



Cabinet Economic Development Committee

Minute of Decision

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New Zealand Emissions Trading Scheme: Reform of Industrial Allocation

Portfolio Climate Change

On 29 June 2022, the Cabinet Economic Development Committee:

- 1 **noted** that there is evidence that some emissions-intensive, trade-exposed (EITE) activities are receiving industrial allocation under the New Zealand Emissions Trading Scheme (NZ ETS) at levels greater than intended to address emissions leakage;
- 2 **noted** that the Minister of Climate Change is seeking to address this over-allocation because it makes it harder to meet climate goals, puts disproportionate pressure on other sectors to reduce emissions, and is an ongoing fiscal cost to the Crown;
- 3 **noted** that the Climate Change Response (Emissions Trading Reform) Amendment Act 2020 introduced the phase-out of industrial allocation to reduce allocation through two complementary approaches:
 - 3.1 a general phase out rate: this started as an annual reduction of 0.01 in the level of assistance for all activities for the period 2021-2030, then 0.02 from 2031 to 2040, and then 0.03 from 2041 to 2050;
 - 3.2 a legislated process, which enables the Minister of Climate Change to recommend decreased or increased phase-out rates for one or more activities;
- 4 **noted** that the general phase-out reduces the risk that over-allocation will recur in future;
- 5 **noted** that the additional phase-out mechanisms provide for temporary or permanent activity-specific increases to phase-out rates, and that an intent of these mechanisms is to address any over-allocation if it does arise in future;
- 6 **noted** that in 2021, the Climate Change Commission (the Commission) recommended that the government consider over-allocation risks, eligibility rules, updates to the electricity allocation factor (EAF) and allocative baselines;
- 7 **noted** that in April 2021, the Cabinet Environment, Energy and Climate Committee (ENV) approved the terms of reference for a review of industrial allocation policy [ENV-21-MIN-0009];
- 8 **noted** that proposed changes to industrial allocation policy were publicly consulted on from July to September 2021;

- 9 **noted** that in April 2022, Cabinet agreed that officials would, as part of the emissions reduction plan, continue work on exploring the risk of emissions leakage from the cement sector and options to manage this risk through alternatives to industrial allocation policies [CAB-22-MIN-0110];
- 10 **noted** that alternative policies to industrial allocation are being progressed through a different work programme, and that any policy decisions on this matter will be sought separately;
- 11 **noted** that further changes to industrial allocation policy would be needed if an alternative emissions leakage mitigation policy is implemented;
- 12 **noted** that the Minister of Climate Change will seek advice from officials on engaging with industrial allocation recipients to enter arrangements to support rapid decarbonisation;
- 13 **noted** that the impact of the NZ ETS on electricity prices is described by the electricity allocation factor (EAF), and is a component of allocative baselines used in calculating industrial allocation;
- 14 **noted** that the EAF was set in 2012 and is no longer accurate due to the electricity market developing differently to what was modelled;
- 15 **noted** that in August 2021, ENV noted the Minister of Climate Change's consultation report on options for resetting the EAF, and invited him to report back with further detail on implementation [ENV-21-MIN-0041];

Updating allocative baselines

- 16 **noted** that allocative baselines are used in the calculation of industrial allocation;
- 17 **noted** that the allocative baselines are based on activity data from the 2006/07, 2007/08, and 2008/09 financial years, as required by the Climate Change Response Act 2002 (CCRA);
- 18 **noted** that the requirement to calculate allocative baselines from these historical years is resulting in over-allocation to some activities;
- 19 **noted** that updating allocative baselines using data from recent financial years will reflect recent emissions intensities and address most over-allocation occurring now;
- 20 **noted** that updating allocative baselines will remove windfall gains to EITE firms, and direct fiscal costs to the Crown, estimated at approximately \$60 million;
- 21 **agreed** to remove the statutory restriction setting the 2006/07, 2007/08, and 2008/09 financial years as the basis for determining allocative baselines;
- 22 **agreed** that allocative baselines be updated with a call for data from the financial years 2016/17, 2017/18, 2018/19, 2019/20, and 2020/21;
- 23 **noted** that allowing the exclusion of data from one year would smooth any distortions to production and emissions related to COVID-19 and the COVID- 19 response;
- 24 **agreed** that firms be required to provide data from all requested financial years but can exclude data from either the financial year 2019/20 or the financial year 2020/21 when calculating specified emissions and specified total amount of product;
- 25 **agreed** to enable the Minister of Climate Change to review and update allocative baselines considering data from new base years in future;

- 26 **agreed** that updates to allocative baselines using data from new base years in future can only occur five or more years after the most recent update using data from new base years;
- 27 **agreed** that the Minister of Climate Change will be enabled to call for data via Gazette notice, to provide evidence as to whether the activity is receiving industrial allocation at a level that means it no longer faces a net NZ ETS cost, and if so, use this data to update allocative baselines in future;
- 28 **agreed** that, when making later updates to allocative baselines, the Minister of Climate Change must be satisfied that the activity is receiving industrial allocation at a level that means it no longer faces a net NZ ETS cost;
- 29 **agreed** that all allocative baselines be reviewed every ten years, following their most recent review;

