Submission by

to the

Environment Select Committee

on the

Climate Change Response (Emissions Trading Reform) Amendment Bill

17 January 2020

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CLIMATE CHANGE RESPONSE (ETS) AMENDMENT BILL –

DRAFT SUBMISSION BY BUSINESSNZ,[1] AND BUSINESSNZ ENERGY COUNCIL

1.0 INTRODUCTION

1.1 BusinessNZ welcomes the opportunity to provide feedback on the Climate Change Response (Emissions Trading Reform) Amendment Bill (the 'Amendment Bill').

1.2 An emissions trading scheme is a market-based policy instrument that provides a cost-effective way to assist in controlling greenhouse gas emissions if designed properly. The nature and significance of the NZ ETS has evolved from a nested system under the Kyoto Protocol to a key policy instrument supporting the decarbonisation of the NZ economy at a low cost. Many of the current NZ ETS settings – reflecting legacy objectives or transitional measures – are incompatible, incomplete, or altogether lacking for the purpose of meeting emissions reduction budgets at a low cost. BusinessNZ accepts that the NZ ETS must be reformed.

1.3 The nature of the changes proposed in the Amendment Bill – and which we address in this submission – is to enable the Minister to recommend regulations on various matters pertaining to the ETS (and specifically, if auctions are introduced). We therefore recognise that (except industrial allocation) the Amendment Bill addresses ETS design changes from a high-level perspective and expect that technical details on these changes will be consulted on separately in the context of amendments to ETS regulations (e.g. as per MfE's most recent (2019) consultation document on auction price control levels and auction volumes[2]).

1.4 However, with respect to industrial allocations, we would like to stress that decisions on the phase-out rates should not be taken in isolation from other related strands of the industrial allocation reform (e.g. allocative baseline and electricity allocation factor). The lack of a holistic approach to reforming allocations undermines business confidence and raises the risk that policy decisions are made on incomplete or incorrect impact assessments.

1.5 Accordingly, we address the issues in the Amendment Bill on the basis of whether the proposed high-level changes move the scheme in the right direction of achieving NZ's emissions targets at lowest cost overall, whilst reiterating that an effective ETS must have the following characteristics:

a. A cap on domestically-issued rights to emit

b. Access to international markets

c. Price management mechanisms to deal with significantly low or high prices

d. No free allocation of units over the longer term

e. Allocation through auctions.

1.6 The framing above is intended to help provide a clear policy line of sight between any anticipated increase in carbon price, the desired domestic transition to a low carbon economy (both its nature and how it might be achieved), and the impact on the international competitiveness of the export sector.

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

[2] https://www.mfe.govt.nz/sites/default/files/media/Climate%20Change/reforming-the-ets-proposed-settings-consultation.pdf

SUMMARY OF RECOMMENDATIONS

Business NZ:

a. Supports the introduction of auctions.

b. Accepts that a cap should be set on the volume of emission rights issued domestically under the ETS. Although a cap may also be warranted for international units in the shorter term due to quality uncertainties, careful consideration should be given to whether / how a limit should be set over the longer term given the risk of failing to achieve cost-effective mitigation outcomes as a result of the limit.

c. Supports the introduction of an auction reserve price – we view this mechanism to be superior to a fixed price floor for the ETS overall.

d. Supports the introduction of a cost containment reserve to help manage significantly high NZU prices.

e. Does not comment here on the actual levels of the auction reserve price, CCR price trigger and auction volumes as proposed in MfE's most recent (2019) consultation on Reforming the ETS. Our views on those matters will be provided as a separate response to the consultation.

f. Considers that decisions on phase-out rates should be made as part of a holistic assessment of other related strands of allocation reform (allocative baseline and EAF). Given the complexity of decisions that ensue from this reform, we agree that that a 0.01 default phase-out rate is set until 2030.

g. Over the long term, supports the phase-out of industrial allocation in a way that differentiates between the different levels of carbon leakage amongst the covered industrial activities. Commencement of increased phase-out should have an adequate notice period.

h. Challenges the requirement for EPA to annually publish entity-level net emissions and suggests instead a smaller step up the regulatory pyramid via strengthening recommendation 4.3 of the NZX Corporate Governance Code.

i. Supports the introduction of strict liability infringement notices as preferable to the increased use of criminal offences for low-level offending.

j. Considers the penalty fee set at three times the carbon price is excessive.

k. Supports the introduction of an auction monitor to oversee the auction process and validate the auction results.

