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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

(OTHER MATTERS)

Methanex appreciates the opportunity to make its second submission to the Government in regard to the 2016 NZ ETS Review Consultation process, addressing the matters raised in the Discussion Document released on 24th November 2015.

We recognise the importance of an economically sustainable transition to a low carbon economy in order to meet the challenge of climate change and that New Zealand has a part to play in reducing global emissions. We support an effective Emissions Trading Scheme that preserves the competitiveness of our economy and recognises the ongoing contributions of existing industries.

In our first submission we made the following observations:

1. Improving the performance of the NZ ETS needs to be considered in the context of relative international action. We also noted that the NZU price was accelerating rapidly and is now well in excess of the prevailing emission unit price elsewhere in the world, including in the EU.
2. As a domestic only scheme, it is likely that achieving ambitious climate change obligations will be difficult and costly, emphasising the need to restore access to international offsets at the earliest opportunity.
3. The global commodity price slump which is affecting a range of businesses and industries in New Zealand challenges the presumption that New Zealand businesses are in a better position now to incorporate higher carbon costs without negative economic consequences than they were following the Global Financial Crisis.

The second leg of the submission process addresses a range of matters which we consider to be of great significance in determining the continuing success of the NZ ETS. Methanex believes the following are important considerations in determining the future path of the NZ ETS and New Zealand's response generally to meeting climate change mitigation objectives:

1. **International relativity of carbon costs:** The carbon price faced by businesses and households in New Zealand needs to be benchmarked against the carbon costs imposed in other countries. Too much emphasis on domestic abatement will likely result in higher carbon costs in New Zealand than those faced in other countries.
2. **International competitiveness of NZ businesses:** Maintaining the international competitiveness of New Zealand's productive sector should be a paramount objective – maintaining economic growth will be necessary to enable New Zealand to afford to successfully transition to a high income, low-carbon economy over time.
3. **Free allocation to trade exposed companies:** In considering removal of free allocation to trade-exposed industries post 2020, measures which result only in reducing the international competitiveness of New Zealand businesses will not reduce global emissions nor produce a beneficial outcome for New Zealand. In fact, for some industries like ours, a domestic-centric approach to the removal of free allocation has the very real potential of increasing global emissions.
4. **Restore international linkages:** On the basis that climate change mitigation requires reduction in global emissions, there is no environmental value in emphasising domestic abatement ahead of bona fide international offsets. Re-establishing international linkages at the earliest opportunity is critical to meeting the policy objective of ensuring NZ ETS participants are able to pursue least cost abatement opportunities. Upon reviewing the Discussion Document we believe that, going forward, it is important for long-term planning to re-emphasise that least cost abatement remains a fundamental climate change policy objective.
5. **Auctioning is a useful instrument if used to maintain price stability:** Auctioning units from within a policy-determined domestic carbon budget is unlikely to moderate New Zealand carbon prices from the high cost of domestic abatement. However, an auctioning mechanism that provides additional units when required, with reserve prices aligned to international carbon prices, will assist in moderating and stabilising carbon prices consistent with the policy objective of least cost abatement.
6. **Near-term NZU liquidity is a concern:** Contrary to the assertions made in the Discussion Document we have concerns about there being sufficient short-term liquidity of banked units prior to the implementation of auctioning or international linkages being restored.¹ This concern is founded on the belief that banked units are held by participants principally as a hedge to offset future, uncertain, carbon liabilities and so it may take an unsustainably high price to induce holders to release units early.

CONTEXT FOR INCREASING CARBON PRICES IN NEW ZEALAND

Before discussing the core topics raised in the Discussion Document it is worthwhile considering the current carbon pricing environment in order to bring some context to determining the appropriate carbon price signal for New Zealand businesses and households.

