



Developing an Australian style free allocation model for industry

Date:	07 August 2009	MfE Priority:	Urgent
Security Level:		Number of Attachments:	Nil
		MfE Ref No:	09-B-02165

Action Sought

	Action Sought	Deadline
Minister for Climate Change Issues Hon Dr Nick Smith	<p>Agree that proposals to amend the industrial allocation provisions in existing legislation should include at least the minimum key parameters included in this paper (being the basis of eligibility, intensity based approach, phase-out rate, levels and basis of assistance, review provisions, eligible classes of emissions, allocation process and powers)</p> <p>Indicate which of the other key allocation parameters you wish to include in proposals to amend existing legislation</p> <p>Agree to officials conducting an informal 1:1 engagement with industry as discussed in this briefing following the Government announcing its policy intentions about the ETS</p>	12 August 2009

Ministry for the Environment Contacts

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Executive Summary

Purpose

This paper seeks guidance from you on the content of legislative proposals for free allocation and your approval to conduct informal engagement with industry before December 2009.

Timing challenges implementing free allocation

Providing certainty for firms over free allocation by 1 July 2010 will be extremely challenging. The government could potentially improve this situation by providing detail in legislation on key free allocation parameters and adopting work already done for the Australian scheme, where this is possible.

Content of legislation

Ministers will need to decide which industrial allocation parameters should be fixed in legislation. We recommend that, at a minimum, amended legislation specifies:

- An activity basis of eligibility
- Intensity based assistance
- The phase out rate
- Initial levels (allocative baselines) of assistance set at 60% and 90% of relevant activity averages
- Allocation review provisions
- The classes of emissions to be included in allocative baselines
- Allocation process and ministerial powers within this process

We also recommend that legislation specifies tests and thresholds for both emissions intensity and trade exposure. Specifying these in legislation will provide a large amount of certainty for industry and will provide for a significantly smoother post legislative process.

Implications of a capped intensity based allocation

Adding a cap on the overall level of allocation would add an extra dimension to the challenge of providing certainty for firms by July 2010. In making final decisions on allocation, the government would need to be certain that the cap would not be breached.

If a capped approach were considered, we would also recommend that legislation specifies the level of the cap, subject to a five-yearly review or similar.

Adopting work from Australia

It may be possible to borrow heavily from the Australian Carbon Pollution Reduction Scheme (CPRS), in order to shorten the timeframes for allocation, for some firms. Officials do not yet know the extent to which this will be possible and will be engaging with Australian officials during August to discuss utilising the detail of their approach.

[withheld]

Recommended Action

We recommend that you:

- (a) **Note** the timing challenges in providing certainty to industry over free allocation to the industrial sector by 1 July 2010
- (b) **Note** the potential to decrease the timeframes for free allocation to industry through including key allocation parameters in legislation and adopting aspects of the Australian scheme

- (c) **Agree** that proposals to amend the industrial allocation provisions in existing legislation should include at least the minimum key parameters included in this paper (being the basis of eligibility, intensity based approach, phase-out rate, levels and basis of assistance, review provisions, eligible classes of emissions, allocation process and powers) **Yes/No**
- (d) **Indicate** which of the other key allocation parameters you wish to include in proposals to amend existing legislation:
- i. A trade exposure test **Yes/No**
 - ii. An emissions intensity test **Yes/No**
- (e) **Note** that introducing a capped intensity approach would have implications for the allocation process and a decision would be needed on whether to specify the cap in legislation.
- (f) **Direct** officials to provide advice for the Emissions Trading Scheme Ministerial Group on the inclusion of the above key allocation parameters in amended legislation **Yes/No**
- (g) **Note** the need to engage industry before December to improve our ability to prepare for the post legislative phase of allocation
- (h) **Note** the risks associated with such informal engagement, which are lessened the more the government is explicit about policy intentions
- (i) **[withheld]** **Yes/No**
- (j) **[withheld]**

Stuart Calman
 Director
Climate and Risk

Date

Hon Dr Nick Smith
Minister for Climate Change Issues

Date

Purpose of Report

1. This paper:
 - explains the process required to implement an Australian style approach to free allocation and the timing challenges involved;
 - seeks your direction as to which allocation parameters to include in proposals to amend existing legislation;
 - seeks your approval to conduct limited engagement with industry, pre-legislation, to aid the eventual preparation of allocation regulations noting the risks of such an engagement.

