

20-D-00925

s 9(2)(a)

Stuff

s 9(2)(a) [@stuff.co.nz](mailto:s9(2)(a)@stuff.co.nz)

Dear s 9(2)

()

Thank you for your email of 5 June 2020 requesting the following under the Official Information Act 1982 (the Act):

Does the ministry hold any internally or externally prepared advice on the distribution and/or use of auction revenue from the proposed emissions trading reforms beyond that in the publicly available submissions?

If so, could I please request a copy of all advice?

If this request needs refining, please let me know.

The Ministry for the Environment has identified eight documents in scope of your request, as listed in the attached table. Some information within these documents has been withheld under the following sections of the Act:

9(2)(f)(iv) to maintain the constitutional conventions for the time being which protect the confidentiality of advice tendered by Ministers of the Crown and officials

18(d) that the information requested is or will soon be publicly available

I am satisfied under section 9(1) of the Act that, in the circumstances, withholding this information is not outweighed by other considerations that render it desirable to make the information available in the public interest.

Two additional documents in scope were authored by the Treasury. Under section 14 of the Act, we have partially transferred your request to the Treasury, as the information in these documents related to your request is more closely connected with its functions.

Please note the Government has explored multiple options for using the proceeds from auctioning emission units under the reformed New Zealand Emissions Trading Scheme. The Government is yet to make any decision on this matter.

You have the right to seek an investigation and review by the Office of the Ombudsman of my decision to withhold information relating to this request, in accordance with section 28(3) of the Act. The relevant details can be found on their website at: www.ombudsman.parliament.nz.

Please note that due to the public interest in our work the Ministry for the Environment will publish responses to most of our requests for official information on our web site on our [OIA responses page](#) shortly after the response has been sent to you.

If you have any queries about this, please feel free to contact our Executive Relations team.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Roger Lincoln', is positioned to the left of a vertical line.

Roger Lincoln
Director, Climate Change

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the Official Information Act 1982

List of documents

Document no.	Document date	Title & document type	Decisions	OIA sections applied
1	24 January 2019	2019-B-05236 NZ ETS tranche 2 - upcoming decisions briefing to MIN <i>Briefing note</i>	Released in full	
2	24 January 2019	NZ ETS tranche 2 slides <i>Presentation</i>	Released in full	
3	14 February 2019	2019-B-05281 ETS Auction Proceeds and the Transition to a Low Emissions and Climate Resilient New Zealand <i>Briefing note</i>	Released in part	9(2)(f)(iv)
4	17 September 2019	Policy paper - Auctioning use of proceeds_v1.0 <i>Policy brief</i>	Released in full	
5	21 November 2019	2019-B-06254 MfE feedback on Treasury hypothecation report <i>Briefing note</i>	Released in part	9(2)(f)(iv)
6	5 March 2020	<i>Briefing note</i> Title withheld in full under s 9(2)(f)(iv) of the Act	Withheld	9(2)(f)(iv)
7	30 April 2019	2019 B 05536 Joint advice on the Interim Committee's recommendations on agriculture <i>Briefing note</i>	Withheld in full ¹	18(d)
8	June 2020	Rules for auctioning in the NZ ETS <i>Regulatory impact statement</i>	Withheld in full ²	18(d)

¹ Publicly available at <https://www.mfe.govt.nz/more/briefings-cabinet-papers-and-related-material-search/briefing-notes/joint-advice-response>

² Publicly available at <https://www.mfe.govt.nz/more/briefings-cabinet-papers-and-related-material-search/regulatory-impact-statements/impact-5>



Upcoming Decisions – Emissions Trading Scheme Tranche Two

Date Submitted:	24 January 2019	Tracking #: 2019-B-05236	
Security Level	In-confidence	MfE Priority:	Non-Urgent

To Hon James Shaw, Minister for Climate Change	Action sought: read slides prior to discussion with officials on 31 January	Response by: N/A
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Actions for Minister's Office Staff	Note
Number of appendices and attachments # 1	Titles of appendices and attachments (ie separate attached documents): 1. NZ ETS tranche 2 – upcoming decisions
Note any feedback on the quality of the report	

Ministry for the Environment contacts

Position	Name	Cell phone	1 st contact
Principal Author	Charlotte Berg	022 517 3258	
Responsible Manager	Matthew Cowie	021 531 288	✓
Director	Roger Lincoln	027 290 7625	

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New Zealand Emissions Trading Scheme Tranche 2 – upcoming decisions

Key Messages

1. This briefing provides you with information to support your upcoming discussion with officials on the second tranche of improvements to the New Zealand Emissions Trading Scheme (NZ ETS).
2. The aim of the discussion is to get your feedback on our initial recommendations, and any areas of concern you or your colleagues may have.
3. We have attached slides outlining key decisions expected to be included in tranche two. These relate to industrial allocation, auctioning hypothecation, market governance, market transparency, compliance, forestry and the fixed price option.

