Submission by

to

Ministry for the Environment

on the

Proposed changes to New Zealand Emissions Trading Scheme limit and price control settings for units 2022

6 October 2022

PROPOSED CHANGES TO NEW ZEALAND EMISSION TRADING SCHEME (ETS) LIMIT AND PRICE CONTROL SETTINGS FOR 2022

Introduction

1. BusinessNZ Energy Council (BEC)[1] welcomes the opportunity to provide feedback to the Ministry of Enviornment (referred to as 'the Ministry') on its consultation document: *Proposed changes to New Zealand Emissions Trading Scheme limit and price control settings for units 2022* (referred to as 'the paper').

2. We support New Zealand's transition to a net-zero emissions future. Climate change is a global matter. New Zealand contributes to this global problem and has a responsibility to act.

3. We stress that New Zealand – including its businesses – has a role to play in achieving the reductions sought under the Paris Climate Agreement. Climate change impacts will not dissipate if only some or a few global actors transition.

4. We would like to acknowledge that Businesses across New Zealand are already working hard to make impactful contributions to mitigate climate change, striving to be world leaders.

5. As New Zealand strives to achieve meaningful emissions reductions, actions taken by government must be sensible, just and consider all trade-offs.

6. We believe that the focus should be on good outcomes for New Zealand overall. Therefore, global competitiveness and living standards must not be forgotten whilst New Zealand decarbonises. Instead, there should be a just transition. In other words, we believe New Zealand should follow the least cost pathway to achieve net-zero emissions by 2050.

7. New Zealand's ETS is a powerful market tool that will primarily contribute to the country achieving its emissions targets. To ensure the scheme is effective, we recognise that adjustments may be necessary overtime. However, it is important to strike the right balance between regulatory changes and regulatory certainty. The proposed options outlined in the paper raise several concerns we wish to address.

8. Overall, we are generally not opposed to price-setting adjustments over time. However, we are concerned the proposed setting adjustments indicated in this paper will likely rapidly accelerate NZU prices from 2023 rapidly, thereby resulting in significant uncertainty and cost increases in a very short time frame.

9. We believe NZU prices should increase justly in an incremental manner to ensure real and meaningful emissions reductions, without unintended consequences, such as carbon leakage.

10. The following provides the Ministry with general comments, concerns, and considerations on the proposed changes to unit limits and price control settings. Overall, the submission balances the broad view of New Zealand's business community. We have encouraged members to provide their own submissions on proposed changes outlined in the paper.

[1] More information about BEC can be found under annex 1.

ETS will do the heavy lifting, let it do its job

11. We believe New Zealand's ETS is an effective and necessary instrument that ensures the external emissions costs are internalised by those who are responsible for their release. A price on carbon sends a powerful signal to emitters, creating both a 'stick and carrot' to encourage decarbonisation.

12. The ETS is the most effective policy tool to encourage businesses to adopt cleaner practices in a flexible and least cost way. But we need to let the ETS do its job.

13. We agree that the price of carbon must be adequate to ensure there are sufficient incentives for stimulating innovation and the uptake of clean technology. We recognise the ETS must change overtime, securing the effectiveness of this powerful instrument.

14. However, it is important that any changes impacting the price of carbon are done incrementally over time in a transparent and cautious manner. Abrupt adjustments that accelerate the price of carbon come with serious risks.

Changes to the Cost Containment Reserve (CCR) and auction volumes

15. The proposed changes to the price control settings could reduce the estimated stockpile of 'unnecessary surplus units' defined by the Climate Change Commission (CCC). However, we are concerned such changes – both outlined by the CCC recommendations and MfE's proposals – do not place sufficient weight on the ramifications of pushing carbon prices too high too soon. In a presentation given by the CCC, they acknowledged the level of surplus units estimated is very uncertain.

16. Currently, New Zealand's ETS provides certainty to participants and dispels the transactional costs of unnecessary regulatory complexity. Splitting the CCR into two tiers, with different unit volumes that vary continually from year to year, results in unnecessary complexity and heightened uncertainty over future carbon prices.

