**OFFICE OF THE MINISTER**
**OF ENERGY AND RESOURCES**

The Chair
**Cabinet Economic Growth and Infrastructure Committee**

# Funding New Zealand's international oil stockholding obligation

## Proposal

1 This paper seeks agreement to increase the existing appropriation that funds the cost of New Zealand's international oil stockholding obligation, and to fund that increased appropriation by increasing the Petroleum or Engine Fuel Monitoring Levy.

## Executive summary

2 The cost of meeting New Zealand's International Energy Agency (**IEA**) treaty obligation to hold oil stock has risen beyond the existing $3 million per annum Vote Energy appropriation, principally due to a decline in domestic oil production (which increases the stock that New Zealand is required to hold). There is a high risk that the existing appropriation will be insufficient to cover the cost of contracts that are required in February 2013 to meet the IEA obligation.

3 As a member of the IEA, New Zealand has an obligation to contribute to global oil security by holding 90 days of net imports of oil stock. New Zealand currently meets this obligation by purchasing ticket contracts, which are an option, in return for an annual fee, to purchase specified quantities of stock at market prices in the event of an IEA-declared oil supply emergency.

4 The Ministry of Business, Innovation and Employment (**MBIE**) has publicly consulted on a "user-pays" proposal to fund the IEA obligation through a levy on fuel of 0.113 cents per litre (which amounts to 4.5 cents for a 40 litre tank of fuel). The vast majority of submitters either agreed with, or were neutral to, the proposal to meet the cost of the IEA obligation through this small levy.

5 I propose that a legislative amendment be made to allow for the increase of the rate of the existing Petroleum or Engine Fuel Monitoring Levy (**PEFML**) from 0.045 cents per litre to 0.158 cents per litre. This would fully fund the increased appropriation that is required to cover the cost of the IEA obligation. Collecting the required revenue by increasing an existing levy would avoid the administrative and enforcement costs of a new levy, and would minimise compliance costs for business. It would also return the present $3 million per annum from the existing appropriation to the Crown.

6 I propose to report back to the Cabinet Economic Growth and Infrastructure Committee with final recommendations on the levy rate, and on which fuels the PEFML should apply to, following the necessary legislative amendment.

## Background

7 The cost of meeting New Zealand's IEA treaty obligation to hold oil stock has risen beyond the existing $3 million per annum Vote Energy appropriation, principally due to a decline in domestic oil production in the medium-term (which increases the stock that New Zealand is required to hold). There is a high risk that the appropriation will be insufficient to cover the cost of ticket contracts that will be tendered in February 2013.[1] If a new appropriation is not granted New Zealand is likely to become non-compliant with its IEA obligation.

8 Following a one-off increase of the 2012/13 appropriation to $5.160 million, the Minister of Finance asked officials to report back to Cabinet on options for responding to the rising cost of the obligation.[2]

9 MBIE undertook a broad review of New Zealand's oil security over 2012 which included an analysis of options for addressing the international obligation. On 29 October 2012 Cabinet agreed to the release of an oil security discussion document, and invited me to report back by 1 March 2013 on options for responding to the rising cost of the IEA obligation.[3, 4] Submissions have been received.

## Status quo

10 Commercial inventories held by oil companies in New Zealand contribute to part of the IEA obligation. The Crown presently meets the remainder of the obligation by entering into "ticket contracts" with oil companies/traders in other IEA countries. Tickets are an option, in return for an annual fee, to purchase specified quantities of stock at market prices in the event of an IEA-declared oil supply emergency. Tickets are backed by government-to-government agreements that specify that the host government will not impede the release of stock in an emergency.[5] Tickets are presently funded from general taxation.

11 New Zealand's stockholding obligation comes from its membership of the IEA. IEA members are required to contribute to global oil security by holding 90 days of net imports of oil stocks. OECD members formed the IEA in 1974 following the 1973/74 oil crises.

12 New Zealand is too small to mitigate international oil supply disruptions on its own and the collective arrangement under the IEA is New Zealand's best choice for coping with such disruptions. The stockholding mitigates the market power of large oil producing nations. Release of the global stockholding during disruptions also helps protect New Zealand from significant damage to its economy from extreme oil price spikes.

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[1] These contracts would cover the period April 2013 – March 2014. MBIE cannot enter ticket contracts for which it has not secured sufficient appropriations.
[2] March Baseline Update letter from Minister of Finance to Minister of Energy and Resources.
[3] EGI Min (12) 24/4.
[4] Given the need to finalise funding arrangements for the IEA obligation, final policy recommendations relating to the domestic oil security proposals in the discussion paper will be provided independently of this proposal.
[5] New Zealand currently has government-to-government agreements with Australia, Denmark, Japan, the Netherlands, and the United Kingdom. Officials expect to finalise an agreement with Spain in 2013.

