

In Confidence

Commercially sensitive

Office of the Minister for Climate Change

Chair

Cabinet Environment, Energy and Climate Committee

APPROVAL TO CONSULT ON NEW ZEALAND EMISSIONS TRADING SCHEME SETTINGS

Proposal

1. I seek your approval to publish a consultation document on regulatory proposals for New Zealand Emissions Trading Scheme (NZ ETS) settings. These proposals implement the improvements being made to the NZ ETS through the Climate Change Response (Emissions Trading Reform) Amendment Bill (the Emissions Trading Reform Bill). The proposals will begin to align the settings of the NZ ETS with the emission reduction targets recently passed into law through the Climate Change Response (Zero Carbon) Amendment Act 2019. It includes proposals regarding a provisional emissions budget, emissions unit auction supply volumes, and price controls.
2. I also seek approval to release a *Framework for International Carbon Market Cooperation* document, which will be released online at the same time as the consultation document. The NZ ETS is currently closed to international carbon markets and I am not proposing to change this now.

Executive summary

3. The NZ ETS is the Government's key policy tool for reducing greenhouse gas emissions, meeting our climate change targets and transitioning to a low emissions economy. It is important that the Government is able to manage the supply of emissions units into the NZ ETS to align with our emissions budgets and climate change targets.
4. Historically, the NZ ETS has not had a cap on the number of emissions units available within the scheme. This was primarily an issue when the scheme was open to international emissions trading markets, causing an influx of units, a major drop in the New Zealand Unit (NZU) price and the build-up of a significant unit stockpile.
5. This Cabinet has agreed to improve the NZ ETS through amendments to the Climate Change Response Act 2002 (CCRA) [CAB-17-MIN-0547.01 refers]. The

Climate Change (Emissions Trading Reform) Amendment Bill 2019 was introduced to the House on 24 October 2019.

6. The Emissions Trading Reform Bill provides a framework for key aspects of the structure of the NZ ETS, including beginning Government auctioning of NZUs and allowing for emissions within the NZ ETS to be capped. The specific details of how parts of the framework will operate in practice, including the finer operational details and quantitative settings necessary for creating and implementing the cap, will be made through regulations.
7. Three critical sets of regulations need to take effect alongside the passing of the Emissions Trading Reform Bill: regulations on NZ ETS settings, auctioning rules and forestry accounting. Consultation has started on proposed auctioning rules [CAB-19-MIN-0580] and on forestry accounting [ENV-19-MIN-0054 and CAB-19-MIN-0561 refer]. This Cabinet paper seeks approval to begin consultation on NZ ETS settings. The regulatory settings will directly affect the emissions trading market, influence NZU prices, and catalyse the transition to a low emissions economy.
8. The high level decisions to put a cap on emissions and a cost containment reserve price control mechanism on the NZ ETS have already been taken [EGI-17-MIN-0369 refers] and this consultation is an opportunity to draw out more specific and relevant feedback on the potential impacts of the proposed settings.
9. The consultation document seeks views on a provisional emissions budget for the period 2021-2025, which will be the forerunner of the budgets set under the Zero Carbon Act. The provisional emissions budget will be used to determine the supply of NZUs available for the Government to auction annually under the reformed scheme.
10. The consultation document also seeks feedback on price control settings. This includes a new price ceiling mechanism called a cost containment reserve and a price floor that will be implemented through an auction reserve price. The cost containment reserve works as a backstop to avoid the possibility of unexpectedly high prices by releasing an additional supply of units when a specified price trigger is reached. Trigger prices are the upper extreme of NZU prices and therefore should be used rarely, if at all, and not be the key driver for the market price.
11. An analysis conducted by Treasury in August 2019 found that if NZU prices were to rise to the proposed trigger price of \$50 in 2020 it would likely have a moderate impact on families, being an increase in costs for middle-income households by \$3.40 (0.3%) per week.
12. The consultation document also proposes a transitional arrangement to bridge between current policies and the NZ ETS unit supply and price settings. This arrangement will address the risk of unit supply issues in 2020, which may otherwise destabilise the market and result in cost and investment uncertainty. I propose to allow NZ ETS participants to meet their 2020 obligations by using the fixed price option, which I propose is increased to \$35 per NZU for activities over 2020. This transitional arrangement will require changes to the Emissions Trading Reform Bill through a Supplementary Order Paper, subject to Cabinet agreement.
13. I acknowledge that some stakeholders may react negatively to the proposed increased price settings and that there is likely to be a fiscal cost from expected use of the fixed price option. Raising the fixed price option to \$35 for 2020 emissions, is

likely to reduce its use in 2021 and the fiscal costs. While there will be an economic impact from increased emissions prices, the sooner it occurs, the sooner it will encourage more immediate investments in low emissions technologies and practices and lower the overall economic costs in the future.

