

Chair

Cabinet Environment, Energy and Climate Committee

APPROVAL TO CONSULT ON IMPROVEMENTS TO THE NEW ZEALAND EMISSIONS TRADING SCHEME

Proposal

1. I seek your agreement to publicly consult on a package of proposed changes to the New Zealand Emissions Trading Scheme (NZ ETS).
2. The proposed changes are aimed at improving the framework of the NZ ETS and providing the basis for a credible and well-functioning scheme in the 2020s and beyond. These proposals have been informed by a review of the NZ ETS which concluded in July 2017.
3. Hon Jones and I are also proposing a package of improvements specifically related to forestry in the NZ ETS. These proposals are set out in an accompanying Cabinet paper [*New Zealand Emissions Trading Scheme (ETS) Review: Improving the ETS for forestry* refers] and discussion document, to be considered alongside this paper.
4. The changes that I propose taking to consultation cannot be fully implemented until key decisions have been taken in relation to the Zero Carbon Bill (ZCB). These include decisions on the 2050 target and the role of the independent Climate Change Commission (Commission), which may need to be reflected in NZ ETS settings.

Executive Summary

5. The NZ ETS is the Government's key policy tool to reduce emissions and support New Zealand to meet its climate change targets. The NZ ETS currently requires all sectors of the economy to report on their emissions and, with the exception of agriculture, surrender New Zealand Units (NZUs) to the Government for these emissions.
6. The price of NZUs sends a signal to businesses to invest in low emissions technologies and forestry. This means, if set up appropriately, the NZ ETS can play a critical role in signalling the Government's ambition to reduce emissions and transition to a net zero emissions economy.
7. The 2015/16 review found that, under current settings, the NZ ETS will not effectively assist New Zealand to meet its 2030 target under the Paris Agreement (or any new 2050 target under the ZCB). In particular, it found that the Government does not have the tools to manage the supply of units in the NZ ETS, and that the operation of the scheme has created significant regulatory uncertainty.
8. In July 2017, in response to the findings of the review, the previous Government made four in-principle decisions to improve and strengthen the overall integrity and credibility of the NZ ETS [EGI-17-MIN-0369]. This Cabinet subsequently noted that these changes would be pursued through legislative amendments by the end of 2019 [CAB-17-MIN-0547.01 refers].

9. Taken together, the in-principle decisions provide the Government with the tools to put a cap on the NZ ETS. They are to:
 - a. coordinate decisions on the supply settings in the NZ ETS over a five-year rolling period
 - b. introduce auctioning of units, to align the supply of units in the NZ ETS to our climate change targets
 - c. limit participants' use of international units when the NZ ETS reopens to international carbon markets¹
 - d. develop a different price ceiling to eventually replace the current \$25 fixed price option.
10. The attached discussion document seeks feedback on proposals to begin implementing the in-principle decisions. These proposals are to:
 - a. establish a process for coordinating and managing unit supply decisions and identifying what factors need to be taken into account when making these decisions (e.g. advice from the Commission)
 - b. introduce sealed-bid, single-round auctions with uniform pricing, with an open question on auction frequency. The discussion document also seeks views on whether cash obtained from auctioning NZUs should be hypothecated for a specific purpose
 - c. establish a new price ceiling, in the form of a volume-limited cost containment reserve as part of the auction mechanism, to replace the current fixed price option
 - d. limit the use of international units either through restrictions on government purchase or through limiting the volume of units that are imported/surrendered by NZ ETS participants.
11. These proposals are intended to improve the framework of the NZ ETS to allow the Government to align unit supply with our emissions reduction targets. Together, these proposals would allow the Government to put a cap on the NZ ETS in a well-managed and well-signalled way and would increase confidence in the operation of the scheme.
12. It is important to start consultation on these issues now to have legislative changes to the NZ ETS, informed by final policy decisions on the ZCB, in place by the end of 2019. This is because there will need to be legislative amendments to the Climate Change Response Act 2002 (the Act), as well as the development of associated regulations, if the proposed NZ ETS changes are agreed.
13. Further consultation will be required before unit supply volumes and settings for the NZ ETS can be put in place.² I intend to seek Cabinet approval to consult on regulations to

¹ Note that no decision has been made on when the NZ ETS could reopen to international units. The Government has previously agreed that we will only use international carbon markets after 2020 if the units are genuine and have environmental integrity; that by doing so, we will maintain progress towards our transition to a net zero target; that it makes economic sense to do so; and we can do it in a way that will maintain a steadily rising domestic carbon price, to maintain incentives in domestic abatement opportunities, such as forestry [CAB-18-MIN-0248 refers].

² The volumes and settings include the level of a price ceiling, the level of any limit on international emissions units and the volume of units to be sold via auctioning.

set the specific unit supply volumes in 2019, following final policy decisions on the ZCB, including on the 2050 target and the role of the Commission.

14. I also propose consulting now on other issues identified during the review, where in-principle decisions were not made. These include:
 - a. how decisions on phasing down industrial allocation levels are made over time.
 - b. improving the compliance regime by introducing infringement offences for low level non-compliance, and options to change the penalty for failing to surrender or repay units
 - c. seeking feedback on the risks of market misconduct, in order to inform work on improvements to the market governance of the NZ ETS
 - d. improving the provision of market information and establishing a dedicated NZ ETS web portal
 - e. a number of technical operational improvements.
15. Forestry is an important source of emissions abatement for New Zealand and how we transition to a net zero emissions economy. For this reason, Hon Jones and I are also proposing a package of improvements related to forestry in the NZ ETS. These proposals aim to improve NZ ETS incentives for new forest planting, including permanent forests. These proposals are set out in an accompanying Cabinet paper and discussion document, to be considered in conjunction with this paper [*New Zealand Emissions Trading Scheme (ETS) Review: Improving the ETS for forestry* refers].
16. These proposals will support the three fundamental commitments this Government agreed for climate change policy and the transition of the New Zealand economy to net zero emissions [CAB-18-MIN-0218 refers]. The implementation of these proposals will take a holistic view, promoting leadership at home and internationally, a productive, sustainable and climate-resilient economy, and a just and inclusive society.
17. This consultation will not consider agricultural emissions or agricultural allocation. The question of whether and how agriculture should enter the NZ ETS is currently being considered by the Interim Climate Change Committee (Interim Committee). I expect that Cabinet will consider this issue once the Commission has considered the findings of the Interim Committee, expected in 2019.
18. I seek approval to release a discussion document (Appendix 1) to support consultation on the proposals noted above. I propose that public consultation occurs over a 6 week period across August and September 2018.

