Reforming industrial allocation in the New Zealand Emissions Trading Scheme

Consultation document

Ministry for the Environment
Manatū Mō Te Taiao

New Zealand Government

Disclaimer

The information in this publication is, according to the Ministry for the Environment's best efforts, accurate at the time of publication. The Ministry will make every reasonable effort to keep it current and accurate. However, users of this publication are advised that:

- The information does not alter the laws of New Zealand, other official guidelines, or requirements.
- It does not constitute legal advice, and users should take specific advice from qualified professionals before taking any action based on information in this publication.
- The Ministry does not accept any responsibility or liability whatsoever whether in contract, tort, equity, or otherwise for any action taken as a result of reading, or reliance placed on this publication because of having read any part, or all, of the information in this publication or for any error, or inadequacy, deficiency, flaw in, or omission from the information in this publication.
- All references to websites, organisations or people not within the Ministry are for convenience only and should not be taken as endorsement of those websites or information contained in those websites nor of organisations or people referred to.

This document may be cited as: Ministry for the Environment. 2021. *Reforming industrial allocation in the New Zealand Emissions Trading Scheme: Consultation document*. Wellington: Ministry for the Environment.

Published in July 2021 by the
Ministry for the Environment
Manatū Mō Te Taiao
PO Box 10362, Wellington 6143, New Zealand

ISBN: 978-1-99-003360-5
Publication number: ME 1573

This document is available on the Ministry for the Environment website: environment.govt.nz.

Contents

Tables

Figures

Message from the Minister

Over the past four years, New Zealand has made progress towards developing the institutional and governance framework necessary to reduce greenhouse gas emissions and adapt to the impacts of climate change.

The New Zealand Emissions Trading Scheme (NZ ETS) is an important part of this framework. The recent legislative reforms will help reduce emissions and move to a low-emissions economy. A key part of these reforms was the changes to industrial allocation, in order to begin phasing out assistance to emissions-intensive and trade-exposed industries.

Industrial allocation helps to manage the impact of the emissions price on industry. This is important to avoid the loss of international competitiveness for trade-exposed firms, and reduce the risk of the NZ ETS driving emissions overseas, rather than mitigating them.

This review is an opportunity for the Government, industry and the public to consider the future of industrial allocation. In the short term, we must urgently address over-allocation. There is evidence that some industries are receiving more support than intended under the Climate Change Response Act 2002. This is because some eligibility and allocation settings are out of date and do not reflect recent improvements in the emissions intensities of industry. Over-allocation is a pressing problem, as it will make it much harder and unnecessarily costly for New Zealand to reduce emissions and meet climate change targets.

There are also questions about the long-term direction of industrial allocation. Other policies could protect the competitiveness of industries, but maintain a stronger incentive to reduce domestic emissions. This consultation document will start a public conversation on alternative measures, such as carbon border adjustment mechanisms, which could be introduced sometime in the future.

This consultation document includes proposals to improve industrial policy and support effective emissions pricing, in order to encourage businesses to reduce emissions, innovate and invest in low-emissions practices. To ensure technical accuracy, a technical advisory group helped to develop the proposals and analysis.

Your feedback on the proposals in this document will shape any legislative changes required to set up a better framework.

Hon James Shaw
Minister of Climate Change

About this consultation

We are seeking your feedback for a review of industrial allocation

The Government is reviewing industrial allocation (also known as free allocation) in the New Zealand Emissions Trading Scheme (NZ ETS). This consultation document seeks feedback on options that will inform proposed regulatory changes to industrial allocation through an amendment to the Climate Change Response Act 2002.

What is industrial allocation?

Industrial allocation is the provision of free emissions units (New Zealand Units or NZUs) to industries considered emissions-intensive and trade-exposed (EITE).

Industrial allocation reduces the cost of the NZ ETS for industry. The purpose is to reduce the risk of the emissions price driving EITE firms, production and the associated emissions overseas, which could increase global emissions. This risk is known as **emissions leakage**.

Why review industrial allocation?

Industrial allocation policy sits within a set of broader climate change objectives for New Zealand. The Government has committed to reducing emissions to meet domestic and international climate targets. Current levels of industrial allocation are likely unsustainable in the context of New Zealand's future emission budgets.

There are clear tensions between the purpose of industrial allocation and New Zealand's other climate objectives. We may need trade-offs between supporting industry and meeting increasingly ambitious emissions budgets. The Government considers it appropriate to review the current industrial allocation settings, as well as the longer-term direction of the policy.

What does the review address?

The purpose of the review is to:

- assess New Zealand's industrial allocation policy
- ensure it manages any ongoing risk of emissions leakage
- ensure consistency with our climate change commitments.

The review is particularly concerned with addressing **over-allocation**. There is evidence that some industries are receiving allocations greater than intended to address leakage. Over-allocation makes it harder to meet future climate change targets, puts unnecessary pressure on other sectors to reduce emissions, and is an ongoing fiscal cost.

Where does this consultation fit within the review?

This consultation forms the public facing part of the review and seeks feedback on policy options to address problems with industrial allocation. The Ministry for the Environment will use the feedback to consider revisions to the policy proposals. Final policy recommendations will be provided to the Government in 2022.

Your views

We would like your input for this review. This consultation document includes:

- proposals to realign current industrial allocation settings
- alternative measures to address leakage that may better support New Zealand's climate change commitments.

Feedback on these proposals will inform Government decisions on short-term changes to industrial allocation, and the longer-term direction of the policy.

What this consultation document covers

Section 1 explains the rationale behind industrial allocation policy and sets out the context for the review. It defines emissions leakage and explains current eligibility and allocation settings.

Section 2 describes the purpose of the review, the problems with current industrial allocation policy, and the criteria and objectives to assess different proposals.

Sections 3, 4 and 5 outline the proposals we are consulting on. Section 3 looks at options to improve the current allocation calculation settings to address over-allocation. Section 4 proposes reassessing the eligibility of industrial activities and options to improve the current eligibility tests. Section 5 considers other options for reform, and addresses technical issues with the policy.

Section 6 considers alternative measures to address emissions leakage.

Section 7 is an initial assessment of the impact of changes to allocations and eligibility on EITE firms, the Government, regional economies and Māori.

What it doesn't cover

Several matters are not part of the review. These include:

- **The phase-out of industrial allocation** introduced in 2020 through the Climate Change Response (Emissions Trading Reform) Amendment Act. This setting was recently reviewed, decided and implemented. However, the impacts of the phase-out on policy options are discussed in the context of broader changes to the policy.
- **Updating the Electricity Allocation Factor (EAF)** value and modelling methodology. The EAF is an important industrial allocation setting used to measure the impact of the NZ ETS on electricity prices. A review of the EAF began in late 2019 and public consultation has recently concluded on updating the EAF and modelling methodology. The industrial allocation review does consider proposals where the EAF is a component of the eligibility settings – but not the EAF calculation methodology or value.
- **Agricultural free allocation policy** is outside the scope of the review. This is currently being considered in the He Waka Eke Noa – Primary Sector Climate Action Partnership work programme.
- How the **methodology for NZ ETS unit supply settings** accounts for industrial allocation.

The Industrial Allocation Review Technical Advisory Group

We established a Technical Advisory Group (TAG) to provide independent expertise on industrial allocation, trade, economics and climate policy to support the review. The TAG was asked to test evidence, analysis and policy options, to help draft the consultation document.

The TAG met three times and reviewed the consultation document at each stage of its drafting. Its recommendations have informed the proposals to be consulted on, as well as the impact analysis.

The consultation document presents the TAG's recommendations, where consensus was reached on specific proposals. Appendix 1 outlines the TAG's positions on the consultation questions.

Consultation on NZ ETS market governance

A parallel consultation is addressing changes to the market governance in the NZ ETS. Market governance refers to the processes, policies and rules to manage the risk of misconduct in the NZ ETS primary, secondary or derivatives market. Current market governance arrangements are not fit for purpose and are unable to address a variety of market risks.

The market governance consultation will be of interest to industrial allocation recipients, as it will directly affect the future rules and operation of New Zealand's carbon market.

You can find out more by visiting the market governance consultation page.

Next steps

This consultation will run from Thursday 8 July to Friday 17 September 2021. To find out how to participate and make a submission see section 8 of this document.

We will include your feedback in a summary of submissions to be published in late 2021. The results from this consultation, alongside further policy analysis, will inform advice to Ministers about policy changes to industrial allocation. These changes are likely to be progressed through an amendment to the Climate Change Response Act introduced in 2022, and later through changes to the industrial allocation regulations.

Any actual changes to allocations or eligibility are unlikely to take effect until 2024.

More information

1. Visit the website https://consult.environment.govt.nz/climate/reforming-industrial-allocation-in-the-nz-ets.
2. Ask the NZ ETS team at etsconsultation@mfe.govt.nz.

Summary of proposals

Proposals to reform allocation calculations

Allocative baselines are out of date and contribute to over-allocation.

- The Government proposes to update all allocative baselines immediately with activity data from new, more recent base years.
- There are options for how often to update allocative baselines after this. We would like your views on: a one-off update, or updates every year, or every 5 or 10 years.
- The TAG's preferred option is to update the baselines every 10 years.

Proposals to reform eligibility for industrial allocation

Eligibility decisions are out of date and contribute to over-allocation.

- The Government is considering retesting the eligibility of all activities, using data from recent base years. The TAG supports this.
- There are also other options to improve the eligibility criteria if eligibility is reassessed:
  - developing New Zealand-specific emissions intensity thresholds
  - using New Zealand's Electricity Allocation Factor (EAF) to assess eligibility, rather than an Australian EAF (as currently)
  - improving the trade exposure test.

Other options to improve industrial allocation

Other proposals address technical issues.

- The consultation seeks feedback on:
  - streamlining the process to update allocative baselines when emissions factors and the EAF are changed
  - improving the process for new activities to seek eligibility for industrial allocation
  - setting limits on new activities seeking eligibility for industrial allocation
  - voluntary or mandatory reporting of activity data by firms receiving allocations
  - changing the five-year transition period for eligibility changes.

The long-term direction of industrial allocation and alternative mechanisms

The Government is interested in beginning a discussion with industry and the public on future industrial allocation policy.

- We are seeking feedback on three alternative policies: 1. carbon border adjustment mechanisms, 2. direct payments to industry, and 3. partial exemptions from the NZ ETS.
- We also invite feedback on whether:
  - industrial allocation or an alternative should explicitly support emissions reductions
  - wider considerations should be incorporated into industrial allocation policy, or an alternative.

Section 1: Introduction and context

This section sets out the context for this review, namely the:

- risk of emissions leakage
- current industrial allocation settings for eligibility and allocation calculations.

The risk of emissions leakage

Emissions leakage (also known as carbon leakage) can occur if the NZ ETS does not reduce emissions as intended, but exports (or leaks) them overseas. This can result when New Zealand firms lose market share or shift production to other countries with weaker climate policies, in order to reduce compliance costs and remain competitive in an international market.

If our emissions were exported to countries without a hard emissions cap in place, leakage would undermine New Zealand's commitment to reduce global emissions.

How real is the risk of emissions leakage?

There is still a risk of leakage, which justifies protective measures, at least in the short term. Many of our major trading partners do not have emissions pricing comparable to the NZ ETS. Furthermore, those countries with emissions pricing still provide substantial levels of support to industry.

In 2018, we commissioned a report[1] on competitiveness and emissions leakage. It found that some sectors are vulnerable to leakage if there was a high emission price and competing jurisdictions did not have similar climate policies.