Next Steps

4. Read slides prior to discussion at meeting with officials on 3 January

Signature

Matthew Cowie

Acting Director, Climate Change Directorate

Date

Hon James Shaw

Minister for Climate Change

Date

NZ ETS tranche 2

Upcoming decisions

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Purpose of the session

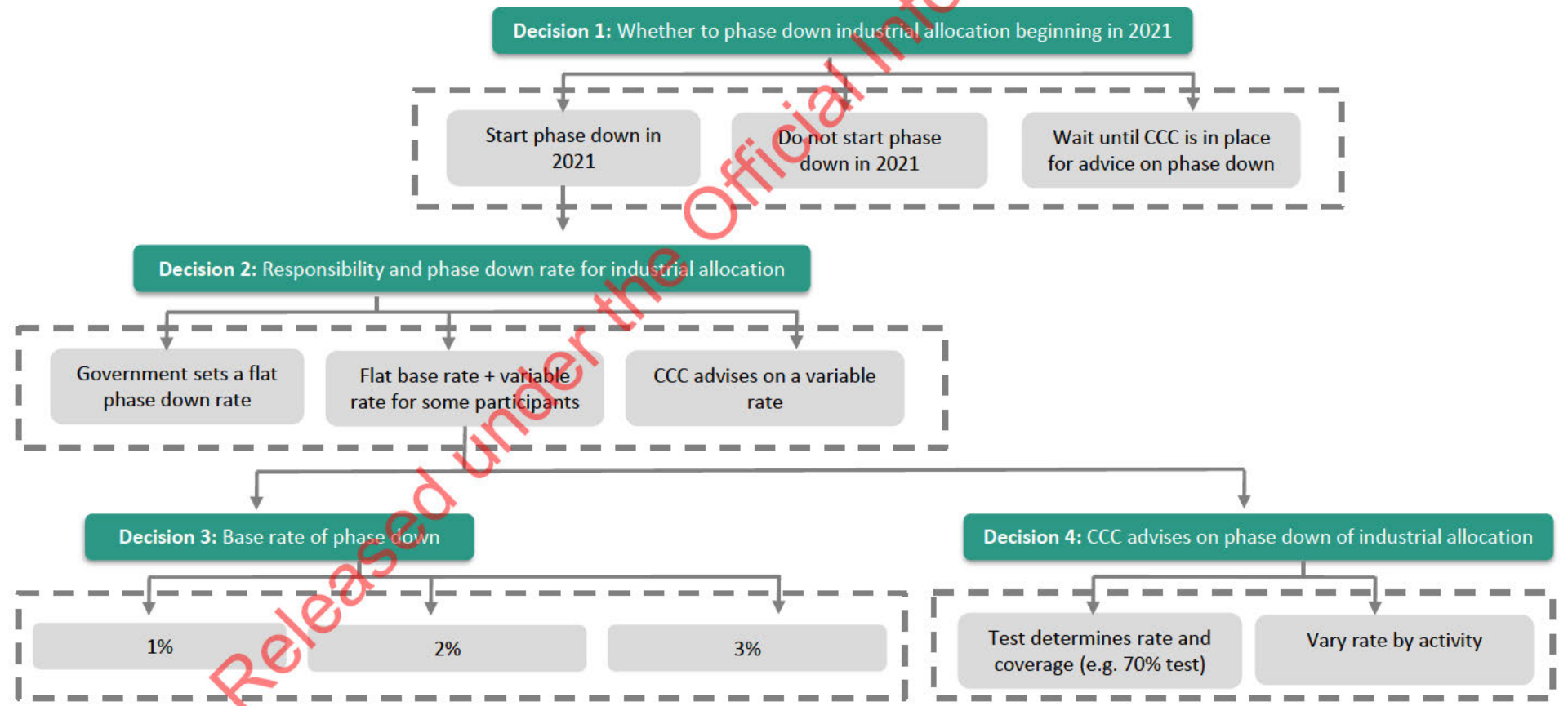
- To inform you of the decisions expected to be sought in the Tranche 2 NZ ETS Cabinet paper (March 2019)
- To seek your feedback on the initial recommendations we are proposing
- To ascertain specific areas of interest/concern you or your colleagues may have

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Key decisions	Notes
<p>Industrial allocation Decision on the process and potential level of any phase-down of industrial allocation</p>	<p>Protection from the risk of emissions leakage, providing certainty for business while managing the risk of over-allocation and meeting emission budgets Key Ministers: Parker, Nash, Jones, Woods, DPM</p>
<p>Auctioning hypothecation Decision on whether auction proceeds should be hypothecated, and if so how</p>	<p>Treasury advice is normally that funds are not hypothecated, but strong views from stakeholders to hypothecate. Coalition agreement that any revenue generated if agriculture comes into the NZ ETS is recycled back to agriculture. Key Ministers: Robertson, Jones, O'Connor, PM</p>
<p>Market governance Decision on regulator, auctioning monitor and how to manage market risks more broadly</p>	<p>Administrative burden needs to be balanced with improving the integrity of the market and recognition of how we expect the market to operate in future. <u>It is likely that only in-principle decisions can be taken in 2019.</u> Key Ministers: Faafoi, Jones, DPM</p>
<p>Market transparency Decisions on whether to make more information publicly available</p>	<p>Confidentiality of information and benefits of improved transparency Key Ministers: Jones</p>
<p>Compliance Decisions on whether to replace the \$30 per unit penalty for late surrenders</p>	<p>Robust compliance regime that allows for future international linking Key Ministers: Jones, Sage</p>
<p>Fixed Price Option Decisions on if/how/when it might be changed</p>	<p>Trade-offs between fiscal cost and consumer/industrial cost burden Key Ministers: Jones, Robertson, Parker, DPM</p>
<p>Forestry Decisions on averaging and harvested wood products</p>	<p>Fiscal cost and increasing confidence and incentives for sequestration Key Ministers: Jones, Robertson, DPM</p>
<p>Agriculture Some process decisions may be needed prior to Interim Committee report</p>	<p>A significant work programme is underway, you will be provided with a briefing on the key issues, decisions and timeframes later in January.</p>

Industrial allocation

Objective	Ensure levels of assistance are set to align with budgets while minimising the risk of emissions leakage
Initial recommendation	<ol style="list-style-type: none">1. Start phase down in 20212. Industrial allocation should phase down with a flat base rate, plus a variable rate for some participants3. Initial base rate of a phase down should be set at 1-2%, with CCC to advise on variable rate
Considerations	Industrial allocation helps protect industry from emissions leakage but shifts costs onto the Government and other consumers/businesses within the economy.
Proposed next steps	Cost impact assessment of the proposals Supporting your engagement with your colleagues