17. Continuous changes in the ETS structure, including possible changes related to price settings year by year, could increase uncertainty, and cause unintended consequences, such as carbon leakage instead of just carbon emission reductions.

18. The CCC has justified its recommendation to split the CCR based on the argument that the CCR cap has been met three times in the last six auctions. The CCC believes this should occur rarely and should not be a market expectation of the NZU price level. The CCC argues a higher cap would increase the carbon price and reduce stockpiled units.

19. We are concerned that this argument, and subsequent justification for a two-tier CCR, is a significant departure from the original purpose of the CCR: a mechanism to dampen prices and provide price stability.

20. The purpose of the CCR is to release additional units beyond a certain threshold to stablise prices. This mechanism is important. It reduces the risk of carbon leakage and mass afforestation. The latter is a problem according to the CCC. Clearly, it no longer seems the CCR is based on price stability, but instead on reducing stockpile units. For instance, we note this swift departure by the CCC:

"The purpose of these price controls is to manage the risk of the NZU price at auction being out of line with what is necessary to meet emissions budgets, and to signal the bounds of expected prices in the NZ ETS." (Note the absence of price stability)[2]

21. If price stability is no longer the main justification for the CCR – which seems to be the case – and the threshold is set too high, we question the purpose of the mechanism. Yet we believe the CCR is necessary to ensure price stability. The threshold must remain as it was intended – ensuring the threshold is not remarkably high, to keep prices stable. NZU prices must increase justly if New Zealand is to achieve a 'just transition.'

22. Price stability with incremental increases is crucial. It ensures consumers domestically can afford their current living standards, while securing the economic competitiveness of New Zealand's exports and protecting investor sentiment in decarbonisation across the economy.

23. If the price settings are changed, it will be for the second time in less than two years. The auction floor has risen from $20.00 to $30.00 in year 2022, with a 7% increase for each following year. The CCC recommends doubling the floor to $60.00 for year 2023. We believe tripling the auction floor in three years does not qualify as a just transition. We think the current settings of a 7% increase each year to $39.32 by 2026 is sufficient.

24. The same concern is true for the CCR. In 2021, the CCR rose from $50.00 to $70.00. For 2023, tier one thresholds – under options two to five – the increase will be from $143.43 to $203.00 by 2026, and for tier two thresholds, from $163.64 to $254 by 2026. These are significant increases in such a short timeframe. The risks of accelerating NZU prices further should not be underestimated.

The limits of higher prices: time is needed

25. Higher carbon prices place natural limits on decarbonisation in the short-term. As mentioned, the carbon price is a powerful signal, mobilising investment in green technology and encouraging emitters to adopt low carbon practices. Yet, naturally, there is a time lapse between investment decisions in decarbonisation and emissions reductions.

26. It takes time for businesses to source and allocate capital, implement R&D, test the feasibility of low carbon technology, co-ordinate with multiple stakeholders, build infrastructure – including sourcing the materials and employing the skilled workers needed to produce low carbon products.

27. We are concerned that the paper's proposals do not place weight on ensuring businesses have sufficient time to actualise emissions reductions.

28. Our members – from energy producers to large energy consumers – have made significant investment decisions to build renewable generation, switch fuel sources and adopt more efficient processes in the near term. The NZU price is a large reason for this decision. But businesses need time to develop, test and deliver low emissions technology and reduce gross emissions.

[2] *Advice on NZ ETS unit limits and price control settings for 2023-27,* Climate Change Commission, 2022.

29. All things being equal, higher NZU prices will increase wholesale electricity prices. Emission prices impact the operating costs of thermal and geothermal generation. Since wholesale electricity prices are heavily driven by the marginal cost of gas and particularly coal, high NZU prices will flow through to wholesale electricity prices. In the long-term, transitioning to alternatives is positive. However, thermal generation still plays a crucial role in firming intermittent generation and powering industries that currently have limited alternative fuel sources.