A more recent report[2] found that without industrial allocation, some industrial activities carried out in New Zealand are at risk of leakage at current NZU prices[3]. Table 1 shows estimates of the price at which an activity's total emissions costs is greater than current estimated profits for the activities.[4] The analysis assumes that firms face 100 per cent of their emissions costs.

Table 1: Estimated carbon prices at which four activities are at risk of emissions leakage

Criterion	Activity A	Activity B	Activity C	Activity D
EBIT[a] falls to zero: activity expected to wind down	$265 – $595	$30 – $80	$35/t	$20/t
EBITDA[b] falls to zero: activity expected to stop	$430 – $760	$130/t	$50/t	$30/t

[a] Earnings before interest and tax.

[b] Earnings before interest, taxes, depreciation and amortisation.

1 Countervailing forces: Climate targets and implications for competitiveness, leakage and innovation

2 This report was based on data collected from four EITE activities in 2020. These were the production of burnt lime, the production of fresh cucumbers, the production of cartonboard, and the production of cementitious products.

3 Potential for emissions leakage from selected industries in the ETS.

4 Activity details removed for confidentiality.

Over time, the risk of leakage is expected to change, as other jurisdictions introduce new climate change measures, or existing trading schemes reduce free allocation. However, differences in international climate commitments, emissions mitigation policies and free allocation rules could persist over the medium to long term. Not everyone will face an equivalent carbon price or cap, which suggests the risk of leakage could remain for some time.

The current industrial allocation system

Industrial allocation (IA) was introduced to reduce the risk of leakage. Free allocations of NZUs assist firms carrying out industrial activities that are emissions-intensive and trade-exposed (EITE)[5]. Firms can use these NZUs to:

- meet a portion of their surrender obligations (if they have them), or
- sell them to generate cash to offset the increased cost of electricity and fossil fuels with an embedded emissions price.

In many cases, EITE firms have contracts with their fossil fuel suppliers to transfer allocated NZUs to the supplier for the emission associated with the fuel purchased, in lieu of selling NZUs and transferring cash.

New Zealand's approach to industrial allocation

New Zealand's IA system is based on output and emissions intensity. This links the allocation of units to a firm's annual level of production (output basis) and fixed allocative baselines that reflect an activity's emissions intensity per unit of output (intensity basis).

Because the baselines are fixed, improvements in a firm's energy and emissions intensity reduces the cost impact of the NZ ETS, while maintaining a constant level of free NZUs per unit of production. Output and intensity-based allocation does not encourage absolute reductions in emissions by cutting production, but does promote lower emissions intensity.

Eligibility

There are rules to determine which activities are eligible for IA. The Act includes two tests: trade exposure and emissions intensity.

Trade exposure

Trade exposure tests whether products are exposed to international trade. The test determines whether a firm is unable to pass on an emissions cost to consumers, because they are competing with businesses in other countries.

It is assumed that if a product is traded internationally the price is set offshore, and therefore New Zealand firms are price takers and unable to pass price increases on to consumers. This makes it difficult for domestic firms to pass on an emissions price without being at a competitive disadvantage to overseas firms not facing equivalent emissions costs.

---

[5] Appendix 2 lists the 26 activities that are eligible to receive industrial allocation in New Zealand. More information on these activities and the firms currently receiving an allocation can be found on the Environmental Protection Authority's website.

The Climate Change Response Act 2002 defines trade exposure broadly. An activity is considered trade-exposed, unless there is no international trade of the activity output across oceans, or it is not economically viable to import or export it.

Emissions intensity

Emissions intensity is the amount of emissions generated from an activity relative to the revenue or profit generated from the sale of the activity's output. It is a measure of the impact of an emissions price on an activity's profitability. The greater the emissions relative to the revenue generated by an activity's output, the more a change in the emissions price affects the profitability of the firm doing the activity.

Intensity thresholds: An activity is classified as **moderately emissions-intensive** if the intensity is equal to or greater than 800 t CO_2-e[6]/$1 million revenue, but less than 1600 t CO_2-e/ $1 million revenue. It is **highly emissions-intensive** if it is equal to or greater than 1600 t CO_2-e/ $1 million revenue. If an activity has an emissions intensity below the moderately intensive threshold it is ineligible for IA.

If the trade exposure criterion is met, the two thresholds determine a:

- moderately intensive activity as being eligible to receive 59 per cent of their emissions costs
- highly intensive activity as being eligible to receive 89 per cent.

Table 2 shows the possible eligibility categories based on emissions intensity and trade exposure tests.

Table 2: Eligibility and threshold categories

	Not trade-exposed	Trade-exposed
Emissions intensity < 800 t CO_2-e/$1 million revenue	Ineligible	Ineligible
Emissions intensity >= 800 but < 1600 t CO_2-e/ $1 million revenue	Ineligible	Moderately intensive and eligible to receive 60% of emissions costs (the phase-out cut this to 59% in 2021)
Emissions intensity >= 1600 t CO_2-e/$1 million revenue	Ineligible	Highly intensive and eligible to receive 90% of emissions costs (the phase-out cut this to 89% in 2021)

Allocation calculation

Allocative baselines

Allocations are calculated using an allocative baseline, which is the amount of emissions attributed to a unit of product. Most activities have a single baseline. However, some have two or more, reflecting their intermediate products or inputs. The baselines are calculated at the national sector level.

[6] CO_2-e or carbon dioxide equivalent is a metric that compares the global warming potentials of different greenhouse gases to carbon dioxide.

Calculation of allocation

A firm's allocation is calculated using the formula:

$$A = P \; x \; AB \; x \; LA$$

Where:

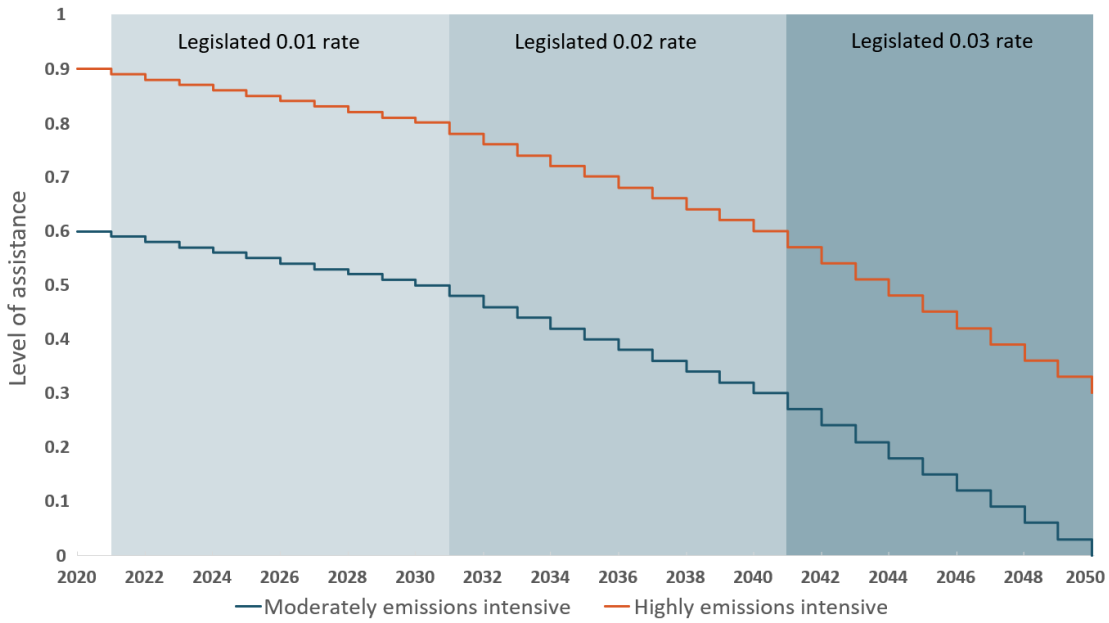
- *A* is the firm's allocation for a single product (NZUs)
- *P* is the firm's total production of the product (typically in tonnes)
- *AB* is the allocative baseline for the product (t CO_2-e/t product)
- *LA* is the level of assistance a particular activity receives (0.59 or 0.89 as based on the emissions intensity thresholds).

Recent changes to industrial allocation policy

The Climate Change Response (Emissions Trading Reform) Amendment Act 2020 (the ETR Act) introduced a phase-out of the level of assistance (LA in the formula above). The phase-out rate has started at a default rate of one percentage point each year between 2021 and 2030, and will increase to two percentage points (0.02) in 2031–40, and then three percentage points in 2041–50.[7]

Figure 1 shows the phase-out for moderately and highly emissions-intensive activities. In 2021 the two levels of assistance are 0.59 and 0.89.

Figure 1: Phase-out of the level of assistance for moderately and highly emissions-intensive activities



The ETR Act also enabled the Government to increase the phase-out rates for individual activities after 2025, and decrease them after 2030, based on the recommendations of the Climate Change Commission.

[7] The ETR Act allows for the Government, based on the recommendations of the Climate Change Commission, to decrease the phase-out rate for one or more activities if the risk of leakage remains unacceptably high.

The purpose of the phase-out was to align allocations with New Zealand's emissions budgets. Still, the initial gradual rate means that highly intensive activities could still be eligible for a 30 per cent level of assistance in 2050. The prospect of firms still receiving an allocation at this time is inconsistent with our long-term climate change goals.

Section 2: Problem definition and objectives

This section discusses the problems with current IA settings, and the purpose of the review. It also describes the objectives for IA policy, and the criteria used to assess the proposals in this consultation document.

Over-allocation and inconsistency with climate targets

Over-allocation

Over-allocation can be hard to conceptualise because of competing but valid interpretations. This creates tension when considering the purpose of IA policy, as over-allocation can be seen as both a problem and benefit.

Here we consider two interpretations of over-allocation:

1. an allocation greater than intended, to reduce the risk of leakage
2. an allocation that encourages firms to reduce emissions by lowering the emissions intensity.

Allocations greater than intended to reduce the risk of leakage

The Government has collected evidence that some activities are receiving allocations greater than is intended, to minimise the risk of emissions leakage. An example would be a highly intensive activity receiving an allocation equal to 91 per cent of its actual NZ ETS costs – when the policy intent is for an 89 per cent allocation.

This form of over-allocation is not caused by the incorrect application of current legislation, but rather by out-of-date policy settings, and emissions-intensity improvements made by EITE firms since allocative baselines and eligibility were set in 2010. The Act anchors eligibility and baselines to revenue, emissions and production data from the financial years 2006/07, 2007/08 and 2008/09. Over-allocation results when firms have been able to maintain a fixed level of allocation while reducing their emissions intensity.

Output and intensity-based allocations that promote lower intensity

This alternative interpretation sees over-allocation as a benefit and not a problem. The incentive for EITE firms comes from being able to sell surplus units above the intended level of assistance and profit. The assumption is that firms use allocations to invest in further improvements in energy and emissions intensity.

Over-allocation in these circumstances would support New Zealand's emissions reduction and economic goals. There would be a case, then, to retain current IA settings to maintain the incentive to reduce intensity.

Over-allocation risks outweigh the benefits

The Government accepts that output and intensity-based allocation can theoretically promote lower emissions. Some EITE firms have said they invested in lower emissions technology because of the prospective financial returns from IA, and future investments depend on allocations that are not held against future NZ ETS costs.

However, the Government has limited evidence of IA leading to investment in lower emissions. It would also be difficult to separate business-as-usual improvements and those that depend on allocation. This is because investments that reduce intensity often have financial drivers, other than IA. It is difficult to justify maintaining over-allocation, given that the benefits may be marginal.

