

21 September 2018

Vicky Robertson  
Chief Executive  
Ministry for the Environment  
PO Box 10362  
WELLINGTON 6143

Sent via email: etsconsultation@mfe.govt.nz

Dear Vicky

## Improvements to the New Zealand Emissions Trading Scheme

First Gas Limited welcomes the opportunity to make a submission to the Ministry for the Environment on the consultation document "*Improvements to the New Zealand Emissions Trading Scheme*" published in August 2018. We are also making this submission on behalf of Gas Services NZ Limited (GSNZ), a separate business with common shareholders that has agreed to purchase the Ahuroa Gas Storage facility and Rockgas LPG business from Contact Energy.

We agree with the consultation document that a credible Emissions Trading Scheme (ETS) will be an important tool in New Zealand's transition to a low-emissions economy.<sup>1</sup> The reviews completed to date suggest the ETS is not working as well as intended due to:

- The Government not having the tools required to manage the supply of units;
- The settings and management of the ETS creating significant uncertainty; and
- Technical and operational issues causing administrative inefficiencies.

We support the government addressing these issues with the ETS to support the country's transition to net zero emissions by 2050. Our submission focuses on the proposals intended to:

- Develop an ETS that provides greater certainty of process and cost to participants;
- Provide a more flexible and transparent scheme; and
- Make the scheme easier and simpler for participants to manage their obligations and access units.

We consider these factors in our responses to selected consultation questions set out in **Appendix A** of this submission.

### About First Gas

First Gas operates 2,500 kilometres of gas transmission pipelines and more than 4,800 kilometres of gas distribution pipelines across the North Island. These gas infrastructure assets transport gas from Taranaki to major industrial gas users, electricity generators, businesses and homes, and transport around 20% of New Zealand's primary energy supply.

GSNZ is a related party that has agreed to purchase the underground gas storage facility at Ahuroa in Taranaki that will store gas on behalf of users that require flexibility in their gas supply (for example to support intermittent renewable electricity generation). GSNZ has also announced its acquisition of the Rockgas LPG business, which has around 90,000 customers across the country.

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<sup>1</sup> Page 14, section 1.3 of the consultation document.

As part of our gas transmission business, First Gas purchases natural gas to run our compressor stations that support the delivery of gas. To date, we have elected to have the gas producer manage ETS obligations in respect of this gas. However, we are interested in opting in to the ETS and managing First Gas and GSNZ's carbon requirements together, as our obligations increase, and our business matures.

### **Importance of addressing risk of carbon leakage from energy system**

First Gas is committed to supplying a reliable source of energy to our customers. Gas is a cleaner burning fuel than coal, and one quarter the price of electricity for industry per kWh supplied. The Productivity Commission's recent report on a *Low emissions-economy* projects that natural gas has a continued role in our economy, with more than 100 PJ of gas consumed per year in each of the scenarios modelled in the Commission's report.<sup>2</sup>

Carbon leakage<sup>3</sup> is an issue that needs to be carefully addressed when reviewing climate change policies and the role of the ETS. Many of our major customers undertake activities that are both emissions-intensive and trade-exposed (EITE). Currently, eligible activities receive a free allocation of emissions units to protect firms whose international competitiveness may be at risk from ETS costs. This mitigates the risk that production and investment move to countries that are not subject to carbon pricing, which would have the perverse effects of increasing global emissions. We strongly encourage the government to analyse the risk of carbon leakage as it amends the ETS and considers the settings for EITE participants.

### **Coordination of unit supply decisions**

First Gas supports the proposed coordination of unit supply decisions. We consider that for the ETS to be effective, it must be aligned with the carbon budget and ultimately the country's emissions target. It is encouraging to see the consultation document support this view, and we endorse the proposal to provide a five-year rolling supply of emissions units that is coordinated with:

- The volumes of New Zealand emission units (NZUs) to be auctioned;
- The use and/or limit on international units; and
- The ceiling price (either as part of the cost containment reserve or fixed price option mechanism).

The coordination of unit supply decisions should offer greater certainty and predictability to business and investors in New Zealand. Setting the key components of the ETS in advance will allow investors some certainty of the likely costs to their business for both their current operation and emissions reduction opportunities. First Gas considers that the price option mechanism remains fit for purpose and provides greater certainty for participants.

Notwithstanding this, we agree that certainty must be tempered with some flexibility within the system. The setting of the carbon budgets, the level of units supplied through auctions, and any price ceiling must reflect the wider factors influencing both New Zealand's and the international response to climate change. For example, the carbon budget may assume technology improvements, but if these do not eventuate at the expected rate, businesses may not be able to reduce emissions to the level expected.

