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PEPANZ Submission: New Zealand Emissions Trading Scheme Review 2015/16

Introduction

This document constitutes the Petroleum Exploration and Production Association of New Zealand's (PEPANZ) submission in respect of *New Zealand Emissions Trading Scheme Review 2015/16: Discussion document* ("the discussion document"), which was released by the Ministry for the Environment in November 2015. This submission is further to our submission on Phase 1 ("Priority Matters") of this review in February 2016.

PEPANZ represents private sector companies holding petroleum exploration and mining permits, service companies and individuals working in the industry.

This submission is in two parts:

- Part 1 – Overarching issues
- Part 2 – Responses to questions in the discussion document

Part 1 – Overarching issues

PEPANZ welcomes the opportunity to again input on the review of the New Zealand Emissions Trading Scheme ("NZ ETS" or "scheme"). Climate change is a global challenge and whilst much policy will be conceived on a domestic basis, to be effective the policy and regulatory response to climate change must deliver globally rational outcomes. New Zealand's goal, like many countries around the world is to reduce emissions over time. Our domestic and global energy mix is nonetheless highly dependent on hydrocarbons and New Zealand has an export focussed economy and growing population.

To reduce greenhouse gas emissions we need to use energy more efficiently, transition from higher carbon energy sources to lower-carbon sources and renewable energy options and find ways to address emissions in the agricultural sector. Substituting coal with natural gas in electricity is for instance one of the fastest, lowest-cost and most secure routes to decarbonisation (and improved air quality) for many countries around the world, particularly those that don't possess New Zealand's favourable combination of extensive renewable energy options and a small population.

It is essential therefore that New Zealand's policy responses to climate change not only make sense for our domestic energy system but that carbon leakage is avoided, over both the immediate and longer term. It is important our policy framework doesn't simply create wealth transfers to other nations without any beneficial impact on global emissions.

Continuing investment in exploration for, and production of hydrocarbons, has provided reliable gas supplies into the New Zealand energy system for the last 50+ years. This supply continues to underpin security of electricity supply, large scale domestic industries as well as residential and commercial users. In turn the continuing existence of these sources of demand underpins ongoing investment in exploring for and developing hydrocarbon resources for domestic use and consumption, and for export. Given the uses of this energy, in the absence of this domestic supply it is likely gas would need to be imported as LNG and/or other hydrocarbon resources utilised (i.e. coal) instead.¹

International trade in energy, and trade in energy intensive products, will continue to be important and can assist to decarbonise the global economy if regulatory settings around the world are properly configured towards meeting that objective. It is important for instance that New Zealand's policy settings don't discourage investments here that could contribute to net global reductions in emissions, or be neutral, even if they may lead to more domestic emissions in New Zealand.

For example any large gas discoveries made could potentially be developed to provide exported LNG to other parts of the world to support electricity generation, thereby reducing emissions vs coal based electricity plants that predominate in many countries. Where this can be commercially undertaken factoring in an appropriate carbon price, it is consistent with both domestic economic objectives and global climate change objectives for such investments to progress.

To avoid carbon leakage from current industries and to allow globally rational developments (in both commercial and greenhouse gas terms) to progress in New Zealand it is critical there is access to international markets and offsets. International trading (via either the one way importation of units or the more complex scheme linking) is a vital measure, particularly given New Zealand's high domestic cost of abatement. These international connections should logically be representative of New Zealand's main trading partners and competitors such that New Zealand is not placed at a competitive disadvantage relative to those jurisdictions.

The NZ ETS is currently a purely domestic-facing scheme whose units are now solely domestically originated and sourced. Whilst it has trading attributes, given these features and the lack of liquidity and depth in the created market, it is not particularly well suited to discovering an efficient least cost price based on underlying economic fundamentals. These aspects need to be resolved for the scheme to function effectively and in a way that is closer to what was originally conceived (i.e. within a global carbon market).

There is a widespread view, as recognised in the discussion document, that the settings underpinning the NZ ETS will change over coming years. Whilst this is inevitable, to provide some degree of certainty to those parties subject to the scheme it is important this occurs in a predictable

¹ Refer for instance to page 50 of the New Zealand Energy Scenarios to 2050 project undertaken by the Business Energy Council, available from <https://www.bec.org.nz/projects/bec2050>.

manner. What business wants is predictability and stability of the conditions and frameworks in which they operate so they can plan with greater confidence, knowing that the assumptions they make about the future are broadly likely to hold.