Table 1: Impact of emissions price on electricity price[3]
All prices in the body of the table are in c/kWh

Level of impact	Sector	Electricity price 2021	Emissions price ($ per NZU[1])				
			$50	$75	$100	$150	$200
High	Residential	30.6	1.9	2.9	3.8	5.7	7.6
	Commercial	18.5	1.7	2.5	3.3	5.0	6.6
	Industrial	17.1	1.6	2.4	3.1	4.7	6.2
Low	Residential	30.6	1.1	1.7	2.2	3.3	4.4
	Commercial	18.5	1	1.5	1.9	2.9	3.8
	Industrial	17.1	0.9	1.4	1.8	2.7	3.6

Note:
1 New Zealand Unit (NZU) represents one metric tonne of carbon dioxide equivalent (tCO_2e).

Source: NZIER

Table 2: NZU component increase estimate[4]
Increase in NZU component from an NZU price of $75 as a percentage of the 2021 price.

Fuel	Sector	2021 price (c/kWh)	Emissions price			
			100	150	200	250
High impact	Residential[1]	30.6	3.1%	9.3%	15.5%	21.7%
	Commercial	18.5	4.5%	13.4%	22.3%	31.2%
	Industrial	17.1	4.5%	13.6%	22.6%	31.7%
Low impact	Residential[1]	30.6	1.8%	5.4%	8.9%	12.5%
	Commercial	18.5	2.6%	7.7%	12.8%	17.9%
	Industrial	17.1	2.6%	7.9%	13.1%	18.4%

Note:
1 Prices include GST of 15%

Source: NZIER

30. Higher electricity wholesale prices also come with consequences that the Ministry must seriously consider. Commercial and industrial businesses have the potential to electrify a portion of, or all, their processes, depending upon the commercial viability of doing so. Electrification is a considerable opportunity to reduce gross emissions. On the flip side,

[3] NZIER
[4] NZIER

higher wholesale electricity prices create a barrier to electrification and emissions reductions.

Significant constraints

31. Over the years, NZU prices have accelerated significantly. In 2013, the price was near $2.00, it then increased to around $35.00 in 2020, and $85.00 in 2022.[5] We agree this is necessary to decarbonise New Zealand's economy. However, we note that our members are already taking meaningful action. Also, businesses are facing significant barriers that lie outside the ETS.

32. Constraints include supply chain disruptions, limited supplies in general, higher import costs and labour shortages. We are also concerned around the effects on overall inflation with a substantial increase in the price of the ETS.

33. Given the recent record levels of inflation recorded through the Consumer Price Index (CPI), there has been a concerted effort by the Reserve Bank of New Zealand over 2022 to get inflation levels back down to annual increases between 1 and 3 percent on average over the medium term. With the OCR currently at 3.5 percent and market expectations expecting it to reach at least 4 percent, this will likely cause a sizeable dampening effect on the economy to get the inflation genie back in its bottle. Therefore, stoking the inflationary fires soon after concentrated efforts to dampen them could contribute to a duel adverse outcome of increasing prices and slower economic growth.

34. DETA Consulting has identified around 1,100 fossil fuel powered boilers dispersed across 400 organisations and businesses, producing 24PJs of heat, the equivalent of 65% of the South Island's electricity consumption.[6] Replacing these boilers with low carbon alternatives, such as heat pumps, provides meaningful emission reductions. However, despite the strong ETS signal and the best efforts of businesses sourcing alternative boiler technology, supplies remain limited. Even if they can source available supplies, these businesses also face a tight labour market and a shortage of workers with the required expertise to install and maintain new heat pumps and biomass powered boilers.