We strongly support the proposal that the settings are only changed when compelling evidence is available to support a change. We also endorse the proposal that there should be restrictions on when and how unit volumes can be altered between the second year and five-year period. Confidence in the ETS will come from certainty and transparency around decision-making. For these reasons, it is essential that the Government provide evidence supporting any changes in context, and rationale for the new settings for the ETS.

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<sup>2</sup> *Low-emissions economy*, final report, Productivity Commission, August 2018.

<sup>3</sup> Carbon leakage is the displacement of production to countries with less stringent climate policies, increasing global emissions. The current NZ ETS free allocation system minimises this potential impact through restricting free allocation only to emissions intensive and trade exposed activities (i.e. where NZ ETS costs cannot be passed on and create risks to international competitiveness).

**Affordability and climate change**

When reviewing climate change policy, it is critical that the Government appropriately balances competing objectives of energy affordability, reliability and climate change mitigation. Energy affordability is already a key issue for this country, as evidenced by the first report on the Electricity Price Review (EPR).<sup>4</sup> Experience in other countries (most recently Australia) highlights the risk of pushing ahead with changes to climate change policy without adequately safeguarding affordable energy supplies.

While New Zealand is blessed with abundant renewable energy resources, we are concerned that if climate change policy is pushed too far and too fast this could significantly increase energy costs and prices.

To ensure an enduring climate change response, the issue of energy affordability must factor into policy decisions. Without proper consideration, there is a risk that climate change policy is abandoned because it becomes politically untenable.

**Contact person**

First Gas supports the development of a strong and credible emissions trading scheme and looks forward to further engagement on this matter. If you have any questions regarding this submission, please contact me on 06 215 4046 or via email at [Lynette.Taylor@firstgas.co.nz](mailto:Lynette.Taylor@firstgas.co.nz).

Yours sincerely



**Lynette Taylor**  
Regulatory Advisor

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<sup>4</sup> *Electricity Price Review, Hikohiko Te uira*, first report for discussion, MBIE, 30 August 2018, <https://www.mbie.govt.nz/info-services/sectors-industries/energy/electricity-price-review/consultation/first-report.pdf>

## Appendix A: First Gas' response to consultation questions

First Gas' has responded to selected consultation questions that relate to improving the certainty, predictability, transparency and ease of access to the ETS.

Question	First Gas comments
<p>1 What issues should the decision maker consider when making unit supply decisions?</p> <ul style="list-style-type: none"> <li>• proper functioning of the ETS</li> <li>• NZ's projected emission trends</li> <li>• number of NZUs expected to be allocated</li> <li>• emissions covered by the ETS</li> <li>• arrangements that govern the operation of the ETS</li> <li>• any limit on international units</li> <li>• emissions budgets, such as those proposed in the Zero Carbon Bill</li> <li>• recommendations from the independent Climate Change Commission proposed in the Zero Carbon Bill</li> <li>• agreements or arrangements regarding international emissions reductions</li> <li>• non-ETS climate change mitigation policies</li> <li>• modelling of New Zealand's domestic abatement potential and costs</li> <li>• forestry reporting periods</li> <li>• forecasts of international carbon prices</li> <li>• inflation rates—other (please explain).</li> </ul> <p>Is there anything else that should be considered?</p>	<p><b>Carbon budget and wider environment are key issues to be considered</b></p> <p>The Emissions Trading Scheme will be an important tool for New Zealand's transition to a low-emissions economy.<sup>5</sup> Therefore, it is essential that the framework and settings for the ETS are right.</p> <p>First Gas has previously submitted to the Productivity Commission<sup>6</sup> that the ETS settings must be linked to and support the carbon budgets. It is encouraging to see the consultation document develop this theme.</p> <p>We agree that certainty must be tempered with some flexibility within the system. While aligning unit supply with the carbon budget provides a clear line of sight with the long-term goal, deciding the level of unit supply through auctions and any price ceiling must also consider wider influences both in New Zealand and internationally. For example, forecasts of international carbon prices may influence the ceiling price in New Zealand to maintain competitiveness. It is important that the decision-maker also consider the impact of the ETS on affordability, and the resulting prices customers may face from a faster transition to a lower-emissions economy.</p> <p><b>Need to consider recommendations from the Climate Change Commission</b></p> <p>The decision-maker should take into consideration the recommendations of the Climate Change Commission and the decision-maker for the carbon budgets. These parties may already consider New Zealand's domestic abatement potential and costs and agreements regarding international emissions reductions. Overlapping the roles of different decision-makers could risk further uncertainty and inconsistency.</p> <p><b>Decision-maker must demonstrate that decisions are made on an evidence basis</b></p> <p>A further consideration for the decision-maker is that of transparency and consistency. We recommend the decision maker must ensure significant decisions and amendments to either process or component values of the ETS are based on strong evidence.</p> <p>Regulatory uncertainty is one of the issues with the current regime. This may relate to cost and supply, and regulatory uncertainty may also exist if the basis for the process or decisions made is not clear and transparent. We recommend any significant changes to the ETS process or component values be explained and the evidence supporting the change</p>

<sup>5</sup> Page 14, section 1.3, consultation document.

