

# Emissions trading bulletin

## Industrial allocation update

No 12 September 2009

The Government has introduced the Climate Change Response (Moderated Emissions Trading) Amendment Bill ('the Bill') to Parliament, to amend the Climate Change Response Act (CCRA).

This bulletin explains the changes proposed to the industrial allocation provisions of the New Zealand Emissions Trading Scheme (NZ ETS) and provides an update on how the Government intends to implement the new allocation provisions after the enactment of legislation.

There will be an opportunity for consultation on detailed regulations once the Act has been amended.

### Overview of changes to the industrial allocation provisions of the NZ ETS

The allocation provisions of the Bill are designed to better address competitiveness impacts on New Zealand industries and to more closely align with the approach to free allocation being taken under the proposed Carbon Pollution Reduction Scheme (CPRS) in Australia. This will facilitate effective implementation of this element of the NZ ETS and will result in assistance being provided to sectors where international evidence suggests competitiveness-at-risk pressures exist.

Initial implementation of this part of the Bill will focus strongly on two things:

- getting the system of making free allocations established and operational
- gathering data on emissions so that the 2011 review is better informed than current data will allow.

This means that initial levels of allocation may not be precise in all cases. However, the NZ ETS contains a transition phase which includes a price cap and a two-for-one progressive obligation until 2013. During this time all industries will be provided with significant assistance. This means the risks from adopting allocation provisions that are not specifically designed for the New Zealand economy are reduced.

#### Uncapped allocation

The Bill changes the allocation provisions of the existing CCRA from allocating a fixed pool of emissions to an uncapped approach to allocation. There is no longer an explicit limit on the number of New Zealand units (NZUs) that can be allocated to the industrial sector.

The allocation plan process for the industrial sector has been replaced with both detail in the primary legislation and provision for regulations to be made by the Minister for Climate Change Issues that specify the level of free allocation for each eligible activity.

#### Allocation linked to output

The annual allocation that each eligible person will receive will be made in advance ('a provisional allocation') based on their previous year's output, with a reconciliation mechanism (ie, a true-up payment) to be used once actual output is known.<sup>1</sup>

Allocation will not be given in advance for those who begin conducting an eligible activity (ie, new entrants), but these people will be able to apply to receive an allocation once production in their first year is known.

#### Allocation on the basis of activities

Allocation will be granted to those carrying out eligible activities. This is distinct from the approach of granting free allocation on the basis of firms, facilities or sectors. (An 'activity' is the chemical or physical



transformation of a set of inputs into a given set of outputs.) The allocation provisions require each activity seeking assistance to be defined before its case for assistance can be determined.

The principles guiding the definition of activities in the Bill are based on those in the CPRS, with the intent that where similar activities exist in both countries, activities will be defined similarly.

### **Eligibility for assistance**

The Bill contains two tests that activities must pass before they are considered eligible: a trade exposure test and an emissions intensity test.

The trade exposure test prevents assistance from being granted to activities where:

- the activity is electricity generation, or
- there is no international trade of the output of the activity across oceans, or
- it is not economically viable to import or export the output of the activity.

The emissions intensity test is based on tonnes of emissions per 1 million New Zealand dollars of revenue. Under this test there are two thresholds:

- a moderately emissions-intensive threshold of 800 tonnes of CO<sub>2</sub>-e per 1 million New Zealand dollars of revenue, as compared against the weighted average emissions intensity from those conducting the activity in New Zealand
- a highly emissions-intensive threshold of 1600 tonnes of CO<sub>2</sub>-e per 1 million New Zealand dollars of revenue, as compared against the weighted average emissions intensity from those conducting the activity in New Zealand.

The intention is for data from the financial years 2006/07, 2007/08 and 2008/09 to be used in applying the thresholds.

These emissions intensity thresholds are broadly equivalent to the revenue thresholds in the CPRS, adjusted for the exchange rate. The use of a sector average means even where one firm is particularly emissions intensive, it will not qualify for free allocation if the activity average does not meet the thresholds. The converse also applies.

