Holcim

A Submission on

Updating the New Zealand Emissions Trading Scheme

Submission from Holcim (New Zealand) Ltd to the Ministry for the Environment

EMISSIONS TRADING IN NEW ZEALAND

Holcim Climate Change Policy Digest No. 10

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Preface

Holcim New Zealand again welcomes the opportunity to represent our views on current proposals to update the New Zealand Emissions Trading Scheme (NZ ETS).

Holcim New Zealand has been a full participant in the New Zealand Emissions Trading Scheme (NZ ETS) since its inception for our sector.

We have engaged proactively and constructively with successive Governments throughout a prolonged policy-making and legislative process, and our stance has remained consistent: we fully support the ETS as the optimal path for New Zealand's trade-exposed, energy intensive sector to make its contribution to New Zealand's efforts to reduce emissions.

Our company has publicly committed itself to full and transparent participation in the national policy debate on climate change in New Zealand. This submission is part of a series of *Climate Change Policy Digests* and other documents, published by Holcim New Zealand, that analyse and discuss in detail climate change policy instruments that are, or might be, available to regulators and legislators.[1]

These documents are freely available to all interested parties.

[1] All of Holcim's previous publications in this area are available at: www.holcim.com/nz (select *Sustainable Development/Climate Change*).

Summary

We have previously endorsed the restriction of certain CERs in the NZ ETS, where such CERs arise from environmentally questionable activities. Notwithstanding this specific endorsement, we caution strongly against impulsively blazing a trail of policy revision based on what is happening, or might happen, in the EU ETS, in Australia, or elsewhere. It is understandable, even praiseworthy, that our ETS should evolve as national and international circumstances change, but each policy revision must be carefully considered on its merits.

We assert that, on the whole, the NZ ETS in its present form is a well-crafted instrument for New Zealand to meet its Kyoto emissions reduction obligations. This can only improve when certain additional recommendations of the 2011 ETS Review Panel are implemented. Other international schemes, with limitations in scope of coverage, less clever design, or tardy implementation are in the position of having to "patch up" intrinsic weaknesses in their systems that are not so manifest in the NZ ETS. It would be both ironic and regrettable if the integrity of the NZ ETS was tarnished by incautiously adopting policy modifications that were conceived originally to compensate for fundamental structural flaws in overseas ETS schemes – flaws that are not present in the successfully operating NZ ETS.

We do acknowledge Government's concern that purchase of overseas compliance units by NZ ETS participants makes it difficult for Treasury to "balance the books". We promise to work with Government to address this dilemma.

We fully support aspirations for environmental integrity of the NZ ETS, and the desire to improve prospects for future links with other emissions trading schemes.

We note with pleasure the Minister's desire that amendments to the NZ ETS should "*strike a fine balance of doing our fair share while ensuring the ETS doesn't impact unreasonably on New Zealand businesses and households*". This statement provides the criteria we employ to test all proposed amendments to our ETS.

If so, then it seems to us that some of the amendments proposed in the consultation document do not pass these tests.

We are also unimpressed by the desire, implicit in the proposals, to extinguish all Government risk by transferring it to business and industry.

Finally, we are disappointed that the Consultation Document sets out the concerns of Government in persuasive detail, yet makes only vague efforts to quantify the actual magnitude or materiality of the problems identified. It is difficult and even unfair to expect industry to make sound judgment on the proposals contained in the Consultation Document without clear factual bases for calculating cost and risk.

The Minister's *Foreword* (p.3)

We agree with the Minister that New Zealand should remain committed to being part of an international solution on climate change whilst also remaining conscious of the challenging economic conditions faced by householders and business.

We commend the Minister for his nuanced desire that the proposed amendments should "*strike a fine balance of doing our fair share while ensuring the ETS doesn't impact unreasonably on ….businesses and households*", and that the ETS should be "*fit for purpose and delivering ….long-term benefit*".

The minister is correct to state that the NZ ETS is both the most cost-effective and efficient way we can do our fair share.

The New Zealand Emissions Trading Scheme (p.4)

We note the statement that Government amended the ETS in 2009 "*in order to moderate its impact during the global economic downturn*", and that this moderation principally took the form of a transition phase for the first few years of the scheme.

We applaud the stated intent to continue with a moderated approach.

