STRATERRA™
NATURAL RESOURCES OF NEW ZEALAND

Submission

To the

ETS Review Panel

On

"New Zealand Emissions Trading Scheme (NZ ETS) Review 2011"

Introduction (see pages 5ff for answers to consultation questions)

1. Straterra Inc was formed in 2008 to be a collective voice for the New Zealand resource sector. Its membership represents 84% by value of New Zealand minerals production (excluding oil & gas, and geothermal), as well as exploration, research, service and support. Straterra works closely with the petroleum sector and has links to the geothermal sector.

2. The resource sector makes a significant contribution to the New Zealand economy. Oil, gas, coal, gold, aggregates and other minerals contributed $2.15 billion to GDP in 2008, compared to the wine industry ($0.45bn), and tourism ($6.66bn). Resource exports in 2009 earned $3.6bn (8.2% of total goods exports) while dairy in that year was $10.0bn, and overseas tourism, $9.3bn. In 2009 there were 6800 people employed directly in mining, and 8000, indirectly, flowing from the economic activity of the 6800. The median wage for a mining employee was $57,320 in 2008, compared to the New Zealand median of $33,530.

3. Minerals production (excluding oil & gas and geothermal) by value was close to $2 billion in 2009, divided between: coal ($710 million), gold and silver ($673m), aggregates ($425m), and ironsands ($163m).

4. Straterra welcomes the opportunity to submit to the ETS Review Panel. We do so from the perspective that businesses operating in New Zealand, or considering investment in New Zealand, may legitimately expect to be treated fairly, and to find clarity in legislation and regulations. This is necessary for upholding the rule of law and promoting New Zealand's attractiveness for investment. Answers to the consultation questions are provided below.

5. We note our broad support for the submissions to the ETS Review Panel made by Business New Zealand and the Greenhouse Policy Coalition. Both submissions enter into much greater detail on, and substantiate many of the issues we raise in our submission.

6. Properly encouraged and managed, the resource sector's contribution to the New Zealand economy could grow significantly. As a resource-rich country, and with new technologies and changing demands, New Zealand's mineral and energy resources will afford economic opportunities for many decades to come. Naturally, these opportunities will need to be developed in the context of New Zealand's response to climate change issues.

Executive summary

6. The Minister responsible for International Climate Change Negotiations, Hon Tim Groser, has consistently argued that the global response to the climate change challenge must proceed from the international to the domestic.

7. As the first consideration for the Panel, the prospect for improvement of the international situation is bleak, certainly in the short or medium term, and, possibly, in the long term. We refer to the state of the international negotiations, the state of international carbon markets, and meaningful domestic actions being taken by other countries, in particular, New Zealand's key competitors in international trade.

8. That consideration should influence very strongly New Zealand's domestic actions, and the ETS review 2011 provides a key and timely opportunity.

9. From a NZ resource sector perspective, Straterra urges careful attention to be given to assessing the adequacy of the **allocation regime**.

10. Recall that the purpose of allocation is to protect the energy-intensive, trade-exposed (EITE) sector from the impact of the price of carbon on the competitiveness of that sector. Allocation is essential because we have a price of carbon, and many, if not most, of our competitors do not. As well, businesses are constrained in managing risk arising from uncertain or unknown future carbon prices because of the lack of significant and mobile carbon markets.

11. Without allocation, emissions reductions would occur because economic activity, be it current or future, would transfer out of New Zealand. This is often referred to as "carbon leakage" and is a negative outcome for the New Zealand economy, and global emissions. Carbon leakage is particularly critical for New Zealand because of the importance of exports to our economy, compared to that of other countries. For example our trade/GDP ratio is close to 60% while that of the US and of the EU as a whole is a little more than 25%, as BusNZ point out in their submission.

12. The tests for the ETS review panel to consider are: whether or not the allocation regime is fit for purpose, given the international context, and whether or not mining is appropriately considered in the allocation regime. As matters stand, the allocation regime fails both tests, for the following reasons.

