

In Confidence

Office of the Minister for Climate Change

Chair, Cabinet Environment, Energy and Climate Committee

Industrial Allocation for Producing Refined Petroleum Products

Executive summary

1. Section 161A of the Climate Change Response Act 2002 (the Act) provides for regulations to be made prescribing activities that are eligible for industrial allocation. Industrial allocation is aimed at protecting the competitiveness of emissions-intensive, trade-exposed firms through providing emission units to partially offset cost increases resulting from the New Zealand Emissions Trading Scheme (NZ ETS).
2. This paper proposes that the activity of producing refined petroleum products is prescribed as an eligible industrial activity under the Act. The paper also makes proposals regarding specific matters relating to the activity. Only one business carries out the activity in New Zealand: The New Zealand Refining Company Limited (Refining NZ).
3. In order to qualify for industrial allocation, activities must be moderately or highly emissions-intensive and satisfy the trade exposure test set out in section 161C(1)(c) of the Act. I am satisfied that the activity of producing refined petroleum products satisfies these tests.
4. The rate at which a firm carrying out an eligible industrial activity will receive units depends on the activity's emissions intensity classification and allocative baseline.¹ I propose that the regulations prescribe the emissions intensity classification and allocative baseline set out in Appendix 1 calculated from data submitted by Refining NZ for this purpose.
5. Refining NZ's entry into the NZ ETS will be at a net cost to the Government, due to the allocative baseline being calculated on 2006-2009 activity data as required under the Act. I have initiated a review of industrial allocation policy. One possible outcome will be a recalculation of allocative baselines using new data. I intend providing a terms of reference for this review to Cabinet by the end of June 2020.

¹ An allocative baseline is a benchmark rate of emissions per unit of production that is used to calculate the amount of allocation for an activity.

Background

Industrial allocation

6. In 2002 Refining NZ entered into a Negotiated Greenhouse Agreement (NGA) with the Crown. This agreement means Refining NZ is currently exempt from participation in the NZ ETS. Under current policy settings, Refining NZ will face emission costs from the NZ ETS after the NGA ends at the end of 2022.
7. The NZ ETS provides for industrial allocation to protect the competitiveness of the firms most heavily affected by emissions pricing. These are firms that have faced a large increase in costs as a result of the scheme (because they are emissions-intensive), but have not been able to pass on those costs through higher prices (because they are trade-exposed). These Emissions Intensive Trade Exposed (EITE) firms may be unable to pass on costs where they face competition from foreign firms that are not subject to a comparable cost on emissions in their home countries.
8. In July 2017, Cabinet agreed on the climate change policy treatment of Refining NZ once its NGA expires [CAB 17-MIN-0404 refers]. Cabinet agreed to bring Refining NZ into the NZ ETS and provide allocation on the same basis as other EITE firms.
9. To give effect to Cabinet's July 2017 decision, regulations need to be created to designate producing refined petroleum products as an eligible activity within the NZ ETS. s 9(2)(b)(ii)
[REDACTED]
10. As a result of these concerns, in December 2019, Cabinet agreed to the start of a review of industrial allocation policy [CAB-19-MIN-0598 refers]. s 9(2)(b)(ii)
[REDACTED]
11. s 18(d)
[REDACTED]
12. I intend to present a written terms of reference for the review to Cabinet by the end of June 2020.

Content of regulations

13. The Act provides that regulations may be made prescribing eligible industrial activities for the purposes of allocation and prescribing, as appropriate, the elements in respect of each activity that qualifies for industrial allocation, including the following:
 - 13.1. Activity description.** A description of the input(s), transformation, and output(s) that constitute a specific activity.
 - 13.2. Prescribed products.** Units for measuring production volume, which determine the number of units a firm receives in a given year.
 - 13.3. Emissions intensity classification.** Classification that determines the level of assistance for which an activity qualifies.
 - 13.4. Allocative baseline.** Benchmark rate of emissions per unit of production that is used to calculate the amount of allocation for an activity.

Data collection process

14. In order to determine the proposed emissions intensity classification and calculate proposed allocative baseline, it was necessary to collect data for the activity under section 161D of the Act. This required the development of an activity description and its prescribed products.
15. Section 161E of the Act required certain matters to be considered before setting the activity definition. Section 161F(2) also required consultation on the activity description and prescribed product prior to requesting data from Refining NZ. Officials worked directly with Refining NZ representatives, assisted by independent experts, in order to satisfy these requirements.
16. Once the activity definition for the purposes of data collection was finalised, a call for data for the activity of refining petroleum was issued under section 161D of the Act and published in the New Zealand Gazette on 15 October 2018.
17. The provision of data from the one firm carrying out this activity, Refining NZ, was based on a self-assessment model. There was no requirement for mandatory third-party audit or verification. However, the Act specifies a series of offences and penalties for providing altered, false, incomplete or misleading information. The provided data was subject to a process led by the independent experts to assess the risk of errors or inaccuracies associated with data that may otherwise result in an incorrect emissions intensity classification or allocative baseline.