Background

The New Zealand Emissions Trading Scheme can be a powerful tool in New Zealand's transition to a low emissions economy

19. The NZ ETS was established in 2008 to support New Zealand to meet its international climate change targets and reduce emissions below business as usual levels. It does so by putting a price on greenhouse gas emissions and removals.
20. In practice, the NZ ETS requires all sectors of the economy to report their emissions and, with the exception of agriculture, surrender NZUs to the Government for these emissions. This means that businesses need to factor the costs of their emissions into their decision-making.

21. The NZ ETS is the only emissions trading scheme in the world that includes the forestry sector. Forestry is an important source of abatement for New Zealand and is critical in helping meet our emission reduction targets. Over 90 per cent of the participants in the NZ ETS are from the forestry sector. The sector comprises a diverse group of businesses and people, from large forestry companies with significant administrative capacity to small farm-foresters who rely on consultants for advice.
22. The performance of the NZ ETS has been mixed since it began in 2008. An evaluation in 2015 found that the NZ ETS helped New Zealand meet its international commitments, but that it had not yet materially reduced domestic emissions from business as usual. This was largely a result of unlimited access to low-cost international units that were available in the first commitment period of the Kyoto Protocol from 2008-2012.
23. In recent years the NZ ETS has been strengthened by prohibiting the use of international units for surrender (making the scheme domestic-only from mid-2015) and a decision by the Government in 2016 to phase out the 'one-for-two' transitional measure (more detail is provided on this below). This has seen the NZU price rise from around \$5 in 2015 to a peak of over \$22 in July this year.
24. It is expected that at these higher price levels, the cost of carbon will start being factored into business decisions. There is evidence that the higher carbon price is promoting increased investment in forestry, which is considered one of New Zealand's most cost-effective abatement options in the short to medium term.

The New Zealand Emissions Trading Scheme review 2015/16 identified areas for improvement

25. The previous Government initiated a review of the NZ ETS in anticipation of a new international climate change agreement, which concluded in Paris at the end of 2015 (the Paris Agreement), and New Zealand's target to reduce emissions to 30 per cent below 2005 levels by 2030 (the 2030 target).
26. The review was conducted in two stages.
 - a. Stage I focused on whether or not to remove the one-for-two transitional measure. This measure allowed some companies to surrender one NZU for every two tonnes of greenhouse gas emissions.
 - b. Stage II focused on the overall design and operation of the NZ ETS, and whether it would effectively support New Zealand to meet future emission reduction targets under the Paris Agreement.
27. Stage I of the review resulted in the phase-out of the one-for-two transitional measure from 1 January 2017. As a result, New Zealand businesses will face full emission obligations under the NZ ETS from 1 January 2019.
28. Stage II of the review found that the current framework of the NZ ETS is not fit-for-purpose for the 2020s and beyond. In particular, it found that the Government does not have the tools to manage the supply of units in the scheme (i.e. there is no cap on emissions). This means that under the current settings, the NZ ETS will not effectively assist New Zealand to meet its 2030 target (or potentially any new 2050 target under the ZCB). This is because:
 - a. the Government does not have the tools required to effectively manage the supply of units in the scheme so that it aligns with the 2030 target

- b. current NZ ETS settings create significant regulatory uncertainty, meaning businesses do not have information enabling them to make sound decisions about the value of carbon and the cost-effectiveness of investments
 - c. operational and technical issues are causing administrative inefficiencies.
29. In response to these findings, in July 2017 the previous Government made four in-principle decisions [EGI-17-MIN-0369 refers]. These are to:
- a. coordinate decisions on the supply settings in the NZ ETS over a five-year rolling period
 - b. introduce auctioning of units, to align the supply of units in the NZ ETS to our emission reduction targets
 - c. limit participants' use of international units when the NZ ETS reopens to international carbon markets³
 - d. develop a different price ceiling to eventually replace the current \$25 fixed price option.
30. Once implemented, these in-principle decisions will provide the Government with the ability to determine unit supply in the NZ ETS in a well-signalled and well-managed way. Together, these proposed changes would effectively limit the number of units in the NZ ETS, enabling the Government to align unit supply with New Zealand's future emissions budgets/targets and allow emissions in the NZ ETS to be capped.
31. This will ensure that the NZ ETS is able to drive emissions reductions in line with our emission reduction targets and transition pathway. These decisions also address business and stakeholder feedback that a well-functioning market with clear rules and a predictable framework is needed for the carbon price to effectively impact long-term investment decisions.
32. In addition to these in-principle decisions, there are a range of other aspects of the NZ ETS that can be improved to address the findings of the review. These include a package of proposed changes relating to forestry [*New Zealand Emissions Trading Scheme (ETS) Review: Improving the ETS for forestry* refers], options for decisions on industrial allocation after 2020, improvements to how people can access market information as well as other operational and technical improvements.
33. In December 2017, this Cabinet noted that the in-principle decisions would be pursued through amendments to the Act by the end of 2019, following the commencement of the ZCB [CAB-17-MIN-0547.01 refers].

How the proposed changes to the New Zealand Emissions Trading Scheme fit with the Zero Carbon Bill

34. The ZCB will provide New Zealand's long-term strategy for responding to climate change and transitioning to a low emissions economy. The proposed NZ ETS consultation is focused on considering what legislative changes are necessary to ensure the scheme can support the outcomes of the ZCB process.
35. The proposals will support the three fundamental commitments this Government agreed for climate change policy and the transition of the New Zealand economy to net zero emissions [CAB-18-MIN-0218 refers]. The implementation of these proposals will take a

³ Note that no decision has been made on when the NZ ETS could reopen to international units.

holistic view promoting leadership at home and internationally, a productive, sustainable and climate-resilient economy and a just and inclusive society.