In our view, the global economic conditions that originally prompted Government to adopt the transition measures have demonstrably *not* improved.

> *In our industry, national cement demand has dropped 20% since the original ETS transition measures were adopted in 2009.*
>
> *National cement demand has dropped by 25% from January 2008.*

National economic circumstances have only grown more difficult since the 2009 ETS amendments. In considering amendments proposed in this Consultation Document, it is worth asking the question:

What has changed since 2009 that encourages us to adopt amendments to the ETS that would escalate costs to participating firms?

And, let us be absolutely clear: auctioning units in conjunction with restrictions on surrender of international units will certainly increase costs to liable participants.

Impact of the ETS to date (p.4)

We congratulate Government that *"…there is already evidence the scheme is having positive impacts on investment decision…*", including in forestry and renewable energy generation. This is heartening news.

So, quite evidently, the ETS is operating reasonably efficiently. It has encouraged multiple emission reduction investments, whilst operating at costs that must be

encouraging such investment – which is not the case in the EU ETS. Indeed, given the present state of the only other operating ETS market, in the EU, it is arguable that the NZ ETS has substantially *exceeded* its remit to ensure New Zealand is doing its fair share.

With that in mind, we are not encouraged by the concluding statement that we "*now need to refine the ETS to ensure it operates as efficiently as possible and helps New Zealand do its fair share*".

This statement is a *non sequitur*. It does *not* follow from the preceding discussion on the impact of the ETS on investment decisions – nor from any subsequent discussion in the Document.

Further, we must query the measurement of "fair share" compared to our overseas trading partners and competitors. Are others <u>really</u> doing their "fair share"?

Keeping in mind the example of the EU ETS (above), we note also that the *ad hoc* Durban Working Group is not due to report its recommendations on international action until 2015. We note that the Australian CPM retains its fixed price basis until 2015; and the recently announced Korean ETS only proposes to commence also in 2015. Even then, both of these provide for net allocations materially in excess[2] of those prevailing in the NZ ETS now. If we are serious about "fair share", then the leisurely timing of such international developments hardly provides a convincing basis for hasty amendment and tightening of an ETS that is already operating successfully.

We strongly urge the retention or "freezing" of current transition measures – including the 1:2 surrender ratio – until the next Review of the NZ ETS (2016). At that point, we will then be certain that comparable international action has indeed finally got off the ground – and we can hope that the concept of "fair share" will actually have real meaning for New Zealand.

"Fair share" Impact on Holcim New Zealand: As forecast in our verbal submission to the 2011 ETS Review Panel, the liability of Holcim New Zealand for the 2011 NZ ETS compliance period amounted to <u>10% of our operating profit after</u> tax.

In summary, the argument that we must further "refine" an ETS that has operated cost effectively and efficiently in the midst of a major global recession seems very shaky indeed – on the evidence of the Consultation Document's own facts, and on the evidence of comparable international action, actual or intended.

[2] Australian CPM: 94.5%. Korean ETS: 95%.

The 2011 Review of the ETS (p.5)

We acknowledge the summary of the recommendations of the 2011 ETS Review Panel.

Again, we draw attention to the statement of Government's objectives for the ETS. In particular, the ETS should:

> "*support efforts to maximise the long-term resilience of the new Zealand economy at least cost*" [our emphasis]

This statement provides a lens through which we view this Consultation Document and the proposals it presents. We commend it to the Ministry in its consideration of submissions to this consultation.

The Government's proposed changes (p.5)

Phase out: On "fair share" arguments, we seek *retention* of the current 1:2 transition measure at least until the next Review in 2016.

Maintain the fixed price: We support maintenance of the $25 fixed price option until the outcome of the next Review.

Auctioning: We support the proposal for auctioning.

We do not support auctioning that is conflated with a restriction on international units.

Quantitative restrictions: We strongly oppose any attempt to restrict the quantum of international units surrenderable as compliance units in the NZ ETS.

Linking to Australian price ceiling after 2015: We support the power to extend the fixed price option beyond 2015.

We reserve judgement on the proposal to align that price ceiling with Australia (after 2015), until sufficient time has lapsed and sufficient information has developed from an operating Australian market to understand its implications.

On the issue of linking more broadly, we urge the Minister and his officials to exercise great caution and unblinking objectivity to such proposals.