Comment

Activity description and prescribed product

18. Under the Act, firms are entitled to allocation if they carry out an eligible industrial activity. The activity definition proposed in this paper is the result of collaborative work between officials and Refining NZ, assisted and reviewed by the independent experts prior to the data collection exercise.

19. I propose that the activity description and prescribed product set out in regulations should be the same as those used to collect data on the activity. Any significant change to the activity description and prescribed products is likely to require a further data collection process. There was sufficient consultation under the Act though working directly with Refining NZ prior to the activity and product descriptions being included in the call for data. The information gathered is specific to that description. Furthermore, there has been no feedback following the issuing of the call for data that would provide grounds for the activity and product description to be changed.
20. The proposed activity description and prescribed product are set out in Appendix 1.

Trade exposure

21. In order to qualify for industrial allocation as a prescribed eligible industrial activity, an activity must be trade-exposed. Section 161C(1)(c) of the Act provides that an activity is trade-exposed unless, in the Minister's opinion,-
 - 21.1. there is no international trade of the output of the activity across oceans; or
 - 21.2. it is not economically viable to import or export the output of the activity.
22. I am satisfied that the outputs for the activity of refining petroleum are internationally traded across oceans. Therefore, this activity should be classified as trade-exposed.

Emissions intensity classification and allocative baseline

23. As outlined above, firms are entitled to allocation if they carry out an eligible industrial activity. The number of units a firm receives for production in a given year is calculated using the following formula:
$$\text{Allocation} = \text{Level of Assistance} \times \text{Quantity of Production of Prescribed Product} \times \text{Allocative Baseline}$$
24. The Act provides for initial levels of assistance of 90% for highly emissions-intensive activities and 60% for moderately emissions-intensive activities. An activity is classified as highly emissions-intensive if it generates more than 1,600 tonnes carbon dioxide equivalent (tCO₂-e) per million dollars revenue; and moderately emissions-intensive if it generates between 800 and 1,600 tCO₂-e per million dollars revenue. Allocative baselines are based on historic data and are calculated from total emissions divided by total production.
25. Based on the data submitted by Refining NZ, I propose the emissions intensity classification and allocative baseline set out in Appendix 2 are prescribed in regulations.
26. The Climate Change Response (Emissions Trading Reform) Amendment Bill provides for a 1% per year phase out of rates of assistance over 2021 to 2030. Consequently by the time Refining NZ enters the NZ ETS, the applicable rate of assistance will be 87%.

Consultation

27. This paper was prepared by the Ministry for the Environment. The Ministry for Primary Industries, Ministry of Business, Innovation and Employment, Ministry of Foreign Affairs and Trade, Ministry of Justice, Ministry of Transport and the Treasury were consulted and concur with the content of this paper.
28. The Department of the Prime Minister and Cabinet and Te Puni Kokiri were informed.
29. Section 161F of the Act prescribes consultation requirements that must apply prior to issuing notices for the purposes of data collection under section 161D. These consultation requirements have been complied with in relation to the proposed eligible industrial activity set out in this paper. Accordingly, through this process, the activity description and prescribed product proposed in this paper have been subject to consultation.

Financial implications

30. The Act provides for allocation to people who carry out eligible industrial activities and appropriations broadly account for this fiscal cost. Determining the eligibility, emissions intensity and allocative baseline for the activity of refining petroleum will affect the overall fiscal cost for industrial allocation. In addition, given industrial allocation is intensity-based, the precise fiscal cost depends on the volume of production for the activity in a given year.
31. This paper asks for Cabinet policy agreement to draft amendment regulations to enable Refining NZ to receive an allocation of emission units from 2023. § 9(2)(b)(ii)

32. Based on the emissions intensity classification and allocative baseline outlined in this paper, and emissions reporting under the NGA, officials estimate the fiscal costs of industrial allocation for the activity as follows:

Activity	Fiscal impact (\$m / year) ²
Allocation of emission units for refining petroleum	§ 9(2)(b)(i)
NZ ETS revenue from entry into the NZ ETS of emissions from consuming electricity and natural gas, and combusting fuel oil, fuel gas, asphalt and flare gas	§ 9(2)(b)(ii)
Net fiscal impact	§ 9(2)(b)(ii)

33. The allocation fiscal cost will be absorbed by the Ministry for the Environment's appropriation 'Allocation of New Zealand Units'.

² Estimates of costs and revenues are based on full NZ ETS obligations, a carbon price of \$25 per unit, and production and emissions remaining at 2018 levels for calendar year 2023.