36. The final policy decisions for the ZCB will have implications on the unit supply settings of the NZ ETS. Specifically, the ZCB proposes to set a new 2050 target in legislation, create a process for setting emission budgets and establish the independent Commission. The proposed changes to the NZ ETS complement the ZCB process as they can provide the basis for helping meet emission budgets, any new 2050 target, and support our transition to a net zero emissions economy.
37. This round of consultation is not considering what the unit supply volumes will be because decisions on the ZCB should be reflected in NZ ETS settings. These volumes should not be set in advance of the ZCB outcomes because:
 - a. NZ ETS supply volumes and settings should reflect the new 2050 target and emission budgets, and further economic analysis is needed to inform these decisions
 - b. the role of the Commission with respect to the NZ ETS is yet to be determined
 - c. there has been no decision on what proportion of our target will be delivered through the use of international emission reductions.
38. Specifically, this means consultation at this stage is not considering:
 - a. the level of a limit on international units in the 2020s
 - b. the level of a new price ceiling and number of units associated with it⁴
 - c. the proposed number of units to auction.
39. I propose to consult on these subsequent matters in 2019 following final policy decisions on the level of our 2050 target and role of the Commission (discussed further below).

Comment

I seek Cabinet approval to consult on proposed changes to the New Zealand Emissions Trading Scheme

40. I am seeking agreement to publicly consult on a number of proposals to improve and strengthen the NZ ETS through the release of the attached discussion document, *Improvements to the NZ ETS: consultation document* (Appendix 1). These proposed changes would put in place the framework needed to implement the Government's in-principle decisions. They also include some proposals aimed at improving the operation of the market.
41. The proposals and eventual decisions on implementation details will help establish an enduring framework for the effective operation of the NZ ETS. This framework will balance predictability for market participants (by providing transparent processes for change) and flexibility for the Government to be able to adjust the scheme to reflect changing circumstances.
42. These proposals are set out in the attached discussion document, and outlined below. In addition, Hon Jones and I are proposing a package of improvements related to forestry

⁴ Note that it is proposed in the consultation material that the price ceiling would be set at a level above \$25 (the current level of the fixed price option) and that it would increase over time.

in the NZ ETS. These are included in a Cabinet paper and discussion document, to be considered alongside this paper [*New Zealand Emissions Trading Scheme (ETS) Review: Improving the ETS for forestry* refers]. Following Cabinet agreement, I intend to commence a six week consultation period from 13 August to 21 September 2018. This timeframe was scheduled to avoid overlap and confusion with the ZCB consultation, which took place over June and July this year. This timeframe should also allow amendments to the Climate Change Response Act to be introduced to the House of Representatives in 2019.

43. The NZ ETS consultation will be open to the public. Recent experience with NZ ETS review consultation shows it is likely to be mostly attended by subject matter experts and participants in the scheme. Officials will hold a series of meetings in the main centres, along with meetings in relevant regional locations focused on forestry aspects of the proposals.

The discussion document will seek views on a range of proposals for improving the New Zealand Emissions Trading Scheme

44. The following section provides an overview of the proposals included in the attached discussion document, to be released for public consultation. These proposals relate to:

- I. **Coordinating unit supply decision-making** and consulting on what factors need to be taken into account when making these decisions, such as advice from the Commission
- II. **Auctioning** via implementing sealed-bid, single-round auctions with uniform pricing, with an open question on auction frequency
- III. **A new price ceiling** in the form of a volume-limited auction cost containment reserve as part of the auction mechanism, to replace the current fixed price option
- IV. **Volume limit on international units** either through restrictions on government purchase, or through limiting the volume NZ ETS participants are able to import/surrender.

45. I also intend to consult on proposals for other changes to the NZ ETS where in-principle decisions were not made. These proposals address issues that were identified through the NZ ETS review, but required additional work to identify options. These proposals are important for increasing regulatory predictability and ensuring good market function.

46. These other proposals relate to:

- V. **A phase-down of industrial allocation** - decisions on how future industrial allocation levels will be determined
- VI. **Market governance** - feedback on the risks of market misconduct, in order to inform work on improvements to the market governance of the NZ ETS
- VII. **Market information** - improving the provision of market information and establishing a dedicated NZ ETS web portal
- VIII. **Compliance and penalties** - improve the compliance regime by introducing infringement offences for low level non-compliance, and options to change the penalty regime for failing to surrender and repay units

- IX. **Technical and operational improvements** - a number of technical operational improvements.

Some of the proposals being considered could have significant impacts on the market

47. Overall, I consider these proposals will increase confidence in the NZ ETS and create a predictable market framework. Some proposals, however, will likely generate stakeholder reactions or have an impact on the market.
48. The inclusion of an option to begin a phase-down of industrial allocation from 2021 may generate a significant response from stakeholders. This is because, unlike the other proposals, a phase-down would have a direct cost impact on affected firms (i.e. there would be a reduction in the amount of NZUs these firms receive).
49. I am also aware that the continuation of the \$25 fixed price option creates some risks to the Government if the carbon price rises. The proposed new price ceiling needs to be in place before the current \$25 fixed price option is removed. If NZU prices rise above \$25 before this point, there is a risk that the fixed price option might be used extensively. This would risk the ability of the NZ ETS to drive the right amount of emissions reductions and shift costs of meeting our targets from participants to the Crown.
50. The fiscal risks from the fixed price option have risen over previous months as the NZU price has moved closer to \$25. The NZU price has risen from \$18 in September 2017 to its current price of \$23. This change is mostly in response to the Government's public signalling about its higher ambition for future climate change action.
51. While the previous Government committed to keeping the current fixed price option in place until auctioning or international units are introduced it may be necessary to make changes to the existing fixed price option this year in order to adequately manage the fiscal risks. I will continue to evaluate the timing options with officials and relevant Ministers.
52. Forestry is also likely to be a key issue raised by stakeholders, and this is considered in a separate Cabinet paper [*New Zealand Emissions Trading Scheme (ETS) Review: Improving the ETS for forestry* refers].