Auctioning hypothecation	
Objective	To enable funds generated from auctioning to best support a fair and just transition to a low-emissions and climate-resilient New Zealand in a transparent manner.
Initial recommendation	Initial view is that auction proceeds should not be hypothecated through the Act. This allows for a wider discussion on the objectives and aims of hypothecation through non-legislative mechanisms.
Considerations	<p>Hypothecation is generally not supported by Treasury</p> <p>Government budget prioritisation processes are designed to ensure government spending is directed to its highest and best value use.</p> <p>Exceptions to this would generally meet the following criteria and auctioning revenue does not:</p> <ul style="list-style-type: none"> • Cost Recovery – clear connection between cost recovery and benefit, e.g. MPI Food Safety charges • Beneficiary pays principle – tax/charges paid by those benefiting from the service, e.g. ACC levies, road user charges <p>Availability of Funds</p> <ul style="list-style-type: none"> • Dependent on auction volumes, variable over time. • Funds may reduce in the longer term as targets reduce just as the need for funds increases <p>NZ First Coalition Agreement</p> <p>If agriculture is to be included within the NZ ETS then all revenues from that source will be recycled back into agriculture to encourage agricultural innovation, mitigation and additional planting of forestry.</p> <p>Public trust and acceptability</p> <p>Hypothecation can help to increase acceptability of new tax measures when the public is informed about how funds are to be spent.</p> <p>Submissions support hypothecation</p> <p>Clear support for hypothecation from submitters (86% of 106 submitters who commented)</p> <p>A wide range of purposes were suggested:</p> <ul style="list-style-type: none"> • Climate mitigation and adaptation • Supporting a just transition by supporting vulnerable groups • Research and development – mitigation/adaptation/agriculture emissions reduction • Wider environmental objectives, e.g. soil erosion control, pest control • Tackling emissions reductions in difficult sectors e.g. aviation and marine transport
Proposed next steps	Engaging with the Just Transitions Unit on the objectives and aims of hypothecation

Market governance (including auctioning)

Objective

- Create an effective, efficient and transparent trading market which supports the broader objectives of the NZ ETS
- Ensure that participants can trade fairly and with integrity, recognising the presence of small participants

Initial recommendation

- Appoint a regulator for insider trading and market manipulation (EPA, FMA or other)
- Introduce the function of an auction monitor into the CCRA
- In-principle or high-level decisions on the broader market governance framework

Considerations

Significant time pressure means it is likely only in-principle decisions will be made on the broader governance framework

- We do not yet have preferred options on improvements to the broader market governance framework. Therefore the scale of the drafting complexity involved with the remaining issues is unclear.

Risks remain that if CCRA changes are sought in March, this could affect PCO's ability to draft the changes in 2019.

- If there is a desire to make any meaningful changes to the broader governance framework, such as moving to exchange-based trading, this will require further consultation on the proposed changes.
- In that case, an amendment that comes after March may be necessary if Ministers do wish to introduce a broader, coherent governance framework.

The Minister for Forestry has raised a concern with the provision of advice to small participants from consultants active in the ETS market.

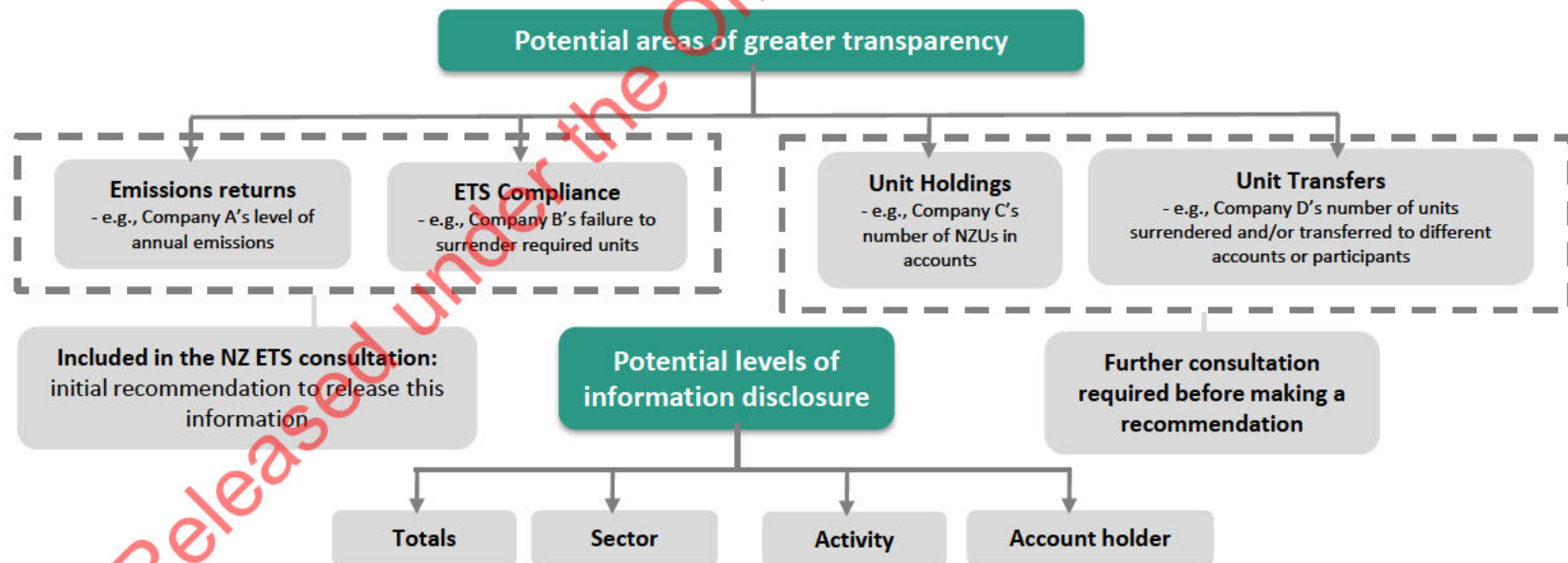
- This issue is in scope and we are considering the options at present, but our preliminary view is that making improvements to this issue in the short term is likely to be very difficult.

