

Regulatory Impact Statement

New Zealand Emissions Trading Scheme: Industrial Allocation for Production of Reconstituted Wood Panels (Group 5 Activity)

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 production of reconstituted wood panels has been identified as a proposed new eligible industrial activity under the Act, having been found to be both trade-exposed and emissions-intensive. The regulations being proposed will allow firms who carry out this activity to apply for an 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.

As is the case with all proposed new eligible industrial activities, there are inherent data risks surrounding the calculation of New Zealand Units that firms engaging in this activity will be allocated. The Ministry evaluated these risks as part of the analysis that resulted in its recommendation to make the proposed regulations for production of reconstituted wood panels.

Kevin Currie, Director Environmental Protection

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 overseas firms that do not face a comparable cost on emissions in their home countries.
3. Cabinet has previously decided that assistance¹ in the form of an 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).² This framework was incorporated into the Act in December 2009. The proposed regulations implement this framework.
4. 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.
5. 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.³

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

² See: <http://www.climatechange.govt.nz/publications/ris/ets-industrial-allocation.html>

³ 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”.

6. 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.
7. Regulations allowing allocation of New Zealand Units to EITE firms on an intensity basis have already been agreed to for 23 activities. 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.⁴ On 2 August 2010 Cabinet agreed to make regulations prescribing a second set of four activities (the Group 2 Activities).⁵ On 13 September 2010, Cabinet agreed to make regulations prescribing a third set of two activities (the Group 3 Activities).⁶ On 15 November 2010, Cabinet agreed to make regulations prescribing a fourth set of five activities (the Group 4 Activities).⁷ Following analysis of the information supplied in response to the *Gazette* notices, a fifth set containing one additional activity has now been identified as eligible for allocation (the Group 5 Activity).
8. Further details on the status quo were provided in the previous RIS (for group 1 activities).⁸

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 Units.
10. The Ministry recommends the making of regulations prescribing the production of reconstituted wood panels as an eligible industrial activity. This activity has been identified as fulfilling the criteria of being both emissions-intensive and trade-exposed, and therefore qualifies for eligibility under the Act.
11. 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).
12. 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 production of reconstituted wood panels. Rather the proposal and this RIS focus on:
 - the description of the activity;

⁴ See CAB Min (10) 23/6.

⁵ See CAB Min (10) 27/7.

⁶ See CAB Min (10) 33/8.

⁷ See CAB Min (10) 41/5.

⁸ See: <http://www.climatechange.govt.nz/publications/ris/ets-industrial-allocation.html>

- the products to be used as the basis for an allocation.

Objectives

13. 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.

Regulatory impact analysis

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

14. How an eligible industrial activity is defined, including the start and end points (i.e. the boundaries of the activity), will determine 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.
15. 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.
16. 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).⁹

Activities proposed in the consultation document

17. In December 2009, the Ministry published *Development of Industrial Allocation Regulations under the New Zealand Emissions Trading Scheme: Consultation Document* (the Consultation Document).¹⁰ The Consultation Document proposed activity descriptions and the products to be used as the basis for allocation.¹¹ 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.
18. Stakeholders were also invited to nominate additional activities that they considered were potentially eligible.

New activities identified during the consultation process

19. Following release of the December 2009 consultation document, 27 further proposed activities were identified by submitters, as potentially eligible for allocation, one of which was the production of reconstituted wood panels.
20. 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.
21. 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.¹²
22. 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.
23. For other proposed activities and products, stakeholders suggested significant changes to the proposals during the consultation. This was the case for the production of reconstituted wood panels.
24. 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.¹³ This is considered in more detail below.

⁹ It is currently unclear as to whether or when this scheme will be introduced in Australia.

¹⁰ See: <http://www.mfe.govt.nz/publications/climate/development-industrial-allocation-regulation-ets/index.html>

¹¹ See Annex 1: <http://www.mfe.govt.nz/publications/climate/development-industrial-allocation-regulation-ets/index.html>

¹² See: <http://www.climatechange.govt.nz/consultation/industrial-allocation/summary-activity-analyses/index.html>

¹³ See Section 2: <http://www.mfe.govt.nz/publications/climate/industrial-allocation-submissions-summary/index.html>