I intend to provide stakeholders with details on the expected forward process for the NZ ETS and ZCB decisions

53. As noted earlier, most of the proposals in the discussion document are focused on improving the framework of the NZ ETS so it can support New Zealand's transition to a low emissions economy. This means further decisions will be required to draft regulations on technical details, such as the operational details for auctioning as well as unit supply settings and volumes.
54. I acknowledge that focusing consultation on the framework of the NZ ETS, and not on the detailed unit supply settings and volumes may be criticised by stakeholders. This is because they may be expecting the Government to provide more detail on their expected emissions costs in the 2020s. We can mitigate this by publishing the expected timeline for these decisions and consultations.
55. I intend to report to Cabinet in early 2019 seeking approval to consult on the development of regulations to inform the technical details and initial unit supply volumes, after final policy decisions on the proposals within this paper and the ZCB have been made. These regulations are likely to reflect the new process proposed in the discussion document for annually setting and announcing unit supply volumes in the NZ ETS.

56. I propose that officials lead the development of these settings and regulations, and that the initial unit supply volumes be aligned with our 2030 emissions reduction target under the Paris Agreement. This approach would mean that initial unit supply settings in the NZ ETS are set by the Government while the Commission is being established, but would allow for the Commission to input into these settings in the future.
57. This approach, including consultation in 2019, would provide NZ ETS participants with key information about how the NZ ETS will operate while also allowing policy decisions on the ZCB to be incorporated before 2020.
58. The proposal to introduce annual regulation updates to set NZ ETS unit supply volumes on a five-year rolling period could also ensure that future unit supply settings in the NZ ETS align with our future emissions budgets and allow for input from the Commission (see *Coordinated unit supply decision-making*).
59. I consider that this approach balances the urgent need to provide information to the NZ ETS market while ensuring the role of the Commission is taken into account when making future NZ ETS unit supply decisions. Once the Commission has been established, it would inform the annual unit supply regulation update. This approach would allow both legislative and regulation changes on the NZ ETS to occur by the end of 2019.

Proposals

60. Each of the specific proposals for consultation are set out in more detail below.

I. Coordinating unit supply decision-making

Proposal

61. The discussion document includes a proposal to introduce an annual process for setting and announcing NZ ETS unit supply settings and volumes over a five-year rolling period. This will set an overall limit (cap) on the number of units supplied into the NZ ETS market. The process would include setting and announcing:
- a. the volume of units to be auctioned
 - b. the level of the price ceiling, and the volume of units to be held in reserve if the cost containment proposal is implemented (see para 75 below for more detail on the cost containment reserve)
 - c. the volume of units expected to be allocated through industrial allocation
 - d. the limit on the use of international units.
62. Feedback is sought on what factors should be taken into account when setting unit supply volumes, and whether there needs to be any restrictions on how and when decisions are made.

Analysis

63. Following the review, an in-principle decision was taken to coordinate NZ ETS unit supply decisions over a rolling five-year period. This would extend an already existing provision that requires an 'overall NZU limit' (commonly referred to as a 'cap') is in place before auctions can be held in the NZ ETS.
64. Currently, if auctioning is introduced, the auctioning provisions would need to take into account industrial allocation volumes and would put a limit on the volume of units that

could be auctioned and allocated each year. This limit would be set in regulations initially for five years into the future, and then extended annually by a further year. Currently, the limit on auctioning and allocation volumes could only be changed with one year's notice.

65. Coordinating and announcing unit supply decisions over a five-year rolling period is aimed at:
- a. providing NZ ETS participants with greater predictability about expected unit supply over a normal business planning timeframe (five years); and
 - b. providing the Government flexibility to make changes to NZ ETS unit supply settings, provided it follows a transparent and predictable process.
66. The discussion document seeks feedback on the proposal to coordinate decisions on unit supply settings on a five-year rolling period, including what must be taken into account when making unit supply decisions, such as recommendations from the Commission proposed in the ZCB, and modelling of New Zealand's domestic abatement potential and costs.
67. It also seeks feedback on what restrictions should be placed on adjusting unit supply settings once they have been set (i.e. years two to five of the five-year rolling period). For example, restricting adjustments to when there has been a significant change in projections of emissions or changes in targets, or ensure that adjustments to volumes must not be more than a certain fixed percentage. Prescribing these would help build confidence in the market and improve regulatory predictability for market participants.

II. Auctioning

Proposal

68. The discussion document seeks feedback on a proposal to implement auctioning in the NZ ETS using a sealed-bid, single-round auction format with uniform pricing. It also seeks feedback on the appropriate frequency for auctions, signalling that some flexibility is likely to be appropriate. No preferred option is put forward on frequency, however the document signals that monthly or quarterly auctions may be most appropriate.

Analysis

69. Auctioning is a way for the Government to distribute units into the NZ ETS at the market price through a competitive bidding process. Auctions are a common feature of many other emissions trading schemes. The Act already includes a provision enabling regulations to be made to sell units by auction, but this has not yet been carried out.
70. Following the review, there was an in-principle decision to introduce auctioning to allow the Government to manage the relationship between units in the NZ ETS and New Zealand's emissions reduction targets. Auctioning gives the Government this ability by providing a way to distribute the portion of New Zealand's emissions budget that would not otherwise be able to be allocated through the NZ ETS.⁵
71. Over the 2021 – 2030 period for New Zealand's 2030 target, it is currently estimated that 44.1 million NZUs would be available to be auctioned. This is estimated to generate cash for the Crown in the range of \$0.88 - \$2.21 billion over 2021-2030.⁶

⁵ Not allocating this volume to the market would place higher costs on the economy than necessary for meeting our 2030 target.

⁶ Assuming a carbon price range of \$20 - \$50.

72. Over time, auctioning NZUs will have a positive impact on both the Crown's operating statement and balance sheet.⁷ Under current fiscal policy practices, unless a policy decision is taken to use the cash obtained from auctioning NZUs for a specific purpose, it would be retained by the centre. The discussion document seeks views on whether this cash should be hypothecated for a specific purpose. For example, other ETS specify that auctioning proceeds should be used towards supporting emissions reductions, and benefitting disadvantaged communities.
73. The discussion document seeks feedback on a preferred option for the high-level design of an auctioning mechanism. This proposal is to auction NZUs using a sealed-bid, single-round uniform price auctioning format. This means that all auction participants would submit bids at the same time, with each bid including a price and a volume of units. The clearing price would then be determined through the auction by matching these bids to the available demand. Uniform pricing means that all bidders that cleared the auction would pay the same market clearing price. This proposal is preferred as it is simple, resistant to collusion and is accessible for small participants.
74. The discussion document also seeks feedback on auction frequency. No preferred option is put forward at this time as decisions regarding auctioning volumes and stakeholder feedback are needed to get information on the impacts of different options. Given the size of New Zealand's carbon market, it appears holding auctions monthly or quarterly may be most appropriate.
75. The discussion document signals that some flexibility may need to be retained with regards to auction frequency. This would ensure that auctioning runs smoothly in the future, while also having regard to the coordinated decision-making process and the need to provide sufficient market certainty.

