



## PROACTIVE RELEASE COVERSHEET

<b>Minister</b>	Watts	<b>Portfolio</b>	Climate Change
<b>Title of briefing paper</b>	Progressing updates to industrial allocation in the emissions trading scheme	<b>Date to be published</b>	Friday 11 October 2024

### List of documents that have been proactively released

<b>Date</b>	<b>Title</b>	<b>Author</b>
	<a href="#">Cabinet paper: Progressing updates to industrial allocation in the emissions trading scheme</a>	Minister of Climate Change
25 September 2024	<a href="#">Cabinet Economic Policy Committee Minute of Decision: Progressing updates to industrial allocation in the emissions trading scheme (ECO-24-MIN-0201)</a>	Cabinet Office
1 August 2024	<a href="#">Regulatory Impact Statement: Emission costs incurred by New Zealand Steel Limited for cogenerated electricity</a>	Ministry for the Environment

#### Information redacted **YES**

Any information redacted in this document is redacted in accordance with the Ministry for the Environment's policy on proactive release and is labelled with the reason for redaction. This may include information that would be redacted if this information was requested under Official Information Act 1982. Where this is the case, the reasons for withholding information are listed below. Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

#### Summary of reasons for redaction

Legal privilege – paragraphs 33 and 34 of the Regulatory Impact Statement

## Policy and Privacy

Office of the Minister of Climate Change

ECO - Cabinet Economic Policy Committee

## Progressing updates to industrial allocation in the Emissions Trading Scheme

### Proposal

- 1 I seek Cabinet agreement to delegate powers to allow the Minister of Climate Change to make decisions and issue drafting instructions for updating industrial allocative baselines in emissions trading scheme regulations.
- 2 I seek Cabinet agreement to a change to industrial allocation policy treatment for New Zealand Steel Development Ltd (NZ Steel) for its use of cogenerated electricity under the New Zealand Emissions Trading Scheme (NZ ETS).
- 3 I also seek Cabinet decision on when the above updates to industrial allocation regulations enter into force.

### Relation to government priorities

- 4 The proposals in this paper support the coalition agreements between the National Party and our coalition partners – restoring confidence, certainty and price stability in the NZ ETS and strengthening and streamlining Government regulation.

### Executive Summary

- 5 New Zealand's industrial allocation system protects firms in certain industries from facing the full costs that the NZ ETS would otherwise place on them. The purpose of industrial allocation is to reduce the risk of industrial activity reducing or closing in New Zealand and production moving elsewhere in the world.
- 6 Under the industrial allocation system, firms in industries that are emissions intensive and exposed to international competition receive New Zealand units (NZUs) from the government each year. Allocations are based on the industry-wide average emissions intensity of an activity (an "allocative baseline"), and the actual level of a firm's production. The value of allocations made in 2023 was \$400 million.<sup>1</sup>

### *General update to all industrial allocative baselines*

- 7 Industrial allocation "baseline" settings – that is, emissions per product unit – have not been updated since they were first set in 2010 and consequently are out of date. Officials have collected data to support updates to the baselines so that allocations reflect firms' actual emissions intensity and emissions costs. This process is part of implementing reform legislation from 2023.
- 8 Updating baselines to reflect this new data will affect firms ranging from small glasshouse tomato and rose growers to some of our largest firms, such as Methanex. Most firms would see a reduction in their allocation. Overall, there will be a net

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<sup>1</sup> 5.6 million NZUs at the 2023 carbon price in regulations of \$71.97

reduction in allocations made to industry of approximately 112,000 units, valued at \$6.7 million<sup>2</sup> per year.

- 9 I seek Cabinet approval for delegation to the Minister of Climate Change to make decisions and issue drafting instructions for amendment regulations to the Climate Change (Eligible Industrial Activities) Regulations 2010, updating the baselines. The new baselines are outcomes of applying methods prescribed in the Climate Change Response Act 2002 and no policy decisions are required.
- 10 I also seek Cabinet approval to make decisions and issue drafting instructions for technical amendments to two activity definitions that are eligible to receive industrial allocation. I will bring the amendment regulations to Cabinet before the end of 2024 for approval.
- 11 I also seek Cabinet decision on when these updates are first applied. The earliest date is 1 January 2024 through the annual true-up process for industrial allocation. This will prevent further overallocations and address instances of under allocation as soon as possible, with a net fiscal benefit to the Crown of approximately \$6.7 million. This is the start date that has been signalled to the public and firms in the course of amending legislation and collecting data.
- 12 However, the change for some firms is significant. An alternative start date of 1 January 2025 would give those firms time to adjust to the outcome of this one-off regulatory process.