Production of reconstituted wood panels¹⁴

25. A small number of NZ companies produce wood panels for the domestic and export markets. The products include medium density fibre board (MDF), particle board (or chip board), oriented strand board (OSB) and other company specific brands such as Triboard. All these products appear to have broadly similar uses and can be collectively described as reconstituted wood panels. In addition to the reconstituted wood panels some companies produce raw veneer (from logs) and veneer products (plywood and laminated veneer lumber).
26. During the consultation stage an activity for medium density fibre board (MDF) was being developed in Australia for the proposed CPRS. However, stakeholders indicated that the New Zealand wood panels industry produces the much broader range of products mentioned above. It became apparent that the range of options available in developing an activity definition included:
 - A single activity definition encompassing a broad range of products
 - Multiple activity definitions for specific products (e.g. MDF, Triboard, strandboard, etc.)
 - Several activity definitions covering categories of similar products (e.g. reconstituted wood panels, etc.)
27. Option 1 was ruled out because of the very wide range of products with distinct uses, many of which have low emissions intensities (such as production of veneer and veneer products). There are some overlaps between end uses however and the analysis shows there are three reasonably distinct product categories with broadly similar uses. It was therefore considered that option 2 could be ruled out, as product-specific activity definitions could risk a distortion in the market where some similar (substitutable) products receive different levels of allocation. The most appropriate option was to define activities according to broad product categories (option 3).
28. Three potential activity definitions were identified on this basis: production of reconstituted wood panels, production of low density particle boards and production of veneer products (such as plywood and veneer lumber). These activities could be distinguished by product density and particle size.
29. Industry indicated their support for a single activity definition for reconstituted wood panels, encompassing the manufacture of products like MDF, particle board, OSB and Triboard.
30. Data from industry submissions indicated that the only activity likely to exceed the emissions intensity threshold for moderately intensive activities was the production of reconstituted wood panels. With confirmation from the industry, it was decided that it was not worthwhile continuing with the other activities.
31. Again, the key matter was the extent to which activity definitions may affect investment decisions by taking account of substitutability between the different types or products. The proposed activity definition for reconstituted wood panels covers a broad range of

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.

products with similar uses, but is distinct from other wood products with different uses, and which are also substantially less energy intensive.

32. Industry submitted that the activity definition for production of reconstituted wood panels should encompass the production of panels from harvested logs rather than from wood particles. However officials recommended that the definition be circumscribed so as to include production from wood particles only, as:
- Wood chips are an intermediate product which can be substituted for bought-in product instead of being manufactured. The industry's information suggests that up to 50% of the chips used to produce MDF and particle board are in fact traded. While there is currently no trade in certain types of chips or in strands and flakes, it is theoretically possible there could be.
 - To define the input as being harvested logs would be inconsistent with the treatment of chipping operations in the market pulp and various paper activity definitions (where chipping is excluded).
33. In assessing the eligibility of this activity for allocation, detailed checks have been conducted to assess the completeness and reasonableness of the data submitted and the associated risks, consistent with the approach taken for the previous groups of activities.¹⁵
34. Detailed checks have revealed that there is low/medium risk associated with the data used to determine the eligibility, and medium risk in respect of allocative baseline for this activity. The data risk rests in the accuracy of the production and revenue data provided by submitters.
35. In relation to production data, this was provided by submitters in volumetric terms (m³) rather than by weight. For the purpose of calculating an allocative baseline, production is required to be in the unit of tonnes. Conversion from m³ to tonnes is dependant on the density of the product. Given the uncertainty over the mix of products and their density, there is no basis to ascertain if the production data is reasonable.
36. In relation to revenue data, the market price (price per tonne of product) for reconstituted wood panels deviated greatly among submitters. One outlier firm had a significantly lower market price than the other firms. Although there is insufficient information to substantiate why this is so, the firm has confirmed that all sales are at arms length, and the revenue data it submitted is in line with that disclosed in its statutory accounts. On balance, and consistent with the approach adopted previously where a firm's data was consistent with other publically available data, officials considered that the revenue data submitted by the firm was reasonable.
37. To increase overall confidence in the industry-wide data, officials obtained third-party assurance over data from the largest producing firm, as this was most likely to sway the allocative baseline. This data is therefore able to be relied on for purposes of the industry's eligibility and the allocative baseline process. To decrease the risk further would require assurance work to be carried out on the other firms' data. There is limited value from undertaking further assurance work for this activity, because it would be a costly undertaking relative to the benefits.

¹⁵ The Ministry for the Environment contracted PricewaterhouseCoopers to check a complete set of data was submitted by each firm and assess the risk of errors or inaccuracies associated with data resulting in incorrect emissions intensity classifications or allocative baselines. In some cases, specific data sets have been audited.

Consultation

38. In December 2009, the Ministry published the Consultation Document.¹⁶ 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.
39. For production of reconstituted wood panels, submissions were received from six firms. Officials have for the most part dealt with the Wood Processors Association (WPA) who have acted on behalf of the industry.
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.¹⁷
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*. The Ministry has published Activity Analyses setting out its assessment and its recommendations.¹⁸ The consultation requirements in the Act (Section 161F) were met.

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 is taking place 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).

¹⁶ See: <http://www.mfe.govt.nz/publications/climate/development-industrial-allocation-regulation-ets/index.html>

¹⁷ See: <http://www.mfe.govt.nz/publications/climate/industrial-allocation-submissions-summary/index.html>

¹⁸ See: <http://www.climatechange.govt.nz/consultation/submissions-industrial-allocation/summary-activity-analyses/index.html>

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.