Over-allocation needs to be addressed because:

- **It is inconsistent with the policy intent of IA**: EITE firms are receiving an actual level of assistance greater than intended under the Act to reduce the risk of leakage, which is deemed to be 0.59 and 0.89 for moderately and highly intensive activities. A decrease in intensity implies a lower risk of leakage and therefore less need for allocation.
- **It mutes the incentive to reduce emissions by reducing output**: IA was meant to retain an emission price signal on EITE industries when making choices about production. For example, a highly intensive activity should face an 11 per cent emissions cost. Over-allocation removes this cost, dampening the incentive to reduce production. An allocation above 100 per cent of an activity's NZ ETS costs could motivate EITE firms to increase production and overall emissions.
- **It is a direct and indirect fiscal cost**: When the Crown allocates units to industry, it is recorded as an expense in the Government's financial statements. Over-allocation increases the direct fiscal cost of IA. There is also an indirect fiscal cost, as over-allocation reduces the number of NZUs the Government can auction.
- **Allocation over 100 per cent leads to windfall gains for EITE firms**: Over-allocation creates fiscal and incentive risks when allocations are greater than 100 per cent of an activity's direct and indirect NZ ETS costs. It brings a windfall of units to emitting firms, effectively allowing them to profit from the NZ ETS. This affects market efficiency and price discovery in our carbon market if it is not liquid.

Table 3: Impact of over-allocation from a highly emissions-intensive activity

Level of assistance for hypothetical activity	Incentive problem	Windfall gain problem	Fiscal cost
89%	• Incentive for efficiency improvement = full NZU price • 11% NZU price incentive to reduce output	No windfall gain	Accepted fiscal cost of providing IA
95%	• Incentive for efficiency improvement = full NZU price • 5% NZU price incentive to reduce output	• Firm given extra NZUs that they would otherwise purchase • No efficiency problem for the NZ ETS market	Increased fiscal cost from 5% over-allocation
>100%	• Incentive for efficiency improvement = full NZU price	• In a liquid carbon market, EITE firms sell surplus units and there is no reduction in market efficiency	Potentially significant increase in fiscal cost from

Level of assistance for hypothetical activity	Incentive problem	Windfall gain problem	Fiscal cost
	• No NZU price incentive to reduce output • Perverse incentive to increase production (they are better off than the world with no emissions pricing)	• In an illiquid carbon market, firms hold onto allocated units, potentially driving up emissions prices – reducing efficiency in the market	over-allocations >100 per cent

It was intended that over time, reducing the level of assistance to firms would manage over-allocation. However, the planned phase-out of allocations was suspended in 2009 and will only resume this year, following the passage of the ETR Act in mid-2020. The slow initial phase-out will be insufficient to address over-allocation in the short to medium term. As it increases in the 2030s and 2040s, and the Government can adopt activity-specific phase-out rates from 2026, the risk of over-allocation can be managed more effectively.

Data collected to inform the review shows evidence of over-allocation. Table 4 shows the change in emissions intensity[8] and the actual level of assistance for four industrial activities that are being over-allocated.

Table 4: Change in emissions intensity and estimated actual level of assistance for four industrial activities

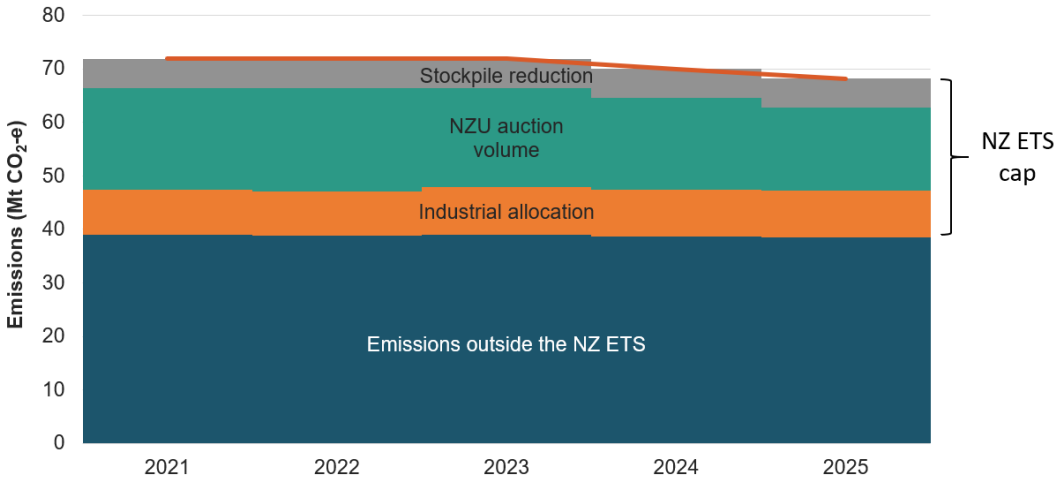
Activity	Intensity decrease since 2010 (%)	Estimated level of assistance (%)
Activity A	79.9	305
Activity B	35.8	124
Activity C	15.0	105
Activity D	8.3	98

Consistency of industrial allocation with emissions budgets

New Zealand will adopt emissions budgets to set the pathway for reaching the 2050 target. To help drive reductions, the Government has set a limit or cap on the volume of units in the NZ ETS. Figure 2 shows the breakdown of the provisional emissions budget (2021-2025) and the volume of the NZ ETS cap for this period.

[8] This refers to their emissions with respect to production (also known as the allocative baseline). Not to be confused with the emissions intensity used for eligibility, which is emissions with respect to revenue.

Figure 2: Breakdown of New Zealand's provisional emissions budget



New Zealand's provisional emissions budget[9] includes emissions covered by the NZ ETS and not covered by the scheme (such as agricultural emissions). Emissions covered by the scheme comprise the NZ ETS emissions cap.[10] IA over the first emissions budget will take up a large portion of the NZ ETS cap (about 30 per cent). IA is forecast to remain stable over this period.[11]

In the context of the emissions budgets, IA is a volume of emissions the Government allows to be emitted without facing a price. To meet progressively smaller budgets, bigger reductions are needed from other sources of emissions under the scheme, if allocations remain at current levels or increase.

Over-allocation reduces the number of NZUs the Government can sell at auction. Units freely allocated by the Government cannot also be sold through auctioning. This creates an indirect fiscal cost, from reduced auction proceeds.

Although over-allocation reduces auction proceeds, it does not affect the total volume of units supplied into the NZ ETS market. The lower auction volume is balanced by firms selling surplus units into the market. If the carbon market is liquid, it does not matter if unit supply comes from auctioning or over-allocation. However, it is probable that over-allocated units are more likely to be saved for future compliance, and auction units are more likely to be traded. This means that over-allocations will reduce market liquidity (and therefore efficiency of price discovery), compared to auctioning.

The objectives of industrial allocation

The purpose of the review is to assess New Zealand's IA policy and ensure it effectively manages any ongoing risk of emissions leakage, and aligns with our climate change commitments. In particular, the review addresses over-allocation in the short to medium term.

---

9 The provisional emissions budget will be superseded by the first emission budget set under the Zero Carbon Act by the end of 2021.

10 The NZ ETS cap is made up of industrial allocation, auction volume and stockpile adjustment volume. The stockpile adjustment is a volume of the cap the Government withholds from auctioning, to address oversupply in the NZ ETS market.

11 There is some uncertainty due to COVID-19 impacts, high energy prices, and whether the Marsden Point Refinery will enter the NZ ETS.

The purpose of IA is to reduce the risk of emissions leakage. However, IA policy and the NZ ETS are nested in broader climate objectives. Ensuring IA is credible and fit for purpose will mean balancing sometimes-competing objectives. An approach that emphasises leakage risk and minimises economic impacts may make it harder to meet emissions budgets. On the other hand, aligning allocations and budgets could remove levels of assistance needed to prevent leakage.

It is the Government's view that IA should be consistent with New Zealand's broader climate change objectives. It should:

- form part of an enduring institutional framework to reduce emissions out to 2050 and beyond
- drive behavioural changes to create a sustainable and climate-resilient economy.

Although IA should continue to address leakage, this should not be at the expense of our legislated climate change commitments.

Criteria for assessing options

The consultation document evaluates each proposal against the status quo to assess how it performs, using the following criteria:

1. **Supports the purpose of the NZ ETS.** IA should drive mitigation in line with emissions budgets, and make a meaningful contribution to lowering global emissions. It should ensure an appropriate incentive is maintained for EITE firms to reduce emissions.
2. **Addresses over-allocation.** IA should avoid unacceptable levels of over-allocation.
3. **Addresses the risk of emissions leakage.** IA should continue to minimise the risk of leakage. It should mitigate the loss of competitiveness for EITE firms that face higher costs because of the NZ ETS, and prevent the export of domestic industries that increase global emissions.
4. **Regulatory certainty and predictability.** Changes to IA should give recipients certainty. Future allocation policy needs to be predictable over typical investment horizons.
5. **Minimises administrative burden and complexity.** IA should support an efficient NZ ETS, which minimises administrative costs, as well as compliance costs and burden for EITE firms.

Policy options in this document are assessed against the criteria, using the notation in table 5.

Table 5: Impact analysis notation

Notation	Description
✓✓	Strongly supports the criteria
✓	Supports the criteria
o	Neutral
x	Opposes the criteria
xx	Strongly opposes the criteria

Criteria

Question 1: Do you agree with the five criteria to assess the proposals in this consultation document? Why, or why not?

Approach to options selection and impact analysis

Cabinet agreed to the scope of the IA review before this consultation. The terms of reference for the review[12] set out the proposals considered in the consultation document. Additional options identified through the TAG process have also been included.

The proposals included address issues with IA policy arising from the allocation calculation and eligibility settings prescribed in the Climate Change Response Act. We have grouped the options into three categories:

1. Options to reform allocation calculations (section 3)
2. Options to reform eligibility for industrial allocation (section 4)
3. Other options to reform industrial allocation (section 5).

For each set of proposals, a qualitative impact analysis has been included using the criteria discussed above. This analysis assesses the alignment and consistency of different policy options with the objectives of industrial allocation.

A separate impact analysis has been included on updating allocative baselines and reassessing eligibility on EITE firms, the Government, regional economies and Māori (section 7). These proposals are assessed specifically as they are expected to have the most impact on allocations. The other proposals are not evaluated with the same rigour because of data limitations and the anticipated small effect on allocations compared to updating baselines and reassessing eligibility.

[12] Available from the consultation website.

Section 3: Options to reform allocation calculations

This section considers reforms to the settings used to calculate industrial allocations. It focuses on proposals to update the current, out-of-date allocative baselines, which are the main cause of over-allocation.

Updating baselines using new base years

An activity's allocative baseline is calculated using historical data from the financial years 2006/07, 2007/08 and 2008/09. This anchors allocations to historical emissions from over 10 years ago. Although this gives certainty to industry about their future allocations, and can promote investment in lowering emissions intensity, it has also caused over-allocation.

Updating the baselines with data from new base years would realign allocations to reflect the current emissions intensities of industrial activities. This would reduce over-allocation, and future allocation would reflect the current risk of leakage.

Option 1: Status quo – no change to allocative baselines

The baselines would not be reassessed and would remain unchanged. Allocations would continue to be based on an activity's emissions intensity from over 10 years ago, and not take into account reductions in intensity or changes in industry structure. This would perpetuate over-allocation and continue unnecessary costs to the Crown.

