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Dairy Companies Association of New Zealand

Submission to:

The Ministry for the Environment

On

New Zealand Emissions Trading Scheme Settings

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The Dairy Companies Association of New Zealand (DCANZ) appreciates the opportunity to submit on the *New Zealand Emissions Trading Scheme Settings.* Effective and fair operation of the New Zealand Emissions Trading Scheme (ETS) is importance to DCANZ member companies, that collectively account for more than 98% of the milk processed in New Zealand and the vast majority of New Zealand's dairy exports.

1. General comments

In providing this submission, DCANZ notes that there is a range of dairy processors in New Zealand, operating across multiple species and geographies. These processors also vary greatly in size, exposure to legacy infrastructure, opportunity to access alternative energy sources, and ability to access capital. This may result in variation in the views on specific aspects of this submission. DCANZ's submission focuses on aspects of the consultation where there is a commonly held perspective.

The ETS settings have significance to dairy processors in light of:

- Energy being a significant input requirement for dairy manufacturing;
- There being significant capital investment in existing infrastructure;
- New Zealand dairy processors being participants in a highly competitive international market with limited ability to pass additional costs on to customers and competition with overseas based companies not facing similar costs.

Milk processors are a component of a larger sector. Impacts on them, whether through reduced returns or increased calls on capital, result in a lower return to their dairy farming suppliers. This then impacts on local, regional and the national economies.

While DCANZ acknowledges the potential impacts of climate change, and the associated need to take actions to reduce these, this should be done in a manner that protects the New Zealand economy and community from unnecessarily or unreasonable adverse affects.

DCANZ believes actions taken should be practical to achieve, and where based on assumptions that expose parties to risk, that risk should be proportional to the robustness of assumptions.

Given the potential severity of impacts on businesses should a number of the assumptions made in the development of these proposed settings later be proven to be incorrect, it would be prudent for government to implement them incrementally. This will reduce the potential for businesses to be faced with situations that cause long term and/or significant negative outcomes.

Key assumptions underpinning the proposed Emission Trading Scheme (EST) settings that DCANZ question include:

- The belief that businesses will always have the ability to pass on additional costs to customers while retaining their current or a positive commercial position. At this point there is limited evidence to suggest that this is the case within the dairy market, especially within the commodity component of this market. This is highly relevant for dairy processors who, in the main, are competing in international markets against other processors not facing similar added costs or constraints.
- The ability of businesses to both fund their ETS liabilities and invest in emissions reduction while remaining financially sustainable,
- That liable businesses have access to alternative energy sources to allow emission reduction to the extent assumed. For example, within the South Island there is no access to natural gas, while nationally, the consistent availability of biomass in the volumes required to displace coal does not exist. This is of extreme importance for a sector that processes large volumes of highly perishable food products on a daily basis,
- The willingness of those parties holding NZ units in a speculative manner (i.e. not required to meet their own liabilities) to sell into what could quickly become a small, undersupplied market,
- The ability of the proposed cost control measures to adequately control the market, given the markets small size, disconnect from the buffering influence of the international market, and concerns over likely behaviour of entities currently holding the "stockpiled" NZUs.

2. Submission Questions

Q1. Do you agree with the proposal to set a provisional emissions budget[1] of 354 Mt CO2-e for the 2021 – period? If not, why not?

DCANZ agrees that a provisional emissions budget be set, however considers the proposed budget overly ambitious.

Taking a straight-line approach to emission reduction sends a clear signal to emitters and reduces the requirement for increased reductions in the future. However, it ignores the reality of the need for liable businesses to transition their activities through planning and implementing investments in emissions reductions over time.

Businesses are starting from where they are now. They are not in a position to operate with greatly lessened emissions profiles tomorrow without (in all likelihood) significant impacts on their business. The straight-line approach reduces the ability for a planned, ramping, transition and will place many businesses in the position of having to carry the increased costs of meeting their emissions liabilities while also attempting to invest to reduce emissions over time. This may be possible for some businesses however it is also highly likely to reduce the ability of other businesses to invest to reduce emission, whether at all or as quickly as they may otherwise have been able to.

If actual reduction in emissions is the goal of Government then the approach taken should recognise both the financial constraints faced by businesses and the practicality of transitioning what are for the dairy processing sector, large, expensive processing infrastructure in a rapid manner.

The emissions budget is also calculated based on a broad view of mitigation potential across New Zealand sectors and businesses. The ability to mitigate quickly and at low cost does not necessarily sit with individual businesses with significant immediate liabilities, or with the ability to influence uptake of mitigations. An "averaging" approach across the country does not allow for identification of those businesses (or sectors) that may be more exposed, and less able to make immediate change. These will be at greater risk of negative business impacts beyond their immediate control. DCANZ recommends the higher (least reduction) emissions budget be used initially until the underlying assumptions used by officials in these calculations are shown to be correct.