14. There are options for when to begin consultation. Consulting as soon as possible on the proposed settings will allow consultation to take place at a similar time to when the Select Committee is considering the Emissions Trading Reform Bill. This will allow the public to consider the proposals for regulations and the proposed amendments to the CCRA as a package.
15. Consulting as soon as possible on specific volumes and prices also provides the market with greater clarity regarding the Government's intentions, allowing for early visibility, limiting the risks of more sudden market shocks in the future, and providing regulatory certainty and predictability for NZ ETS participants. Ensuring that this happens before 2019 emissions surrenders are due by May 31 2020 will provide the market with more relevant information to inform decision making.
16. Postponing consultation to 2021 would delay New Zealand's transition to a low emissions economy and further erode the effectiveness of the NZ ETS as a tool to help meet future emissions targets. Regulatory uncertainty will continue, investment decisions will be changed or delayed, and opportunities will be lost. It also risks undermining the credibility of the NZ ETS internationally if we delay the introduction of capping our greenhouse gas emissions. I anticipate this could reduce our ability to keep the option open of accessing international carbon markets if this makes sense in the future.
17. The attached consultation document seeks feedback on these proposals (Attachment 1: *Reforming the New Zealand Emissions Trading Scheme: Proposed Settings*)
18. I seek approval to release the consultation document to support public consultation over a ten week period across December 2019, and January and February 2020. This period includes the Christmas break so is longer than the typical consultation period to ensure there is sufficient time for people to review and submit feedback, but will still allow for the consultation to begin before the 2020 surrender year begins.
19. Attachment 2 contains a document that considers New Zealand's potential future access to international carbon markets (*Framework for International Carbon Market Cooperation*). I seek feedback on this document and approval for it to be released at the same time as the NZ ETS settings consultation document. The NZ ETS is currently closed to international carbon markets, and no proposals are made to currently change this. However, the framework discusses the potential objectives for any future cooperation and the key principles that New Zealand would consider before engaging in international carbon markets.

Background

The emissions trading scheme is a key tool to support meeting our climate change targets and in transitioning to a low emissions economy

20. Cabinet made decisions to amend the CCRA to establish a framework for NZ ETS settings in December 2018 [CAB-18-MIN-0606.01 refers]. The bulk of these

changes are part of the Emissions Trading Reform Bill, which had its first reading on 5 November 2019 and was referred to the Environment Select Committee for consideration.

21. Included in those changes are several provisions to enable the development of regulations. The Emissions Trading Reform Bill allows for consultation on proposals for NZ ETS supply regulations to take place before it has passed, to enable consultation alongside public submissions on the bill.
22. Regulations for controlling the supply of NZUs into the NZ ETS will support New Zealand to meet our Nationally Determined Contribution under the Paris agreement and the 2050 target set under the CCRA provisions made by the Climate Change Response (Zero Carbon) Amendment Bill 2019 (Zero Carbon Act). NZ ETS settings will provide stability and certainty to help ensure smoother transition to a low emissions economy. It will also allow the Government to manage the scheme in a way that supports a just transition, because it will provide the tools to manage the price of NZUs in a way that encourages emissions reductions without causing shocks to the economy.
23. The amendments included in the Emissions Trading Reform Bill and the regulatory proposals for NZ ETS settings are interdependent. The amendments, proposals, and the auctioning rules, should be considered a package.

Comment

Aligning proposed NZ ETS settings to our emissions targets

24. New Zealand has emissions reductions targets under the Zero Carbon Act and the Paris Agreement. Decisions about NZ ETS settings need to take both of these targets into account.
25. The Emissions Trading Reform Bill and the Zero Carbon Act implement their targets through two mechanisms. First, the Zero Carbon Act allows emissions budgets to be set for five-year periods, which will guide climate change-related policy toward achieving the Zero Carbon Act target and the Paris Agreement contribution. Secondly, the Emissions Trading Reform Bill requires regulations for NZ ETS settings, which control the supply of NZUs into the NZ ETS to best achieve the emissions budgets.

The provisional emissions budget

26. The Emissions Trading Reform Bill requires the Crown to set a provisional emissions budget in order to guide decisions on regulations for overall emissions limits and price control settings. The provisional emissions budget will set the amount of greenhouse gases New Zealand can emit over the period 2021-2025. The attached consultation document proposes a provisional emissions budget of 354 Mt CO₂-e for this period, based on straight line reductions towards the Zero Carbon Act 2050 targets.
27. New Zealand's forecast net emissions under current policies are 368 Mt CO₂-e for the period 2021-2025. Meeting the proposed provisional emissions budget would

require an additional 13 Mt CO₂-e of emissions reductions or sequestration beyond current forecasts.¹

