Regulatory Impact Statement: Threshold for liquid fossil fuels opt-in

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Emissions Trading Regulations: Threshold for Liquid Fuels Opt-In

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by the Ministry for the Environment.

It provides an analysis of options to determine which purchasers of liquid fossil fuels will be able to opt in as voluntary participants in the New Zealand Emissions Trading Scheme (ETS). This implements a policy change that was made as part of the Climate Change (Emissions Trading and Other Matters) Amendment Act 2012.

Opting in allows a fuel purchaser to take on the ETS compliance obligations associated with the fuel it buys, and in particular to manage its own risks around changing emission unit prices. The options considered would either restrict this option to a limited number of large fuel retailers, or allow a larger number of transport and industrial fuel users to also become voluntary ETS participants.

These options have been assessed on the basis of their impact on administration and compliance costs, both for the sector and for the EPA, and on the basis of any impacts on the market for liquid fuels. However given that ETS costs are a small component in liquid fuel pricing, all such impacts are relatively small.

Allowing each additional fuel purchaser to opt in will impose some additional costs on the relevant fuel suppliers.

These policy options will not impair private property rights, market competition, or the incentives on businesses to innovate and invest, or override fundamental common law principles (as referenced in Chapter 3 of the Legislation Advisory Committee Guidelines).

Malcolm McKee, Acting Director, Climate and Risk

Status quo and problem definition

Policy decision to be implemented

1. Previously the Climate Change Response Act 2002 (the Act) specifies, in Schedule 4 Part 3, that purchasers of jet fuel could opt in as voluntary ETS participants if their purchases exceed 10 million litres per year. Purchasers of other liquid fossil fuels, (petrol, aviation gasoline, diesel, fuel oil, and any other fuels that might be developed and sold in the future) could not opt in.

2. The Climate Change (Emissions Trading and Other Matters) Amendment Act 2012 amended the Act to make a number of changes to the ETS. One of these was to amend Schedule 4 so that (effective from 1 July 2013) purchasers of all liquid fuels are able to opt in as voluntary ETS participants. This amendment implements a Cabinet decision of June 2012 by removing the restriction that only jet fuel purchasers can opt in. It also replaces the threshold of 10 million litres with the words 'where any prescribed threshold is met'.

Implications of status quo

3. If regulations are not made to introduce thresholds, in principle any purchaser, no matter how small, would eventually be able to opt in. Given the very large number of fuel purchasers this clearly introduces a risk of excessive administrative costs both for the EPA and for the liquid fuels industry.

Problem definition

4. The mandatory liquid fossil fuel participants are the four major oil companies, who import fuels or take them from the Marsden Point refinery. Large volumes of fuels are also sold by Gull New Zealand Ltd, which is now a fifth major participant in the wholesale fuel market. The Cabinet decision to open up opt-in to all fuels was intended to allow all five of these firms to manage their ETS obligations on the same basis, which is desirable both from a competition point of view and to reduce their compliance costs.

5. In addition, there are about twenty domestic distributors who buy fuel from these five companies and on-sell it to users. Some of these distributors, as well as some of the larger transport and industrial fuel users, are likely to have an interest in opting in. The choice of a threshold, or thresholds, for participation will determine which, if any, of these fuel purchasers are allowed to opt in. As detailed below, this will have implications for the market in liquid fuels and for the costs met by different market participants.

6. This RIS evaluates proposals to make regulations which will complete implementation of the 2012 policy decision by specifying the required thresholds for purchasers of all liquid fossil fuels.

7. Since there was no policy intent to change the current status of opt-in purchasers buying jet fuel, these regulations will also ensure that the current threshold of 10 million litres for purchasing jet fuel is retained.

Background on opting in to the ETS

Existing rules for voluntary participation in the ETS

8. The ETS is structured on the basis that only large-scale purchasers of any fuel will be able to opt in. Gas and coal purchasers are able to opt in to the ETS, but only if they buy a large amount of fuel: 2.0 PJ of gas or 250,000 tonnes of coal per year. These thresholds are equivalent to between 60 and 140 million litres of liquid fuel. This threshold approach was adopted for several reasons:

    a. Opting in involves significant administrative costs for the EPA.

    b. Opting in places potentially significant costs on upstream mandatory ETS participants. They are required to account for all fuel that they sell to opt-in participants and deduct it from their surrender obligations, while still managing their obligations for other emissions including any other fuel they sell.

    c. For smaller fuel purchasers, the costs involved in managing ETS obligations, and sourcing relatively small numbers of emission units, are likely to outweigh the perceived benefits.

