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Information for release

[IN CONFIDENCE]

Inland Revenue
Te Tari Taake

POLICY AND REGULATORY STEWARDSHIP

TE TAI ŌHANGA
THE TREASURY

Tax policy report: Alternatives to Industrial Allocation policy

Date:	19 September 2024	**Priority:**	Low
Security level:	In Confidence	**Report number:**	IR2024/173 T2024/2259

Action sought

	Action sought	Deadline
Hon Nicola Willis **Minister of Finance**	**Agree** to recommendations	03 October 2024
Hon Simon Watts **Minister of Revenue**	**Agree** to recommendations **Note** the contents of this report as the Minister of Revenue and the Minister of Climate Change **Refer** this report to the Minister of Trade, the Minister for Energy, and the Minister for Resources	03 October 2024

Contact for telephone discussion (if required)

Name	Position	Telephone	1st Contact
Martin Neylan	Acting Policy Lead, Inland Revenue	s9(2)(g)(ii) [redacted]	
Lucy England	Senior Policy Advisor, Inland Revenue		✓
Jean Le Roux	Manager, Tax Strategy, The Treasury		
Pawel Borowski	Policy Analyst, Tax Strategy, The Treasury		✓

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: No

Tax Policy Report: Alternatives to Industrial Allocation policy

Executive summary

1. This report seeks your decision on whether to undertake further work on alternatives to Industrial Allocation policy. A first principles analysis of this issue was completed by officials as part of the first Emissions Reduction Plan (ERP1).
2. Industrial Allocation is intended to mitigate the risk of domestic production shifting offshore due to uneven emissions pricing between jurisdictions. To achieve this, firms carrying out activities classified as 'emissions-intensive and trade-exposed' are provided with free emissions units to meet part of their costs under the New Zealand Emissions Trading Scheme.
3. Uneven emissions pricing could lead to New Zealand production and emissions shifting to jurisdictions with less stringent climate policies, possibly resulting in both a net increase in global greenhouse gas emissions (a problem termed "emissions leakage") and/or costs to the New Zealand economy.
4. The risk and impact of domestic production shifting offshore has not been thoroughly assessed to date. This means we do not know whether Industrial Allocation or alternative interventions are a proportionate response to the risk and impact of shifting production.
5. Industrial Allocation has a legislated phase out, but whether the pace of this phase out or the general test for eligibility is appropriate is unclear.[1] Other aspects of Industrial Allocation may also be of concern: it is costly to the Government, it dampens the incentive for firms to decarbonise, and it will become less effective in neutralising any uneven pricing over time due to the legislated phase out. Ultimately, Industrial Allocation is inconsistent with the Government's market-driven approach to meeting emissions budgets.
6. If you would like to undertake further work on alternatives to Industrial Allocation, we consider that, in the first instance, an assessment of the risk and impact of shifting production should be undertaken on a sector-by-sector basis for all or a subset of the sectors currently receiving Industrial Allocation.
7. The Ministry for the Environment and the Ministry of Business, Innovation and Employment would be best placed to lead this analysis given their expertise and access to the relevant data. We recommend you discuss with your Ministerial colleagues commissioning the appropriate agencies to conduct further work, and the possible inclusion of this work in the second Emissions Reduction Plan. As a first step, these agencies could provide scoping advice outlining their proposed approach to sectoral analysis and how long and resource-intensive this would be.
8. Sectoral analysis would not result in direct emissions abatement in the short term. However, if sectoral assessment revealed a risk for New Zealand producers, several alternatives to Industrial Allocation could be further explored, as well as changes to Industrial Allocation. These, if implemented, could directly result in material emissions abatement and/or Government savings.
9. Sector-specific tools supporting the decarbonisation of targeted industries could also have a role in reducing the risk of production shifting, either alongside or instead of Industrial Allocation. However, they would need to be appropriately justified and deployed in a targeted way in order to ensure value for money.
10. If you agree to discuss commissioning this work with your Ministerial colleagues, we can provide further information to support your engagement.

