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NZ ETS Review Consultation
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NEW ZEALAND EMISSIONS TRADING SCHEME REVIEW 2015/16

SUBMISSION BY METHANEX NEW ZEALAND LIMITED

Methanex New Zealand welcomes the opportunity to submit on the Priority Issues outlined in *New Zealand Emissions Trading Scheme Review 2015/16 discussion document*, released by Ministry for the Environment in November 2015. Methanex recognises the importance of an economically sustainable transition to a low carbon economy to meet the challenge of climate change and that New Zealand has a part to play in reducing emissions, as agreed to at the Paris talks. We support an effective Emissions Trading Scheme that provides certainty for the future and preserves the competitiveness of our economy, recognising the ongoing contributions of existing industries.

Methanex is New Zealand's only methanol producer, exporting up to 2.2 million tonnes per year from two sites in Taranaki. Methanex Corporation is the world's largest producer and marketer of methanol. Methanol production adds \$650 million to New Zealand's GDP each year, and sustains 1200 jobs directly and indirectly.¹ Methanol production is a significant contributor to the Taranaki economy, especially at a challenging time for the region given the slump in oil and gas exploration and the ongoing dairy industry downturn.

Methanol production is a significant contributor to helping achieve New Zealand's target of 40% of GDP from exports by 2025 and its continuing production plays an important strategic role in sustaining the domestic natural gas sector, which is vital in providing security of electricity supply and energy for industry and residential consumers.

Methanol operations generate emissions when fuel is consumed during the methanol production process and through shipping methanol to customers. Emissions are mitigated as much as possible by using a renewable energy provider, continuing to make the plants run more reliably and seeking incremental efficiency gains, and increasing shipping fleet efficiencies through fuller vessel loads and backhaul voyages. The increasing use of methanol as a transport fuel overseas, often by blending with petrol, also provides reductions in emissions on a well to wheel basis when compared with petrol.

¹ Economic Impact Analysis undertaken on behalf of Methanex by Business and Economic Research Limited ("BERL"), March 2013

Our current production facilities in New Zealand are limited in making significant gains in emissions reductions with few ‘low hanging fruit’ remaining. There could eventually be potential for methanol to be produced renewably as a niche market, for example using CO₂ and geothermal waste, as is done with a trial plant in Iceland. We are currently investigating the long term viability of such a project, which could be fostered with appropriate business conditions and within an environment of government support for carbon-reducing initiatives.

The challenge for this review will be determining how best to adapt the ETS to meet the government’s objectives in the face of a possibly persistent absence of international linkages and uncertainty concerning the level of carbon price that will achieve a sufficient level of domestic emissions abatement while at the same time avoiding adverse impacts on the economy. In this context, decisions made in regard to moving to full surrender obligations, and the inevitable price implications that will have, should not be made in isolation to addressing the broader issues that have been pushed out into the second submission.

It is our view that an unmoderated, domestic only, ETS will generate high, potentially uncontained, carbon prices in the near term. In the absence of international offsets the only tools available to the Government within the ETS to prevent this is to continue moderating the number of units that need to be surrendered or moderate the cost of those units.

We hold concerns as to how stronger ambition to prepare participants for higher carbon prices and the desire in particular to promote afforestation through the ETS will play out in the absence of international offsets and continue to meet the objective of achieving least-cost abatement. This has been a core principle of New Zealand’s response to climate change and if that aspect remains a key objective then there are some challenges ahead for the NZ ETS to deliver on that outcome in the absence of genuine international linkages.