2.0 DETAILED COMMENTS

Emissions cap

2.1 BusinessNZ agrees in principle that a cap on NZUs is required to help meet emissions budgets and increase credibility in the scheme's effectiveness. We also accept that a limit on international units may be required in the shorter term primarily to deal with the issue of unit quality, and to increase the international credibility in the scheme's environmental integrity. However, we consider that although international linking implies a cap on domestically-issued emission rights, over the long term a limit on international units may jeopardise the cost-effectiveness of mitigation efforts across the linked system, depending on whether or how the limit is set. This is discussed in more detail in the section below on international units.

2.2 Our view is that the decision-maker on unit supply volumes should be independent from the political process, and should have access to the resources and information necessary to make such decisions. On this basis, we welcome the Climate Change Commission's mandate (legislated via the Zero Carbon Bill) to advise on emissions budgets and, by extension, on ETS budgets.

Price management

2.3 BusinessNZ supports the introduction of an auction reserve price as a way to strengthen confidence in low-emissions project investments. This mechanism is superior to a hard price floor across the ETS, as it still allows the secondary market price to be discovered by the unfettered forces of demand and supply. It is our preference for a less, not more, managed ETS.

2.4 We also support having a cost containment reserve as a mechanism to address high prices. Our preference is for a CCR with a single trigger, as indicated in our submission on Auction Rules.[3] Our submission on Auction Rules also discusses other technical aspects pertaining to the CCR.

2.5 We do not comment here on the level of auction reserve price, CCR trigger and reserve volumes. This will be included in a separate submission to MfE's most recent (2019) consultation document on reforming the NZ ETS.[4]

International units

2.6 There are three aspects to the issue of accessing international units, as correctly noted in the Regulatory Impact Statement on unit supply.[5] These are the mode of purchase, quality restrictions and quantity restrictions. Although the changes proposed through the Amendment Bill only concern quantity limits (due to further work required on the other two aspects as per the RIS), we would like to reiterate our previous view on the mode of purchase and quality restrictions as expressed in the 2018 submission on ETS reforms.[6]

2.7 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 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.

2.8 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.

2.9 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

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[3] https://www.businessnz.org.nz/__data/assets/pdf_file/0008/185921/191219-ETS-auction-rules-consultation-002.pdf

[4] https://www.mfe.govt.nz/sites/default/files/media/Climate%20Change/reforming-the-ets-proposed-settings-consultation.pdf

[5] https://www.mfe.govt.nz/sites/default/files/media/Climate%20Change/impact-statement-improving-the-nzets-framework-for-unit-supply-updated-may-2019.pdf

[6] https://www.businessnz.org.nz/__data/assets/pdf_file/0005/155570/180930-ETS-Review-submission-to-MFE-Sept-18.pdf

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).

2.10 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.

2.11 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.

Auctions

2.12 BusinessNZ welcomes the proposed changes with regards to the introduction of NZ ETS auctions. These changes are consistent with our previous submissions, in which we highlighted that the following characteristics are essential for efficient auction outcomes:

- Access should be open to all NZETS participants
- Auctions must have clear rules and timetable
- Auction outcomes should be transparent, while preserving bidder confidentiality
- The bidding process must be competitive.

2.13 We note that although the characteristics above are necessary, they are not sufficient to ensure efficient auctions. Other characteristics are also important, such as

- The auction platform must be qualified and meet predetermined service-level agreements
- The cost of participation in auctions should not be onerous.

These are discussed in more detail in our submission on Auction Rules.[7]

Industrial allocation

2.14 BusinessNZ supports, in principle, the phase-out of industrial allocations where it is clear that the international competitiveness of our energy-intensive, trade-exposed businesses is not jeopardised by the asymmetric application of carbon pricing across jurisdictions.

[7] https://www.businessnz.org.nz/__data/assets/pdf_file/0008/185921/191219-ETS-auction-rules-consultation-002.pdf

2.15 However, we stress that the risk of carbon leakage remains

2.16 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. In principle, we support reasonable phase-down rates as long as the process for changing the current rates results in predictable allocation levels. This, however, is not the case, as separate reforms to allocation levels are being undertaken, which undermines the ability to predict impact on allocation. In particular, at least two other processes have become apparent that will impact the allocation formula: review of the Electricity Allocation Factor (EAF), and now a wider review of the Allocative baseline. 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.

2.17 Furthermore, 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.

2.18 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.[8]

Transparency

2.19 BusinessNZ accepts that the NZ ETS will benefit from greater information transparency to improve the market participants' understanding and confidence when making trading decisions.