28. This target is ambitious. Meeting it will require immediate efforts to reduce emissions, influenced by an increased emissions price. While we have already started to take action to reduce domestic emissions through policies such as the One Billion Trees Programme, the renewable energy strategy, and the proposed Clean Car package, most of these options will take time to deliver and only have recognisable impacts on emissions reductions in the medium-to-long term.
29. If other Government emissions reduction policies deliver greater than projected reductions in the short-term, this could have the impact of reducing emissions prices due to more units being available within the NZ ETS emissions cap. These outcomes are measured in every five-year rolling emissions budget. One possible action could be to reduce the cap further by adjusting the volume of units auctioned.
30. Achieving this proposed provisional emissions budget will require a higher emissions price alongside other policies such as through direct investment opportunities, other regulatory measures and sector-specific policies. Afforestation remains one of the most cost effective ways to meet our targets in the short-term as the economy shifts over time to reduce gross emissions.
31. The proposed provisional emissions budget is consistent with our long-term emissions reduction targets, because it is aligned with a straight-line path from current levels of emissions towards the 2050 target. Making emissions reductions more slowly than this straight-line approach would risk needing a more abrupt and potentially disruptive transition in the future. Going faster would be challenging to achieve given the limits to the speed with which physical assets can be replaced in a short time, such as vehicles and factory equipment.
32. The Climate Change Commission established by the Zero Carbon Act (the Commission) will recommend future emissions budgets, which the Minister then sets and notifies. The Commission is expected to recommend the first three emissions budgets in 2021 for the periods 2022-2025, 2026-2030 and 2031-2035. The provisional emissions budget will be superseded by the emissions budget for 2022-2025, but cannot wait until 2021 as this would delay setting an official cap on emissions in the NZ ETS for another year.

Timing and content of NZ ETS settings regulations

33. Decisions on NZ ETS settings will be announced annually by the Government and apply to the upcoming five years. In this process, the NZ ETS settings for the first two years are fixed unless there are special circumstances that require a change. Levels for the three years following are set and announced, but can be adjusted. This method ensures participants will always have a five-year look ahead of settings to increase confidence and provide predictability, while allowing the Government some flexibility to continue to align the scheme with emissions budgets and targets, and respond to changing circumstances.
34. The regulations for NZ ETS settings will determine:

¹ The 'missing' 1 Mt CO₂-e is due to rounding

- 34.1. the overall limit on emissions covered by the NZ ETS (excluding units for removals and certain pre-existing transfers²);
- 34.2. the limit on any use of international units by participants (if the NZ ETS were to be reopened to international markets in future);
- 34.3. the quantity of NZUs available to be auctioned;
- 34.4. price control settings, being the NZU price trigger for the cost containment reserve ('price ceiling') and auction reserve price ('price floor'); and
- 34.5. the quantity of NZUs available in the cost containment reserve.

Proposals for capping the New Zealand Emissions Trading Scheme

35. The Emissions Trading Reform Bill will give the Government the ability to set annual caps on the emissions covered by the NZ ETS through the coordinated decision-making process described in paragraph 33.
36. The provisional emissions budget is the starting point in determining the overall NZ ETS settings. A series of adjustments are made to this budget to reach the annual NZU auction quantity. The auction quantity is the most important lever and can be adjusted to ensure that the NZ ETS supports us to meet our targets.

The overall NZ ETS unit supply limit

37. The consultation document seeks views on unit supply settings for the NZ ETS from 2021 to 2025. These settings directly affect the emissions trading market, will quickly influence NZU prices, and will catalyse the transition to a low emissions economy.
38. The Emissions Trading Reform Bill sets out a number of matters the Minister for Climate Change must have considered before recommending unit supply limits:
 - 38.1. projected trends in emissions covered and not covered by the NZ ETS;
 - 38.2. the proper function of the NZ ETS;
 - 38.3. the use of international units and markets;
 - 38.4. the forecast availability and cost of ways to reduce emissions and meet targets;
 - 38.5. recommendations of the Climate Change Commission;
 - 38.6. any other matters I consider relevant.
39. Before recommending price control settings, I am required to also consider:
 - 39.1. the impacts of emissions prices on households and businesses;
 - 39.2. international emissions prices;
 - 39.3. Inflation.
40. I have considered those matters, as detailed in the consultation document.

² The limit also does not restrict units allocated for eligible industrial activities or eligible agricultural activities, or provided in accordance with historic negotiated greenhouse agreements.

41. I have proposed a NZ ETS emissions cap for 2021-2025 (an overall limit on emissions covered by the NZ ETS) of 151 million NZUs, made up of these key sources of emission unit supply:
 - 41.1. the expected volume of units to be freely allocated (44 million NZUs);
 - 41.2. the volume of units to be auctioned (80 million NZUs);
 - 41.3. the import of international units (zero);
 - 41.4. the use of units already in participants' accounts (the stockpile) (27 million NZUs).