1. Do you agree/disagree with the drivers for the review?

2. What other factors should the Government be considering in this ETS review?

In the Discussion Document the Government includes the following drivers:

- Improving the performance of the NZ ETS against its objectives
 - Meeting international obligations
 - Reducing net emissions below Business As Usual levels
- Preparing for a more carbon-constrained future
- Increasing certainty about future policy settings
- Managing banked emission units

In assessing these drivers we recommend the Government take the following points into consideration:

(a) Improving the performance of the NZ ETS against its objectives

- Ensuring our international commitments fairly reflect the obligations and, most importantly, the adherence to those obligations by other countries.
 - The effect on global emissions of domestic action in New Zealand. In the absence of consistent carbon pricing globally, reductions made in New Zealand that force industries here to retrench
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will result in those industries moving to other jurisdictions without necessarily reducing global emissions.²

- The extent to which emissions reductions induced by the ETS through higher carbon prices come at the cost of economic output.

(b) Preparing for a more carbon-constrained future

It will be difficult and costly for New Zealand to prepare for a carbon constrained future in the absence of an effective international carbon market to provide a means of least-cost abatement. The difficulties faced in re-establishing international linkages, particularly given the small number of countries that have endorsed the use of international markets³ does not bode well for this to occur in the near-term.

In considering this driver we believe the Government should formulate a wider vision and strategy than focussing solely on the NZ ETS including:

- Addressing the implications of a persistent absence of international linkages to provide a source of cost-effective emission units.
- Assessing the scope and timing of technological developments that will prevent a lower standard of living in New Zealand induced from higher costs to consumers and the decline of emissions-intensive industries.
- Identifying low carbon industries for New Zealand that can realistically demonstrate a comparative advantage and then enable their development in sufficient scale and added value to replace any lost output from emissions-intensive industries.
- Address the implications of high carbon prices on trade (including international tourism) given our distance from markets.

(c) Increased certainty about future policy settings

For the last seven years the Government has largely delivered consistency in the policy settings for the NZ ETS, allowing businesses and consumers to factor in ETS costs and settings into their planning. However, because of changes in the global context, particularly the abandonment of international

² Carbon leakage resulting from industry in New Zealand moving offshore would in some cases cause global emissions to increase. Methanol production in New Zealand is a case in point. Nett emissions from methanol production in New Zealand are less than 0.8 tCO₂e per tonne of methanol. This is one-third of the nett emissions produced by some Chinese coal-based methanol production. China is the marginal producer and would increase its methanol production if production in New Zealand was displaced. We expect that given the generally high level of cost efficiency of New Zealand industry, and high levels of renewable electricity, other industries in New Zealand offer similarly high emissions efficiencies compared with rival producers in other countries which supports retention of those industries in this country.

³ Notwithstanding the recently signed Ministerial Declaration on Carbon Markets, based on data compiled from national communiqués on INDC's made to the UNFCCC, only a handful of developed countries and major emitters have endorsed the use of international markets. The list notably excludes the United States, European Union, China, India and Australia, who would all need to participate for an effective global carbon market to develop. Information has been taken from data compiled by the Center for Climate and Energy Solutions as at 31 December 2015 (<http://www.c2es.org/indc-comparison>) and by reference to a compilation report provided by the UNFCCC (http://unfccc.int/files/adaptation/application/pdf/all__parties_indc.pdf).

market mechanisms, we urge caution on considering major policy setting changes, particularly those aimed at delivering short-term price related outcomes while the medium to long term pathway remains uncertain.

(d) Managing banked emission units

Of the 140 million NZU's units current held, the majority is held by foresters who will need to surrender units when they harvest in years to come and so it can't be considered abnormal for those units to continue to be held back.

Therefore, the number of units that could be fairly described as representing an over-hang is much smaller. Without access to international offsets to provide liquidity, those available units will be quickly released into the market and any perceived over-hang will disappear in short order. We are already seeing a rapid acceleration toward the effective NZU price cap of \$12.50 (determined by the \$25 fixed price option in the context of the discounted surrender obligation). NZU prices started 2015 at about \$6 and are now sitting at \$11 for May 2016 delivery and \$12 for May 2017 delivery.⁴ It is also worth noting that the price of emission units in Europe ("EUA's"), in the only other comparable emission trading scheme anywhere in the world, were recently trading at equivalent to NZ\$9⁵ with signs of further downward weakness. Consensus forecasts compiled recently by Carbon Pulse pick a median EUA price of Euro 13 (NZ\$22) by end 2020 but more importantly show a 28% reduction from previous forecasts. In this context moving to full surrender obligation in the short-term and maintaining the fixed NZ\$25 price could see carbon prices in New Zealand exceeding carbon prices in Europe by a significant margin.