2.20 We also recognise that, compared to NZ ETS, some international carbon markets (e.g. EU ETS) publicly release greater detail on participant-level compliance and emissions information. Any future linking with such markets will likely require an alignment of transparency requirements, so changes to improve information provision in the NZ ETS should be done with that prospect in mind.

2.21 However, BusinessNZ is not convinced that, in proposing that EPA annually publishes entity-level net emissions or removals broken down by activity (as applicable), sufficient analysis has been done of the potential risks that such annual publication might give insights into commercially sensitive information.

2.22 With respect to the proposed change, the regulatory impact statement notes that[9]

> "the cons of this option are that it releases information that some participant businesses may consider to be commercially sensitive, such as being able to allow for the calculation of annual production volumes, energy operating costs,

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

[9] Page 6 in https://www.mfe.govt.nz/sites/default/files/media/Climate%20Change/impact-statement-improving-transparency.pdf

and what products they import for manufacture. However, this type of data can often be determined for public companies from annual reports, which are published by several large NZ ETS participants."

2.23 This assessment of what constitutes commercially sensitive information is incomplete. What also matters is whether the level of detail on publicly released data, taken together, allows one to determine the extent to which an *individual* market player might be in short or surplus of emissions unit, resulting in strategic behaviour in the market.

2.24 Furthermore, although it may be possible to determine production volumes and energy operating costs from annual reports of some businesses, these estimations would inherently be within a margin of error. NZ is a different market than other international markets due to its size. Combining these estimates with emissions information may increase the risk that greater information transparency materially affects a business' competitive position. The impact analysis should consider this aspect.

2.25 Finally, because ETS is premised upon an upstream point of obligation, emission returns are not representative of an entity's carbon footprint and so would in some instances be misleading. Furthermore, an upstream producer will have no knowledge of how their product is utilised and has no control over how or how efficiently their products are used. It would therefore make more sense for emissions to be published by the emitting entity.

2.26 At minimum, any release of emissions information should (i) be on a fixed annual date basis, and (ii) give participants and allocation recipients due to notice prior to release.

2.27 Overall, our view is that the growing engagement of NZ businesses with the TCFD framework will continue to improve information transparency for the purpose of effectively participating in the NZ ETS. The growing voluntary disclosure of information under the TCFD provides a good compromise for improving NZ ETS transparency without an increased risk of an unintended release of commercially sensitive information. If this proposed measure were to proceed, BusinessNZ would support a smaller step up the regulatory pyramid via strengthening recommendation 4.3 of the NZX Corporate Governance Code. For more details, please refer to our recent submission on Climate-Related Financial Disclosures.[10]

Infringements and penalties

BusinessNZ:

2.28 Business NZ supports the introduction of strict liability infringement notices as preferable to the increased use of criminal offences for low-level offending.

2.29 We accept, in principle, that only non-compliance resulting in criminal prosecution should be published, and cases when this may occur should be clearly defined. In its preamble, the Amendment Bill states that

> "Information about significant non-compliance will be made publicly available"

However, what constitutes "significant non-compliance" is nowhere defined in the Bill, although the regulatory impact statement implies this to include cases of gross carelessness, knowingly making or failure to surrender/repay units by due date.[11] The Amendment Bill should leave no interpretation on this matter.

[10] https://www.businessnz.org.nz/__data/assets/pdf_file/0007/185920/191219-Climate-Related-Financial-Disclosures-Discussion-Document.pdf

[11] Section 107 on p.21 in https://www.mfe.govt.nz/sites/default/files/media/Climate%20Change/impact-statement-improving-compliance-and-penalties.pdf

2.30 We consider the increase of the penalty for failing to surrender or repay units by due date from $30/unit to a multiple of 3 times the carbon price to be excessive. Although other jurisdictions may have similarly high penalties, they do not have the same characteristics as the NZ ETS with all gases (including those with high GWPs), the inclusion of forestry (and potentially agriculture) and low (if any) exemption thresholds for small firms from mandatory participation. Linking with other schemes is not a valid reason at this stage.

2.31 Furthermore, the RIS presents no evidence that a low penalty rate has contributed to non-compliance or that increasing it is required. We recommend that the penalty rate is set at $30/NZU or carbon price at the time of the original infringement, whichever is the higher. Furthermore, Force Majeure provisions be introduced to protect firms from penalties when the ability to surrender or repay units is outside their control.

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.