Linking has its attractions – and we *support* the concept on liquidity grounds – but actual practice may diverge radically from the theory, at least in the early stages of linking. The risk here for New Zealand is that linking to much larger schemes, particularly those in early-stage development, will almost certainly expose us to the alarming and highly destructive market price volatility that appears to characterise such markets. Witness the volatility in both Phase 1 and Phase 2 of the EU ETS.

We include the Australian CPM in our definition of a "larger" scheme.

On the issue of the treatment of agriculture, we remain perplexed that Government seems prepared to defer agriculture until 2018, whilst it proposes yet further increases of stringency for the sectors that are already carrying the burden of New Zealand's entire "fair share" efforts.

There is also some irony in the conditions Government has set for agriculture's entry to the ETS: availability of abatement technology, and comparable international action. Why do these conditions not apply similarly to other sectors?

In our own case, available abatement technology requires the investment of several hundred million dollars in new plant (recalling that we have long since plucked the low hanging fruit of incremental improvement in our existing facilities). This hardly constitutes easily "available" abatement technology by any standards. And, even then, such investment would mitigate thermal fuel emissions only. *Calcination* emissions from our manufacturing process, for which we are directly liable in the ETS, are irreducible – exactly as is argued for major sources of agricultural emissions.

In the light of the generosity of treatment of agriculture, we hardly think it unreasonable to seek a deferral of the phase out of transition measures that serves only to further increase our liability burden, at the very time when we can least bear it.

Transition phase (p.6)

We oppose the proposed gradual phase out of the 1:2 transition measure to 2015.

We support maintenance of the $25 fixed price at least until the next Review in 2016.

We are puzzled by the assertion that "*businesses need certainty about when they will face full obligations*" [our emphasis]

If "full obligations" is a synonym for "full price", then this assertion is patently invalid.

As we have noted often in past submissions, business primarily needs certainty about *policy* – not price. A clear, well-defined policy *pathway* is the basic requirement for business certainty. We doubt that any person can actually offer certainty about the financial cost of the "full" obligation, whenever that occurs, most especially in the hyper-variable carbon market.

We do not discount the importance of price and costs at any point in time: of course these are important. But, managing price risk in a dynamic way is the bread and butter of modern business. What Government can contribute is certainty about the environment within which business must manage such risks. In this context, "environment" means medium to long-term policy direction, a comprehensible legislative underpinning, and a firm regulatory framework.

Irrespective, in current circumstances, we can state bluntly that certainty of full obligation in 2015 is precisely *not* the certainty that business needs at this point.

It is not helpful to frame proposals for updating the NZ ETS in terms of assuring the timing of full obligation. This is secondary to assurance of policy direction and framework.

Further to the issue of policy "certainty", and with reference to Sections 16-20 of the recent *Cabinet Minute of Decision*[3] on the proposed amendments to the NZ ETS, we note with concern the considerable freedom given to the Minister – and *all future* Ministers – to amend key regulations of the NZ ETS affecting stringency of allocation, transition measures, auction conditions and so forth. Expectations or fears of such *ad hoc* amendments by other, future, Ministers is hardly conducive to certainty for the business community. It is precisely this sort of uncertainty that is corrosive, and tends to quench enthusiasm for desirable business investment.

Supply of NZUs after 2012 – The situation (p.7)

We are considerably more sanguine than the Consultation Document that participants "are *required* to purchase international units" [our emphasis] in order to fulfil surrender obligations under the ETS.

[3] http://www.climatechange.govt.nz/consultation/ets/cab-min-12-8-7.pdf

We like the flexibility and opportunity to "shop around" for the best deal!

And, we think this is entirely consistent with Government's objective that emissions reductions should be delivered in the most cost-effective manner possible.

That is the nature of an open market. It is also a defining characteristic of effective and efficient markets. The fact that we are concerned here with a carbon market is almost incidental. Do we believe that New Zealand business should have the same freedom of choice in its purchases of carbon as it does for purchases of machine parts, or mobile phones, or office stationery?

If we do not believe that; if we believe it necessary to "fine-tune" what is already a well-functioning market; then, do we have a market at all?

We are underwhelmed by the references to the EU ETS and the Australian CPM and to their plans to "manage" the level of purchasing of international units through auctioning. Such an *appeal to authority* is no less suspect or fallacious in this context than in any other debate.