III. Price ceiling

Proposal

76. The discussion document seeks feedback on a proposal to replace the current \$25 fixed price option with a volume-limited auction cost containment reserve, which is a different type of price ceiling.

Analysis

77. A price ceiling is a measure designed to discourage the emissions price from rising above a certain price level. Price ceilings are common features in other ETS internationally, and aim to limit extremely high prices that can undermine the political acceptability of an ETS policy.
78. The NZ ETS has a price ceiling known as the \$25 fixed price option (\$25 FPO). The \$25 FPO allows participants with surrender obligations to pay \$25 per unit to the Government as an alternative to surrendering units, guaranteeing the maximum compliance cost for participants. It does not create NZUs that can be traded in the market. If used, however, the fixed price option indirectly adds to the supply of NZUs in the market as it means that other units will not be surrendered.
79. Following the NZ ETS review, an in-principle decision was taken to develop a different price ceiling to replace the current \$25 FPO. This is because the \$25 FPO is not

⁷ The transaction of selling a unit by auction is fiscally neutral, however, when NZUs are surrendered revenue is recognised in the operating statement and there is an increase in cash assets on the balance sheet.

sustainable for the long term. The \$25 price level is lower than expected domestic and international carbon prices in the 2020s. If the \$25 FPO remains, it could cause the amount of units in the NZ ETS to exceed the emissions budget associated with New Zealand's 2030 target, shifting responsibility (and the cost) of meeting the target to the Government.

80. The NZ ETS review also considered the case for introducing a price floor into the scheme as many submissions pointed to the low historical prices as evidence that a price floor was needed in the future.
81. However, it was decided that a strong case for a price floor could not be made at that point in time because:
- a. The main driver of these low prices was the unlimited access that participants had to low-priced international units. The Government took a decision that a volume limit on the use of international units would be imposed in the future (if a decision were taken to re-open the market to international units). This volume limit was viewed as the most effective way to ensure that the NZ ETS would deliver both more domestic emission reductions and higher prices.
 - b. Implementing a 'hard' price floor where a certain minimum price in the market was guaranteed at all times would be administratively complex and may also incur fiscal risks.⁸
 - c. While 'soft' price floors (such as setting a minimum price for units sold at auction) may be easier to implement, they might not be very effective at influencing the NZU market price.⁹
82. The discussion document seeks feedback on a preferred option for replacing the \$25 FPO. This proposal is to develop a volume-limited 'cost containment reserve' as part of the auctioning mechanism.
83. A volume-limited cost containment reserve is a type of price ceiling where the Government sets aside a number of units¹⁰ to be released for sale only if a specified trigger price is reached. If the sale price of NZUs reached the trigger price at an auction, additional supply from the cost containment reserve would be made available. As expectations around future supply influence prices, this would put downward pressure on the NZU price, even before additional units are actually sold.
84. The proposal in the discussion document notes that while the trigger price is not being set at this stage, it is expected to be set at a level higher than \$25 and that this price level would increase over time. It also outlines the intention that the trigger price level, and the volume of units in the cost containment reserve, would be managed as part of the five-year rolling period.

⁸ This is because the Government may need to commit to buying an unlimited volume of units from the market if prices were to fall below the floor level.

⁹ The 'soft' price floor mechanism that is most commonly used within other ETS is to set a minimum price at auction. However, this approach will only have an impact on market prices if auction volume is an important source of supply. Auction volumes are forecast to be a relatively small fraction of supply into the NZ ETS and there are a substantial number of NZUs already banked by participants – both of these factors will dilute the impact of any auction floor price on NZU prices.

¹⁰ No decision has been made on where these units will come from. The units could come from a portion of the emissions budget which is set aside, or from outside the budget. If they came from outside the budget this would require the Crown to secure a corresponding volume of emissions reductions (either domestically or internationally).

85. The discussion document also seeks feedback on a process for how Government will react if the cost containment reserve price ceiling is struck or other significant events occur that may impact on the appropriateness of the price ceiling. There is no preferred option at this stage, as this may depend on the role and functions of the Commission.
86. This volume-limited cost containment reserve is the preferred option as it would provide a tool to balance the price risks for NZ ETS participants against the fiscal and target risks for the Government. It would be a 'softer' price ceiling compared to an FPO-style ceiling, as it would not guarantee a maximum compliance cost per unit for participants. How much effect a cost containment reserve has on the market price of units would depend on the amount of units held in the reserve.

IV. Limit on use of international units

Proposal

87. The discussion document seeks feedback on enabling two modes of purchase if the NZ ETS should be reopened to international carbon markets.
- a. Directly – through market participants purchasing, trading and surrendering international units themselves. The volume limit would be placed at the point of surrender or import.
 - b. Indirectly – via the government purchasing international emission reductions and auctioning a corresponding amount of NZUs into the scheme. A volume limit would be imposed through restrictions on the volume purchased and auctioned by the government.
88. It is not possible to make choices between these two modes at this time as we need to know more about which types of international market we would be engaging with, and also the rules for international accounting currently negotiated as part of the Paris Agreement.
89. In addition to the volume restriction, any international emission reductions that are used towards our targets would need to have high environmental integrity. New Zealand is engaging with both domestic experts and international partners to ensure that these standards can be developed and implemented.
90. The discussion document also seeks feedback on whether different types of NZ ETS participant (e.g. industrial allocation recipients, post-1989 foresters) should have different quantitative limits, if direct purchasing by NZ ETS participants is enabled in the future. This is because there is a risk of unintended consequences and windfall profits if firms are able to surrender international units while also receiving NZUs from the Crown.