13. Mining is considered an EITE sector. This has never been challenged through the many cycles of climate change policy development we have conducted in New Zealand, and it is self evident that most mining companies would meet any test of EITE contemplated to date. A range of legal opinions exist on whether the Act allows mining to be eligible for allocation. However, as a result of some specific features of the current Act, and the broad definition of the concept of an "activity", there are no mining companies eligible for allocation in New Zealand

14. Were these features changed, as they should be in light of the objective to achieve fair, equitable and economically-rational outcomes from the allocation regime, mining companies would then be able to assess their emissions intensity in a manner equivalent to other sectors. As a result of that process, some, or many mining companies would be eligible for allocation.

15. Specifically, these factors are:

    a) *Liquid fossil fuels*: For mining, LFF are a process input, not a transport fuel in the traditional sense. LFF should be considered, therefore, as part of the assessment of emissions intensity of mining;

    b) *Fugitive emissions* are inherent in many mining operations, especially underground coal mining. Their management is driven by health & safety concerns, noting FE are also a significant source of GHG liability. Either FE should be zero-rated to allow mines to focus on H&S, or they should be made eligible for allocation, as part of the assessment of emissions intensity of mining;

    c) *Activity definition*: Mining is a complex process by which raw materials are extracted at a site, processed via physical and/or chemical means, and transformed into saleable products. The concept of an Activity does not currently allow for the inclusion of the mining process itself within the scope of the Activity. Thus, even if LFF and FE were considered as recommended, mining companies would still fail to qualify for Allocation. [1]

15. In addition, there are issues of concern that affect EITEs generally. Firstly, there should be no phasing out of free allocation until there is evidence of significant international progress and domestic action by our key trade competitors.

16. Secondly, the levels of free allocation, of 60% and 90%, respectively, for moderately and highly emissions-intensive activities should be reviewed. The reason is that these levels, and the thresholds for classifying moderate and high, 800t CO2e and 1600t CO2e per $1m of revenue respectively, were drawn from a scheme designed in Australia for Australian conditions, but not implemented or tested in that country. It is possible that these levels of allocation, and the allocation thresholds, are not correctly positioned to achieve the purpose of allocation. Analysis of New Zealand conditions is required, against the purpose of allocation.

17. Then, there are two specific issues of concern to elements of the NZ resource sector.

18. At the current price of carbon, coal users face price rises of up to 35%. For many coal users, there is no viable alternative energy source; therefore, this price increase is simply a cost impost. Dropping the price of carbon to $6.25 or establishing a 4:1 surrendering obligation would address this issue during this period of negligible international progress and major international uncertainty.

19. In terms of accounting for liabilities, smaller companies face a complex and costly administrative burden. This is particularly the case for smaller coal producers and wholesalers to do with coal produced, coal purchased, coal processed, and coal sold. This needs review.

[1] To provide background on this anomaly, we inherited this situation when we picked up the features of the CPRS, as they stood at the time. Rudd's concept was that mining companies should not get Allocation, hence the way the concept of Activity was defined. For this, and many other reasons, the CPRS and Rudd were thrown out. (In this context the Panel might note the industry and public reaction to Rudd's super tax.) So, not only is there no reason for NZ to pick up features of the CPRS that have no application or relevance to NZ, it is our contention that this particular feature of the CPRS would never have survived in Australia had the CPRS been implemented there.

Recommendations

20. Straterra asks the ETS Review Panel to:

- Note the lack of international progress on climate change issues, and domestic action being taken by our key competitors in international trade;
- Note the importance of the impact our ETS has on the competitiveness of our EITE sectors, and the consequent importance of an effective allocation regime; and
- Note the current allocation regime will fail, therefore, to achieve its stated purpose and that amendments to this regime are both "necessary" and "desirable" for this purpose to be achieved.