Proposed next steps

- Consultation with potential regulators and selected stakeholders on their views on a regulator for the new prohibitions, the function of an auction monitor, and the broader governance framework
- Further consideration of timing – there may need to be a further tranche of market governance decisions following the March paper

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Market transparency	
Objective	<ul style="list-style-type: none"> • Create an effective, efficient and transparent trading market which supports the broader objectives of the NZ ETS • Ensure that participants can trade fairly and with integrity, recognising the presence of small participants
Initial recommendation	<ul style="list-style-type: none"> • More information made available regarding emissions returns and ETS compliance • Consultation with selected market participants regarding information available on unit holdings and unit transfers • Further analysis of potential legal, commercial and administrative barriers to disclosing
Considerations	<ul style="list-style-type: none"> • Potentially opposing views between emitters and foresters • Minister for Forestry is concerned foresters are presently disadvantaged with limited market transparency • Emitters may consider their emissions trading information commercially sensitive • Information disclosure can be onerous for small participants
Proposed next steps	<ul style="list-style-type: none"> • Consultation with selected market participants on disclosing unit holdings and unit transfers • Further analysis of potential legal, commercial and administrative barriers to disclosing the preferred level of information detail, e.g., Privacy Act



Compliance– Excess Emission Penalty (EEP)

Objective

Replacing current penalty for late surrenders with a regime that is:

- sufficiently stringent to effectively deter non-compliance;
- simpler for administrators and participants; and
- sufficiently robust to allow for international linking.

Initial recommendation

Replace the \$30 per unit penalty with a two-tier regime:

1. There will be a fixed percentage that is based on a participant’s culpability (e.g. 40% penalty for gross carelessness, as New Zealand Customs already uses).
2. If the participant still fails to surrender the units, there will be an additional penalty based on the market price, in line with international approaches

Considerations

The compliance regime should deter non-compliance while being simple for administrators and participants. The regime should be robust enough to allow for future international linking to other emissions trading schemes.

Proposed next steps

Consult with Ministry of Justice

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The Fixed Price Option (FPO) and moving to a new price ceiling

Proposed decisions

Operational decisions are needed to allow the cost containment reserve to eventually replace the FPO. Any transitional options for increasing the FPO price level to support a smooth transition to the CCR should also be considered.

Objective

To support a smooth transition to the new price ceiling (from the FPO to the cost containment reserve) in line with wider NZ ETS and climate change objectives

Considerations

Further operational decisions are needed to eventually remove the FPO
Cabinet has decided that the FPO will be replaced with a cost containment reserve when auctioning is ‘fully operational’. Further decisions by Cabinet are needed to specify how this transition will work e.g. to enable the FPO to eventually be removed and to amend related legislative provisions as needed (e.g. the SSG levy references the \$25 price level).

Transitional measures to support moving to the new price ceiling should be considered
Ministers have decided the FPO will remain in place at \$25 for surrenders due in 2019. There is an opportunity to consider if a transitional increase in the FPO price level (e.g. for surrenders due in 2020) aligns with wider Government climate change objectives and should be pursued through this year’s legislative change. This could support a smooth transition to the cost containment reserve as it is expected to be set at a level above \$25.

Proposed next steps

Feedback from you on transitional measures. We will include operational decisions on how to remove the FPO in the March paper.

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Other policy decisions in Tranche 2

Forestry

- Introduce averaging accounting for new forests
- Options for transitioning to averaging accounting for existing post-1989 forests (details to be worked through)
- Whether and how the NZ ETS recognise emissions mitigation of long-life harvest wood products

Agriculture (potentially)

Due to time limitations, some process decisions, such as approval to consult on the recommendations of the Interim Committee may be required.

Paris Agreement (potentially)

If required, changes needed to implement decisions on operationalising the Paris Agreement.

Climate related financial disclosures (potentially)

There may be a case for enabling climate related financial disclosures through the Climate Change Response Act. We are working with MBIE on this.

Voluntary cancellation of units (potentially)

If required, any changes needed for voluntary cancellation of units (e.g. for the purposes of offsetting or carbon neutrality claims) from 2021.

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Timeline for policy decisions

Tranche 2
March 2019

- Decisions in tranche 2 are needed in March to allow for drafting and Bill introduction expected in July

Government
decision on ag
emissions
June/July 2019

- This may need to be included in changes to the CCRA

Consultation on
regulations
July/August 2019

- Regulations are required to give effect to the legislative changes
- This will include unit supply (e.g. price control settings, auction volumes), compliance, auctioning operational details, forestry, etc.

Regulations
Sept/Oct 2019

- Decisions on regulations are needed in Sept/Oct to allow for drafting with the aim of taking effect from 1 Jan 2020

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ETS auctioning proceeds and the transition to a low-emissions and climate-resilient New Zealand

Date Submitted:	14 February 2019	Tracking #: 2019-B-05281	
Security Level	IN CONFIDENCE	MfE Priority:	Non-Urgent

	Action sought:	Response by:
To: Hon James Shaw, Minister for Climate Change	Agree to next steps	18 Feb 2019

Actions for Minister's Office Staff	Return the signed report to MfE.
Number of appendices and attachments	Nil
Note any feedback on the quality of the report	

Ministry for the Environment contacts

Position	Name	Cell phone	1 st contact
Principal Author	Kate Whitwell	022 493 0114	
Responsible Manager	Matthew Cowie	021 531 288	✓
Director	Roger Lincoln	027 290 7625	

Key Messages

1. This briefing provides you with an update on the NZ ETS work stream considering whether and how auctioning proceeds should be used towards specific purposes and seeks your direction on next steps. We discussed this topic with you at an officials meeting on 31 January 2019 and you expressed a clear view in favour of direct hypothecation of auctioning proceeds through the Climate Change Response Act 2002 (CCRA).
2. We consider that decisions relating to the use of auctioning proceeds should be taken as part of the wider work programme that is investigating the role of the Government in supporting a just transition to a low emissions and climate resilient New Zealand.
3. We therefore recommend that auction proceeds should not be hypothecated through legislative change to the CCRA as part of the March decisions on tranche 2 of improvements to the NZ ETS to allow time for this wider discussion to occur.
4. § 9(2)(f)(iv)
 Our initial advice is not to seek to progress this option through Cabinet early in 2019. We advise that this idea should be part of the broad discussion about climate change policy spending already underway across Government.
5. Should this wider discussion result in an approach that requires legislative change to the CCRA there are options to enable these changes to be made later this year, for inclusion

in the CCRA amendment bill. Inclusion in the CCRA amendment bill will depend upon the option chosen, as additions after the bill is introduced will be required to be within scope of the bill. Inclusion at a later stage, such as during Committee of the whole House as a Supplementary Order Paper, would not provide for public submissions on the changes.

