

17 September 2021

Ministry for the Environment
Wellington

By email: etsconsulting@mfe.govt.nz

Submission on 'Reforming industrial allocation in the New Zealand Emissions Trading Scheme'

Introduction

- 1 Lawyers for Climate Action NZ Inc. (**LCANZI**) is a society comprising over 250 lawyers and an additional number of non-lawyer associate members. Our goals are to:
 - (a) raise public awareness and understanding of the threat of climate change;
 - (b) advocate for legislation and policies to ensure New Zealand meets or exceeds its commitment under the Paris Agreement and achieves net zero carbon emissions as soon as possible; and
 - (c) facilitate free or reduced cost legal assistance to community groups working to fight climate change.
- 2 LCANZI welcomes the opportunity to provide comments on: *Reforming industrial allocation in the New Zealand Emissions Trading Scheme*.

Context

- 3 The impacts of climate change pose an incredible threat to humanity, our economy and our natural environment. The recently released August 2021 IPCC report sets out the most up to date scientific evidence on climate change and shows that these impacts are accelerating rapidly.
- 4 There are now only years, not decades, left to take the action required to protect future generations. Many of the changes we have already seen will take hundreds if not thousands of years to reverse. It is unequivocal that immediate, rapid and large-scale reductions in global emissions are required to limit global warming to 1.5°C or even 2°C.
- 5 New Zealand needs to take decisive action now to rapidly reduce emissions.
- 6 It is in this context that LCANZI considers that the policy of free allocation is inconsistent with the overriding purpose of the ETS - reducing emissions and responding to the threat of climate change.

Summary of position

- 7 The risk of emissions leakage should not be at the expense of New Zealand's climate change commitments because we cannot afford further delay; we have not yet taken meaningful action on reducing emissions and it is 13 years since the ETS came into force. LCANZI urges the Technical Advisory Group (**TAG**) to focus (above all else) on ensuring that the ETS is an effective tool to respond to climate change.

- 8 LCANZI supports the broad direction of the proposals in addressing the calculation and eligibility settings prescribed in the Climate Change Response Act 2002.
- 9 However, we consider that the policy of free allocation is a blunt instrument that results in more harm than good.
- (a) Free allocation compensates firms in emissions-intensive and trade-exposed (EITE) industries, so they can compete with cheaper offshore producers who are subject to weaker emissions pricing. This results in lower prices for emissions-intensive goods, which can disadvantage the purchase of lower-emissions products. This diminishes the incentive to invest in low emissions technology / alternatives that are needed for New Zealand's transition to a net-zero economy. This is contrary to the overriding purpose of the ETS.
 - (b) Due to the very limited number of emissions that are impacted by the price of carbon in New Zealand,¹ the ETS currently falls short of its overriding purpose.² Free allocation of units is a significant contributing factor to this major flaw in the ETS. In addition, the ETS' lack of coverage places a disproportionate burden on the businesses whose emissions are impacted by the price of carbon. This gives rise to fairness and efficiency issues.³
 - (c) On the other side of the equation, our view is that the risk of leakage is overstated and there is a lack of positive evidence of potential and/or actual leakage in New Zealand. It seems likely that the free allocation is enriching shareholders and slowing action on climate change rather than protecting jobs. Furthermore, given the extreme shortage of skilled workers in NZ, protecting emissions intensive jobs is a very questionable policy goal.
- 10 LCANZI's position is that free allocation should be phased out rapidly, say over the next five years.⁴ New Zealand should instead:
- (a) accept and manage emissions leakage; and/or
 - (b) follow global trends to introduce a carbon border adjustment mechanism.

The objectives of free allocation

- 11 Industrial allocation (also known as 'free allocation') is the provision of free emissions units (New Zealand Units or **NZUs**) to EITE industries.
- 12 The stated purpose of the free allocation is to 'reduce the risk of the emissions price driving EITE firms, production and the associated emissions overseas, which could increase global emissions. This risk is known as emissions leakage.'⁵
- 13 The Climate Change Response Act 2002 defines trade exposure broadly. An activity is considered trade-exposed, unless there is no international trade of the activity output

¹ 30.2%.