21. Accordingly, Straterra proposes the following measures to modify the NZ ETS and its operation, for the purpose of the allocation regime to be achieved:

a) Define the concept of "activity" to enable mining to include all processes from uplift of material from the mine face, to transformation into a saleable product, to ensure parity of treatment with other EITE industries, and to ensure the goals of allocation are met;

b) Within the above, include liquid fossil fuels in the assessment of the emissions intensity of mining;

c) Within the above, either, zero-rate fugitive emissions, or include FE in the assessment of the emissions intensity of mining;

d) Review the levels of 60% and 90% free allocation to moderately and highly-intensive emitters, and the intensity thresholds for defining moderate and high of 800t CO2e and 1600t CO2e per $1m of revenue respectively, in light of Australia failing to implement the activity scheme adapted for use in New Zealand, of the differences between the Australian economy and New Zealand's, and in light of the importance of allocation to protect EITE industries, in the face of the uncertain international situation;

e) Delay the phasing out of free allocation, and have phasing out conditional on receipt of evidence of significant action internationally, and, in particular, by our key competitors in international trade;

f) Reduce the carbon price to $6.25 a tonne or establish a 4:1 unit-surrendering obligation, until a global price on carbon, and significant and mobile international carbon markets emerge; and

g) Review the emissions accounting procedures for mining companies, in particular, for smaller coal producers and wholesalers.

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Consultation Questions

Note: Where we have not answered a question, this is because we either lack the expertise to provide an answer, or we do not have a view on the item under discussion.

Q1 **Do you agree/disagree with the Panel's assessment of the current impact of the ETS? If not, why not?**

We are not in a position to agree or disagree on the information available - the Panel's assessment is at a high or macro level, and the ETS has been running for a very short time.

Q2 **What impacts of the ETS have you experienced to date?**

In your response we would be interested in:

a. financial impacts you have experienced and how you have managed these (eg, passed them on to consumers)

At the current price of carbon, coal users have experienced price rises of up to 35%. For many coal users, e.g. some dairy processors, there is no alternative energy source; therefore, the price increase is simply a cost impost.

b. how significant the impact of the ETS has been relative to other changes, such as GST increase, consumer demand changes and oil price increases

c. whether the ETS has yet influenced your investment decisions (eg, on low-carbon technologies, and land development)

This is very difficult to assess as yet, however, could be an important consideration in the future.

d. whether the ETS has yet influenced your operating decisions (eg, input sourcing, supply chain, choice of energy supply)

e. other impacts of the ETS (eg, social, environmental).

Q3 **What are your views on the administrative efficiency of the ETS?**

In your response we would be interested in comments on:

a. compliance costs associated with the ETS (including brokerage fees)

b. complexities of ETS reporting requirements (such as accounting methodologies)

Smaller mining companies face a complex and costly administrative burden in accounting for liabilities. This is particularly the case with coal producers and wholesalers to do with coal produced, purchased, processed and sold. For example, coal may be blended from different sources to create a saleable product meeting particular specifications.

c. penalties for breaching ETS obligations

d. the organisation of this administration across government, including the role of the Environmental Protection Authority.

Q4 **In your opinion, are the modelling results in paragraph 62 of the Issues statement (page 21) likely to reflect the actual macroeconomic impacts of the ETS? If not, in your opinion, how will the ETS affect New Zealand in overall economic terms?**

It is difficult to answer this question because the future of the world's response to climate change issues is extremely uncertain. The modelling depends on a number of assumptions holding, e.g. on the international situation and how that evolves, which are not possible to test at present.

We do say that New Zealand should view international developments as a key driver of policy in New Zealand because misalignment between the NZ ETS and measures being taken overseas could cause adverse impacts on the NZ economy, discussed under other headings.

Q5 **Do you agree/disagree with the Panel's assessment of the impact of the ETS after 2012? If not, why not?**

We are unable to forecast with any accuracy the impact of the current ETS after 2012. All of the projections rely on various assumptions, which are, as yet, untested and untestable.

That said, it is safe to say that if the NZ ETS continues unchanged, New Zealand may expect to experience serious adverse impacts on the economy from carbon leakage *if* other countries, in particular our key competitors in international trade, do not legislate and enforce meaningful abatement measures, and *if* significant and mobile international carbon markets do not emerge.

One aspect that is often forgotten when considering carbon leakage is avoided or deferred investment that could occur as a consequence of New Zealand having a carbon price and other, key countries not having a carbon price. While it is extremely difficult to quantify this effect, it may be assumed the adverse impact on the New Zealand economy in the future could be significant.