[1] The Ministry for the Environment have recently advised relevant Ministers on commissioning a review of phase-out rates for specific sectors by the Climate Change Commission.

Purpose

11. This report seeks a decision from the Ministers of Finance and Revenue on whether to undertake further work on alternatives to Industrial Allocation policy. Inland Revenue and The Treasury have completed a first principles analysis of this issue in line with action 5.4.2 of the first Emissions Reduction Plan (ERP 1).

Background

12. Industrial Allocation policy is currently used to mitigate the risk of domestic production and emissions shifting offshore in response to uneven emissions pricing between jurisdictions. A project on alternatives to Industrial Allocation was included in ERP1 to explore "long-term options to address emissions leakage". This work was driven by concerns that Industrial Allocation is inconsistent with New Zealand's emissions reductions targets, and, over the long term, would become less effective in preventing the possible shifting of domestic production and emissions offshore.
13. The Climate Change Commission also noted these issues and recommended that the Government explore alternatives to Industrial Allocation in the longer-term in their 2023 draft advice on the direction of the second Emissions Reduction Plan.
14. Work on alternatives to Industrial Allocation aligns with growing international interest in the problem of uneven emissions pricing between jurisdictions and the consideration of novel policies to address this, such as a Carbon Border Adjustment Mechanism (CBAM), which imposes a carbon cost on imported products. The EU and the UK are both implementing CBAMs, US Democrats have expressed some interest in CBAMs, and options are currently being explored in Australia and Canada.
15. We have undertaken the following work in completion of action 5.4.2 in ERP1:
    - A 'test-case' assessment of the risk of domestic cement production shifting offshore in response to uneven emissions pricing and the possible climate and economic impacts of this.
    - A first principles review of alternative options to address the risk of domestic production shifting offshore in response to emissions pricing, including a carbon border adjustment mechanism, product standards and subsidies.
16. Based on this work, action 5.4.2 has been marked as complete in the Climate Change Chief Executives Board's progress reporting to the Climate Priorities Ministers Group.
17. This work has informed our recommended next steps – that Ministers commission analysis to better understand the risk and impact of domestic production shifting on a sector-by-sector basis. This analysis is necessary in order to determine whether the status quo policy (Industrial Allocation) or alternatives to it are necessary or proportionate responses to the problem of shifting production.

Policy problem

Uneven emissions pricing between jurisdictions might cause production to shift offshore and this could result in economic and climate impacts

18. There are different levels of emissions pricing across international markets which can create an uneven playing field between international competitors in relation to emissions pricing.[2] As a result, some producers facing higher emissions pricing might become

[2] We define 'emissions pricing' to include explicit costs arising from policies such as the NZ ETS as well as implicit costs arising from broader climate regulation.

uncompetitive and shift their production and emissions to jurisdictions with lower climate obligations.[3] This may result in economic and climate impacts.

19. Uneven emissions pricing does not necessarily lead to domestic producers losing competitiveness, and shifting production does not necessarily lead to lasting domestic economic harm or higher global emissions.

20. Only a narrow range of producers are at risk of becoming uncompetitive because of uneven emissions pricing – those that are unable to either:

    20.1 pass on the costs because of international competition and/or elasticity of demand,

    OR

    20.2 absorb the costs, whether by lowering their profit margins; or by employing non-emissions related cost-cutting measures; or by lowering the emission intensity of their products to reduce costs.

21. Emissions-intensive and trade-exposed sectors are less likely to be able to either pass on or absorb the costs, but the exact level of risk is sector-specific.

Potential economic and climate impacts will vary over time and from sector-to-sector

Economic impact

22. A shift in production can have short-run negative economic impacts, including loss of GDP, employment, outputs, and investment, with potential ripple effects downstream. These impacts would be concentrated in regional economies where production is lost. The extent of any economic impact would depend on the likely substitution. For example, if domestic producers shift to an import model, some jobs may still be required and would generate income in New Zealand. Effects on the New Zealand economy as a whole would be proportional to the relative importance of the affected production to the wider economy.

