Emissions Trading Bill - Talking points for oral hearing on submission

1. Thank you for the opportunity to present my written submission.

2. My concerns with this Bill relate to the proposals on free allocation to industrial and agricultural businesses.

3. Business NZ has noted that an effective ETS would have no free allocations in the longer term. That's because we would be living in a world in which all countries were taking vigorous climate action. The case for free allocation is an acknowledgment that we live in a second-best world and that transitionally, the costs of across-the-board carbon pricing domestically could lead to emissions-intensive activities relocating to less ambitious jurisdictions.

4. However, the effect of free allocation is, to all intents and purposes, to confer a subsidy. It results in lost revenues to the Crown and requires the rest of the economy to do more to reduce emissions. Not only does that compromise the effectiveness of the ETS, but it also weakens the incentives for emissions-intensive businesses to reduce their own emissions to the extent that they can.

5. Given those drawbacks, free allocation can best be justified on the basis that it is necessary to prevent emissions leakage that would result in an increase in global emissions. In other words, free allocation should be about protecting the environment.

6. This is not what New Zealand's current free allocation system does because its eligibility criteria are not designed to deliver that. To receive free units, a business only needs to show that it is emissions intensive and that there is – or could be – international trade in its products. It does not need to show that meeting its obligations under the ETS could put it out of business, or that if the activity involved was relocated overseas, that would increase global emissions.

7. In all likelihood, we have been giving free units to businesses that did not need them, or are less efficient than their overseas competitors. It appears that the eligibility criteria are designed to protect businesses and jobs as much as they are designed to protect the climate. If that is the case, the criteria should transparently provide for this.

8. Such a regime might have been acceptable as a short-term measure to support businesses to adjust to a new ETS. When free allocation was first provided for in the Act back in 2008, the Government agreed in principle to start phasing out free allocation from 2013, and to remove it altogether by 2025. However, the scheme was weakened by a 2009 amendment act which, amongst other things, removed quantity limits and deferred the phase-out indefinitely.

9. I appreciate that this was done in the immediate aftermath of the global financial crisis. But that is long past. As is so often the case, measures taken ‘temporarily’ in the wake of a crisis have become a permanent part of the scenery. It is time to return to a more environmentally defensible justification for free allocations.

10. As things stand, with just five years to go until the original end date, we have made no progress at all in winding back these concessions. Worse, as you can see from the first page of the handout, if the default phase out rates in the Bill as introduced are applied, free allocation for EITE activities will not be phased out completely until 2060. For agriculture, the level of assistance would still be 70 per cent in 2050 and would not reach zero until 2120 or later.

11. The Bill does not do enough to get us back on track. While it provides for the Minister to review phase out rates, it does not positively require that to happen. It is possible we will continue to provide free units to existing EITE activities for no good reason and for years to come.

12. Not only that, but the Bill allows for new businesses undertaking existing activities, and even new activities, to get free units under the existing eligibility criteria. As the Bill stands, highly emissions-intensive industries operating in a way which is inconsistent with best practice, could arrive in New Zealand and demand free allocations. Not only that: because our allocations are based on how much a business chooses to produce, there is no upper limit on the quantity of units that could be handed out for free.

13. In my written submission, I proposed changes to the eligibility criteria to help address this problem. On reflection, I am convinced that a more radical solution is needed. The Bill should confine free allocations to those activities already receiving it. It should also remove the possibility of existing businesses adding new emissions intensive activities that would be eligible for free allocation. Finally it should eliminate the possibility of new emissions-intensive businesses being attracted to New Zealand on the basis that those emissions qualify for free allocations.

14. Furthermore, existing businesses carrying out existing EITE activities should not be able to increase their free allocations by increasing their production levels without limit.

15. I have attached to this note new recommendations that would prevent these things from happening.

16. If this can’t be done, then at the very least the eligibility criteria for free allocation should be amended, as laid out in my submission (see change sought #2).

17. The other changes I am seeking are to ensure that existing EITE activities only receive units they actually need, and that they make a fair contribution towards meeting our obligations. They include:

- Requiring the Government to stop providing free allocations to existing businesses that are not actually at risk of emissions leakage;
- Requiring the Government to ensure that free allocation volumes are adjusted as and when the emissions intensity of EITE activities changes;
- Using benchmarks based on best practice to determine allocative baselines (as does the EU); and,

18. If these changes are not made, we risk falling short of meeting our targets and continuing to send conflicting messages about the direction of policy.

19. I would also like to respond to several points made by other submitters. First, I note in that regard, that a number of submitters have suggested that the Bill should not specify levels of assistance beyond 2030, because that issue could be dealt with through the upcoming review of free allocation. But, the cabinet paper is clear that the review is not about phase out rates. It is about updating the baselines on which free allocations are determined. If the select committee is not going to address the issue of phase out rates now, it will not be addressed.

20. Secondly, submitters have argued that adjusting or removing free allocation could disincentivise businesses from pursuing emissions reductions that are currently being funded by over-allocations. That argument flies in the face of the rationale for having an ETS at all. And frankly, it is up to the Government, and not EITE businesses, to decide who should receive subsidies for emission reduction technologies. You should ignore this special pleading.

Additional changes sought

Note: The following changes are preferred to those set out as changes 2 and 3 in my written submission.

Add new provisions to:

1. Amend section 161A(1)(a) of the principal Act to prevent the Governor General from making regulations that specify any new eligible industrial activity; and,
2. Amend section 81 of the principal Act to:
    a. Specify that any person who was not an eligible person for the relevant eligible industrial activity in 2019 is not an eligible person; and,
    b. Replace the formula for calculating the PDCT of an eligible industrial activity so that it cannot exceed the amount of each prescribed product from the eligible industrial activity that the eligible person produced in the year ended 31 March 2020.

Explanation of handout

1. On the second page of the handout you will find a figure showing how free allocation fits together with domestic emissions budgets and our first nationally determined contribution. The emissions budget for 2026-30 is purely illustrative - the Climate Change Commission will of course be providing advice in February 2021 on what the first three emissions budgets should be.

2. The difference between the solid orange line (gross emissions) and the solid green line (net emissions) is the contribution of forest sinks using NDC target accounting.

3. The difference between the solid green line (net emissions) and the solid shaded area (domestic emissions budget) is the additional gross emissions reductions needed to meet the domestic emissions budget.

4. The difference between the domestic emissions budget (solid shaded area) and the dotted purple line (NDC budget) is the quantity of international units that would need to be purchased to meet the NDC. In this scenario, that quantity would be 64 $MtCO_2$, which at 25 $/tonne represents a Crown liability of $1.6 billion over 10 years or $160 million per year.

5. The effect of output-based free allocation within a shrinking emissions cap is to reduce the amount of the emissions budget remaining for the rest of the economy. In the scenario shown, free allocation to EITE activities and agriculture together accounts for around 75% of the annual NZ ETS unit supply in 2030.

6. The volume of free allocation to EITE activities in 2026-30 assumed that output levels remain constant at the 2025 level and the level of assistance is phased down at 1 percentage point per year to 2030. If free allocation can be awarded to new activities and new entrants into existing activities, there is nothing to prevent the total volume of free allocation to EITE activities increasing over this period and consuming an even greater share of the emissions budget.