



## Review of proposed provisional emissions budget and NZ ETS price control settings in response to COVID-19

Date Submitted:	9 April 2020	Tracking #: 2020-B-06618	
Security Level	In-confidence	MfE Priority:	Urgent

	<b>Action sought:</b>	<b>Response by:</b>
To Hon James Shaw, Minister for Climate Change	Agree with officials the recommendations for the provisional emissions budget and NZ ETS price control settings	<b>15 April 2020</b>

Actions for Minister's Office Staff	<b>Return</b> the signed report to MfE.
Number of appendices and attachments	Nil

### Ministry for the Environment contacts

Position	Name	Cell phone	1 <sup>st</sup> contact
Principal Author	Vanessa Chalk		
Responsible Manager	Matthew Cowie	██████████	✓
Director	Roger Lincoln	██████████	

## Review of proposed provisional emissions budget and NZ ETS price control settings in response to COVID-19

### Key Messages

1. The purpose of this briefing is to advise you on our recommendations for New Zealand's provisional emissions budget (2021-25) and the settings for the New Zealand emissions trading scheme (NZ ETS).
2. Our advice is based on feedback and analysis from the public consultation on these subjects that closed in February 2020, and also on our opinion about how these decisions are affected by the impact of the COVID-19 pandemic on the economy and greenhouse gas emissions.
3. We consider progressing with the provisional emissions budget and NZ ETS price control settings that were proposed in the consultation document released in December 2019 remain broadly appropriate, despite the changed circumstances presented by COVID-19. This is because:
  - a. current reforms to the NZ ETS allow the NZU price to adjust in a constructive manner as the outlook for the economy and emissions evolves
  - b. the scheme provides a number of important safety valves to avoid significant unacceptable impacts on NZU prices and/or operation of the market.
4. We believe adopting the previously proposed NZ ETS settings with only minor adjustments will provide regulatory stability and certainty to help ensure a smoother transition to a low emissions economy. Gradually and predictably increasing emissions prices will encourage more immediate investments in low emissions technologies and practices and lower the overall economic costs in the future.
5. We recommend that the provisional emissions budget should retain the same methodology originally proposed for calculation of a linear reduction towards to the 2050 Zero Carbon Act target. Moving some of the proposed annual budget volume to the latter part of the period will avoid the risk of oversupplying the market initially, given the inevitable impact that COVID-19 will have on emissions in 2020 and 2021.
6. We also recommend maintaining the proposal to change the fixed price option (FPO) to \$35 for activities from 2020, as you have already agreed (refer 2020-B-06518). This would be enacted by way of supplementary order paper to the Climate Change Response (Emissions Trading Reform) Amendment Bill (ETR Bill), with your delegated decisions for this change confirmed by Cabinet in the relevant Cabinet paper. A second briefing seeks in-principle policy approval from yourself and the Ministers for Forestry and Finance to further amend the FPO by extending the \$35 period beyond 2020 as a backstop in case auctioning does not start in early 2021 as planned.
7. The emission unit auction price floor is now one of the most significant safety valves in light of the forecast recession and the potential significant drop in emissions. We recommend that the reserve price remains at \$20 in 2021 to avoid the Government from auctioning NZUs at less than their long-term value, compromising future emissions

reduction targets and reducing market predictability for foresters and investors in emissions-efficient technologies.

8. Although the cost containment reserve trigger price potentially signals an upward trend in price to the market, which may be seen as risky in a time of economic downturn, the trigger price is in fact less likely to be reached at a time of economic recession, and we recommend that it is maintained at the originally proposed \$50 in 2021.
9. Increasing the price controls annually, rather than the flat line approach proposed in in the consultation, saw significant public support, including by the Climate Change Commission, and we recommend updating the controls to reflect this, for example, by increasing them at the rate of inflation.
10. Following your consideration and any discussion on the recommendations in this briefing we will finalise a draft Cabinet paper due at your office by Thursday 23<sup>rd</sup> April.

## Recommendations

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11. We recommend that you:

- a. **Note** that a public consultation on the provisional emissions budget and NZ ETS settings closed in February 2020 and contained proposals that did not take account the changed situation brought about by COVID-19
- b. **Note** that COVID-19 is expected to have significant impacts on the New Zealand economy and reduce New Zealand's greenhouse gas emissions in 2020, but the long-term impact on emissions is extremely uncertain
- c. **Note** that although the uncertainties associated with COVID-19 pose some risks to making decisions regarding NZ ETS settings, the reformed scheme contains appropriate safeguards to deal with the uncertainty and market changes, and we recommend making these decisions within the coming month so that unit auctioning can still begin in 2021
- d. **Note** that officials have reviewed the proposed provisional emissions budget and NZ ETS price settings because of the impact of COVID-19 on New Zealand's economy and forecast emissions
- e. **Agree** that the following decisions be included in the draft Cabinet paper seeking policy approval for the provisional emissions budget and NZ ETS settings;
  - i. The provisional emissions budget for 2021-25 remains at 354 Mt CO<sub>2</sub>-e
  - ii. The emission unit auction price floor for 2021 remains at \$20
  - iii. The cost containment reserve trigger price for 2021 remains at \$50