² LCANZI's position is that, even with the proposed changes, the ETS will continue to suffer from major flaws and will not achieve the emissions reductions that are needed to meet New Zealand's commitment under the Paris Agreement. This was addressed in detail in LCANZI's submission on *Reforming the New Zealand Emissions Trading Scheme: Proposed Settings* dated 28 February 2021 (**LCANZI's February Submission**).

³ Refer to paragraph 19 of LCANZI's February Submission.

⁴ In stark contrast to the phase down of free allocation brought in by the Climate Change Response (Emissions Trading Reform) Amendment Act.

⁵ *Reforming industrial allocation in the New Zealand Emissions Trading Scheme: Consultation* document (**Consultation Document**), page 7.

across oceans, or it is not economically viable to import or export it. Eligible businesses with moderate emissions are supposed to receive 60 per cent of carbon costs at no charge, and high emitters are intended to receive 90 per cent.

- 14 The allocation of free units is calculated using a baseline formula. The Climate Change Response (Emissions Trading Reform) Amendment Act 2020 (the ETR Act) introduced a phase-out of the level of assistance. However, as the TAG has acknowledged, highly intensive activities could still be eligible for a 30 per cent level of assistance in 2050. LCANZI considers that this is inconsistent with the purpose of the ETS and with our target of being net zero by 2050 or earlier.

ETS failing its overriding purpose – free allocation is a contributing factor

- 15 LCANZI's position in relation to free allocation needs to be seen in the context of the wider design flaws and limitations that the ETS suffers from. These issues were addressed in further detail in LCANZI's submission on *Reforming the New Zealand Emissions Trading Scheme: Proposed Settings* dated 28 February 2021.
- 16 LCANZI considers that carbon pricing can and should play a fundamental role in reducing greenhouse gas emissions and responding to the threat of climate change. To effectively contribute to meeting our emissions targets, our ETS must:
- (a) create a cap on the level of national emissions so that we can ensure emissions are reduced, at a minimum, to the level set out in our emission budgets;
 - (b) induce economically efficient reductions in emissions by setting a single price for all ETS Participants; and
 - (c) provide enough clarity and stability price and policy to incentivise investment in low-emissions technologies.
- 17 The ETS is currently failing to achieve its overriding purpose as a tool to reduce New Zealand's greenhouse gas emissions.
- (a) In its current form the ETS is majorly flawed and will not achieve the emissions reductions that are needed to meet New Zealand's commitment under the Paris Agreement.
 - (b) Most fundamentally, the ETS scheme only impacts on 151 Mt CO²-e of the provisional budget for 2021-25 (42.7%). Furthermore, this actually overstates its potential impact since the free allocation of 44 Mt CO²-e means that, in simple terms, a further 12.4% of emissions are indifferent to the price of NZUs. In other words, the price of NZUs over the five-year period only has the potential to impact 107 Mt CO²-e (30.2%) of the budget emissions. The reality is that the ETS as currently envisaged has no ability to significantly influence our total emissions over the next five years, let alone cap them.
 - (c) The large stockpile of NZUs and international units means that even where emissions are covered by the ETS, there is no mechanism to limit the quantity of those emissions. The Government has recently implemented price controls, but modelling by the Productivity Commission suggests that the price parameters set by government are significantly lower than what would be required to drive necessary abatement levels. In essence, the Government has taken the important step of setting emissions budgets, but has no means of giving effect to those budgets.

- (d) Either further substantial changes to the ETS are required or else our focus should be on other policy measures, such as a carbon tax or individual tradeable emission quotas. The Government's current proposals will not be enough.