Emissions markets are artificially created markets and so those required to, or who choose to participate in them, are concerned not only with the dynamics in the market itself, but especially with the approach of market-regulators. In introducing further policy change to the NZ ETS it is important these are developed robustly with regard to the longer term and well signalled so as to mitigate unnecessary risks and volatility. We are mindful that investors in the upstream petroleum sector, and large industrial enterprises, are generally looking at an investment horizon of 5 to 30 years.

We note the Minister for Climate Change has recently stated the Government wishes to establish a working group involving a range of stakeholders to further consider the future design of the NZ ETS. We would welcome this and would hope such a group is given the resources and time necessary to make well-informed recommendations. PEPANZ would welcome the opportunity to participate in this group or otherwise in further discussions on these matters.

Part 2 - Responses to questions in the discussion document

In this Part 2 of this submission we respond to the specific questions posed in the discussion document.

We note Questions 1 - 8 were answered in PEPANZ’s Phase 1 submission on “Priority Matters” in February 2016. We have not answered Questions 13 - 15 because these relate specifically to the forestry sector. In some cases we have provided a single answer to related questions.

Questions in the Discussion Document	PEPANZ Comments
<p>Other issues: business responses to the NZ ETS</p> <p>9. Do you consider the future cost of emissions in your business planning? Yes/No</p> <p>If yes, how do you do this?</p>	<p>Future emissions costs are a factor that is considered in business plans and when looking at investments in the upstream oil and gas sector. Companies generally consider various carbon prices scenarios alongside assumptions or scenarios for other key costs or values. For multinational companies and internationally focussed projects the potential cost of emissions in New Zealand versus other jurisdictions is particularly relevant.</p>

<p>10. What would improve your ability to take into account the future cost of emissions in your business planning?</p>	<p>A key input to the business planning process is the future price of emissions (i.e. the value of valid emissions units). There are however currently no sufficiently active forward markets with respect to carbon prices to provide clarity as to the likely future price of units, or any ability to readily hedge price risks. This makes forecasting future carbon obligations or managing price risks very difficult.</p> <p>While industry cannot reasonably expect certainty with regard to emissions prices into the future (there isn't certainty for other prices or costs either), improved predictability and stability of the policy settings that make up the NZ ETS framework would assist industry in undertaking informed business planning. Establishing an NZ ETS market (including connections with international carbon markets) that has the depth and scale to support futures/forwards markets would assist long term planning and investment decisions.</p>
<p>Other issues: protecting competitiveness through free allocation</p> <p>11. Under what conditions should free allocation rates start to be reduced after 2020?</p>	<p>Any removal of free allocation should be in line with relevant international developments rather than any arbitrary timelines. Free allocation should only be reduced when the international conditions are such that carbon leakage from New Zealand is no longer a material risk. The rate at which carbon leakage risk declines will be determined by dynamic global factors and so free allocation to trade-exposed industries in New Zealand should remain appropriately benchmarked.</p> <p>It is difficult to judge at this time how global policy settings will evolve over coming years and we are mindful that previous expectations of international policy development in the emissions trading area have not been realised. A pre-determined rate of reduction in free allocation levels risks creating a significant distortion in the international competitiveness of affected businesses, unless it happens to coincidentally align with the pace at which obligations are applied globally.</p> <p>Given that emissions pricing appears likely to emerge on a jurisdiction by jurisdiction, or regional basis, rather than being imposed globally at one time it will be important to consider developments in relevant markets. A particular challenge is that different sectors will be exposed to competitors in different markets, which will likely impose varying policies. This raises the potential for any phase out to occur for different sectors at different times, aligned industry by industry to the level at which those industries globally incorporate a price on emissions.</p>

