



Ministry for the  
**Environment**  
*Manatū Mo Te Taiao*

Ministry for Primary Industries  
Manatū Ahu Matua



3 May 2019

Document Number: **B19-0235**

## Allocations to agricultural processors in the NZ Emissions Trading System

### Purpose:

This brief provides officials' view on consultation options for distributing free allocations to agricultural processors if they are included in the NZ Emissions Trading Scheme.

Minister	Action Required:	Minister's Deadline
Minister of Agriculture  Minister for Climate Change	Note and agree the recommendations contained in the briefing	By Monday 6 May to enable your decisions to be included in the Cabinet paper responding to ICCCs recommendations.

### Contact for telephone discussion (if required)

	Name	Position	Work	Mobile
Responsible Manager	Chris Kerr	Manager, Domestic Climate Change, MPI	04 819 4288	021 963 214
Principal Author	Chris Holland	Senior Analyst, Domestic Climate Change, MPI	04 830 1604	022 006 6275

## Key Messages

---

1. If agricultural emissions are included in the New Zealand Emissions Trading Scheme (NZ ETS) at processor level, we consider the only practical option for introducing obligations in 2021 is likely to be providing allocations to processors, rather than directly to farmers.
2. The Interim Committee identified two viable methods of distributing free allocations to processors:
  - a. **Output based** – where allocations are based on a rate per unit of output of meat, milk or nitrogenous fertilizer; or
  - b. **Proportional** – where allocations are simply a fraction of a processor's emissions.
3. Output based allocations would likely provide an incentive to processors to reduce their emissions liability (though improving efficiency) but allow them to continue to receive the same level of free allocation. However, an output based allocation may create a risk that processors could pass on some of the increased costs under the NZ ETS to farmers but retain the free allocation.
4. Proportional allocations would be simpler, but would reduce the incentive to reduce emissions as any reduction in emissions would also directly reduce a processor's allocation. There would be a lower risk of processors passing on costs to farmers and retaining the free allocation.
5. There is therefore a trade-off between encouraging emissions reductions and ensuring farmers do not face additional costs while processors retain the free allocations. We recommend consulting on the merits of the different allocation options.
6. There may be impacts to the NZ ETS arising from allocations to agricultural processors. One way to manage these impacts would be to only allocate units to processors when surrender obligations arise, rather than in advance. This would prevent large volumes of units entering and exiting the market by effectively 'netting-off' between allocations and surrenders. We recommend you consult the public on this question.

## Recommendations

7. The Ministry for Primary Industries and Ministry for the Environment recommends that you:

a) **Note** we consider that if agricultural processors were included in the NZ ETS the only practical option available is likely to be providing allocations directly to processors of milk, meat and nitrogenous fertilizer.

**Noted**

b) **Note** the Interim Committee identified two options for allocations to processors either an output based approach or a proportional allocation

**Noted**

c) **Agree** to consult on options for allocation at a processor level, including output based and proportional allocations.

**Agreed / Not Agreed**



Carolyn Homes  
Acting Director  
Environment and Communities Policy  
Ministry for Primary Industries

Hon Damien O'Connor  
Minister of Agriculture

/ / 2019



Matthew Cowie  
Acting Director  
Climate Change Directorate  
Ministry for the Environment

Hon James Shaw  
Minister for Climate Change

/ / 2019



## Background

---

### Issue

8. Minister Shaw has instructed officials to prepare a Cabinet paper seeking decisions for the Government to consult on including agricultural processors in the New Zealand Emissions Trading Scheme (NZ ETS). This brief provides our initial assessment of the allocation decisions which would be part of the Cabinet paper and would form the basis of the Government's consultation.

### Analysis

#### *Objectives of free allocation*

9. The Coalition Agreement between the New Zealand Labour Party and New Zealand First (Coalition Agreement) notes that 'if the Climate Commission determines that agriculture is to be included in the ETS, then upon entry, the free allocation to agriculture will be 95% but with all revenues from this source recycled back into agriculture in order to encourage agricultural innovation, mitigation and additional planting of forestry'.
10. The Interim Committee considers the main reason for providing free allocation to the agriculture sector is to help manage the social impacts of emissions pricing on farmers and rural communities.

#### *Who would receive allocations?*

11. Farmers are expected to ultimately bear the additional cost which we would expect to be passed through by processors (meat and milk processors and nitrogenous fertiliser sellers). However, we consider that it would be impractical to implement a farm level allocation within the next 2-5 years due to the administrative complexity and cost of identifying and allocating to around 30,000 individual farmers. Therefore we consider that the only practical option available for introducing obligations in 2021 is likely to be providing allocations directly to processors who would be included in the scheme.