Option 2: One-off update of baselines

All allocative baselines would be reassessed and updated immediately using new base years. Once this has occurred, future calculations would apply the new baselines. The Government would not plan to reassess baselines in the future.

This could be an efficient way to reduce over-allocation and minimise the uncertainty of future allocation decisions for industry. However, in the long term this option would again result in over-allocations, as industry makes further improvements in efficiency.

Option 3: Update baselines every year

All allocative baselines would be reassessed and updated immediately, using new base years, and then updated every year. This continuous update would base allocations on actual[13] rather than historical emissions. It would completely mitigate over-allocation across New Zealand industry. However, it would introduce significant uncertainty for industry, which would likely undermine business investment and future reductions in emissions.

Annual updates would also be highly resource-intensive for the Government.

---

13 Actual emissions based on a national average.

An option to base allocations on actual firm emissions (rather than average activity emissions) was considered. However, this would remove the incentive given to lower emissions-intensive industries, which receive a greater portion of their emissions costs than their more emissions-intensive peers.

Option 4: Update baselines every five years

Under this option, the baselines would be reassessed and updated immediately, and then every five years.

This option would correct current over-allocation and prevent future over-allocation as industry continues to improve emissions efficiency – which the newly updated baselines would account for. This would support the objectives of the NZ ETS and the alignment of IA with the emissions budgets.

However, industry would only have certainty for the level of allocations over five years. Because business investments typically have horizons of 10 to 15 years, this option could undermine future investment in reducing emissions. The Government would also have to regularly amend the IA regulations for new baselines, adding administrative burden and cost.

Option 5: Update baselines every 10 years

The baselines would be updated immediately and then every 10 years. This proposal received majority preference from the TAG.

This option would address over-allocation now, but risk some over-allocation over time, particularly just before a new update. The long-term risk is traded off with certainty for industry over typical investment timelines.

A longer reassessment schedule would keep allocations stable for a set period. Industry would remain motivated to reduce emissions through exposure to the NZ ETS price signal, which is expected to rise.

This option strikes a fair balance between removing current over-allocation, correcting it in future, and giving industry certainty about future allocations. Although it raises the current administrative costs, reassessments would be infrequent and costs would be offset by the savings from reducing allocations.

Table 6: Assessment of option to update allocative baselines

Option	Consistent with NZ ETS objectives	Addresses over-allocation	Addresses emission leakage risk	Regulatory certainty and predictability	Minimises administrative burden, costs and complexity
Status quo – No change to baseline years for calculating of allocative baselines	o	o	o	o	o
One-off reassessment using updated baseline years	✓ Supports alignment of IA volumes and emissions budgets	✓ Addresses current over-allocation but risks over-allocation longer term	o Realigns allocations to levels deemed appropriate to reduce the risk of leakage	✓ Allocations would change, but EITE firms would have certainty about future levels	o Greater administrative burden from updating baselines, but minimal as it is a one-off
Reassessment of baselines every year	✓✓ Ensures alignment of IA volumes and emissions budgets; supports a strong ETS price signal	✓✓ Addresses current and future over-allocation	o Realigns allocations to levels deemed appropriate to reduce the risk of leakage	xx Uncertainty for EITE firms about future levels of allocations	xx Ongoing administrative costs
Reassessment of baselines every 5 years	✓✓ Ensures alignment of IA volumes and emissions budgets; supports a strong ETS price signal	✓✓ Addresses current and future over-allocation	o Realigns allocations to levels deemed appropriate to reduce the risk of leakage	x Uncertainty for EITE firms about future allocations	x Ongoing administrative costs
Reassessment of baselines every 10 years	✓ Supports alignment of IA volumes and emissions budgets	✓ Addresses current over-allocation but risks some over-allocation longer term	o Realigns allocations to levels deemed appropriate to reduce the risk of leakage	✓ EITE firms would have certainty about future levels of allocations over typical investment timeline	o Greater administrative burden from updating baselines, but minimal as updates are infrequent

Allocation calculations

Question 2: Should allocative baselines be updated using new base years? Why, or why not?

Question 3: Should the reassessment be a one-off update, or a periodic update? Why, or why not?

Question 4: If periodic reassessment is legislated, what would be an appropriate period – every year, 5 years, 10 years, or something else? Why?

Which new base years should be used?

The financial years 2016/17, 2017/18 and 2018/19 could be the new baseline years, providing data that is relatively recent, and reflecting changes to emissions intensities over the last decade. The years 2019/2020 and 2020/21 should be excluded due to production and revenue distortions from COVID-19. Alternatively, the years 2019/2020 and 2020/21 could be included but weighted to account for distortions.

The new base years would also apply if eligibility were reassessed.

Future updates to baselines will require collecting activity from new base years. These would likely be the financial years before baselines are scheduled to be changed.

Allocation calculations

Question 5: Do you agree the financial years 2016/17, 2017/18 and 2018/19 should be used as new base years to update allocative baselines? Why, or why not?

Question 6: Should the financial years 2019/20 and 2020/21 be included, but with a weighting provision? Why, or why not?

Section 4: Options to reform eligibility for industrial allocation

This section looks at proposals to reassess eligibility and improve the eligibility tests.

Reassessment of eligibility using new base years

Like allocative baselines, eligibility based on emissions intensity (the emissions intensity test) is assessed using historical base years. Current eligibility decisions no longer reflect the impact of an emissions price on an activity's profitability, which is leading to over-allocations. The Government proposes reassessing eligibility with new base years.

Option 1: Status quo – no reassessment

Under this option, current eligibility decisions remain the same, and the eligibility status of activities is unchanged. This would perpetuate over-allocation already occurring, and put unnecessary pressure on our emissions budgets.

Option 2: Reassessment using new base years

Under this option, the Government would immediately reassess the eligibility of activities currently eligible for IA, with new base years. This proposal was supported by the IA review TAG.

If eligibility was retested, some highly emissions-intensive activities could fall below the current threshold, causing the level of assistance to drop. Moderately intensive activities that fall below the current threshold would become ineligible. Of the 26 currently eligible activities, 11 are close to a threshold and would most likely change eligibility status.

Using updated base years would ensure that eligibility decisions reflect changes in emissions, production and revenue over the last decade. This could reduce over-allocation to firms no longer at risk of emissions leakage.

Table 7: Assessment of option to reassess eligibility

Option	Consistent with NZ ETS objectives	Addresses over-allocation	Addresses leakage risk	Regulatory certainty and predictability	Minimises administrative burden, costs and complexity
Status quo – no reassessment of eligibility	o	o	o	o	o
Reassessment of eligibility using updated baseline years	✓ Supports alignment of IA volumes and emissions budgets	✓ Realigns eligibility decisions with current emissions intensities of activities, addressing some over-allocation	o Realigns eligibility decisions to reflect actual risk of leakage	o A one-off reassessment would give EITE firms enough certainty on future eligibility status and levels of allocation	✓ Reduces the number of eligible activities, minimising administrative burden and costs

Eligibility

Question 7: Should eligibility be reassessed using new base years?

Other options for reassessing eligibility

Several options fit under the reassessment of eligibility and could improve the eligibility tests.

New Zealand-specific thresholds

The current emissions intensity thresholds are:

- above 800 for moderately intensive activities
- above 1600 t CO_2-e/$1 million revenue for highly intensive activities.

They were taken from the Australian Carbon Pollution Reduction Scheme, to align with the eligibility of trans-Tasman activities. The Australian scheme was never implemented, and the thresholds reflect the impact of an emissions price on the profitability of Australian industry.

As the composition of Australia's EITE sector differs from New Zealand's, the thresholds currently used for eligibility decisions may not reflect the cost impact of the NZ ETS on domestic activities. We could improve the intensity test by developing thresholds specific to New Zealand.

Option 1: Status quo – no change to current thresholds

The current emissions intensity thresholds developed for Australian industry would remain in place to assess the eligibility of domestic activities. If eligibility was reassessed, the current thresholds would apply.

Option 2: Develop New Zealand-specific thresholds

New thresholds would be based on domestic industries. These would be implemented before the reassessment of eligibility.

There could be more thresholds, to better target levels of assistance to specific EITE industries. The current system uses two thresholds to do this. An issue with this approach is that activities with intensities close to these thresholds could be under- or over-assisted. For example, an activity with an emissions intensity of 1590 t CO_2-e/$1 million revenue would currently be classified as moderately intensive, despite being very close to the highly intensive threshold. This small discrepancy results in a significant step-change in support.

A framework could be developed to provide 'higher resolution' coverage that more effectively targets assistance levels commensurate with an activity's exposure to an emissions price. This could be the introduction of a third or fourth threshold, or a sliding scale, which defines a bespoke level of assistance for each activity.

How to go about developing these thresholds is an open question. The benefits would need to be traded off against the complexity and effectiveness of doing so, when the Australian thresholds could be suitable enough.

Developing New Zealand-specific thresholds would be complex and resource-intensive, requiring large amounts of data from industries. It would also require complex economic modelling and analysis from the Government. This proposal would therefore incur significant compliance and administrative costs.

It is uncertain whether these thresholds would be any more effective at categorising domestic industry than the current Australian ones. However, there could be some additional benefit from adding intermediate thresholds, by preventing under- or over-assistance for industries on the margin.

Table 8: Assessment of New Zealand-specific thresholds

Option	Consistent with NZ ETS objectives	Addresses over-allocation	Addresses leakage risk	Regulatory certainty and predictability	Minimises administrative burden, costs and complexity
Status quo – no change to current emissions intensity thresholds	o	o	o	o	o
New Zealand-specific thresholds	✓ Similar impact to using current thresholds; however, could prevent under- or over-assistance	✓ Similar impact to using current thresholds	o	x Could create extra uncertainty for EITE firms about future eligibility status	xx Significant administrative and compliance costs

Eligibility

Question 8: Should new emissions intensity thresholds for New Zealand industry be developed? Why, or why not?

Question 9: Should more thresholds be added into the eligibility criteria? Why, or why not? How many would be appropriate?

Question 10: Would a sliding scale threshold system better target eligibility and assistance? Why, or why not?

Using the electricity allocation factor to assess eligibility

An electricity allocation factor (EAF) is an estimate of the impact of an emissions price on electricity prices.

An emissions price increases the cost of electricity generation from fossil fuels (such as coal or gas-fired power plants). For industries that use a lot of electricity, emissions pricing can lead to significant increases in electricity costs.

New Zealand's IA policy uses an EAF for both allocation calculations and eligibility. Calculation of an activity's emissions intensity, which determines its eligibility status, uses the Australian EAF of 1 t CO_2-e/MWh. Calculation of the allocative baselines (which affect how many units a firm is allocated) uses the New Zealand EAF of 0.537 t CO_2-e/MWh.

The Australian EAF is considerably higher than New Zealand's. This means electricity emissions are overstated compared to other fuel emissions. Therefore, the cost impact of the NZ ETS on businesses using electricity is overstated for eligibility purposes.

Changing the emissions intensity test to use New Zealand's EAF could help ensure future eligibility decisions reflect the actual impact of the NZ ETS on the electricity costs EITE firms face, and correct an anomaly in IA policy where Australian data is used.

Option 1: Status quo – retain the Australian EAF

Eligibility will continue to be calculated using the Australian EAF. Eligibility decisions would continue to reflect the cost impact of an emissions price on Australian industries, from over 10 years ago.

Option 2: Use the New Zealand EAF

The emissions intensities of different industrial activities would be recalculated with the New Zealand EAF. These new intensities would be applied if eligibility was retested.