Q6 **What impacts do you expect to experience after 2012 (given the current design settings of the ETS)?**

In your response we would be interested in:

a. how impacts will change once the transitional phase ends

A meaningful global response on climate change is clearly not going to happen by 2012, or any foreseeable time thereafter. Therefore, under current settings and the inadequate allocation regime, increased impact on production and investment will occur. Production of gold, coal, petroleum, and, perhaps, other minerals would be "encouraged" to reduce and/or move offshore - and new investment in exploration and mining in New Zealand reduce, a factor that is often overlooked.

b. whether any significant business risks are created by uncertain carbon prices, and if so, how these risks could be mitigated

The key question is whether there will be operating international, regional or bilateral carbon markets, and, how these and the NZ market are regulated. Uncertainty here, if the ETS design remains unchanged, does pose significant risks to the NZ resource sector.

c. any competitiveness risks and therefore risks of carbon leakage

The big risk for New Zealand is that if our businesses face a carbon price and similar businesses overseas do not, and we don't make the necessary changes to the allocation regime, the EITE businesses, including minerals production, could move offshore, or, in terms of future opportunities, not come to New Zealand.

d. any business opportunities and benefits that may arise

e. how you expect abatement technologies to develop by 2015 and beyond

We do not know, and, equally, how could anyone know? Despite huge international investment in carbon capture, transport and storage technologies, these are still far from being implemented at a large scale worldwide. Despite the inception of the Global Research Alliance, breakthroughs in agricultural abatement technologies may be decades away.

As a general observation, if low-carbon technologies really were in the frame of being a tangible reality by 2015, the world would know that and would be seeking to implement them rapidly. And progress towards decarbonisation of the global economy would be discernable, which it is not!

f. comparison between carbon prices and abatement costs

g. how you expect the ETS to affect New Zealand socially and environmentally in the long term.

Q7 **As forestry is New Zealand's largest source of carbon credits and has a significant influence on emissions reduction in New Zealand, do you think the ETS provides enough incentive for forestry investments? If not, why not.**

We voice the self-evident truth that once all available and suitable land is planted in permanent forests, the carbon sink effect will cease, and New Zealand will be managing a carbon store, and the risks and liabilities associated with that.

The real question, therefore, is what will New Zealand do in terms of abatement, once we no longer have forest sink opportunities.

Q8 **Do you agree with the Panel's assessment of the impacts of the ETS on Māori? If not, why not?**

Q9 **In your opinion, what impacts of the ETS have Māori experienced to date?**

Q10 **In your opinion, how will the ETS affect Māori in the longer term?**

Q11 **Do the scenarios in table 4.1 in the Issues statement (page 28) capture the most likely outcomes for the international framework after 2012? If you answered no, what other scenario(s) do you suggest the Panel should consider?**

Certainly, it is worth reflecting on what could happen internationally. However, there is always a risk of missing crucial issues when painting speculative scenarios. For example, the scenarios say nothing about what other countries might do or not do, whether bilateral, regional or international carbon markets emerge and to what extent, to what extent we can access these markets, or on the likelihood of whether the aspirational targets being set by various countries will ever be met. All of these will affect carbon prices.

But speculation on scenarios is a distraction from the real issue. This is that the international situation is uncertain and is likely to remain so, for some considerable time. That appears to be the opinion of the Minister responsible for International Climate Change Negotiations Hon Tim Groser, and, indeed, of many serious commentators on these issues.

Q12 **How might the objective(s) of the ETS change under each of these scenarios? In particular:**

a. what do the different scenarios imply about the costs New Zealand should be imposing on its economy through the ETS in the short term?

The wrong question is being asked. The ETS should impose minimal costs on the economy until there is evidence of sufficient global uptake of policies that effectively decarbonise economic

activity. At this stage, it is far from evident that this will be the case in the short, medium or long term. If we do otherwise, we would be doing more than "our fair share", carrying the risk of harm to our economy, and achieving no benefits for the world's climate.

b. what considerations should influence how the costs of any international obligation New Zealand faces should be shared between different sectors of the economy such as the split between emitters and taxpayers and the relative abilities of different sectors to reduce emissions?