18 It is in this context that the policy of free allocation should be considered.

- (a) The free allocation of NZUs contributes to the disproportionate burden on those businesses whose activities are captured by the ETS. To meet progressively smaller budgets, bigger reductions are needed from other sources of emissions under the scheme, if allocations remain at current levels or increase.
- (b) Efficiency issues also arise. Some of the lowest-cost abatement opportunities for New Zealand are unlikely to be realized in EITE industries, while a significant price movement is likely required to induce that degree of abatement in already burdened businesses.
- (c) While the closure of high-emission business gives rise to transition issues that must be addressed, this is a necessary part of decarbonizing the economy

Emissions leaking / protecting economic competitiveness

19 The TAG's current position is that '[t]here is still a risk of leakage, which justifies protective measures'.⁶ Although the Consultation Document acknowledges that the risk of leakage is expected to change over time, it concludes that the risk will persist for some time.

20 LCANZI believes that the risk of leakage is overstated and that New Zealand should not be in the business of providing subsidies to emissions-intensive industries for the following reasons.

- (a) As our experience with the current regime illustrates, it is notoriously difficult to work out the level of subsidy required. Information asymmetry between the Government and businesses makes it very difficult to reliably ascertain how badly affected a company would be if exposed to emissions pricing. It is also very difficult to define subsidies without unintended side effects. This is due to the number of factors that contribute to production decisions.
- (b) Given the complexity of production decision making, there are significant limitations in *ex ante* analysis, of the kind that the TAG relies upon in the Consultation Document.⁷ For example, Sense Partners (2018) assessed the impacts of emission prices on the profits of trade exposed producers in New Zealand and found that while average firms could absorb relatively high emission prices with reduced profitability, others (particularly primary metals) would be highly sensitive to price increases. Other variable factors that determine commercial viability, which are arguably more significant than emissions pricing, include exchange rates, international commodity prices, input costs, and market competition.⁸ However the study did not consider businesses' debt obligations,⁹ demonstrating the difficulty in such analysis. These studies are ultimately

⁶ Consultation Document, page 11.

⁷ The report relied upon by the TAG: Tim Denne, *Potential for emissions leakage from selected industries in the ETS*, January 2021 is an *ex ante* estimation relying on compiled data.

⁸ Ibid.

⁹ Benjamin Rontard and Catherine Leining, *Future Options for Industrial Free Allocation in the NZ ETS*, Motu Working Paper 21-13, September 2021, at page 33.

attempting to predict firm-level decision making over what will likely be highly volatile decades.

- (c) Empirical *ex post* studies on the topic, undertaken in jurisdictions that are better resourced to assess emissions leakage, have concluded that there is no evidence to date of significant carbon leakage.¹⁰ There are also potential limitations in these studies, which only further demonstrates the complexity and difficulty of this issue.¹¹ What can be said definitely, is that there is a lack of positive evidence of potential and actual leakage, both in comparable markets and in New Zealand.
- (d) Our major trading partners all have moved or are moving to net-zero policies including pricing of emissions. Accordingly, the idea of competing against jurisdictions that do not properly price emissions is becoming increasingly fanciful. In addition, the better way to deal with this is not by free allocations in New Zealand, but by accepting and managing emissions leakage and/or introducing a carbon border adjustment mechanism (see below).

Accepting and managing emissions leakage

- 21 Free allocation compensates EITE firms so they can compete with cheaper offshore production, subject to weaker emissions pricing. This results in lower prices for emissions-intensive goods, which can disadvantage the purchase of lower-emissions products. This is contrary to one of the aims of the ETS, to incentivise long-term investment in low-emissions technologies.
- 22 It is important the consumers face price signals away from EITE industries and towards substitute products. The free allocation prevents these price signals from operating, whereas they are maintained by a carbon border adjustment as discussed below.
- 23 If subsidies are propping up EITEs, we should really ask whether those are industries we want located in New Zealand and how they fit with our net zero pathway. Rather than providing millions of dollars worth of free allocations, this money might be better spent in helping regions transition away from emissions-intensive industries to zero-emissions industries.
- 24 As Benjamin Rontard and Catherine Leining put it in their paper, *Future Options for Industrial Free Allocation in the NZ ETS*:

Instead of having taxpayers fund free allocation to prevent emissions leakage, the government could opt to accept emissions leakage and manage the impacts. Domestically, the government could do this by supporting local workers and communities with transitioning to alternative employment. Internationally, the government could do so by increasing New Zealand's contribution to global mitigation by taking on a more ambitious international target or otherwise supporting additional mitigation in other countries.

