Submission by

to the

Ministry for the Environment

on the

Reforming the New Zealand Emissions Trading Scheme: Proposed settings

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1. INTRODUCTION

1. BusinessNZ[1] welcomes the opportunity to provide feedback on the consultation document 'Reforming the New Zealand Emissions Trading Scheme: Proposed settings.'

2. The key premise for our submission is that greater ambition, and therefore policy action, is not only increasingly accepted, but welcomed by many businesses (no more tangibly demonstrated than through leading businesses pledging to adopt science-based targets). However, the greater ambition needs to be balanced with the long-term durability of the framework and policy settings being put in place. To ensure this durability, a holistic approach must be taken to policy decisions, one that would recognise the inter-dependent nature of various Government work streams running in parallel.

3. We are therefore concerned about what appears to be a fragmented and rushed policy push. The current array of consultations involve overlapping and sometimes contradicting proposals. In some cases, assumptions are based around unproven and/or yet to be implemented additional policy measures (e.g. EV incentives, Clean car standard and clean car discount programmes). In other cases, the impact assessment is incomplete. All this goes to undermine business confidence and the base on which investment decisions are made. We have previously commended MfE for having adopted a progressive approach to the development of an incredibly complex system by staging the consideration of the issues. It would be regretful to see this undone.

4. In this submission, we address the questions asked in the consultation paper bearing in mind our general position on the following key issues:

   — Policy decisions on the pace of emissions reduction must be based on a good understanding of the trade-offs between emissions benefits and business costs.
   — The settings for determining price bands must be reasonably transparent to enable market participants to form expectations around price paths.
   — The issue of accessing international units must be addressed with urgency given the expected level of abatement, and to provide any confidence that the CCR will be an effective tool.
   — Before the CCC advice is available, a cautionary approach on policy decisions would be warranted.

2. SUMMARY OF RECOMMENDATIONS

BusinessNZ:

— Agrees with the proposal to set net emissions for 2021 and 2020 at levels held at 2020 to allow determining auction volumes before CCC is set up.

[1] Background information on BusinessNZ is attached as Appendix One.

- Has reservations towards a number of sector-specific assumptions used in the MAC report that underpins the analysis in this consultation paper and recommends that these assumptions are first verified with the industry participants.
- Agrees with the Government's determination that no adjustments should currently be made to the overall NZU auction supply.
- Recommends that withholding volumes from auctions as a means to deal with the NZU stockpile be delayed until a better understanding is formed of the possible impacts on secondary market supply.
- Disagrees with the calculations used to reach the proposed annual auction volumes, due to:
    - Insufficient analysis on the impacts that withholding auction volumes may have on future market supply as compared to expected supply.
    - Incomplete assessment of appropriate free allocation volumes given that these volumes were determined in isolation from other strands of allocation reform.
- Prefers the introduction of a technical auction reserve price as proposed in the December 2019 consultation on ETS auction rules.
- Recommends a more gradual increase of the FPO, so that it is set at $30 for the 2020 emissions year, and $35 for the 2021 emissions year.
- Does not comment on the specific value of the price trigger level, given the insufficient evidence provided, and recommends that the settings for determining the price trigger be made more transparent.
- Recommends a review of the formula for CCR volumes to consider impacts from withholding auction volumes (due to stockpiled units), and that provisions should be put in place to clarify how the market could source the extra 10% of "potential additional demand" when required.
- Supports the principle that the most cost competitive carbon abatement should be pursued (with the safeguards to ensure unit integrity) and recommends that the Government accelerate its work on identifying options for accessing international carbon markets.

3. DETAILED ANSWERS

Provisional emissions budget

Q1	Do you agree with the proposal to set a provision emissions budget of 354 $MtCO_2e$ for the 2021-25 period? If not, why not? Please include your views on: — Using a straight-line approach towards the 2050 target — The considerations that were included in proposing the provisional emissions budget

5. With regards to the approach for setting emissions budgets, BusinessNZ has the following view:

   — We agree with the proposal to set net emissions for 2021 and 2020 at levels held at 2020. This will allow determining auction volumes before CCC is set up.

   — A straight-line approach over the short-term may be appropriate given its simplicity and the requirement to provide a five-year forward view of auction volumes to the market. We note, however, that CCC is expected to provide its recommendations on the first three emissions budgets in early 2021, and these may supersede the straight-line approach proposed in the consultation paper.