*Specific update for NZ Steel's electricity allocation factor*

- 13 NZ Steel has been receiving an industrial allocation for consuming electricity from on-site cogeneration since 2010. However, a recent independent review has found that this cogenerated electricity is not affected by emissions pricing, meaning that NZ Steel has been receiving an allocation to compensate it for costs it is not actually facing. The cost to the Crown is approximately 225,000 NZUs per year, or \$13.5 million.
- 14 NZ Steel has not contested this finding but has sought a 'phased transition' for changes to its industrial allocation. The Crown separately has a funding agreement with NZ Steel for the installation of an electric arc furnace. The project is running ahead of schedule and expected to deliver one million tonnes of emission reductions per year from the end of 2025.
- 15 I propose to remove NZ Steel's overallocation from using cogenerated electricity and develop specific electricity allocation factors (EAF) each year for NZ Steel, reflecting its sources of electricity in that year.
- 16 I seek Cabinet's decision on when this change takes effect. The earliest this over-allocation could be removed is from 1 January 2024. However, applying this from 1 January 2025 would recognise the significance of the change for NZ Steel, who have argued the nature and timing of the change was not clear in communications at the time of negotiations around the arc furnace project.

*Future updates*

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<sup>2</sup> Using the secondary market price of \$60 as at 20 August 2024. All financial forecasts of changes to allocations use this price in this Cabinet paper.

- 17 I expect to receive data that affects allocative baselines and the EAF each year, requiring further updates to the regulations. These updates follow a legislative formula and there is no discretion involved. Unlike, the one-off updates to baselines discussed above, these changes would become routine and ongoing. Consequently, I seek an ongoing delegation from Cabinet to make decisions and issue drafting instructions to amend update baselines each year due to annual updates to the general EAF and other components of allocative baselines. I will ensure that Cabinet still has visibility of any changes that could have significant impacts on firms.

## Background

- 18 New Zealand's industrial allocation system protects firms in certain industries from facing the full costs that the NZ ETS would otherwise place on them. The purpose of industrial allocation is to reduce the risk of industrial activity reducing or closing in New Zealand and production moving elsewhere in the world. This would have economic and social consequences to New Zealand and would potentially increase global emissions.
- 19 Under the industrial allocation system, firms in industries that are emissions intensive and exposed to international competition receive New Zealand units (NZUs) from the government each year. The allocations allow firms to offset their NZ ETS-related costs. Allocations are based on the industry-wide average emissions intensity of an activity, and the actual level of a firm's production.<sup>3</sup>
- 20 Firms receiving industrial allocations include those in large emissions intensive and trade exposed industries such as steel and cement manufacturing. But less obvious industries are also eligible, including the growing of some vegetables in glasshouses, and production of newsprint and whey powder.
- 21 Decisions on eligibility and entitlements for industrial allocations were, in general, last made in 2010. Those decisions were made on firm level data from 2006 to 2009 and are significantly out of date. Twenty-six industrial activities are eligible and over eighty firms receive allocations from the Environmental Protection Authority each year. The value of allocations made in 2023 was over \$400 million and this is recognised as an expense in Crown accounts.

## Analysis

### *General update to all allocative baselines*

- 22 I have collected data to support updates to the industrial allocation "baseline" settings so that allocations will better reflect firms' actual emission costs. This process is part of implementing reform legislation from last year, which requires the Minister to update baselines.
- 23 The baseline update will affect firms differently. Some firms would see a reduction in their industrial allocation, and some would see an increase. These changes result from industry consolidation, and emission factor and plant efficiency changes. While the allocative baselines decrease for 80 percent of firms, they increase for the rest.

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<sup>3</sup> The rate of industrial allocation or the 'level of assistance' is currently being phased-out at one percentage point each year. Highly emissions intensive activities receive an allocation equivalent to 86% of their NZ ETS costs, and moderately emissions intensive receive a 56% allocation.

- 24 These decisions are technical in nature. Allocative baselines are solely based on emissions and production data from firms and determined using a formula in the Climate Change Response Act 2002. The Minister of Climate Change sets the resulting allocative baselines in regulations.
- 25 I seek Cabinet's approval to delegate to the Minister of Climate Change the power to make decisions and issue drafting instructions for amendment regulations to the Climate Change (Eligible Industrial Activities) Regulations 2010.
- 26 I will bring the amendment regulations to Cabinet for approval when drafted. Once implemented through regulatory change, the updates will result in approximately 112,000 fewer NZUs being allocated per year (\$6.7 million).
- 27 Indicative new allocative baselines have been communicated to firms.