Context

6. In December 2018, Cabinet agreed to develop an auction platform and regulations to implement the auctioning of New Zealand Units (units) within the NZ Emissions Trading Scheme (NZ ETS) [CAB-18-MIN-0606.01 refers].
7. Auctioning units will generate funds for Government in future and the question of where to spend these funds needs to be determined. In the absence of any legislative change, NZ ETS auction proceeds would return to the Crown total operating revenue for distribution through Government budgeting processes.

A range of approaches to directing auction proceeds have been used overseas

8. There are four ways in which revenues from carbon pricing have been used in other countries:¹
 - Returned to general Government budgets. This occurs to 44% of revenues raised through carbon pricing worldwide. For example, Ireland uses its carbon tax to increase the Government's overall revenue. This extra revenue was useful for the Irish Government when responding to the Global Financial Crisis.
 - Hypothecated towards low-carbon projects (46% of carbon pricing revenues worldwide). For instance, revenue from Quebec's emissions trading scheme is allocated to a Green Fund and spent on climate change mitigation and adaptation projects, with two-thirds of revenue spent on public transport and vehicle electrification projects.
 - Used to reduce other taxes (6% of global carbon revenues). As Sweden's carbon tax has increased, employers' social contributions have been reduced and the most vulnerable households have benefited from income tax exemptions.
 - Used on direct premiums or subsidies (4% of global carbon revenues). Switzerland redistributes two-thirds of the revenue from its carbon tax to businesses and households, with every citizen receiving a monetary deduction in the cost of the mandatory health insurance programme.

Neither the Productivity Commission nor the Tax Working Group express a firm view on the hypothecation of auction proceeds

9. Neither the Tax Working Group nor the Productivity Commission came to a conclusion on whether NZ ETS auction proceeds should be hypothecated. Nevertheless, both organisations provide some useful factors to consider.
10. The Tax Working Group states in its Interim Report that it supports the NZ ETS raising revenue through the auctioning of NZUs, as this could raise significant fiscal benefits for the Government. No view is provided as to how revenue should be used, with the Group noting that taxation revenue can allow for the reduction of more distortionary taxes and/or allow for spending on other Government priorities.

¹ Institute for Climate Economics, Climate Brief No. 55, *Carbon Pricing Across the World: How to Efficiently Spend Growing Revenues?* By Clément Métivier and Sébastien Postic.

11. The Productivity Commission lists four ways that NZ ETS auction proceeds could be used:
 - i. Reducing distortionary taxes (such as income taxes and GST);
 - ii. Investing in specific initiatives (such as funding research and development on new low-emissions technologies, or investing in public transport and cycleways);
 - iii. Supporting vulnerable households, communities and businesses (such as by assisting poorer households facing higher heating and transport costs, or providing Emissions Intensive Trade Exposed firms with tax exemptions or free allocation);
 - iv. Contributing to general Government revenue.
12. The Productivity Commission also notes that consideration should be made of how closely the rationale for revenue raising and the area of spending are linked.

The purpose of auctioning units is to align volumes with climate change targets

13. The primary purpose of the NZ ETS is to assist New Zealand to meet its climate change targets by setting a cap on emissions. This purpose will drive decision-making on the volume of units that can be released for auctioning.
14. The amount of funds generated each year will be dependent on both auction volumes and NZU price. Over time, while NZU prices are expected to rise, the volume available for auction is expected to decrease in order to meet increasingly more ambitious targets. The Tax Working Group notes that as New Zealand reduces its net greenhouse gas emissions NZ ETS auctions will cease to be a reliable tax base in the longer term.
15. Key information regarding expected auction unit volumes is not yet known, meaning that it is not yet possible to accurately estimate the amount of money that would be generated each year in NZ ETS auctions.

Labour and New Zealand First Coalition Agreement must be taken into consideration later this year if agriculture were to enter the NZ ETS

16. While the decision needed from Cabinet is about the NZ ETS auction revenue from the existing NZ ETS sectors, an argument could be made that the Labour-NZ First Coalition Agreement sets a precedent for hypothecation.
17. The Labour and New Zealand First Coalition Agreement states that, *if the Climate Commission determines that agriculture is to be included in the ETS, then upon entry, the free allocation to agriculture will be 95% but with all revenues from this source recycled back into agriculture in order to encourage agricultural innovation, mitigation and additional planting of forestry.*
18. The Government's decision on whether agriculture is to be included in the NZ ETS is expected to be made later in 2019, following recommendations from the Interim Climate Change Commission.