   — Some of the analysis used to determine the ETS settings relies on other work streams that are currently running in parallel, such as the review of the Electricity Allocation Factor, and MBIE consultations on accelerating renewable generation and energy efficiency. The outcomes of these inter-related work streams may have a material impact on emission budget settings. Given the time constraints that require decisions to be made with less information than desirable, we recommend that a cautionary approach is taken to setting the provisional emissions budget in the short term.

   — Over the long-term, the CCC will need to strike a balance between (i) the global imperative to "front-load" emissions reductions given the higher cost of delayed action on emissions as reported in many studies,[2] and (ii) the pace at which the economic costs of the low-carbon transition could increase in response to different carbon budgets. For example, tighter budgets are likely to increase electricity prices,[3] and the pace of such increase is important because electricity is a critical enabler of the low-carbon transition. Overall, and as noted in previous submissions, BusinessNZ believes that domestic emission control efforts need to be commensurate with the international action on climate change.

6. With regards to sector-specific abatement, BusinessNZ has the following view:

   — We agree that the sector-specific effort required to meet the provisional budget is ambitious, but we question how MfE has factored issues such as investment cycles (e.g. what assumptions were used in capital replacement timeframes), availability of capital, and time to implement and run low-carbon projects.

   — Table 1 in the consultation paper (p.28) provides a breakdown of the annual abatement effort that would be required by sectors to meet the provisional emissions of 354 $MtCO_2e$ over the 2021-25 period. Our understanding is that the estimates in this table are based on MfE's recent analysis of marginal abatement

[2] A number of studies have shown that delaying action increases the costs of reducing emissions. See for example https://www.annualreviews.org/doi/abs/10.1146/annurev-environ-102017-025817, https://voxeu.org/article/cost-delaying-action-stem-climate-change-meta-analysis, https://www.carbonbrief.org/every-five-year-delay-in-meeting-paris-goals-could-add-20cm-to-global-sea-levels. Amongst other reasons, the higher cost is due to locking-in investments in high-carbon assets with long useful lives and also due to the increased concentration of carbon dioxide with disruptive effects on natural cycles.

[3] See for example ICCC' report on accelerated electrification https://www.iccc.mfe.govt.nz/what-we-do/energy/electricity-inquiry-final-report/accelerated-electrification-evidence-analysis-and-recommendations/

cost curves (MACC),[4] which references the analyses by Dr Atkins on the abatement options for industries.[5]

— We question the validity of some of the assumptions used for assessing the abatement potential for the steel industry, which include "blast furnace optimisation" as an abatement option (p.28 in the MACC report). This is totally incorrect as NZ Steel does not even use blast furnace technology. We consider assumptions for other industries (e.g. aluminium, cement and refining) are also incorrect. This not only invalidates the mitigation assumptions in Table 1 of the consultation paper but challenges the credibility of MfE's analysis.

— Furthermore, it is unrealistic to expect process efficiency improvements in heavy industry to meet the proposed reductions. Efficiency improvements have already been made, and it is impractical to obtain energy for high grade process heat from non-fossil fuel sources. High costs of electricity (both energy and connection costs) will act as a significant disincentive for electrification of process heat. Despite new renewable generation, prices will remain high as the system will reflect thermal costs for marginal generation.

— Lastly, the consultation paper notes that the proposed emissions budget through to 2025 will require the remaining baseload gas-fired power station to be displaced by new wind and geothermal stations by mid-2024. With respect to electricity generation, we would like to note that achieving emissions reduction cannot be seen in isolation from the other two objectives of ensuring reliability and security of supply. Displacing thermal plant without first having a plan to solve New Zealand's storage problem puts the security and reliability of our electricity supply at risk. This aspect must necessarily be considered when determining the appropriate emissions budgets.

Unit supply settings

Q2	Do you support the decisions made regarding the technical volume adjustment decisions? If not, why not?
Q3	Are there any adjustments that need to be considered?

7. We consider that technical volume adjustments are generally needed in the scheme due to legacy ETS settings, and for the other reasons outlined by the Government. Over the long term, we support the Government's continued monitoring of participants' compliance with their surrender obligations and the intention to further strengthen those efforts.

[4] https://www.mfe.govt.nz/sites/default/files/media/Climate%20Change/marginal-abatement-cost-curves-analysis_0.pdf
[5] https://www.eeca.govt.nz/assets/Resources-EECA/research-publications-resources/Options-to-Reduce-New-Zealands-Process-Heat-Emissions.pdf

8. We agree with the Government's determination that no adjustments should currently be made to the overall NZU auction supply due to technical considerations and forestry, for the reasons given in the consultation paper.

