbon dioxide equivalent by 2030 covering all sectors including agriculture could raise \$2.1 billion per year over the next ten years. However, it is noteworthy that whatever the auction revenue available, we can expect the New Zealand Government purchasing a generous amount of international units, so that New Zealand can meet its 2030 nationally determined contribution.



charge a tax on EITE imported goods equivalent to the emissions price under the NZ ETS.

- 54 In an effort to determine whether the free allocation regime remains fit-for-purpose and will support meeting the 2050 target, I recommend that the Select Committee should encourage the Government to review the regime within five years, including the eligibility criteria for free allocation. As part of that review, I also recommend that alternative regimes to free allocation are carefully analysed including border emissions adjustment policies and the recycling of auction revenues to EITE activities to support research, development and deployment of relevant low-emissions technologies.

Recommendation

In addition to the above changes sought to the Bill, I recommend that the Select Committee should encourage the Government to review the free allocation regime within five years, including the eligibility criteria.