13 The average price of New Zealand's contribution to the IEA stockholding between 2007 and 2012 using tickets ranged from USD 0.79/tonne/month to USD 1.86/tonne/month. This compares with the expected benefit of the total IEA stockholding which is estimated to be USD 29/tonne/month.[6, 7]

## Problem definition

*Non-compliance with oil stockholding treaty obligation*

14 Without an increase to the appropriation to cover tickets, New Zealand will become non-compliant with its IEA treaty obligation from April 2013. The forecast cost of meeting New Zealand's obligation using tickets is shown in Table 1. The existing $3 million outyears appropriation is insufficient to cover these costs.

**Table 1: Forecast of ticket contract costs**

| **Fiscal year** | *2013/14* | *2014/15* | *2015/16* | *2016/17* |
|---|---|---|---|---|
| **Cost ($ million)** | 5.185 | 6.697 | 8.658 | 10.579 |
| **Existing appropriation ($ million)** | 3.000 | 3.000 | 3.000 | 3.000 |

15 The root cause of the rising cost of the IEA obligation is the forecast decline of domestic oil production in the medium-term (which increases the stock that New Zealand is required to hold). MBIE expects the recent increase in petroleum exploration activity to result in an upturn in domestic oil production in the medium-to long-term which will result in a downturn in ticket costs.

16 Non-compliance with New Zealand's IEA obligation would likely result in significant damage to New Zealand's international reputation. It is likely that a number of New Zealand's closest partners would perceive New Zealand to be free-riding on the collective international oil security arrangements, and would exert pressure on New Zealand to comply. Oil security is closely linked to security generally, and oil security is a key driver of the foreign and security policies of many IEA/OECD countries. Non-compliance could, for example, have implications for trade arrangements with those countries.

17 I am aware that Australia has been non-compliant with its IEA obligation for over a year. Australia has been heavily criticised for this by key IEA members (the US, France, Germany, Japan, and the United Kingdom) and is under instruction from the IEA to report back this year on its proposals for returning to compliance.

## Recommended option for meeting stockholding obligation

*New Zealand should continue to meet its IEA obligation with government-procured tickets*

18 Given the risks to New Zealand's international standing from non-compliance, I strongly recommend that New Zealand continues to meet its IEA obligation. I also propose that New Zealand continues to meet the obligation through ticket contracts, since tickets are of the order of 10 percent of the cost of building domestic stockholding.

[6] Oak Ridge National Laboratory (2012): *Benefits of Emergency Oil Stocks: A Study of IEA Stocks and Benefits* (a study commissioned by the IEA).
[7] This is the benefit to global importing regions (including New Zealand).

*Risks of recommended option*

19 There is a risk that, at some time in the future, New Zealand will not be able to procure sufficient ticket contracts to meet its obligation.

Withheld under section 9(2)(j) of Official Information Act 1982

20 MBIE expects that, barring anomalous ticket market conditions, there will be sufficient ticket supply in the future for New Zealand to maintain compliance with its obligation.

Withheld under section 9(2)(j) of Official Information Act 1982

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Withheld under section 9(2)(g)(i) of Official Information Act 1982

*Tickets should be funded by increasing the PEFML*

22 Rather than continuing to fund tickets from general taxation, I propose that a user-pays system be implemented. The best option for a user-pays system is a levy on fuel. While there are good equity arguments for and against levy funding over tax funding[9], securing sustainable funding for tickets is the most important consideration. The required levy would be approximately 0.113 cents per litre, which amounts to 4.5 cents for a 40 litre tank.

23 The best option for implementing a levy is the existing PEFML. Collecting the required revenue via an existing levy would avoid the administrative and enforcement costs of setting up a new levy, and would minimise compliance costs for business.

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Withheld under section 9(2)(g)(i) of Official Information Act 1982

[9] There are two benefits to consider when considering the equity of levy funding over tax funding: the oil security of the stockholding, and the avoided cost of non-compliance with the IEA obligation. It can be argued that levy funding should be preferred over tax funding since it better targets the cost of oil security at the direct beneficiaries of that security. Conversely, it can be argued that tax funding should be preferred over levy funding since the benefit of the avoided cost of non-compliance has public good characteristics, and so should be funded from general taxation.