23. In the long term, the economic impact will depend on whether the capital and labour currently employed is reallocated to a more or less productive economic use than the displaced activity. If production shifts primarily because of differences in emissions pricing across jurisdictions, the long-term economic impact is likely to be negative.

24. If the production of certain products shifted overseas, this could affect New Zealand's ability to access these products with implications for New Zealand's economic security and resilience.

Climate impact

25. The shifting of production offshore could also result in higher net global emissions – this is commonly referred to as 'emissions leakage'. Whether global emissions increase would depend on: the emissions intensity of the substitute, and whether that substitute production is within an emissions cap established domestically or under a Nationally Determined Contribution; as well as any additional international transport emissions.

It is unclear whether Industrial Allocation is a necessary or proportionate response to the risk and impacts of shifting production, and it has other characteristics that might concern Ministers

26. Industrial Allocation was put in place in 2010 as a transitional measure to support firms carrying out activities classified as 'Emissions-Intensive and Trade-Exposed' (EITE) by

[3] We define 'shifting production' as the displacement of domestic production with offshore production. This can occur if domestic production moves offshore, or, if domestic production loses market share to offshore producers importing their product into the domestic market.

providing them with free emissions units to meet part of their costs under the New Zealand Emissions Trading Scheme (ETS).

27. EITE activities are identified based on their emissions costs as a proportion of total revenue. This is a proxy for but does not accurately capture the ability of these firms to absorb their emissions costs, for example, by lowering their profit margins or by finding non-emissions related efficiencies.

28. Further, the EITE definition does not require an assessment of a firm's ability to pass on emissions costs while remaining competitive. The existence of international trade in a given sector, regardless of its size, is currently accepted as sufficient to classify emissions-intensive industries as trade-exposed.

29. EITE activities also differ greatly in emissions intensity,[4] their substitutability, and their market destinations. These differences affect the risk and impact of production shifting in individual sectors, but they are not fully factored into the calculation of Industrial Allocation entitlement or the phase-out rate.

30. Allocations of free emissions units under Industrial Allocation that are not warranted by the risk and impact of shifting production can exacerbate the distortion between EITE and non-EITE sectors. This misallocation of units can lead to higher marginal abatement costs for non-EITE sectors, placing undue burden on them to provide the reductions necessary to meet New Zealand's climate objectives.

31. Industrial Allocation impacts the emissions price signal faced by consumers of recipient products, weakening their incentive to choose less emissions intensive products. An increasing share of the unit supply is from Industrial Allocation, and on current forecasts these units will exceed the ETS cap by 2035. Industrial Allocation is therefore becoming increasingly inconsistent with the Government's climate strategy, which is based on achieving emissions reductions at least cost through the ETS.

32. Industrial Allocation had a fiscal cost to the Government of $600 million in 2022, which is expected to reduce over time due to the phase out. If units were not allocated through Industrial Allocation, they could be sold through ETS auctions. This would still add to the liability (as these units would be added to the stockpile), but would also produce a cash inflow for the Crown (depending on whether the units sell). Units could also be removed from the market altogether, which would essentially mean 'tightening the cap further' as these units would not be available. This would reduce Crown expenses and would have a favourable OBEGAL impact in the short term (all else being equal) but would result in fewer units surrendered and less revenue in the future.

33. For these reasons, the ongoing rationale for Industrial Allocation and additional or alternative forms of support for EITE industries in relation to Government objectives should be further considered after sectoral analysis. Further work on alternatives to Industrial Allocation should also take into account the impact of new measures being implemented by trading partners (such as CBAMs) on New Zealand exporters.

Sectoral analysis of the level of risk and impact of production shifting offshore will be necessary to inform further work on Industrial Allocation and potential alternatives

34. Although some New Zealand producers might be at risk of shifting production as a result of uneven emissions pricing, the level of this risk and the materiality of impact have not been comprehensively assessed across emissions-intensive and trade-exposed sectors.