Background

2. You intend to ask Cabinet to agree in-principle to implement an Australian style free allocation to industry, with the detail of the approach based on the Australian Carbon Pollution Reduction Scheme (CPRS) as much as is sensible.
3. It is also your intent that the Emissions Trading Scheme Ministerial Group shall develop further policy to be implemented through an amendment Bill on the detailed design of intensity-based allocation.
4. You intend that Cabinet confirms these decisions in September following preparation of drafting by the Parliamentary Counsel Office. In order for this to occur, the Ministerial Working Group will need to make decisions about the content of the Bill by the end of August.

Timing challenges in implementing allocation

5. The CPRS gives assistance to “activities”, rather than firms or sectors. Activities are chemical or physical transformations of inputs to produce a given set of outputs. This is designed to target assistance to the most emissions intensive parts of businesses that may “leak” overseas. It is these activities that must meet emissions intensity and trade exposure tests.
6. The Australian approach requires definitions to be created for potentially eligible activities. Each activity definition requires a description of the chemical and physical process, key outputs and inputs, a basis for allocation, emission inclusions/exclusions and which financial costs can be included in eligibility calculations (where a value added approach is used).
7. In order to implement an Australian allocation approach in New Zealand, a similar process to theirs would need to be undertaken:
 - Establishing rules, principles and process regarding activity definitions;
 - Identifying and defining potentially eligible activities;
 - Collecting emissions and financial data from those conducting these activities;
 - Analysis of data by government and assessments of activity eligibility and allocative baselines (entitlements to allocation per unit output);
 - Notification of eligibility decisions and allocative baselines;
 - Applications and allocation of units.
8. Officials recognise that you want the industrial sector to be covered by surrender obligations by 1 July 2010. We also note your desire to include relatively little detail on the face of the legislation, remaining close to the current Act in terms of the amount of detailed content. There is significant tension between these two objectives.
9. Following the process above from scratch in New Zealand will be time consuming and would mean that not only would it be very difficult to make determinations by 1 July 2010, there would be little certainty about firms’ free allocations beyond the content of legislation.
10. This is problematic because firms want to be certain as soon as possible about what their initial free allocations will be (ideally by or before the sector enters the ETS). Certainty about free allocation allows them to consider anticipated units in investment decisions and purchasing strategies and to enter into agreements to “forward sell” units.
11. There are two steps which can potentially be taken to speed up the process and improve certainty for industry: (i) providing detail in legislation on key free allocation

