Submission by

to the

Ministry for the Environment

on the

Annual updates to New Zealand Emissions Trading Scheme limits and price control settings for units 2024

14 June 2024

– A BUSINESSNZ AND BUSINESSNZ ENERGY COUNCIL (BEC) SUBMISSION – ANNUAL UPDATES TO NZ ETS LIMITS AND PRICE CONTROL SETTINGS FOR UNITS 2024

Introduction

1. We welcome the opportunity to provide feedback to the Ministry for the Environment on its consultation document titled the *Annual updates to New Zealand Emissions Trading Scheme limits and price control settings for units 2024.*

2. BusinessNZ and BusinessNZ Energy Council (BEC) supports New Zealand's net-zero carbon target. Collectively, New Zealand's business community has a dominant role in achieving reductions sought under the Paris Agreement. The Emissions Trading Scheme (ETS) underpins this role, remaining the main tool motivating businesses to undertake emission reductions.

3. The strategic direction of ETS policy, including its unit and price settings, is therefore important to New Zealand's business community. The direction set by the Government has the potential to hasten investment in emission reductions, if the cost of avoiding emissions is less than the carbon price, keeping New Zealand comparable with its peers while creating economic and social benefits beyond climate change objectives.

4. Equally, the direction set by the Government risks increasing the costs of doing business beyond what is optimal and necessary to achieve our targets, damaging the commercially viability of operating in New Zealand. This is especially true for energy intensive businesses that play an important role in our economy.

5. A more costly transition which diverts private and public resources away from alternative investments, which command equally important weight, would minimise the potential economic and social wellbeing of current and future generations. The choices highlight tight tensions and trade-offs between the costs and benefits of possible pathways the ETS could trek.

6. This submission addresses questions set out in the consultation document relating to setting changes and other matters as they relate to methodology/technical changes. Beyond these questions, this submission outlines broader strategic positions we recommend the Government's ETS policy should pursue and retain, as well as discussing further concerns and considerations on behalf of New Zealand's business community.

Summary of recommendations

- We recommend restoring regulatory certainty by way of legislating issued and allocated units over a longer period, preferably out to 2050, or at the minimum, over the three budget periods to 2035.
- We recommend retaining the current ETS structure and principles to ensure the lowest cost pathway to net-zero.
- We recommend addressing externalities the Government deems a problem through non-ETS measures. This could include bonding and insurance instruments to deal with afforestation externalities.
- We recommend amending the Climate Change Response Act to strengthen incentives to undertake emission reductions.
- We support the Commission's recommendation to adjust unit volumes to account for methodological changes made in the 2023 Greenhouse Gas Inventory.
- We recommend the Ministry undertake, or release, more analysis to confirm the Commission's stockpile estimate and the assumptions underlying its estimation before volumes reduce. This will help ensure volume reductions accurately reflect the level of surplus units without weakening the effectiveness and function of the ETS.

- We recommend evaluating alternative measures that could replace or complement current price setting arrangements as part of the Government's strategy to strengthen the ETS.

Comments on broader positions beyond setting changes outlined in the document

Retain the current structure and ensure the lowest cost pathway to net-zero

7. The ETS is a powerful tool, internalising the cost of emitting by way of signalling to emitters the scarcity of the environment's limit to withstand carbon emissions. Decisions about where net-emission reductions come from are decentralised and technology neutral. **We recommend retaining this principle.**

8. This approach works well, as in contrast, centralised decisions discerning the exact balance in the ETS between gross reductions and sequestration is at risk of being determined on incomplete information that is forever changing and quick to be outdated.

9. Reaching net-zero requires thousands if not millions of decisions from the level of individual, household, and business. Information underpinning these decisions, including different business strategies, asset lifecycles, individuals' willingness to pay, risk appetites, consumer preferences, all in the backdrop of shifting market dynamics and emerging technologies, is not completely known to policymakers.

