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Dear Bertrand

Development of Industrial Allocation Regulations under the New Zealand Emissions Trading Scheme

Business New Zealand is pleased to have the opportunity to provide a submission to the Ministry for the Environment on its consultation paper entitled 'Development of Industrial Allocation Regulations under the New Zealand Emissions Trading Scheme', dated December 2009.[1]

Introductory Comments

Business New Zealand welcomes the release of the Ministry for the Environment's consultation paper. With the passage of the Bill into law last December, and the commencement date for those businesses who undertake industrial processes looming, officials now need to move with some haste to deliver trade-exposed business with certainty on the degree of protection they will be afforded.

Business New Zealand approaches this consultation with mixed feelings. The general form of the package of moderating features in the amended Climate Change Response Act 2002 (the 'Act'), including the intensity-based approach to allocation, are most welcome by business. These features recognise the delicate balance between setting New Zealand on the path towards a sustainable, low carbon economy, and the need to protect existing businesses and the communities in which they operate.

[1] Background information on Business New Zealand is attached in Appendix One.

However, recent international developments now potentially conspire to defeat a key purpose of the Act – the avoidance of a competitive disadvantage and the minimisation of the risk of carbon leakage. The practical effect of the allocation regime is that it now risks not being fit for New Zealand business circumstances.

In light of these new circumstances, officials must now work harder than ever to ensure that New Zealand firms are not locked into a period of serious competitive disadvantage. Given the limited flexibility available under the Act, key elements to ensuring this are likely to involve an electricity emissions factor that accurately reflects the Government's own expectations of price pass-through and broad activity definitions. Ultimately, legislative amendments may be necessary.

The balance of this submission addresses these issues in more depth.

The Impact of Copenhagen's Inconclusive Outcome

A 'business-as-usual' path is no longer available to officials post-Copenhagen The inconclusive outcome from Copenhagen suggests that there is little evidence that tangible progress will be made towards the conclusion of an international, broad-based agreement to reduce emissions by the end of 2010. This raises serious doubt as to whether a successor agreement to the Kyoto protocol will be concluded in time to commence by 1 January 2012.

The New Zealand economy will contain a cost of carbon from 1 July 2010. However, our major trade-competitors – Australia, China, and America continue not to have schemes or policies that internalise a cost of carbon into their businesses and wider economies. The European scheme has neither the coverage nor the stringency of the New Zealand scheme.

Business New Zealand does not yet consider that the point has been reached to reconsider the efficacy of New Zealand's current domestic policy settings. The prospect remains of an international agreement of some form being reached. However, the increased uncertainty of timely progress towards other countries adopting a price of carbon heightens the risk that any competitive disadvantage effects are unlikely to be short-term. In this increasingly likely scenario *all* trade-exposed firms – regardless of whether they are carbon intensive or not – face a cost that their trade-competitors do not. The implementation of the allocation regime needs to be seen in this light.

Australia's Failure to Legislate a Trading Scheme

The explanatory note to the Climate Change Response (Moderated Emissions Trading) Amendment Bill stated, amongst other things that its purpose was to:

> "• reduce competitiveness impacts of the NZ ETS and provide greater certainty for economic growth:
>
> ....

- maximise the degree of harmonisation with the Australian Carbon Pollution Reduction Scheme to reduce trans-Tasman competitiveness risks:”[2]

Section 3(1)(b) of the Act states that its purpose is, amongst other things:

> “…..a greenhouse gas emissions trading scheme……that supports and encourages global efforts to reduce greenhouse gas emissions….”

The status of the negotiations on a successor international agreement is sufficient in itself to raise doubt about the attainment of these objectives. However, Business New Zealand considers that the absence of an Australian scheme (the Carbon Pollution Reduction Scheme, or ‘CPRS’) now places the attainment of the stated purposes of the Act in significant doubt.