9. However, we would like more clarity on the processes in place to ensure the key issues are addressed in the future in a timely manner. For example, addressing the differences in domestic and international forestry accounting standards may affect how/whether NZ ETS can link with other carbon markets.

Q4	Do you agree with the proposal to address the NZ ETS unit stockpile by reducing the annual volume of NZUs available for auction? If not, why not?
Q5	Do you agree with 27 million NZUs being removed from auction volume between 2021-25? If not, why not?

10. We question the basis on which the volumes to be withheld from auctions have been determined (54 million NZUs over 2021-2030, with half of that in the 2021-2025 period). The consultation paper notes that "targeting the same volume as held by individuals or businesses with no direct surrender obligations provides assurance that these NZUs are available to be sold" (p.46).

11. We disagree with this conclusion. If there is expectation for NZU prices to rise, then the incentives to bank NZUs holdings become stronger as it allows unit holders to benefit from higher prices in the future. Therefore, it cannot be concluded with certainty that the volumes withheld from auctions will be offset by increased supply in the secondary markets originating from businesses with no direct surrender obligations.

12. A better understanding is required of how businesses with no direct surrender obligations respond to different price signals. There is a real risk that withholding volumes from auctions would result in an artificial shortage of units in the market (relative to the expected supply underpinning the ETS budgets). As a consequence, NZU prices may rise to a level that would unnecessarily trigger the CCR.

13. More broadly, and putting the volumes question aside, we would like to note that if the proposed approach is used, it creates a precedent whereby any future increase in the NZU bank could be offset by a future withholding of auction volumes.[6] This could create uncertainty around unit supply if corrections to auction volumes imply an ETS cap that is significantly different from that expected under the published emissions budgets.

14. Although we accept that the issue of stockpiled NZUs must be dealt with, we would like to see what alternative options have been considered (e.g. burden sharing with non-ETS sectors), and the reasoning for preferring the option presented in the consultation paper.

Q6	Do you agree with the steps and calculations taken to reach the proposed annual auction volumes?

[6] This issue would arise due to the ability to carry over units from one emissions budget to the next.

15. We do not agree with the calculations to reach the proposed annual auction volumes for the reasons described above with regards to stockpile adjustments, and for the reasons below with regards to free allocation.

16. Step 3 in the determination of the NZ ETS cap involves taking into account free NZU allocation volumes. The Government proposes that 44 million NZUs be freely allocated over the period 2021-25, which was determined based on a phase-down rate of 1 per cent per year (from 2021) but excluding considerations of the electricity allocation factor (EAF) that the Government is currently reviewing.

17. We believe that determining free allocations in isolation from other proposed allocative changes is a major omission. Our view is that the three strands of allocation reform (i.e. those affecting the Level of assistance (LA), allocative baseline (AB), and EAF) must be the subject of a holistic/integrated public assessment by the Climate Change Commission who will make recommendations to the Minister regarding amendments to the allocation provisions.

18. Any change to the allocation rules must be done in a way that provides predictability of future settings, so that businesses can estimate the impact of policy changes and make the necessary (often significant) capital investments to reduce emissions from their operations. Given the uncertainty of impacts from changes to allocation settings, we agree the proposed 0.01 default phase-out rate is set until 2030, but changes beyond 2030 should following review and recommendations by the Climate Change Commission.

19. Over the long term, we support the option for phasing out free allocation in a way that differentiates between the different levels of carbon leakage amongst the covered industrial activities, so long as such decisions are made holistically as discussed above. The commencement of increased phase-out should have an adequate notice period – commencing the second budget period after a change is made (i.e. minimum of 5 years). We agree that the Climate Change Commission should be empowered with providing advice on whether lower or higher phase-out rates are appropriate, as in providing its advice, the CCC is required to have regard to international responses to climate change that have been taken or are planned to be taken.[7]

Q7	Do you support the proposal to auction 80 million NZUs over 2021-25 period plus 2 million NZUs for auctioning trial in 2020? If not, why not? Please include your views on the process for adjusting auction volumes

20. As discussed in the answer to Q5 and Q6, we do not agree with how the volume of 80 million NZUs has been determined to be auctioned over the 2021-25 period due to:

    — Insufficient analysis on the impacts that withholding auction volumes may have on future market supply as compared to expected supply

[7] As per the Zero Carbon Bill, Subpart 2 – Commission's functions, duties and powers

— Incomplete assessment of appropriate free allocation volumes given that these volumes were determined in isolation from other strands of allocation reform.