[4] This is factored into the firm's entitlement to some extent - there are two levels of emissions costs coverage available through Industrial Allocation, depending on whether the firm is 'moderately' or 'highly' emissions intensive. In 2024 the level of assistance for highly emissions intensive activities equates to 86% of the firm's emissions costs, compared to 56% for moderately emissions-intensive activities. The level of assistance is being phased out overtime.

35. Given the lack of analysis of the problem of domestic production shifting due to uneven emissions pricing, it is unclear whether Industrial Allocation is a necessary or appropriate policy response to this problem.

36. Should Ministers want to undertake further work on alternatives to Industrial Allocation, we recommend that you discuss options with the Minister of Energy and Minister of Resources. We consider that the best approach to further work is for the relevant Ministers to commission the Ministry for the Environment and the Ministry of Business, Innovation and Employment to undertake sectoral analysis to determine the current and future risk of production shifting offshore and the potential short and long-term impacts.

Further work on alternatives to Industrial Allocation could be included in ERP2

37. The second Emissions Reduction Plan (ERP2) is currently being drafted. If Ministers agree to commission sectoral analysis of the risk and impact of domestic production shifting this could be formalised and signalled to stakeholders in ERP2. The Minister of Climate Change will shortly be asked to provide feedback on the draft ERP2 chapter titled "Strengthening the NZ ETS" [Ministry for the Environment, BRF-5253 refers]. If Ministers agree to sectoral analysis, the work could be included in this chapter.

38. The second and third emissions budgets are projected to be tightly balanced. Though the results of a sectoral analysis are unlikely to deliver abatement in the second emissions budget, they would inform future decisions on alternatives to Industrial Allocation. These alternatives could deliver direct emissions abatement in the medium term and would support the Government's price-driven approach to delivering emissions budgets.

Options and next steps if Ministers agree to undertake further work on alternatives to Industrial Allocation

39. If you would like to undertake further work on alternatives to Industrial Allocation, we consider that, in the first instance, an assessment of the risk and impact of shifting production should be undertaken on a sector-by-sector basis. This sectoral analysis would allow officials to assess which policy interventions (including the status quo – Industrial Allocation) are proportionate and appropriate to mitigate the risk and impacts (if any).

40. The Ministry for the Environment and the Ministry of Business, Innovation and Employment, would be best placed to lead this analysis due to their expertise and access to relevant data.

41. We recommend you discuss commissioning the appropriate agencies to conduct further work with the Minister for Energy and the Minister for Resources. As a first step, these agencies could provide scoping advice outlining their proposed approach to sectoral analysis and how long and resource-intensive this would be.

42. It is likely that sectoral analysis would be a relatively resource intensive process. Firm-level data would need to be obtained and analysed to determine the ability of the firm to either pass on or absorb their emissions costs in the absence of Industrial Allocation. If this analysis points towards possible shifting of production offshore, the materiality of climate, social and economic impacts should also be assessed to inform any case for intervention. To optimise this process, officials could focus on the top five recipients of Industrial Allocation, who received 72% of all free emissions units in 2022.[5]

[5] The top five recipients are producers of steel, methanol, cement, aluminium, and fertiliser, see https://www.epa.govt.nz/industry-areas/emissions-trading-scheme/industrial-allocations/decisions/

43. Completing a sectoral analysis would not directly result in material emissions abatement in the short term. However, sectoral analysis will provide a strong basis on which to make future decisions on alternatives or amendments to Industrial Allocation that could directly result in material emissions abatement and/or savings.

44. If Ministers do not wish to commission sectoral analysis, relevant agencies could still consider options to improve Industrial Allocation. We do not recommend this approach as we consider that the case for intervention (if any) should be determined through sectoral analysis before options (including changes to the status quo) are considered for their effectiveness.

Consultation

45. The Ministry for the Environment, the Ministry of Business, Innovation and Employment, the Ministry of Foreign Affairs and Trade and the Climate Change Chief Executives Board were consulted on the contents of this report.