The policy objective of retaining competiveness of New Zealand business *vis a vis* Australia has been frequently stated by the Government as key to the changes being made to the Labour-led emissions trading scheme. For example, the explanatory note to the moderated emissions trading bill stated:

> “Differences between the Emissions Trading Schemes of both countries, particularly levels of protection, could have large impact on levels of trade between the 2 countries”[3]

> “In summary, although competitiveness will depend on a variety of factors, all other things being equal, differences in allocation methodologies could cause certain activities to become more productive in one country over another, leading to one country loosing (sic) market share or production shifting across the Tasman.”[4]

However, the Australian Government has been unable to legislate its CPRS and it is now clear that the Australian Parliamentary opposition will support neither the CPRS nor trading in general. A recent survey also shows public support for the CPRS plummeting. On this basis, the Ministry for the Environment has decided that the ‘Australian-track’ is unavailable to New Zealand businesses where their activities do not meet the tests for emissions intensity and trade-exposure as set out in section 161C of the Act. In short, if a New Zealand-based activity does not qualify under the ‘New Zealand-track’, the ‘Australian-track’ is not going to be available as a potential catch-all, despite the fact that business expectations were raised that it would be.

The absence of the CPRS has potentially severe implications for New Zealand businesses. Most obviously, relative to their New Zealand counterparts, Australian businesses will not face a cost of carbon *at all*. This places the New Zealand scheme and its effect on the competitiveness of all New Zealand businesses into sharp relief.

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[2] Climate Change Response (Moderated Emissions Trading) Amendment Bill, Explanatory note, page 1

[3] Op cit, page 16.

[4] Op cit, page 18.

Given the state of advancement of the Australian activity definitions and allocation calculation methodologies, and the differences in the New Zealand-track criteria, it is also likely to mean that for the same activity many New Zealand businesses are likely to find they are at a lower eligibility threshold than their Australian competitors, or ineligible altogether. Iron casting is potentially an example of the former and food processing is potentially an example of the latter.

The risk associated with this is real. The mere fact that an activity has been defined in Australia means that it is being carried out and it is likely to be subject to international trade (either by competing with exporters from other countries, or a domestic substitute for imports). As outlined in the explanatory note to the Climate Change Response Amendment Bill, New Zealand is Australia's sixth largest export market and New Zealand's principle export market.[5]

It is true, of course, that regardless of the approach taken in Australia, that the New Zealand scheme needs to contain tests in order to determine who requires assistance and who does not. It is also self evident that such tests need to ensure that those who are most affected receive the assistance. However, the failure of the Australians to legislate for the CPRS is likely to give rise to competitive outcomes that are inconsistent with the policy objectives sought by the Government.

In fact, the process set out in the legislation potentially serves to entrench this. Once gazetted, eligible activities and allocative baselines for highly intensive activities are set for five years. While ostensively intended to deliver businesses with investment certainty, the absence of the CPRS now ensures that the cost differential endures, thereby exacerbating the competitive disadvantage.

There is also significant down-side risk. The absence of an Australian scheme means that a first-mover disadvantage is likely to be the reality, particularly if Australia ultimately moves in step with America. Our trade competitors are unlikely to mirror the allocation methodology used in New Zealand but match the degree of protection to suit their domestic economic circumstances. In light of the ability to back-date allocation, many businesses will be giving careful consideration to whether the option value of waiting is higher than being locked-in to a relatively low allocation regime for five years. Carbon leakage and import substitution risks will be hard to avoid in these circumstances.

[5] Op cit, page 16.

Other Contextual Factors of Relevance to the Implementation of the Allocation Regime

Two other contextual factors are relevant to the implementation of the allocation regime in New Zealand. These are:

1. New Zealand's Kyoto position. On 15 April 2009, the Minister announced that New Zealand is now expected to exceed its Kyoto target by 9.6 million tonnes, giving rise to a surplus worth an estimated $241m; and

2. the projected surplus to be generated from the scheme: in papers released by the Minister on 9 October 2009, the Minister showed that while the negative fiscal impact of the moderated scheme relative to the Labour-led scheme was significant (driven by the cost of free units to business), that the Government was still expected to have a positive fiscal impact of $864m between 2010 and 2012.

Business New Zealand recognises that there is a difference between the New Zealand position, and the Crown's position. However, the increasing likelihood of a Kyoto surplus, as well as an expected surplus from the scheme provides officials with a greater opportunity to demonstrate that the burden of the scheme on business is fair.

In light of the new international context, it is critical to the maintenance of business confidence in the operation of the emissions trading scheme that the government is not be seen to profit at their expense for little or no good environmental purpose.

Implications for the Implementation of the Allocation Regime

The implications of the above, for the implementation of New Zealand's allocation regime, should be fairly obvious. Even if New Zealand firms are more carbon or energy efficient than their trade-competitors, ultimately it's the relative impact across jurisdictions that matters. While carbon intensity is the cost driver, officials should not lose sight of the risk being addressed – that of carbon leakage. Carbon and energy efficient New Zealand businesses (such as food processors) should not be penalised.