The international unit limit in the NZ ETS

42. I propose an international unit limit for the period 2021-2025 of zero. No decisions have been made regarding New Zealand's access to international carbon markets. It is also important that we focus immediately on decarbonising New Zealand's economy rather than seeking to import units to offset our gross emissions.
43. The five-year rolling cap requires this limit on international units to be reconsidered and adjusted annually as part of the coordinated decision-making process, ensuring that the appropriate balance will be struck between domestic and offshore mitigation.
44. Although the current proposal for international units is zero, it is important that there is transparency to the public regarding how cooperation with international carbon markets would occur. Therefore, within the discussion document section on international unit limits there will be a link to a webpage that the public can access if they require further information regarding this framework. The framework document is included in *Attachment 2*.

Price control settings

45. Price controls provide the Government with a mechanism to help manage unacceptably low or high prices in the NZ ETS and limit the risk of prices falling outside of a range needed to meet an emissions budget. All other emissions trading schemes currently include some price control features.
46. Price controls also provide a secondary function by signalling to the market expectations of future emissions prices. The price ceiling and floor enable businesses to develop long-term expectations of their costs of participating in the NZ ETS to better inform their investment decisions and business planning.
47. I propose the introduction of a price floor, which would take the form of a reserve price at auction. This means the government would not sell units below this price, although it would not prevent the secondary market from trading below this value. An annually increasing auction reserve price floor allows investors to plan for future emissions costs and/or assess the potential revenue from emissions removals. The document proposes a value of \$20 for 2020, increasing \$2 per year over the period 2020-2025.
48. In proposing this setting, the consultation document notes
 - 48.1. Businesses wanting to decrease costs related to emissions pricing can use the price floor as a basis for calculating the likely minimum costs of NZ ETS

compliance and justifying whether making investments in low-emissions technologies or practices will be viable.

- 48.2. The price floor also can provide investors in forestry an indication of the forecast revenue to be earned by investing in new forest planting.
 - 48.3. An increasing price floor ensures that the Government will not be obliged to sell NZUs at auction for less than the specified price floor value. This protects the Government from making longer-term financial losses by selling NZUs for less than the potential cost to the Crown of issuing these units.
 - 48.4. The risk that a price floor below the likely future level of international emissions prices by 2030 would have important fiscal implications. If the Government were to sell units at auction during 2020–25 for less than their expected future value, this could result in the Government locking-in expected losses if it then needed to purchase higher-priced international units or directly fund additional domestic abatement in the future. International emissions prices have been trending upwards, and the current average of the four main comparable markets is approximately NZ\$30 per tonne.³
49. I also propose a price ceiling be implemented through a ‘cost containment reserve’. The consultation document proposes a price trigger for the cost containment reserve that starts at \$50 in 2020 and rises at \$10 per year over the period 2020-2025.
 50. The cost containment reserve trigger price is intended to be set outside the expected cost of emissions abatement for meeting our targets, and should therefore be used rarely, if at all. While this price trigger is the upper extreme of expected and acceptable prices in the NZ ETS, it will not be the key driver for the market price, which will be ultimately determined by unit supply and demand. It is a backstop mechanism and does not represent a forecast that NZU prices in the market are expected to reach \$100 by 2025.
 51. The current price ceiling mechanism, the \$25 fixed price option, has provided a high degree of market stability in recent years. However, in 2019 it led to Operating Balance before Gains and Losses (OBEGAL) reductions for the Crown due to participants being able to purchase emissions reductions at a price that was less than the market value of an NZU at the equivalent time. This is expected to also occur for emissions surrenders due in 2020 relating to 2019 emissions.
 52. Under the current drafting of the Emissions Trading Reform Bill, this ceiling will be replaced by the cost containment reserve when the first NZU auction occurs.
 53. Removal of the fixed price option is a key reform to the scheme, however, I am concerned that this status quo of immediate removal upon auction may create unstable emission prices over the next year, leading to cost uncertainty for participants, households and the economy.
 54. Should a trial auction of a small volume of NZUs take place in late 2020, as has been signalled, then under the current proposal in the Emissions Trading Reform Bill, the fixed price option will be automatically removed. The immediate removal of the fixed price option will give substantial market power to persons holding

³ The EU, Beijing, Korea and California schemes.

emissions units, due to constrained emissions unit supply added to the market throughout 2020. Consequently, there is a risk of rapid escalation and short term volatility in NZU prices until more significant supply becomes available through auctions in 2021.