Price controls

Q8	Do you agree with the proposal to set an auction reserve price floor at $20 for 202-25? If not, why not?

21. BusinessNZ has previously expressed its preference for a technical reserve price alongside an in-principle auction reserve price,[8] and therefore views the current proposal as incomplete. Our view is that indexing the minimum auction price to the price in the secondary market supports price discovery, and therefore market efficiency. Keeping the methodology for determining the technical reserve price confidential is of utmost importance, as it would otherwise create incentives to pre-determine the auction clearing price; this would cause a certain estimated price level to become an undesirable focal point for bidding strategies.

Q9	Do you agree with the proposal to increase the fixed price option to $35 for obligations arising from activities over 2020?

22. We question the basis on which the 2020 FPO is set at $35, as this seems to be arbitrarily chosen as the mid-point between the current FPO of $25 and the CCR trigger price of $50. The Government could consider a more gradual and measured increase, with the FP set at $30 for the 2020 emissions year, and $35 for the 2021 emissions year.

Q10	Do you agree with the proposal to set the price ceiling trigger of the cost containment reserve at $50 for the 2020-25 period? If not, why not?

23. In determining the price trigger for the CCR, "the Government has drawn upon marginal abatement cost (MAC) analysis it has undertaken across all sectors of the economy" (p.60). However, the published MAC report[9] provides the MACCs for 2030 but not also for 2021-25. Furthermore, as the report correctly observes, MAC estimates are not a projection of price paths. Although the estimates suggest that by 2030 carbon prices in the range of $0 and $50 can deliver significant net abatement through afforestation, it may well be that the units issued for carbon removals are held in accounts and not sold in the market, allowing the price to rise well above $50. It is impossible for us to comment on the appropriateness of the $50 price ceiling over the next five years given the evidence provided.

24. Abstracting from the actual level of the price trigger, we would like more transparency on how the trigger is set and updated. MfE's 2018 ETS consultation paper[10] proposed two

[8] See our Dec 2019 submission on the rules of auctioning https://www.businessnz.org.nz/__data/assets/pdf_file/0008/185921/191219-ETS-auction-rules-consultation-002.pdf
[9] https://www.mfe.govt.nz/sites/default/files/media/Climate%20Change/marginal-abatement-cost-curves-analysis_0.pdf
[10] Improvements to the New Zealand Emissions Trading Scheme, August 2018.

options for price triggers settings: (i) the decision-maker has the discretion to determine settings, and (ii) settings are determined by mandated formulae. The Government did not have a preferred option at the time; however, based on the current proposal, it seems that the first option is preferred. We agree with MfE's initial assessment that option 1 "may give less transparency and predictability."[11] We would therefore like to see the impact analysis that was used to determine the preferred option for setting price triggers, and what considerations have been given to mitigating impacts on transparency to the extent possible.

Q11	Do you agree with the proposed annual cost containment reserve volumes to be released if the price ceiling trigger is hit? If not, why not?

25. The Government proposes that CCR volumes are set at "90 per cent of the difference between forecast net emissions covered by the NZ ETS and the volume of NZU supplied into the scheme through free allocation and auction" (p.61).

26. We have the following comments with regards to the formula above:

    — The determination for 90 per cent was made on the basis that future net emissions have usually been over-estimated, and that 100 per cent would increase the risk of over-supply. We think that provisions should nevertheless be put in place to clarify how the market to source the extra 10% when this is required. For example, this could be done by increasing the limit otherwise contemplated for international units.

    — The difference between net emissions and units supplied is not a true reflection of "potential additional demand," as it does not necessarily exclude banked units. If some stockpiled NZUs are withheld from NZU auctions, then taking the difference means that those banked units are added back into the calculation.

27. Overall, our biggest concern is around the lack of clarity on how CCR volumes will be sourced. CCR volumes released will need to be 'backed,' which for the Government means "acquiring approved units from international markets, or by other activities or investments that reduce emissions domestically, such as afforestation." Furthermore, the Government will require that the "equivalent emissions reductions must be obtained as soon as reasonably practicable at the end of the emissions budget period" (p.61).