Recommended actions

We recommend that Ministers:		Minister of Finance	Minister of Revenue
a)	**refer** a copy of this report to the Minister for Energy, the Minister for Resources, and the Minister of Trade.		Referred
b)	**note** that action 5.4.2 in the first Emissions Reduction Plan is complete and this will be reflected in up-coming reporting on progress towards that plan.	Noted	Noted
c)	**indicate** if you would like to undertake further work on alternatives to Industrial Allocation.	Yes/ No	Yes/ No
If you wish to undertake further work, we recommend you:			
d)	**note** we consider the best approach to progress this work is to undertake sectoral analysis of the risk and impact of shifting production in sectors currently receiving Industrial Allocation.	Noted	Noted
e)	**note** the resourcing implications of carrying out sectoral analysis are unclear and would require scoping by relevant officials. To reduce resourcing impacts, the analysis could focus on the top five emitting sectors which receive the majority of Industrial Allocation.	Noted	Noted
f)	**agree** to discuss options for undertaking further work on alternatives to Industrial Allocation with your Ministerial colleagues, including the appropriate agency lead for this work and whether future work should be incorporated into the Government's second Emissions Reduction Plan.	Agree/Disagree	Agree/Disagree
g)	**note** advice on increasing the phase out of Industrial Allocation was provided to Ministers on 13 June 2024 (Ministry for the Environment BRF-4875)	Noted	Noted

Jean Le Roux
Manager, Tax Strategy
The Treasury

Martin Neylan
Acting Policy Lead, Inland Revenue
Inland Revenue

Hon Nicola Willis
Minister of Finance
/ /2024

Hon Simon Watts
Minister of Revenue
/ /2024

From: Lucy England
To: Lucy England [TSY]
Subject: Fw: Draft cover note on Alternatives to Industrial Allocation advice
Date: Friday, 31 January 2025 11:23:12 am
Attachments: Outlook-t3t20e3i.png

[IN CONFIDENCE]

From: Pawel Borowski [TSY] <Pawel.Borowski@treasury.govt.nz>
Sent: 25 September 2024 15:22
To: Emma Grigg <emma.grigg@parliament.govt.nz>
Cc: Lucy England <Lucy.England@ird.govt.nz>; Jean Le Roux [TSY] <Jean.LeRoux@treasury.govt.nz>; Carly Soo [TSY] <Carly.Soo@treasury.govt.nz>
Subject: Draft cover note on Alternatives to Industrial Allocation advice

Kia ora Emma,

As requested, please see the below draft cover note for the report on alternatives to Industrial Allocation (IR2024/173; T2024/2259 refers) sent to you last week.

Draft cover note

Ministers need to decide on further work ahead of setting ERP 2
MoF an MoR were responsible for the ERP 1 action 5.4.2 on alternatives to Industrial Allocation. The report notes this action has been completed and asks MoF and MoR to decide on whether to undertake further work.

The report is not urgent but it seeks Ministers' decisions in the next two weeks because the Government is currently setting ERP 2, which can include further work on alternatives to Industrial Allocation. MfE is briefing the Minister of Climate Change on the proposed EPR 2 text. Departmental and Ministerial consultation are scheduled for mid October and Cabinet decisions are expected in November (see below the indicative timeline from MfE).

MCC review draft plan	*Minister/MfE*	*4th Oct*
MCC review full and final draft plan	*Minister/MfE*	*10th Oct*
Departmental/Ministerial Consultation	***Agencies/Ministers***	***14th – 21st Oct***
Lodge for committee	*MCC office*	*31st Oct*
ECO	*Ministers*	*6th Nov*
Cabinet	*Ministers*	*11th Nov*

The draft ERP2 discussion document noted that work is progressing on updating Industrial Allocation settings. Officials think there is merit in further work on the suitability of Industrial Allocation, and including it in the ERP2. The sectoral analysis recommended in *the report would provide strong basis to make future decisions on alternatives or amendments to Industrial Allocation that could directly result in material emissions abatement and/or savings.*

*The Minister of Climate Change is also taking two separate papers related to industrial allocation to Cabinet. The first paper '***Progressing updates to industrial allocation in the emissions trading scheme'** *is scheduled for Cabinet ECO Committee this week. The second paper '***New Zealand Aluminium Smelter electricity allocation factor update**' *has been circulated for Ministerial consultation and will be submitted to Cabinet within the next few weeks. The report on* 'Alternatives to Industrial Allocation' *does not address the issues from these two Cabinet papers, however it does recommend that further work to explore alternatives to industrial allocation.*

Work on alternatives to Industrial Allocation cuts across several portfolios and Government priorities, including economic and fiscal priorities of MoF.