10. There are concerns about externalities resulting from the current approach, which can be addressed through non-ETS instruments, as discussed later. Nevertheless, **the core principles and foundations underlying the ETS structure remain sound. We recommend retaining the current structure**. Retaining the current structure, with forestry remaining in the ETS, will find the lowest cost pathway of both gross reductions and sequestration to reach net-zero.

11. In other words, it ensures New Zealand can achieve our target without it being more costly than it needs to be, while upholding the principle that the atmosphere cannot differentiate between one tonne abated at its source and one tonne sequestered from forestry. In contrast, continued tweaks aimed at rebalancing the ETS to favour gross reductions in sectors preferred by the Government, follows a more costly path which embeds uncertainty.

Restore regulatory certainty by way of legislating issued and allocated units over a longer period, preferably out to 2050, or at the minimum, over the three budget periods to 2035.

12. Over the past four years, the signal sent by the carbon price, setting the direction of travel and the level of investment in new technology, has been weakened by persistent regulatory uncertainty. A significant cause of the uncertainty has been driven by constant change and proposed changes to ETS unit and price settings. Yearly consultations leading up to the current day have repeated cycles of uncertainty. Speculation on what the level of units available at auction might be and the price corridor they might follow has not aided market stability.

13. Uncertainty has been exacerbated by threats to the underlying structure of the ETS, risks to the property rights of forestry NZUs due to the 2023 ETS review and commentary pitting sequestration against gross emission reductions. Providing the market with more certainty and confidence about the structure of the ETS out to 2050 and the level of units available over this period should be a top priority. We are pleased the Government is committed to restoring regulatory certainty to the ETS.

14. Establishing the regulatory frameworks which businesses operate under, followed by preserving the core foundations of such regimes over time, is a prerequisite for business investment.

Uncertainty about the durability of regulatory regimes stunts and can delay investment until uncertainty settles. The same is true for ETS policy. Uncertainty about ETS policy, including climate change policy more generally, undermines investment. Constant interference should therefore be avoided.

15. There is an inherent trade-off between stability, improving investment certainty, and on the other hand, frequent amendments, reviews, and proposed changes to settings, improving the regime's function. Both are important. But we believe the current approach has frequently tipped disproportionately towards the latter at the cost to market stability and investment certainty.

16. **We recommend the ETS settings, once in accordance with New Zealand's emission targets, should remain in place for a longer period. The sinking cap of units to be issued or allocated between now and 2050, or at the minimum, over three budget periods out to 2035, should be fixed and known to the market by way of legislation.** The market will adapt accordingly, better informing their investment decisions.

17. Despite the current approach providing flexibility and an annual opportunity to reset the cap if amendments are required, **we believe the process for determining ETS settings for five years ahead is too frequent**. Over the past three years, yearly setting amendments have regularly changed the outlook businesses operates under. There is a general expectation that setting changes are excluded for the first two years, unless due to special circumstances as described in the Act. This provides some confidence and reassurance.

18. However, yearly consultation and changes to the five-year, and possibly two-year outlook, provides a large shadow over final investment decisions that have paybacks longer than two to five years. This is especially true for emission reduction investments involving large sums and complex plans. Sovereign risk paralyses such plans and in doing so undermines the political durability of the regime.

Price control trigger price and volume

19. The consultation document outlines two options for price settings. First, maintain the status quo. Second, lower the trigger price corridor. We question the paper's justification for lowering the trigger price corridor and the auction volume, including the problem this option aims to address. The problem definition is not articulated.

20. If the Government adjusts auctions in 2025 and 2026, instating a lower price corridor and a reduced auctioned volume, it should signal a clear and reasonable justification to the market. Change could be justified as written under legislation on the "proper functioning of the ETS." However, the ETS is functioning currently and the current market price being lower than the floor price does not indicate that the floor is set incorrectly. Low prices seem likely to stem from uncertainty, described above, and less demand, as well as discussions about lowering the floor without providing clear price guidance.