9. However, the threshold for jet fuel was set much lower than for gas and coal. This was done in response to the particular structure of the airline industry and to allow regional airlines to opt in as nominally separate participants. There are no commercially independent opt-in participants buying or using such a small amount.

10. The Act requires a stand-down period of twelve months before a new opt-in registration takes effect. When an opt-in participant decides to deregister and hand the reporting and surrender obligations back to the fuel supplier, there is a further stand-down period of 48 months before the opt-in participant is released from these obligations. These requirements are imposed because the aim of opting in is to allow both the supplier and the opt-in participant to manage their price risks over time. It is not the intent of the Act that fuel purchasers should be able to strategically opt in and out again in response to price changes.

Scope and implications of opt-in

11. Under the Act, purchasers can only opt in on the basis of fuel that they buy directly from a mandatory participant. Liquid fuel purchasers can only opt in for fuel that they buy directly from the oil companies or from importers; they must consistently buy more than the threshold volume from these suppliers, not from retailers. This applies whether or not the retailer has itself opted in. This has some consequences for opting in by liquid fuels purchasers:

    a. Whenever fuel users (as opposed to fuel resellers) are able to opt in there is a risk of creating a new market distortion due to this different treatment of customers who buy their fuel from different suppliers (oil companies or resellers).

    b. An opt-in participant must account for all fuel that they buy from mandatory participants in their annual emissions return, while excluding any fuel they might buy from retailers. Mandatory participants, but not retailers, must account for and deduct fuel sold to opt-in participants in their emissions return.

12. In contrast to gas and coal, ETS costs are a relatively small component of the price of liquid fuels – not more than 3 cents per litre for diesel at current ETS settings, with a unit price of $25. At current, much lower, unit prices the actual cost of the ETS is immaterial and can only have a small effect on price competition.

13. Liquid fuel participants have the option to apply for a Unique Emissions Factor (UEF), if their fuel composition varies so that the emissions factors used for reporting are no longer accurate. This option is also available to opt-in participants. However, there have been no applications for liquid fuel UEFs to date, and it is very unlikely that any opt-in participants would apply.

Alternative commercial arrangements

14. A number of fuel users, including some who made submissions on this proposal, have already effectively 'opted in' by making a commercial arrangement with their fuel suppliers. The purchaser sources emission units and provides them to the supplier as part of the fuel purchase. From the point of view of these users, opting in would not change their current approach to sourcing emission units. Opting in would just make it mandatory for fuel suppliers (if they are mandatory participants) to allow these purchasers to source their own units.

Objectives

15. The policy objective for the amendment to the Act was to reduce or eliminate a potential market distortion at the wholesale level, by allowing large fuel retailers to opt in.

16. Regulations to carry this into effect are expected to meet the Government's normal criteria for regulations in this area, by contributing to the efficiency, effectiveness, transparency, clarity, equity and environmental integrity of the ETS. None of the options considered are expected to affect the environmental integrity of the ETS, but there would be a risk of doing so if there are so many opt-in participants that monitoring and auditing become difficult.

Regulatory impact analysis

Range of options considered

17. The most basic issue to be determined is what volume of fuel is set as a threshold. This is important to determine how many fuel purchasers will be able to opt in. The practical range is from about 10 million litres, which would let a large number of industrial and transport users opt in, to about 100 million litres which would restrict entry to only a few large wholesalers or resellers.

18. There are also options in terms of how a threshold is set for the various fuel types. A separate threshold could be set for each individual fuel type, so that for example a purchaser would be able to opt in specifically for diesel if they buy more than the threshold amount of diesel in a year. Alternatively a combined threshold could be set for all fuels so that a purchaser who buys more than the threshold amount, in total, can opt in for all fuels.

19. As indicated above, there is no policy intention to change the existing threshold for jet fuel. Regardless of how other fuels are treated, these regulations must ensure that jet fuel purchasers who buy more than 10 million litres a year, and who may already be opt-in participants, will continue to be eligible. For this reason, if a single new threshold is set for all fuels combined, say 100 million litres, then it would work in parallel with the existing threshold for jet fuel. For example, a firm could opt-in either:

    a. As a jet fuel participant if it buys more than 10 million litres of jet fuel in a year, or

    b. For all LFFs if it buys more than 100 million litres of all LFFs combined.

