MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

Ministry for the Environment
Manatū Mō Te Taiao

EECA TE TARI TIAKI PŪNGAO
ENERGY EFFICIENCY & CONSERVATION AUTHORITY

Aide Memoire

Title	**Ministers' meeting – Large emitters engagement**
Date of submission	**7/11/2022**
To	**Hon Dr Megan Woods, Minister of Energy and Resources,** **Hon James Shaw, Minister of Climate Change**
From	**Andrew Caseley, EECA Chief Executive** **Melody Guy, MfE Director, ETS Markets** **Sharon Corbett, MBIE Policy Director, Energy and Resource Markets**
Agency reference numbers	EECA MEMO 123 BRF-2410

Purpose

1. The aide memoire provides you both with information ahead of your meeting with senior officials from EECA, MBIE and MfE on Thursday 10 November 2022 from 11:45am – 12:15 in Minister Woods' office (7.4EW).
2. The purpose of this meeting is to:
    a. support the way forward in respect to New Zealand Steel's request for support for their decarbonisation project; and
    b. discuss the potential options for supporting significant decarbonisation projects by large industrial emitters.

Context

3. NZ Steel recently proposed partnering with government on a significant decarbonisation project. Specifically, it is requesting funding from GIDI and other support. NZ Steel's parent company, Bluescope[1] will decide whether to progress to a full feasibility study phase in

[1] Bluescope are an international company headquartered and publicly listed (ASX) in Australia

February 2023, so they are seeking a firm indication of the support Government is prepared to provide preferably prior to them meeting as a board.

4. We expect similar requests in future from other very large industrial emitters. The Government response to NZ Steel's proposal could set a precedent for what other Emissions Intensive Trade Exposed (EITE) firms will expect in terms of government financial support for decarbonisation projects.

5. In this context, this briefing:

   a. sets out the potential levers to support decarbonisation investments by industrial emitters such as GIDI or the NZ ETS industrial allocations or a mix of both,

   b. provides further information on the NZ Steel decarbonisation project and NZ Steel's request for support, and

   c. seeks your initial views on next steps, both in relation to the specific NZ Steel proposal and in terms of support for very large industrial emitters more generally.

6. An annotated agenda, with key points for discussion, is attached as an annex.

NZ Steel decarbonisation project

7. Details of NZ Steels' proposal are commercially sensitive (with strict market information requirements under Bluescope's ASX listed status) and so officials request this content is kept confidential.

NZ Steel's proposed decarbonisation project could almost halve NZ Steel's emissions

8. NZ Steel is looking at a decarbonisation project involving the installation of an electric arc furnace (EAF) at the Glenbrook steel mill to reuse scrap steel for an estimated 50% of their current steel production. The technology is proven and widely used globally. A preliminary estimate of the cost of this project is Commercial Information

9. The proposed project is likely the single largest decarbonisation project that could arise countrywide. It is expected to almost halve NZ Steel's emissions by cutting out 800k tonnes per annum. This would be a significant contribution towards New Zealand meeting its emissions budgets but given the three year build period would not arise until the end of the first emissions budget period.

10. Other project benefits include electricity demand response flexibility through an appropriately structured PPA, the retention of onshore steel production, and retention[2] of high paying employment in the longer term by the ongoing operation of the Glenbrook Steel Mill .

NZ Steel has indicated that Government support will be a key factor in its decision on the project

11. NZ Steel has advised that they expect the project's pre-feasibility study will be completed by the end of 2022 and its Board will decide whether to progress to a full feasibility study in February 2023. NZ Steel has emphasised that a key factor in the Board's decision will be the progress with Government to confirm substantial financial support and relevant policy certainty. Without significant Government support, there is a risk NZ Steel may choose to defer the project Commercial Information

NZ Steel has requested GIDI or other appropriate Government funding to cover 100% of capital funding required for a new arc furnace . . .

12. EECA has received a detailed request for Government funding support from NZ Steel. The request is for Commercial Information for a new arc furnace Commercial Information. NZ Steel has advised it will bear the substantial costs (their description) and risk of transition and repurposing associated with the change in their production operating model. NZ Steel would still use the existing method for the remaining 50% of production (100% would currently provide inappropriate levels of other risks and production transition costs).

13. EECA still needs to conduct a comprehensive due diligence assessment but notes the project could be a highly attractive decarbonisation opportunity given the proven technology and the significant carbon abatement on offer. The abatement cost is also likely to be highly attractive.