21. We emphasise that recent auction clearance failures do not reflect a market failure. When auctions have not cleared, it signals the market determines that there is enough supply to meet demand without the need to access auctioned units. As a result, the market is self-solving any assessed oversupply at a price below the floor. Should the auctions fail to fully clear beyond the December auction, any on sold volume will be removed from the market with the effect of reducing the surplus or stockpile. This self-correction will occur independently, removing the need to intervene. Lowering the price control trigger corridor to account for failing auctions or less short-term demand than expected does not improve the 'functioning' of the market.

22. However, this is not an admission that problems do not exist with the current approach to setting the level of reserve units, the price they are released and the auction floor price. Determining the price floor, CCR price level and the volume of reserve units, is problematic given evolving market, technological, economic, and social trends.

23. Uncertainty about abatement cost curves, including the assumptions and scenarios used to model a price range consistent with meeting emissions budgets, underline the inherent limitations of setting price controls in their current form. It highlights the potential value of alternative measures that could better protect against carbon leakage and ensure consistency with international prices without constant top-down tinkering to price settings.

24. **We <u>recommend</u> assessing alternative measures that could replace or complement current price setting arrangements as part of the Government's strategy to strengthen the ETS.**

Address externalities through non-ETS measures, not through ETS settings

25. As noted, the uncertainty to whether forestry remains in the ETS has casted more uncertainty. Its possible removal distracts from following the lowest cost combination of gross reductions, sequestration, and capture. Concerns relating to forestry remaining in the ETS centre around several externalities. This includes the economic impact on local communities and risks of fire and extreme weather on the Government's future obligations. These concerns are justified but they should be addressed through non-ETS instruments rather than ETS price and unit settings.

26. Over the past years, the ETS has been asked to do too much. Its role is to simply provide a price signal, reflecting the marginal cost of emitting an additional tonne of carbon. Distorting the price in the effort to resolve the externality does not effectively address the externality. It only undermines the tool itself. The externalities require their own separate measures.

27. As noted in previous submissions, in principle, **we <u>support</u> the adoption of non-ETS instruments to address the externalities resulting from afforestation**. Concerns about the level of afforestation and its economic impact on regional communities could be addressed through land-use planning and consenting from the local council level.

28. Substantive evidence of a problem however will need to be assessed before any options are considered. Arbitrary and blanket changes to land-use planning would likely impair the property rights of landowners and should require compensation for regulatory taking. It could risk constraining or restricting afforestation on land with low to very little risk of causing external costs upon public property or other landowners.

29. Fire and weather risk could be addressed through bonding and insurance instruments. They would be best designed to reflect risk and internalise external costs. Internalising costs, including the cost of slash, would help incentivise better forest management and discourage planting on high-risk land. Again, such measures should be assessed on their own costs and benefits.

Strengthening the power of industrial allocations to drive emission reductions

30. The Climate Change Response (CCR) (Late Payment Penalties and Industrial Allocation) Amendment Bill, passed in 2023, introduced legislative changes relating to industrial allocations under the ETS. Several changes were welcomed. Other changes were opposed due to their impact on discouraging investment. Further amendments to the Act aimed at removing barriers and uncertainty to investment would represent a quick and easy win to encourage emission reductions without direct cost to taxpayers beyond changes to legislation.

31. We supported a one-off reset to allocative baselines in 2023 to support the future integrity of the ETS, updating baselines to 2016-2021 data. Conversely, amendments that locked-in periodic allocative baseline reviews every ten years, and activity specific baselines every five years based on the Minister's satisfaction that allocations are equal to or greater than emissions cost, has baked-in uncertainty and disincentivised step-change investments in emission reductions.

32. If a firm which receives allocations invests in emission reduction technology, its allocative baseline is at risk of being reset to account for the emission reduction. Despite the main role of allocations acting as an instrument to minimise carbon leakage, they also incentivise and improve the commercial viability of emission reduction projects. NZUs no longer required for meeting future surrender obligations can be sold, helping to fund the project.

33. For example, an industrial user wants to substitute natural gas with electrolysis for making hydrogen. The capex and opex is high. The investment has a long payback period, ten to fifteen years. For sake of argument, the project significantly reduces its emissions. The allocation it continues to receive, be it reducing to zero over the coming decades due to the legislated phasedown rate, helps fund the investment's payback over the period.