Analysis and Advice

19. Supporting the transition to a low-emissions and climate-resilient New Zealand will require the Government to spend money across a wide range of domestic climate change priorities, in addition to the potential need to purchase high-integrity international units.
20. Investment may be required in areas such as:
 - research, deployment and adoption of low-emissions innovations as recommended by the Productivity Commission

- supporting communities vulnerable to the economic impact of climate change policies
 - supporting communities vulnerable to the impact of climate change.
21. Using current emissions projections it is unlikely that New Zealand will be able to meet its 2030 Nationally Determined Contribution (NDC) under the Paris Agreement through domestic abatement alone. Therefore the Government will also need funds to purchase high-integrity international units to meet this commitment.
 22. The wider Government work programme to support a just transition to a low emissions and climate resilient New Zealand is still under development.
 23. The transition is likely to entail significant demands on Government resource, e.g. through social policy for equity purposes, education and re-training, research and development for reducing long-term costs, etc.
 24. It would be valuable to consider and prioritise these demands in total alongside this proposal.
 25. These demands are likely to evolve over time and may not match auction proceeds in phasing or scale. Returning proceeds to the centre allows regular prioritisation through the budget.
 26. We recommend that consideration of the possible use of auction proceeds should become part of the discussion about Government spending priorities for climate change.
 27. § 9(2)(f)(iv) however trying to pursue a detailed proposal like this now would:
 - risk getting ahead of the wider discussion on Government priorities for climate change policy
 - consume policy, legal drafting and Ministerial time that may put at risk meeting the deadline for climate change legislation to be complete by the end of 2019.
 28. We recommend that this § 9(2)(f)(iv) proposal be included inside the wider Government discussion about climate change spending priorities as there is still time later in 2019 for this structure to be included within the CCRA legislation change.

Consultation and Collaboration

Stakeholders support hypothecation towards wider climate change objectives

29. While hypothecation is rare within the New Zealand Government, stakeholders suggested in the 2018 NZ ETS consultation that there are a wide range of uses to which NZ ETS auction proceeds could be directed, the majority of which relate to taking action on climate change.
30. In the consultation on improvements to the NZ ETS held in August and September last year, a clear majority of 91 of the 106 submitters who responded to the relevant question supporting directing auction proceeds towards a particular purpose (85% of responses). Submitters said that hypothecating revenue would maintain the integrity of the NZ ETS, increase the scheme's behaviour change component, and could provide a double dividend of emissions reduction and public benefit.
31. Submitters were most often in favour of using proceeds to support climate change mitigation and adaptation (60 submitters or 57%). The second most popular use of proceeds was assistance to specific groups, including Māori and New Zealanders on low incomes.

32. Only two submitters wanted auction proceeds to be directly returned to all New Zealanders through a form of tax dividend.
33. A minority of submitters opposed hypothecation, stating that this would create inefficiencies in administration and that it risked benefiting some New Zealanders more than others.

Hypothecation best practice

34. The Treasury advises that hypothecation is best suited to situations where there is a clear connection between the charge and the activity funded (for example, road user charges and the National Land Transport Fund), or where services are provided on a cost-recovery basis. Outside of these instances, hypothecating revenues can hamper the Government's ability to prioritise its spending through the Budget process, and reduce flexibility to scale funded activities up or down as conditions change. For these reasons, hypothecating revenues outside of these instances is generally not recommended.

Next Steps

35. We propose that you meet with your colleagues to discuss climate change spending priorities and which revenue streams might be considered as part of this topic. We would work with other agencies (particularly TSY and MBIE) to provide supporting materials for any meeting on this topic.
36. We propose that when a decision is made later this year on the inclusion of agriculture within the NZ ETS, we provide advice on ways to meet the requirements of the *Labour and New Zealand First Coalition Agreement* regarding the recycling of revenue from agriculture back to the sector.

Recommendations

37. We recommend that you

- a. **Note** that the revenue flow from NZU auctioning is just one of many fiscal considerations that are needed across the Government's climate change policy framework
 - b. **Agree** to meet with your colleagues to discuss climate change spending priorities and include the possible use of ETS auction proceeds as part of that discussion.
- Yes/No
- c. **Engage** with colleagues regarding the possibility of ^{s 9(2)(f)(iv)} [REDACTED]
 - d. **Note** that if the Government does decide to hypothecate auction revenue through the CCRA that this could be included in legislative changes later in 2019 once the wider climate change spending priorities have been agreed across Government
 - e. **Agree** not to make legislative change to hypothecate auction proceeds as part of the tranche two decisions on NZ ETS improvements due to go to cabinet in March 2019.

Yes/No

- f. **Note** that officials would like to discuss the contents of this briefing with you at the next Ministers weekly meeting.

Signatures

Roger Lincoln
Director, Climate Directorate

Date

Hon James Shaw
Minister for Climate Change

Date

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Memorandum

17 September 2019

To: Jack Bisset
Cc: Corina Comendant
From: Toby Stevenson
Re: **Use of proceeds from carbon auctions**

Use of proceeds

The questions this paper addresses are

1. What are the options for the use of proceeds from carbon auctions?
2. How would these approaches be formalized?

Carl and Fedor ((2016)¹ note that the treatment of proceeds from carbon pricing or carbon taxes do tend to find their way back into the same policy direction that led to the measures in the first place.

Policy discussions of global policies to price the emission of greenhouse gases such as carbon dioxide, whether through direct taxes or indirect cap-and-trade mechanisms, often focus on the desired effect of the new price—reduced emissions by marginally increasing the cost of carbon-intensive energy consumption — rather than the potentially substantial government revenues generated alongside. This stands in contrast to Bartbold's (1994) observation that environmental excise taxes (such as gas taxes or chemical fees) were historically used primarily as revenue devices rather than incentives to change behavior. In this way, carbon taxes are perhaps more similar to dual-purpose “fiscal-behavioral” sin taxes on alcohol and tobacco products (with the “sin” in this case being carbon emissions).

Options for the use of proceeds include wholly or partially allocating proceeds in a number of ways and several recurring themes come up in the literature. For proceeds from the New Zealand ETS the options for use of the proceeds can be characterised as follows:

- GHG emission reducing projects - matching the use of proceeds to other activities that serve the purpose of the trading scheme or carbon tax
- Broader “green” objectives – utilising the proceeds from carbon reduction for other externalities
- Even broader social objectives (that struggle for funding otherwise) – this includes addressing any regressivity of the carbon cost
- Offsetting taxation on economic enhancing activities – this is where the proceeds are applied to targeted taxation to balance the economic impact of carbon pricing.
- Government’s general expenditure – this includes paying down debt where government is running a budget deficit.