35. The current economic warfare unleashed by Russia's invasion of Ukraine is casting Europe into a catastrophic energy crisis. Europe has no choice but to adopt more renewable energy faster than it would otherwise. This has significant consequences for New Zealand's energy transition. As European countries pull all the policy levers, they can, technology that would have been available for New Zealand will now be prioritised and used in Europe, especially technology produced on the continent. Energy security concerns are not isolated to European countries. Globally, the world is transitioning and faces its own barriers to energy security.

36. In the energy sector, New Zealand is often a technology taker, and due to our size, we are low in the pecking-order so to speak. New Zealand will increasingly find it more difficult to source raw materials, components, and products, such as wind turbines, solar panels, biofuels, and micro-chips to name but a few, as the world races to decarbonise by 2050. If New Zealand does source limited technology, businesses will pay a premium. Businesses faced with no available technology will have no choice but to pass the higher cost of carbon on to consumers with higher prices.

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[5] *NZ ETS prices: Don't bank on the bull run continuing,* Ernest Young, February 2022

[6] New Zealand's Process Heat Fuel Future, DETA Consulting, 2022

37. We are concerned that passing the higher cost on to consumers will exacerbate inflationary pressures, without leading to the meaningful gross emissions reductions sought in the short-term. New Zealand is at the mercy of forces out of our control. We urge the Ministry to seriously consider contextual factors – like continuing supply disruptions flowing from COVID-19 and Europe's energy crisis – which will provide a salient barrier to the effectiveness of elevated carbon prices in the short-term.

38. As noted in the Climate Change Commission's recommendations, an emissions price increase from $50/tCO2e to $100/tCO2e increases the cost of fossil gas by 31% for industrial users. [7] Under the current trajectory, prices seem likely to pass $100/tCO2e in the near future. Higher energy prices for industrial users will pass through to businesses across the economy, and subsequently to consumers – adding inflationary pressures.

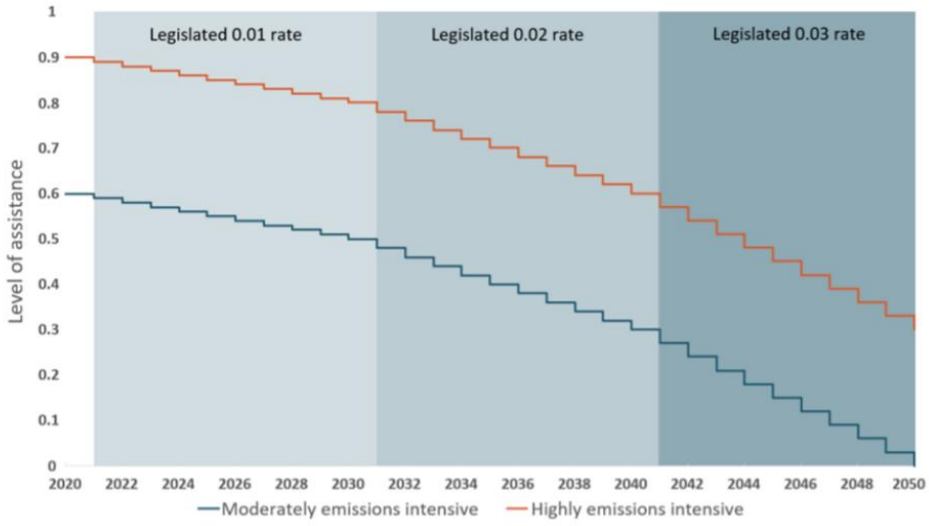
39. We acknowledge the fair consideration given to the costs consumers will face if the proposed changes are implemented. The paper outlines the vast consequences for consumers, firms, and electricity prices. We agree that the impacts will vary across firms.

40. We are concerned NZU prices that rise too quickly will also flow through to small and medium size enterprises. In all, 97% of all New Zealand's businesses are SMEs, employing a considerable number of the country's workforce. The proposed settings will impose a disproportionately heavy cost on New Zealand's SMEs, already struggling due to supply vulnerabilities, labour shortages and macroeconomic uncertainty, as the NZU cost accumulates across the supply chain.