34. However, the presence of a periodic review every ten or five years, possibly stripping away the payback, overshadows the final investment decision. The investment itself involves risk with high capex and opex. The periodic reviews worsen the risk and encourages firms to purchase NZUs today to offset future liability and defer step-change reductions until the reset risk is alleviated by the level of phase down. Inadvertently, the firm is now incentivized to keep emission reductions above or at the level of phase down, slowing emission reductions.

35. This is not isolated to a hypothetical example. Its presence is disincentivising New Zealand's allocation recipients' investments in emission reductions. Legislative changes in 2023 have led to increased uncertainty and dampened incentives. This outcome is counter to the Government's climate obligations and most importantly an undesirable outcome for the climate.

36. **We <u>recommend</u> amending the CCR Act to include the Minister's consideration for capital and operating expenditure when testing the over-allocation of units.**

37. Providing legislative assurance that the Minister would consider the capital and operating expenditure undertaken by a firm before any baselines are reset would reduce uncertainty and strengthen the incentive to invest in step-change emission reductions. Any concern about over-allocation is counteracted by the legislated phase-down rate overtime.

<u>Comments on specific BAU steps in the consultation document</u>

Step 1: Align with climate change targets

38. As mentioned in the document, the first step sets out how unit limits align with New Zealand's emissions budgets, NDC and the 2050 target. The paper outlines three options. First, retain the status quo. Second, apply minimal adjustments to account for methodological changes. Lastly, adjust settings further to account for non-ETS policies.

39. **We <u>support</u> the Commission's recommendation to adjust volumes to account for methodological changes made in the 2023 Greenhouse Gas Inventory (GHG Inventory).**

40. We view adjustments to account for methodological changes to the GHG inventory as necessary to support the regime's integrity. Accurate data and information on carbon emissions is important to upholding the credibility of how emissions are calculated.

41. The paper seeks feedback on whether auction volumes should be tightened to reflect emission reductions resulting from non-ETS policies such as the Government Investment in Decarbonising Industry (GIDI) Fund. In principle, we support tightening the cap to offset the water-bed effect resulting from this policy. Without tightening the cap, NZUs no longer demanded are available to other participants, dampening prices without reducing net-emissions.

42. Notwithstanding the effectiveness of non-ETS policies to address coordination problems, solve 'chicken-and-egg' problems and speed-up project timelines, it highlights the limits of non-ETS policies to reduce net-emissions, unless the cap is also adjusted.

43. On the other hand, as noted in the paper, tightening unit volumes to reflect reductions resulting from non-ETS policies would likely mean over-achieving New Zealand's emissions budgets, buffering against the need for offshore abatement to achieve our NDC. However, this comes with a cost in the form of higher prices.

44. Non-ETS policies, like GIDI, were in part justified to keep carbon prices from 'going too high.' Adjusting the cap to account for the water-bed effect would likely have short-term inflationary and distributional impacts the Government should consider. This highlights the inherent trade-off between over-achieving our emission budgets and the costs the Government, businesses and individuals are willing to pay.

Step 2: Allocate the emissions budgets to NZ ETS and non-ETS sectors

45. We agree with the calculation outlined in step 2.

Step 3: Technical adjustment

46. We do not oppose the technical adjustments made in step 3.

Step 4: Account for industrial allocation volumes

47. We agree with the calculation of industrial allocation volumes outlined in step 4.

Step 5: Set the reduction volume to address unit surplus.

48. The Commission has updated its unit surplus estimate to 68 million units, within a range of 51 – 81 million units. This is an increase of 19 million units since 2022 estimates. The paper outlines three options: continue with current settings, update the reduction for 2027-28 to account for the estimated surplus, and lastly, update surplus reductions for 2025-28 to reflect the new surplus estimate.

49. The Ministry notes that the Commission's recommendations are more likely to be in strict accordance with meeting emissions budgets. **We believe the proposed changes to auction volumes, as recommended by the Commission, based on the estimated stockpile is concerning due to uncertainty about the stockpile**. There is a large variation in the estimated stockpile, and therefore uncertainty about its actual figure. There is also little detailed analysis publicly available on how the Commission derived its estimate, nor the assumptions underlying its estimation.