Using the New Zealand EAF could ensure the eligibility test does not overestimate the materiality of an emissions price on electricity use, and aligns eligibility with New Zealand industry. If the EAF was periodically updated, this would raise the question of whether future updates of the EAF should trigger a reassessment of eligibility.

This approach would reduce the emissions intensities for activities where electricity is included in the calculation. This would affect the eligibility of industries heavily dependent on electricity and close to the intensity thresholds. This could reduce some over-allocation if industries were made eligible due to their high electricity use.

However, regular EAF updates and frequent eligibility reviews could bring some uncertainty for EITE firms. The EAF depends on many factors that are not wholly predictable. If eligibility was continually reassessed every time the EAF was updated, high electricity users could find themselves eligible one year and ineligible the next. Continuous reassessment would also create some administrative burden for the Government. This proposal could also require adjustment of the thresholds, as these were calculated when electricity generation had a higher emissions intensity.

Table 9: Assessment of using the New Zealand EAF to assess eligibility

Option	Consistent with NZ ETS objectives	Addresses over-allocation	Addresses leakage risk	Regulatory certainty and predictability	Minimises administrative burden, costs and complexity
Status quo – retain the Australian EAF	o	o	o	o	o
Use the NZ EAF	✓ Supports alignment of IA volumes and emissions budgets	✓ Could change the eligibility status of some activities that use electricity and are currently over-allocated	o	x Periodic EAF updates could trigger eligibility reassessments, creating uncertainty for some EITE firms on eligibility	x Periodic EAF updates could trigger eligibility reassessments, creating administrative costs and burden for the Crown

Eligibility

Question 11: Should the New Zealand EAF be used when determining eligibility? Why, or why not?

Question 12: Should periodic updates of the EAF trigger a recalculation of eligibility? Why, or why not?

Trade exposure test

The trade exposure test is all-inclusive by default. If the product of any domestic industrial activity is traded overseas, it is automatically considered to have met the trade exposure test.

This broad test is likely capturing some activities that are not trade-exposed. A more calibrated test could ensure only activities genuinely at a competitive disadvantage are eligible for IA.

Option 1: Status quo – retain the current test

The current test for trade exposure would be retained and used to determine eligibility if reassessed.

Option 2: Change the test

A new, more rigorous test would:

- more accurately define trade exposure (or the ability for firms to pass on price)
- only capture activities at genuine risk of trade exposure.

This new test would be applied if eligibility was reassessed.

Other emissions trading schemes use a quantitative metric to determine trade exposure – usually by finding the percentage of international imports and exports with respect to the total supply of a commodity into the local market (imports + domestic production). Something like this could better determine the risk of trade exposure, and regular updates could account for changing international conditions.

Although the current test is simple, efficient and wide ranging enough to capture most industrial activities in New Zealand, it may over-prescribe some activities as trade-exposed. A new test could be better at determining differing levels of exposure, and targeting eligibility to the most at-risk firms.

However, it is highly likely the largest recipients of IA would meet a more rigorous test. Steel, aluminium and methanol are clearly trade-exposed. Improving the test would only affect the eligibility of activities receiving a small portion of the total IA volume. Changing the test would likely make only a minimal improvement to current over-allocation. It would also be difficult to implement and costly to administer.

Table 10: Assessment of changing the trade exposure test

Option	Consistency with NZ ETS objectives	Addresses over-allocation	Addresses leakage risk	Regulatory certainty and predictability	Minimises administrative burden, costs and complexity
Status quo – retain the current test	o	o	o	o	o
Change the test	o Minimal impact on the NZ ETS price signal and meeting budgets	o Minimal impact on over-allocation as most large industrial activities would meet a more rigorous test	o	x Uncertainty for EITE firms about future eligibility	xx Resource-intensive; substantial administrative costs

Eligibility

Question 13: Should the trade exposure test be changed? Why, or why not?

Question 14: What would be a more appropriate method to determine trade exposure?

Section 5: Other options to reform industrial allocation

This section considers other proposals identified by the Government and TAG to address technical issues with the current regime, and help ensure the policy aligns with the objectives of the review.

Streamline updates to allocative baselines

Under sections 161A–161E of the Climate Change Response Act 2002, the baselines for an activity cannot be updated without following a prescribed process that requires:

- a Gazette notice
- those carrying out the activity to calculate specified emissions, revenue and production using a prescribed methodology, and submit these calculations
- using the calculated data when updating a baseline.

A consequence is that updates of emissions factors or the EAF cannot be used to directly update allocative baselines. To update them using a new or amended methodology, the Minister would need to follow the process above.

This process is cumbersome and a barrier to updating baselines to account for new emissions factors or EAF. The Government seeks feedback on how to streamline this process.

Option 1: Status quo – retain Gazette notice requirements

The current process for updating baselines would be retained, requiring a new Gazette notice every time baselines are changed for new emissions factors or EAF.

Option 2: Simplify the updating process to reflect changes in methodology

The Act would be amended to allow updates to allocative baselines, **without** requiring:

- the Gazettal of a ‘call for data’ process
- those carrying out the activity to submit re-calculated data if the calculation methodology has changed.

Fuel use or electricity data collected via previous Gazette notices would be used and combined with updated emissions factors or an updated EAF to recalculate emissions and corresponding baselines.

Annual emissions returns use emissions factors prescribed in the Act’s regulations. If these factors do not match those used to calculate baselines, emissions subject to an emissions price would not match those that receive assistance. This poses risks of under- or over-allocating units to industry. This option would ensure that emissions costs remain more closely aligned

with assistance. It would also support the integrity of the NZ ETS and New Zealand's climate policy by promoting best practice for calculating emissions within the NZ ETS.[14]

Because updates to emissions factors and the EAF are irregular, this option could cause some uncertainty for EITE industries. However, this would be constrained, as any changes to emissions factors or the EAF are subject to consultation and an associated delay in implementation. This approach would also mitigate against NZ ETS costs significantly increasing without a corresponding increase in allocation.

Table 11: Assessment of updating baselines due to methodology change

Option	Consistency with objectives of NZ ETS	Addresses over-allocation	Addresses leakage risk	Regulatory certainty and predictability	Minimise administrative burden, costs and complexity
Status quo – retain Gazette notice requirements	o	o	o	o	o
Allow allocative baselines to automatically update if the calculation methodology changes	✓ Best-practice methodology for calculating emissions and baselines	✓ No over-allocation due to historical emissions factors or an out-of-date EAF	o	x Updates of emissions factors or the EAF are irregular, and the magnitude of any change is uncertain. This could cause some uncertainty for industry	✓✓ Considerably more efficient – full data collection not required

Other reforms to industrial allocation

Question 15: Do you agree with the proposal to simplify the process to update allocative baselines, to reflect changes to emissions factors, EAF or other changes to methodology? Why, or why not?

Question 16: Are there other changes to sections 161A-E of the Act that could better streamline IA processes?

[14] This is not an issue for the EAF, as emissions associated with electricity generation are accounted for via fuel use.

Allocations for new activities

Unclear eligibility process

The Act currently allows new industrial activities to seek eligibility for IA. This recognises that technology changes and industry development could give rise to new activities that are at risk of emissions leakage. Without an opportunity to receive free allocation, the NZ ETS could become a barrier to new industries – some of which could contribute to New Zealand's climate change goals (such as a biofuels plant).

However, the process for new activities to seek eligibility is unclear and difficult for new industries to meet, as it is tied to historical base years. The Act is unclear about how eligibility would be assessed for new activities not carried out in the current base years. This could be an issue for:

- industries that have developed since the base years
- new activities not carried out in New Zealand before.

In both circumstances, there would be no activity data from the legislated base years to apply the emissions intensity test and assess eligibility.

To make it easier for new activities to seek eligibility, the intensity test could allow firms to use their most recent activity data.

For new activities not carried out in New Zealand before, eligibility could be assessed using international data. However, this could be complex and difficult for the Government to verify.

Other reforms to industrial allocation

Question 17: Do you agree with the proposal to clarify the eligibility process for new activities? Why, or why not?

Should new activities be eligible for industrial allocation?

Although new activities can currently seek eligibility for IA, there is the question of whether this should be allowed in future. Giving allocations to new emissions intensive activities would:

- encourage more emissions
- increase the volume of IA under the NZ ETS cap, making it harder to meet emissions budgets
- increase the direct and indirect fiscal costs of IA policy.

On the other hand, a new activity could be beneficial. IA could support a new industry that competes against a domestic activity with a higher emissions intensity.[15] In this case, IA could help reduce New Zealand's emissions.

[15] Such as biofuels. A biofuels plant would be emissions-intensive, but likely less so than the use of fossil fuels. Supporting a biofuels plant through IA could reduce emissions if biofuels displace the use of fossil fuels.

The Government seeks feedback on:

- whether new activities should still be allowed to seek eligibility for IA
- acceptable conditions for new entrants to receive an allocation.

Option 1: Status quo – new activities can seek eligibility

New activities will continue to be allowed to seek eligibility. To better support this, the Act would be amended to improve the process for new entrants.

Making it easier for new activities to seek eligibility could be inconsistent with the purpose of the NZ ETS, if it leads to a rise in emissions, or makes it harder to meet emissions budgets.

It is unlikely that a new, highly emissions-intensive industry would attempt to set up in New Zealand and apply for IA, given the economic barriers (eg, increasing NZ ETS costs, phase-out of IA). It is unlikely that retaining the status quo would have a material impact on meeting future budgets.

The eligibility of new activities would increase the fiscal costs of IA. Although it would not contribute to over-allocation (assuming the new activity would have a current allocative baseline), it would still increase the overall quantum of IA, which would reduce New Zealand's auction volume.

There could be some extra administration to assess eligibility.

Option 2: No new activities can seek eligibility

New industrial activities would not be allowed to seek eligibility for IA.

Disallowing new activities measures well against the objectives of the NZ ETS and our climate commitments in the short term. It would stop future increases in IA volumes from new activities, reducing the risk of not meeting emissions budgets. It would also prevent IA from encouraging new EITE firms moving to New Zealand and increasing domestic emissions. Both these risks are likely to be low, given the barriers for new, highly emitting industries to set up here.

However, there could also be a risk of emissions leakage. If the NZ ETS prevents new industries from moving to New Zealand that are less emissions-intensive than current activities, this would increase global emissions and be a form of emissions leakage.

This proposal could unfairly favour more emissions-intensive industry over alternative, less intensive activities that could emerge in the future. In the long run, New Zealand would miss the economic gains of a new industry, and the climate benefit of a less emissions-intensive activity.

Option 3: New activities can seek eligibility if they can prove environmental benefit

New activities could seek eligibility, but the firms would have to show that it would have an environmental benefit over current eligible activities.

Removing eligibility for new activities might support emissions budgets; however, a blanket ban on all new activities could have perverse incentives, such as preventing lower emissions activities from entering the market. This would increase the risk of emissions leakage.

A possible solution could be to grant eligibility to new activities that can demonstrate a positive environmental effect compared to a competing activity. This could ensure that these new activities are not cut out of the market. However, this would likely require extensive analysis to quantify why and how they have better outcomes – which could create significant administrative costs to the Crown. This could be complex and difficult to determine.