Reassessing eligibility

- 30 **noted** that an activity's eligibility for industrial allocation is determined by a trade exposure and an emissions intensity test;
- 31 **noted** that out-of-date eligibility test outcomes, based on 2006/07, 2007/08, and 2008/09 financial year data could be contributing to over-allocation;
- 32 **agreed** to remove the statutory restriction setting the 2006/07, 2007/08, and 2008/09 financial years as the basis for reassessing eligibility;
- 33 **agreed** to reassess the emissions intensity of existing eligible activities with the use of data from the financial years 2016/17, 2017/18, 2018/19, 2019/20, and 2020/21;
- 34 **noted** that allowing the exclusion of data from one year would smooth any distortions to emissions and revenue related to COVID-19 and the COVID-19 response;
- 35 **agreed** that the firms will be required to provide data from all requested financial years, but can exclude data from either the financial year 2019/20 or the financial year 2020/21 when calculating specified emissions and specified revenue;
- 36 **noted** that emissions intensity thresholds used in the eligibility test were set such that if an activity's emissions costs exceeded 2 percent of its revenue, it was deemed moderately emissions intensive unless its emissions costs exceeded 4 percent of its revenue, in which case it was deemed highly emissions intensive;
- 37 **noted** that emissions intensity thresholds used in the eligibility test were based on an emissions price of \$25;
- 38 **noted** that emissions intensity thresholds used in the eligibility test no longer accurately reflect the risk of emissions leakage due to the increase in emissions price, and that therefore the rationale to provide assistance to activities that have emissions costs in excess of 2 or 4 percent of their revenue is no longer preserved;
- 39 **agreed** to update the emissions intensity thresholds used in the eligibility test to reflect changes to the emissions price;

40 **agreed** that the thresholds used in the eligibility test be calculated according to the methodology set out below:

Emissions intensity category	Threshold conversion methodology
Moderately emissions intensive	$800 * \frac{25}{\text{new emissions price}}$
Highly emissions intensive	$1,600 * \frac{25}{\text{new emissions price}}$

41 **agreed** that the ‘new emissions price’ in the methodology defined above will be the ‘price of carbon’ set by or in accordance with regulations made under section 30W of the CCRA at the time the first call for data using new base years is issued;

42 **noted** that, at the time the eligibility thresholds are calculated for the purpose of reassessing eligibility, the methodology described above will ensure that if an activity’s emissions costs exceed 2 or 4 percent of revenue, it will be classified as moderately emissions intensive, or highly emissions intensive respectively, and receive industrial allocation at a level that reflects this classification;

43 **noted** that updating the emissions intensity thresholds and reassessing eligibility could result in some activities moving eligibility category;

44 **noted** that an activity moving from the moderately emissions intensive category to the highly emissions intensive category would result in an increase to the level of allocation for this activity;

45 **noted** that the above reflects the increased risk of emissions leakage to firms in carrying out such an activity because their emissions costs have increased and by definition they cannot recover those costs;

46 **noted** that the Minister of Climate Change expects any potential increases in allocation resulting from reassessing eligibility would be far outweighed by the overall reduction in allocation resulting from the full set of policy changes;

47 **noted** that reconciling the potential changes would result in a net estimated saving to the Crown of at least 600,000 NZUs or \$45 million per annum;

48 **noted** that any viable changes to the trade exposure test would not better support the objectives of the NZ ETS, nor would they better address over-allocation or the risk of emissions leakage;

49 **noted** that the Minister of Climate Change is not proposing any change to the current trade exposure test;

50 **noted** that a five-year delay exists in implementation of any reclassification of an eligible activity from highly emissions intensive to moderately emissions intensive, or from moderately emissions intensive to ineligible;

51 **noted** that there is a need to retain some delay before a decrease in an activity’s level of assistance comes into effect to ensure firms have a level of regulatory certainty, but that this needs to be balanced with correcting over-allocation as soon as practicably possible;

52 **agreed** to reduce the five-year delay period for a decrease in eligibility classification to two years;

- 53 **noted** that reducing this delay period imposes some regulatory risk, and increases the risk of emissions leakage but addresses over-allocation sooner;
- 54 **noted** that any policy decisions would be signalled in 2022, and that relevant amendments to legislation would come into force in 2024;
- 55 **noted** that this would mean four years of advance warning of a possible reduction in allocation due to eligibility reassessment;
- 56 **noted** that there is no delay period for increases in allocation due to eligibility reassessment;