28. It is unclear how the Government could ensure that carbon removals through afforestation to back-up CCR volumes could be obtained at the end of the emissions budget period given the short time horizon of emissions budgets (of five years) and lack of understanding of real constraints on the possible rate of land-use change (as caveated in the MACC report). It is expected, therefore, that backing of CCR volumes will rely on access to international markets. We therefore urge the Government to accelerate its work on identifying options for accessing international carbon markets (with safeguards on integrity) and require the Government to provide more clarity on how CCR volumes will be sourced if access to international markets is delayed.

[11] Page 35 in the 2018 ETS consultation paper.

29. Lastly, we would also like more clarity on they carry-over rules for CCR units from one emissions budget to the next. This is an important aspect as it will affect the price at which CCR units are sold, and the market participants' hedging strategies in the future.

Release of NZ ETS information

Q12	Do you agree with the proposed approach for release of NZ ETS settings information? If not, why not?

30. Yes

Q14	Do you have any other comments?

31. With regards to the impact assessment of proposed policies, BusinessNZ has the following view:

    — Stronger action to combat the effects of climate change is welcomed by many businesses, and we support the Government's ambition to de-carbonise the New Zealand economy over the long term. Although we cannot escape the fact that the low-carbon transition will imply some costs on businesses, we would like to see that policy decision-making process is based on a sound understanding of the trade-offs between business impacts and emissions reductions, and that the ensuing policies strike the right balance.

    — We are therefore concerned that decisions on proposed settings are being made without an assessment of impacts on businesses. The nature of these impacts can be multi-faceted, with direct consequences across supply chains, and indirect consequences on dependent industries. We urge the Government to undertake an analysis of economy-wide impacts of proposed policies before decisions are made. Otherwise, rushed decisions are likely to cause a low acceptance of policy direction early on, preventing the momentum building for tighter targets later on.

32. With regards to international units, BusinessNZ has the following view:

    — Step 5 in the determination of the ETS cap involves setting a limit on international units. We are surprised that the consultation paper does not raise specific questions with regards to this important issue, and are reiterating our position on this matter below: [12]

    — First, we think that dispelling the uncertainty around the quality of international units is the more pressing issue – businesses will not be willing to purchase units if there is any doubt about their ability to subsequently surrender them (regardless of a quantitative limit). It would appear that to dispel this uncertainty, the government

[12] This was expressed in our two previous submissions: https://www.businessnz.org.nz/__data/assets/pdf_file/0005/155570/180930-ETS-Review-submission-to-MFE-Sept-18.pdf and https://www.businessnz.org.nz/__data/assets/pdf_file/0006/187476/BusinessNZ-Submission-on-CCRA-ETS-Amendment-Bill-Consultation.pdf

would need to pre-identify which units businesses could surrender post-purchase, and publish this list (by way of a 'white list'). BusinessNZ suggests that getting this process underway should be a high priority.

— Second, we consider that the mode of purchase of international units is not an 'either/or' question – both government and business could be allowed to purchase such units, especially if a quantity limit is set and the environmental integrity is assured.

— With regards to quantity limits, we accept the rationale that the possibility of future linkages with international carbon markets requires the NZ ETS to provide a credible ambition signal. In the absence of linkages, this would be in the form of a cap on domestic emissions. However, we would like to observe that when a linkage takes place between schemes A and B, it is the *overall* cap of the linked system that matters. If it is cheaper to abate in A than in B, then market participants from B should be allowed to purchase A units until the marginal abatement costs (as reflected in prices) between the two schemes converge – at this point the carbon price delivers cost-effective mitigation (the optimal outcome). If a limit is set on the number of A units that B participants can surrender, then the optimal outcome may not be achieved (unless the limit is set high enough to allow this outcome to eventuate).

— Furthermore, we would like to observe that much of the driver to set limits on international units has historically been fuelled by a lack of credibility in the quality of those units. Therefore, if a system is set so that the quality of those units can be assured, then the rationale for limits becomes inconsistent with the objective of achieving cost-effective mitigation outcomes.

— Given that the issue of quality is still being addressed (and may take time), we accept that a quantity limit on international units may an appropriate course of action in the short term, and that it should be managed via the five-year rolling process. This would also reduce the risk that the domestic transition is delayed due to heavy reliance on international mitigation efforts. However, we do not agree that this limit is necessary over the long term given that (i) businesses will have committed by then to a decarbonisation pathway (with locked-in low-carbon investment decisions) in response to their rising emissions liabilities, and (ii) an appropriate mechanism for determining the environmental integrity of international units will have been set up.

Appendix One - Background information on BusinessNZ

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.