Energy Resources Aotearoa
POWERING A BETTER NEW ZEALAND TOGETHER

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Environment Select Committee

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Petition of Alex Johnson: End free carbon credits by 2030 and undertake other actions to reduce emissions

Introduction

1. Energy Resources Aotearoa is New Zealand's peak energy sector advocacy organisation. We represent participants across the energy system, providing a strategic sector perspective on energy issues and their adjacent portfolios. We aim to enable constructive collaboration to bring coherence across the energy sector through and beyond New Zealand's journey to net zero carbon emissions by 2050.

2. This document constitutes our evidence in response to a request from the Environment Select Committee (the 'Committee') to provide a submission in response to the petition on ending the free allocation of carbon credits *inter alia* from Alex Johnson: Petition of Alex Johnston: End free carbon credits by 2030 and undertake other actions to reduce emissions (petitions.parliament.nz).

Key messages

3. The allocation of free units is a core element of an efficient, well-functioning New Zealand Emissions Trading Scheme (**NZETS**).

4. The purpose and effects of free carbon credits (more formally referred to as **industrial allocation**) are often misunderstood by the public and those without a deep understanding of the origins of the NZETS. That misunderstanding is demonstrated clearly in the petition in front of you today from Alex Johnson.

5. The primary purpose of industrial allocation, and the basis for its establishment in the NZETS, is to compensate firms operating at the time of the introduction of the NZETS for negative impacts on their property rights and profits.

6. Emissions leakage was instead used as the criterion to mitigate the scope of who was eligible for compensation rather than defining its purpose. Free carbon credits were not allocated to subsidise firms for their carbon emissions. The allocation of free units does not dampen the incentive to reduce emissions.

These units have a market value (or opportunity cost) and facilitate an efficient choice by emitters to sell and abate or keep and emit.

7. The use of so-called *complementary measures* should be largely unnecessary in light of a fixed and declining emissions cap. A Carbon Border Adjustment Mechanism (**CBAM**) is unlikely to be appropriate in the context of the NZETS.

8. To remain well-functioning, NZETS settings need to be stable and predictable. They should encourage businesses and producers to reduce emissions while encouraging innovation and the development of cleaner alternatives. Decisions should be based on demand and supply fundamentals rather than influenced by incessant political 'smoke' signals.

A well-designed emission reduction scheme: a brief explainer

9. A well-designed scheme balances the environmental imperative with the cost imposed on consumers, producers and taxpayers. Such a scheme:

    a signals optimal abatement via an efficient carbon price;

    b minimises compliance costs, and in doing so, the cost to the economy; and

    c maintains New Zealand's reputation as a place to invest.

10. Key to achieving these outcomes are:

    a a well-orchestrated and measured transition; and

    b suitable 'safety-values'.

11. These features (and others) led New Zealand (as the second jurisdiction in the world after the European Union ['**EU**']) to adopt an emissions trading scheme ('**ETS**') as part of the Climate Change Response (Emissions Trading) Amendment Act 2008. This was in preference to the original government proposal for a carbon tax set at$15/t CO_2.

12. The key difference between an ETS and a carbon tax is that the former fixes the quantity limit of emissions (known as the emissions cap) and lets the interaction between demand and supply set the carbon price. In contrast, a carbon tax sets the 'price', and the quantity of emissions adjusts to reflect that price (by being incentivised to reduce emissions up to the level of the tax and emitting if more costly to abate than paying the tax).

The role of property rights and compensation

13. When the NZETS was introduced, the rationale for compensation was the need to protect the property rights of existing emitters. This was achieved through the allocation of 'free' emission units. The NZETS increased firms' production costs and, in some cases, lowered asset values substantially in a way that shareholders could not have anticipated at the time of the investment.

14. Existing emitters had a legitimate expectation that they should retain their 'first-use' rights, even in the face of a (new) need to constrain carbon emissions. The expropriation of the rights to emit with or without compensation was informed by:

    a the approach taken to other natural resource issues (such as fisheries), and

    b the objectives of the NZETS.