The evidence suggests the greater the annual per capita revenue extracted through carbon pricing or a carbon tax, the less the propensity to earmark it for specific projects or categories of projects. Thus schemes that obtain revenue from marginal emissions (where for example some baseline emissions are grandfathered or exempt) result on lower per capita emissions. Revenue from a carbon tax regime tend

¹ Carl, J., & Fedor, D. (2016). *Tracking global carbon revenues: A survey of carbon taxes versus cap-and-trade in the real world*. Energy Policy, 96, 50-77.

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result in higher per capita revenue because carbon taxes tend to be more comprehensive so in those jurisdictions proceeds may be less likely to be fed back into projects.

Given the level of per capita revenue governments then select the proportions of revenue to be allocated by category of qualifying investments or specific investments. For example Den et al (2017)² report:

The EU ETS Directive (Directive 2003/87/EC) provides that at least 50% of the revenues generated from the auctioning of allowances (or the equivalent in financial value of these revenues) should be used to support the achievement of specific climate and energy activities. This intention is further declared in a 2008 European Council Statement on the use of auctioning revenues.

The EU ETS Directive (Article 10) lists the climate and energy objectives and/or measures on which the money should be spent. This includes, inter alia, the reduction of greenhouse gas emissions, the development of renewable energies, carbon capture and storage, energy efficiency (and related research and development) a shift to low emission and public forms of transport and measures to avoid deforestation. The revenues may also be used to cover administrative expenses of the management of the ETS.

Carl and Fedor ((2016)³ provide estimates of the value of proceeds from carbon trading and carbon taxes allocated across 56 jurisdictions:

We estimate that more than \$28.3 billion in government “carbon revenues” are currently collected each year in 40 countries and another 16 states or provinces around the world. Of those revenues 27% (\$7.8billion) are used to subsidize “green” spending in energy efficiency or renewable energy, while 26% (\$7.4billion) go toward state general funds. Notably, 36% (\$10.1billion) of today's carbon revenues—the largest share overall – are returned to corporate or individual taxpayers through paired tax cuts or direct rebates. Our observations of carbon pricing in the real world suggest that while the form of a carbon pricing system may be theoretically interchangeable in terms of incentivizing emission reductions, system form does seem to matter in terms of how revenues are used. Namely, cap-and-trade systems earmark a larger share of global revenues for additional “green” spending, while carbon tax systems more commonly refund revenues or otherwise direct them towards government general funds.

Carbon pricing is intended to introduce the cost of an externality into the economy so firms and households feel the direct impact of their decisions. Allocation of proceeds offers government an opportunity to make economies more efficient, strategically cushion the impact of environmental policies on costs and buy off political opposition to climate-change mitigation. Bowen (2015) summarises the use of carbon pricing revenues in a number of jurisdictions as shown in Table 1.⁴

² Xavier Le Den, Edmund Beavor, Samy Porteron, Adriana Iliescu (2017) *Analysis of the use of Auction Revenues by the Member States* For the European Commission Directorate-General for Climate Action

³ Carl, J., & Fedor, D. (2016). *Tracking global carbon revenues: A survey of carbon taxes versus cap-and-trade in the real world*. Energy Policy, 96, 50-77.

⁴ Alex Bowen (2015) *Carbon pricing: how best to use the revenue?* Policy Brief

Table 1 use of carbon pricing revenues in practice

Country/jurisdiction	Start date	Use of carbon pricing revenues
Finland	1990	General central government budget; some reductions in personal income taxes and employers' social security contributions later (no formal hypothecation)
Netherlands	1990	Some reductions in personal income taxes and employers' social security contributions (no formal hypothecation); climate mitigation programmes
Norway	1991	General central government budget; some reductions in personal income taxes (no formal hypothecation)
Sweden	1991	General central government budget; some reductions in personal income taxes and (later) employers' social security contributions (no formal hypothecation)
Denmark	1992	Environmental subsidies and returned to industry; some reductions in personal income tax and employers' social security payments (no formal hypothecation)
UK	2001	UK 2001 Initial reductions in employers' social security payments (no formal hypothecation)
Boulder, Co	2007	Boulder, CO 2007 Climate mitigation programmes
Quebec	2007	Quebec 2007 Climate mitigation programmes
British Columbia	2008	British Columbia 2008 Reductions in business and personal taxation; "revenue neutrality" mandated
California	2013	Some free allocation of quotas to emitters; spending for environmental purposes, with an emphasis on improving air quality; at least 25 per cent to be spent on programmes that benefit disadvantaged communities
Sources: Sumner et al. (2011), ICMM (2013), C2ES (2014).		

Table 2 lists the options for proceeds and provides the Carbon Pricing Leadership Coalition's⁵ summary views on the opportunities and challenges associated with each.

⁵ The Carbon Pricing Leadership Coalition is an action based platform made up of government and industry leaders in set up on the back of support for carbon pricing from 74 countries and 1,000 companies at the United Nations Climate Summit in September 2014.

Table 2 pros and cons of common options for revenue use

Approach	Opportunities ⁶	Challenges ⁷
GHG emission reducing projects	<ul style="list-style-type: none"> • Funding prioritisation • Corrective potential • Thematic coherence and public support 	<ul style="list-style-type: none"> • Market distortions • Negative perception of increased public spending • Risk of inefficiency • Inadequate level of expenditures • Picking winners
Channelled into broader “green” projects	<ul style="list-style-type: none"> • As above 	<ul style="list-style-type: none"> • As above
Applied to meet social objectives	<ul style="list-style-type: none"> • Address household fairness • Enhance public support 	<ul style="list-style-type: none"> • Potentially missed productivity opportunities
Targeted taxation	<ul style="list-style-type: none"> • Improve efficiency of tax system burden to improve public support • Promote economic activity 	<ul style="list-style-type: none"> • Preferential treatment of certain groups • Ensuring efficacy of carbon price
General government expenditure	<ul style="list-style-type: none"> • Increased resource availability • Economic support 	<ul style="list-style-type: none"> • Lack of clear returns
Debt reduction	<ul style="list-style-type: none"> • Long term economic benefits • Intergenerational affordability 	<ul style="list-style-type: none"> • Limited public appeal
Transitional support for industry	<ul style="list-style-type: none"> • Drive economic growth • Reduce industry opposition 	<ul style="list-style-type: none"> • Ensuring efficacy of carbon price • Picking winners and vested interests.