#### *Options for determining allocations.*

12. The Interim Committee identified two viable approaches to distributing free allocations to processors. These were an output based approach (similar to the method applied to industrial allocations in the NZ ETS) and a proportional approach.
13. Under an **output based** approach a processor's allocation would be calculated as:

**Allocation = processor's annual production x allocation factor x allocation rate (95%)**

14. This would mean that a processor's allocations would change as its output (of milk, meat or nitrogenous fertilizer) changed. Processors would have an incentive to reduce the emissions intensity of their production. Processors who considered they were more efficient than the average or default could apply for a Unique Emissions Factor (UEF) which would allow them to reduce their emissions liability while retaining free allocation.
15. One potential drawback of this incentive is the risk that processors might be able to require farmers to undertake emissions reduction activities in order to claim a UEF, but would not pass on the benefits to the farmer. We recommend including this as a consideration during consultation. Firstly to establish whether this is a concern held by farmers, and if so, to explore ways to address it.
16. An alternative to an output based approach would be **proportional allocation** where allocations are simply a fraction of a processor's annual emissions. This would be calculated as:

**Allocation = processor's annual emissions x allocation rate (95%)**

17. Proportional allocations would provide a much lower incentive to reduce the emissions intensity of production and to seek a UEF. This is because processors would not retain their allocation if their estimated emissions reduce. We therefore expect a lower risk that processors would be able to pass on costs on farmers while retaining the benefit of free allocation.
18. There is therefore a trade-off between encouraging emissions reductions and ensuring farmers do not face additional costs while processors retain the free allocations. We recommend consulting on the merits of the different allocation options.

*Netting off obligations and allocations.*

19. Supplying 95 percent allocation for agricultural processors creates significant risks for the operation of the NZ ETS market due to the large volume of units that would be added to the scheme. This would supply around 37 million extra units to the market per year (total annual unit supply is currently around 22 million, including 10 million for industrial allocation).
20. The sudden inclusion of a large volume of units could create price volatility in the market and undermine participants' confidence in the scheme. There is also a risk that this approach, combined with other NZ ETS settings, could reduce the effectiveness of the NZ ETS by increasing the amount of units banked in private accounts. If the agricultural sector moves to a farm-level point of obligation in the future this could create further price volatility for the NZ ETS.

21. Netting-off surrender obligations with 95 percent allocation would reduce the risk of price volatility by NZ ETS market by removing the large 'ebb and flow' of units by agricultural processors. This could be achieved by providing allocations to agricultural processors when their surrender obligations are due, rather than in advance. Currently free allocation recipients receive allocations in advance, and are not net-off. We recommend you seek public feedback on this option as part of the consultation.

*Implications for future farm level options.*

22. A decision on methods for determining allocation at a processor level as an interim measure would not necessarily carry over to a future farm level policy. Moving to farm level would be an opportunity to reconsider the method of allocation, and should be part of the future work plan for farm level implementation.

PROACTIVELY RELEASED

[five pages redacted under s9(2)(g)(i) of the Official Information Act]

PROACTIVELY RELEASED

PROACTIVELY RELEASED



Appendix 2: Summary of key policy decisions on agriculture and climate change

**1 IS THERE A NEED FOR POLICIES TO INCENTIVISE AGRICULTURAL EMISSIONS REDUCTION?**

**YES**  
 Officials agree with the Interim Committee's that policies are needed now to incentivise effective agricultural emissions reduction

**NO**  
 INDUSTRY-GOVT AGREEMENT

OR

**2 PRICE OR REGULATION**

**PRICE**  
 Officials agree with the Interim Committee's position that a price signal is the most appropriate mechanism

**REGULATION**  
 INDUSTRY-GOVT AGREEMENT

OR

**3 DO YOU WANT TO LEGISLATE IN 2019?**

**YES**

**NO**

OR

**PROCESSOR-LEVEL**  
 Officials recommend focusing on introducing a processor level pricing instrument this year.  
 Note: This option enables you to also work on long term options (e.g. farm-level scheme) in parallel.

INDUSTRY-GOVT AGREEMENT

FARM-LEVEL ETS/LEVY

DIRECT REGULATIONS

**KEY STEPS NEEDED FOR THIS OPTION:**

- 1 What pricing mechanism is used?  
e.g. NZ ETS or Levy
- 2 Coverage  
(e.g. which livestock?)
- 3 Free allocation  
e.g. Who receives units? On what basis?
- 4 Hypothecation  
e.g. governance and uses of funds
- 5 Incentives for early adopters  
(e.g. rebates, grants)
- 6 Calibrating obligations with climate change targets