	<p>The focus should be on the development of suitable metrics based around the extent of global emissions covered by emissions pricing in other jurisdictions (at an economy and sectoral level) and comparable effort, in terms of GDP per capita or some other appropriate metric, as opposed to arbitrary time triggers.</p>
<p>12. What impact would it have on your investment decisions over the next few years if there was a clear pathway or criteria for phasing out of free allocation after 2020?</p>	<p>Introducing criteria for the phase out of free allocation would provide a degree of increased certainty for business. As noted above in response to Question 11, any criteria employed should be related to the underlying purpose of free allocation rather than an arbitrary timeline.</p>
<p>Other issues: managing unit supply – international units</p> <p>16. If international units are eligible for NZ ETS compliance in the 2020s, should any of the following restrictions be placed on their use?</p> <ul style="list-style-type: none"> a) restrictions on where units can be sourced from (location of and/or types of projects) b) restrictions on how many units can be surrendered c) others (please explain). 	<p>We are mindful the design of the NZ ETS had at its core the unrestricted use of international offsets. The rationale for this was multifold including a recognition that domestic abatement options would likely be expensive and insufficient and that the use of bona fide international offsets is a legitimate and rational means for countries to meet their global obligations. Ultimately global emissions reduction is the only thing that matters and so whether it is achieved through domestic or foreign abatement is irrelevant. Furthermore by allowing the use of international offsetting the New Zealand Government has been positioned to take on more ambitious emissions reductions commitments.</p> <p>As outlined above in Part 1 of this submission we consider it critical that the NZ ETS reconnects with international carbon markets and that international units again become eligible for NZ ETS compliance. With regard to the specific restrictions suggested:</p> <ul style="list-style-type: none"> a) Only units that represent genuine offsets should be allowed (i.e. linked markets should meet the UNFCCC core principles and trading protocols relating to environmental integrity). There should also be robust monitoring, reporting and verification standards to maintain the integrity of the NZ ETS. Beyond providing for this we see no prima facie reasons to limit where units could be sourced from or for what they relate to. What this means in terms of specific rules will clearly require detailed work and a degree of international agreement. We understand New Zealand is already involved in ongoing international work in this area. b) We don't consider there should be restrictions on how many international units can be surrendered. If companies are able to source units (whether domestic or international) that represent genuine offsets and thereby account for their

	<p>emissions, their ability to do this should not be restricted by arbitrary limits. To prevent this taking place whilst some sectors are exempted from the scheme entirely would be particularly illogical.</p> <p>c) We have not identified further restrictions that are warranted.</p>
<p>Other issues: managing unit supply – auctioning</p> <p>17. Should auctioning be introduced in the NZ ETS? Yes/No/Unsure If yes, when?</p> <p>a) in the next two to three years</p> <p>b) within five years (before 2020)</p> <p>c) after five years (post 2020).</p>	<p>We consider it is premature to say whether, and if so when, auctioning should be introduced. It is more important to determine the role/s or purpose/s of auctioning (see answer to Question 18 below) than to consider potential timelines at this stage.</p>
<p>18. What should be the role or purpose of an auctioning function in the NZ ETS, if one were introduced?</p> <p>a) to align supply in the NZ ETS more closely with our international target</p> <p>b) to more actively manage NZU prices</p> <p>c) other (please explain).</p>	<p>We consider any introduction of auctioning is more logically focussed on allocating supply of units rather than managing prices (particularly given the existence of a price cap). We are mindful the role for auctioning is partially linked to the availability of international units and whether these are accessed directly by market participants or by the government.</p> <p>If however NZU liquidity becomes an issue in the near-term (as for instance holders of banked units may continue to use those units to hedge their forward surrender obligations) it may be necessary for government to provide additional supply by way of auctioning.</p>
<p>19. How should auctioned NZUs relate to other sources of unit supply in the NZ ETS, especially NZUs generated through forestry removals and/or international units?</p>	<p>In the interests of reducing complexity, transaction costs and the potential for distorted market outcomes, it is desirable for all emissions units to be treated equally regardless of whether they are sourced from forestry, by auction, free allocation, or international market.</p> <p>Fungibility of units regardless of their source is desirable as it will help facilitate the further development of market trading mechanisms, including futures and forwards markets. The presence of different types of units within the NZ ETS would in contrast add complexity and complicate the functioning of the market and the development of market mechanisms.</p>

Other issues: managing price stability

20. What impact has carbon price volatility in the NZ ETS had on your business?
- a) minor
 - b) moderate
 - c) significant.