The risks of carbon leakage

41. Carbon prices must be proportionate to a country's ability to respond accordingly. New Zealand should not be of the view that since country *X* has carbon price *Y,* we should have the same or a similar price. Recognising country context is crucial. Each country will inevitably trek its own path on the journey to decarbonsiation – New Zealand is no different. We urge the Ministry to consider the unique consequences across New Zealand's economy if NZU prices are to accelerate as proposed.

Figure 1: Phase-out of the level of assistance for moderately and highly emission-intensive activities



[7] *Advice on NZ ETS unit limits and price control settings for 2023-27,* Climate Change Commission, 2022.

42. In the New Zealand context, higher NZU prices coupled with the incremental phase out of industrial allocations and changing baseline years for these allocations, dramatically increases the risk of carbon leakage. Despite the current allocation for energy intensive and trade exposed businesses (EITE), the level of assistance for moderately emissions intensive businesses is phasing out to 0% by 2050, and close to 30% for highly emissions intensive businesses by 2050 (shown in figure 1 above).

43. If industrial allocation adjustments are not done right, and allocations reduce rapidly over a short timeframe, the higher NZU prices resulting from changes to price control settings indicated in this paper will significantly increase the risk of firms leaving New Zealand. We agree with the Ministry's statement:

    "If prices rose to reach the Commission's recommended CCR trigger prices, this price rise, in combination with the phase-out of industrial allocation, might have the impact of closing down firms in some industries in New Zealand unless they rapidly decarbonise."[8]

44. Carbon leakage is not just a real risk to any economy, it is also decoupled from just carbon emission reductions. Carbon leakage refers to the situation where the cost of climate policies – in this case the ETS – increases the cost of operating in a particular country and in response to a high price point for carbon businesses move production to countries with less stringent climate policies, consequently, increasing total emissions globally. The European Union – a world leader in climate policy – acknowledges this significant risk, and has included provisions, such as industrial allocations, to ensure carbon leakage risks are alleviated.

45. Golden Bay Cement, located in Whangarei, has substituted used tires and construction waste such as treated demolition wood – that otherwise would have gone to landfill – for 50% of its coal usage. The company is currently testing the feasibility of substituting alternative sources, such as non-recyclable plastic waste for most of its remaining coal usage. Rapidly increasing NZU prices risks companies, like Golden Bay Cement, losing their competitive edge over global competitors, while additionally worsening the economic viability of operating in New Zealand. Demand for goods, like cement, will not subside if businesses exit. Instead, demand will be filled by producers who use more emissions intensive processes in less climate stringent countries.

46. The risk of carbon leakage is a significant possibility if NZU prices accelerate too quickly. This remains a prominent concern for New Zealand's business community. As mentioned, climate change is a global challenge. Nothing is gained if industry moves from an energy efficient country to an energy inefficient jurisdiction with no creditable emissions trading scheme or carbon tax equivalent. Shifting emissions offshore is contrary to the global mission of mitigating gross emissions.

47. For example, New Zealand's comparatively high renewable electricity mix means aluminum produced here emits substantially fewer carbon emissions compared with that produced by overseas competitors. The Tiwai Point aluminum smelter emits 15 tonnes less CO2-e per tonne[9] Production leaving New Zealand could be replaced by coal powered production elsewhere, leading to no gross emission reductions globally. Instead, it would lead to job losses, supply chain vulnerabilities and lower tax revenues.

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[8] *Proposed changes to New Zealand Emissions Trading Scheme limit and price control settings for units 2022,* MfE, 2022.

[9] Submission on discussion document: Accelerating renewable energy and energy efficiency, New Zealand Aluminium Smelters Limited, 2020.

48. Therefore, from a global perspective, New Zealand can produce, does produce, and should continue to produce lower emitting goods – while at the same time, securing employment and economic activity.