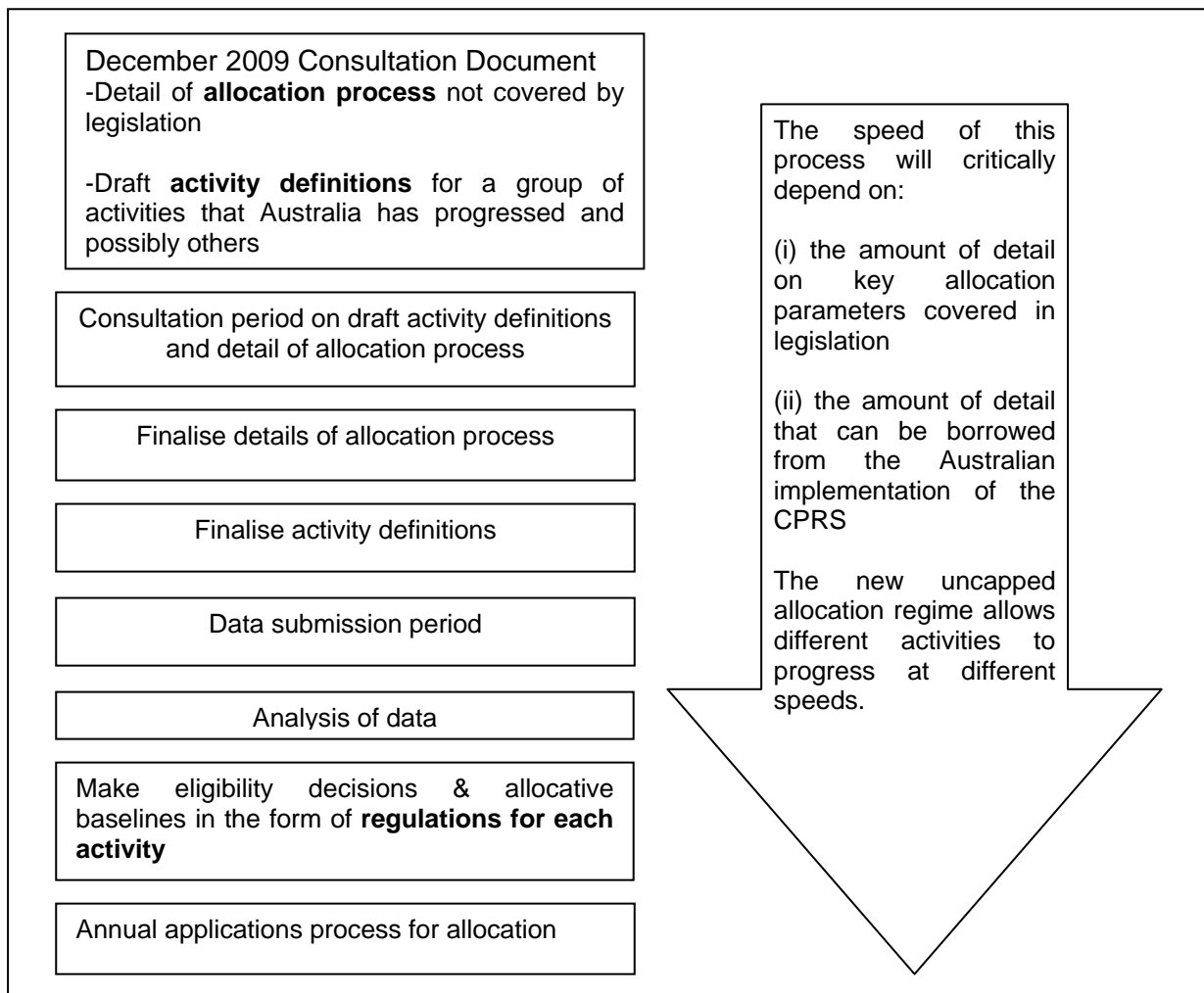
parameters and (ii) accelerating the allocation process by adopting work already done by Australia, where this is possible and fit for New Zealand's circumstances.

Process required to implement an Australian approach post-legislation

12. Based on the understanding that an amendment Bill will pass in December 2009 we have outlined the indicative process in implementing free allocation below¹.
13. This process would begin with the release of a consultation document in December 2009 that contained draft activity definitions and proposals for the detail of the free allocation process not contained in legislation.
14. There would need to be a consultation period on the draft activity definitions and detail of allocation process. This would also involve the opportunity for previously unknown activities and definitions to be submitted, considered and finalised.
15. The detail of free allocation process not contained in legislation would need to be decided, so that as each activity definition was finalised, relevant data could be submitted by industry. This data would be used to determine whether the activity qualified for free allocation, what the allocative baseline should be, and each firm's initial allocation based on applications. A truncated process might be possible where there can be extensive borrowing from Australia.
16. It is important to note the uncapped free allocation process allows for the possibility of different activities progressing at different rates. While this could create equity concerns among those stakeholders who receive allocation later, it would allow free allocation to be delivered as soon as each activity is ready rather than waiting for all activities to finish the process.
17. Certain parts of this process (e.g. provision of information) may need to be mandatory.

Figure 1 Indicative free allocation process

¹ Note that this process does not have regard to the process in existing legislation.



Content of legislation

18. The key choice faced by the Ministerial Group will be which allocation parameters to place in legislation and which to leave to the allocation process that follows. The secondary choice is what detail to include on these parameters in legislation.
19. The generic advantages and disadvantages of providing for allocation decisions to be in the primary legislation rather than regulations are summarised below:

Advantages of primary legislation	Disadvantages of primary legislation
<ul style="list-style-type: none"> ▪ Commercial certainty is provided earlier for firms ▪ Regulatory process is reduced to more technical issues ▪ A less prescriptive process for free allocation is likely to be allowed by Parliament ▪ Reduced risk of review of allocation regulations by Regulations Review Committee and the Legislative Advisory Committee (LAC) 	<ul style="list-style-type: none"> ▪ Loss of flexibility during allocation process ▪ A more difficult select committee process ▪ Loss of flexibility to adapt to changing circumstances

Minimum allocation parameters required in legislation

20. It is recommended that as a minimum, amended legislation provides the same amount of certainty over allocation parameters as in existing legislation and reflects the in-principle decisions made by Cabinet. The advice we propose to develop for the Ministerial Group will recommend that the existing legislation would be updated to reflect the new approach to allocation for industry as follows:

Basis of eligibility (“activities”)

21. As already discussed, the approach being adopted in Australia is to consider eligibility on an activity basis. If an activity approach was not adopted in New Zealand, our ability to borrow from Australian work would be limited. Other reasons to prefer an activity based approach are that narrowly defining the eligible entity limits the potential for leakage of part of a production process and reduces scope for double counting.

