Submission

By

THE NEW ZEALAND INITIATIVE

To the Ministry for the Environment

on

Reforming industrial allocation in the New Zealand Emissions Trading Scheme

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INTRODUCTION AND SUMMARY[1]

Thank you for the opportunity to submit on "Reforming industrial allocation in the New Zealand Emissions Trading Scheme," by the Ministry for the Environment ("MfE").

This submission is made by The New Zealand Initiative, a think tank supported primarily by chief executives of major New Zealand businesses. The purpose of the organisation is to undertake research to contribute to the development of sound public policies in New Zealand to help create a competitive, open, and dynamic economy and a free, prosperous, fair, and cohesive society.

The New Zealand Initiative supports the government's commitments under the Paris Climate Agreement and to achieve net zero emissions of long-lived greenhouse gases from 2050. We consider the New Zealand Emissions Trading Scheme ("ETS") is among the world's leading cap-and-trade systems for reducing greenhouse gases.

Industrial allocations ("IAs") serve to prevent leakage, which as MfE correctly notes can raise global emissions (p7). By preventing job losses caused by leakage, IAs can also enhance public support for emissions policies.

Leakage is the result of different (implicit or explicit) carbon prices across countries. Businesses can arbitrage these differences by relocating production to countries with lower carbon prices. In addition, trade-exposed domestic businesses can fail if forced to compete against offshore companies who derive a competitive advantage from a lower carbon price.

By aligning the effective carbon price with offshore prices, free allocations of emission units can prevent leakage and business failures. IAs can adjust the effective carbon price for trade-exposed businesses so that carbon pricing is neither a source of competitive advantage or disadvantage, neutralising leakage and failure risks.

The problem is that the current formula for allocating New Zealand Units ("NZUs") to trade-exposed businesses does not take relative carbon prices into account. The formula for industrial allocations is:[2]

$$A = P \; x \; AB \; x \; LA$$

where

- A is the firm's allocation for a single product (NZUs)
- P is the firm's total production of the product (typically in tonnes)
- AB is the allocative baseline for the product (t CO2-e/t product)
- LA is the level of assistance a particular activity receives (0.59 or 0.89 as based on the emissions intensity thresholds).

[1] Disclosure: the author of this submission owns a limited number of New Zealand Units through SALT Funds Management.
[2] Consultation document, p.14.

Since relative carbon prices do not inform allocations, industrial allocations have no connection to leakage risks.

The lack of a connection to leakage appears to have led to a serious over-allocation problem. A study commissioned by MfE, published earlier this year, found three of the four industries it surveyed had received industrial allocations of NZUs of more than 100% of their actual emissions.[3] One of the industries receive allocations three times greater than its emissions. We would not expect leakage to justify allocations of more than 100% of emissions.

Our submission is that the highest priority for MfE's industrial allocation reforms is to connect industrial allocations to leakage risks by basing allocations on relative carbon prices paid by domestic businesses and their offshore competitors. Relative carbon prices should be direct inputs into the allocation formula. Revising the allocation formula is the most direct solution to the over-allocation problem.

Unfortunately, the consultation document suggests MfE is considering reforms to every element of IAs *except* the formula. It is unclear why. The allocation formula is not among the matters which MfE says are out of scope (p8). There can be no argument that tying allocations to relative prices would impose an unreasonable analytical burden. Only 70 firms across 23 sectors received free allocations of NZUs in 2020. Any analytical overhead is small in comparison to the value at stake.

POLITICAL FEASIBILITY

The current rule for allocating IAs to trade-exposed firms threatens public support of IAs and emissions policies more generally.

Based on data from the Environmental Protection Agency, free allocations of NZUs to IA recipients in 2020 were worth more than $500 million at the current NZU price. Because these units were allocated using a formula which no direct link to leakage, it is unclear what share of these huge transfers removed leakage risk, and how much was a gift of taxpayer funds to commercial businesses. Based on the January 2021 study by Resource Economics cited above, it seems likely that more than half of industrial allocations are gifts. This is intolerable.

IAs can protect public support for emissions policies by preventing job losses via leakage, but there is a limit to what the public will pay. We estimate IAs to the three largest recipients, totally more than $300 million in 2020 at the current NZU price, amounted to more than $80,000 per job per year.

We question the merits and political sustainability of the current approach.

[3] Resource Economics (2021), "Potential for emissions leakage from selected industries in the ETS." Study commissioned by Ministry for the Environment, January. Link

AN ALTERNATIVE APPROACH

With the recent increase in the NZU price to above $50, leakage and IAs are now acute issues.

Policy makers have two ways to level relative carbon prices to protect trade-exposed businesses:

- Border adjustments to the price of imported goods; and
- IAs.

Leakage can also be substantially ameliorated by policy settings which align the domestic carbon price with trading partners.

While both border adjustments and IAs contribute to a level playing field for carbon prices, each has contrasting fiscal effects and different information overheads.

The government can use the two mechanisms in combination. Border adjustments on imported goods could be the primary means of levelling relative carbon prices while providing a fiscal benefit. Allocations of NZUs could be based on relative carbon prices *after* accounting for border adjustments. IAs would be a residual means of mopping up any gaps in the border adjustment.

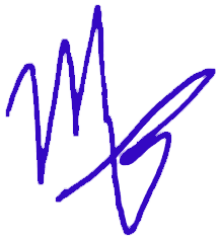
IAs are a fiscal drag. The government and taxpayers stand to gain hundreds of millions of dollars in avoided over-allocation by revising the formula for industrial allocations.

Officials can manage the analytical overhead of a price-based approach to IAs by shifting the burden of proof on trade-exposed firms to demonstrate their exposure to lower carbon prices offshore after border adjustments. With a limited number of firms eligible for IAs, it is difficult to see any great analytical burden from revising the allocation formula.

CONCLUSION

MfE's highest priority for its reforms should be to revise the formula for industrial allocations. The current formula does not consider relative carbon prices for trade-exposed firms. Accordingly, industrial allocations have no direct link to leakage risks. The recent increase in NZU prices calls for an urgent revision of the allocation formula. If left unchanged, the existing formula will gift hundreds of millions of dollars-worth of public funds to large emitters some with foreign owners. This outcome will threaten the political sustainability of IAs and possibly emissions policies more generally.

Thank you for considering this submission. We would welcome the opportunity to discuss the contents of this submission further with you.



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