

Regulatory Impact Statement

New Zealand Emissions Trading Scheme: Industrial allocation for group 2 activities

Some of the content of this document has been deleted where the information is either commercially sensitive or legally privileged. Deletions and the reason are shown with the text '[Deleted]'.

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

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

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

² See CAB Min (10) 23/6.

highly emissions intensive and trade exposed; or the activity is an Australian eligible industrial activity.

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 assistance³ 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 the previous RIS (for group 1 activities).⁴
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.
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 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.⁵ Following analysis of the information supplied in response to the *Gazette* notices, five additional activities have now been identified as eligible for allocation.
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 an initial set of 12 activities and it is assumed that regulations are also made for the five additional activities.
8. Further details on the status quo were provided in the previous RIS (for group 1 activities).⁶

³ The level of assistance will be reduced each year by 1.3% beginning in 2013.

⁴ See: <http://www.climatechange.govt.nz/publications/ris/ets-industrial-allocation.html>

⁵ See CAB Min (10) 23/6.

⁶ See: <http://www.climatechange.govt.nz/publications/ris/ets-industrial-allocation.html>

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 the 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; and
 - 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.

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 used in Australia.

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).⁷ The Consultation Document proposed activity descriptions and the products to be used as the basis for allocation.⁸ 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.
17. 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.⁹
18. 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 following activities:
 - the production of glass containers; and
 - manufacturing of carbon steel from cold ferrous feed.
19. For other proposed activities and products, stakeholders suggested significant changes to the proposals in the Consultation Document. The Ministry assessed these alternative proposals against the matters the Minister must have regard to under the Act and considered potential impacts for the different options. The Activity Analyses sets out the Ministry's assessment and conclusions.¹⁰ This was the case for one activity, the production of cementitious products, which is discussed below.

Production of cementitious products

⁷ See: <http://www.mfe.govt.nz/publications/climate/development-industrial-allocation-regulation-ets/index.html>

⁸ See Annex 1: <http://www.mfe.govt.nz/publications/climate/development-industrial-allocation-regulation-ets/index.html>

⁹ See: <http://www.climatechange.govt.nz/consultation/industrial-allocation/summary-activity-analyses/index.html>

¹⁰ See Section 2: <http://www.mfe.govt.nz/publications/climate/industrial-allocation-submissions-summary/index.html>

20. The manufacture of cement involves two stages, the production of clinker and the milling of clinker into cement. The first stage of producing clinker is emissions intensive and where the majority of emissions are emitted. The cement milling stage is not emissions intensive in its own right. There are two options to defining this activity:
 - Clinker definition which only contains the production of clinker, being the emissions intensive stage in the process
 - Cement definition which covers both steps in the process
21. Officials recommended the clinker activity definition to the Minister because trading of clinker is possible. This is demonstrated by the importation of small quantities in the past to cover unexpected plant outages, albeit this is not normal business practice. The cement milling stage should be considered as a standalone activity, and is not emissions intensive in its own right. It was also consistent with the definition proposed in Australia and most consistent with the matters to which the Minister must have regard.
22. A cement definition would be appropriate if clinker was not a readily traded product (as noted above, previous trading had been small scale and not normal practice). The cement industry in New Zealand is integrated, in that there are no standalone clinker producers or cement millers. The industry preference is for a cement definition. They further argue that a clinker definition, unlike a cement definition, would not incentivise the reduction of emissions by way of reducing the clinker content in cement.
23. The Minister directed officials to develop a cement activity definition.
24. Having determined that cement would be the end point, which is the first step with regard to the activity definition, the next step was to determine the structure of the allocative baseline, which would determine the units that a firm would receive. Four options were considered
 1. Two allocative baselines, one for clinker and another for cement milling;
 2. One allocative baseline for cement, i.e. the production of clinker and the milling of clinker into cement;
 3. Two allocative baselines, one for cement (including the clinker used) and another for clinker not used to produce cement (e.g. if it were traded); and
 4. One allocative baseline covering emissions from the entire cement process but based on the clinker produced.
25. Not all of these options were consistent with the matters which the Minister must have regard to. In evaluating the options, particular consideration was given to ensuring:
 - a fair and appropriate allocation which accurately reflects the emissions and does not lead to significant under or over allocation;
 - allocation does not impact on investment decisions; and
 - consistency with other activities.
26. In considering the impact of allocation on investment decisions the two types of decisions which are relevant are decisions to expand production and or invest in different filler options that would substitute for clinker, reducing the emissions per tonne of cement.
27. The production of cementitious products is likely to be a highly emissions intensive activity. This means firms carrying out this activity would likely be entitled to an allocation

covering 90% of their emissions. However, there is a risk with these options that the way in which the allocative baselines are calculated could result in an allocation in excess of this.