Analysis

91. The Act already allows for the development of regulations which would allow and limit the use of international units for both modes. This is because the use of international units was an important part of the Kyoto Protocol framework that the NZ ETS was originally designed for. Specifically, the regulations could provide detail on:
- a. quantity and quality restrictions on the use of international units
 - b. different quantitative limits on international units for different types of participants

92. The discussion document signals that both modes of purchase could be enabled and seeks feedback on what impacts the different modes might have on participants and the market.

Other proposals

V. A phase-down of industrial allocation

Proposal

93. The discussion document seeks views on how decisions to phase down industrial allocation should be made.

Analysis

94. Firms carrying out certain industrial activities (those that are emission-intensive and trade-exposed) are allocated NZUs for free (industrial allocation). The Government provides free allocation to these activities to reduce the risk of emissions leakage – i.e. if NZ ETS costs mean that a New Zealand activity is unable to compete with offshore production because the offshore producer does not have similar costs, potentially causing global emissions to increase.

95. The NZ ETS review identified that over time the Government will be providing more units through industrial allocation than necessary to mitigate the risk of emission leakage. However, it is difficult to robustly assess at what level the risk of leakage becomes material.

96. The Paris Agreement requirement for increasingly more ambitious action (over subsequent targets) means that current levels of industrial allocation (combined with other NZ ETS settings) will risk eventually surpassing our emissions budgets. We now have to consider this alongside the risk of leakage when thinking about free allocation.

97. For the Government, industrial allocation has both direct and opportunity costs. Every unit allocated is an expense to the Crown and a unit which cannot be auctioned. The earlier a phase-down starts, the lower the risk of needing to make a sharp adjustment in the future due to the risk of industrial allocation surpassing our emission budgets.

98. On the other hand, recipients of industrial allocation include significant manufacturing sites (e.g. New Zealand Steel, New Zealand Aluminium Smelter, and Methanex). If these sites were to close, there would be significant impacts for their employees and their local areas.

99. In the discussion document I propose to consult on two issues:

- a. how decisions on phasing down industrial allocation are made over time, including options to legislate for a phase-down in advance, establishing a test to initiate phase-down in legislation, or a decision-making process which could enable decisions to be based on better information and analysis in future. Both of the second two options would allow considerations about the availability of low-emissions technology to be included in the decision-making process.
- b. the impact to firms and the market of beginning a phase-down of industrial allocation in 2021 at rates between 1 and 3 per cent per year.

100. Note that:

- a. a phase-down rate of 1 per cent per year is currently specified in the Act (this was originally intended to apply from 2013 onwards, but was put on hold in 2012)

- b. a phase-down rate of 3 per cent would set a path to reducing industrial allocation to zero by 2050, in line with proposals for a new 2050 target in the ZCB. However, it could create a material risk of emission leakage for some industries.

VI. Market governance

Proposal

101. The discussion document seeks feedback on the risks of market misconduct, in order to inform work on improvements to the market governance of the NZ ETS.

Analysis

102. The market governance of the NZ ETS needs to ensure that the rules and oversight that are in place provide sufficient protection for market participants but do not restrict their flexibility to trade freely with each other.
103. There are several potential issues with the current market governance regime that need to be considered. These include the potential for manipulation of the NZU price, insider trading on the basis of non-public information, false or misleading advice provided to small participants, among other issues.
104. While there is limited evidence that these types of activities have occurred to date within the NZ ETS, other ETS markets have experienced these types of misconduct and it has contributed to a drop in confidence in those markets.
105. We need to 'future-proof' the NZ ETS as there are a number of areas where the NZ ETS could change over the coming years, including the start of auctioning, the potential for higher prices and the possible inclusion of the agricultural sector.
106. The discussion document seeks feedback from participants about the risks of market misconduct, both at present and also in the future. This information will help inform any future work that is undertaken by the Government to improve market governance.
107. The New Zealand carbon market includes large industrial players and financial intermediaries with capacity and financial expertise as well as smaller participants who have surrender obligations but otherwise have relatively limited financial experience.¹¹ Any changes to market governance could have significant and varying compliance costs for different types of market participants, and these impacts need to be well understood before coming to a preferred position.

VII. Market information

Proposal

108. The discussion document will provide a link to a new NZ ETS website. The purpose of the website is to make it easier to access NZ ETS information to support informed decision-making. The website will be tested with the public during consultation.

Analysis

109. Market information refers to how the Government provides NZ ETS information and communicates relevant policy announcements to the market. Easy access to information is important as it allows NZ ETS participants to make appropriate decisions about their

¹¹ For example, the forestry sector has many small scale participants who rely on consultants to manage participation on their behalf.

obligations and to judge the cost-effectiveness of investments in low emissions technologies or forestry.

110. The NZ ETS review found the release of information to the market could be significantly improved and that information is challenging to find and to understand. For example, information and data is currently spread across different government agencies' websites, often with little explanation about how the data could be used.
111. A new dedicated NZ ETS website will have NZ ETS policy announcements and links to relevant information, such as projected emissions, historical emissions and the number of units held in accounts.
112. Establishing a dedicated NZ ETS website is a practical response to improve regulatory predictability. It would complement the proposed coordinated decision-making process, as the annual unit supply announcements could be provided on the website alongside a schedule for announcements.
113. Alongside the discussion document, an initial version of this website will be established and tested with the public during the consultation period.

VIII. Compliance and penalties

Proposal

114. I am proposing to improve the compliance and penalties regime in the NZ ETS by:
 - a. replacing some low-level prosecution offences with a set of infringement penalties, while retaining the ability to prosecute for more serious offending (such as wilful and intentional non-compliance)
 - b. considering changes to the existing \$30 per unit penalty that applies for failing to surrender units, including an option to have a regime similar to that for income tax returns.

