

Regulatory Impact Statement

New Zealand Emissions Trading Scheme: Industrial allocation for group 3 activities

Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by the Ministry for the Environment. It provides an analysis of the options available to the Minister for Climate Change Issues when exercising his discretion in terms of recommending regulations to prescribe eligible industrial activities for the allocation of New Zealand emissions units under Section 161A of the Climate Change Response Act 2002 (the Act). The Minister may recommend the making of regulations to prescribe eligible industrial activities and other matters as appropriate including:

- i. the description of the activity;
- ii. whether the activity is highly emissions intensive or moderately emissions intensive
- iii. the products to be used as the basis for allocation;
- iv. the methodologies to be used for calculating the amount of each product;
- v. for each product, one or more allocative baselines
- vi. the allocation factors for electricity and natural gas feedstock;
- vii. the information that must be kept for verification purposes; and
- viii. the adjustment to allocative baselines to reflect the impact of electricity related contracts.

Cabinet has previously decided that an intensity based approach to free allocation of emissions units should be used to provide assistance¹ to firms most impacted by the implementation of the New Zealand Emissions Trading Scheme (NZ ETS). This framework was incorporated into the Act in December 2009. The proposed regulations implement this framework. On 28 June 2010, Cabinet agreed to make regulations for an initial group of 12 eligible activities.² On 2 August 2010, Cabinet agreed to make regulations prescribing a second set of five activities.³

The Act (Section 161A(3)) requires that before recommending that regulations be made prescribing eligible industrial activities for the purposes of allocation of New Zealand units, the Minister must be satisfied that the activity is moderately emissions intensive or highly emissions intensive and trade exposed; or the activity is an Australian eligible industrial activity.

¹ The level of assistance will be reduced each year by 1.3% beginning in 2013.

² See CAB Min (10) 23/6.

³ See CAB Min (10) 27/7.

The Ministry published a public consultation document on the development of industrial allocation regulations in December 2009. Section 161D of the Act provides for a process whereby the Minister may issue notices calling for information for the purposes of proposed allocation to industry. Section 161F sets out consultation requirements before the Minister notifies an activity in the Gazette calling for information. All of the activities proposed to be prescribed as eligible industrial activities have been subject to calls for information with extensive direct consultation on these matters. This has allowed the Minister to make a detailed assessment of the available options.

The proposed regulations will allow firms who carry out the prescribed eligible industrial activities to apply for a free allocation of New Zealand emissions units. This will reduce the net cost increase resulting from the NZ ETS. Compliance costs are voluntary as firms can choose whether to apply for an allocation and are, in any case, likely to be minimal. The potential impacts on business investment and market competition have been considered under the various options available where this is relevant. The risks of these impacts are minimised or removed in the preferred policy options. The preferred policy proposals do not override fundamental common law principles.

Stuart Calman, Director

Signature:

Date:

Status quo and problem definition

Status Quo

1. The Climate Change Response Act 2002 (the Act) established the New Zealand Emissions Trading Scheme (NZ ETS). Under the NZ ETS, some firms have a legal obligation to surrender emissions units to cover their direct greenhouse gas emissions or the emissions associated with their products. To do this, firms need to acquire emissions units and this effectively puts a price on greenhouse gas emissions. From 1 July 2010, the stationary energy, industrial process (SEIP) and liquid fossil fuels (LFF) sectors were obliged to surrender emissions units.
2. Some firms may face a large increase in their fuel and energy costs if their activities are emissions-intensive. In many cases this cost is expected to be passed on to customers through higher prices. However, some firms may be trade exposed, such that they are unable to pass on this increase in costs to their customers in the light of competing firms that do not face a comparable cost on emissions in their home countries.
3. Cabinet has previously decided that assistance⁴ in the form of a free allocation of emissions units would be targeted at those firms most affected by the introduction of a price on emissions, that is emissions intensive and trade exposed (EITE) firms. The Act sets out an intensity-based approach to allocation. Further details of this approach were provided in a previous RIS (for group 1 activities).⁵
4. The Act (Section 161A(3)) requires that before recommending that regulations be made prescribing eligible industrial activities for the purposes of allocation of New Zealand emissions units, the Minister must be satisfied that the activity is moderately emissions intensive or highly emissions intensive and trade exposed; or the activity is an Australian eligible industrial activity.⁶
5. The Minister has used his power under the Act (Section 161D) to issue notices in the *New Zealand Gazette* requesting information necessary to determine whether to prescribe an activity as an eligible industrial activity and, if so, the allocative baseline for each product of that activity.
6. On 28 June 2010 Cabinet agreed to make regulations prescribing an initial set of 12 activities eligible for allocation of New Zealand emissions units (the Group 1 Activities) and invited the Minister to present further papers seeking agreement to provide allocation to further activities that meet the eligibility criteria set out in the Act.⁷ On 2 August 2010 Cabinet agreed to make regulations prescribing a second set of five activities (the Group 2 Activities).⁸ Following analysis of the information supplied in response to the *Gazette* notices, a third set containing two additional activities have now been identified as eligible for allocation (the Group 3 Activities).