22. We suggest that legislation is clear that an activity approach will be used by setting out a number of principles that the Responsible Minister should have regard to when developing activity definitions. These principles would be based on the principles adopted in Australia. It would also be useful for legislation to describe what an activity definition may contain (e.g. output, inputs, emissions to be included).

Intensity based approach

23. Legislation should reflect that allocation will be awarded on an intensity based approach (allocation will be in proportion to output).

Phase out rate

24. As agreed in principle by Cabinet legislation will need to reflect the moderated phase-out rate and the detail of how this will operate in practice (allocation will be equal to 98.5%² of the previous year’s allocation).

Initial levels and basis of assistance

25. Legislation will need to specify there will be two initial levels of assistance, 60% and 90% depending on the emissions intensity. We also recommend that legislation is clear that the levels of assistance relate to 60% and 90% of emissions from the relevant activities, in line with the Australian approach.

26. While Cabinet has agreed in principle to set assistance at 90% and 60% of “average” levels we suggest that the Act provide flexibility for this level to be an Australian average, New Zealand average, overseas average, or averages or estimates of any of these.

Allocation review

27. Legislation should specify that all aspects of the new allocation regime will be subject to the five-yearly review, potentially including a notice period for any changes.

Eligible classes of emissions

28. Legislation should specify that the classes of emissions that will contribute to the levels of free allocation per unit of output will be as per existing legislation³. Note that, unlike the CPRS, existing legislation provides no free allocation for use of liquid fossil fuels.

Allocation process and powers

² Based on the phase out rate agreed in principle by Cabinet.

³ Existing legislation provides free allocation for emissions from industrial processes and from direct use of steam, natural gas, geothermal steam, used or waste oil.

29. The existing legislation contains a process that must be followed before free allocations can be made to industry. This process is illustrated in Annex 1. Given that the existing process is not well suited to an intensity-based uncapped allocation process, we suggest that the process in the Act is modified.
30. Legislation will need to provide the power for the Responsible Minister to (via regulations) define activities, make assessments about which activities are eligible for free allocation, determine the amounts of free allocation that each eligible activity will receive and for these free allocations to be made via an application process under these regulations. It is likely that these powers will need to include the ability to compel certain persons to provide information or to exclude persons from allocation if information is not provided.
31. There will also need to be the ability to specify details of free allocation process not contained in legislation.
32. In providing the Responsible Minister with regulation making ability, the legislation will need to set out boundaries on this power. The existing Act already contains a number of such requirements (matters to which the Minister must have regard) in Section 81 that apply to the making of allocation plans. These will need to be updated to reflect the new approach to free allocation and any other allocation parameters that you decide to include in the Bill.

Other key allocation parameters recommended for legislation

33. All the substantive policy decisions that affect people's entitlements to free allocation should be included in legislation. Beyond the minimum parameters outlined above, two other parameters are critical, what the trade exposure test will be, and what the emissions intensity test will be.
34. The inclusion of these two parameters in the legislation is consistent with the Legislative Advisory Committee guidelines.

Trade exposure test and thresholds

35. The purpose of a trade exposure test is to identify those firms that cannot pass on the cost of emissions, because the price of their products is set in countries which do not have an emissions price. Firms can be trade-exposed in export markets or in the domestic market (from imports).
36. Activities will either be trade exposed or not. Those who fail the trade exposure test will not receive any assistance. Trade-exposure can be measured qualitatively or quantitatively. If it is measured quantitatively, then a numerical threshold is required.
37. If it is decided to include trade exposure tests and thresholds in legislation, the following two options should be considered:
 - The approach pursued in Australia where the test for trade exposure is trade share (the ratio of value of imports and exports to the value of domestic production). The threshold for assessing trade exposure used by the Australians is where this ratio is greater than 10%, with an allowance for those who can demonstrate a lack of ability to pass through costs
 - The approach identified by a Technical Advisory Group (TAG) in 2008. All products would be considered as trade exposed except those products where:
 - a. There is no current international trade of the product across oceans, or
 - b. It is impracticable to ship the product between New Zealand and another country, or