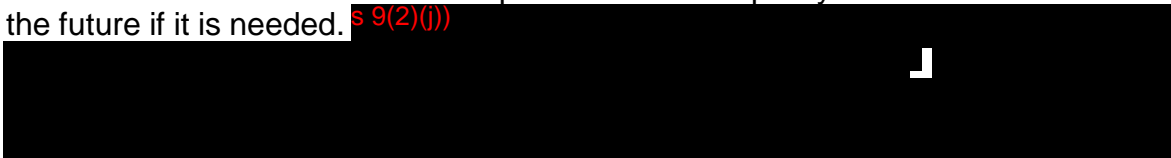
55. In order to mitigate risks relating to market stability and consequent costs, I propose the fixed price option remains available to participants to use in 2020 and 2021 to meet obligations arising from 2020 activities, even if auctions have already occurred. I also propose increasing the fixed price option for surrender obligations arising from activities over the 2020 calendar year to \$35 per NZU.
56. Increasing the fixed price option to \$35 is consistent with our need for accelerating emission reductions to meet targets, while also supporting the cost and regulatory certainty requirements of participants. This level is the mid-point between the proposed initial price floor (\$20) and price ceiling (\$50) and therefore provides the smoothest possible price path from the existing NZ ETS settings to the new. Increasing the fixed price option also reduces the likelihood of it seeing extensive use in 2021, and minimises the risks related to reduced OBEGAL.
57. Should Cabinet agree to this change, contingent on feedback from consultation, it will be introduced via Supplementary Order Paper. In the meantime, I will ask the Select Committee to consider market stability as the NZ ETS transitions to the proposed unit supply and price settings.
58. I stress that I consider it unlikely that the NZU price would reach the cost containment reserve trigger price, given the size of the stockpile and the range of emissions abatement options available.
59. Work to date has identified a range of opportunities that can deliver net cost savings to the New Zealand economy, even without pricing emissions. These include improving energy efficiency in process heat and electricity use, and improving vehicle fuel efficiency and adopting electric vehicles. Many opportunities are available at low-to-moderate costs that could collectively deliver substantial emissions reductions, such as:
 - planting new forests, extending forestry harvest rotations, and avoiding deforestation (\$0 - \$50/tCO_{2e})
 - building wind farms or geothermal power stations to displace gas- and coal-fired electricity generation (\$25 - \$100/tCO_{2e})
 - switching from coal and diesel to biomass or electricity for low- and medium-temperature process heat (\$50 - \$100/tCO_{2e})
60. The key considerations listed in the Emissions Trading Reform Bill when making decisions on the proposed price ceiling are:
 - 60.1. the range of acceptable emissions prices that will be required to achieve the emissions reductions required to deliver the provisional emissions budget
 - 60.2. impacts on New Zealand households, including how these impacts are distributed across the population
 - 60.3. impacts on businesses and the economy
 - 60.4. the level and trajectory of international prices.

61. Regarding impact on households, a preliminary analysis led by the Treasury in August 2019 showed that the direct impacts of higher emissions prices on households was likely to be moderate, on average. For example, doubling emissions prices (to \$50) from today's level (\$25) would increase costs for middle-income households by \$3.40 (0.3%) per week.
62. Treasury noted that the lowest-income households face a slightly greater impact from emissions pricing because they spend a larger proportion of their income on emissions-intensive goods. An increase in the emission price to \$50 would see households in the lowest 20% of income levels increase their weekly costs by \$2.00 (0.4%). With fewer resources, lower income households will have less ability to change behaviour or invest to reduce their exposure to emissions prices.
63. The Treasury analysis was based on assumptions of no significant behaviour change, no improved vehicle fuel efficiency and no uptake of higher renewable electricity. Therefore, I consider that even these relatively low estimates are likely to be higher than what actually occurs. This is in line with previous emissions reductions related forecasts, which have generally ended up being less than originally predicted.
64. In our recent Cabinet paper 'Transition to a low emissions economy', myself and the Minister for Economic Development identified our expectation that emissions prices in the NZ ETS will not go beyond \$35 in the short-to-medium term, or beyond \$50 in the long term [ENV-19-MIN-0023 refers]. The Productivity Commission, for the Low Emissions Economy report, modelled a range of pathways to different target options. The modelled scenarios, consistent with our announced 2050 target, show prices at 2030 between \$25-\$50/tonne CO₂e.
65. The effectiveness of the cost containment reserve in dampening emission unit prices is dependent on the volume of units allowed for release, and the impact this additional supply has on the required demand. I am proposing that the quantity of NZUs initially available in the cost containment reserve be based on 90 per cent of the difference between forecast net emissions covered by the ETS, and the quantity of NZUs supplied into the scheme through free allocation and auction. This would allow the majority of NZUs required to meet annual surrender obligations to be made available if the reserve was released, without providing a total quantity that would require no emissions reductions be made, or stockpile units used.
66. This would result in a cost containment reserve of 5.8 million NZUs in 2021, 6.3 million NZUs in 2022, 7.2 million NZUs in 2023, 8.2 million NZUs in 2024 and 8.9 million NZUs in 2025. Given that auctioning is likely to begin at the end of 2020, for that year I propose a nominal quantity of only 1 million NZUs in the cost containment reserve.
67. Although the above reserve will be proposed in the consultation document with supporting rationale, the market response to the release of the cost containment reserve is an area that is particularly difficult to predict. Therefore, to inform the final regulation settings made, the Ministry intends to have discussions with a group of industry experts during the consultation period to gain further advice on the potential market implications of releasing different reserve quantities.