Table 12: Assessment of limiting new activities from seeking eligibility

Option	Consistent with NZ ETS objectives	Addresses over-allocation	Addresses leakage risk	Regulatory certainty and predictability	Minimises administrative burden, costs and complexity
Status quo – new activities can seek eligibility	o	o	o	o	o
Disallow any new activities to seek eligibility	✓/x Would prevent future increases in allocation volumes, avoiding increases in emissions and pressure on budgets Lost opportunities from barring new, less emissions intensive activities from New Zealand	o	x Discourages new, less emissions-intensive activities from coming to New Zealand, resulting in a form of leakage	✓ Sends a clear signal to industry that new activities are not eligible	✓ Avoids future administrative costs from assessing eligibility
Only allow new activities to seek eligibility if they can show environmental benefit	✓ Supports new, less emissions-intensive activities coming to New Zealand, reducing domestic emissions and meeting budgets	o	✓ Supports new, less emissions-intensive activities coming to New Zealand, reducing the risk of leakage	o Retains the possibility of new activities becoming eligible, but more complex assessment could create uncertainty for applying firms	x Assessment of eligibility would be complex and add administrative costs

Other reforms to industrial allocation

Question 18: Should new activities be able to seek eligibility? Why, or why not?

Question 19: Should there be any caveats on new activities seeking eligibility, such as proof of environmental benefits compared to existing activities?

Reporting emissions, production and revenue data

There is limited data available to monitor IA policy. Because global climate policy is continually evolving, as is the trade of global commodities, the risk of emissions leakage and over-allocation is always changing. Currently, firms with direct surrender obligations must submit an emissions return, and production data is collected for allocation applications. However, most of it is protected under confidentiality provisions.[16] Indirect data for emissions[17] and revenue is not gathered at all for allocation purposes.

To improve the Government's ability to monitor IA policy in future, we are considering new mandatory and voluntary data reporting obligations.

Option 1: Status quo – limited reporting

Under this option, the current limited reporting of activity data would continue. The Government would continue to have little oversight on the current leakage risk to industry or over-allocation. The consequence is that future allocation decisions will be ill-informed and based on incomplete data, increasing the risk of leakage or over-allocation.

Option 2: Mandatory reporting

The Government could better monitor and assess the risk of leakage if recipient firms had to submit their annual production, emissions and revenue data. Doing so would allow better oversight and ensure that IA policy is meeting its objectives and not providing windfall gains to firms.

This option would be burdensome for both the Government and industry. However, the benefit of updated information could outweigh this.

Another issue is that not all EITE firms have surrender obligations in the NZ ETS, and therefore do not routinely collect emissions data. Having to provide this data on an annual basis would be a burden for these firms. However, there is a strong argument that taxpayer-funded IA should require regular data collection, to provide confidence that appropriate levels of allocation are being administered.

The Ministry of Business, Innovation and Employment is investigating an energy and emissions reporting scheme for large energy users. This follows consultation on such a proposal set out in *Accelerating renewable energy and energy efficiency discussion document*. Depending on whether Cabinet agrees to progress such a scheme, officials will consider whether it could support IA data requirements.

Option 3: Voluntary reporting

A less restrictive option would be to allow the voluntary provision of emissions, production and revenue data. When a firm applies for allocation, they would be invited to give additional activity data and consent for the Government to use it, to inform IA policy.

---

16 Data from emissions returns submitted after 1 January 2021 will be published by the Environmental Protection Authority.

17 In most cases, indirect emissions make up the majority of an activity's baseline.

The uptake of this option would likely be poor, due to the compliance requirements and costs for firms. Still, it could provide some useful data to help the Government make future allocation decisions.

Table 13: Assessment of mandatory and voluntary reporting

Option	Consistent with NZ ETS objectives	Addresses over-allocation	Addresses leakage risk	Regulatory certainty and predictability	Minimises administrative burden, costs and complexity
Status quo – limited reporting	o	o	o	o	o
Mandatory reporting	✓✓ Supports the NZ ETS by allowing the Government to continually assess the risk of leakage and over-allocation	✓ Helps the Government monitor and respond to the risk of over-allocation	✓ Helps the Government monitor and respond to the risk of leakage	o	x Additional compliance costs for firms to report annually
Voluntary reporting	o Minor improvement as reporting would likely be minimal	o Minor improvement as reporting would likely be minimal	o Minor improvement as reporting would likely be minimal	o	o Minimal additional compliance burden as firms would report voluntarily and accept the costs

Other reforms to industrial allocation

Question 20: Should firms that receive IA be required to report their emissions, revenue and production data annually? Why, or why not?

Question 21: Would voluntary reporting be more appropriate, and still provide some oversight of leakage and over-allocation risk? Why, or why not?

Transition period for changes to eligibility

Under current legislation, it takes five years to implement a change in eligibility from highly to moderately emissions-intensive, or from moderately intensive to ineligible. In that time, an activity would continue to be eligible at its prior level of assistance, perpetuating current over-allocation. It would be a perverse outcome and an unnecessary cost to the taxpayer if some industries continue to get more support than they need for an additional five years.

However, the five-year transition period could allow time for firms to adjust to a change in eligibility. This transition period would avoid the abrupt cost of a firm becoming ineligible and losing their allocation.

The transition period becomes important if the Government reassesses eligibility. We would like feedback on whether to retain the five-year period, to assist firms whose eligibility has been affected.

Option 1: Status quo – retain the five-year transition period

If eligibility was reassessed, keeping this provision would give industry time to move to a full emissions price. It would continue some over-allocations for a further five years.

Option 2: Remove the transition period

Given the evidence of over-allocation already occurring, this lag time could undermine New Zealand's progress towards emissions targets – particularly the short-term 2030 target. Removing the transition period would reduce over-allocation in the short term. Over five years, there could be significant over-allocation if there are eligibility changes.

However, removing this lag would create uncertainty for firms if it led to a sudden change to their allocation, preventing them from transitioning efficiently and adjusting to a full emissions price.

Option 3: Reduce the transition period to one or two years

This option would provide some transitional assistance to firms affected by an eligibility change, while reducing the time during which over-allocation would occur. Windfall gains to industry could still be in the tens of millions.

Option 4: Increase the transition period to 10 years

This option would give long-term certainty tor firms affected by an eligibility change if retested. The downsides are:

- a longer period for over-allocation
- long-term administrative burden.

Table 14: Assessment of eligibility transition periods

Option	Consistency with objectives of NZ ETS	Addresses over-allocation	Addresses leakage risk	Regulatory certainty and predictability	Minimises administrative burden, costs and complexity
Status quo – retain the five-year transition	o	o	o	o	o
Remove the five-year transition	✓ Could make it easier to meet 2030 target	✓✓ Reduces over-allocation in the short term	o	xx EITE firms would face an abrupt change in eligibility and allocations	o
Reduce the transition to one or two years	✓ Could make it easier to meet 2030 target	✓ Reduces over-allocation in the near term	o	x EITE firms would have a small window of assistance before a change in eligibility	o
Increase the transition to 10 years	x Long-term risk of over-allocation could make it harder to meet 2030 target	xx Risks long-term over-allocation after a change in eligibility	o	✓✓ EITE firms would have long-term certainty about eligibility status and allocation levels	x Would prolong administrative IA costs after a change in eligibility

Other reforms to industrial allocation

Question 22: Should the five-year transition period for changes in eligibility status remain, or be changed? Why, or why not?

Section 6: Future of industrial allocation policy

As international efforts to reduce emissions strengthen and become more ambitious, IA policy will need to be flexible, resilient and compatible with a low-emissions future and a just transition. It will also need to evolve in step with emissions pricing regimes in other countries, and the changing risk of emissions leakage.

Changing the settings will address the current issues with IA in the short term. However, over time, we could need fundamental changes in policy, to keep assistance in line with wider climate targets.

Your feedback

The Government intends to start a conversation with industry and the public on the longer-term direction of IA policy. This consultation document sets out alternative policies to mitigate leakage. We would like your views on these. We do not anticipate moving to an alternative policy in the current emissions budget period (2021–26), and any move will need careful consideration.

Alternative mechanisms to reduce emissions leakage

Carbon border adjustment mechanisms

A carbon boarder adjustment mechanism (CBAM) is a measure to compensate for the difference between the carbon pricing applied to domestic goods, and the carbon pricing (or lack of it) applied to imports in their country of origin.

CBAMs can take different forms, including a tax on imports equivalent to a domestic carbon cost (adjusted at either the point of sale/consumption or at the border); an extension of a domestic emissions trading scheme to imports; or a rebate of carbon cost on export. They are broadly aimed at incorporating the cost of carbon emissions into the pricing of imports. CBAMs raise issues of consistency with international trade obligations, and any introduction in New Zealand would require a complex and lengthy development process.

A CBAM could help ensure equitable emissions pricing is applied to emissions intensive imports and exports. By levelling domestic and international commodity prices, a CBAM would ensure the NZ ETS price signal is better reflected in the domestic economy. IA on the other hand compensates EITE firms so they can compete with cheaper offshore production, subject to weaker emissions pricing. This results in lower prices for emissions-intensive goods, which can disadvantage the purchase of lower-emissions products such as timber. A CBAM would also generate revenue for the Crown that could fund projects for mitigating or adapting to climate change.

CBAMs are often viewed as difficult to design and implement, given the need to be transparent, administratively efficient, environmentally effective, scientifically robust and compliant with World Trade Organisation rules. Some jurisdictions are currently considering CBAM proposals. It is not yet clear how these will be designed or implemented.

Direct payments to EITE firms

In lieu of allocating free NZUs, direct cash payments to EITE firms would offset the cost impact of the NZ ETS. The payments could be ring-fenced for investment in reducing emissions, and require repayment if not used for that purpose.

Payments could be made on the basis of output and intensity, similar to the current IA system. The value of the payment could be linked to New Zealand's emissions price. An alternative approach could decouple the level of assistance from NZUs entirely, and be based on an estimate of the payment needed to keep the industry in New Zealand. This option could create some risk of over-paying firms, particularly under the current IA approach and settings.

The EU ETS gives cash-based support for indirect electricity emissions. Something like this, but extended to all emissions, could be an effective way of targeting support to reduce the risk of emissions leakage.

Another option could be a fund that EITE firms could access for research, development and use of low-emissions technologies. This would be similar to existing schemes to support industry improvements in energy efficiency and process heat. Unlike free allocation, which compensates industries, a fund would support emissions reductions, allowing firms to reduce their NZ ETS costs.

Providing cash instead of NZUs would remove a source of unit supply in the NZ ETS market. This could have complex and unpredictable impacts on the emissions price, meeting emissions budgets, and calculating future auction volumes. More work is needed to understand the implications of this proposal. It is also unclear if this proposal would better address emissions leakage than IA.

The implementation of a support scheme that provides cash support would need to consider consistency with World Trade Organisation rules. However, other jurisdictions already successfully use such measures.

Partial exemptions from NZ ETS surrender obligations

In this option, a partial exemption would be indexed to a firm's emissions, rather than output (as is the case with IA). Instead of receiving an allocation based on annual levels of production and fixed allocative baselines, a firm would simply have their surrender obligation reduced by a set percentage. For example, a highly emissions-intensive firm could be exempt from 89 per cent of its obligation. The exemption could be reduced over time in line with the assessed risk of emissions leakage.

This option would link the level of support for firms with their actual direct NZ ETS costs, eliminating any future risk of over-allocation, as no units would be allocated. It could also better align with the public's understanding of how the current IA policy works – rather than the actual complex system that links the level of support to production.

However, this option would not help EITE firms that do not have surrender obligations but still incur indirect costs from higher fuel or electricity prices.

Future of industrial allocation

Question 23: Should we look at an alternative mechanism to address emissions leakage? Why, or why not?

Question 24: What alternative mechanisms to IA would better address the risk of emissions leakage, and support domestic and international emissions reduction targets?