20. For consultation purposes, these two variables (the volume and how fuels are grouped) were consolidated into four options:

    1. A low threshold for each fuel type, set at or near 10 million litres a year similar to the existing threshold for jet fuel.

    2. A low combined threshold for all fuels, set at or near 35 million litres a year.

    3. A higher threshold for each fuel type (other than jet fuel which stays the same) for example approximately 30-40 million litres per year each for petrol and diesel.

    4. A high combined threshold for all fuels, set at or near 100 million litres a year.

21. The consultation document indicated the preferred option was Option 4, which would achieve the objective of enabling a large wholesaler to opt in without creating any new issues or costs for fuel suppliers and retail purchasers.

22. Some submitters also suggested that they should be able to opt in, although their own purchases are so small that they could not opt in under any of these options. For this reason, a fifth option will be considered:

    5. A very low combined threshold of about 10 million litres a year of all fuels.

Criteria for options analysis

23. All of these options are considered to be equivalent in terms of environmental integrity: emissions from the liquid fuels sector will continue to be reported with similar accuracy and integrity, as at present. The only issue would be if there were so many participants that they challenge the EPA’s ability to monitor and audit this sector.

24. Transparency and clarity also appear to be similar for all options. The level of transparency and clarity of ETS regulations, transactions and reporting will not be affected. Although one submitter mentioned transparent operation of the liquid fuels market as a benefit, it is difficult to see how opting in for one very small component of the cost of fuel would achieve this. The rules for ETS participation do not affect the transparency, or otherwise, of pricing by fuel suppliers.

25. *Effectiveness:* Any of the options considered will be effective, as they will achieve the policy objective which drove the legislative change now being implemented. However, if more purchasers are allowed to opt in, the claimed benefits of opting in are available more widely.

26. *Efficiency:* The most important issue for efficient operation of this option is the impact on compliance and administration costs. If a fuel retailer or user is enabled to opt in, it will need to account for all fuel that it buys from mandatory participants and include that in its emissions return. Each fuel supplier (as a mandatory participant) is required to account for these fuels and deduct them in its own emissions return. This is a mandatory imposition of costs on a third party, so it needs to be justified by the benefits of allowing opt-in. In addition, allowing more participants adds significant auditing and other costs for the EPA.

27. *Equity:* Regulations should be fair and treat different ETS participants in an equitable way. Setting a threshold inevitably means some different treatment of purchasers who are just above and below the threshold. Because both resellers and users can opt in, there may be some complex commercial relationships between mandatory participants, opt-in participants, and non-participants all of whom can sell fuel to one another.

Economic, environmental and fiscal impacts

28. As discussed above [11] there is a perceived market distortion at present because substantial fuel companies cannot directly manage their ETS obligations on the same basis as mandatory participants who are also their competitors. Opt-in by fuel users will cause a potential distortion between retail (fuel purchased from a non ETS participant) and other fuel (purchased from a mandatory ETS participant) used by opt-in participants. However, because the ETS cost is a small part of the cost of fuel (and small in comparison to year-to-year changes in oil prices) any direct impact on price competition will be small.

29. The cost of opt-in for fuel suppliers and participants is difficult to quantify. Because liquid fuels are often bought at the pump by individual drivers, accounting for opt-in fuel may be more complex in this sector than for gas or coal.

30. The EPA has substantial ongoing costs for the general operation of the Registry and account maintenance. In addition there is a one-off set-up cost of approximately $20,000 for any set of new participants. However these costs are very difficult to assign to individual new participants.

31. In addition all of the new participants will be regularly audited by the EPA. Currently the average cost of an audit is about $12,000. However, if a mix of fuel resellers and users opt in, the complexities around accounting for fuel bought from mandatory participants, from other opt-in participants, and from non-participants would make auditing in this sector more challenging than others.

32. The benefits of opting in are also very difficult to quantify. Some submitters noted potential benefits to themselves, of up to about $80,000 a year for a small participant opting in for 10 million litres. However, as discussed below [42] this is a transitional gain achieved by opting in at a time of falling and very low prices, and would be achieved at the expense of suppliers or other users. Any long-term benefit will be smaller, and will only be achieved by the opt-in participant effectively managing price risks over time.

33. As discussed above [23] there is no difference between these options in terms of their environmental impact. In all cases the total surrender obligation, for suppliers plus opt-in participants, is expected to be an accurate reflection of the total emissions from the use of the fuel.