50. **We <u>recommend</u> the Ministry undertake, or release, more analysis to confirm stockpile assumptions before reducing the volumes available at auction. Confirming the extent of the surplus will ensure any volume tightening accurately reflects a sufficient problem without inadvertently damaging the effectiveness and function of the ETS.**

51. If unit volumes are tightened further in 2025-28 based on an overly optimistic stockpile surplus estimate, and auctions fail to clear, there is a material risk the market may lack sufficient liquidity. The Commission's analysis which has guided the recommendations to tighten volumes has not adequately considered the outcome where auctions fail for the rest of the year. If auction failures occur and auctioned volumes are also reduced starting in 2025, the market could have less units available than the Commission expects.

52. Sufficient liquidity is a vital component of a functioning ETS market, ensuring surrender obligated parties can obtain units at the right time and price. Continued volume tightening increases the material risk participants will not be able to obtain units required to meet their surrender obligations, with the possible likelihood of increased speculation, hoarding, market volatility and liquidity issues.

53. Considering regulatory certainty is undermined if volumes change, with participants most likely required to adapt their market strategies, it is important that change is justified and demonstrated. Evidencing rigour of assumptions and forecasts will provide more confidence and certainty that such change is needed to meet New Zealand's climate targets. As it stands, such robust certainty and confidence is lacking.

54. We are also concerned about the Commission's current forecasting approach to forestry mandatory emissions reporting periods (MERPs) as it relates to the Commission's final unit volume recommendations. A main driver of the Commission's revision was based on new evidence of forestry unit flow.

55. This evidence should have been foreseeable as from 2017/18 the trend of a peak issuance of units at the end of MERPs had become clear. Despite not knowing that exact number in previous years' advice, the 2022/23 period could have been foreseen, forecasted, and incorporated into the Commission's recommendations. An adjustment to the Commission's forecasting approach would be valuable.

Step 6: Set the approved overseas unit limit

56. International units will be important to provide flexibility in New Zealand's transition pathway longer term. Work is needed to consider the role and ability of the Government to leverage Article 6 of the Paris Agreement. Enabling access to international markets may help New Zealand deliver stronger global contribution that better reflects the lowest cost pathway to reach net-zero domestically and internationally.

Appendix One - Background information on BusinessNZ and BEC

BusinessNZ is New Zealand's largest business advocacy body, representing:

- Regional business groups EMA, Business Central, Canterbury Employers' Chamber of Commerce, and Employers Otago Southland
- Major Companies Group of New Zealand's largest businesses
- Gold Group of medium sized businesses
- Affiliated Industries Group of national industry associations
- ExportNZ representing New Zealand exporting enterprises
- ManufacturingNZ representing New Zealand manufacturing enterprises
- Sustainable Business Council of enterprises leading sustainable business practice
- BusinessNZ Energy Council of enterprises leading sustainable energy production and use
- Buy NZ Made representing producers, retailers and consumers of New Zealand-made goods

BusinessNZ 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 and services for enterprise, BusinessNZ contributes to Government, tripartite working parties and international bodies including the International Labour Organisation (ILO), the International Organisation of Employers (IOE) and the Business and Industry Advisory Council (BIAC) to the Organisation for Economic Cooperation and Development (OECD).

The BusinessNZ Energy Council (BEC) is a group of New Zealand's peak energy sector organisations taking a leading role in creating a sustainable energy future. BEC is a division of BusinessNZ, New Zealand's largest business advocacy group. BEC is a member of the World Energy Council (WEC). BEC members are a cross-section of leading energy sector businesses, government and research organisations. Together with its members BEC is shaping the energy agenda for New Zealand.

Our vision is to support New Zealand's economic wellbeing through the active promotion of the sustainable development and use of energy, domestically and globally. With that goal in mind, BEC is shaping the debate through leadership, influence and advocacy.