. . . continued industrial allocation under the New Zealand ETS . . .

14. NZ Steel carries out an EITE activity and so receives the highest number of industrial allocations of any entity in New Zealand (in excess of 2m per annum). NZ Steel has requested:

    a. Confidential advice to Government

    b. Confidential advice to Government

[2] The Glenbrook steel mill currently employs 1,150 full-time staff and supports many service businesses.

Confidential advice to Government [redacted]

c. Confidential advice to Government [redacted]

15. Confidential advice to Government [redacted]

16. Officials still need to ascertain the merits and rationale of this proposal.

. . . and support to minimise risks regarding scrap steel supply

17. To support its proposed decarbonisation project, NZ Steel is also seeking government support securing an adequate supply of scrap steel. NZ Steel advise that certainty of scrap steel supply is critical to achieving desired outcomes of their investment. NZ Steel would welcome discussions with government to explore what form of support could be provided to NZ Steel to minimise the risks associated with uncertainty of scrap steel supply.

We seek direction from Ministers on engaging in further negotiations with NZ Steel on its decarbonisation project.

18. EECA (in conjunction with other parts of Government including MfE, MBIE and at the appropriate moment Treasury) is continuing to engage with NZ Steel to fully understand the proposal as presented and to complete a sufficient level of due diligence in order to confidently advise Ministers. EECA expects to report back to Ministers before the end of 2022 with a comprehensive response on NZ Steel's proposal.

19. Alongside this, agencies are considering the broader policy implications of agreeing to a substantial level of support for the NZ Steel decarbonisation proposal. The following sections outline policy considerations to support Ministers' decision on next steps in considering the proposal from NZ Steel. It is also noted that the Government's decision on the NZ Steel proposal is likely to set expectations for future levels of funding support with other very large emitters through the GIDI fund and other appropriate sources of Government support. It is therefore important that any precedent-setting impacts are considered.

The roles of GIDI and industrial allocation

GIDI and industrial allocation have different purposes

20. The purpose of the GIDI is to directly reduce emissions from businesses (targeted predominantly at industrial process heat), through co-funding energy efficiency and fuel switching projects. Any supported projects have an 'additionality' requirement, which means that without co-funding from Government, they would be unlikely to be implemented, or unlikely to be implemented until a later date.

21. GIDI has been expanded to $650m over four years (or nearly $1b over 7 years) to support emission reductions, including through partnerships with very large emitters. It is tasked with delivering more and faster emissions reductions than would be likely if relying on other policies alone e.g. the NZ ETS.

22. The purpose of industrial allocations in the NZ ETS is to mitigate the risk of emissions leakage[3] and to retain global market competitiveness for New Zealand based businesses who are subject to the NZ ETS. The policy supports firms carrying out EITE activities to meet some of their emissions costs as they frequently cannot compete without this support due to either imported product not being subject to NZ ETS pricing or competitors in export markets not being subject to an ETS equivalent.

23. It is not a purpose of industrial allocations to support decarbonisation[4]. If an investment reduced the emissions costs faced by a firm that also received industrial allocation per unit of product, the allocation does not change. This is because allocation rates are tied to emissions from historical years. Depending on perspectives, this results in overallocation or a return on investment.

Proposed changes to industrial allocations introduce uncertainty and may be impacting decarbonisation decisions

24. Some firms are receiving an over-allocation of New Zealand Units (NZUs) because allocative baselines use data more than a decade old. In this time, the energy and fuel profiles of some

3 There is a risk that Emissions Intensive and Trade Exposed (EITE) industries close in New Zealand and offshore production increases in countries with weaker climate policy. This is known as emissions leakage and could increase global emissions. The closure of these industries would also have implications for employment and regional economies in New Zealand.

4 It is also important to note that the primary driver of industry decarbonisation is the NZ ETS, not industrial allocation. Although EITE activities receive industrial allocation support, they still face 100 per cent of their emissions costs through either direct surrender obligations, or indirect emissions costs (i.e. emissions costs passed through the supply chain).

businesses have shifted, or market players have changed resulting in baselines that are no longer reflective of current emissions costs.