49. We must ensure policies do not eventuate in the unintended consequence of shifting emissions elsewhere, exacerbating climate change and abdicating New Zealand's responsibility. A balanced approach to the ETS settings provides some certainty that carbon leakage will be alleviated.

50. New Zealand businesses have the opportunity to produce and export sustainable goods to a global market that increasingly places a premium on sustainability. Yet this cannot occur if the cost differential between New Zealand and its competitors increases rapidly and exponentially in a short timeframe.

51. Moreover, emissions intensive businesses play an important role in the New Zealand economy. The possible absence of these firms – if they decide to exit – would spell severe strategic supply chain vulnerabilities. New Zealand's firms are interconnected, with many relying on locally sourced materials and manufactured goods. The closure of one large firm can cause significant disruption across the supply chain.

52. Firms leaving New Zealand would negatively impact delivery times, production costs, and security of supply, undermining the country's economic resilience. For instance, NZ Steel has a strategic presence in New Zealand, with sectors across the economy, like construction, reliant on its products. In late 2020, a strut on Auckland's Harbour Bridge was damaged. The strut was replaced by NZ made steel in 18 days.[10] However, if an imported product had been needed, the repair would have taken weeks or months due to shipping delays during COVID-19.

53. If carbon prices accelerate too quickly and do not incrementally increase to ensure a just transition, we risk this not just affecting several ecosystems that rely on emissions intensive goods, but also energy security. For instance, the exit of Methanex would significantly limit the amount of gas supplied in New Zealand, with higher wholesale prices and considerable consequences for energy security and affordability. Higher NZU prices combined with the phase-out of allocations and the proposed baseline adjustments, are likely to exacerbate the risk of this scenario occurring.

54. As of 2022, only around 30% of all global emissions are priced.[11] The global average carbon price is $6.[12] Due to low average prices and stark variation between schemes, New Zealand businesses do not operate on a fair playing field. A degree of imbalance is to be expected if New Zealand is to take meaningful action on climate change.

55. However, the proposals presented in this paper are likely to exacerbate the already unbalanced playing field with overseas competitors. Higher prices and declining allocations significantly risk the economic viability of operating emissions intensive and energy intensive businesses in New Zealand. We recognise fossil fuels must be phased out, yet we reiterate that this must be done justly as many firms currently have no viable alternative. Without a viable alternative, in the short to medium term, the benefits of higher NZU prices are limited, and will have unintended effects.

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[10] *Gas Market Settings Investigation: Report to the Minister of Energy & Resources*, Gas Industry Co, September 2021
[11] M*ore countries are pricing carbon, but emissions are still too cheap,* International Monetary Fund Blog, July 2022
[12] Ibid,. p1

Regulatory uncertainty

56. As mentioned previously, if the proposed price setting changes occur, this would be the third change in recent years. We acknowledge that the Climate Change Commission's ability to provide annual recommendations falls within its remit, and the Government can choose to agree or set its own course of action. Nevertheless, such recommendations and adjustments unintentionally create uncertainty. Businesses are heavily impacted by regulatory uncertainty.

57. We reiterate that the Ministry must remember annual changes impact investor sentiment. Regulatory uncertainty affects businesses' willingness to invest in reducing emissions. Businesses will be too weary to invest in clean technology if regulatory changes occur frequently. Policy settings could be more conservative or aggressive than anticipated, impacting business plans and leading inevitably to many businesses choosing either to remain in or exit New Zealand. Regulatory stability is needed to ensure business confidence and encourage investment in cost-effective abatements.

APPENDIX ONE – BACKGROUND INFORMATION ON THE BUSINESSNZ ENERGY COUNCIL

The BusinessNZ Energy Council (BEC) is a group of leading energy-sector business, government and research organisations taking a leading role in creating a sustainable, equitable and secure energy future.

BEC is a brand of BusinessNZ and represents the World Energy Council in New Zealand. Together with its members, BEC is shaping the energy agenda for New Zealand and globally.

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&use
- Buy NZ Made representing producers, retailers, consumers of NZ-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).