This expectation gives rise to a clear principle - trade-exposed businesses undertaking the same activity should be afforded the same levels of protection (or as close to it as possible).

What does this mean? Business New Zealand recognises that the legislative framework set out in the Act gives officials limited flexibility in terms of how it is implemented. But it is simply unacceptable now that the international ground has shifted, for officials to fall back on the rigidities of the law.

A low (capped) price of carbon while necessary, should not be seen as a sufficient reason for minimising the levels of free allocation. Business New

Zealand has seen a pervading ethos of minimising the cost of the scheme to the Crown drive the pursuit of spurious accuracy into the design of how emissions are to be measured. Business New Zealand's sense is similar with regard to the application of the allocation regime.

It is timely that officials reassessed the effect of the allocation on business longevity. How officials apply the allocation regime will be critical for business, particularly through to the end of 2012.

Practical Steps

In the absence of other jurisdictions having emissions trading or carbon taxes, officials need to err on the side of generosity when developing the specific detail around the allocation of free units. Despite the inflexibility of the legislative framework, Business New Zealand believes there are two avenues available for officials to deliver a fair and reasonable allocation outcome. These are the choice of the electricity emissions factor and the activity definitions. This section of the submission briefly canvasses these aspects.

The Choice of Electricity Emissions Factor

Business New Zealand believes that an emissions factor of **1.0** is both justified on its own merits and warranted on the basis of the changed international context. Officials have, instead proposed a factor of 0.52 be used, based on the outcome of modelling work done for a sub-group of the stationary energy and industrial process technical advisory group. Business New Zealand considers this outcome to be flawed, for the following reasons:

1. the modelling focused on short run, and not long-run costs: our view is that detailed short-run marginal cost ('SRMC') modelling is unnecessary, for the following three reasons:

    a. long run supply curves will tell the whole story. This is that the ability for generators to recover the cost of carbon is constrained (or not) by the long-run costs of new generation capacity. This fact is widely acknowledged by the Ministry of Economic Development, the Electricity Commission and their consultants. The general expectation is:

        > "that wholesale electricity prices will continue to rise in the future, reflecting the increasing cost of building new generation plant"[6]

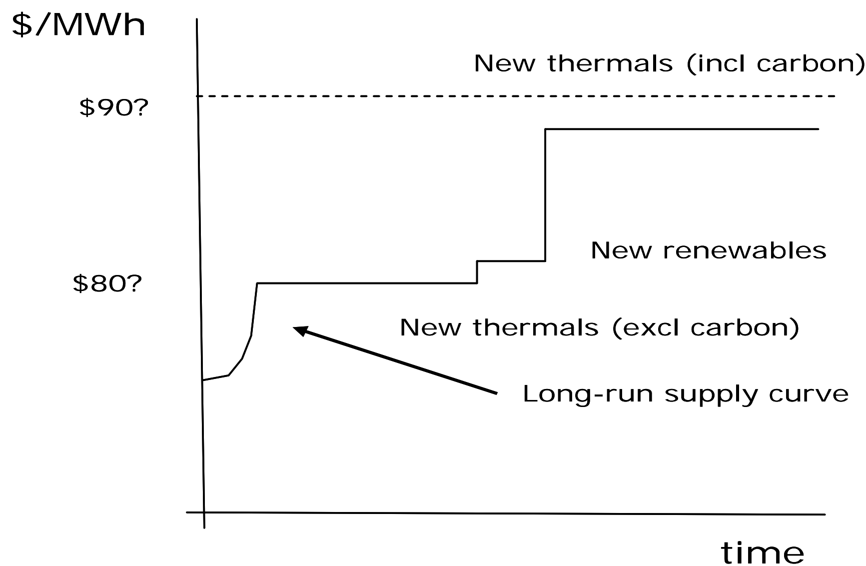
        However, significant uncertainty exists regarding the extent and timing of the increases. For example, it is extremely difficult to forecast the impact on long-run prices of resource consenting

[6] A Preliminary Report to the Ministerial Review of Electricity Market Performance by the Electricity Technical Advisory Group and the Ministry of Economic Development entitled 'Improving Electricity Market Performance, Volume Two: Appendices', dated August 2009, page 59.

difficulties, and the quality and accessibility of the resource (particularly relevant to geothermal and wind). And not being a developer, Ministry of Economic Development is unlikely to have any special insight into the likelihood of its long-run cost estimates actually being observed in the market.