Other proposals

68. The consultation document also seeks feedback on the approach for release of information about NZ ETS settings. The proposal is to release information in a way that provides certainty for participants and avoids disruption of the market.

Guidance is needed for engagement with offshore markets

69. The Zero Carbon Act target is required to be met, as far as possible, through domestic reductions and removals of emissions. Nationally Determined Contributions under the Paris Agreement represent a country's highest possible mitigation ambition. When New Zealand communicated its first Nationally Determined Contribution, the Government at the time noted that it expected to use a combination of domestic reductions and removals, as well as offshore mitigation, to meet it.
70. Cabinet has agreed it would maintain options for securing access to international carbon markets if this makes sense in the future [CAB-18-MIN-0248 refers], but also agreed that there would be limits placed on the use of offshore mitigation [CAB-18-MIN-0248 and EGI-17-MIN-0369 refer].
71. Work is needed now so we have options to access quality international markets in the future if it is needed. § 9(2)(j)
 To keep the option open of potentially accessing such international carbon markets in the future, we will need to introduce changes to the NZ ETS, such as a cap on our ETS emissions, to demonstrate the robustness of our system.
72. In order to ensure that New Zealand would only access international markets with environmental integrity, I propose that Cabinet agree that the *Framework for international carbon markets cooperation* be used to guide officials' engagement with potential cooperation partners (attachment 2). The framework would ensure that officials' early engagement with potential partners is within boundaries set by Cabinet. This includes principles such as environmental integrity, transparency, proportionality and consistency with wider domestic climate policy. It also outlines objectives such as supporting the stability of the NZ ETS, and flexibility for New Zealand's transition pathway.
73. This framework would be superseded by a negotiating mandate from Cabinet for any formal negotiations. Cabinet's approval would also be required to conclude negotiations and implement any instrument, before any international transfers could be made. I expect this process to take several years.
74. I will report back to Cabinet if any of the potential arrangements come to the point at which formal negotiations may be ready to begin.

Risks

75. The Government is running this consultation alongside the Parliamentary process for the Emissions Trading Reform Bill to enable stakeholders to be able to review and provide feedback on the legislative and regulatory proposals at similar times. The Emissions Trading Reform Bill specifically empowers consultation on regulations prior to the bill coming into effect, so there is limited risk to the legality of this process. However, because the bill will not yet have passed, there is a risk that changes made to it by Parliament may impact on the regulations proposed in the consultation document.
76. Officials will ensure that they consider feedback provided to Select Committee on the Emissions Trading Reform Bill and feedback provided as a result of consultations on regulations as a package, when forming final policy decisions early next year. These decisions will come before Cabinet as final policy decisions to make regulations, and any bill changes that the departmental report recommends via Select Committee.
77. The proposed regulations for NZ ETS settings within the consultation document are based on our forecasts for future emissions. Although officials frequently improve the modelling and evidence base for emissions reductions, proposals based on forecasting will always carry a degree of risk related to accuracy and unexpected changes. For this reason, the Emissions Trading Reform Bill enables the limits and price control settings to be adjusted out-of-schedule if the cost containment reserve is triggered, the price floor is hit, or in the case of various other unexpected changes to criteria, emissions budgets, or force majeure events.
78. Proposing specific settings within the consultation document also poses a market sensitivity risk around releasing new information to the market that may send signals regarding the NZU price that influence participants' buying and selling behaviour.
79. Officials believe that the settings proposed in the consultation document are sufficiently justified and relatively in line with what has previously been signalled to the market, so should not cause any abrupt shocks to the NZU price.

Next Steps

80. I propose to announce the consultation on NZ ETS regulations immediately following approval by Cabinet.
81. To complement the release of the consultation document, a series of stakeholder workshops will be scheduled.
82. I intend to report back to Cabinet on the outcomes of consultation and seek final policy decisions and approval to issue drafting instructions on the new regulations before the middle of 2020.

Consultation

83. This paper was prepared by the Ministry for the Environment. The Treasury, the Ministry for Primary Industries, the Ministry of Justice, the Ministry of Transport, the Department of Conservation, the Environmental Protection Authority, the Ministry of Foreign Affairs and Trade, and the Ministry of Business, Innovation and

Employment were consulted in its preparation. The Department of the Prime Minister and Cabinet and Te Puni Kōkiri were informed. Where feedback was received it is reflected in this paper.