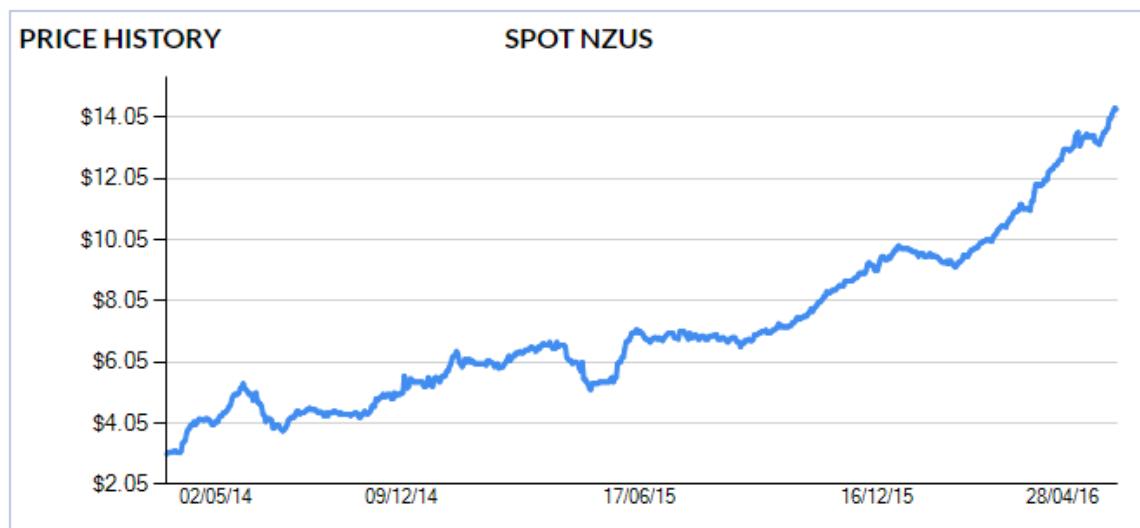
¹ Discussion Document, Page 22

- The price of NZUs stands at \$16.00 (May 2017 delivery) and has more than doubled in price over the last 12 months.²
- As the most credible international benchmark, the EUA futures price (Dec 2016 delivery) has fallen by approximately 20% in the same period and is now 6.37 Euro (\$10.40 in NZ dollar terms or 35% less than the current NZU futures price).³
- Other countries are currently meeting their obligations by lower cost means, including developed nations with higher incomes per capita than New Zealand. As an example, Norway is meeting its abatement obligations by purchasing international offsets at between 3-4 Euro (NZ\$5 - \$6.50). Its latest purchase was for 330,000 CER's from solar energy projects in Africa concluded this month. It has purchased over 10 million CER's in the last 12 months and previously acquired 30 million units via the Nordic Environment Finance Corporation at an average of 2.20 Euro (NZ\$3.60).⁴

The accompanying charts show the relative performance of NZUs and EUAs over the past two years:

1. NZU prices have increased steadily during 2014-15. By the end of last year NZU prices were equivalent to EUA prices. The NZU price has increased more rapidly following release of the Discussion Document and public statements by the Government signalling the likely removal of the one-for-two surrender mechanism and increased emphasis on promoting afforestation through the ETS. As at 29 April 2016 NZU Spot offers stood at \$14.35, while offers for May 2017 delivery were \$16.00.⁵

Figure 1: NZU Spot Prices 2014-2016⁷



2. EUA prices increased at a modest rate until late 2015. However, since the start of this year EUA prices have fallen significantly. There has been a rally in the EUA price during April but towards the end of the month a bearish sentiment returned, shaving back most of the earlier

² Commtrade quotation 29 April 2016 (www.commtrade.co.nz)