15. The Labour-led Government that established the NZETS recognised the risk of infringing property rights and that firms would face losses due to its introduction. Box 4 on pages 59 and 60 of 'The Framework for a New Zealand Emissions Trading Scheme' explicitly stated:

> "However, some will not be able to pass the bulk of these costs on, resulting in profit impacts for shareholders and (potentially) some loss of competitiveness. The term "stranded assets" is sometimes used in this context."[1]

16. Compensation was given based on this rationale. However, to narrow the scope for potential compensation, it was decided to focus on 'competitiveness-at-risk' as the criterion to determine who received free units. It was always clear that this was not the reason for compensation:

> "*The government considers it unhelpful to frame discussion on assistance issues in terms of competitiveness-at-risk considerations because the concepts are poorly defined and the impacts often overstated*. There are many factors that influence firms' profitability and competitiveness. Emissions pricing would be just one of them, and its impact would be difficult to distinguish from those factors that managers and shareholders must (currently) routinely address."
>
> (emphasis added)

17. An important consequence of industrial allocation, but not the reason for, is that it manages the real risk of emissions leakage by reducing the cost impact of the NZETS on Emissions Intensive and Trade Exposed ('**EITE**') firms and reducing any competitive disadvantage with offshore firms subject to weaker climate policy. For companies that would not be able to pass on costs to their consumers (predominantly commodity exporters or those subject to import competition) 'free' allocation was seen as a market leveller for internationally exposed EITE firms. [2]

18. This is significant because the global playing field was at the time of the NZETS' establishment far from level and sixteen years on this unfortunately remains the

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1 The Framework for a New Zealand Emissions Trading Scheme, published by the Ministry for the Environment and The Treasury, September 2007.

2 On the other hand, petrol and power companies were deemed to be able to pass on the carbon costs and there ineligible to receive free units.

case. Globally, only 23% of greenhouse gas emissions are covered by a carbon price, with carbon prices varying significantly between jurisdictions. Further, only 4% of global greenhouse gas emissions face a direct carbon price within the range needed by 2030.[3]

19. However, it seems even this basic understanding (as set out above) has been lost to time. It is contrary to contemporary views from officials within the Ministry for the Environment who, in response to a letter to their Minister from Energy Resources Aotearoa, said that:

> "I would like to clarify that the core purpose of industrial allocation is to mitigate the risk of emissions leakage by reducing competitive advantage. It is not to "compensate incumbent firms for the impact of the NZ ETS on their existing property rights."[4]

Some common myths about free units

'Free industrial allocation is a subsidy'

20. No. A common criticism of industrial allocation (or 'free' carbon credits, as they have become known) is that they provide a subsidy to a select group of internationally competitive EITE businesses. These firms extract, produce or use fossil fuels in their production processes and are subject to international competition from jurisdictions that do not have a carbon price.

21. This view that free allocations are subsidies demonstrates a misunderstanding of the true nature of industrial allocation. A subsidy involves the government providing financial assistance to individuals or firms with the intention of encouraging production or consumption. Compensation to mitigate a loss of property rights does not meet this definition. A subsidy is different. Industrial allocation is not a production subsidy for emissions-intensive output.

'Free industrial allocation prevents emission reductions'

22. No. The mere obligation to trade units delivers the objectives of the NZETS – the abatement effect is achieved by the trading obligation and is independent of whether the recipient is given all necessary units or has to buy them all (or with any intermediate allocation). Officials accepted this point as set out in the Framework, which states:

> "Economic theory suggests that the free allocation of emission units (as opposed to auctioning) will typically not affect firms' decisions on levels of production."[5]

23. Moreover, industrial allocation incentivises investing in emissions reductions because firms can sell the New Zealand Units (**NZUs**) they receive or borrow

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3 See the World Bank's State and Trends of Carbon Pricing 2022 here: content (worldbank.org).

4 Letter from Minister Simon Watts to Energy Resources Aotearoa dated August 2024.

5 *op. cit*, 'The Framework', page 69, Box 6.

against the asset. As such, it is a source of capital that can be used to help fund new low emissions technology.