- c. An equivalent level of cost of emissions is included in the price of competing products.
38. Our initial thoughts favour using the approach developed by the TAG. The TAG approach would probably more effectively identify firms that are trade-exposed because the Australian approach would be more difficult for firms who faced the threat of competition from imports. The TAG approach would still prevent products that are clearly not trade-exposed (like electricity) from gaining free allocation.
39. We suggest that trade exposure tests and thresholds are included in legislation. All of the above advantages of legislating are present. We are unlikely to want to provide any greater flexibility than the TAG trade-exposure test provides and this should be a relatively straightforward inclusion in the legislation.

Emissions intensity test and thresholds

40. Even if firms are trade-exposed, they may not face a material impact from a price on emissions. The emissions intensity tests and threshold(s) determine whether the amount of emissions cost faced by the producers is material.
41. For trade-exposed firms, the emissions intensity test will determine whether they receive 90% assistance, 60% assistance or zero assistance. At a minimum legislation will need to be clear that there will be two intensity thresholds that relate to the two levels of assistance.
42. Common options for the intensity test include testing on the basis of emissions as a proportion of (i) revenue, (ii) cost or (iii) value added.
43. The use of costs as a metric for determining free allocation is not favoured because this would skew the free allocation towards capital intensive industries without effectively identifying those industries at greatest risk.
44. While a value added metric is closely related to profitability, which is the underlying concern, there is a close relationship between value added and revenue metrics and revenue data are likely to be more transparent.
45. The Australians use emissions per unit of revenue as their primary test of emissions intensity, although they also allow producers to apply to have their eligibility considered on the basis of a value added test.
46. There is no clear threshold at which the impact of an emissions price becomes material to a producer. Because of the emphasis on alignment with Australia, it would be desirable if thresholds were set at a level that treated producers similarly regardless of whether they were in New Zealand or Australia.
47. Our initial thoughts are that legislation should include numerical thresholds based on emissions per unit revenue only (with no provisions for a value added test) by adjusting the two Australian revenue thresholds in a way that ensures that activities that qualify in Australia are likely to qualify for assistance in New Zealand.
48. We also believe that this should be done in such a way that allows the possibility of using New Zealand data, Australian data, overseas data, or averages or estimates of any of these to determine a New Zealand activity's eligibility.
49. There will be criticisms over the precise choice of an emissions intensity threshold. This will include criticisms of the existing quality of data on emissions from New Zealand firms used to inform the decision about the thresholds.

50. While there are limitations to the existing data on emissions intensity there is unlikely to be any better emissions data available on a broad scale until it is gathered during the actual free allocation process. If emissions intensity thresholds were set in regulations, limited engagement with industry pre-December 2009 could be used to inform the impacts of thresholds on a few particular activities of interest.

Implications of applying a capped intensity-based allocation

51. The advice above assumes that intensity based allocation will be uncapped; i.e. that there will be no constraint on the overall number of units issued to firms, and therefore that the volume of allocation can rise and fall freely with output levels. Introducing a cap on allocation would increase certainty around the fiscal and economic costs of an intensity-based approach to free allocation, but would also have implications for the allocation process.

52. This is because, as the overall level of allocation is constrained by a cap, rates of allocation to individual firms potentially need to be adjusted each year to reflect actual output and ensure the cap is not breached. As a result, it may not be possible to specify clear initial levels of assistance (and any fixed phase out in that level of assistance) on the face of the Bill.

53. In addition, the government must be certain about the overall level of allocation for all eligible activities before allocation for any individual activity can be finalised. Under an uncapped system, where there is no cap to breach, the government can more safely proceed on an activity by activity basis, finalising allocations for individual activities as and when data on eligibility and outputs becomes available.

54. To address this under a capped system, Ministers could either:

- a. Finalise allocation for all firms together, meaning that the timeline for finalising allocations is determined by progress on the 'slowest' activities (e.g. those for which we can draw the least data/ assistance from Australia). This would make it unlikely that significant certainty can be provided for any firm about their level of allocation before July 2010; or
- b. Set the cap at a very high level (at least initially) that it is very confident it will not breach. This carries risks and implies that the government is at least relatively certain about the broad volume of allocation needed when it sets the cap. A high cap may also raise credibility issues.