<sup>6</sup> <http://firstgas.co.nz/wp-content/uploads/First-Gas-submission-to-low-emissions-economy-inquiry.pdf>

Question	First Gas comments
	<p>be disclosed. For example, it may be determined that certain international emissions units could be accessed. If the supply however is limited, this limit should be explained and supported by evidence driving that decision.</p>
<p>2 What, if any, restrictions should be placed on the NZ ETS decision maker when making unit supply decisions? (For example, currently one year's notice must be given for changes to unit supply volumes).</p>	<p>First Gas considers that supply decisions should provide certainty and be reasonably predictable. The annual update to the rolling five-year unit supply decisions supports that concept of predictability and certainty. These supply decisions will cover volumes, ceiling price and any availability of international units. These are fundamental components of the ETS. There should not be significant changes to the 5-year view unless justified on an evidence basis.</p> <p>We support the consultation document view that, in general, there should be no changes in the current year or the first year of the rolling five-year view.</p> <p>We also agree there should be restrictions to when and how components of the ETS can be altered in the 2 – 5-year period. We support the view in the consultation document that this should only occur when there has been a significant change in context.</p>
<p>3 Do you agree with the proposal to implement a single-round, sealed bid auction format with uniform pricing? If not, why not?</p>	<p><b>Keep the mechanism simple and encourage participation</b></p> <p>We understand from the discussion document that an in-principle decision has been made to implement an auction format for available emissions units. This being the case, we support the proposal to keep the mechanism simple. This will minimise costs and encourage participation.</p>
<p>4 Do you think that auctioning frequency should be:</p> <ul style="list-style-type: none"> <li>• weekly (not preferred)</li> <li>• monthly</li> <li>• quarterly</li> <li>• annually (not preferred).</li> </ul>	<p>We agree with the proposal that all participants on the New Zealand Emissions Trading Register (ETR) should be able to participate at auction. One of the aims of the auction format is to maintain a level of competition for the units. Competition will be enhanced by more participants.</p>
<p>5 Do you agree with the proposal that all NZ ETR account holders should be able to participate at auction? If not, why not?</p>	<p>We suggest that the auction frequency should be monthly, as this will allow new entrants to participate in the auctions without delay.</p>
<p>6 Do you think that the Government should use the proceeds gained from the auctioning of NZUs for specific purposes? If so, please explain what those purposes would be</p>	<p><b>Use of auction proceeds</b></p> <p>We consider the Government is best placed to determine the use of any proceeds gained from the auctioning of emissions units, and there is no real value gained from ring-fencing ETS revenue.</p> <p>The Government should be able to decide how best to use the funds generated to meet its policy objectives – with the flexibility to spend either more money or less money than is generated from the ETS to support emissions reductions or climate adaptation.</p>