24 The PEFML is currently set at 0.045 cents per litre on petrol, diesel, ethanol, and biodiesel, and covers certain IEA-related costs (including acquiring energy data), as well as fuel quality and safety monitoring. Following submissions on the oil security discussion document, MBIE is investigating whether the PEFML should be extended to cover domestically consumed jet fuel and fuel oil. These fuels comprise nine percent of fuels that could in-principle be targeted for cost recovery of tickets.

*The fuels that the PEFML applies to, and the levy rate, should be set in regulations rather than the Act*

25 I propose that a legislative amendment be made to the Energy (Fuels, Levies, and References) Act 1989 to expand the purpose of the PEFML to include IEA obligation costs, and to provide for the Minister of Energy and Resources to make regulations specifying the fuels that the PEFML applies to, as well as the levy rate[10]. I will make a final recommendation to Cabinet on fuel coverage and the levy rate when the regulations are made.

*The new PEFML revenue should fund an increased appropriation for tickets*

26 I propose that the existing appropriation be increased to reflect the forecast rise in ticket costs, and that the additional PEFML revenue fully funds the appropriation. I also propose that the levy rate is smoothed over the next three fiscal years.[11] The required increase in the levy rate to cover 2013/14 – 2015/16 would be approximately 0.113 cents per litre[12] so that the new levy rate would be approximately 0.158 cents per litre.

*Setting the levy rate*

27 The appropriation and levy rate could be updated as necessary as forecasts of ticket costs are updated. Any revenue over-recovery or under-recovery would be taken account of when setting the levy rate for the next period. The levy rate (additional to that required for the existing PEFML revenue) would be calculated using the following formula:

$$\text{Rate} = \frac{\text{forecast ticket contract cost for three years - surplus from previous period}}{\text{forecast fuel demand for three years}}$$

*Rejected options*

28 Table 2 summarises the other options for responding to the IEA obligation that I considered, and the reasons for rejecting them in favour of the recommended option.[13]

[10] The Act presently allows the Minister of Energy and Resources to prescribe the levy rate up to a maximum of 0.045 cents per litre.
[11] A smoothed levy rate is recommended over annual levy rates since it would reduce costs for business.
[12] The calculation of this levy rate is sensitive to forecasts in domestic oil production, domestic oil demand, ticket contract prices, and the USD/NZD exchange rate. A typical sensitivity range for these forecasts is 0.07 – 0.16 cents per litre.
[13] See pp. 4-7 of the attached regulatory impact statement for a full discussion of these options.

**Table 2: Rejected options**

| Option | Reason that option was rejected |
|---|---|
| Building domestic stockholding | Ticket costs are of the order of 10 percent of the cost of building domestic stockholding |
| Placing a mandate on industry to hold stock | Government procured tickets are less costly than a mandate on industry to hold stock |
| Continuing to fund tickets from general taxation | A new appropriation bid would have to compete with existing priorities and there is a risk that the bid would fail, resulting in the costs associated with non-compliance |

## Consultation

29 I have consulted with the Minister of Finance, the Minister of Transport, and the Minister of Customs on this proposal.

30 MBIE released a discussion document containing the levy proposal on 30 October 2012. 15 submissions were received and of these 10 contained direct comments on issues relating to the IEA obligation[14]. The vast majority of submitters either agreed with, or were neutral to, the overall proposal to meet the IEA obligation through PEFML-funded ticket contracts.

31 Prior to the release of the discussion document, MBIE discussed the levy proposal with a number of key stakeholders[15]. A number of these noted that minimising the frequency of levy rate changes by smoothing the levy over a number of years would help to reduce compliance costs.

32 The Treasury, the New Zealand Customs Service, and the Ministry of Transport have been consulted on this paper. The Department of the Prime Minister and Cabinet has been informed.

## Financial implications

33 The recommended option would save the Crown $3 million per annum since the appropriation for tickets would be fully funded by the additional PEFML revenue. While the PEFML increase may not be in place by the start of 2013/14, once it is in place, the rate will be set such that it recovers the total forecast cost for the period 2013/14 – 2015/16. Any revenue over-recovery or under-recovery would be taken account of when setting the levy rate for the next period.

34 If Cabinet does not agree by February 2013 to increase the appropriation, New Zealand is likely to become non-compliant with its IEA treaty obligation. An alternative to agreeing to the PEFML proposal is for Cabinet to agree to increase the appropriation but to fund it from Crown funds.

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[14] These 10 submissions were from Refining NZ, Wiri Oil Services Limited, Chevron, Z Energy, Gull, the Motor Trade Association, the Automobile Association, Air New Zealand, the Bioenergy Association of New Zealand, and the Sustainable Energy Forum.

