

**In Confidence**

Office of the Minister of Climate Change  
Cabinet Environment Committee

**Terms of reference for the industrial allocation policy review**

**Proposal**

- 1 This paper provides Cabinet with the terms of reference for the review of industrial allocation policy within the New Zealand Emissions Trading Scheme (NZ ETS).

**Relation to government priorities**

- 2 This work contributes to the government's priorities to grow and share New Zealand's prosperity more fairly, to transition to a clean, green carbon neutral New Zealand, and to respond to the climate emergency.

**Executive Summary**

- 3 Cabinet agreed to a review of industrial allocation policy in December 2019 s 9(2)(b)(ii) [ENV-19-MIN-0062 refers].<sup>1</sup> In March 2020, Cabinet directed the Minister of Climate Change to provide it with the terms of reference for the review. This paper fulfils that report back.

- 4 The review will have two parts. The first will consider updating the parameters of the existing industrial allocation framework, including the need to reassess eligibility and rates of allocation to firms. Policy decisions, following consultation, s 9(2)(f)(iv)

- 5 The second part will enable a discussion to start on alternatives to the current allocation policy framework. There are different ways of addressing the risk of emissions leakage, including a carbon border adjustment mechanism s 9(2)(f)(iv)

**Background**

- 6 Industrial allocation is the provision of free New Zealand Units (NZUs) to emissions-intensive, trade-exposed (EITE) firms that carry out 'eligible activities' whose competitiveness is considered at risk due to costs placed on

<sup>1</sup> s 9(2)(b)(ii)

the activity by the NZ ETS.<sup>2</sup> A total of 8.3 million NZUs were allocated in 2019.<sup>3</sup> These costs create a risk of emission leakage if these firms were exposed to the full cost of NZ ETS surrender obligations. The purpose of industrial allocation is to mitigate this risk.

- 7 Emission leakage would occur if New Zealand firms lost market share or shifted production overseas to avoid a domestic price on emissions. This is a concern due to the potential economic and employment impacts, particularly for regions where a single emission-intensive facility may be an important part of the local economy.
- 8 Emission leakage is also an issue of environmental integrity. If leakage occurred, this could mean that New Zealand's climate policy might end up driving the export of emissions rather than reducing them.

*Over-allocation of NZUs is occurring*

- 9 Over-allocation is where eligible firms receive allocations greater than what is needed to minimise the risk of emissions leakage. The Climate Change Response Act 2002 (the Act) allows for eligible firms to receive allocations equivalent to 90 per cent or 60 per cent of their NZ ETS costs, based on the emissions intensity of the particular industry activity. An over-allocation would be an allocation greater than an industry's current entitlement under the Act.
- 10 Over-allocation increases the difficulty of meeting New Zealand's emissions reduction targets under the Act by taking up a larger portion of emissions budgets. It has distributional impacts, is a windfall gain for firms, reduces the incentive for abatement across the economy, reduces the effectiveness of the NZ ETS' price signal, and creates fiscal costs for the Crown by reducing the amount of NZUs the government can sell through auctioning.

11 s 9(2)(b)(ii)



12 In March 2020, Cabinet invited the Minister of Climate Change to provide Cabinet the terms of reference to the industrial allocation policy review by June 2020 [CAB-20-MIN-0102 refers]. The reprioritisation of Cabinet availability due to COVID-19 delayed this report back.

13 To inform the case for the review, late in 2020 I called for firms in a subset of EITE industries to provide current emissions, revenue, and production data. Analysis showed that emissions efficiency improvements, fuel switching, changes in industry structure, and NZ ETS surrender exemptions since 2007

<sup>2</sup> These firms face increased costs as a result of the NZ ETS (because they are emissions-intensive) but are not able to pass on those costs (because they are trade-exposed).