Analysis

115. The NZ ETS compliance regime covers a range of matters. Options currently available for addressing non-compliance in the NZ ETS include education, warnings and prosecution. Evidence shows that the majority of offending in the NZ ETS is on the less serious end of the scale of offending.
116. The NZ ETS review and the experience of regulators have identified two areas of the current compliance regime that may no longer be appropriate. These are:
 - a. criminal offences for low-level offending
 - b. the \$30 per unit penalty for failing to surrender or repay units. This can be further broken down into the level of the penalty and the penalty assessment that the Environmental Protection Authority (or Ministry for Primary Industries) is required to perform.
117. The discussion document asks for feedback on proposed changes to the compliance and penalty regime, including:
 - a. introducing a set of strict liability infringement offences instead of an option to prosecute for some low-level offences, while retaining the ability to prosecute for more serious offending (such as wilful and intentional non-compliance)

- b. considering changes to the existing \$30 per unit penalty that applies for failing to surrender units.

118. These are expected to increase levels of compliance over time, provide greater clarity for participants on expectations, and to deliver compliance oversight in a more cost-effective manner.

IX. Technical and operational improvements

Proposal

119. The discussion document also includes proposals for several detailed technical and operational improvements.

Analysis

120. Regulators and participants have identified some technical and operational issues that are causing administrative inefficiencies. Many issues have been dealt with through annual regulatory updates, however several have been identified which require changes to the Act.

121. The discussion document includes proposals to address the following specific issues:

- a. **receiving units where a participant has an overdue obligation** – the proposal is that when the Crown approves a unit allocation, these units are used towards repaying any overdue unit obligation before the remaining balance is transferred to the participant
- b. **partial opt-in**¹² – the Act does not state whether an opt-in participant can choose to opt in for only a portion of their fuel, coal or gas purchases. The proposal is to provide clarity through a change to the Act to either expressly allow for, or prohibit, partial opt-in
- c. **closing a loophole related to coal stockpiles** – there is a loophole available in the operation of the NZ ETS where coal that is stockpiled and sold in later years may not have a surrender obligation. The discussion document seeks feedback on a range of options to address this issue.

122. The discussion document also seeks feedback on six minor and technical proposals, including the retrospective amendment of unique emission factors to fix errors and allowing consolidated groups to apply for an industrial allocation.

Legislative amendments are needed to assist compliance with the Paris Agreement

123. Amendments to the Act are also needed to assist New Zealand's compliance with its obligations under the Paris Agreement. These legislative changes were signalled when New Zealand ratified the Paris Agreement.

124. The discussion document notes that amendments to enable compliance with the Paris Agreement are expected to be made in conjunction with the NZ ETS legislative changes proposed.

¹² An individual can 'opt in' and choose to become a participant for certain activities. This is so large fuel, coal or gas purchasers can take on the emissions reporting and surrender obligations from the supplier.

Next steps

125. I propose to announce the consultation on the NZ ETS in August 2018, following approval by Cabinet.
126. I intend to report back to Cabinet on the outcomes of consultation and seek final policy decisions by early 2019. Several of these decisions will require legislative amendments to the Act. I expect to introduce an amendment bill in 2019.
127. Regulations will need to be developed to fully implement many of the final policy decisions. These include technical details, such as the operational details for auctioning and implementing a price ceiling through a cost containment reserve via an auctioning mechanism. Unit supply volumes will also be set through annual regulation updates. I expect to return to this Committee in early 2019 to begin drafting these regulations.

Consultation

128. Relevant government agencies have been consulted on the contents of this paper. These include the Treasury, Ministry for Primary Industries, the Environmental Protection Authority, Ministry of Business, Innovation and Employment, Ministry of Foreign Affairs and Trade, Ministry of Justice, Department of Conservation, and Te Puni Kōkiri.
129. The Department of the Prime Minister and Cabinet (Policy Advisory Group) has been informed and has reviewed the proposals in this paper.

Financial implications

130. There are currently no direct financial implications and 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. I will seek Cabinet approval for new funding across agencies, including to reflect changes in the core systems and business tools required to support the proposals, when these details have been confirmed.
131. Developing an auctioning mechanism will have financial implications for the Crown. Once the high level design of auctioning is agreed, the auctioning system will then need to be implemented. The Ministry for the Environment was provided with funding for the policy work required for NZ ETS supply management, including auctioning, through Budget 2015. This did not include the cost for building or procuring an auction platform.
132. Implementing an auctioning system was initially estimated to cost between \$2m - \$7.8m over four years (excluding independent monitoring of auctions). This was an early estimate and is dependent on a range of decisions yet to be taken. I am proposing a sealed-bid, single-round auctioning format, which is generally less costly than a multiple round auctioning system. This may result in a reduction to the higher bound of the estimated cost.
133. Any funding for the auction platform will be sought through a separate Cabinet paper or through Budget 2019 based on the preferred auction design.
134. Over time,¹³ auctioning NZUs will have a positive impact on both the Crown's operating statement and balance sheet. Implementing auctioning could generate cash for the

¹³ The transaction of selling a unit by auction is fiscally neutral, however, when NZUs are surrendered revenue is recognised in the operating statement and there is an increase in cash assets on the balance sheet.

Crown in the range of \$0.88 – \$2.21 billion in total over the 2021-2030 decade.¹⁴ Under current fiscal policy practices, unless a policy decision is taken to use the cash obtained from auctioning NZUs for a specific purpose, it would contribute to the consolidated fund.

135. Industrial allocation results in an expense to the Crown. Phasing down industrial allocation at a rate of 0.02 (~2 per cent) per year is expected to reduce the allocation of NZUs by 11 million over 2021-2030, compared to the status quo. At an NZU price of \$25, this would reduce the Crown expense by \$275 million over 2021-2030.
136. Note this paper does not consider any potential free agricultural allocation, which will need to be considered after any decision to bring in surrender obligations for agricultural emissions into the Act.

Human rights

137. There are no inconsistencies between the proposals in this paper and the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Te Tiriti o Waitangi

138. 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.
139. 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 specific engagement with iwi/Māori to reflect their interest in the proposals, and how they may impact on Māori involvement with the NZ ETS.

Legislative implications

140. The discussion document only seeks feedback on proposals, so there are no legislative implications. I intend to seek final decisions to implement these proposals following consultation later this year, once feedback has been incorporated into the analysis. These decisions will require legislative and regulatory change.