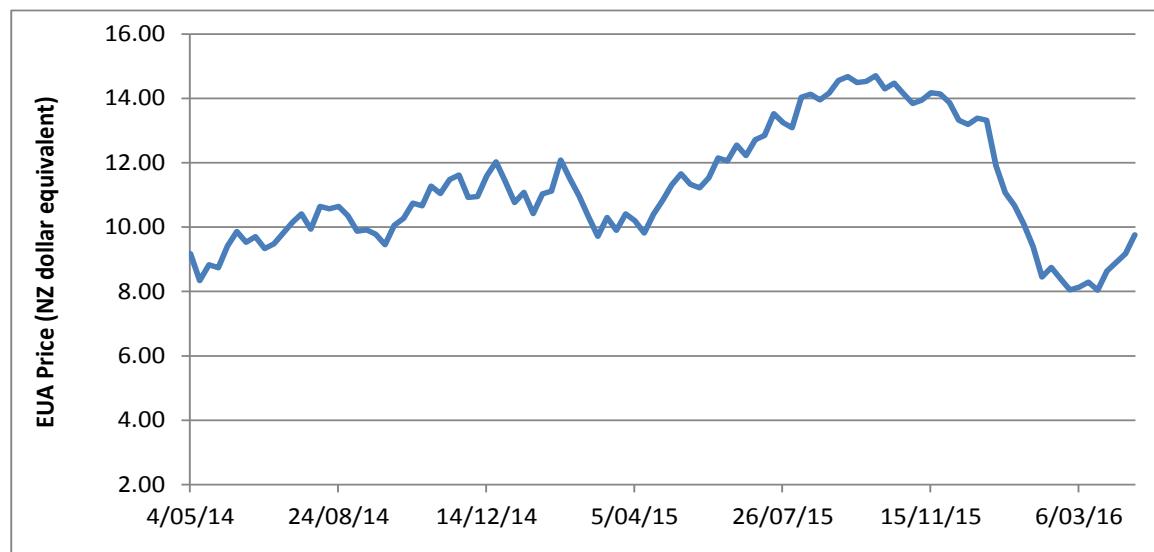
³ Carbon Pulse, 28 April 2016

⁴ Carbon Pulse article dated 13 April 2016 (<http://carbon-pulse.com/18349>)

⁵ www.commtrade.co.nz

gains amid significant uncertainty as to future price direction. The EUA price for December 2016 delivery closed on 28 April at about NZ\$10.40.

Figure 2: EUA Futures – Dec 2016 delivery⁶



Methanex recommends that, in assessing the future price of carbon in New Zealand, the Government ensures that it remains relative to carbon costs faced by business and households overseas.

BUSINESS RESPONSES TO THE NZ ETS

- 9. Do you consider the future cost of emissions in your business planning?**
 - 10. What would improve your ability to take into account the future cost of emissions in your business planning?**
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Methanol production, using natural gas, is an emissions intensive process and so the future cost of carbon is at the fore of our planning, particularly in New Zealand. Methanex' planning horizon in New Zealand extends over at least the next ten years. In that context policy outcomes post 2020 will have a direct bearing on our upcoming investment decisions in New Zealand.

Methanex' objective is to continue operating in New Zealand for as long as it makes economic sense to do so. We carefully consider current policy trends and the overall direction of the choices made between climate change ambition and sustaining economic growth. We do not believe the two objectives to be mutually exclusive, but if the Government moves too fast in increasing the costs of carbon in New Zealand it will force the premature exit of affected businesses before the economy has been allowed sufficient time to develop and establish successful low carbon industries.

Increasing the cost of emissions faced by Methanex in New Zealand without benchmarking to the carbon costs faced by rival methanol producers elsewhere in the world will reduce the international competitiveness of our NZ operation and provide a negative signal regarding the value of future investment in New Zealand.

⁶ Price data sourced from investing.com, exchange rates conversions taken from Reserve Bank historical exchange rate series

In this respect the matters being considered for this second submission, relating to the future of free allocations post 2020, re-establishing international linkages, and measures to maintain price stability are critically important to Methanex.

In assessing the impact of potential climate policy changes on our business into the mid-2020's and beyond, we have two major concerns:

- A shift in policy direction by the Government emphasising that carbon prices need to be higher in New Zealand without there being sufficient reference to maintaining relativity with the cost of carbon in other countries.
- The likely continuing absence of access to international carbon markets as an option for NZ ETS participants at the same time as an increasing emphasis is placed on domestic abatement via afforestation.

Continuing methanol production in New Zealand has clear economic benefits offsetting its headline impact on New Zealand's greenhouse gas inventory:

- Methanex purchases nearly half of all gas produced and sold in New Zealand and in doing so also enables the co-production of approximately 3.5-4 million barrels of natural gas liquids and condensate. This combined impact generates a substantial proportion of the oil and gas revenues earned in New Zealand and the royalties received by Government that would not otherwise accrue.
- Methanex presence stimulates continued investment in the oil & gas sector, an industry which will remain beneficial to the New Zealand economy until such time as the use of renewable resources are sufficiently viable to displace fossil fuels as the principal energy source that sustains our jobs, public services and infrastructure, and general standard of living.
- In addition to natural gas purchases, Methanex spends approximately \$100 million locally each year on salaries, contractors and other goods and services. These include:
 - Payments for gas transmission services that significantly reduce the costs faced by other users of the shared, fixed cost, gas pipeline infrastructure; and
 - Payments for port facilities that substantially contributes to the economic viability of the Port of Taranaki.
- Methanex has the need to continually invest in capital projects to sustain its business in New Zealand. This regular work supports the long-term viability of the engineering sector in the Taranaki region and elsewhere in New Zealand. Since 2008, Methanex has spent over \$500 million in direct capital investment in New Zealand.