Financial implications

84. The consultation timing options have different financial implications. These result from the transition from the fixed price option to the new price ceiling mechanism, the cost containment reserve, set out in the NZ ETS settings consultation document.
85. Starting consultation immediately and thereby communicating an intention to allow emission unit prices to increase, may provide NZ ETS participant's greater incentive to use the fixed price option to meet their 2019 emissions surrenders obligations, and retain their NZUs for use in the future. This could result in a reduction in Crown OBEGAL because it would give participants' access to the fixed price option at a price less than the market price of the NZU.
86. For example, if the price of NZUs was \$35 in 2020, and 75 per cent of participants with surrender obligations used the \$25 fixed price option instead, this would result in a loss of approximately \$248 million to the Government.
87. However, starting consultation after May 2020 may increase the challenges associated with meeting emissions reduction targets, increasing the fiscal risk on the Crown if we were then required to obtain further emissions removals from other sources.
88. OBEGAL in 2021 for 2020 emissions surrenders would also be severely impacted if the fixed price option saw high use but was not raised from \$25.
89. The Treasury considers that no option is risk free, and that on the balance of risk and current available information, consultation should begin in 2019.
90. My proposal to allow the use of the fixed price option as a way to meet surrender obligations for activities over 2020, even if auctions have begun, has potential financial implications of increasing the unit stockpile and reducing OBEGAL. However, increasing the price to \$35 per NZU, is designed in part to mitigate these risks. This will depend on the amount it is used and the price difference between it and the NZU price at the time. There is no sensible way to estimate those implications, as both of these factors depend on market demand and supply responses.
91. There is some uncertainty around the impact of the proposed price controls on the price of emissions, and around how much abatement will be achieved as a result of the emissions price or as a result of non-price measures. Further analysis will be provided prior to final decisions on NZ ETS settings in mid-2020.
92. It is likely that when the Commission recommends the first emissions budget for the period 2022-2025 – which will supersede the provisional emissions budget – better information on policy impacts will be available. However, in the interim, it is necessary to begin the transition.
93. I am not seeking any new funding at this stage. This is because the proposals in this paper are subject to final policy decisions and further implementation details.

Te Tiriti o Waitangi

94. I acknowledge the significant interest iwi/Māori, including Māori entities, have in the NZ ETS, particularly as much of the Māori economy is involved in natural resource management including forestry.
95. I intend for consultation on these proposals to be consistent with the principles of the Te Tiriti o Waitangi, particularly the principles of good faith and partnership. The consultation will include engagement with iwi/Māori through inclusion of the NZ ETS settings as an agenda item on a series of hui that MfE are planning in February 2020.

Legislative implications

96. This consultation has no direct legislative implications.
97. Should Cabinet agree, following public consultation, to the proposed extension and increase to the fixed price option, this will be introduced by supplementary order paper to the Climate Change (Emissions Trading Reform) Amendment Bill currently before the Environment Select Committee.
98. Regulatory changes will be needed to implement the proposals. Drafting approval for these would be sought at the time of policy decisions in mid-2020.

Regulatory impact analysis

99. The consultation document *Reforming the New Zealand Emissions Trading Scheme: Proposed Settings* functions as an interim Regulatory Impact Assessment. The Ministry for the Environment's Quality Assurance panel has reviewed the discussion document and confirms the information provided meets the quality assessment criteria, for this stage of the process, and that it is likely to lead to effective consultation. The consultation will provide more information where there is currently uncertainty. In particular, the consultation process is expected to lead to a better understanding of the impacts of the Provisional Emissions Budget, which can then be expressed in more detail in the Regulatory Impact Assessment that supports any subsequent Cabinet decisions.

Climate implications of policy assessment

100. The Ministry for the Environment's CIPA team has been reviewed this Cabinet paper in respect of the CIPA requirement, and confirms that the greenhouse gas analysis is fit-for-purpose. The Ministry for the Environment CIPA team expects that this analysis will be updated to reflect feedback on the consultation document *Reforming the New Zealand Emissions Trading Scheme: Proposed Settings*.

Gender implications

101. There are no gender implications arising from this paper.

Disability perspective

102. There are no disability implications arising from this paper.

Publicity

103. The attached consultation document will be published on the Ministry for the Environment's website with appropriate context. Officials will email known potentially interested parties to inform them of the consultation.
104. It is important that announcements about the NZ ETS are managed carefully to avoid any market risks, including sudden rises of unit prices in the NZ ETS. In addition, information should not be disseminated in a way that advantages some market participants over others and compromises investments in the scheme.
105. I propose to make a media release on the NZ ETS consultation as soon as possible following Cabinet's consideration of this paper. The consultation document will then be made available on MfE's website. MfE and the Environmental Protection Authority will notify NZ ETS account holders and stakeholders about the release of the consultation document.

Proactive Release

106. I propose to proactively release this paper on the Ministry for the Environment's website in whole, subject to redactions as appropriate equivalent to those under the Official Information Act 1982, once public announcements have been made.