Comparison of options

Option	Comment	Rank (1 high, 5 low)
1 low threshold for each fuel type (10 million litres)	*Effectiveness:* Large number of fuel users able to opt in, up to about 50. Diesel-only users (the majority) would opt in for all their fuel, but others would only be able to opt in for the one fuel (diesel or fuel oil) that they use most. *Market efficiency:* May distort competition due to these opt-in participants only buying fuel from mandatory participants, who are in competition with other suppliers. *Equity:* Nominally equal treatment of jet fuel and other liquid fuel users, but in practice diesel users who are not at all comparable to the regional airlines would be able to opt in. There would be many more opportunities for opt-in in this sector than others e.g. gas and coal. A mix of resellers and users would opt in, and would face complex rules about their obligations for fuel bought from mandatory participants and any bought from other opt-ins and from non-participants. *Compliance and administration costs:* The EPA would need to manage a significant increase in the number of ETS participants, and audit them. Potential additional costs if opt-in participants also apply for unique emission factors (UEFs). This option would allow opt-in by fleet operators who buy some fuel at the pump, which implies significant costs for fuel suppliers in accounting for fuel.	2 4 4 N/A
2 low combined threshold for all fuels (approx. 35 million litres)	*Effectiveness:* In comparison to Option 4, a number of industrial and transport users would be able to opt in, as well as distributors/resellers. Up to about 20 new participants. *Market efficiency:* May distort competition due to opt-in participants only buying fuel from mandatory participants, who are in competition with other suppliers. Unlike some who could opt in under Options1 or 5, participants of this size would be firms who can put significant resources into managing price risk. *Equity:* Allows more opt-in opportunities than other sectors. Rough equivalence with treatment of jet fuel. Some fuel users would opt in, as well as some resellers, so opt-in would affect their choices about fuel purchasing and add complexity to these commercial relationships and decisions. *Compliance and administration costs:* Higher than for Option 4, due to the additional participants. However as some users on this scale have voluntary arrangements	3 2 1 N/A

	with suppliers now, the costs for them and their suppliers are likely to be manageable.	
3 higher threshold for each fuel type (approx. 35 million litres)	*Effectiveness:* Likely to be the same participants as for Option 2, because they typically use almost all diesel (transport) or almost all fuel oil (industrial). The difference is that they would only be able to opt in for this main fuel, and not for any small purchases of other fuels. This suggests that Option 1 or 2 would always be preferred over Option 3 as they allow the full benefits of opting in. *Market efficiency:* Similar to Option 2. *Equity:* Similar to Option 2 but could be seen as more restrictive than for jet fuel. *Compliance and administration costs:* As for Option 2, with slightly more complexity due to exclusion of some fuel.	4 3 3 N/A
4 high combined threshold for all fuels (100 million litres)	*Effectiveness:* Meets the original policy intent, but does not extend benefits of opt-in to smaller purchasers. Gull and potentially some resellers would opt in, but currently no end-users would be likely to meet this threshold. *Market efficiency:* Removes perceived distortion at wholesale level, with no impact on retail market. Firms opting in will have resources available to manage their unit purchases in a similar way to the mandatory participants. *Equity:* Allows similar opportunities in this sector as for gas and coal purchasers, in line with overall policy settings for the ETS. Perceived unequal treatment vs jet fuel. *Compliance and administration costs:* Low as there would only be one to five new participants.	5 1 2 N/A
5 very low combined threshold (10 million litres)	*Effectiveness:* In comparison to Option 1, this allows a few additional mixed-fuel users to opt in, for all of their fuel. *Market efficiency:* As for Option 1, with slightly more possibility of distorting competition. *Equity:* Similar to Option 1, but provides a number of additional liquid fuel purchasers with an opportunity that other fuel users do not have. *Compliance and administration costs:* The additional participants would be small purchasers of a mix of fuels,	1 5 5 N/A

	increasing complexity for suppliers and for auditing.	

34. This comparison suggests that Options 2 and 4 are quite similar in terms of meeting these criteria. The other three options all rank significantly lower.

Consultation

35. The proposal to introduce opt-in thresholds for all liquid fuels was open for public consultation, along with a number of other changes to related ETS regulations, from 24 April to 17 May 2013. Nine submissions expressed views on this proposal; of these four supported a 'high' threshold and five supported a 'low' threshold.