PROTECTING COMPETITIVENESS THROUGH FREE ALLOCATION

- 11. Under what conditions should free allocation rates start to be reduced after 2020?**
 - 12. What impact would it have on your investment decisions over the next few years if there was a clear pathway or criteria for phasing out free allocations after 2020?**
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Methanex' continued presence in New Zealand relies upon maintaining the international competitiveness of methanol produced in this country. Carbon liabilities and the risk of adverse regulatory change are significant differentiating risk factors we face in New Zealand when compared to our other operations around the world, and the operations of our competitors.

With the NZ ETS providing a high level of free allocations to trade-exposed industries, including methanol production, Methanex is able to remain internationally competitive compared with rival producers, none of whom, to our knowledge, currently face any carbon costs. When discussing options for removing free allocation we urge the Government to avoid imposing costs on trade exposed industries in New Zealand that are higher than international competitors.

We are comforted that the Government has clearly signalled that it intends to maintain the existing free allocation settings until 2020. This is entirely consistent with the policies of other countries, including those with active emission trading schemes (EU ETS and the South Korean ETS are prominent examples).

However, we have concerns regarding the prospect of the removal of free allocation to emissions intensive trade exposed companies after 2020. We expect that one of the options that might be considered is to reinstate the currently suspended mechanism in the ETS legislation that specifies free allocation would be reduced at a flat per annum rate. However, the rate at which carbon leakage risk declines will be determined by dynamic global factors and so free allocation to trade-exposed industries in New Zealand should remain appropriately benchmarked. A pre-determined rate of reduction in the level of free allocation will over time accumulate to create a significant distortion in the international competitiveness of affected businesses in New Zealand, unless it coincidentally aligns with the pace at which carbon obligations are applied globally. Our view is that the future reduction in free allocation should be aligned, industry by industry, to the level at which those industries globally incorporate a price on carbon, or evolve technologically.

THE IMPORTANCE OF INTERNATIONAL LINKAGES

16. If international units are eligible for NZ ETS compliance in the 2020s, should restrictions be placed on their use?

The design of the NZ ETS had at its core the unrestricted use of international offsets. This was in recognition that:

- (a) Domestic abatement options would likely be expensive and insufficient to meet demand for emission units in the short-to-medium term at a reasonable cost
- (b) The use of bona fide international offsets is a legitimate and rational means for countries to meet their global climate change obligations. As global emissions reduction is the only metric that matters whether it is achieved through domestic or foreign abatement is irrelevant.
- (c) By allowing the use of international offsetting the New Zealand Government has been able to take on more ambitious emissions reductions commitments.

Although the NZ ETS is no longer linked into international carbon markets the Government has nevertheless increased its ambition to reduce emissions. Methanex recommends that the Government restores international linkages at the earliest opportunity and we believe targeting “in the 2020’s” as the point when international linkages might be restored places increased risk that carbon prices in New Zealand will become elevated compared to international prices. We consider it important to note that, although some sources of international offsets have been criticised as lacking environmental integrity, there are nevertheless a large number of legitimate, low-cost,

carbon reducing projects currently available around the world from which to acquire offsets, as demonstrated by Norway's on-going purchasing of CER's.

AUCTIONING

- 17. Should auctioning be introduced in the NZ ETS?**
 - 18. What should be the role or purpose of an auctioning function in the NZ ETS, if one were introduced?**
 - 19. How should auctioned NZUs relate to other sources of unit supply in the NZ ETS, especially NZUs generated through forestry removals and/or international units?**
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Depending on how quickly the one-for-two surrender mechanism is removed and Government's approach to maintaining a fixed price option, we believe auctioning may be necessary sooner than has been anticipated in the Discussion Document.

We consider that expectations of a high future cost of domestic abatement may contribute to restricting NZU liquidity in the short-term as holders of banked units may continue to retain those units to hedge their forward surrender obligations. Consequently we believe it may be necessary for the Government to provide additional supply, by way of auctioning, in order to maintain a moderated price.⁷

Methanex recommends that the Government accelerate the introduction of auctioning in order to have a means of providing sufficient liquidity to maintain price stability prior to the restoration of international linkages. Auctioning may be complementary to, or used in place of, a fixed price option, as a mechanism to prevent upward/downward price shocks.

PRICE STABILITY MEASURES

- 20. What impact has carbon price volatility in the NZ ETS had on your business?**
 - 21. Do you think measures should be in place to manage price stability?**
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The collapse in international carbon prices during 2012-13 assisted our business by reducing carbon costs, and during this period NZU prices in New Zealand remained more or less aligned with international carbon costs. However, with the removal of access to international offsets we see the risk that carbon prices in New Zealand will escalate rapidly and this time without being aligned to international carbon costs. Our chief concern regarding price volatility is the variability between New Zealand carbon prices and the carbon costs faced by our competitors.

