

## Appendix 1: Terms of Reference for the Industrial Allocation Policy Review

1. These terms of reference define the scope and procedure of the review of industrial allocation policy within the New Zealand Emissions Trading Scheme (NZ ETS).
2. In March 2020, Cabinet invited the Minister of Climate Change to provide a terms of reference for a review of industrial allocation [CAB-20-MIN-0102 refers].

### Context

3. The Government has declared a Climate Change Emergency and committed Aotearoa New Zealand to a path of transition towards net zero carbon emissions by 2050. This will require significant changes to parts of our economy, and the Government has a responsibility to work alongside affected communities and businesses.
4. Industrial allocation is the provision of free New Zealand Units (NZUs) to firms that are emissions-intensive<sup>1</sup> and trade-exposed<sup>2</sup> (EITE). Its purpose is to reduce the risk of emissions leakage by protecting the competitiveness of firms that face increased costs as a result of the NZ ETS, while maintaining an incentive for these firms to make investments that reduce emissions.
5. Emissions leakage is where differing climate policies between countries could result in the displacement of New Zealand production, the loss of market share, or the displacement of investment to higher emissions alternatives overseas with the intent to reduce NZ ETS compliance costs.
6. The Climate Change Response (Emissions Trading Reform) Amendment Act 2020 has initiated a gradual phase-out of industrial allocation, and created a provision for activity specific phase-outs from 2025. However, this process will take time to address the problems described below.
7. Current industrial allocation outcomes result from legislation requiring that data from the financial years between 2007-09 be used for the purpose of determining eligibility and allocative baselines. This legislation was strongly influenced at the time by an intention to align NZ ETS settings with those in the proposed Australian Carbon Pollution Reduction Scheme. The Australian scheme never eventuated.
8. It is now clear some EITE firms are over-allocated and that the economic and fiscal outcomes are not aligned with the policy intent of reducing the risk of emissions leakage. Evidence to support this is:
  - a. a data collection from a subset of EITE industries showing that emissions efficiency improvements, fuel switching, changes in industry

<sup>1</sup> An activity is moderately emissions-intensive if its emissions intensity is between 800-1,600 t CO<sub>2</sub>-e/\$1 mill revenue, and highly emissions-intensive if its emissions intensity is greater than 1,600 t CO<sub>2</sub>-e/\$1 mill revenue.

<sup>2</sup> An activity by default is considered trade-exposed unless there is no international trade of the activity's output across oceans, or it is not economically viable to import or export.

structure, and surrender exemptions have caused significant changes in allocative baselines and in some cases changes in eligibility

- b. a report that found for some industries in the same subset, there is little risk of emissions leakage at current emissions prices.
9. Over-allocation increases the difficulty of meeting New Zealand's emissions reduction targets under the Climate Change Response Act 2002 by taking up a larger portion of emissions budgets. It has distributional impacts, is a windfall gain for firms, reduces the incentive for abatement across the economy, reduces the effectiveness of the NZ ETS' price signal, and creates fiscal costs for the Crown by reducing the amount of NZUs the government can sell through auctioning.

### **Objective of the review**

10. The review will assess the effectiveness of industrial allocation policy and its current settings. Its primary objectives are to ensure that outcomes of industrial allocation policy are aligned with:
  - a. the policy objective of minimising the risk of emissions leakage
  - b. New Zealand's domestic and international emissions reduction targets.
11. In the long term, systemic issues with industrial allocation policy will need to be addressed to ensure support provided to EITE firms is appropriate to offset the risk of emissions leakage in a low carbon New Zealand. This would primarily look at alternative measures that could more effectively reduce the risk of emissions leakage while achieving better environmental and economic outcomes than the status quo. However, development of this will be a longer-term process and take considerable time and development but the conversation regarding options for this can begin here.
12. In the interim and in light of the evidence of over-allocations, this review will consider the options for realigning the parameters of the existing industrial allocation framework. Adjustment to the current industrial allocation framework is necessary as discussion and analysis of alternatives will take several years to conclude and be implemented.

### **Scope**

The review will have two sets of considerations to be discussed in parallel.

#### *Primary Scope*

3. The primary scope will have a focus within the bounds of current industrial allocation policy including but not limited to:
  - a. the emissions-intensity eligibility criteria
  - b. the trade-exposure eligibility criteria

- c. the current mechanism and settings for calculating allocation
14. Specific considerations to be addressed within the primary scope are whether:
- a. current policy settings support emissions reductions to occur, with urgency, in economically efficient ways that are consistent with a just transition for affected communities
  - b. international emissions intensities should be considered when determining eligibility in the New Zealand context
  - c. international climate policy and emissions pricing, and overseas production should be considered when determining eligibility in the New Zealand context (while ensuring there is consistency of any allocation model with New Zealand's international trade commitments)
  - d. new activities should be able to seek eligibility and how they might be treated
  - e. new entrants of an existing eligible activity should be able to receive allocations
  - f. the current method for calculating allocative baselines remains appropriate and if not, what changes would be advised
  - g. allocation should continue to be tied to production or some other metric such as actual emissions
  - h. allocative baselines should be updated and how regularly
  - i. individual firms should be allowed bespoke allocative baselines
  - j. the current five year stand down period for revoking or amending eligibility is appropriate
  - k. the provision of NZUs is the best method to support at risk firms, or whether cash or exemption might be more appropriate
  - l. there should be a limit on the annual support given to EITE firms (individually, for an activity, or collectively), and if not, what measures should be put in place, if any, in case emissions budgets are breached
  - m. assistance should be time bound as a form of transitional investment
  - n. the 'bringing forward' of allocations should be allowed to aid investment in low emissions alternatives, and how this would change the eligibility status of such EITE recipients<sup>3</sup>