The pros and cons in the table above are generic. The approach taken by the Zealand Government on the use of proceeds from the NZ ETS has to weigh the amount of the proceeds to be applied, what policy makers in New Zealand want to achieve across a number of fronts and the public’s potential response to whatever is proposed. Marron and Morris (2016) put it this way:⁸

In deciding how to use carbon revenues, policymakers, analysts, and advocates must consider both policy goals and political realities. Policy goals can differ widely. Environmental advocates often believe that revenues should be used to support further efforts at cutting greenhouse gas emissions (Cottrell et al. 2013; Esch 2013). Analysts worried about the poor want to ensure some revenues are used to offset their burdens (Stone 2015). Tax reformers may see the revenue as a way to reduce business and personal taxes (Marron and Toder 2015). Budget hawks may see the revenue as a way to reduce government deficits (Gale, Brown, and Saltiel 2015). And so on.

⁶ Carbon Pricing Leadership Coalition (2016) *What Are the Options for Using Carbon Pricing Revenues?*

⁷ *ibid*

⁸ Donald B. Marron and Adele C. Morris Brookings Institution (2016) *How To Use Carbon Tax Revenues*

Marron and Morris go on to list 5 lessons that governments' should heed when considering the use of proceeds. One point they make is that the combined approach to carbon pricing and the use of proceeds that gives businesses and consumers a reasonable expectation that the approach will endure in the long run will be more environmentally successful than one that people think may not survive the next election. That is offset by others such as Bowen (2015) who argue equally as forcefully that treatment of proceeds should be able to change as the mix of policies and merits of proceeds allocation approaches shift.

In the New Zealand context we suggest a number of elements should be taken into account when the use of proceeds is considered

- The combined impact of all policies aimed at reducing GHG emissions and the case for augmenting other policies aimed at reducing GHG emissions with the proceeds
- The case for using the proceeds from carbon pricing is an option to target green objectives beyond the narrow target of reducing GHG emissions (for example water quality).
- The case for cushioning the side effect of carbon pricing amongst certain sectors of the economy or just using the proceeds for other social objectives
- Opportunities to improve the functioning of tax-benefit systems, particularly to mitigate any adverse effects of carbon pricing or reduce any economic disincentives to reduce GHG emissions in the current tax system
- The costs and benefits of the options policy makers consider
- Feedback gained through consultation.

Table 3 Options for using auction revenues, and mechanisms for funnelling these revenues

Options for using auction revenues	Mechanisms for funneling auction revenues	Legal instruments
Recycling proceeds to GHG reducing emissions that are otherwise not being supported	<ul style="list-style-type: none"> • Green Investment Fund • Funding CCC and initiatives they wish to progress • Channeling funding through EECA (under its renewed strategic direction) • R&D grants esp agritech 	<ul style="list-style-type: none"> • GIF Act and Regulation?
Targeting green objectives beyond the narrow target of reducing GHG emissions	<ul style="list-style-type: none"> • 	<ul style="list-style-type: none"> •
The case for cushioning the side effect of carbon pricing amongst certain sectors of the economy or just using the proceeds for other social objectives	<ul style="list-style-type: none"> • Taxation • MSD • Funding for community organisations • Targeted schemes such as community housing 	<ul style="list-style-type: none"> •

Mitigating any adverse effects of carbon pricing or reduce any economic disincentives to reduce GHG emissions	<ul style="list-style-type: none">• Taxation	<ul style="list-style-type: none">•
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Feedback on Treasury hypothecation report

Date Submitted:	21/11/2019	Tracking #: 2019-B-06254	
Security Level	IN CONFIDENCE	MfE Priority:	Non-Urgent

	Action sought:	Response by:
To Hon James Shaw, Minister for Climate Change	"note this Briefing"	25/11/2019

Actions for Minister's Office Staff	Return the signed report to MfE.
Number of appendices and attachments	Nil
Note any feedback on the quality of the report	

Ministry for the Environment contacts

Position	Name	Cell phone	1 st contact
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Feedback on Treasury NZ ETS revenue hypothecation report

Key Messages

1. The purpose of this briefing is to update you with our feedback on the Treasury report *ETS Revenue and Mitigation Spending Options* that you received on 15 November 2019.
2. We broadly support the advice within the Treasury report.
3. There are two additional key messages that we wish to bring to your attention:

a. s 9(2)(f)(iv)

- b. We want to highlight that it is likely that the cash received from the ETS (either through the fixed price option or auctioning) is likely to receive more public attention than the accounting revenue.

s 9(2)(f)(iv)

Cash vs. revenue

9. NZ ETS revenue refers to both the cash revenue from auctioning and the non-cash revenue from when NZ units (NZUs) are surrendered to the Government.
10. The Treasury report focusses almost entirely on the use of NZ ETS revenue, without differentiating between cash and non-cash revenue. In overseas markets, public attention and hypothecation decisions have focussed much more strongly on the auction cash that governments receive from the ETS. This public focus on cash doesn't change the accounting considerations for the Government, but it does change the public perception of how much money is available for government use.

11. It is likely that any specific use of the NZ ETS revenue will come under most public scrutiny at the time when the Government receives the cash, rather than when the units are surrendered, due to the greater visibility.

Signature

Mark Storey
Acting Director, Climate Change

Hon James Shaw
Minister for Climate Change

Date

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