<sup>3</sup> At \$39 per NZU, this is an expense of \$320 million per year.

to 2009 have caused significant reduction in emissions intensities and, in some cases, changes in eligibility. This has increased their average level of assistance above their entitlement as shown in table 1 below.<sup>4</sup> The estimated cost to the Crown of the over-allocation at \$39 per NZU is almost \$9 million per year.

Table 1: Results of data analysis in 2020 of allocations to firms in four eligible industries

Activity	Entitled assistance level	Estimated average actual assistance level
s 9(2)(b)(ii)	s	105%
s 9(2)(b)(ii)	s	98%
s 9(2)(b)(ii)	s	124%
s 9(2)(b)(ii)	s	305%

14 A report commissioned by the Ministry for the Environment found that for some industries in the same subset, there is little risk of emissions leakage at s 9(2)(b)(ii)

15 I am also progressing a review of the electricity allocation factor (EAF) separate from this review of industrial allocation. The EAF is a measure of the impact of the NZ ETS on electricity prices and currently accounts for approximately a third of industrial allocations to eligible firms. I propose to consult on an updated EAF methodology as part of annual updates to NZ ETS regulations, as covered in the paper – *Approval to consult on proposed New Zealand Emissions Trading Scheme and Synthetic Greenhouse Gas Levy regulation updates 2021*. A change to the EAF can be implemented through regulations and is therefore not part of the terms of reference.

**Structure of the review**

16 The industrial allocation review will have two workstreams, as detailed in the terms of reference attached to this paper. The two parts are:

- 16.1 a review of the settings within the current framework of industrial allocation policy
- 16.2 opening a discussion on potential longer-term changes to industrial allocation policy and alternative measures to reduce the risk of emissions leakage

17 s 9(2)(f)(iv)

<sup>4</sup> If updated data could be used to determine these. The Act requires the use of historical data from 2007-09.

s 9(2)(f)(iv)

*The primary focus is a review of the parameters that determine eligibility and allocations under the current framework*

18 Over a decade has passed since decisions were made on eligibility and rates of allocation.<sup>5</sup> A significant amount of change has occurred within EITE industries and with climate change policies, both domestically and internationally since then. There is a need to examine and update these settings to ensure the policy accurately manages the risk of emissions leakage and is appropriate for New Zealand's climate change commitments.

19 Two components of the policy framework will be examined in depth. First, eligibility currently depends on both international trade exposure and meeting a threshold for average emissions per \$1m of revenue. The review will consider those tests and determine if improvements and adjustments are necessary. This includes the current five-year delay for implementing decisions that revoke eligibility and change assistance levels.

20 Secondly, allocation decisions are based on industry average emissions and production data from the financial years 2007 to 2009. New entrants are permitted and there is no limit on the total allocations given. The review will provide an opportunity for discussing and adjusting these settings. A particular focus will be on the value of updating the allocative baselines that determine the amount of allocation for different activities by using emissions, production and revenue data from recent years.

21 The Act prescribes eligibility and allocation decisions within the NZ ETS.

s 9(2)(f)(iv)

*The secondary focus is a review of options for managing leakage risk in the longer term*

22 To facilitate discussion on alternative ways to manage leakage risk, the review also allows stakeholders to consider the economic, social and environmental values of managing leakage in the longer term. We should be open to considering the benefits and risks of alternative mechanisms for addressing emissions leakage to learn if, when, and what change might be beneficial for the NZ ETS. Developing an alternative mechanism will take more time and needs to be deliberate and measured, hence the exploratory nature of this second work stream.

<sup>5</sup> The eligibility of activities in New Zealand was based on the methodology made for the Australian Carbon Pollution Reduction Scheme. The Australian scheme never passed into legislation.