The NZU price has more than doubled in less than 12 months and appears set to continue escalating with the expectation that the domestic supply of new carbon units is likely to be constrained and high cost. This trend has been reinforced by Government signalling that a higher carbon price is necessary in the near term, emitters need to take increased responsibility, and by placing an increased emphasis on using the ETS and carbon prices to promote afforestation. Based on the

⁷ Discussion Document, page 21, contemplates auctioning as a "medium-to-long term prospect".

current trend in pricing expectations we expect the NZU price to quickly increase to the \$25 mark set by the current fixed price option. At the current rate of escalation, the NZU price will have reached \$25 before the end of next year.

In this context, maintaining a fixed price option remains necessary in the near-term to prevent the prospect of carbon prices accelerating to unsustainable levels. Given that the effective international price of carbon is far less than \$25, there is a strong argument for reducing the current cap as an interim measure.

Methanex is not averse to the concept of the Government implementing a price corridor. Very low carbon prices are no more sustainable than high prices. However, the most critical factor in this regard is determining an appropriate level for a cap and a floor that will best satisfy the twin objectives of assuring the ETS remains a credible means of meeting our international carbon reduction obligations while assuring a strong economy is maintained.

While maintaining a fixed price option as a cap requires no policy or legislative changes, implementing an effective price floor will be more challenging and at current NZU pricing projections is unlikely to be necessary.

Methanex recommends that a cap on domestic carbon price is maintained, whether it is by maintaining a fixed price option, or by using auctioning as a means of moderating carbon costs.

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- 22. What do you consider are important factors for managing price stability?**
 - 23. What should the Government be considering when managing price stability?**
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Our expectation is that, so long as New Zealand businesses are unable to access international offsets, the price of NZUs will be significantly higher than the effective carbon price faced by competitors in other countries, due to the limited availability of low cost domestic abatement options. It is critical that the Government ensures that the carbon costs faced by New Zealand businesses and households do not exceed the effective carbon cost in other countries.

Methanex recommends that the Government be prepared to supply incremental NZUs, via auctioning, if there is insufficient liquidity provided by the ongoing issuances of units and the existing pool of banked units, in order to ensure carbon prices in New Zealand remain indexed to international carbon costs.

BARRIERS TO UPTAKE OF LOW EMISSIONS TECHNOLOGIES

- 26. Are there any barriers or market failures that will prevent the efficient uptake of opportunities and technologies for reducing emissions?**
 - 27. If so, is there a role for the Government in addressing these barriers or market failures and should it do this?**
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The prospects for significant emissions reductions from industries subject to the NZ ETS are limited in the near-term due to lack of technological opportunities. Consequently we recommend that the

Government places an increased emphasis on non-ETS measures in order to pursue more readily achievable near-term emission reduction options.

We consider there to be significant opportunities to reduce emissions in the transport sector. We recognise that New Zealand is a technology taker in most cases but the Government can usefully leverage off international developments by supporting and enabling the use of alternative fuels. Methanex has been vocal in its support for more open fuel standards and considers methanol to be a promising fuel option particularly since it has the future potential to be produced from renewable sources. There are a number of small renewable methanol production operations already underway around the world, including facilities in Iceland and the Netherlands, targeting the alternative transport fuel market. It will take a considerable amount of further technological development to reach the point where renewable methanol can effectively start displacing traditional methanol production. However, Methanex would like to work with Government and others to explore those future opportunities in New Zealand.

Closing Remarks

The matters under consideration as part of this second leg of the 2016 NZ ETS Review are of great significance in determining the continuing success of the NZ ETS and other complementary mechanisms, and steering a rational and sustainable path between climate ambition and economic welfare.

The Minister has recently stated that the Government wishes to establish a working group to further consider the future design of the NZ ETS involving a range of stakeholders. This is an initiative we fully support and recommend that such a group is established at the earliest opportunity and is given the resources and time necessary to make well-informed recommendations. Methanex would also welcome the opportunity to participate directly in further discussions. We believe we can usefully contribute to the discussion from an international business perspective on issues such as maintaining international competitiveness, avoiding carbon leakage risks and identifying and supporting technological opportunities to reduce emissions.

Yours sincerely



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