3. Should the NZ ETS move to a full surrender obligation for the liquid fossil fuels, industrial processes, stationary energy and waste sectors?

If the Government moves to full surrender obligation we expect the NZU price to quickly increase and to only be constrained by a price cap (at whatever level that is set). Notwithstanding an over-hang of banked units, without access to international offsets, the market for emissions units in New Zealand is fundamentally short and even extreme prices are unlikely to provide sufficient supply of new units from removal activities to match surrender obligations. The faster the Government moves to full surrender obligations and the quicker those banked units work through the system, the more urgently the Government will need to address the domestic carbon price implications and determine what is an economically sustainable limit to that price.

(a) A stronger rationale for ETS participants to take full responsibility

The rationale for change outlined in the Discussion Document understates the concentration of economic risk New Zealand currently faces.

The impact of the Global Financial Crisis on the New Zealand economy was relatively limited compared with many other countries, but with plenty of perceived risk. With similar actions being taken internationally, a rational decision was taken to moderate the NZ ETS.

⁴ Taken from commtrade.co.nz, 9 February 2016

⁵ Carbon Pulse, 9 February, 2016, <http://carbon-pulse.com/14488/>

We are now faced with a significant and sustained global commodity slump spread across a wide range of commodities. New Zealand as a commodity exporter is likely to be more exposed to these circumstances than during the GFC. Methanex has been recently adversely impacted, as have a number of other industries across New Zealand, by a fall in their respective commodity prices and we believe there is considerable forward risk to New Zealand economic growth.

On that basis we don't agree that there is a stronger economic rationale for moving to full surrender obligation than there was when it was last considered in 2011.

(b) Given New Zealand's relatively costly domestic abatement options, it is likely that the NZ ETS will re-open to international markets in the 2020's.

The prospects for re-establishing an efficient and transparent international carbon market to link the NZ ETS to in the next 5-10 years are far from promising. It is also important to recognise the reality that New Zealand's re-entry into an international carbon market will not be determined by the high cost of domestic abatement but by whether suitable international markets exist or not.

We strongly urge that the Government explores to the fullest extent opportunities to establish international linkages even if they are bilateral or regional arrangements. However, in the absence of sufficient international linkages to provide a source of emissions units, the challenge for the Government will be to ensure the high cost of domestic abatement does not generate an unsustainably high cost to the economy.

4. What impact will moving to full surrender obligations have on your business?

Moving to full surrender obligations will add to the underlying upward trend of domestic carbon prices that we are already seeing play out. We consider that the fundamental issue to be addressed is to determine the carbon price trajectory that strikes the best balance, over time, between stimulating cost-effective emission abatement and avoiding adverse economic impacts.

Our understanding is that the costs set out in Appendix 2, Table 3 of the Discussion Document for various carbon price levels only considers direct costs from household consumption of petrol, electricity and natural gas. We caution that this analysis appears incomplete and under-estimates the full cost impacts.

We believe the analysis needs to account for:

- (a) Multiplier effects arising from cost increases for all consumption having an energy or carbon cost component. The inclusion of multiplier effects is standard practice in evaluation of economic impacts so we are concerned that this analysis might ignore those cost impacts.
- (b) Sustained income effects such as disinvestment, switching from consumption to saving, reduced employment or lower-value employment caused as the economy reorganises as a consequence of high carbon costs. These impacts are much harder to assess and place a value on, especially using simple general-equilibrium analysis, but are nevertheless important to measure to fully understand the potential cost implications.

Consequently we expect the real annual cost to businesses and households would be significantly higher than the levels suggested in the Discussion Document.