Submissions from the liquid fuels industry

36. Two submissions were from fuel suppliers who are existing mandatory ETS participants. These companies would be required to account for, and deduct, fuel sold to opt-in participants from their ETS obligations. Two submissions were from retail fuel suppliers who are not mandatory participants. One of these firms intends to opt in as soon as possible and can do so with a threshold of 100 million litres; it is likely that the other would also be able to opt in.

37. These submissions supported a threshold of 100 million litres which would allow a limited number of the larger fuel customers to opt in, and argued that this is essential to limit administration costs. They also preferred that the threshold should be for all fuels, so that there would be no need to account separately for ETS obligations for one or more fuels if these fall below a separate threshold.

38. They also raised a number of concerns:

    a. That there is a need for clarity about the criteria for opting in, e.g. purchasing the threshold amount in a particular year or as a forecast amount, and on what happens if purchases fall below the threshold.

    b. Concern about liabilities for the supplier if an opt-in participant fails to meet its obligations, and possibly vice versa.

    c. Dissatisfaction with the requirement for opt-in to be delayed by twelve months.

39. Officials consider that these issues are generally clear in the Act and existing regulations, but note that the amended regulations must clarify any outstanding points. There is an established process for prospective opt-in participants to apply and demonstrate that they buy more than the opt-in volume, and liabilities for the parties involved are clearly limited to their own reporting and surrender obligations.

40. The twelve-month stand-down (along with the parallel requirement for 48 months notice when opting out again) is a legislated requirement which could only be changed with a further amendment to the Act.

Submissions from fuel users

41. Five submissions were from fuel users who considered that they could be in a position to opt in with a lower threshold. One of these was from a purchaser that buys well over 35 million litres of diesel; they supported Option 1 or 2, with no clear preference.

42. The other four submissions came from firms that may be in a position to opt in under Option 1, and they all preferred a low threshold to allow them to opt in. Two submitters asked for the ability to opt in for all of their fuel, although none of the four options considered in the consultation document would achieve this due to the small amounts they buy: it would need an aggregate threshold of about 10 million litres of all fuels.

43. Submitters anticipated cost savings in their own purchases, because fuel suppliers are currently passing through the cost of units that they bought in 2012 or earlier, at higher than current prices. By opting in now, while unit prices are very low, purchasers would avoid this cost. One submitter quantified these savings as approximately $80,000 for each ten million litres of fuel purchased. However, these savings would be the result of opting in at this specific time, and taking advantage of hindsight which was not available to mandatory participants when they determined their purchasing strategies.

44. Submitters also argued more generally that they should be free to manage their own emission price risks over time.

45. One submitter suggested that the significant costs for an opt-in participant to administer and account for its own emissions would be an adequate deterrent to any opt-in by smaller purchasers when the benefits do not exceed the costs, and that the availability of opt-in, even if it is not widely used, could help ensure transparency in fuel pricing.

46. Some submitters also mentioned equal treatment for purchasers of jet fuel and other fuel as a reason for supporting Option 1. This ignores the fact that airlines are, in practice, much larger purchasers.

Conclusions and recommendations

47. Option 4 achieves the original policy intent of including fuel retailers (not fuel users) with minimal compliance costs and effect on markets, and in line with the approach in other sectors.

48. Option 2 would widen the availability of opt-in to include a number of resellers and large fuel users. This would lead to an increase in compliance and administrative costs, with up to about 20 new participants. However, since some of these users have voluntary 'opt-in' already in place, it is clear that the costs can be manageable for these participants and their fuel suppliers.

49. The options involving a separate threshold for every fuel type (Options 1 and 3) are not recommended. Allowing a purchaser to opt in for one fuel type, while still having to buy other fuels outside of the opt-in arrangement, has no benefits and it would always be preferable to allow opt-in for all fuels if it is to be allowed at all.

50. Options 1 and 5, which involve allowing small users (10 million litres per year approximately) to opt in, are not recommended. These would significantly increase costs for both compliance and administration, with up to 50 new participants and the potential for future growth in numbers. There is no indication of clear long-term benefits to justify the costs.

51. Overall Option 2 is recommended.

Implementation

52. Regulations to set the new thresholds will be made under section 168(1)(o) of the Act. These regulations will be notified in the Gazette, and current and potential participants will be made aware of them by the EPA and MFE.

Monitoring, evaluation and review

53. These provisions will be reviewed, along with other rules and processes for ETS participants, when the ETS is reviewed under Section 160 of the Act. The next such statutory review is expected to occur in 2015.