It is simply wrong to attempt to compare the structure and operation of the NZ ETS with the entirely different, and hugely more limited and less ambitious, sectoral coverage of the EU ETS or the revenue neutral design of the isolationist Australian CPM (as just two example of difference).

We would also be more convinced if the Australian CPM actually had yet developed any practical experience in auctioning. It has not – and it will not until 2015.

Cap and Auction (p.7)

Notwithstanding our disquiet above, we acknowledge the concern of Government that purchases of CERs (for example) may lead to an "*unnecessary flow of funds offshore that may have an adverse impact on the economy*" [our emphasis].

We are not fully convinced by this rather tentative assertion. The Consultation Document does not provide facts to back up its assertion.

> Precisely what is the size of the actual shortfall of compliance units currently filled by overseas purchases?[4]
>
> Precisely what is the present (and future) cost to Government of holding these 'extra' overseas units?
>
> Is this cost truly material?
>
> What proportion of issued NZUs is held and *not* traded on the active market?

[4] The chart on p.7 of the Consultation Document, "Projected supply & demand for units in the ETS, 2013 – 2020", does not answer this question. It makes no distinction between quantum of NZUs issued by Government and the actual, *purchasable* supply of NZUs in the active market.

Why?

Is it the intent that *all* of the shortfall would be substituted by auctioned NZUs?

How will the auction 'cap' change over time?

None of these questions is answered.

We are disappointed that the Consultation Document sets out the concerns of Government in persuasive detail, yet makes only limp efforts to quantify the actual magnitude or materiality of the problems identified.

It is difficult and even unfair to expect industry to make sound judgment on the proposals contained in the Consultation Document without the clear factual bases for calculating cost and risk.

Finally, the point that auctioning NZUs "would not raise revenue for the government" is subtle, but disingenuous. Perhaps it is indeed true that auctioning is not intended as a means of raising revenue for government. This is hardly the point.

The actual fear is that auctioning in conjunction with international unit restrictions will likely raise *costs* for business by escalating the average cost of compliance units. This is precisely the case in the EU ETS, where there is ample evidence of a significant spread between the price of domestic and international units

And, there is no treatment of the *timing* of auctions. Is there an expectation that auctions will be held up-front, prior to the commencement of the compliance period? If so, business will suffer cash-flow effects that hardly seem to accord with Government's desire to avoid unreasonable impacts on New Zealand business and its ability to invest.

And, again with reference to the *Cabinet Minute*[5], the *ad hoc* powers granted to change regulations at one year's notice effectively cripples the prospect of business employing any sort of responsible forward purchase strategy for units. Instead, business must *react* to regulatory changes, rather than confidently forecast and act to purchase forward supply of a key business input.

In our view, stable auction rules should be set for a minimum of three years.

[5] Ibid.

Restriction on international units (p.7)

> Whilst we might be persuaded, on balance, that auctioning is a necessity, *we absolutely oppose restrictions on the purchase and surrender of international units*.

Restrictions of this type are *guaranteed* to escalate the average cost of compliance in the NZ ETS[6].

Again, we note that no attempt is made in the Consultation Document to quantify the actual effects on the average market price of such restrictions. And, we ask:

> Precisely what *level* of restriction on international units is proposed?
>
> How will this change over time?
>
> Given that the proposed changes would be enshrined only in regulation, how can this Government give any certainty that future governments will resist the temptation to "adjust" the initial settings by Ministerial *fiat,* with no or limited reference to liable participants in the NZ ETS?

Restrictions of this type are not acceptable to us under any circumstances – but particularly so in the midst of a severe economic downturn where business *survival* has displaced business growth as the operating paradigm.

Other amendments (p.11)

We acknowledge the desire by Government to facilitate linking with Australia at or beyond 2015. We encourage the evaluation of this option in the 2016 review.

We favour such linking between carbon schemes – but we caution on the timing of such alignment (see p.10 above) to ensure stability of operation before committing to the risk of disastrous price volatility.

Our support is predicated on careful and sensible evaluation by Government of the likely effects – good and bad – of any proposed linkage mechanism. And, we see no reason why the stated measures of efficiency, effectiveness, cost, and resilience should not equally be applied in assessing this proposal as for all others.