55. In addition, a further choice for Ministers will be whether to specify the level of the cap in legislation and the level of phase out of that cap. Like the emissions intensity and trade exposure tests, a cap would be a critical parameter, and the arguments for inclusion on the face of the Bill are similar. Given the critical inter-dependence between the three, it would be difficult to specify emissions intensity and trade exposure tests on the face of legislation without also specifying the level of the cap.

Adopting work from Australia

56. Regardless of the allocation parameters that are in legislation it will be extremely challenging to deliver certainty over free allocation at a firm level by 1 July 2010. Adopting work from Australia is another potential way to provide increased certainty sooner.

57. [withheld].

58. The likely implications of following the Australians as closely as possible will be that:

- a. For some activities we may have the option to adopt the Australian activity definitions, eligibility decisions and allocative baselines with minimal changes. This approach may be criticised as crude, but it is efficient, and has the greatest chance of achieving certainty by 1 July 2010;
- b. For some activities we will have the option of adopting Australian activity definitions but completing the rest of the process ourselves. Delivering certainty over free allocation by 1 July 2010 is likely to prove unrealistic for these activities;
- c. For some activities Australian work will be of no assistance, or will not exist, and we will need to work from scratch.

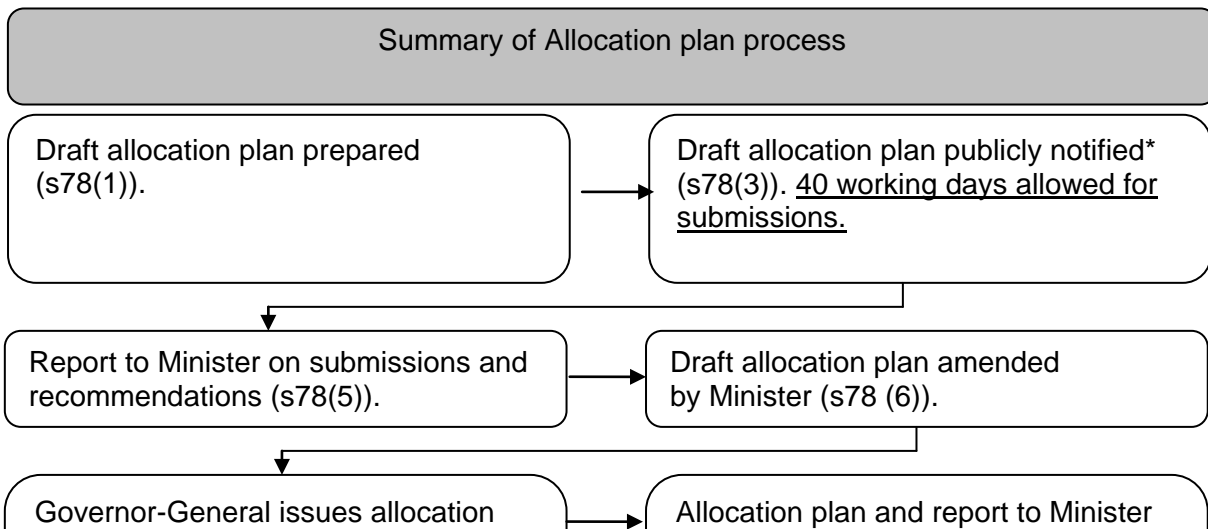
59. Officials do not yet know what proportion of New Zealand activities would be in each category above. However, with your approval, officials propose an informal engagement with individual firms in New Zealand to test the Australian work with a view to informing a December 2009 consultation document. However, there are some risks to this engagement as discussed further below.

60. We also intend to meet with our Australian counterparts to better understand the opportunities for adopting their activity definitions, eligibility decisions and allocative baselines.

Informal engagement pre-December 2009 to inform post legislative process

61. [withheld].

ANNEX 1



Consultation is public consulta

* Available on internet and at relevant Ministry's office.

** Note that this applies to industry, agriculture and fisheries sectors but not forestry.

*** A person must respond to be able to receive an allocation.

**** Note that after making the initial determination the Minister may request further information (s83) and/or may remake the determination under s84.