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<sup>3</sup>Bringing forward is the possible ability to borrow future allocations in bulk instead of receiving them over time as emissions and surrender obligations occur.

- o. annual emissions, production, and revenue data of allocation recipients should be provided to the government to better monitor the risk of emissions leakage
- p. consultation is required on updates to allocative baselines resulting from the annual recalculation of the electricity allocation factor.

### *Secondary Scope*

15. To open discussions on longer term changes to industrial allocation, a secondary set of considerations are to be assessed in parallel. These considerations are:
  - a. what alternative mechanisms to the current industrial allocation regime would better:
    - i. address the risk of emissions leakage and
    - ii. support New Zealand meeting its domestic and international emission reduction targets
  - b. when would it make sense to transition from one regime to the other, and how
  - c. what is the net national benefit of industrial allocation or an alternative mechanism when taking into account all economic, social, cultural and environmental factors
  - d. how industrial allocation or any alternative mechanism can provide an incentive for, and support investment in, emission reductions.
  - e. what should the Climate Change Commission consider before recommending changes to the phase-out of the 'levels of assistance' as part of their mandated requirements in the Climate Change Response Act 2002.
16. Considerations identified in this secondary scope are intended only to begin the discussion around transitioning to alternatives measures. No legislative changes to secondary scope considerations are intended to result from the outcomes of this review in the near-term.

### *Out of scope*

17. The following matters are outside the scope of the review:
  - a. the legislated phase-out of industrial allocation rates of assistance. This policy parameter was recently reviewed, decided and implemented
  - b. the Electricity Allocation Factor (EAF). A review of the EAF is already underway and is a separate part of the industrial allocation review

- c. agricultural free allocation. The review will not consider matters related to assistance for the agricultural sector if it enters the NZ ETS under the backstop provision.
- d. how industrial allocation is accounted for in the methodology for NZ ETS unit supply settings. These settings only need forecast industrial allocation volumes and are not strongly tied to the industrial allocation methodology.

### **Procedure of the review**

- 18. The Ministry for the Environment (the Ministry) will lead the review.
- 19. A small group of specialists with economic and climate policy expertise will be invited to participate in a technical advisory group (TAG) to help assess options for proposed changes to the existing industrial allocation framework. Because the TAG will be focussed on technical options analysis, stakeholders will not be invited to participate or observe. Full consultation with stakeholders will occur in the consultation phase. The Climate Change Commission and the Parliamentary Commissioner for the Environment will also be invited to participate or observe. A terms of reference will be developed for the TAG, defining its purpose, membership, roles and expectations, conflicts of interest and confidentiality.
- 20. The TAG will provide:
  - a. recommendations on specific areas of industrial allocation policy to focus commissioned research on
  - b. expert opinion and scrutiny of the research
  - c. comment on policy options and impacts to inform a consultation document
- 21. Government agencies will provide input into these proposals and the consultation document, including: The Treasury; the Ministry of Foreign Affairs and Trade; and the Ministry of Business, Innovation and Employment, and the Ministry for Primary Industries (and Te Uru Rākau).
- 22. Findings from the public consultation will be reported to the Minister of Climate Change by the end of 2021.

### **Timing of the review**

- 23. The review will begin following the announcement of these terms of reference.
- 24. The Ministry will set up the TAG as soon as possible by invitation.
- 25. Research within the scope of the review will be commissioned by the end of April with a deadline of mid-2021.

26. Public consultation incorporating: research findings, analysis and comments from the Ministry and the TAG, and the resulting policy proposals will begin in the second half of 2021, dependent on approval from the Minister of Climate Change, and Cabinet.
27. Subsequent to the findings of the consultation, advice will be provided to the Minister of Climate Change by the end of 2021.

### **Responsibilities of the Ministry for the Environment**

28. The Ministry is responsible for:
  - a. leading the review and steering its overall direction
  - b. producing analysis and recommendations to include in the final discussion document
  - c. providing support to the TAG
  - d. all deliverables in the review process
  - e. reporting regularly to the Minister on the review's progress.

### **Consultation**

29. The input of stakeholders is important for the review's success. Public consultation will occur over the second half of 2021 to assess stakeholder's appetite for changes to industrial allocation policy. Officials will ensure our partners iwi/Māori are given the opportunity to be involved in the development of proposals.

### **Alignment with other Government work**

30. The review will be aligned with other government work programmes on climate change, particularly the work on market governance in the NZ ETS, the Emissions Reduction Plan, and future work on linking the NZ ETS to international carbon markets.