28. Option 1 has a risk of a small over allocation (about 92% as opposed to 90% of emissions), as a result of decreased clinker content. This estimate is based on substituting clinker with up to 75% additives which is unlikely at the present time therefore the risk associated with this over allocation is low. This option would allow trading to occur and is most consistent with the matters the Minister must have regards to, in particular the way other activities have used multiple allocative baselines for the different stages of the production process. This definition is likely to have the least impact on business decisions, minimising the potential to distort the market.
29. Option 2 only provides an allocation for clinker if it is milled into cement. It would not give an allocation for clinker if it were traded. This option could lead to a significant over allocation (about 143% as opposed to 90% of emissions) if the clinker content in cement was reduced by the substitution of filler. Thus there is the potential to impact on investment decisions. This could to some extent be mitigated by specifying minimum clinker content within cement. If this was set too high then this could stifle innovation however the risk of over allocation would be reduced. Setting a minimum level would therefore need to strike a balance between these two effects. This option was generally consistent with the matters that Minister must have regard to and is simple from compliance and administrative perspectives (although the use of a minimum threshold would add a level of complexity). It is consistent with other integrated activities, such as the production of carbamide (urea), which has a single allocative baseline.
30. Option 3 raised a number of legal concerns. [Deleted]
31. Option 4 has a risk of a small over allocation (about 94% as opposed to 90% of emissions) if clinker was traded. If clinker is not traded then there is no risk of an over allocation. This would have only a small impact on business investment decisions. It is consistent with other integrated activities such as aluminium, which have a single allocative baseline. This option was consistent with the matters to which the Minister must have regard and is simplest from a compliance and administrative perspective.
32. Given the considerations above, officials recommended option 1 as this is most consistent with considerations and the matters the Minister must have regard to. It is least likely to lead to an under or over allocation, or to impact on investment decisions. Officials ruled out option 2 for the risk of significant over allocation and option 3 for legal reasons. Option 4 was officials' second preference.

New activities identified during the consultation process

33. 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. The Activity Analyses sets out

the Ministry's assessment and conclusions.¹¹ This was the case for one activity considered in this RIS: the production of clay bricks and field tiles. This is considered in more detail below.

Production of clay bricks and field tiles

34. Following identification of clay bricks as a potentially eligible activity, a draft activity definition was provided to brick-making firms for comment. Subsequent discussions with the firms identified a range of products that had the same inputs and followed the standard transformation.¹²
35. This raised the issue of how to describe the product(s) and how to structure the allocative baseline(s). Two options were considered, each with a single activity description and either:
 1. a single product and allocative baseline; or
 2. multiple products and allocative baselines.
36. The key considerations in evaluating the two options was to consider the matters to which the Minister must have regard as well as ensuring that:
 - a fair and appropriate allocation which accurately reflects the emissions and does not lead to significant under or over allocation;
 - allocation does not impact on investment decisions by taking account of substitutability between the different types of products produced; and
 - products which are not emissions intensive are not included in the activity as, if they were included, would either effect the eligibility of the other products or receive an allocation when their production may not be emissions intensive in its own right.
37. Under option 1, in order to draft a single product definition to include the range of products, it would need to be defined very broadly. This could lead to products which may not be emissions intensive in their own right falling within the definition and thus receiving an allocation. A single allocative baseline could lead to an over allocation solely on the basis of making a hollow product rather than a denser product as these can have different emissions intensities. This would be an inequitable outcome, and have the potential to distort the market. It would also be inconsistent with the treatment of other activities with different end products with different emissions intensities, such as the manufacturing of carbon steel from cold ferrous feed. A single allocative baseline would be more appropriate if the different products produced are substitutable as this would avoid creating distortions between these products and hence would not impact on investment decisions.
38. Option 2 would lead to a fairer allocation which more closely reflected actual emissions, given the variation in emissions intensity between the products. This removes the risk of an over allocation on the basis of the density or shape of the product, reducing the likelihood of this impacting on investment decisions. Because this means that the activity is not too broadly defined, it minimises the risk of products which may not be emissions intensive in their own right falling within the definition. Multiple allocative

¹¹ See Section 2: <http://www.mfe.govt.nz/publications/climate/industrial-allocation-submissions-summary/index.html>

¹² As defined in the Activity Analysis. See: <http://www.climatechange.govt.nz/consultation/industrial-allocation/summary-activity-analyses/index.html>

baselines would be more appropriate if the different products produced are not substitutable.

39. An analysis of the two options on the level of allocation received was undertaken using data provided by two firms. [Deleted] This suggests that option 2 is preferable to option 1 as it results in a more equal treatment of firms. In addition, option 2 also resulted in a more accurate reflection of actual emissions. It was also clear that the different products were not substitutable which also suggests option 2 is preferable to option 1.
40. The fiscal impact was the same for each option (albeit distributed differently). This was therefore not sufficient to determine which option should apply.
41. Based on these considerations, a pragmatic decision was made to group the products into three broad categories with an allocative baseline for each (i.e. option 2) as this would result in a smaller impact on firms' individual allocations and would avoid potential over allocation. The three categories can be considered as distinct as they have different end uses which are not substitutable. The three categories are:
 - facing bricks and pavers primarily used for façade and landscaping;
 - field tiles and other clay based products primarily used for drainage; and
 - fire bricks where these are produced from clay minerals as the raw materials but not where feldspar, silica and other metal oxides are added as a separate raw material which exceeds the 10% cap on additives primarily used in places that have to withstand high temperatures (e.g. kilns).
42. The 10% cap on additives for fire bricks was set following discussion with industry regarding the current level of additives used to colour the bricks and prevent discolourisation. This also took into account future research and development as brick makers look at ways to reduce the environmental impacts of the manufacturing process.
43. Indications were that those fire bricks that were within the cap would meet the emissions intensity threshold and thus they were included in the activity description, albeit with a separate product description so that they did not receive an over allocation of emissions units. Other fire bricks that exceeded the cap were excluded as this was considered preferable to widening the proposed definition further, potentially including a range of other products that may not be emissions intensive in their own right. In addition, the other fire bricks could be considered as a separate activity.

Consultation

44. In December 2009, the Ministry published the Consultation Document.¹³ 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.
45. 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.¹⁴

¹³ See: <http://www.mfe.govt.nz/publications/climate/development-industrial-allocation-regulation-ets/index.html>

¹⁴ See: <http://www.mfe.govt.nz/publications/climate/industrial-allocation-submissions-summary/index.html>

46. 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.¹⁵

Implementation

47. 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

48. 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).

¹⁵ 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.