We recognise that as an EITE company, eligible for Industrial Allocations, Methanex operations in New Zealand are currently substantially protected from the direct impacts of carbon prices. However, our cost structure and underlying economic drivers are likely to be similar to many other businesses in New Zealand and so we can put into context, the cost impacts for those businesses that could be fully exposed to the prevailing carbon price.

Our business, as with many others in New Zealand, faces intense international price competition and any significant changes in underlying cost structure can have dramatic impacts on where a company stands relative to its competition and by implication its profitability. If methanol production in New Zealand were to be fully exposed to a carbon price of NZ\$25/tonne it would certainly influence our forward investment decisions. We expect this to be a similar scenario that would play out throughout the economy at a carbon price of \$25/tonne with impacts magnifying as the price increases beyond that point.

5. If full surrender obligations are applied, when should this be implemented?

We urge the Government to reconsider its choice in dealing with the matter of full surrender obligations ahead of and in isolation to other broader issues associated with the development of ETS. In particular, assessing the prospects for access to international offsets and a fuller analysis of the domestic cost of abatement are necessary to address the fundamental issue which is what is the carbon price trajectory that will best place New Zealand to bear its fair share of the burden in reducing global emissions and at the same time ensure the economy is not adversely impacted. This further consideration would inform decisions on the scope and timing for increasing domestic pricing, including moving to full surrender obligations.

- 6. If the NZ ETS moves to full surrender obligations should potential price shocks be managed?**
7. If potential price shocks associated with moving to full surrender obligations should be managed, how should this be done?
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We agree with statements in the Discussion Document that the cost of domestic abatement options, including afforestation, will be high. In the absence of international offsets to provide an alternative source for least-cost abatement, the only mechanisms available to reduce the negative impacts of high abatement costs on the economy as a whole are to (a) moderate the ambition in respect to incentivising private investment in afforestation and other abatement options through NZU prices, (b) introduce non-ETS measures to induce reductions, and/or (c) control the price of surrender obligations (either by continuing to discount the number of units or discounting/capping the cost of units surrendered).

We believe a fixed price cap is necessary to prevent a rapid and uncontrolled escalation in carbon prices in the absence of international offsets to provide an alternative safety valve.

8. If the \$25 fixed price surrender option should change, what should it change to and why?

If the discounted surrender obligation is removed and combined with an absence of international offsets, we believe NZU's will quickly increase to the price cap (at whatever level it is set). The following should be considered in assessing what is an appropriate cap:

- A price that induces incremental afforestation and other emission reduction activities. There is evidence to show that a price of \$15 would induce increased afforestation.⁶ However, our view is that the incentive sent by carbon prices could be swamped by movements in log prices and the price of land, so even very high carbon prices may not be sufficient to drive significant emissions reductions via private afforestation.
- The overall income impact on households of a given carbon price. In this respect we believe that the economic analysis undertaken to determine the increase in household or business costs is insufficient to provide guidance on the true economic costs of high carbon prices.
- Carbon prices in Europe are currently below \$10 equivalent with forecasts that are volatile (up and down). In any event, there is a large gap between the prevailing EUA price and the current NZ cap. If the cap remains at \$25 and full surrender obligations are rapidly phased in the domestic carbon price could be significantly higher than the prevailing EU carbon price.

On this basis, and with the need to recognise the impact of not having access to international offsets, we believe there is a case for reducing the fixed price cap and possibly include an escalation mechanism to ensure it provides increasing abatement incentives going forward but does not send a price shock through the economy.

We hope our submission provides assistance the Government in its deliberations. We intend to make a further submission on the broader issues presented in the Discussion Paper and due in April 2016. In the interim we would welcome the opportunity to discuss this first submission with the Ministry or any other matters associated with the Emissions Trading Scheme. If there are any further stakeholder forums or other hearings arranged, including on matters not addressed in the first submission we request that we are given the opportunity to attend.

Yours sincerely



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⁶ "Afforestation responses to carbon price changes and market uncertainties", Prof B. Manley, University of Canterbury, January 2016

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