[15] Z Energy, Chevron, Mobil, BP, Gull, Refinery NZ, Air New Zealand, the Automobile Association, the Motor Trade Association, and the Road Transport Forum.

35 The government would only actually purchase ticketed stock during an IEA-declared emergency if oil companies in New Zealand were unable to secure their own stock. The government would then directly on-sell that stock to companies in New Zealand. However, the mostly likely scenario following an IEA-declared emergency is that the government would release the ticketed stock to the foreign company holding it on the government's behalf. Both options would comply with an IEA direction for members to release stock. Both options would be fiscally neutral.

36 MBIE is investigating options for maintaining downward pressure on ticket costs, including seeking further government-to-government agreements to expand the supply of tickets, and reviewing the terms of New Zealand's stockholding contract to ensure that they are as attractive as possible.

## Human rights

37 There are no human rights issues associated with this proposal.

## Legislative implications

38 The recommended option for funding ticket contracts via an increase in the PEFML would require a legislative amendment to the Energy (Fuels, Levies, and References) Act 1989. The amendment would expand the purpose for which levies can be collected to include IEA obligation costs, remove the maximum levy for petroleum and engine fuel, and allow the Minister of Energy and Resources to make regulations specifying the levy rate and the fuels to which the levy would apply. The Act would continue to bind the Crown following the proposed amendments.

39 I am considering two legislative options for making this amendment:

a. I plan to introduce an energy levies and fees amendment bill which would cover a number of other amendments to energy related levies and fees. I am seeking a legislative priority for this bill.

b. The Customs and Excise Act 1996 must be amended to give effect to the increases to petrol excise duty which will take effect on 1 July 2013. There may be an opportunity to include changes to the PEFML in the same bill.

40 The proposed legislation change would be relatively short.

## Regulatory impact analysis

41 The regulatory impact analysis requirements apply to this policy process and a regulatory impact statement is attached to this paper.

## Quality of the impact analysis

42 The Regulatory Impact Analysis Review Panel has reviewed the Regulatory Impact Statement (**RIS**) prepared by MBIE and associated supporting material, and considers that the information and analysis summarised in the RIS meet the criteria necessary for Ministers to fairly compare the available policy options and take informed decisions on the proposals in this paper.

## Consistency with Government Statement on Regulation

43 I have considered the analysis and advice of my officials, as summarised in the attached regulatory impact statement, and I am satisfied that, aside from the risks, uncertainties and caveats already noted in this Cabinet paper, the regulatory proposals recommended in this paper:

a. are required in the public interest

b. will deliver the highest net benefits of the practical options available

c. are consistent with our commitments in the Government Statement on Regulation.

## Publicity

44 All parties liable for the PEFML would be notified by MBIE or Customs of the change in the rate and fuel coverage at least one month before the change was effected. A press release is also envisaged which would note the changes to the PEFML, and the benefit to New Zealand of membership of the IEA and of IEA oil stockholding.

45 While the vast majority of submitters either agreed with, or were neutral to, the overall proposal to meet the IEA obligation through PEFML-funded tickets, there is a possibility that the proposed levy increase may result in an adverse public reaction. While the proposed percentage increase in the levy rate is significant (0.045 cents per litre to 0.158 cents per litre is a 251 percent increase), the additional cost to fuel consumers is very small (an increase of 4.5 cents for a 40 litre tank). Further, the PEFML change may be made at the same time as the proposed increase to petrol excise duty, which represents a much greater increase for consumers.

46 The clear articulation of the small cost to consumers for helping to improve New Zealand's oil security and avoiding the risk from withdrawing from the IEA should help to mitigate any adverse public reaction.

## Recommendations

*New Zealand should continue to meet its IEA obligation with government-procured tickets*

It is recommended that the Committee:

1 **note** that:

1.1 as a member of the International Energy Agency, New Zealand is required to contribute to global oil security by holding 90 days of net imports of oil stocks;

1.2 New Zealand presently meets its International Energy Agency obligation through commercial inventories held in New Zealand, and by entering into ticket contracts with offshore companies;

1.3 the cost of meeting this obligation is forecast to rise beyond the existing $3 million per annum appropriation;

1.4 the cost of meeting this obligation via ticket contracts is of the order of 10 percent of the cost of building domestic oil stockholding, and it is more economic for government to procure ticket contracts than to place a stockholding mandate on industry;

2 **agree** that New Zealand should continue to meet its International Energy Agency obligation via government procured ticket contracts;