25. On 4 July 2022, Cabinet agreed to update settings for industrial allocation in the NZ ETS to address this over-allocation[5]. The changes relevant to this meeting are:

    a. allocative baselines will be updated using more recent data (FY 2016/17 to 2020/21) with the option to exclude one of the two later years to account for any distortions in production due to COVID related production levels,

    b. the Minister for Climate Change will be able to review and update an activity's baseline with new data five years after the most recent update (five-year rule), but only where there is evidence the activity is no longer facing a net emissions cost, and

    c. all allocative baselines will be reviewed every ten years following their most recent review (ten-year rule).

26. The purpose of legislating future reviews of baselines is to ensure over-allocation arising in the future can be easily corrected, rather than requiring a legislation change. The 10-year review rule will ensure that future governments are required to review (not necessarily update) allocative baselines after 10 years, and the 5-year rule ensures future governments cannot review and update baselines with new data within five years of the last update to provide a window of certainty to EITE firms.

27. Firms such as NZ Steel and Ballance Agri-Nutrients are concerned with the ability to update baselines in future as soon as five years after the previous update. They have reiterated that adjusting allocation in response to an abatement investment reduces the economic benefit of the project. They note the Government wishes to encourage emissions abatement from allocation recipients and the policy decision to allow updates to baselines after five years undermines this.

28. This view was widely shared by EITE firms during consultation on industrial allocation policy options in 2021. These submitters would prefer that government does not have the ability to review and/or update allocative baselines in future.

29. Not legislating the ability to review and update allocative baselines with new data in future will result in eventual over-allocation to firms. This is a fiscal risk to the Crown, a wealth transfer to industry and could make meeting future emissions budgets and international

[5] These changes are being sought through the Climate Change Response (Late Payment Penalties and Industrial Allocation) Amendment Bill (the Bill) which is due before LEG Committee 24 November (previously titled the Climate Change Response (Emissions Trading Scheme and Other Amendments) Amendment Bill).

targets harder to achieve. However, firms delaying decarbonisation investments could also make meeting these commitments harder to achieve.

30. The ability to update baselines with new data – combined with the five- and ten-year rules agreed by Cabinet, aims to strike a middle ground between reducing the future risk of over-allocation, while recognising the need to minimise the investment disincentive that baseline updates cause.

Options for GIDI and/or industrial allocation to support decarbonisation

31. Although GIDI and industrial allocations have different purposes, they both impact an EITE company's incentives to invest in decarbonisation initiatives, albeit in different ways (see paragraphs 20-23).

Decisions on Government support should take into account the combined impact of the two levers

32. The next section discusses some options to minimise the disincentive impact of future reviews of allocative baseline in more detail.

33. Importantly, these options could result in a firm receiving a windfall gain of units in cases where an investment reduces emissions below their allocations. This raises the question of *why* the Crown might need to be a source of investment funding, noting that some EITE firms will have access to capital and may gain competitive advantages through decarbonising.

34. Fundamentally, government support for decarbonisation projects aims to incentivise emissions reductions at a pace and scale needed to achieve our emissions budgets and at an appropriate abatement cost. Although any changes to industrial allocation may provide significant financial benefit, the intent would only be to remove the disincentive to decarbonise associated with future reviews of allocative baselines. Moreover, any support should consider the combined impact of industrial allocation and other financial support such as GIDI to ensure it is limited to that needed to incentivise emissions reductions at the pace and scale needed to achieve our emissions budgets.

Options to manage disincentives associated with future reviews of allocative baseline

35. Officials appreciate that firms can have investment time horizons of 10-15 years, and that future baseline updates within this period can cause uncertainty to the financial return they forecast from their decarbonisation investments.

36. However, it is also important that the risk of over-allocation is reduced in the future, and that this can be flexibly addressed when it occurs.

37. MFE officials are looking at other options that respond to industry concerns while also striking a balance between investment certainty and risk of over-allocation. Officials will need time to consider the merits of these options compared to the current policy decision. At a high level some possible options include:

   a. Constitute contempt of Court/House of Representatives

   b. Constitute contempt of Court/House of Representatives

   c. Constitute contempt of Court/House of Representatives

   d. Constitute contempt of Court/House of Representatives

   e. Constitute contempt of Court/House of Representatives

Constitute contempt of Court/House of Representatives

[7] The percentage of emissions costs the government covers (called the 'level of assistance') is currently being phased out at 1 percentage point per annum. This default rate will increase in future decades. In addition to this default rate, there is the ability for increases to the phase-out rates from 2026 for specific activities.