Q2. Do you support the decisions made regarding the technical volume adjustment decisions?

DCANZ supports the proposed technical volume adjustment decisions with the following caveats:

- All forestry activities should be fully accounted for,
- A review should be undertaken of the level of provision of NZUs to Emissions Intensive Trade Exposed (EITE) industry to ensure that, at most, only the minimum necessary volume of NZUs are being provided,
- Work to allow access to the international market should be prioritised by Government with a timeframe agreed for when this will occur. This should be by way of either the provision of guidance as to which international units will be considered credible and equivalent to NZUs – so these may be purchased directly by liable New Zealand businesses - or through Government purchase of suitable credible international units where the prices of these are lower than the NZ market rate, for on-selling to the New Zealand market.

Q3. Are there other adjustments that need to be considered?

At this time DCANZ has not identified further adjustments that need to be made other than those noted in Q2.

Q4. Do you agree with the proposal to address the NZ ETS unit stockpile by reducing the annual volume of NZUs available for auction? If not, why not?

DCANZ does not support the proposed approach to reduce the NZU stockpile.

DCANZ believes the assumption that under-supplying NZUs into the auction system will see stockpiled NZ units willingly sold into the market at the volumes required and at a price that doesn't have severe impacts on business sustainability is incorrect and gives rise to a significant financial and reputational risk to New Zealand and New Zealand businesses.

The discussion document shows that there is little understanding of the needs of those holding these units to sell. The New Zealand market is regulated, with potentially significant financial impacts for those businesses with emissions liabilities who are unable to access sufficient NZU to meet those liabilities. This market will also be small, with minimal players, and constrained from accessing units internationally.

If those holding NZU have no pressing need to sell into the market then it would make logical sense for these units to be held for as long as possible in what would rapidly become a rising market. This would maximise returns to those holding the units but would be to the detriment of liable businesses, and the New Zealand economy overall (as this increase in price does not relate to any increase in "value" of the units in response to climate change, nor does it bring new or increased value into the economy).

DCANZ notes that concerns have been raised recently that many of these units may in fact have been acquired by their current owners at low cost - possibly via the EITE support pathway. If this is in fact the case then those holding the NZUs have no financial reason to sell at anything less than the maximum price they can receive. There is no downside to holding them. In the small, regulated, and under-supplied market that will operate within New Zealand this provides a significant risk of gaming of the market to maximise individual returns at the expense of the wider economy.

DCANZ believes the proposed approach places liable businesses at unnecessary risk of being forced into an under-supplied market, with high potential for speculative behaviour by parties holding units, on the basis of an unproven and highly debatable assumption.

DCANZ strongly recommends that:

- Government should first address the issue of stockpiling and look at other opportunities to bring stockpiled units into the market, and
- That until this occurs, or it can be demonstrated that the assumption that the proposed approach will in fact see units brought to market at reasonable prices so as not to disrupt the economy and business sustainability, that there be a much smaller under-supply into the market. At this point in

time the quantum of under-supply has not be established, however this could be done in conjunction with the development of steps to reduce the stockpile that are more likely to be effective and lower risk.

Q5. Do you agree with 27 million NZUs being removed from auction volume between 2021–25? If not, why not?

DCANZ does not agree with this for the reasons given above (Q4).

DCANZ believes the assumption that removing this volume of NZUs from the auction will result in a willing release of stockpiled NZUs onto the market is unfounded and places liable businesses at significant and unnecessary risk, with the potential for serious economy wide impacts.

Q.6 Do you agree with the steps and calculations taken to reach the proposed annual auction volumes?

DCANZ does not agree with the current steps and calculations taken to reach the proposed annual auction volumes due to the reasons noted above (Q4).

Due to what DCANZ believes is a flawed assumption regarding the release of stockpiled NZUs onto the market during the period of this emissions budget it is our belief the volume is too small.

The ETS settings as proposed see the risks associated with official's assumptions being incorrect placed on liable businesses. These businesses will have limited options should the assumptions prove to be incorrect, and will be required to weather the impacts of this until adjustments are made. These impacts may be significant and the ability of the Government to make required adjustments in a timely manner is not guaranteed.

As noted previously, DCANZ recommends that an increased supply of NZUs be made available via auction, and that the quantum be determined in parallel with, and informed by, a process that directly addresses the issue of stockpiled NZUs.