And we must be conscious that the best intentions of potential linking partners may not always be carried through into action, or may be 'indefinitely' delayed by changing domestic circumstances.

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[6] Indeed this very fact is employed to justify such measures in the EU ETS, where intrinsic *ab initio* misallocation has led perversely to a negative average cost of carbon for many of the participating sectors.

Nevertheless, we look forward to participating in a timely and measured assessment by New Zealand of the benefits of linking with a future Australian scheme.

Some other matters

Allocation phase out: In the light of the unexpected and prolonged economic uncertainty, Holcim New Zealand urges Government to freeze the 1.3% allocation phase out, and retain the allocation at its 2012 level at least until the 2016 Review.

We appreciate that this matter does not form part of the scope of the Consultation Document.

We plead exigent circumstances. As noted on p.6 above, our industry has suffered catastrophic market decline since 2008, which has been assisted not at all by the Christchurch earthquakes and the subsequent slow pace of re-construction.

Wastes: We ask that combustion of all waste streams be considered eligible activities. The present situation is inconsistent and confusing. It needs to be simplified. Such an amendment would encourage investment in energy recovery from wastes and represent a most desirable co-benefit of the NZ ETS.

Further to this matter, we note our concern that the development of rules recently agreed at UN level has the potential to make combustion of biomass fuels – specifically harvested forest wastes - prohibitively costly.

In the event that, harvested forest rules are indeed devolved into the NZ ETS framework, then *we strongly urge that combustion of forest waste biomass should be an eligible activity.*

We believe these requests align well with Recommendations 3.11 and 3.12 of the 2011 Review Panel.[7]

[7] See Appendix 1, Cabinet paper: proposed amendments to the Climate Change Response Act 2002 – Part 1

Leakage: In line with our previous submissions on the matter, we notify the Minister that imported cement clinker has now (early 2012) entered the New Zealand market – in substantial volumes, and from a country that has *no* mandatory cost of carbon. We expect the loss of up to 10% of the domestic market to unregulated imported product by early 2013. This is on top of the market decline already experienced since 2008.

On this matter, we sincerely ask the Minister to address the following questions:

> Why is it appropriate and equitable for New Zealand business and taxpayers to encourage the import of emissions intensive cement materials into New Zealand?
>
> Why should that encouragement be made in the almost certain knowledge that those imports have a total carbon footprint in excess of locally-produced goods?
>
> Why are certain imported goods (coal) able to be counted as liable under the NZ ETS, and others are not?

Since the mid-1990s, Holcim New Zealand has invested considerable effort and resources in its emissions reductions initiatives and as a constructive and thoughtful participant in all of the climate change policy-making activities that have occupied successive governments. It is distressing that our repeated warnings about the risk of leakage have been proven correct - at a cost to the New Zealand economy, and which displaces emissions, previously subject to regulatory control within New Zealand, to jurisdictions where no such control or cost exists.

Finally, we expect the cost of this leakage may well eventually exceed the cost of the "unnecessary flow of funds offshore" from purchases of international units that so preoccupies Government in this Consultation Document.

That is painfully ironic.

Seeking More Information?

This paper is No. 10 of a series intended to explore in detail the design and operation of the New Zealand Emissions trading Scheme (NZ ETS). For more information on this Digest and views of Holcim expressed in it, please contact:

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This Digest, with a variety of other materials, is also available online at **www.holcim.com/nz**. Limited print copies are also available by contacting the above address with full mailing details.

For more information about Holcim (New Zealand) Ltd: www.holcim.com/nz
For more information about the Holcim Group of Companies: www.holcim.com

About Holcim

Holcim was founded in 1888 as Milburn Lime and Cement Co. Holcim directly employs in excess of 550 people across more than 35 operating sites in New Zealand. The company manufactures cement at Westport and lime, concrete and aggregates at a multitude of locations. In addition, it operates two ships and a fleet of rail and road tankers and concrete delivery trucks.

Holcim (New Zealand) Ltd is a member of the Holcim Group of Companies, which is one of the world's leading suppliers of cement and aggregates, as well as further activities such as ready-mix concrete and asphalt. The Holcim Group holds majority and minority interests in more than 70 countries on all continents and employs some 90,000 people.

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