It is important to evaluate whether the public and private welfare benefits of ensuring zero emissions leakage are worth the public cost. The closure of some industrial production in New Zealand and the redeployment of its labour and capital may be a necessary and ultimately beneficial part of the country's low-emission transition. The risk of leakage can be expected to decrease with the implementation of the Paris Agreement and increasing pressure for producers and investors to disclose

¹⁰ Ibid, at page 5; Arlinghaus, J. (2015) *Impacts of carbon prices on indicators of competitiveness: A Review of Empirical Findings*", OECD Environment Working Papers, 87, OECD Publishing, Paris, in New Zealand Productivity Commission (2018) *Low-emissions economy: Final Report*, available from www.productivity.govt.nz/low-emissions at 117.

¹¹ Verde, S.F. (2020), *The impact of the EU Emissions Trading System on competitiveness and carbon leakage: the econometric evidence*, Journal of Economic Surveys, 34(2), 320-343, in Verde et al (2020), *Achieving Zero Emissions Under a Cap-and-Trade System*, Robert Schuman Centre for Advanced Studies, 26, 3.

and manage climate-related risk. It is possible that emissions leakage from New Zealand could have a minimal or even positive impact on global emissions if the recipient jurisdictions compensate for any emission increases under binding targets or are relatively more efficient producers.

Carbon border adjustment mechanism (CBAM)

- 25 LCANZI consider that, in the medium term, New Zealand should develop a CBAM, whereby an emission price would be added at the point of import into New Zealand for goods from jurisdictions without comparably stringent climate change policies, and New Zealand producers would get a rebate for the emission price paid on the goods manufactured domestically for export.¹²
- 26 As the TAG has acknowledged, a CBAM could help ensure that equitable emissions pricing is applied to emissions-intensive imports and exports. By levelling domestic and international commodity prices, a CBAM would ensure the NZ ETS price signal is better reflected in the domestic economy. In contrast, *'that signal is blunted by output based free allocation and – in the case of some imports – the absence of any emissions pricing'*.¹³
- 27 In contrast, free allocation compensates EITE firms so they can compete with cheaper offshore production, subject to weaker emissions pricing. This results in lower prices for emissions-intensive goods, which can disadvantage the purchase of lower-emissions products such as timber. A CBAM would also generate revenue for the Crown that could fund projects for mitigating or adapting to climate change.

Improvements to free allocation

- 28 To the extent that free allocation remains in place, LCANZI consider that the calculation and eligibility settings prescribed in the Climate Change Response Act 2002 should be adjusted in favour of eliminating overallocation.
- (a) The TAG has acknowledged that there is currently an overallocation of free units and that this is inconsistent with the policy intent of free allocation. The allocative baselines are out of date and contribute to overallocation. This mutes the incentive to reduce emissions and leads to windfall gains for EITE firms.
 - (b) Yet the TAG's preference that the baselines be updated every 10 years risks the same overallocation before the next baseline update. That approach does not strike the correct balance between the harms of overallocation and the asserted risk of undermining business certainty. The only way of significantly mitigating overallocation is to update baseline allocation every year and this is LCANZI's preference (in the event that free allocation continues as a policy, which we contend would be a mistake).
 - (c) Eligibility for free allocation should, at the very least, be reassessed using new base years. This does not, however, go far enough. New Zealand-specific thresholds must be developed¹⁴ and a much more rigorous test be introduced that requires businesses to demonstrate the degree of trade exposure.
- 29 Although the above adjustments to the baseline calculations and eligibility would be an improvement on the status quo, we re-emphasize that it is preferable to simply phase out free allocation over the next five years, to be replaced by the alternatives discussed above.

¹² Ibid, at page 44.

¹³ Ibid, at page 45.

¹⁴ The rationale for using the Australian government's methodology for emission intensity assessment is now outdated, along with the data.

Yours faithfully

A handwritten signature in blue ink, consisting of a large, stylized initial 'J' followed by a series of loops and a horizontal flourish.

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Lawyers for Climate Action NZ Inc.