⁴ The level of assistance will be reduced each year by 1.3% beginning in 2013.

⁵ See: <http://www.climatechange.govt.nz/publications/ris/ets-industrial-allocation.html>

⁶ An Australian eligible activity is defined in section 4 of the Act as “an activity that is, or is likely to be, specified as an emissions-intensive trade-exposed activity in respect of which a person may be allocated emissions units under Australian law”.

⁷ See CAB Min (10) 23/6.

⁸ See CAB Min (10) 27/7.

7. In the status quo, regulations allowing free allocation of New Zealand emissions units to EITE firms on an intensity basis have been agreed to for 17 activities and it is assumed that regulations are also made for the two additional activities.
8. Further details on the status quo were provided in the previous RIS (for group 1 activities).⁹

Problems to be solved

9. The Act (Section 161A) gives the Minister the power to recommend the making of regulations prescribing eligible industrial activities which will enable firms engaged in these activities to apply for an allocation of New Zealand emissions units.
10. Regulations have already been made prescribing the following matters in relation to the eligible industrial activities:
 - the methodology or methodologies for calculating the amount of each prescribed product (Section 161A);
 - the allocation factor(s) for electricity and natural gas feedstock (Section 161A); and
 - the information that must be kept for verification purposes (Section 161A).
11. The options available for each of these matters and the Ministry's recommendations were considered in a previous RIS (for group 1 activities). It is not proposed to make any amendments to the matters set out above in relation to the proposed new activities. Rather the proposal and this RIS focus on:
 - the description of the activity;
 - the products to be used as the basis for an allocation.

Objectives

12. There are two overarching policy objectives:
 - Reduce the risk of competitiveness impacts on domestic firms most at risk under the NZ ETS. Related to this overarching objective are two inter-related objectives:
 - Reduce the risk of New Zealand firms reducing domestic production and allowing for the expansion of production; and
 - Reduce the risk of emissions leakage.
 - Ensure a smooth transition to a low carbon economy by reducing economic disruption (e.g. distorting investment decisions). Related to this overarching objective are three sub-objectives:
 - Provide firms with certainty of the cost impact of the NZ ETS on the SEIP and LFF sectors as the surrender obligations comes into force (i.e. 1 July 2010);
 - Minimise administration costs; and
 - Minimise firms' compliance costs.

⁹ See: <http://www.climatechange.govt.nz/publications/ris/ets-industrial-allocation.html>

Regulatory impact analysis

Description of the activity and the products to be used as the basis for an allocation

13. The description of the eligible industrial activity, including the start and end points (i.e. the boundaries) of the activity, determines the emissions that are included and excluded. This will determine whether the activity meets the requirements to be prescribed as an eligible industrial activity and therefore qualify for an allocation as well as the level of assistance and allocative baseline. This, in turn, will determine which firms are eligible for an allocation and how much allocation they are entitled to.
14. Prior to prescribing an activity as eligible, the Minister may issue a notice in the *New Zealand Gazette* requiring information for the purposes of allocation. Section 161E(1) of the Act set out the matters the Minister must have regard to when defining activities before issuing such a notice. These matters are listed in Annex A.
15. In assessing the information received as a result of the calls for data that were issued, the Ministry has weighted the various matters to reach a conclusion. The matters which the Ministry has attached the greatest weight to are:
 - Activity definitions should be consistent and equitable across industries;
 - The impacts on business investment, geographic location and the structure of the activities; and
 - The activity definitions that were proposed for use in Australia's Carbon Pollution Reduction Scheme (CPRS).¹⁰

Activities proposed in the consultation document

16. In December 2009, the Ministry published *Development of Industrial Allocation Regulations under the New Zealand Emissions Trading Scheme: Consultation Document* (the Consultation Document).¹¹ The Consultation Document proposed activity descriptions and the products to be used as the basis for allocation.¹² Consistent with Cabinet's initial focus on reducing trans-Tasman competitiveness risks, these were based on activity definitions proposed in Australia for activities that had either been found to be eligible or were under consideration for eligibility. Stakeholders were also invited to nominate additional activities that they considered were potentially eligible.