'Other *complementary* measures are also needed'

24. No. The carbon price is adequate until credible evidence to the contrary is presented. The Treasury also supported this stance at the time of the introduction of the NZETS. In its 2008 Briefing to the Incoming Minister of Finance, The Treasury stated that:

> "The adoption of the ETS renders most other abatement policies redundant. Additional policy measures should only be adopted where there are external costs and benefits that are likely to cause an inefficient level of emissions; or information barriers prevent cost effective mitigation from occurring; and the government can take action that would be effective in eliminating or minimising the identified market failure at a cost lower than the cost of purchasing units." [6]

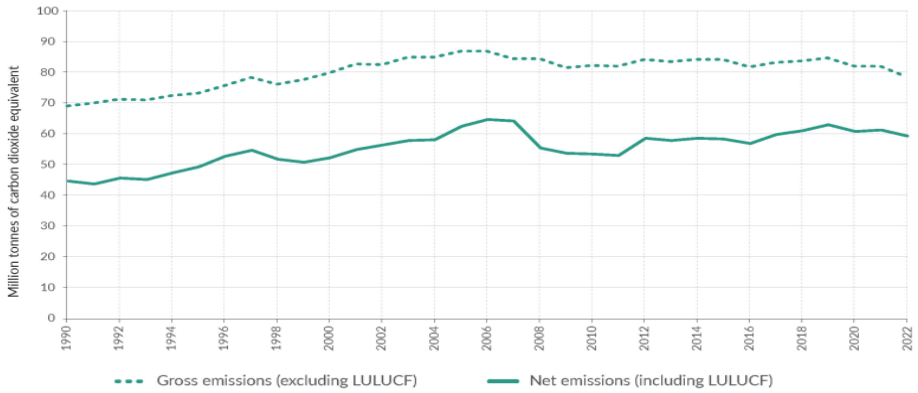
25. Our view is that single policy measures should be used so that their effectiveness can be assessed. If responses are inadequate, the original intervention can be intensified, or additional measures can be deployed. If instead (as has been the unfortunate case) multiple interventions are applied to the same problem, then it will not be possible to assess which intervention to intensify if responses are inadequate because the effects of the different measures will not be separable.

26. Where interventions cause uncertain but irreversible market changes, policy design should set a higher cost-benefit threshold—holding off intervention (rather than being impatient and hasty) until this higher benefit. This is often referred to as recognising the 'option value of waiting' in making irreversible interventions.

27. The Government has time to introduce more aggressive measures progressively should it be shown that the previous ones are failing to deliver the right policy outcomes. Figure 1 below shows this is not immediately apparent from our emission reduction profile.

[6] The Treasury document entitled 'Briefing to the Incoming Minister of Finance, Economic and Fiscal Strategy – Responding to your Priorities, 2008, page 29.

Figure 1: New Zealand's gross and net emissions from 1990 to 2022 (in Mt CO_2-e)



Source: Ministry for the Environment[7]

28. This shows that gross emissions peaked in 2006 and have been declining year-on-year since 2019.

29. In any case, so-called 'complementary measures' are rendered ineffective under a fixed and declining emissions cap, which is in place in the NZETS. There is a 'waterbed effect' of the declining cap that neutralises most other policies to reduce emissions.[8]

30. Complementary measures actively undermine the effective operation of NZETS by blurring or hiding the actual price of carbon from the market. This creates a vicious cycle in which the effectiveness of the NZETS is compromised and further undermined, leading to calls for the greater use of complementary measures.

Do we need a carbon border adjustment mechanism?

31. The petitioner suggests New Zealand implement a CBAM. A CBAM is effectively a tax or tariff at the border enforced on imported goods and services that do not comply with or embody a sufficient equivalent carbon price faced by domestic producers.

32. Several practical issues make the consideration of a CBAM highly problematic to New Zealand. Being:

    a they tend to be more suitable to jurisdictions where there are only modest overlaps between the domestic sectors covered by a carbon price and those sectors that compete against imports. For example, the EU has a narrowly applied carbon price (power and industrial processes), with much of its industrial base being offshored. New Zealand, on the other hand, has a wide application of its carbon price (all except agriculture), effectively covering all

7 See https://environment.govt.nz/publications/new-zealands-greenhouse-gas-inventory-19902022-snapshot/.

8 For further, fuller detail on the 'waterbed' effect and its implications, see our note entitled 'Perspectives Series – The 'waterbed effect': the most important climate policy you've never heard of', dated 30 November, 2021, accessible via the following link: https://www.energyresources.org.nz/dmsdocument/202.