*Timing of when changes take effect*

- 28 I seek Cabinet's decision on when these updates take effect. There are no statutory timeframes for updating industrial allocation regulations following the collection of emissions information.
- 29 The earliest date is 1 January 2024. This can be done through the annual true-up process that will occur in May 2025. Provisional allocations, originally made on projected production values, are adjusted for final production data. This basic process is an annual one that participants in the scheme are used to. The difference this time is that the adjustment would use the new allocative baselines.
- 30 This will prevent further overallocations and address instances of under allocation as soon as possible, with a net fiscal benefit to the Crown of approximately \$6.7. It is consistent with the messaging to the public and firms over the course of the review of baselines. It also addresses a few instances where some firms are being under-allocated under current baselines.
- 31 I am aware that this could be seen as a retrospective change. However, the legislation already requires the annual correction of a previous year's allocation.
- 32 The updates could also come in force one year later, from 1 January 2025. This timing would reflect the significant change for some firms and give those firms time to adjust to the outcome of this one-off regulatory process.

*Approval for changes to two activity definitions*

- 33 For this year's allocative baseline updates, I am also seeking a one-off agreement to make decisions and issue drafting instructions for technical amendments to two activity definitions, which currently do not accurately reflect the activity inputs and outputs. These are technical changes to activity definitions for the production of carbamide (urea), and production of protein meal, which will not materially affect their allocations. Last year's data collection used these two updated activity definitions.

*Specific update for NZ Steel's electricity allocation factor*

- 34 Producing iron and steel from iron sand is a highly emissions intensive and trade exposed industrial activity. In line with the purpose of the industrial allocation policy, NZ Steel receives an allocation to reduce the risk of emissions leakage.

- 35 The estimated impact of the NZ ETS on electricity prices is described as the electricity allocation factor (EAF). NZ Steel uses cogenerated electricity supplied by Alinta at its Glenbrook plant. Since 2010, NZ Steel has been receiving industrial allocation from its use of cogenerated electricity as if that electricity was from the grid; that is, using the general EAF.
- 36 To test the accuracy of that allocation, an independent expert reviewed the relevant electricity contract. It was found that that emissions pricing has no impact on the price for most of the electricity from the cogeneration plant. The exception being a small amount of natural gas, as the contract allows for gas market price pass through. The cost to the Crown of this allocation is approximately 225,000 NZUs per year, or \$13.5 million.
- 37 I propose to remove NZ Steel's over-allocation from using cogenerated electricity by developing annual EAFs for NZ Steel according to its sources of electricity each year. The only emissions that will be counted towards NZ Steel's EAF is that from any natural gas used by the cogeneration plant at a rate of 0.5618 tonnes of carbon dioxide equivalent per megawatt hour and from any grid-based electricity. I will use existing powers in the Act to call for electricity and natural gas consumption data from NZ Steel to apply that framework and update allocative baselines. This will reduce NZ Steel's allocation by 225,000 NZUs per year (\$13.5 million).

*Timing of when changes take effect*

- 38 NZ Steel has not contested the finding that it is currently overallocated. However, NZ Steel has written to the Ministry for the Environment and sought a 'phased transition' for this change. The firm argued that this is a material financial change to the assumptions supporting the funding agreement between them and the Crown for an electric arc furnace, signed in October 2023. NZ Steel sought for the changes to have effect from the start of 2026.
- 39 I seek Cabinet decision on when this change takes effect from. The earliest this change could take effect would be 1 January 2024. This removes the over-allocation of 225,000 NZUs per year (\$13.5 million) to NZ Steel as soon possible.
- 40 As with the updates to allocative baselines, the alternative is to apply this change from 1 January 2025. This would recognise the significance of the change for NZ Steel, who argued the nature and timing of the change was not clear in communications at the time of negotiations around the arc furnace project.

*Ongoing delegation to make future updates*

- 41 I expect to receive updated data including the annual electricity allocation factor each year. This data will affect allocative baselines requiring further updates to the regulations. These updates are technical in nature and there is no discretion involved – the updates will follow a legislative formula. Unlike, the one-off updates to baselines discussed above, these changes would become routine and ongoing.
- 42 Consequently, I seek an ongoing delegation from Cabinet to make decisions and the issuance of drafting instructions for updates to baselines each year. I will ensure that Cabinet still has visibility of any changes that could have significant impacts on firms.