New activities identified during the consultation process

17. During the consultation process, 27 new activities were proposed by stakeholders as potentially eligible for allocation. For those activities that were likely to meet or were very close to the threshold for eligibility, the Ministry developed activity descriptions and products in consultation with persons likely to be substantially affected by any regulation prescribing the activity as an eligible activity. In developing these new activity descriptions, the Ministry assessed them against the matters the Minister must have regard to under the Act and considered potential impacts.

¹⁰ It is currently unclear as to whether or when this scheme will be introduced in Australia.

¹¹ See: <http://www.mfe.govt.nz/publications/climate/development-industrial-allocation-regulation-ets/index.html>

¹² See Annex 1: <http://www.mfe.govt.nz/publications/climate/development-industrial-allocation-regulation-ets/index.html>

18. Following consultation with stakeholders, the Ministry has published activity analyses (the Activity Analyses) for each activity which sets out its assessment against each of the matters the Minister must have regard to and its recommendation to the Minister.¹³
19. For some of the proposed activities and products, stakeholders did not suggest any substantive changes to the proposals during the consultation. Therefore it was not necessary for the Ministry to consider alternative hypothetical options and their potential impacts. This was the case for the production of gelatine.¹⁴
20. For other proposed activities and products, stakeholders suggested significant changes to the proposals during the consultation. The Ministry assessed these alternative proposals against the matters the Minister must have regard to under the Act. The Activity Analyses sets out the Ministry's assessment and conclusions.¹⁵ This was the case for iron and steel manufacturing from iron sand. This is considered in more detail below.

Iron and steel manufacturing from iron sand

21. Iron sand based iron and steel manufacturing is carried out in New Zealand in the following way:
 - mining and concentrating iron sand;
 - transforming the concentrated iron sand to molten iron or solid pig iron;
 - recovering vanadium rich materials;
 - further refining and transforming the iron to cast steel; and
 - hot rolling the steel into rolled products.
22. The key issues for this activity were how to define the start and end points of the activity, how many allocative baselines there should be for the activity, and how these should be structured.
23. Two options were considered for the start point of the activity:
 1. The mining and concentration of iron sand (i.e. the first bullet above).
 2. The input of concentrated iron sand (i.e. the second bullet above).
24. Out of the matters the Minister must have regard to, the key matters in evaluating these two options were:
 - Competitiveness impacts;
 - Activity definitions should be consistent across industries; and
 - The activity definition proposed in Australia.

¹³ See: <http://www.climatechange.govt.nz/consultation/industrial-allocation/summary-activity-analyses/index.html>

¹⁴ It is estimated that this activity will be eligible to receive [withheld] units, resulting in a fiscal cost of [withheld] in 2011/12. This is based on the two for one obligation and \$25 carbon price during the transition phase of the NZ ETS.

¹⁵ See Section 2: <http://www.mfe.govt.nz/publications/climate/industrial-allocation-submissions-summary/index.html>

25. Concentrated iron sand is a tradable commodity (it is currently traded from New Zealand). Therefore option 2 is most consistent with avoiding competitiveness impacts between industries. In addition, option 2 is consistent with other activities and with the approach proposed in Australia, as the emissions from the extraction and production of raw materials used in an activity are generally excluded (therefore mining and extraction activities are considered as separate activities).
26. Option 1 is not consistent with other activities or the approach proposed in Australia. Furthermore, the first step included in option 1 is unlikely to be emission intensive and therefore the introduction of the NZ ETS is unlikely to result in competitiveness impacts.
27. Accordingly, officials recommended option 2 as this is most consistent with the matters the Minister must have regard to, including the key matters.
28. Two options were considered in relation to the end point of the activity:
 1. The production of cast steel, or the production of pig iron where that iron is not used further in the steel making process (i.e. the second and fourth bullet points above).
 2. The production of hot rolled steel products (i.e. the final bullet above).
29. Out of the matters the Minister must have regard to, the key matters in evaluating these two options were:
 - Activity definitions should be consistent across industries;
 - Distortion of competition within the domestic market; and
 - The activity definition proposed in Australia.
30. Option 2 is consistent with the activity of 'manufacturing of carbon steel from cold ferrous feed' which also produces cast steel through a different production process which is often subsequently hot rolled. Option 1 is not consistent with this other activity and therefore, could distort competition in the domestic market for hot rolled steel products.
31. Option 2 is also consistent with the approach taken for the similar activity of 'integrated iron and steel manufacturing' proposed under the Australian CPRS. Option 1 is not consistent with this proposed Australian activity.
32. Accordingly, officials recommended option 2 as this is most consistent with the matters the Minister must have regard to, including the key matters.¹⁶
33. The possible allocative baselines considered were for the:
 1. Production of cast steel
 2. Production of hot rolled steel products
 3. Production of pig iron; and
 4. Production of vanadium bearing products
34. Officials recommended that baselines for all four of the above be adopted.