As is the case for many of the issues raised, the pros and cons of the various approaches to this question have been debated in detail for years in New Zealand. Nonetheless, this is a valid debate. A key consideration is how this issue is managed in other countries. If other countries place a larger share of the burden on taxpayers than we do in New Zealand, this could affect EITE industries in New Zealand. As a general consideration, it is well known that New Zealand overall has a much higher marginal cost of abatement than many other countries because of our emissions profile, as discussed in paras. 17-20 of the issues paper.

c. what is the role of the ETS in preparing New Zealand for the international obligations and other drivers for action it may face in the long term?

Consider first the operational characteristics of the NZ ETS. This scheme is to be a lowest-cost approach to achieving New Zealand's purpose, namely, emissions reductions, because it supposedly encourages economic efficiency, flexibility to manage emissions over time and between sectors, and allow access to international markets (para. 24 of the issues paper).

New Zealand being so small an economy, the ability to buy and sell emissions units internationally is key to achieving lowest cost.

It is a fact, however, that there are no international markets in existence on a scale or accessibility of use to New Zealand. This is because there is no robust and effective international framework and/or functioning and relevant carbon markets, underpinned by domestic legislation and powers of enforcement in relevant countries.

Given the above, the NZ ETS should be placed in a holding pattern until such time as these emerge. This is the appropriate role for the NZ ETS, to meet the Governments objectives of the NZ ETS.

d. should the ETS design be changed in order to strengthen the incentives for domestic abatement? If so, how?

e. how important is continuing access to international carbon markets?

As argued in part (c) of this question, the NZ ETS can only work as intended if New Zealand has access to international carbon markets, with regional or bilateral markets offering only a partial and interim fix.

f. how do you see domestic and international carbon markets developing beyond 2012?

These do not exist as yet, noting the EU scheme is the only ETS worth the name in the world other than the NZ ETS, and it is not an open scheme. We do not agree with the content of table 4.2 on pages 33 and 34 of the issues paper, which we believe to be highly misleading and largely irrelevant.

The key questions when analyzing other countries' actions to inform the review of the NZ ETS are: are they taking action, underpinned by domestic legislation and powers of enforcement; if they are, what is their comparability of effort with New Zealand (noting our country's high overall

marginal abatement costs); who bears most of the burden, taxpayers or businesses; and do they have markets we can access? Table 4.2 fails to address adequately any of these questions.

Q13 **Under what conditions should the ETS scale up to a full obligation? In particular:**

a. Should the fixed price option of $25 continue beyond the current transition phase (ie, after 2012)?

Yes. This should not change until there is evidence of sufficient global uptake of a price of carbon, and accessibility for New Zealand in bilateral, regional or global carbon markets. This is currently far from the case, and is unlikely in the short, medium, or, possibly, even the long term.

b. Should the one-for-two obligation continue beyond the current transition phase?

Yes, with the suggestion that for some industries, e.g. coal users unable to draw on other cost-effective sources of energy, this should be amended into a one-for-four obligation.

Q14 **To what extent, if any, should abatement options be relevant in determining the extent of a sector's participation in the ETS?**

This question would require entering into great detail to answer, and is, possibly, beyond the scope of the review. The real issue is: what is the world actually doing, in terms of legislation of, and powers of enforcement for, measures for abatement. The answer at this stage is nothing of significance; therefore, serious consideration should be given to ensuring New Zealand's EITE sector is adequately protected to prevent unnecessary harm to the national economy from carbon leakage.

Q15 **Under what conditions should new sectors enter the scheme and incur surrender obligations?**

Q16 **Should allocation of NZUs continue as planned under current design settings after 2012?**

No. Major improvements are required, from the perspective of the NZ resource sector (refer to Straterra's recommendations made in the initial section of this submission).