23 s 9(2)(f)(iv) [Redacted]

[Redacted]

[Redacted]

[Redacted]

[Redacted]

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[Redacted]

[Redacted]

[Redacted]

[Redacted]

[Redacted]

[Redacted]

[Redacted]

24 s 9(2)(f)(iv) [Redacted]

[Redacted]

[Redacted]

[Redacted]

[Redacted]

*Consultation on the review will begin in June contingent on Cabinet approval*

25 I will bring a consultation document to Cabinet for consideration in June 2021. Its analysis of options will be influenced by a technical advisory group comprised of specialist economic and climate policy experts. Although the Parliamentary Commissioner for the Environment and the Climate Change Commission have turned down invitations to participate in this group, they are considering roles as observers

**Financial Implications**

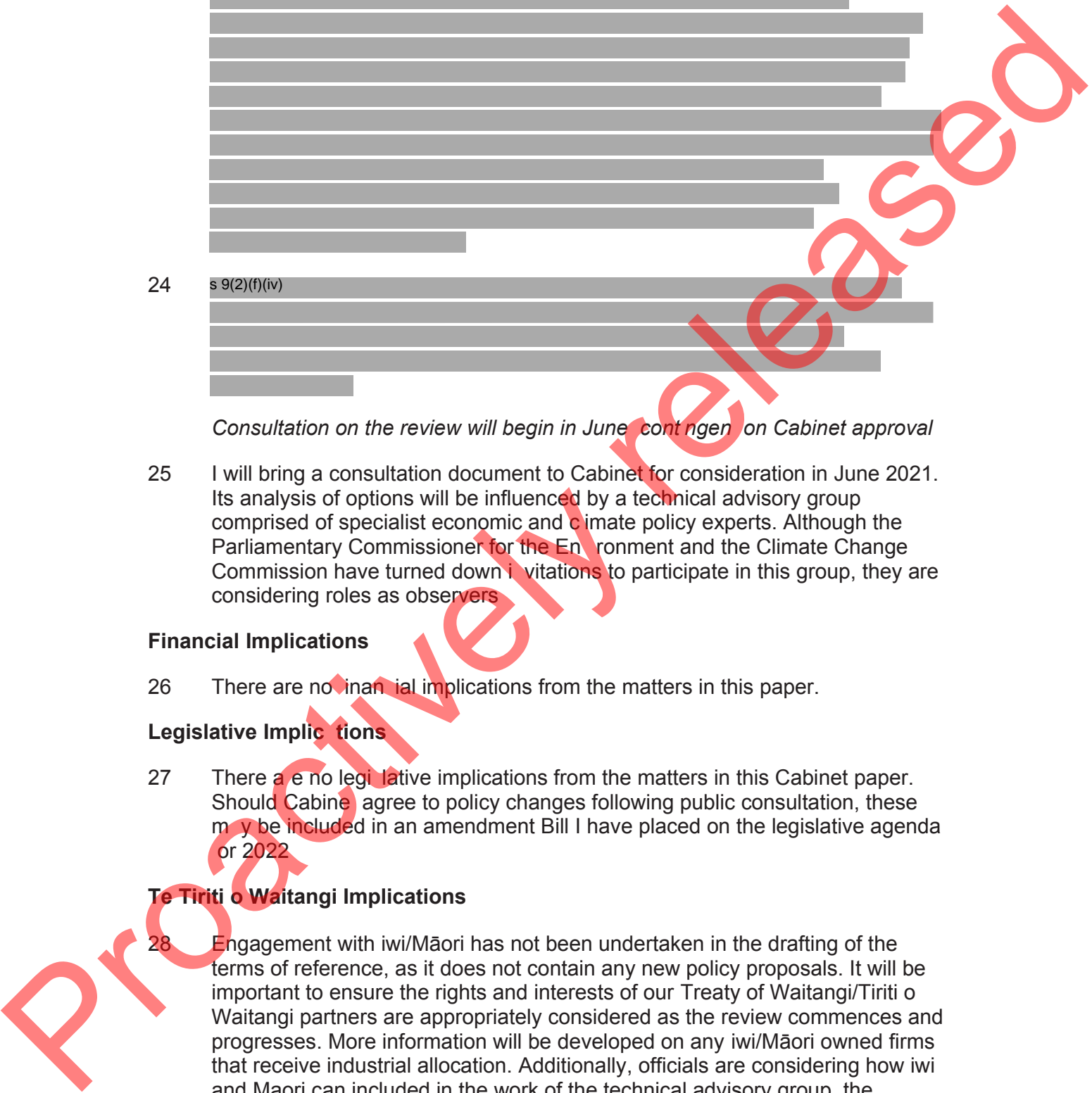
26 There are no financial implications from the matters in this paper.