Question	First Gas comments
<p>7 Do you agree with the proposal to replace the \$25 fixed priced option with a cost containment reserve price ceiling implemented through the auctioning mechanism? If not, why not?</p>	<p>First Gas supports the mechanism of a ceiling price and considers the fixed price option (FPO) mechanism remains fit for purpose.</p> <p>The FPO is the mechanism used under the current ETS. It is simple to understand and administer, signals a maximum price for emissions units to the market, and provides participants with some confidence they will be able to discharge their emissions liability if all other options have been exhausted.</p> <p>A price ceiling mechanism is expected to prevent the emissions price from rising to unreasonably high levels and provides some certainty to the market and investors. The ceiling price allows investors to consider the cost of different investment options as they have certainty about the price of emissions. This encourages investment to lower emissions if the option is less expensive than the cost of carbon.</p> <p>Typically, the fixed price, is expected to be higher than the secondary market price. It is set at such a level to discourage purchase under the FPO as the market can meet requirements at a lower price.</p> <p>The FPO provides certainty to participants by providing a fall-back for unit purchases, if it is the only means available to discharge an emissions liability.</p> <p>The FPO achieves this task and it is simple. The mechanism is not so much flawed, rather the price is being held steady under legislation for a long period of time and there is no control over unit volumes. If a FPO were retained, the dollar value could be removed from legislation and form part of the 5-year rolling supply update</p> <p>It is not clear how the cost containment reserve would add certainty and predictability to the market and investors. Volumes could be released to the market when the reserve price is triggered but it is uncertain what price would then be paid per unit.</p> <p>A cost containment reserve does not appear to offer any greater benefit than the FPO but adds complexity and uncertainty.</p>
<p>8 How do you think the price level and number of units in the cost containment reserve should be managed over time? (Note: specific settings will be consulted on later). Select all that apply.</p> <ul style="list-style-type: none"> <li>• decision-maker has discretion to determine the settings while having regard to certain factors (please explain)</li> <li>• settings are determined by mandated formulae (please explain)</li> <li>• other (please explain).</li> </ul>	<p>Notwithstanding our view that the FPO remains suited for purpose, if a cost containment reserve were used we consider the decision-maker should have discretion to determine settings.</p> <p>The ceiling mechanism is part of the coordinated decision-making approach. It should follow the principle that any decision on supply must consider many factors. This is difficult to achieve using mandated formulae.</p>

Question	First Gas comments
<ul style="list-style-type: none"> <li>increase the limit on international units, if high domestic abatement costs are the cause of the excessively high prices</li> <li>undertake a fuller system review, if the high prices are seen as a sign of wider market dysfunction</li> </ul>	
<p>9 What actions should occur if the price ceiling is struck?</p> <ul style="list-style-type: none"> <li>increase the price ceiling trigger level, if it was set on a too low or erroneous basis</li> <li>government buying international units to compensate for additional units added to the market through the price ceiling</li> <li>adjust the overall cap</li> <li>other (please explain).</li> </ul>	<p>First Gas considers that to maintain credibility and certainty for investors, intervention into markets should be minimised and only occur where there is evidence to suggest intervention is required.</p> <p>In principle, intervention in the ETS should only occur to fix the system if it is failing. It should be a considered response, rather than reactive, as it may affect other actions or policies.</p> <p>The cause of the issue must be determined based on evidence before intervention occurs to ensure the correction to the market is the right one.</p>
<p>10 Do you agree with the proposal to review the price ceiling if another significant event occurs (such as a decision to link the NZ ETS with another carbon market)?</p>	<p>As per our response to question 9, any significant change in the environment may necessitate a review of the ETS parameters.</p>
<p>11 Do you agree that the \$25 FPO may not be appropriate for the short term, and may need to be adjusted before 2020? Please explain.</p>	<p>To support certainty and predictability, we consider the FPO price of \$25 should remain until the new regime is put in place or at least one year's notice has been given of the intention of change. This is similar to the requirement to signal a change to volumes of emission units available.</p> <p>Investors rely on certainty of process as well as value. The Government has to date been very clear that the FPO will remain in place until 2020, and business confidence would be enhanced by sticking to this commitment. If the Act were to be altered to increase the FPO, any new level of FPO should be clearly justified and explained.</p>
<p>12 Which mode of purchase for international units (direct or indirect) would be the best approach for the NZ ETS, acknowledging that there are other significant factors that will influence this decision? Please explain.</p>	<p>First Gas agrees that international units must meet a high standard of environmental integrity, if the ETS is to reopen to the international market. The inclusion of low-quality international units only risks undermining the credibility of the ETS.</p> <p>We also support the view that if limits are to be applied to the number of international units that may be used, this should be signalled in the annual update to the five-year rolling unit supply settings.</p> <p>Once the units have passed the integrity test, how they are purchased is less relevant. We consider that the direct approach would work well. Participants will be more experienced with trading than the Government and can make their own decisions whether to buy units or not.</p>