Changing the approach to assessing eligibility for new activities

- 57 **noted** that the CCRA allows for new industrial activities to seek eligibility for industrial allocation, but that the process is unclear;
- 58 **noted** that the CCRA is silent on how eligibility would be assessed if an activity was not carried out in the historic base years, and that this could act as a barrier to new, less emissions intensive activities seeking eligibility;
- 59 **agreed** that new activities continue to be able to seek eligibility for industrial allocation;
- 60 **agreed** that eligibility assessment for new activities requires consideration against the criteria outlined in section 84C of the CCRA that the Minister must consider when recommending increases to phase-out rates for industrial allocation, instead of using the emissions intensity and trade exposure criteria;
- 61 **noted** that the above process for new activities to seek eligibility would involve the Governor General, via Order in Council, on the Minister's recommendation, recognising a new activity as eligible for industrial allocation after consideration of the criteria referenced in section 84C of the CCRA;
- 62 **noted** that while using a more rigorous set of criteria to determine eligibility for new activities might seem inequitable, it is impractical to use the same criteria for existing activities – the emissions intensity thresholds – because firms performing the new activity would not have any data to provide for such a purpose;

Enabling easy updates to allocative baselines and access to data

- 63 **noted** that the calculation of allocative baselines depends on NZ ETS emissions factors, the EAF, and NZ ETS exemption thresholds, and that these could be updated in future;
- 64 **noted** that updating allocative baselines to reflect updates to NZ ETS emissions factors, the EAF and NZ ETS exemptions thresholds requires a call for data process;
- 65 **noted** that failure to update allocative baselines to reflect changes in these factors risks activities being under- or over-allocated relative to these emissions cost impacts;
- 66 **agreed** to enable allocative baselines to be re-calculated using previously submitted data to reflect changes to NZ ETS emissions factors, the EAF, and NZ ETS exemption thresholds, and that these updates will not be subject to call for data requirements or consultation;
- 67 **noted** that the CCRA limits the ability of the Environmental Protection Authority (EPA) to share emissions return and industrial allocation application data;
- 68 **noted** that the above can act as a barrier to the monitoring and policy development of industrial allocation;

69 **agreed** to require the EPA to share information submitted in industrial allocation applications with the Commission and Ministry for the Environment on request;

Resetting the electricity allocation factor

70 **noted** that in 2021, the Minister of Climate Change consulted on options for methodological changes to the EAF, which is an important part of the rates of allocation certain activities receive in the NZ ETS;

71 **noted** that in August 2021, ENV invited the Minister of Climate Change to report back with further details on the methodology and options for its implementation [ENV-21-MIN-0041];

72 **noted** that the Minister of Climate Change's preferences for the new methodology will provide transparency and minimise variability, while ensuring accuracy over time;

73 **agreed** that the calculated annual EAF value used to determine allocative baselines be determined using an electricity market model that:

73.1 is publicly and freely available, alongside all input data required to operate the model;

73.2 is compliant with Schedule 13.3 of the Electricity Industry Participation Code, meaning it accurately replicates the market clearing algorithm used by the System Operator (Transpower);

73.3 uses a counterfactual input of a reasonable estimate of what offers would have been made by the factual generation stack in the absence of emissions pricing;

74 **agreed** that the EAF in regulations used to determine allocative baselines must be updated each year to be the rolling average of single year EAF values for each of the previous three years;

75 **agreed** that the rolling average EAF will be calculated by the Electricity Authority each year in July, using data up to the end of the financial year ending 30 June;

76 **agreed** that changes to the EAF value used to determine allocative baselines can be made without public consultation;

77 **authorised** the Minister of Climate Change to make annual policy decisions on the EAF used to determine allocative baselines for the purpose of issuing drafting instructions for amendment to the Climate Change (Eligible Industrial Activities) Regulations 2010;

78 **agreed** that the Minister of Climate Change may recommend regulations to set input assumptions for modelling of the EAF, following consultation with those likely to be substantially affected;

79 **agreed** that the consultation requirements will not apply to the first modelling assumptions set in accordance with the above paragraphs;

80 **agreed** that the following modelling assumptions be set in regulations:

80.1 thermal generation (generally offered at relatively high prices) would be offered at lower prices because the removal of emissions pricing reduces their marginal costs;

80.2 hydro generation plants with controllable storage would adjust their offer prices in response, because lower overall prices mean the opportunity cost of water would be lower;

- 81 **agreed** that the Minister of Climate Change can recommend amendments to the modelling assumption regulations, if necessary to improve accuracy, following public consultation;
- 82 **noted** that implementation of the updated methodology is contingent on amendment to the CCRA;

Next steps

- 83 **authorised** the Minister of Climate Change to further clarify policy decisions relating to the amendments above, in a way consistent with Cabinet's decisions;
- 84 **invited** the Minister of Climate Change to issue drafting instructions to the Parliamentary Counsel Office to give effect to the above decisions;
- 85 **noted** that, subject to policy and legislative changes for industrial allocation, a data collection exercise will need to occur to inform updates to allocative baselines and retesting of eligibility;
- 86 **noted** that the Climate Change (Eligible Industrial Activities) Regulations 2010 would need amendment to prescribe updated allocative baselines and levels of emissions intensity.

Janine Harvey
Committee Secretary

Present:

Hon Grant Robertson (Chair)
Hon Carmel Sepuloni
Hon Stuart Nash
Hon Kiri Allan
Hon Priyanca Radhakrishnan
Hon Meka Whaitiri
Hon Phil Twyford
Hon James Shaw
Rino Tirikatene, MP
Dr Deborah Russell, MP

Officials present from:

Officials Committee for DEV