*The existing appropriation should be increased to reflect the forecast increase in costs of ticket contracts*

3 **note** that approval to increase the Non-Departmental Output Expense "Management of IEA oil stocks" appropriation is required by February 2013 to ensure that New Zealand remains compliant with its International Energy Agency obligation;

4 **agree** that the "Management of IEA oil stocks" appropriation will be fully offset by the Petroleum or Engine Fuel Monitoring Levy;

5 **approve** the following changes to appropriations to provide for the management and funding of oil stocks to meet International Energy Agency obligations, with a positive impact on the operating balance;

| | $m – increase/(decrease) | | | | |
|---|---|---|---|---|---|
| **Vote Energy**<br>**Minister of Energy and Resources** | **2012/13** | **2013/14** | **2014/15** | **2015/16** | **2016/17 & Outyears** |
| Non-Departmental Output Expense:<br>Management of IEA oil stocks | - | 2.185 | 3.697 | 5.658 | - |
| **Total operating** | - | **2.185** | **3.697** | **5.658** | **-** |

6 **note** that officials plan to seek further funding for the period beginning 2016/17 and outyears in due course;

7 **agree** that the changes to appropriations be included in the 2012/13 Supplementary Estimates;

*The appropriation for the ticket contracts should be fully funded by increasing the PEFML*

8 **note** that:

8.1 the appropriation for ticket contracts could either be funded from an increase in the Petroleum or Engine Fuel Monitoring Levy (**PEFML**), or from general taxation;

8.2 the vast majority of submitters on a proposal to fund ticket contracts using the PEFML either agreed with, or were neutral to, the proposal;

8.3 the required increase in the PEFML to fund the increase in the appropriation would be approximately 0.113 cents per litre (amounting to 4.5 cents for a 40 litre tank), which would bring the total levy to approximately 0.158 cents per litre;

8.4 increasing the PEFML to fully fund the new appropriation would result in savings of $3 million per annum for the Crown;

8.5 the forecast additional revenue from increasing the levy rate by 0.113 cents per litre is as follows:

| | $m – increase/(decrease) | | | | |
|---|---|---|---|---|---|
| **Forecast additional revenue** | **2012/13** | **2013/14** | **2014/15** | **2015/16** | **2016/17 & Outyears** |
| | **-** | **6.803** | **6.849** | **6.888** | **6.928** |

9 **note** that the entire appropriation for ticket contracts of $20.540 million over the next three fiscal years would be fully funded by the proposed increase in the Petroleum or Engine Fuel Monitoring Levy;

10 **agree** that the Energy (Fuels, Levies, and References) Act 1989 should be amended to:

10.1 remove the maximum levy rate of 0.045 cents for each complete litre of petroleum or engine fuel;

10.2 amend the purpose for which levies can be collected under the Act to include International Energy Agency obligation costs;

11 **invite** the Minister of Energy and Resources to report back to the Cabinet Economic Growth and Infrastructure Committee with an updated estimate of the required increase in the Petroleum or Engine Fuel Monitoring Levy after the necessary legislative amendments are made to give effect to recommendation 10;

*The Minister can make regulations that specify the fuels that the PEFML applies to, and the levy rate*

12 **note** that:

12.1 the Energy (Fuels, Levies, and References) Act 1989 currently specifies that the Petroleum or Engine Fuel Monitoring Levy applies to petrol, diesel, ethanol, and biodiesel;

12.2 officials are currently investigating whether the Petroleum or Engine Fuel Monitoring Levy should be extended to cover domestically consumed jet fuel and fuel oil;

13 **agree** that the Energy (Fuels, Levies, and References) Act 1989 should be amended to provide for the Minister of Energy and Resources to make regulations specifying the fuels that the Petroleum or Engine Fuel Monitoring Levy applies to, as well as the levy rate;

14 **invite** the Minister of Energy and Resources to report back to the Cabinet Economic Growth and Infrastructure Committee with a final recommendation on which fuels the Petroleum or Engine Fuel Monitoring Levy should apply to after the necessary legislative amendments are made to give effect to recommendation 13;

*Other recommendations*

15 **agree** that Parliamentary Counsel Office be issued drafting instructions for the drafting of a bill to implement the proposals set out in these recommendations;

16 **note** the Minister of Energy and Resources intends to release, subject to consideration of any information that would be withheld if the information had been requested under the Official Information Act 1982: 34.1, this paper and all the submissions received on the oil security discussion paper.

**Hon Phil Heatley**
**Minister of Energy and Resources**

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