Question	First Gas comments
<p>14 How do you think decisions on a phase-down of industrial allocation should be made? Select all that apply.</p> <ul style="list-style-type: none"> <li>• make an up-front decision to phase-down industrial allocation from 2021</li> <li>• set a test or condition that would trigger a phase-down</li> <li>• establish a decision-making process to determine industrial allocation rates over time</li> <li>• other process (please explain).</li> </ul>	<p>First Gas suggests that there has not been sufficient evidence presented in the consultation document to indicate that the industrial allocation should be phased down at present. To initiate change without a strong evidence base risks reducing certainty and undermining confidence in the process and the ETS.</p> <p>The industrial allocation is in place to mitigate the risk of carbon leakage. It is provided to industries that are emissions intensive and have trade exposed activities (i.e. where NZ ETS costs cannot be passed on and create risks to international competitiveness). We consider that the components of the calculation may need review, but this does not indicate the risk of carbon leakage has changed.</p> <p>We suggest that, as with any other change to key parts of the ETS, change to the allocation should be supported by evidence. We suggest that if it is considered the risk of carbon leakage has reduced, then further investigation could be conducted.</p> <p><b>Determining allocation rates</b></p> <p>We recommend that a decision-making process be established to determine the appropriate allocation rates. This process could occur at specified periods and signal any intent to reduce the industrial allocation for any industry or activity well in advance of it occurring. For the purposes of transparency, any change to the allocation rates should be based on evidence of a lower risk of emissions leakage. The allocation rates and calculation could be refined to reflect the risk of carbon leakage for different industries and activities.</p>
<p>15 If a decision-making process for industrial allocation is implemented, which of the following factors should the decision-maker taken into account? (Select all that apply).</p> <ul style="list-style-type: none"> <li>• New Zealand's emission budgets</li> <li>• the risk of emission leakage, with the aim of avoiding leakage driven by differential emission pricing policies, and based on economic analysis of the markets for EITE activities and their products</li> <li>• other sources of supply into the NZ ETS</li> <li>• the availability of low-emissions technologies</li> <li>• New Zealand's international obligations</li> <li>• other (please explain).</li> </ul>	<p>First Gas recommends that a decision-making process be undertaken for determining the industrial allocation.</p> <p>The decision maker should only need to consider the risk of emissions leakage, with the aim of avoiding leakage driven by differential emission pricing policies and should be based on economic analysis of the markets for EITE activities and their products.</p>

Question	First Gas comments
<p>16 If a phase-down is initiated in future, which of the following rates for phasing-down industrial allocation should be considered?</p> <ul style="list-style-type: none"> <li>• 0.01 per year</li> <li>• 0.02 per year</li> <li>• 0.03 per year</li> <li>• Other (please explain).</li> </ul>	<p>First Gas does not consider that sufficient evidence has been presented to support a reduction in the risk of emissions leakage.</p>
<p>17 What impact would changes to the levels of industrial allocation from 2021 have on your investment or business decisions?</p>	<p>While First Gas does not receive an industrial allocation, we have some concerns that a reduction without a strong basis of evidence would result in industry moving offshore.</p> <p>Potentially, this could significantly affect how we would recover the costs required from the gas transmission system, with a risk that the balance of our fixed costs would move from industry to residential consumers. Such a change would have broader energy policy implications by affecting the affordability of natural gas used in homes and businesses.</p>

## Operational issues

Question	First Gas comments
<p><b>3.2 Market governance</b></p>	<p>First Gas generally supports the market governance proposals that seek to ensure that participants are both adequately informed and protected when they trade NZUs.</p> <p>As with all markets, the potential for misconduct needs to be mitigated as it will undermine the confidence in the market and the effectiveness of the ETS. It is also important to balance governance with simplicity. If the regulatory requirements are overly complex and onerous, it will make it more difficult and expensive to engage with the NZ ETS. Compliance costs should be kept to a minimum to encourage engagement in the scheme.</p>
<p>19 Do you think that there would be benefits from publishing individual emissions data reported by NZ ETS participants? (Please explain.)</p>	<p>We consider that publishing individual emission data is a useful step in encouraging compliance and incentivising emissions reductions. It should encourage businesses to look at others within their sector, assess what reductions have occurred, and ideally create incentives to further share knowledge within sectors.</p>
<p><b>3.4 Compliance and penalties</b></p>	<p>For the ETS to function well, we support the necessary market controls being in place. If participants don't comply with the rules, then a penalty should be incurred.</p> <p>We agree with the proposal that the level of penalty should reflect the level of infringement. Where there are lower-level instances of non-compliance, the penalty should be lower.</p>

Question	First Gas comments
22 Do you agree with the proposal to introduce strict liability infringement offences for low-level non-compliance? If not, why not?	First Gas has no concerns with this proposal, ensuring that the rules are clear, and participants are not penalised for simple errors. The proposal to include the offences and maximum fees in the legislation seems a reasonable approach.
26 What option do you see as most appropriate for the excess emissions penalty?	In principle, we consider the proportional approach more appropriate, as it reflects the level of non-compliance.
28 Should large purchasers of coal, natural gas or obligation fuels have the ability to opt-in for only a portion of their obligations?	One of the aims of the auction process is to increase competition for the units. By allowing large purchasers of hydrocarbons to opt-in for some or all of their obligations this will encourage participation in the market. This will drive liquidity in the market.