### Cost-of-living Implications

- 43 Updates to allocative baselines will result in a reduction of approximately 2.3% in the overall level of industrial allocation. Over time and at the margins, this will result in more emissions-efficient producers gaining market share, drive emission reductions, and change consumer behaviours.
- 44 The impact on consumers is expected to be minimal. One of the largest decreases in allocative baselines is for growing fresh cucumbers. A cucumber grower will have a 78% reduction in their allocation from this change, which amounts to approximately \$60 per tonne of cucumbers. A tonne of cucumbers was valued at \$2750 in 2020/21.

### Financial Implications

- 45 The current fiscal forecast is based on the continuation of existing allocative settings. I expect an reduction in industrial allocation from the updates to allocative baselines to be approximately 112,000 NZUs per year, or \$6.7 million<sup>4</sup>.
- 46 The policy change for NZ Steel replaces the use of the general EAF with an annual calculation that will result in a NZ Steel specific EAF each year. This change results in a decrease of approximately 225,000 emission units per year allocated to NZ Steel (\$13.5 million).
- 47 The cogeneration plant is expected to be impacted by the move to an electric arc furnace. The contract with Alinta will need to be renegotiated because of that change and the existing contract expires near the end of 2026. Therefore, no fiscal implications can be provided beyond that year.
- 48 Should Cabinet agree to implement these changes from the earliest possible date, 1 January 2024, the combined reductions of industrial allocation against the forecast for 2024/25 is \$30.4 million. Adjustments to 2024 allocations made for the first six months of 2024 will be reflected in the allocation expense for 2024/25.. Reduced Crown expenses from unit allocations will have a positive impact on OBEGAL. Since unit allocations are not a cash item, there is no cash impact.
- 49 Should Cabinet decide to implement updates from 1 January and the NZ Steel change from 1 January 2025, the combined reductions of industrial allocation against the forecast for 2024/25 is \$16.9 million.
- 50 Should Cabinet agree to implement these changes from 1 January 2025 instead, the combined reductions of industrial allocation against the forecast for 2024/25 is \$10.2 million.
- 51 Table 1 below presents these options accordingly:

**Table 1: Approximate reduction in allocation expense from proposal**

Fiscal year \$ million	2024/25	2025/26	2026/27	2027/28 and outyears
Unit allocation expense (updates)		-\$6.7	-\$6.7	-\$6.7
• start 1 January 2024 or	-\$10.0			

<sup>4</sup> Using the secondary market price of \$60 (20 August 2024) and assumes constant 2020/21 production of iron and steel products from NZ Steel over the period.

<ul style="list-style-type: none"> <li>start 1 January 2025</li> </ul>	-\$3.4			
Unit allocation expense (NZ Steel)		-\$13.5	-\$6.8	
<ul style="list-style-type: none"> <li>start 1 January 2024 or</li> <li>start 1 January 2025</li> </ul>	-\$20.3 -\$6.8			
Total impact on unit allocation expense		-\$20.2	-\$13.5	-\$6.7
<ul style="list-style-type: none"> <li>all start 1 January 2024 or</li> <li>split start or</li> <li>all start 1 January 2025</li> </ul>	-\$30.3 -\$16.9 -\$10.2			

### Legislative Implications

- 52 The decisions in this paper will be reflected in the Climate Change (Eligible Industrial Activities) Regulations 2010. I will bring amendment regulations to Cabinet later this year for approval.

### Impact Analysis

#### *Regulatory Impact Statement (general baseline updates)*

- 53 The Ministry for Regulation has determined that this proposal to amend industrial allocation regulations is exempt from the requirement to provide a Regulatory Impact Statement on the grounds that the government has limited statutory decision-making discretion or responsibility for the content of proposed delegated legislation.

#### *Regulatory Impact Statement (NZ Steel electricity allocation factor)*

- 54 A Ministry for the Environment Regulatory Impact Analysis (RIA) panel has reviewed the "Emission costs incurred by New Zealand Steel Limited for cogenerated electricity" regulatory impact statement and considers that it meets the RIA requirements.

#### *Climate Implications of Policy Assessment*

- 55 The Climate Implications of Policy Assessment (CIPA) team has been consulted and confirms that CIPA requirements do not apply to these proposals as they are not expected to result in any significant, direct emissions impacts.