Recommendations

The Minister for Climate Change recommends that the Committee:

1. **Note** that the emissions trading scheme is a key tool to support meeting our climate change targets and transitioning to a low emissions economy;
2. **Note** that proposals for New Zealand Emissions Trading Scheme (NZ ETS) settings will support the effective operation of the NZ ETS;
3. **Note** that consulting on New Zealand Emissions Trading Scheme regulations at the same time as the Select Committee stage of the Climate Change Response (Emissions Trading Reform) Amendment Bill will enable the public to consider the proposals together;
4. **Note** that the Bill specifically empowers consultation on regulations to take place prior to the Bill coming into effect;
5. **Agree**, for the purpose of consultation, the proposed provisional emissions budget for 2021 - 2025 is 354 Mt CO₂-e
6. **Note** the proposed provisional emissions budget for 2021 – 2025 requires 13 Mt CO₂-e of emissions reductions or sequestration beyond current forecasts;
7. **Agree**, for the purpose of consultation, the proposed NZ ETS emissions cap for 2021-2025 is 151 million units, made up of these key sources of emission unit supply:
 - 7.1. The expected volume of units to be freely allocated (44 million NZUs);
 - 7.2. The volume of units to be auctioned (80 million NZUs);
 - 7.3. The import of international units (zero); and
 - 7.4. The use of units already in participants' accounts (27 million NZUs);
8. **Note** price controls are mechanisms that help manage unacceptably low or high prices in the NZ ETS and limit the risk of prices falling outside of a range needed to meet an emissions budget;
9. **Agree**, for the purpose of consultation, the proposed price control settings are:
 - 9.1. a price floor of a value of \$20 per NZU for 2020, which would increase \$2 per year over the period 2020-2025; and
 - 9.2. a price ceiling, implemented through a 'cost containment reserve', that starts at \$50 per NZU in 2020 and increases at \$10 per year over the period 2020-2025;
10. **Note** although the price ceiling is the upper extreme of expected and acceptable prices in the NZ ETS, it will not be the key driver for the market price, which will be ultimately determined by unit supply and demand;
11. **Note** under the current drafting of the Emissions Trading Reform Bill, the fixed price option will be replaced by the cost containment reserve from the first auction.
12. **Note** this arrangement has a high risk of market instability due to the market power this gives to sources of supply over 2020, should the first auction be held at the end of 2020, as is planned.

13. **Note** a continuation of the fixed price option available for 2020 emissions will provide certainty of emission unit supply for participants until Government auctions are fully operational in 2021.
14. **Note** an increase of the fixed price option to \$35 per NZU to apply for surrender obligations arising from activities in 2020 signals the Government's intention to accelerated emission reductions in the economy, while providing for market stability and predictability.
15. **Agree**, for the purpose of consultation, to a policy change that will allow the continuation of the fixed price option to meet surrender obligations for 2020 activities.
16. **Agree**, for the purpose of consultation, that the rate of the fixed price option is \$35 per NZU for all surrender obligations arising from 2020 activities.
17. **Agree**, for the purpose of consultation, that the volume of units available annually within the cost containment reserve will be based on 90 per cent of the difference between forecast net emissions and the volume of units added to the scheme
18. **Note**, that market impacts of releasing different cost containment reserves is a particularly challenging area to forecast, and the Ministry for the Environment will convene a group of industry experts to discuss this area further during consultation before final regulation recommendations are made.
19. **Agree** to release the attached consultation document to support public consultation from mid-December 2019 to late-February 2019 on proposals for NZ ETS settings;
20. **Agree** to allow the Minister for Climate Change to make minor editorial, design and technical and minor policy changes to these consultation documents as needed;
21. **Note** that the Minister for Climate Change will report back to Cabinet by mid-2020 with final policy recommendations;
22. **Note** that the proposals in this document and the attached appendices are commercially sensitive and the release of this information will have implications for the NZ ETS market;
23. **Note** that considerations around public release of information need to be managed carefully;

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25. **Note** that the *Framework for International Carbon Markets Cooperation* provides guidance to officials in discussions with potential international carbon market partners;
26. **Agree** the *Framework for International Carbon Markets Cooperation* is publicly released alongside the consultation document on NZ ETS settings;
27. **Note** that a formal negotiating mandate would be needed from Cabinet before any formal negotiations on international carbon market cooperation could begin;
28. **Agree** that the Minister for Climate Change will proactively release this paper on the Ministry for the Environment's website, subject to redactions equivalent to withholdings under the Official Information Act 1982.

Authorised for lodgement.

Hon James Shaw
Minister for Climate Change

**Attachment 1. Reforming the New Zealand Emissions Trading Scheme:
Proposed Settings**

Attachment 2: Framework for International Carbon Market Cooperation