Regulatory impact analysis

141. The Regulatory Quality Team at the Treasury has determined that the regulatory decisions sought in this paper are exempt from the requirement to provide a separate Regulatory Impact Assessment as the relevant issues have been addressed in the attached discussion document prepared by the Ministry for the Environment.
142. The discussion document has been reviewed by a panel drawn from the Regulatory Impact Analysis Teams in the Treasury, Ministry for Primary Industries and Ministry for the Environment. The panel considers that the discussion document contains the key elements of a RIA and is adequate to support the level of Ministerial decisions being sought in this Cabinet paper, given the stage in the consultation process. The options are focussed primarily on the framework of the NZ ETS and not specific settings. For

¹⁴ Given current projections that there are 44.1 million tonnes CO₂-e of the emissions budget associated with New Zealand's 2030 target that will not be allocated by other means, and assuming an NZU price range of \$20 - \$50.

instance, consultation is being proposed on the design of a mechanism to auction units, and not on the detailed settings such as the amount of units to be auctioned.

143. The document is clearly written, with a clear problem definition and objectives. The criteria are clearly outlined and applied to analyse a wide range of options, including those which have been considered and discarded (these are attached in appendix one). The options have been developed and analysed based on currently available information. For the post-consultation regulatory impact analysis, more detailed information will be required on the economic and fiscal costs, including some economic modelling. It is expected that the consultation questions will help to elicit more cost information.
144. There is some discussion of operational issues in the discussion document, which is at a suitable level given the pre-consultation stage.

Gender Implications

145. This paper has no gender implications.

Disability Perspective

146. This paper has no disability implications.

Publicity

147. 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.
148. I propose to make a media release on the NZ ETS consultation approximately one week following Cabinet's consideration of this paper. The discussion document will then be made available on MfE's website. MfE and the EPA will notify NZ ETS account holders and stakeholders about the release of the consultation document.
149. Hon Jones and I are also proposing a package of improvements specifically related to forestry in the NZ ETS. These proposals are set out in an accompanying Cabinet paper [New Zealand Emissions Trading Scheme (ETS) Review: Improving the ETS for forestry refers] and discussion document. This discussion document will then be made available on the Ministry for Primary Industries website. The release of both discussion documents will happen at the same time.
150. I also intend to proactively release this Cabinet paper, with redactions consistent with the withholding grounds in the Official Information Act 1982, at the same time as the consultation documents.

Recommendations

The Minister for Climate Change recommends that Committee:

1. **note** that the New Zealand Emissions Trading Scheme (NZ ETS) is the Government's key policy tool to reduce greenhouse gas emissions and support New Zealand to meet its climate change targets.

2. **note** that under current settings the NZ ETS will not effectively assist New Zealand to meet its 2030 target under the Paris Agreement, or potentially any new 2050 target under the Zero Carbon Bill.
3. **note** that in December 2017 this Cabinet noted four in-principle decisions made by the previous Government and that the changes would be pursued through legislative amendments to the Climate Change Response Act 2002 by the end of 2019.
4. **note** that the discussion document on improvements to the NZ ETS will include options for implementing the in-principle decisions. These proposals are to:
 - 4.1 introduce sealed-bid, single-round auctions with uniform pricing, with an open question on auction frequency
 - 4.2 establish a new price ceiling, in the form of a volume-limited cost containment reserve as part of the auction mechanism, to replace the current fixed price option
 - 4.3 limit the use of international units either through restrictions on government purchase, or through limiting the volume able to be imported/surrendered by NZ ETS participants
 - 4.4 establishing a process for coordinating and managing unit supply decisions and identifying what factors need to be taken into account when making these decisions, such as advice from the independent Climate Change Commission (the Commission).
5. **note** that implementing the in-principle decisions would allow the Government to align unit supply with our emission reduction targets and budgets, and provide the Government with the tools to put a cap on emissions via the NZ ETS.
6. **note** that the final policy decisions on the Zero Carbon Bill will have implications on unit supply settings of the NZ ETS, including any new 2050 target, emissions budgets and the role of the Commission.
7. **note** that the proposed changes to the NZ ETS would complement the Zero Carbon Bill process as they can provide the basis for helping meet emissions budgets and support the transition to a net zero emissions economy.
8. **note** that this consultation is not consulting on specific unit supply settings and volumes (e.g. the level of any price ceiling, the level of any limit on international emissions units, or the volume of units to be sold via auctioning).
9. **note** that providing details on technical aspects and unit supply settings in regulations will require further consultation in 2019.
10. **invite** the Minister for Climate Change to report back to Cabinet by the end of 2019 with proposals for setting unit supply volumes in regulations.
11. **note** that the discussion document on improvements to the NZ ETS includes options aimed at improving market function and governance to address other issues identified during the review. These include:
 - 11.1 options for future decisions on industrial allocation
 - 11.2 seeking feedback on the risks of market misconduct, in order to inform work on improvements to the market governance of the NZ ETS
 - 11.3 improving the provision of market information and establishing a dedicated NZ ETS web portal

- 11.4 improving the compliance regime by introducing infringement offences for low level non-compliance, and options to change the penalty regime for failing to surrender units
- 11.5 a number of technical and operational improvements.
12. **note** that a package of improvements related to forestry in the NZ ETS is being considered in an accompanying Cabinet paper and should be considered in conjunction with this paper [*New Zealand Emissions Trading Scheme (ETS) Review: Improving the ETS for forestry* refers].
 13. **agree** to release a discussion document for public consultation from 13 August 2018 to 21 September 2018 on proposals to improve the NZ ETS
 14. **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.
 15. **agree** to allow the Minister for Climate Change, in consultation with the Minister of Finance and the Minister for the Environment, to amend the consultation document on the timeframe to change the fixed price option, if he considers that changes are needed to manage fiscal risks associated with the current \$25 fixed price option.
 16. **note** that if, following advice on options to manage fiscal risks arising from the current fixed price option, the Minister for Climate Change, in consultation with the Minister of Finance and the Minister for the Environment, considers it necessary, Cabinet may be invited to consider more expedient action to reduce the fiscal risk and/or put in place an interim solution.
 17. **invite** the Minister for Climate Change to report back to Cabinet, following public consultation, to seek final policy decisions in early 2019, with a view to introducing a Climate Change Response Amendment Bill to Parliament in 2019.
 18. **note** any new funding required to implement the final policy decisions noted above will be sought through a separate Cabinet paper or through Budget 2019.
 19. **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