Explicitly supporting emissions reductions

IA policy or an alternative method could be adapted to explicitly promote reductions in emissions. However, it is uncertain how this could be achieved. Current IA policy does provide some incentive to reduce emissions via increasing emissions efficiency. However, this is not the primary intent of the policy, and it does require allocative baselines to remain constant over an extended period, which leads to over-allocation.

Expanding the policy to explicitly support emissions reductions could undermine the objective to protect New Zealand firms from emissions leakage. It could be more appropriate to look at other ways to promote reductions. The Government is interested in whether IA policy or an alternative measure could, or should, encourage lower emissions. A CBAM could be a feasible way to incorporate incentives, by adjusting the emissions price that higher-emitting industries are exposed to, relative to lower alternatives.

Future of industrial allocation

Question 25: Should IA policy or any alternative explicitly encourage firms to reduce emissions? Why, or why not?

Question 26: What method could be used to encourage emissions reductions?

Incorporating other considerations into policy

There is also a question as to whether IA decisions should take into account the wider benefits of IA policy (or an alternative mechanism) to industries. Allowing for economic issues could help industry make a smooth and just transition. Considerations could include the financial benefit of keeping New Zealand production, or the social benefit of supporting employment in regions.

Incorporating other factors could complicate the policy and undermine its purpose to reduce leakage. The Government is interested in public opinion on whether to include wider factors in the policy.

Future of industrial allocation

Question 27: Should IA decisions or any alternative include wider considerations – such as economic, social, cultural and environmental factors – when determining support for industry? Why, or why not?

Question 28: How would these new considerations interact with the goal of reducing emissions leakage?

Section 7: Impacts of updating baselines and reassessing eligibility

This section considers the impacts of updating allocative baselines and reassessing eligibility on EITE firms, the Government, and regions where an EITE firm is a large part of the local economy. It also considers the impacts of the proposals on Māori, and Te Tiriti o Waitangi implications.

About this analysis

The impact analysis focused on two proposals:

1. Updating baselines using new base years
2. Reassessing eligibility using new base years.

These proposals would have the greatest impact on allocations as they directly address the cause of over-allocation: historical baseline years. The impacts of the other proposals are expected to be comparatively small. Assessing the two main options provides a good indication of the economic costs and benefits of updating industrial allocation policy.

The Government has limited industry data due to restrictions in the Act. This puts limitations on the impact assessment for all 26 activities. The basis for this analysis is the data collected from the four EITE activities subject to the 2020 data collection: the production of burnt lime, the production of fresh cucumbers, the production of cementitious products, and the production of cartonboard. When extrapolating these findings to all EITE activities, conservative assumptions have been used to ensure impacts and conclusions are not overestimated.

The direct financial impacts on EITE firms can be determined, but the impact on emissions is more difficult to assess. This is because the financial incentive to reduce emissions will not change. For this reason, it is uncertain how addressing over-allocation would affect business decisions and subsequently emissions.

Impacts on other proposals, such as updating the emissions intensity thresholds, or the trade exposure test is not possible. Impact analysis of these would require extensive data collection and modelling.

Table 15: Summary of costs and benefits of updating baselines and reassessing eligibility

Affected groups	Comment	Impact	Evidence certainty
Additional costs of updating allocative baselines and reassessing eligibility compared to taking no action			
EITE firms	• Reduction in allocations for most EITE firms • Eligibility status of EITE firms close to emissions intensity thresholds could change, reducing allocations or making some firms ineligible • Higher NZ ETS costs from reduced allocations • Allocations would remain at a level to reduce the risk of leakage	• Updating baselines is estimated to reduce allocations by $31.5 million[18], annually • Reassessing eligibility is estimated to reduce allocations by $20.3 million, annually • Updating baselines and reassessing eligibility is estimated to reduce allocations by 42 million, annually	• High-medium • Government collected evidence that four activities are currently being over-allocated • The four activities are considered a representative sample of other eligible activities in New Zealand • Conservative assumptions used to extrapolate overall level of over-allocation from the four activities – likely under-estimating total over-allocation
Government	• Some fiscal costs from implementing changes to IA	• Low	• N/A
Other	• Reduction in allocations could affect regional economies and employment where there is a large EITE firm • Māori could be impacted by changes to IA policy, particularly in the forestry sector and some regions with large Māori population	• Regional impacts expected to be small given proposals maintain a level of IA sufficient to protect against leakage • Impact on Māori expected to be small given few Māori businesses receive allocations	• High • Allocations will be realigned with the levels of assistance intended under the Act – ensuring a level of industrial is maintained to minimise the risk of leakage across the economy
Additional benefits of updating allocative baselines and reassessing eligibility compared to taking no action			
EITE firms	• Ensures EITE firms face an emissions price at the margin, encouraging emissions reductions	N/A	• Medium • Reducing over-allocations will ensure EITE firms face an incentive to reduce emissions • Cannot estimate impact because emissions data is not available

[18] All cost estimates in this section assume a $35 NZU price.

Affected groups	Comment	Impact	Evidence certainty
Government	• Reduction in over-allocation would decrease the direct fiscal cost of IA • Reduction in over-allocation would increase the auction proceeds • Improves the effectiveness of the NZ ETS to reduce emissions and meet climate change targets	• Decrease in direct fiscal cost of IA of about $42 million, annually • Increase in annual auction proceeds of between $24 million and $60 million, assuming an auction clearing price of $20 and $50	• High-medium (same as the cost to EITE firms)
Other	• Increased contribution from industry towards climate change targets – reducing the emissions reductions required from other sectors	N/A	• Medium

EITE firms

There are three interrelated financial costs from removing over-allocation. First, firms would receive fewer free NZUs to offset their emissions costs. Because NZUs are freely allocated and have a market value, they are a financial asset to firms. A reduction in this asset would be a financial cost and would reduce the profitability of a firm.

Second, a reduction in allocations would increase the number of units a firm would need to source from the secondary market to meet their surrender obligations (if any). Meeting this cost would affect a firm's profit margin, and could fluctuate depending on the current NZU market price.

Third, a reduction in allocations would mean EITE firms have fewer units to sell and offset indirect NZ ETS costs, such as higher electricity costs. Increased fuel and energy costs would be absorbed in the firm's profit margin (assuming they are in fact trade-exposed and unable to pass the cost on to consumers). The increase in indirect costs would depend on the current NZU price and the hedging behaviour that firms use to smooth out energy costs.

An immediate update of all allocative baselines would reduce the amount of allocation EITE firms receive. A firm carrying out a highly emissions-intensive activity could see its effective level of assistance (say 100 per cent) reduced to the level deemed appropriate in the Act (89 per cent).

The 2020 data collection of the four EITE activities showed that updating baselines and reassessing eligibility using recent data is causing $8 million of over-allocation each year to these industries.

Extrapolating the findings from the 2020 data collection, the impact of updating baselines with recent data could reduce allocations to industry (8.28 million units in 2019) by about 900,000,

or by $31.5 million[19] per year. For the 22 activities where data was not collected, it is assumed their allocation drops by 10 per cent, due to a reduction in their primary allocative baseline.[20] This drop in allocation is based on the activity with the lowest drop in allocative baseline from the 2020 data collection.

The impact of reassessing eligibility using recent data (and current rules) would reduce allocations by an estimated 580,000 units or $20.3 million per year. This assumes that EITE activities close to an emissions intensity threshold will fall below if reassessed using updated data.

If both allocative baselines and eligibility were reassessed using current rules but recent data, the total amount of over-allocation across all 26 activities is estimated to be 1.2 million units or $42 million per year.[21]

The financial impact of just updating the emissions intensity criteria to use the New Zealand EAF could reduce allocations by $23 million per year at a $35 emissions price. However, this amount should be treated with some caution as it assumes the intensity thresholds remain the same. It is possible they would need to change if the New Zealand EAF was used for eligibility purposes.

Although the update of the baselines and the reassessment of eligibility would be a cost to EITE firms, a reduction in their allocation is a removal of free units to a level deemed appropriate to reduce the risk of leakage. The removal of over-allocation should not put EITE firms at a competitive disadvantage and at greater risk of leakage.

The Government further expects that changes to allocations and eligibility will only minimally affect the competitiveness of EITE firms. Other factors, including exchange rates, energy and commodity prices, are greater and more likely to influence business investment and financial viability.

The Government

Addressing over-allocation by updating baselines or reviewing eligibility would reduce the fiscal cost of IA.

The Government would reduce the direct fiscal cost of IA by allocating fewer NZUs. Allocations are recorded as an expense in the Government's financial statements, which creates a liability. As stated, the allocation of the four eligible activities (table 4) that are over-allocated is estimated to be $8 million in 2019. The total 2019 allocation to these industries was $37 million.

Reducing over-allocation would also allow the Government to auction more units and increase auction revenue over the first emissions budget period. As discussed in section 3, over-allocation increases the volume of IA in the NZ ETS cap. Reducing over-allocation means there are fewer un-allocated units in the cap that can be auctioned. Proposals to

---

19 All cost estimates in this section assume a $35 NZU price.

20 This is a simplified method and does not take into account that some activities have several baselines.

21 This analysis is extrapolated from the four industrial activities where data was recently collected and should be used with caution. Best efforts have been made in the assumptions and derivation, and the estimates are conservative, to give some level of certainty.

realign allocation volumes to account for over-allocation would increase the auction volume. Removing over-allocation could increase annual auction volumes by 1.2 million NZUs, which would increase auction revenue by $24 million to $60 million.[22]

Regional economies

A number of large EITE firms are significant contributors to particular regional economies. The cost impact of reducing IAs could include some flow-on effects in some regional economies, but these are uncertain. Any impacts are likely to be minimal, given the proposals will maintain enough support (as regarded by legislation) for firms to stay competitive against overseas activities.

Furthermore, the cost impacts from reducing allocations are small compared to other costs that firms face. Other input costs, such as fuel and electricity, are far more material than those imposed by the NZ ETS, and more likely to drive business decisions that would have a regional impact. For example, many industrial firms have recently cited high electricity prices as threatening their financial viability in New Zealand.

Māori and Te Tiriti o Waitangi implications

Māori have a significant stake in climate policy. Climate change threatens the loss of culturally significant land, taonga species, and resources affecting the perpetuity of mātauranga and tikanga Māori.

There is a strong Tiriti and Māori interest in NZ ETS. This is driven by a commitment to reduce emissions and address climate change, and the potential impacts of emissions pricing on Māori involvement in forestry and agriculture – particularly as these sectors dominate Māori economic development and employment.

Free allocation policy, as it relates to agriculture and forestry, is of direct interest to Māori. An example is the allocation of NZUs to pre-1990 forest owners to compensate for the loss of land value from NZ ETS deforestation liabilities. This touched on issues of the equitable treatment of Māori-owned land received from Treaty settlements.

Assessing the Māori interest in IA policy is more complex. IA is mainly of interest to EITE firms receiving an allocation – most of which are owned or majority-owned by overseas entities. None are Māori-owned, nor are there significant Māori interests in these companies. As Māori-owned businesses largely do not receive IA, they would not be directly affected by changes to allocation or eligibility settings.

However, the Māori economy may be more exposed to the risk of emissions leakage than the broader New Zealand economy.[23] This could mean IA is more important to Māori than to the economy as a whole – implying there is a broad Māori interest in IA policy and its outcomes.