**Legislative Implications**

27 There are no legislative implications from the matters in this Cabinet paper. Should Cabinet agree to policy changes following public consultation, these may be included in an amendment Bill I have placed on the legislative agenda for 2022

**Te Tiriti o Waitangi Implications**

28 Engagement with iwi/Māori has not been undertaken in the drafting of the terms of reference, as it does not contain any new policy proposals. It will be important to ensure the rights and interests of our Treaty of Waitangi/Tiriti o Waitangi partners are appropriately considered as the review commences and progresses. More information will be developed on any iwi/Māori owned firms that receive industrial allocation. Additionally, officials are considering how iwi and Maori can included in the work of the technical advisory group, the preparation of the consultation document, and ensuring consultation on policy



options is meaningful and coordinated to reduce and manage the burden on iwi and Māori.

## Impact Analysis

### Regulatory Impact Statement

- 29 The impact analysis requirements, including the climate implications of policy assessment, do not apply to the matters in this paper, as no policy decisions are sought.

### Consultation

- 30 The following agencies provided feedback on this paper: the Ministry of Business, Innovation and Employment, Energy Efficiency and Conservation Authority, the Environmental Protection Authority, the Ministry for Primary Industries, and the Ministry of Foreign Affairs and Trade. The Department of Prime Minister and Cabinet and Te Puni Kōkiri were informed. Feedback received from those agencies is reflected in this paper.

### Communications

- 31 The terms of reference for the review will be published on the Ministry for the Environment's website after Cabinet consideration of this paper.
- 32 Industrial allocation policy is of significant interest to many of New Zealand's largest firms. The process for this review provides opportunities for stakeholder involvement and a long lead in time for change.

### Proactive Release

- 33 I intend to release this paper subject to any redactions under the Official Information Act 1982 within 30 days after Cabinet consideration.

### Recommendations

The Minister of Climate Change recommends that the Committee:

- 1 **Note** that firms in eligible activities (ones that are emissions-intensive and trade-exposed) receive an allocation of NZUs to reduce the risk of emissions leakage;
- 2 **Note** officials have collected evidence of over-allocation in the current industrial allocation system;
- 3 **Note** that over-allocation is present in the current system due to outdated settings, emissions intensity improvements, changes in market structure, and NZ ETS surrender exemptions;
- 4 **Note** that over-allocation could make it harder to meet emission targets and is a significant ongoing fiscal cost to the Crown;

- 5 **Note** that in March 2020, Cabinet invited the Minister of Climate Change to present a paper to Cabinet containing the terms of reference for a review of industrial allocation policy [CAB-20-MIN-0102 refers];
- 6 **Note** the terms of reference for the review attached to this paper;
- 7 **Note** the terms of reference sets out the review in two parts:
  - 7.1 a review of the settings within the current framework of industrial allocation policy;
  - 7.2 opening a discussion on potential longer-term changes to industrial allocation policy and alternative measures to reduce the risk of emissions leakage;
- 8 **Agree** the Minister of Climate Change can make minor changes to the review's terms of reference before their publication;
- 9 **Invite** the Minister of Climate Change to present a consultation document on proposed updates to industrial allocation policy to Cabinet in June 2021.

Authorised for lodgement

Hon James Shaw

Minister of Climate Change

Appendix 1: Terms of Reference for Industrial Allocation Policy Review

Proactively released