¹⁶ It is estimated that this activity will be eligible to receive [withheld] units, resulting in a fiscal cost of [withheld] in 2011/12. This is based on the two for one obligation and \$25 carbon price during the transition phase of the NZ ETS.

35. Officials considered that allocative baselines should be made available for cast steel and hot rolled steel products (i.e. points 1 and 2 above), as this is consistent with the approach proposed for integrated iron and steel production under the Australian CPRS.
36. Officials considered that it was also desirable to include a pig-iron baseline to provide flexibility for changing market conditions or production interruptions. The proposed Australian CPRS approach did not include a baseline for pig iron. However, including a pig iron baseline in the New Zealand definition would allow for demand for pig iron increasing, or for possible steelmaking production interruptions which could lead to production being shifted away from steelmaking to iron production. In addition, inclusion of a pig iron baseline would create more flexibility to provide for allocation to any new market entrants that might produce pig iron only.
37. For vanadium bearing materials, the amount of emissions and revenue attributable to these materials is relatively small, suggesting that they might be considered a by-product rather than a principal product for which a separate allocative baseline should be provided. However, in reaching a recommendation, officials had regard to potential impacts on business investment and future-proofing. A separate allocative baseline for vanadium bearing materials would provide flexibility for potential projects to increase vanadium recovery. Accordingly, officials recommended a separate allocative baseline for vanadium bearing materials.
38. A further question was whether the baselines should be structured on a 'residual' basis, where each baseline represents the emissions (per unit of product) associated with a non-overlapping step in the process or alternatively on a non-residual basis where each baseline represents all emissions (per unit of product) up to the point of each product in question. Officials concluded that a residual baseline approach was appropriate as it is consistent with the approach taken in other activity definitions, is the most transparent approach and avoids potential over allocation when one step in the production process changes.

Consultation

39. In December 2009, the Ministry published the Consultation Document.¹⁷ The Government received 57 submissions. Where responses raised issues that are relevant to the options and impacts considered in this RIS then these have been identified and discussed in the relevant sections above.
40. In April 2010 the Ministry published the Summary of Submissions, which summarises the key issues raised, the Ministry's assessment of these proposals and the Government's conclusions.¹⁸
41. In addition, the Ministry has consulted directly with relevant stakeholders on activity descriptions before issuing a notice requiring information for the purposes of allocation in the New Zealand *Gazette*. This is a requirement under the Act (Section 161F). The Ministry has published Activity Analyses setting out its assessment and its recommendations.¹⁹

¹⁷ See: <http://www.mfe.govt.nz/publications/climate/development-industrial-allocation-regulation-ets/index.html>

¹⁸ See: <http://www.mfe.govt.nz/publications/climate/industrial-allocation-submissions-summary/index.html>

¹⁹ See: <http://www.climatechange.govt.nz/consultation/submissions-industrial-allocation/summary-activity-analyses/index.html>

Implementation

42. The proposal will be given effect through regulations prescribing activities as eligible industrial activities under the Act. The Ministry will administer the regulations and the Act provides for allocation decisions to be made by the Chief Executive. Further details on implementation were provided in the previous RIS (for group 1 activities).

Monitoring, evaluation and review

43. The Act requires the Minister to conduct regular reviews of the operation and effectiveness of the NZ ETS (Section 160). The first review will occur in 2011 and will occur every five years thereafter. The Act (Section 160(5)) also specifies what the review must cover, although the review is not limited to these matters. Further details on monitoring were provided in the previous RIS (for group 1 activities).

ANNEX A

Before issuing a notice calling for information for the purposes of allocation to industry, the matters the Minister must have regard to under Section 161E(1) of the Act are:

- Activities must be defined by reference to a physical, chemical or biological transformation of inputs into outputs;
- Activities should not be defined by reference to the technology or fuel used, the age of the plant or the quality of the types of feedstock used when the activity is carried out;
- Activities should be defined in a way that -
 - is consistent and equitable across industries;
 - takes into account the impacts on business investment, geographic location and the structure of the activities;
 - takes into account the potential for intermediate products produced when the activity is carried out to be substituted for bought-in inputs;
- There should be no overlaps between activity definitions;
- The activity definitions should reflect those used in Australia; and
- Any other matters the Minister considers relevant.