Constitute contempt of Court/House of Representatives [redacted]

38. Constitute contempt of Court/House of Representatives [redacted]

39. Constitute contempt of Court/House of Representatives [redacted]

40. Constitute contempt of Court/House of Representatives [redacted]

41. Constitute contempt of Court/House of Representatives [redacted]

Relationship between GIDI and NZGIF

42. New Zealand Green Investment Finance (NZGIF) is a green investment bank established by Government[8] to help accelerate investments that reduce greenhouse gas emissions in New Zealand. Accordingly, NZGIF is positioned to compete against commercial banks and other private green finance providers.

43. What NZGIF offers is distinct from GIDI. It offers access to investment capital in order to make a commercial return[9] whereas GIDI's investment principles are purely for the prompt and effective decarbonisation to help meet the governments emission budgets. The GIDI grant lever is designed to address the funding gap that remains after businesses have secured the available capital or debt, taking into account the required returns on equity or cost of debt servicing. GIDI grants do not normally exceed 50% of incremental costs, and

[8] NZGIF is listed within Schedule 4A of the Public Finance Act 1989 and the Minister of Finance and Minister for Climate Change are our shareholding ministers.
[9] NZGIF do not offer grants, subsidies or concessionary terms

businesses still need to secure finance for their share of project costs which in some cases may be as high as 90%.

44. As a limited liability company independent of government, NZGIF have a broad and flexible mandate for investments including debt to equity and the ability to take commercial risk positions that help attract co-investors. Accordingly, NZGIF apply investment conditions to manage their liability on investments that can include taking a stake in a company for example. GIDI does not have the same assessment parameters for commercial risk due to offering grants with an expectation of environmental and social, rather than commercial return. GIDI was premised on research that showed the need to cover a funding gap even once private investment was secured. Accordingly, GIDI is often a more appealing funding option for decarbonisation projects, but is capable of operating hand in hand with private or NZGIF investment.

45. A company may choose to seek funding from the GIDI fund at the same time as seeking additional investment from private green finance providers including NZGIF. Because of competing demands on capital, securing the remaining finance remains a significant barrier to businesses committing to decarbonisation projects. EECA's GIDI private finance pilot is seeking to address this barrier by providing open public access to information about the financial institutions that are most active in offering decarbonisation finance options, working with these institutions to improve their product offerings, and to encourage their clients to decarbonise. 25% of GIDI Round 4 businesses had explored private finance through the pilot.

46. Unlike SME's, EITE firms typically have multiple finance options available to them. Free and frank opinions [redacted]

Next Steps

47. EECA will commence with their due diligence on the NZ Steel GIDI proposal and provide a further update to Ministers by the end of 2022.

48. Subject to ministerial direction, officials can provide further advice on options to manage disincentives associated with future reviews of allocative baselines.

Annex 1: Annotated agenda

1. Context

- NZ Steel will decide whether to progress to a full feasibility study for their Electric Arc Furnace decarbonisation project in February 2023.
- GIDI has been significantly expanded ($650m over four years or nearly $1b over 7 years) to support emission reductions, including through partnerships with large emitters.
- Meanwhile some very large emitters have raised concerns that the changes to industrial allocation policy will disincentivise significant decarbonisation projects.

2. New Zealand Steel decarbonisation project

- NZ Steel is considering installation of an electric arc furnace at Glenbrook to reuse scrap steel for 50% of their steel production, with an estimated project cost of Commercial Information
- This could be a highly attractive decarbonisation opportunity given the proven technology and the significant emissions reductions (800kT per annum).
- NZ Steel has submitted a detailed request for GIDI funding Confidential advice to Government [redacted]

We seek direction on:

- *Do Ministers support EECA undertaking full due diligence on the NZ Steel proposal?*
- *What process/mechanism would Ministers require for a substantial level of Government support to be provided e.g. Cabinet Approval?*

3. Possible options to support decarbonisation

- Although GIDI and Industrial Allocations have different purposes, the two levers do interrelate in that they both impact incentives to decarbonise.
- Options to support decarbonisation include:
  - Including in GIDI decisions (e.g. on size of contribution), the taking into account of the impact of industrial allocations on the economics of a decarbonisation investment.
  - Constitute contempt of Court/House of Representatives [redacted]

We seek Ministers' direction and initial views on which levers to pursue and carry out further work on

4. Next Steps

- EECA will provide a further update to Ministers on the NZ Steel GIDI proposal by the end of 2022.
- MfE/MBIE/EECA will provide further advice on options to support decarbonisation more broadly as requested by Ministers in or following this meeting.