



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

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Security Level	IN CONFIDENCE	MfE Priority:	Non-Urgent

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

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

Ministry for the Environment contacts

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Key Messages

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

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

Context

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

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

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

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

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

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

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

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

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

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

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

Analysis and Advice

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

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

Consultation and Collaboration

Stakeholders support hypothecation towards wider climate change objectives

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

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

Hypothecation best practice



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

Next Steps

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

Recommendations

37. We recommend that you:

- a. **Note** that the revenue flow from NZU auctioning is just one of many fiscal considerations that are needed across the Government's climate change policy framework
 - b. **Agree** to meet with your colleagues to discuss climate change spending priorities and include the possible use of ETS auction proceeds as part of that discussion.
- Yes/No
- c. **Engage** with colleagues regarding the possibility of ^{s 9(2)(f)(iv)} 

 - d. **Note** that if the Government does decide to hypothecate auction revenue through the CCRA that this could be included in legislative changes later in 2019 once the wider climate change spending priorities have been agreed across Government
 - e. **Agree** not to make legislative change to hypothecate auction proceeds as part of the tranche two decisions on NZ ETS improvements due to go to cabinet in March 2019.

Yes/No

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

Signatures

Roger Lincoln
Director, Climate Directorate

Date

Hon James Shaw
Minister for Climate Change

Date