domestic manufacturing or processing and is heavily dependent on a wide range of imports some of which it domestically produces (such as urea);

b New Zealand has spent decades entering into trade agreements that reduce border tariffs and taxes (and it continues to try to do this). The imposition of a CBAM by New Zealand runs counter to this ethos. Our reliance on exports (predominantly agricultural, which are not subject to a carbon price) to pay our way in the world could come under threat if we imposed a CBAM on imports and could be the cause for retaliatory measures by those countries we export to; and

c a CBAM is only effective in protecting domestic producers (in New Zealand, for example, urea producers) from importers who do not face a carbon cost but does not protect exporters who face a cost of carbon but who are exposed to unequal competition from other jurisdictions who do not, like methanol. Some other form of protection would still be required for our exporters where this occurs.

33. These are non-trivial issues that make the application of a CBAM in New Zealand highly problematic. We also understand that its implementation is not going smoothly in the EU, especially concerning its impact on the right to sustainable development for developing countries. For example, importing flowers from Africa has raised several practical issues.

Stable and predictable carbon policy settings are essential to a well-functioning NZETS

34. The NZETS is the key tool to help New Zealand meet its emissions budgets, the Nationally Determined Contribution (**NDC**), and the 2050 target. The NZETS is the main incentive driving market-led measures to reduce net emissions.

35. However, constant changes – especially those suggested by the petitioner – are destabilising to a well-functioning NZETS capable of delivering predictable market outcomes. Updating NZETS settings every year has already introduced significant price volatility and uncertainty for the market.

36. We advise steadying the NZETS with appropriate legislative guardrails and providing much-needed predictability in policy settings. This will enable the NZETS to deliver net emissions reductions in line with the budgets and targets without unnecessary and avoidable emissions leakage offshore or incentivising the premature shutdown of industry within New Zealand.

37. We reiterate our feedback to the Ministry for the Environment on their recent consultation on NZETS settings, in which we recommended (among other recommendations):

a stabilising the NZETS settings through legislation so that the sinking cap is made visible to the market through to 2050;

b reducing the frequency of reviewing the NZETS settings – annual is too frequent and has created price volatility and market uncertainty;[9]

c considering a lower price corridor as a stabilising influence when reviewing the cost containment reserve; and

d ensuring that industrial allocation rights are preserved by legislation through 2050. [10]

Frequent reviews disincentivise investment in emissions reduction

38. The changes suggested by the petitioner would create a massive disruption to the nature and operation of the NZETS.

39. We reiterate our concern that regular changes to the NZETS – particularly the annual NZETS settings reviews and the discretionary five-yearly review of industrial allocation – may undermine future investment in emissions reductions, which conflicts with the purpose of the NZETS. If emitters expect their allocative baseline to be reduced quickly in response to significant emissions reduction investments, their incentive to make these investments is moderated.

40. Timeframes such as these may have the unintended consequence of incentivising only incremental improvements in recipients' emissions efficiency, as the rational response may be to reduce their emissions only to their allocative baseline and no further (or to seek subsidies to compensate for this diminished commercial incentive). This could undermine the case for more significant 'step-change' scale investments in emissions reductions.

41. Significant emissions reduction investments often have payback periods beyond ten years, so the prospect of an allocative update within five years may, perversely, deter emissions reduction investment. [11]

42. This is a significant barrier to industrials making gross emissions reduction investments.

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9 The annual reviews also create unessential workload for officials, businesses and commentators who must participate.

10 Annual updates to NZETS limits and price control settings for units 2024. See our submission here: 283 (energyresources.org.nz).

11 If an industrial firm makes a large investment in decarbonisation, it is doing so on the expectation it will continue to receive (and sell) its allocation for the avoided emissions over a given period (usually a 10-15 year investment horizon).

Concluding remarks

43. We would like to thank the Committee for the invitation to submit on this petition and would be more than happy to present our submission to the Committee in person at the appropriate time.

44. Stability and predictability are two critical touchstones for an effective and well-functioning NZETS. Constant policy changes and overly frequent reviews are destabilising and should be removed from legislative obligations.