In addition to using these emissions intensity thresholds, the Minister for Climate Change Issues may confer eligibility on trade-exposed activities if the

same activity meets equivalent thresholds under the CPRS, or is likely to do so.

The current intent is to define the types of emissions that are to be included in the calculation of an activity's weighted average emissions intensity through regulations.

As noted below, where eligibility is conferred on the basis of eligibility of the same activity under the CPRS, liquid fossil fuels may be included in allocative baselines to the same extent they are under the CPRS.

The Bill does not contain emissions intensity thresholds that allow activities to qualify on the basis of emissions as a proportion of value added.

The Bill allows flexibility for the Minister for Climate Change Issues to use a figure representing the 'emissions intensity' of electricity used for determining eligibility under the CPRS (1 tonne of CO<sub>2</sub>-e per MWh), although this figure is not stated in the Bill. The current intent is to use the same figure used under the CPRS.

### **Levels of assistance**

There will be two tiers of assistance depending on whether the activity is moderately or highly emissions intensive. These levels begin at 60 per cent and 90 per cent of the allocative baseline (a benchmark number of NZUs per unit output) for the activity and phase-out at a rate of 1.3 per cent from 2013 (calendar year). This means that in 2013 the rate of assistance for highly emissions eligible activities will be  $90\% \times 98.7\% = 88.8\%$  and so on.

For eligible activities, the Minister for Climate Change Issues will establish allocative baselines based on either:

- the average emissions and electricity use per unit output from the activity, based on data collected from those undertaking the activity in New Zealand in the financial years 2006/07, 2007/08 and 2008/09, or
- information on equivalent emissions and electricity use per unit output from Australia.

The second of these considerations is designed to allow the adoption of allocative baselines that have been developed in Australia, with modifications to reflect the different emissions intensities of electricity generation in the two countries.



The intent is that the electricity 'allocation factor' used to develop allocative baselines will be a New Zealand factor such as the one developed by the Stationary Energy and Industrial Processes Technical Advisory Group (0.52 tonnes of CO<sub>2</sub>-e per MWh).

The classes of emissions from an activity that can count towards allocative baselines will be the same as emissions that count towards the industrial allocation 'pool' under the existing Climate Change Response Act, except where eligibility is conferred on the basis of eligibility under the CPRS, emissions from liquid fossil fuels will be able to be considered to the same extent they are in the CPRS.

There is no intent to update allocative baselines during commitment period 1 of the Kyoto Protocol.

### **Review of free allocation provisions**

The Bill contains provisions for a five-yearly review of the free allocation provisions beginning in 2011. Certain amendments to allocation regulations will have a five-year time lag (subject to the actions of future parliaments).

### **Process for free allocation to be made to eligible people**

The regulation-making process to enable people who are eligible to receive a free allocation will be as follows.

- The Minister for Climate Change Issues develops draft activity definitions for activities that are potentially eligible.
- These draft activity definitions will be consulted with affected parties. It is intended that this will occur via a December 2009 consultation document. This document will also seek notice of other potentially eligible activities.
- Once activity definitions are finalised, the Minister may require emissions, financial and other information from people conducting the activity and consider the eligibility of the same activity in Australia.
- If the activity is considered eligible, the Minister may develop regulations containing allocative baselines based on either average emissions and electricity use per unit output from the activity using the data collected above or based on information from Australia. The Minister may not make regulations

unless satisfied the activity is eligible.

- Once regulations are in force, eligible people will be able to provide specified data to apply for and receive a provisional free allocation of NZUs in accordance with the formula in the Bill.

## **Government's approach to implementing free allocation**

Given the entry date of 1 July 2010 for the stationary energy and industrial processes sectors, a primary concern during the implementation of the industrial free allocation process will be establishing activity definitions, eligibility and allocative baselines (if appropriate) of each defined activity in the shortest possible timeframe.