While it is generally agreed that new geothermal plant is economic at or around current long-run prices, the cost of additional capacity is expected to move fairly quickly into, and beyond, the $90.00/MWh range. Long-run prices in this range would enable all electricity generators to fully recover the effective cost of carbon of $12.50/MWh without the threat of new, cheaper generation being brought into the market to prevent it.

The nature of the price uplift can be shown diagrammatically as follows:



The most recent security of supply assessment by the Electricity Commission is informative in this regard. It signals growing concerns that at current price expectations, fewer generation plants are coming forward. This supports the above contention that long-run prices are likely to lift;[7]

b. SRMCs depend on long-run costs in any case: the modelling undertaken on behalf of the sub-group explicitly acknowledges that SRMCs must correspond to long-run marginal costs (LRMCs) in any case, if the system is expanding in an economically balanced way. The discomfort with using LRMCs directly for price effects appears to be that it's hard to know how

[7] It is also worthwhile noting the inappropriateness of using SRMC as the basis of future wholesale electricity market prices – in assessing the efficiency of any reformed industry it is generally not appropriate to contrast arrangements with the ideal of perfect competition. This debate was had at some length in the context of the Wolak report.

much new renewables plants will actually be utilised. In Business New Zealand's view, this worry is misplaced. Some new renewables may not be fully baseloaded but the simple average of the spot price should still match the baseload unit cost of the renewable plant;[8] and

c. the modelling is highly assumption dependent: Business New Zealand appreciated the modelling effort at the time, but our view is that the detailed assumptions that sit behind it effectively render it redundant. The simulated SRMCs depend entirely on the commissioning program for new capacity and relies on the Electricity Commission's Generation Expansion Model for the supposedly optimal expansion sequences for each carbon cost scenario;

2. the Government *expects* the price of electricity to rise by somewhere between 0.8c/kwh and 1.0c/kwh (or $8.00/MWh to $10.00/MWh). For example:

> " …… and the increase in electricity prices is estimated to be 0.8c/KWh ….. "[9]
>
> "These (proposed) changes will halve the price impact on households for fuel and electricity to 3.5c/l and 1c/kWh."[10]

On a straight translation, these expected increases equate to emission factors of between 0.65 and 0.8. In addition, Ministry of Economic Development considers that:

> "Pricing carbon and other emissions, such as through an emissions trading scheme, will have a significant impact on electricity costs and overall prices"[11]

Putting aside for the moment the uncertainty associated with such forecasts noted above, Business New Zealand knows that the Government's own advisers have consistently advised that electricity generators do not need to be protected from the effect of the Emissions Trading Scheme on the basis that they can pass the cost on. To now assume anything less would give cause to recognise a need to compensate electricity generators for a financial loss caused by the scheme's introduction. But electricity generation is explicitly excluded from being able to receive a free allocation because it is deemed not to

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[8] The reason is that if some renewables are not baseloaded, then the spot price will be zero while those plants are on the margin, and the spot price must therefore be higher when they are operating at capacity to pay for capital cost of new renewables; the partial loading effect cancels out for plants that have zero operating cost.

[9] Explanatory note, Ibid, page 34.

[10] Minister for the Environment, press release entitled 'Revised ETS balances NZ's environment & economy', dated 14 September, 2009.

[11] A Preliminary Report to the Ministerial Review of Electricity Market Performance, Ibid, Volume One: Discussion Paper', dated August 2009, paragraph 61, page 28

be trade exposed, (indeed, it is deemed to be “very obviously not”[12]). The consultation document reiterates this view where it says:

> “In many cases this price will be passed through to consumers; for example, through higher electricity prices and gas prices.”[13]

To now try to argue, based on a highly contested position struck in a completely different context (of a Labour-led Government, a thermal ban and the Labour/Greens/New Zealand First designed trading scheme) that generators are only likely to pass on half of the cost of carbon would now appear to be both incongruous and unprincipled; and

3. it is important to remember in the context of the consultation document that the practical effect of the regulations will be to entrench the emissions factor in place until 2015.[14] Therefore, it is not only long-run price movements in the next year or so that are relevant but anticipated price movements through to 2015. In addition, the emissions factor is being set in the context of a moderated scheme (i.e. a price cap and a progressive obligation). While it is difficult to forecast the future price path of carbon, one can reasonably assume that once the moderating features roll-off at the end of 2012 (just 18 months into the five year period), that the price of carbon New Zealand businesses will be facing with be significantly higher in an increasingly carbon-constrained world than the current effective price of $12.50/t CO_2.