In the intervening period other options to allow businesses to meet their liabilities should be enabled. These may include providing an extended period during which the fixed price option may be used, or allowing access to credible international units.

Q7. Do you support the proposal to auction 80 million NZUs over the 2021–25 period plus 2 million NZUs for auctioning trial in 2020? If not, why not? Please include your views on the process for adjusting auction volumes.

DCANZ supports the initial/trial auction process in 2020. It is important that this process be tested and, should it be found necessary, modified prior to 2021.

DCANZ does not support the volume of 80 million NZUs being made available for auction due to concerns regarding the assumed entry of stockpiled NZUs to the market as noted above (Q4).

Q8. Do you agree with the proposal to set an auction reserve price floor at $20 for the period 2020–25? If not, why not?

DCANZ supports the proposed auction reserve price.

DCANZ notes that should credible international units become available at a lesser price (and New Zealand not allow access to such units) that this price should be revisited. Credible emissions reductions mitigations made anywhere across the globe have similar positive outcomes. Locking New Zealand out of accessing such units while NZU prices within our small market climb unnecessarily high is of no benefit to combating climate change, nor the New Zealand economy and the well being of the country.

Q9. Do you agree with the proposal to increase the fixed price option to $35 for obligations arising from activities over 2020?

DCANZ does not support the immediate lifting of the fixed price option to $35.

An immediate lift in fixed price option cost from current rate provides limited transition for the market. Investment decisions will have been made for future activities and action on the basis of the current situation. DCANZ recommend a sliding transition from the current fixed price rate to a higher rate ($30) over the course of the first emissions budget.

As an alternative, Government could set a price equivalent to the average international price. While individual liable businesses are not currently able to access credible international units, the Government could do so and use this as a mechanism to link the New Zealand and international markets without unnecessary fiscal risk (as they could always under-write the New Zealand price with the purchase of international units).

Q10. Do you agree with the proposal to set the price ceiling trigger of the cost containment reserve at $50 for the 2020–25 period? If not, why not?

DCANZ notes that a significant or rapid escalation of prices could constrain companies from investing in the transition to lower emissions. We also note that the trigger price for the cost containment reserve is not a predictor for the maximum market price that will be faced by companies. That will depend upon a range of factors including:

- market sentiment in response to use of the cost containment reserve;
- the size of the containment reserve relative to unmet demand in the market, and
- lag times between an escalation of prices, actions to release the containment reserve into the market, and market response to the additional supply.

The experience of similar market intervention mechanisms in agricultural markets (e.g. the European intervention price for skim milk powder) is that the market price can move well beyond trigger price levels.

DCANZ suggests that given the uncertainties regarding the effectiveness of the cost containment reserve, the trigger price might be too high. We suggest consideration is given to pegging it against international unit prices e.g. average international price +20%.

This would ensure the New Zealand market and NZU prices were connected to international prices, limiting both any competitive disadvantage New Zealand exporters may otherwise face, and reducing opportunities for speculative behaviours that placed the New Zealand economy at undue risk.

Q11. Do you agree with the proposed annual cost containment reserve volumes to be released if the price ceiling trigger is hit? If not, why not?

DCANZ supports the release of cost containment reserves (CCR) should a price ceiling be triggered if this approach is continued with following this consultation.

DCANZ does not support the current CCR volume for the reasons noted previously (Q4) regarding the assumption that an under-supply of NZUs to the auction will result in a release of stockpiled NZUs onto the market. DCANZ recommends that:

- The difference between auction volumes and required NZUs be decreased significantly or removed entirely, or
- An alternative mechanism is developed to address the issue of stockpiled NZUs directly rather than placing liable businesses at substantial risk should the supporting assumptions upon which this policy is based prove to be incorrect.

Q12. Do you agree with the proposed approach for release of NZ ETS settings information?

DCANZ agrees with the proposed approach for the release of NZ ETS settings information.

4. Additional comments.

To reduce risk of speculative market behaviours that would undermine the ability of liable businesses to remain financially sustainable DCANZ recommends that access to NZUs via the Government auction, including access to CCR volumes (if released), be limited to those entities that have an ETS liability, either immediate or in the future, that requires access to NZUs.

Anyone would be able to continue to participate in the broader NZ ETS, with any entity (whether having ETS liabilities) able to purchase or sell NZUs outside of the auction process.

The New Zealand market is small, regulated and, on the basis of the proposed policy settings, will be disconnected from the international market. The opportunity for speculators to game this market is very real. Such behaviour provides no benefit from an emissions reduction perspective, nor would they benefit the New Zealand economy.

It is possible that some parties may be concerned should restrictions be placed on who may or may not participate in the auction process and the impacts of this approach would need to be carefully considered.