Changes in IA would affect the profitability of industries that employ a high proportion of Māori compared to other ethnic groups (in manufacturing, agriculture and forestry). Also,

---

[22] Auction revenue depends on the auction clearing price. The revenue range here is determined by the minimum auction clearing price set by the auction price floor ($20) and the upper bound set by the cost containment reserve price trigger ($50).

[23] *Māori Impacts from the Emissions Trading Scheme: Detailed Analysis and Conclusions.*

Māori employment could be disproportionately affected in regions with a large Māori population, and where one or two EITE facilities dominate the local economy. This risk could be acute in rural areas with wood-processing plants.

Still, the proposals set out here are unlikely to affect employment, as they retain enough assistance to reduce the risk of leakage and prevent the closure of industrial facilities.

Section 8: How to have your say

The Government welcomes your feedback on this consultation document. The questions posed throughout this document are summarised in section 9. They are a guide only and all comments are welcome. You do not have to answer all the questions.

To ensure your point of view is clearly understood, you should explain your rationale and provide supporting evidence where appropriate.

> Question 29: Do you have any other comments, ideas or feedback that could help support the Government form final policy decisions?

Timeframes

This consultation starts on Thursday 8 July 2021 and ends on Friday 17 September 2021.

When the consultation period has ended, we will develop final policy advice that considers these submissions.

How to provide feedback

There are two ways you can make a submission:

- via Citizen Space, our consultation hub, available at https://consult.environment.govt.nz/
- write your own submission.

If you want to provide your own written submission you can provide this as an uploaded file in Citizen Space.

We request that you don't email or post submissions as this makes analysis more difficult. However, if you need to please send written submissions to IA review, Ministry for the Environment, PO Box 10362, Wellington 6143 and include:

- your name or organisation
- your postal address
- your telephone number
- your email address.

If you are emailing your feedback, send it to etsconsultation@mfe.govt.nz as a:

- PDF, or
- Microsoft Word document (2003 or later version).

Submissions close at 5 pm on 17 September 2021.

More information

Please direct any queries to:

Email: etsconsultation@mfe.govt.nz

Postal: IA review, Ministry for the Environment, PO Box 10362, Wellington 6143

Publishing and releasing submissions

All or part of any written comments (including names of submitters), may be published on the Ministry for the Environment's website, environment.govt.nz. Unless you clearly specify otherwise in your submission, the Ministry will consider that you have consented to website posting of both your submission and your name.

Contents of submissions may be released to the public under the Official Information Act 1982 following requests to the Ministry for the Environment (including via email). Please advise if you have any objection to the release of any information contained in a submission and, in particular, which part(s) you consider should be withheld, together with the reason(s) for withholding the information. We will take into account all such objections when responding to requests for copies of, and information on, submissions to this document under the Official Information Act.

The Privacy Act 2020 applies certain principles about the collection, use and disclosure of information about individuals by various agencies, including the Ministry for the Environment. It governs access by individuals to information about themselves held by agencies. Any personal information you supply to the Ministry in the course of making a submission will be used by the Ministry only in relation to the matters covered by this document. Please clearly indicate in your submission if you do not wish your name to be included in any summary of submissions that the Ministry may publish.

Section 9: Consultation questions

Criteria

Question 1: Do you agree with the five criteria to assess the proposals in this consultation document? Why, or why not?

Allocation calculations

Question 2: Should allocative baselines be updated using new base years? Why, or why not?

Question 3: Should the reassessment be a one-off update, or a periodic update? Why, or why not?

Question 4: If periodic reassessment is legislated, what would be an appropriate period – every year, 5 years, 10 years, or something else? Why?

Question 5: Do you agree the financial years 2016/17, 2017/18 and 2018/19 should be used as new base years to update allocative baselines? Why, or why not?

Question 6: Should the financial years 2019/20 and 2020/21 be included, but with a weighting provision? Why, or why not?

Eligibility

Question 7: Should eligibility be reassessed using new base years?

Question 8: Should new emissions intensity thresholds for New Zealand industry be developed? Why, or why not?

Question 9: Should more thresholds be added into the eligibility criteria? Why, or why not? How many would be appropriate?

Question 10: Would a sliding scale threshold system better target eligibility and assistance? Why, or why not?

Question 11: Should the New Zealand EAF be used when determining eligibility? Why, or why not?

Question 12: Should periodic updates of the EAF trigger a recalculation of eligibility? Why, or why not?

Question 13: Should the trade exposure test be changed? Why, or why not?

Question 14: What would be a more appropriate method to determine trade exposure?

Other reforms to industrial allocation

Question 15: Do you agree with the proposal to simplify the process to update allocative baselines, to reflect changes to emissions factors, EAF or other changes to methodology? Why, or why not?

Question 16: Are there other changes to sections 161A-E of the Act that could better streamline IA processes?

Question 17: Do you agree with the proposal to clarify the eligibility process for new activities? Why, or why not?

Question 18: Should new activities be able to seek eligibility? Why, or why not?

Question 19: Should there be any caveats on new activities seeking eligibility, such as proof of environmental benefits compared to existing activities?

Question 20: Should firms that receive IA be required to report their emissions, revenue and production data annually? Why, or why not?

Question 21: Would voluntary reporting be more appropriate, and still provide some oversight of leakage and over-allocation risk? Why, or why not?

Question 22: Should the five-year transition period for changes in eligibility status remain, or be changed? Why, or why not?

Future of industrial allocation

Question 23: Should we look at an alternative mechanism to address emissions leakage? Why, or why not?

Question 24: What alternative mechanisms to IA would better address the risk of emissions leakage, and support domestic and international emissions reduction targets?

Question 25: Should IA policy or any alternative explicitly encourage firms to reduce emissions? Why, or why not?

Question 26: What method could be used to encourage emissions reductions?

Question 27: Should IA decisions or any alternative include wider considerations – such as economic, social, cultural and environmental factors – when determining support for industry? Why, or why not?

Question 28: How would these new considerations interact with the goal of reducing emissions leakage?

Other comments

Question 29: Do you have any other comments, ideas or critical feedback that could help support the Government form final policy decisions?

Appendix 1: Industrial Allocation TAG position on consultation questions

This table outlines the TAG's positions on the policy options and questions proposed in this consultation document. Some questions have been broken down into options (a., b.,) where appropriate to identify positions. These positions are based on an early version of the consultation document and ahead of the benefit of insight from the consultation process.

The level of agreement between TAG members is broken into three tiers:

1. full support means all TAG members
2. majority preference means 3 or 4 out of 5 TAG members
3. consult means more input from consultation process is required before TAG can firm up its position.

Some questions were added in a later version of this consultation document and were not reviewed by the TAG. These are labelled with an asterisk.

Table 16: TAG position on consultation questions

Questions	Answer	TAG level of support
Criteria		
1) Do you agree with the five criteria to assess the proposals in this consultation document?	Yes	Full support
Allocation calculations		
2) Should allocative baselines be updated using new base years?	Yes	Full support
3) Should the reassessment be		
a. a one-off update, or a	No	
b. a periodic update?	Yes	Full support
4) If periodic reassessment is legislated, what would be an appropriate period – a. every year		
b. 5 years		Consult
c. 10 years	Yes	Majority preference;[24] consult
d. Something else?	No	–
5) Do you agree the financial years 2016/17, 2017/18 and 2018/19 should be used as new base years to update allocative baselines?	Yes	Full support
6) Should the financial years 2019/20 and 2020/21 be included but with a weighting provision?		*
Eligibility		
7) Should eligibility be reassessed using new base years?	Yes	Full support
8) Should new emissions intensity thresholds for New Zealand industry be developed?		
a. With no change in EAF for eligibility (retain Australian EAF)		Consult
b. With change to NZ based EAF (refer Q10)		Consult

[24] Some concern from the TAG that 10 years allows too much time for over-allocations to happen. The 5 and 10-year options should be consulted on before final TAG recommendation.

Questions	Answer	TAG level of support
9) Should more thresholds be added into the eligibility criteria? Why, or why not? How many would be appropriate?		Consult
10) Would a sliding scale threshold system better target eligibility and assistance?		Some preference; consult
11) Should the New Zealand EAF be used when determining eligibility? Why, or why not?		
a. With no change in eligibility thresholds		Consult
b. With changes to eligibility thresholds (refer Q7)		Some preference; consult
12) Should periodic updates of the EAF trigger a recalculation of eligibility?		
a, If aligned with allocative baseline assessment (refer Q4)	Yes	Majority preference
b. If more frequent than allocative baseline assessment		
13) Should the trade exposure test be changed?	No	Majority preference; consult
14) What would be a more appropriate method to determine trade exposure?		Consult
Other reforms to industrial allocation		
15) Do you agree with the proposal to simplify the process to update allocative baselines, to reflect changes to emissions factors, EAF or other changes to methodology?	Yes	Majority preference
16) Are there other changes to sections 161A-E of the Act that could better streamline IA processes?		*
17) Do you agree with the Government's proposal to clarify the process for new activities to seek eligibility?	Yes	Full support
18) Should new activities be able to seek eligibility?	Yes	Full support
19) Should there be any caveats on new activities seeking eligibility, such as proof of environmental benefits compared to existing activities?	Yes	Majority preference; consult
20) Should firms that receive IA be required to report their emissions, revenue and production data annually?	Yes	Majority preference; consult
21) Would voluntary reporting be more appropriate, and still provide some oversight of leakage and over-allocation risk?	No	Majority preference
22) Should the five-year transition period for changes in eligibility status remain, or be changed?		Consult
Future of industrial allocation		
23) Should we look at an alternative mechanism to address emissions leakage?		Consult
24) What alternative mechanisms to IA would better address the risk of emissions leakage, and support domestic and international emissions reduction targets?		Consult
25) Should IA policy or any alternative explicitly encourage firms to emissions reductions?		*
26) What method could be used to encourage emissions reductions?		*
27) Should IA policy or any alternative include wider considerations – such as economic, social, cultural, and environmental factors – when determining support for industry?		*
28) How would these new considerations interact with the goal of reducing emissions leakage?		*

Appendix 2: Table of emissions-intensive and trade-exposed activities

Table 17: Emissions-intensive and trade-exposed activities

Activity	Emissions intensity
Aluminium smelting	High
Manufacture of carbon steel from cold ferrous feed	High
Manufacture of iron and steel from iron sand	High
Production of burnt lime	High
Production of carbamide (urea)	High
Production of cartonboard	High
Production of caustic soda	High
Production of cementitious products	High
Production of clay bricks and field tiles	Moderate
Production of cut roses	High
Production of ethanol	Moderate
Production of fresh capsicums	Moderate
Production of fresh cucumbers	Moderate
Production of fresh tomatoes	Moderate
Production of gelatine	Moderate
Production of glass containers	Moderate
Production of hydrogen peroxide	High
Production of lactose	Moderate
Production of market pulp	High
Production of methanol	High
Production of newsprint	High
Production of packaging and industrial paper	High
Production of protein meal	Moderate
Production of reconstituted wood panels	Moderate
Production of tissue paper	Moderate
Production of whey powder	Moderate

References

International Carbon Partnership. 2021. *Emissions Trading in Practice: A Handbook on Design and Implementation*. Washington DC: World Bank Group.

Karamea Insley, Chris, & Meade, Richard. 2008. *Māori Impacts from the Emissions Trading Scheme. Detailed Analysis and Conclusions*. Wellington: Ministry for the Environment.

NZIER. 2009. *New Zealand's 2020 emissions target negotiations. Impact on the Māori economy*. Wellington: NZIER.

Denne, T. 2021. *Potential for emissions leakage from selected industries in the ETS.* Resource Economics.