In your response we would be particularly interested in:

a. the effectiveness of allocation in reducing competitiveness risks

The allocation regime is poorly designed because it fails to achieve its objectives for the mining sector. This is the key issue for the NZ resource sector, and Straterra has made proposals for improvement (see Straterra's recommendations).

b. the impact of allocation on incentives to reduce emissions

There is some confusion. The purpose of allocation is not to provide an incentive for reducing emissions; it is to protect the EITE sector from unfair international competition. The wrong question has been asked. The real question is whether the transition phase (paras 28 and 29 of the issues paper) provides an incentive to reduce emissions. The answer is that it does, and that regardless of whether or not the allocation regime is functioning properly, New Zealand would reduce emissions post-2012, as matters stand, but potentially at the expense of economic resilience, running counter to government objectives. Therefore, the transition phase also needs amendment (see Straterra's recommendations).

c. whether the allocation thresholds should be amended

Yes, they should. As well, the concept of "activity" as currently envisaged fails to adequately consider the real nature of mining which is the series of actions undertaken by a producer from

the extraction of raw materials, to physical and chemical processing, to transformation into a saleable product (see Straterra's recommendations).

d. whether the process to determine allocative baselines should be changed

Yes, they should. The current thresholds for moderately and highly emissions intensive, 800t and 1600t per $1m of revenue respectively, are taken from a scheme designed in Australia for Australia but never implemented or tested by the designers. The figures of 60% and 90% free allocation to each category, respectively, also appear to be arbitrary, when applied in the New Zealand context.

To elaborate: the Australian scheme was designed with the Australian economy in mind, averaged across sectors. The New Zealand economy is very different. When it comes to identifying EITE industries, there are relatively few candidates. We have one aluminium smelter, one oil refinery, one methanol plant, a handful of pulp & paper mills and cement plants, two large hard-rock gold mining companies, a few petroleum and coal mining companies, one large dairy company, and so forth. Therefore, a case-by-case approach is the appropriate approach for New Zealand and should be pursued.

At issue is the working of the NZ ETS in the future, in the short, medium and long term. The risk is that if our competitors in international trade continue to do nothing meaningful, New Zealand's EITE sector will face risks that are inadequately provided for in the allocation regime. (See Straterra's recommendations.)

e. whether the allocation of units to small and medium sized enterprises (SMEs) is the most administratively efficient way for protecting impacted sectors either for SMEs or government.

Size of business, per se, is an irrelevant consideration. If the NZ ETS is intended to be all sectors, all gases, the key issues in terms of protection are emissions intensity and trade exposure, for any business. The most efficient way of protecting EITE industries to get the settings right for the allocation regime and the transition phase, as discussed.

A further key consideration is the administrative burden faced by businesses in the accounting of emissions. It is possible for some businesses that the cost of this would outweigh any benefits of free allocation. A review of the requirements for businesses to administer their obligations under the NZ ETS is needed.

Q17 **Should the ETS cover synthetic greenhouse gases (SGG) from 2013, as currently legislated?**

a. if no, what other policy tools or what combination of policy tools should be used to encourage reduction in SGG emissions?

b. if yes, are there supporting measures or amendments to the ETS that could support implementation and reduce administrative and compliance costs?

c. if the ETS should be amended to cover only some SGG-using sectors: which ones, why, and what policies should be developed for the others?

In your response we would be interested in

d. estimated impacts of the ETS coverage of SGGs (such as compliance costs for direct participants, on rates of gas recovery and recycling or destruction, and on management of leakage)

e. arguments for or against alternative policy tools

f. estimated impacts, including behavioural impacts in terms of incentives to reduce emissions, of alternative policy tools.

Q18 **Are there are any other issues, in particular any related to the matters set out in section 160(5) of the Act as summarised in Chapter 1, you think the Panel should consider? If so, please provide details of your view on them.**

No, other than to summarise very briefly what we believe to be the key issues facing the NZ resource sector. We ask the Panel to once more consider the following:

The purpose of the allocation regime and transition phase is to protect the EITE sector from unfair international competition, thereby avoiding undesirable carbon leakage.

The prospects of achieving a level playing field, internationally, on carbon prices, are slim, in the short, medium and long term.

Therefore, New Zealand needs to get the allocation regime right, as a matter of priority. It is far from that at present. That said, a few simple amendments, as we have recommended, would resolve the matter, meeting the Government's objectives for the NZ ETS.