### Population Implications

- 56 There are no significant population issues from the proposals in this paper. I have been mindful of the fundamental purpose of industrial allocation, being to mitigate against the risk of a loss in domestic production, with the local economic and societal impacts this would bring to a region such as South Auckland.

### Use of External Resources

- 57 Advice in this paper was based on the work of an independent expert (Concept Consulting) and extensive engagement with NZ Steel throughout the analysis and reporting phases which cost \$30,000. The consultant has assisted officials several



times in the measurement of NZ ETS impacts on electricity contracts. A competitive procurement process was followed for this work.

### Consultation

- 58 The Treasury, the Ministry of Business, Innovation and Employment, the Ministry of Primary Industries, Te Puni Kokori and the Energy Efficiency and Conservation Agency were consulted on this Cabinet paper. Comments received have been incorporated.

### Communications

- 59 I intend to contact the chief executive officer of NZ Steel personally following Cabinet's decision.

### Proactive Release

- 60 I intend to proactively release this paper and associated Cabinet committee papers and minutes within 30 business days of final decisions being confirmed by Cabinet, subject to redaction as appropriate under the Official Information Act 1982.

### Recommendations

The Minister of Climate Change recommends that the Committee:

#### *Allocative baseline updates*

- 1 **Agree** the Government will continue to make ETS policy decisions that will prioritise price stability and credibility in the market
- 2 **Note** that industrial allocation baseline settings – that is, emissions per product unit – have not been updated since they were first set in 2010 and consequently are out of date;
- 3 **Note** that data has been collected from all recipients of industrial allocation to update allocative baselines;
- 4 **Agree** to delegate powers to make decisions and issue drafting instructions for amendment regulations to the Climate Change (Eligible Industrial Activities) Regulations 2010 to the Minister of Climate Change in accordance with the emissions information obtained and with decisions in this paper;
- 5 **Note** that the new baselines set out in the amendment regulations will be the result of applying methods set out in the Climate Change Response Act and will not involve policy decisions;
- 6 **Agree** the delegation in recommendation 4 includes making decisions and issuing drafting instructions to make technical amendments to the activity definitions of the production of carbamide (urea), and the production of protein meal.

#### *New Zealand Steel Development Ltd (NZ Steel) matters*

- 7 **Note** that NZ Steel has been receiving an industrial allocation for consuming electricity using the general electricity allocation factor (EAF);

**IN C O N F I D E N C E**

- 8 **Note** a large amount of NZ Steel's electricity demand is supplied under contract with Alinta Energy Ltd until near the end of 2026 through an on-site cogeneration plant;
- 9 **Note** that an independent review has found that that almost all of this cogenerated electricity is not affected by emissions pricing;
- 10 **Agree** the Minister of Climate Change can determine a unique EAF for NZ Steel each year from data on the amount of electricity consumed at the site, the electricity generated by the cogeneration plant, and the quantity of natural gas used by the cogeneration plant;
- 11 **Agree** the emissions that can be counted towards NZ Steel's electricity allocation factor are those from any natural gas used by the cogeneration plant at a rate of 0.5618 tonnes of carbon dioxide equivalent per megawatt hour and from any grid-based electricity;

*Timing matters*

- 12 **Either**
  - 12.1 **Agree** that the amended regulations for all updates including for NZ Steel's cogeneration use will take effect from 1 January 2024, or
  - 12.2 **Agree** that the amended regulations for all updates except that relating to NZ Steel's use of cogenerated electricity will take effect from 1 January 2024, with the NZ Steel change taking effect from 1 January 2025, or
  - 12.3 **Agree** that the amended regulations for all updates will take effect from 1 January 2025;

*Ongoing delegation to make future updates*

- 13 **Note** updates to all allocative baselines in regulations will be needed each year due to annual updates to the general electricity allocation factor and other components of allocative baselines;
- 14 **Agree** to delegate an ongoing power to the Minister of Climate Change to make decisions and issue drafting instructions for amendment regulations to the Climate Change (Eligible Industrial Activities) Regulations 2010 in accordance with annual data updates;
- 15 **Note** that regardless of this general ongoing delegation, the Minister of Climate Change will ensure that Cabinet is informed of any updates to the regulations that are expected to have significant impacts on firms.

*Next steps*

- 16 **Invite** the Minister to seek Cabinet approval for amendment regulations to update allocative baselines before the end of 2024.

Authorised for lodgement

Hon Simon Watts

**IN CONFIDENCE**

Minister of Climate Change

**IN CONFIDENCE**