How Activities are Described

The definition of activities lies at the very heart of the allocation regime. A failure to have an activity determined as eligible and carbon intensive could be the difference between the output continuing to be produced in New Zealand, or production shifting offshore to Asia. Business New Zealand acknowledges that the area of activity definitions is both highly technical and complex. However, Business New Zealand has the following observations:

1. while the Act is fairly prescriptive with regard to determining whether an activity is carbon intensive or not, some discretion does exist (for example, the Minister has some discretion “any other matters that Minister considers relevant”). Business New Zealand urges officials to utilise discretion at every possible opportunity;

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[12] Ministry for the Environment consultation document entitled ‘Development of Industrial Allocation Regulations under the New Zealand Emissions Trading Scheme’ dated December 2009, page 95.

[13] Op cit, page 1.

[14] In making this statement, Business New Zealand assumes that even where new regulations can be gazetted that lift the threshold of compensation immediately, that officials are unlikely to apply a different (i.e. higher) electricity emissions factor in those circumstances, but not for others. Business New Zealand also assumes that for certainty reasons, officials will not contemplate providing themselves with the flexibility to adjust the electricity emissions factor from year to year.

2. officials (or businesses for that matter) are unlikely to get it right first time. Therefore the goal should not be the pursuit of methodological perfection, but an activity definition that complies with the requirements of the Act *and* is fit-for-New Zealand business circumstances now (and not some expectation of business operating conditions in two years time);

3. officials should disaggregate industrial processes into separate activities where it acts to benefit the businesses concerned but also use site-based processes descriptions where that enables a higher intensity threshold to be reached. While the CPRS activity definitions tend to split processes, it does so on the basis that both a revenue and value-add intensity tests are being used. This is not the case in New Zealand;

4. given the novelty of the economic instrument, officials are highly unlikely to be able to accurately forecast the impact of the scheme on businesses incentives, and even less likely to be able to establish ex-post causality. Business New Zealand appreciates that it is important that the definition of activities do not result in perverse outcomes. However, in its view the risk of significant emissions leakage is greater if a strict, legalistic approach to the definition of activities is taken; and

5. it is important that officials do not 'overcook' the transformational element of the scheme's possible effects. It is widely recognised that the scheme is unlikely (at least initially) to result in significant emissions reductions. Officials should not, therefore, seek to use the activity definitions process as a vehicle to substantially change business behaviour. This is particularly relevant given international circumstances. In Business New Zealand's view, it is preferable (and less damaging to the economy) to define the activities generously (this should also help with getting them into place more quickly and so avoiding calls to delay sector entry) but then use the following years to:

    a. see what happens internationally, and

    b. refine the activity definitions as may be appropriate in light of learning-by-doing.

Other Issues

Business New Zealand has a number of other comments on a variety of issues such as officials' approach to materiality, the timeframe within the work is being undertaken, and the communications strategy.

1. *materiality (emissions rule 11)*: Ministry for the Environment proposes that a 'best endeavours' approach should be adopted. This is a helpful start but is only relevant to those circumstances where the effort required to capture and calculate the emissions from a particular

source is disproportionate to their size. Business New Zealand also suggests that a more generic materiality threshold such as those used in financial reporting, should be applied once the boundaries or edges of the activities have been determined;

2. timeframes: as noted above, a pragmatic approach to implementing the allocation regime is likely to contribute to achieving sensible, and timely outcomes. The need for pragmatism is reinforced by the inability to rely on the CPRS allocative baselines. Given the significance of the cost of carbon being faced by many businesses, signals of a less than pragmatic approach by officials is likely to result in the process becoming bogged down. This would, in turn, potentially impact on the Ministry for the Environment's ability to deliver on the following objective:

   > "The Government will make all reasonable endeavours to give firms certainty over allocation before obligations under the NZ ETS start in July 2010."[15]

   If this objective cannot be achieved then industrial process sector participants will have higher energy costs and potentially face serious cashflow implications. In light of this risk, these participants may seek to delay the sector entry date beyond 1 July 2010 for the same reasons the Minister gave behind the delay of sector entry dates from 1 January to 1 July 2010:

   > "You could not start up the ETS without the details of the allocation plans being known. Many of them (stationary energy and industrial) are processes of production. Without knowing the net impact on the prices of the goods or services they provide, it's very unfair to impose that requirement on them."[16]

   In other words, the absence of allocation for stationary energy and industrial processes would make their inclusion untenable;

3. *communication with potential participants*: the commercial implications of the allocation process, combined with the legislative exclusion if businesses do not participate in the process when required suggests that the Ministry for the Environment faces an extremely high burden of proof to inform businesses about what is happening. The Ministry for the Environment must demonstrate that it is doing all that it can to ensure that as many companies as possible are aware of the allocation process and its importance. In light of this, the Ministry for the Environment's communication strategy is almost as important as resolving matters of substance at this stage in the process;

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[15] Ministry for the Environment consultation document, Ibid, page 6.

[16] See http://nzenergy-environment.co.nz/home/free-articles/inevitable-delay-for-stationary-energy-ets-start-smith.html

4. *low carbon, high energy-intensive SMEs*: while outside the scope of this consultation, Business New Zealand remains deeply concerned about the plight of low carbon, but high energy intensive businesses who compete with overseas businesses. Despite being trade exposed, these businesses are simply expected to absorb the higher cost of energy that they will face from 1 July 2010. As the cost is from indirect sources of carbon, these businesses have limited ability to adapt (the cost of carbon will be reflected in all generator offers, including those predominantly renewable) or mitigate (this is dependent on the extent of the energy efficiency gains available). The expectation of cost absorption is simply unrealistic in the current economic conditions and we continue to urge the Government to implement some measures that will alleviate SMEs from the additional costs they will face that their competitors will not; and

5. *the scheduled review*: while also strictly outside the scope of the review, in light of the dramatically changed international context the Government should now bring the scheduled review forward.

Summary

Officials must find themselves in a quandary – that of trying to implement a scheme that works for New Zealand but is designed around a non-existent Australian scheme and the expectation of aggressive global co-operation to reduce emissions. Business is in a quandary – that of general acceptance of the emissions trading scheme and the certainty that the framework provides, but increasing disappointment with its inability to now deliver stability in the competitive landscape.

Recent events, combined with the allocation regime contained in the Act raise significant doubt about the extent to which the allocation process will deliver an outcome that is fit for the competitive environment in which New Zealand business operate.

The absence of an Australian scheme means that those opportunities expected to have been delivered in terms of the ability to manage across-Tasman competitiveness impacts, and to benefit from the considerable amount of work the Australian Government has done on industrial allocation baselines, are now moot.

Business New Zealand considers that the information presented demonstrates the need for a timely reality check for those who hold the view of the commencement of the emissions trading scheme will have a limited competitive impact. Business New Zealand considers that it has made a strong case for policy makers to err on the side of more generous compensation *per se*. This is particularly important when considering eligibility for compensation for trade-exposed carbon-intensive businesses that do not meet the New Zealand-track emissions intensity test or have no equivalent activity specified in the Australian scheme.

Officials have until our trade-competitors are pricing carbon into their economies (or the review) to recalibrate the allocation processes in a more stringent direction should that be required. In the meantime, officials should work closely with businesses to avoid the risk of carbon leakage.

Business New Zealand is happy to discuss any aspect of this submission with the Ministry for the Environment, should it wish.

Yours sincerely

John A Carnegie
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Business New Zealand

APPENDIX ONE: ABOUT BUSINESS NEW ZEALAND

Encompassing four regional business organisations (Employers' & Manufacturers' Association (Northern), Employers' & Manufacturers' Association (Central), Canterbury Employers' Chamber of Commerce, and the Otago-Southland Employers' Association), Business New Zealand is New Zealand's largest business advocacy body. Together with its 70-member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, Business New Zealand is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

In addition to advocacy on behalf of enterprise, Business New Zealand contributes to Governmental and tripartite working parties and international bodies including the ILO, the International Organisation of Employers and the Business and Industry Advisory Council to the OECD.

Business New Zealand's key goal is the implementation of policies that would see New Zealand retain a first world national income and regain a place in the top ten of the OECD (a high comparative OECD growth ranking is the most robust indicator of a country's ability to deliver quality health, education, superannuation and other social services). It is widely acknowledged that consistent, sustainable growth well in excess of 4% per capita per year would be required to achieve this goal in the medium term.