In practice this will mean the Minister for Climate Change Issues adopting activity definitions developed under the CPRS wherever possible. In practice, it is unlikely that a New Zealand-specific activity definition will be developed unless a corresponding CPRS activity definition has not been developed or the inputs, outputs, or chemical/physical transformation described in the CPRS definition is materially different from the relevant New Zealand activity.

In the short run (up to 2013), given the focus on establishing the systems necessary to operate the free allocation provisions and improving data quality and the transition phase, activities in New Zealand would need to differ in a very substantial way from those in Australia for this to be considered material.

It also means that, where possible, the Minister for Climate Change Issues intends to use the flexibility provided by the Bill to confer eligibility on the basis of eligibility, or likely eligibility, of the same activity under the CPRS and to adapt the relevant allocative baselines using New Zealand's electricity allocation factor.

In practice this will mean that some activities will take longer than others to have activity definitions developed, eligibility decisions made and regulations made (if appropriate) containing allocative baselines. It is anticipated that there will be a number of categories of activities:

- those where CPRS activity definitions, eligibility decisions and allocative baselines can be adopted, meaning regulations will be able to be



promulgated relatively quickly

- those where CPRS activity definitions are available and can be adopted but either (i) collection of data will need to occur to test eligibility and develop allocative baselines (if appropriate) or (ii) more information is needed from the CPRS on eligibility and allocative baselines. Where data is available under both the CPRS and from New Zealand, the current intent is to use CPRS data to provide a consistent approach and given the likelihood of larger sizes of most industries in Australia
- those where there is little work that can be adopted from the CPRS and where the allocation process will need to start from scratch in New Zealand, including the definition of activities and collection of activity data.

### **Collection of financial, emissions and other data**

Despite the intention to adopt CPRS eligibility settings and allocative baselines wherever possible during the initial stages of the free allocation process, it is also intended that the Minister for Climate Change Issues will exercise powers to require information on emissions, revenue and output for activities for which definitions are produced.

The reason for this is that this information is likely to be required for the 2011 review of the emissions trading scheme and for some activities it may ultimately prove faster to decide eligibility and develop allocative baselines in New Zealand rather than wait for sufficient progress to be made under the CPRS.

This data collection exercise may initially focus on those activities where it is likely to be required to determine eligibility and develop allocative baselines, rather than those where data may only be required to inform the 2011 review.

### **How to get involved in the industrial allocation process**

The Government intends to release a consultation document in December 2009 following the passage of legislation.

This document will mark the start of the allocation process. It is expected that this document will provide

the opportunity for stakeholders to comment on the draft activity definitions based on those already developed under the Australian CPRS and to seek notice of additional activities believed to be eligible.

It is also intended that this document contains proposals for comment on the emissions, financial accounting and other guidance that will be required to be followed by industry where data is required by the Minister for Climate Change Issues for the purposes of establishing the eligibility of an activity, establishing allocative baselines and reviewing the operation of the emissions trading scheme.

### **Limited informal discussions with industry during the select committee process**

There may be some limited discussions between officials and stakeholders on specific issues during the Select Committee. This is unable to be confirmed until the Select Committee has been established and the role of departmental advisers has been confirmed. Select Committee approval would be needed for officials to discuss certain matters with stakeholders.

As noted in the Minister for Climate Change Issues' speech introducing the Bill to Parliament, the Government has an interest in the impact of the moderated NZ ETS on certain sectors. If approved by the Select Committee, there may also be discussions between these sectors and officials.

### **Where to go for more information**

- To view a copy of the Minister for Climate Change Issue' speech introducing the Bill to Parliament visit <http://www.beehive.govt.nz/minister/nick+smith>
- To view a copy of the Bill visit <http://www.legislation.govt.nz/>

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<sup>1</sup>Note that this reconciliation mechanism is only regarding free allocation and does not take account of surrender obligations that those receiving free allocation might have under the scheme.