34. s 9(2)(b)(ii)
- 34.1. s 9(2)(b)(ii)
- 34.2. s 9(2)(b)(ii)
35. The review of industrial allocation policy may result in updates to all allocative baselines before 2023, including for this activity. s 9(2)(b)(ii)

Legislative implications

36. Prescribing specific activities as eligible industrial activities for the purposes of allocation of New Zealand units under the Act requires regulations to be made under section 161A of the Act. I recommend that drafting instructions for regulations to achieve this purpose be issued to the Parliamentary Counsel Office.

Impact analysis

Regulatory impact statement

37. The Treasury Regulatory Quality Team has determined that a Regulatory Impact Assessment is not required because the relevant issues have already been addressed by existing impact analysis, as attached as Appendix 3.
38. Indications of costs in the Regulatory Impact Assessment are out of date due to improved data on emissions and production. These changes are not considered to impact the quality of the analysis or its conclusion.

Climate implications of policy assessment

39. The Ministry for the Environment has been consulted and confirms that the CIPA requirements do not apply to this proposal. The direct emissions impacts are unable to be accurately determined in quantitative terms.

Human rights

40. There are no inconsistencies between the proposal and the Human Rights Act 1993.

Gender Implications

41. There are no immediate disability implications of the proposals in this paper.

Disability Perspective

42. There are no immediate disability implications of the proposals in this paper.

Publicity

43. It is important that Refining NZ and recipients of industrial allocations are aware of the review of industrial allocation policy and the potential for updates to all allocative baselines. While the proposals in this paper will assist Refining NZ with forecasting costs and making investment decisions, there is probability that allocation settings may be very different once the firm enters the NZ ETS in 2023.
44. I will identify this risk when I communicate Cabinet's decisions on the proposals in this paper to Refining NZ.

Proactive Release

45. I propose that this Cabinet paper is proactively released with sensitive information withheld consistently with the Official Information Act 1982.

Recommendations

The Minister for Climate Change recommends that the Committee:

1. **Note** that the New Zealand Refining Company Limited (Refining NZ) currently has a Negotiated Greenhouse Agreement (NGA) with the Crown and is accordingly exempt from participation in the New Zealand Emissions Trading Scheme (NZ ETS);
2. **Note** that the NGA expires at the end of 2022 and Refining NZ will become a mandatory participant in the NZ ETS and face emission costs;
3. **Note** that in July 2017 Cabinet agreed to provide assistance to Refining NZ through a data notice made under section 161D of the Climate Change Response Act (the Act) to establish eligibility for producers of refined petroleum products in relation to eligible industrial activities, and regulations made under existing powers in the Act which will specify an allocation baseline;
4. **Note** that the Minister for Climate Change has consulted Refining NZ under section 161F of the Act, as required before notifying the activity in the Gazette under section 161D;
5. **Note** that the Minister for Climate Change issued a data notice under s161D of the Act in October 2018 for the activity of producing refined petroleum products;
6. **Approve** the making of regulations under section 161A of the Act, prescribing activity of producing refined petroleum products as an eligible industrial activity and approve the activity description, prescribed product, emissions intensity classification and allocative baseline set out in the Appendices to this paper;
7. **Agree** that the Minister for Climate Change may issue drafting instructions to Parliamentary Counsel Office to draft regulations;
8. **Invite** the Minister for Climate Change to present a further paper to Cabinet seeking approval of the regulations prescribing the eligible industrial activity under the Act;

9. **Note** that the entry of Refining NZ into the NZ ETS from 2023 under current settings will have a net fiscal cost to the Crown because more emission units will be freely allocated than will be surrendered for emissions.
10. **Note** this net fiscal cost results from the calculation of the allocative baseline in Appendix 2 using activity data from 2006 to 2009 as required under the Act.
11. **Invite** the Minister for Climate Change to present a further paper to Cabinet by the end of June 2020 containing a terms of reference for a review of industrial allocation policy including possible updating of allocative baselines.
12. **Agree** that this Cabinet paper should be proactively released with sensitive information withheld consistently with the Official Information Act 1982.

Authorised for lodgement.

Hon James Shaw
Minister for Climate Change

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Appendix 1: Activity description and prescribed product

Refining petroleum

Activity description

The physical or chemical transformation of crude petroleum, bio-feedstocks, refinery residue, condensates and intermediate petroleum products into petrol, diesel, kerosene, fuel oil, bitumen, and other associated products involving the conduct of the following process:

- a. distillation; or
- b. adjustment of molecular weight and structure.

Activity outputs

Refined petroleum products as defined in the above definition.

Product basis of allocation

Kilo-barrels of refined petroleum products

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Appendix 2: Emissions intensity classifications and allocative baselines

Activity	Emissions intensity	Product	Allocative baseline
Refining petroleum	High	Refined petroleum products	36.99 tonnes of carbon dioxide equivalent per kilo barrel 36.99 tCO _{2e} /kbbbl

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Appendix 3: Regulatory Impact Analysis

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