The Treasury and the Minister of Finance *have an interest in this issue primarily because production shifting offshore due to uneven emissions pricing can have negative economic and social impacts. Further work on this issue would allow officials to better understand the risk and impacts of this problem. Further work is also warranted because Industrial Allocation is costly to the Government and is increasingly inconsistent with the Government's climate strategy, which is based on achieving emissions reductions at least cost through the ETS.*

The Ministry for Environment and the Minister of Climate Change *might be also concerned about the climate impacts of production shifting offshore. MfE's role involves assessing the impact of Industrial Allocation on reducing emissions and how it's phase-out aligns with New Zealand's climate change commitments.*

The Ministry of Business, Innovation and Employment, the Minister for Energy, and the Minister for Resources *have an interest in this work because of the economic impacts of Industrial Allocation on select sectors, including investment, innovation, employment, economic resilience and security.*

Happy to chat if helpful,

Pawel

Dr Pawel Borowski (he/his) | **Analyst, Tax Strategy** | **Te Tai Ōhanga – The Treasury**
Email/IM: pawel.borowski@treasury.govt.nz

From: Lucy England
To: Lucy England [TSY]
Subject: Re: IR2024/173 MOR SIGNED
Date: Friday, 31 January 2025 11:15:13 am
Attachments: Outlook-ncktdglg.png

[IN CONFIDENCE]

From: Pawel Borowski [TSY] <Pawel.Borowski@treasury.govt.nz>
Sent: 30 September 2024 09:30
To: Lucy England <Lucy.England@ird.govt.nz>
Subject: Re: IR2024/173 MOR SIGNED

[IN-CONFIDENCE]

Oh wow, that was quick! Did Angela say anything about MoR's reactions?

Thanks for sharing!

Dr Pawel Borowski (he/his) | **Analyst, Tax Strategy** | **Te Tai Ōhanga – The Treasury**
Email/IM: pawel.borowski@treasury.govt.nz

From: Lucy England <Lucy.England@ird.govt.nz>
Sent: Monday, September 30, 2024 9:24 AM
To: Pawel Borowski [TSY] <Pawel.Borowski@treasury.govt.nz>
Subject: FW: IR2024/173 MOR SIGNED

[IN CONFIDENCE]

Mōrena Pawel – see report signed ! no more work...

I am planning to spend time this week collating the background docs etc.

Lucy

From: Angela Graham <Angela.Graham@parliament.govt.nz>
Sent: Friday, September 27, 2024 11:25 AM
To: Martin Neylan <Martin.Neylan@ird.govt.nz>; Lucy England <Lucy.England@ird.govt.nz>
Cc: jean.leroux@treasury.govt.nz; Emma Grigg <Emma.Grigg@parliament.govt.nz>; Ministerial Services <MinisterialServices@ird.govt.nz>; Kerryn McIntosh-Watt <Kerryn.McIntosh-Watt@ird.govt.nz>; Paul Kilford <Paul.Kilford@ird.govt.nz>; Helen Kuy <Helen.Kuy@parliament.govt.nz>
Subject: IR2024/173 MOR SIGNED

HI All,

Please see the signed report attached. MoR is not seeking any further work on this issue.

Angela Graham
Private Secretary Revenue
Office of the Hon Simon Watts| MP for Northshore
Minister of Climate Change | Minister of Revenue
Parliament Buildings, Wellington 6160, New Zealand
Mobile: s9(2)(g)(ii) [redacted] | Email: angela.graham@parliament.govt.nz

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