We understand price volatility to this point in time has had only a minor impact on businesses in the upstream petroleum sector due to the relatively low price levels that have predominated and the existence of the transitional measures.

The substantial level of price volatility has nonetheless had an impact on confidence in the market. A degree of price stability is important for the political credibility and durability of the NZ ETS, particularly in its current form as a domestic-only trading scheme. Prices that are excessively high or low are also likely to undermine the performance of the NZ ETS against its objectives. The greater issue however remains long-term uncertainties as to market design and the potential impacts of this on emission unit availability and prices.

Looking forward, as emissions pricing potentially forms a greater part of overall costs it will become an important determinant of profitability for emissions intensive businesses (e.g. if emissions costs equate to say 5% of total costs this would likely represent a large proportion of potential profits) and so volatility or perceived volatility could create material uncertainty for new business investments, whether new projects or upgrades, extensions etc.

<p>21. Do you think measures should be in place to manage price stability? Yes/No/Unsure</p>	<p>Yes. Significant price volatility, which is a material risk given the current market design and small market size, would potentially be damaging to domestic consumers (through price increases) and could also undermine confidence in the market and create investment uncertainty.</p> <p>A price cap remains a valid option until the concern that the burden being placed on New Zealand businesses is disproportionate to that being faced by their trade competitors dissipates.</p> <p>We note that increasing the scale of the market, for example through enhanced international connections, may reduce many of the risks that direct measures to manage price stability would be designed to address by improving market depth and liquidity, improving futures and forward markets and maintaining international competitiveness in terms of emissions pricing. Care must be taken though as international connections can also import risks (i.e. price shocks in connected markets) particularly if the markets connected to are larger than the NZ ETS, which is likely. The nature of those connections therefore needs to be carefully considered from this perspective as well as from others such as environmental robustness.</p>
<p>22. What do you consider are important factors for managing price stability?</p> <p>a) upper price limits (e.g., fixed price option, or a price ceiling implemented through an auctioning mechanism)</p> <p>b) lower price limits (e.g., price floor)</p> <p>c) other (please explain).</p>	<p>There is a potential role for both upper and lower price limits. Upper limits are particularly important with a small illiquid market such as the current NZ ETS. We note that lower price limits have a natural limit of \$0 whereas upper prices without a limit are uncapped. In such instances risks are asymmetric.</p> <p>The gap between any upper and lower limits must be sufficient so as to enable the market to function effectively. If the limits are frequently close to clearing prices then they will likely influence the price substantially, with the market participants unduly adapting their actions to the actions or signals of the regulator and rather than the signals provided by the market process and its underlying fundamentals.</p>
<p>23. What should the Government consider when managing price stability?</p>	<p>Factors that should influence the decision to manage price stability include:</p> <ul style="list-style-type: none"> • the functioning of the market (e.g. risks of market failure); • the workability of market arrangements; and • the depth and liquidity of the NZ ETS market, particularly in the absence of access to international markets.

<p>Other issues: operational and technical matters</p> <p>24. Are you aware of ways the administrative efficiency of the NZ ETS could be improved? Yes/No/Unsure</p> <p>25. Can you provide further information to support your answer? We would be interested in comments on:</p> <ul style="list-style-type: none"> a) complexities involved in NZ ETS participation b) penalties for breaching NZ ETS obligations c) any technical or operational changes that could be made to the NZ ETS to improve efficiency. 	<p>Overall our members indicated that administratively the NZ ETS is functioning reasonably well. A specific issue noted was that the NZEUR website can be very slow on the final filing and surrender dates (e.g. on these dates it is common for the site to freeze and lock users of registry accounts for substantial periods).</p>
<p>Other issues: addressing barriers to the uptake of low emissions technologies</p> <p>26. Are there any barriers or market failures that will prevent the efficient uptake of opportunities and technologies for reducing emissions?</p> <p>27. If so, is there a role for the Government in addressing these barriers or market failures and how should it do this?</p>	<p>The focus in the discussion document is on options to reduce New Zealand’s domestic emissions. The Government should not however omit considering how New Zealand’s domestic policies can and will influence our potential contribution to reducing global emissions through producing and exporting products in a GHG efficient manner.</p>