Yes/No

- f. **Agree** that while no change is recommended to the overall provisional emissions budget for 2021-25, in order to reduce the possibility of oversupplying the emission unit market initially, there should be a slight auction volume reduction over 2021-22, and an increase for 2023-25

Yes/No

- g. **Agree** that, for the purpose of the draft Cabinet paper, the auction reserve price floor and cost containment reserve price trigger increase annually, for example, by the rate of inflation

Yes/No

- h. **Agree** that the extended FPO should be set to \$35, as originally proposed, and will be included in the Cabinet paper supporting the supplementary order paper to the NZ ETS reform Bill.

Yes/No

- i. **Meet** with officials for further discussion

Yes/No

## Signature

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*This briefing has been electronically approved by*

Roger Lincoln  
Director  
**Climate Change Directorate:**

Hon James Shaw  
**Minister for Climate Change**

**Date**

## Review of proposed provisional emissions budget and NZ ETS price control settings in response to COVID-19

### Purpose

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12. The purpose of this briefing is to provide analysis and seek your feedback on proposals that form part of the package of NZ ETS settings for you to take to Cabinet for policy decisions in early May. The decisions discussed here are:
  - a. The volume of the provisional emissions budget
  - b. The price of the fixed price option (FPO) for 2020 emissions
  - c. NZ ETS price control settings, being the auction reserve price floor and cost containment reserve trigger price
13. This briefing discusses the potential changes to each of these proposals as a result of the COVID-19 pandemic.

### Context

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14. Consultation on the proposed provisional emissions budget, and NZ ETS unit supply and price control settings closed at the end of February 2020. The public submissions from the consultation showed a wide range of views regarding the ambition of the provisional emissions budget, emission unit (NZU) auction volumes and price controls. You recently received a briefing note that analysed the submissions in detail (2020-B-06566).
15. Since the consultation, the significant impacts that the COVID-19 pandemic will have in New Zealand have become apparent.
16. In order to continue with plans to begin auctioning in 2021, decisions about the NZ ETS settings are needed now because:
  - a. changing the FPO requires further amendments to the Bill by a supplementary order paper, which is going to Cabinet on 11 May 2020<sup>1</sup>.
  - b. officials need to continue to complete a regulatory impact assessment and a draft Cabinet paper including a full package of NZ ETS settings
  - c. the auction platform is currently being procured by MfE with a target start date for auctions of early 2021

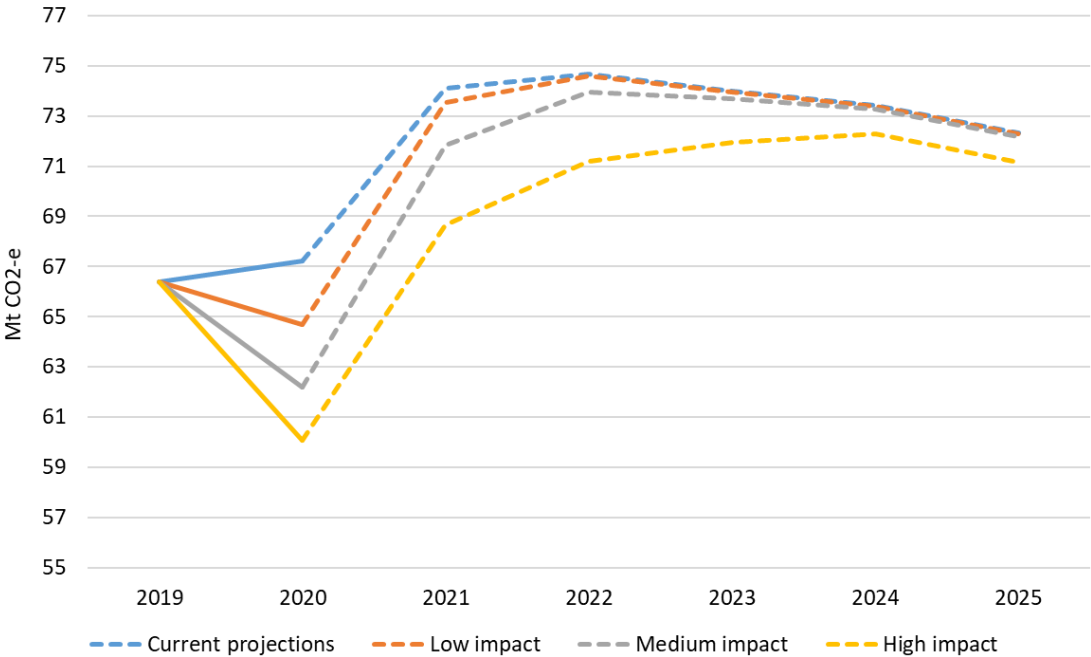
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<sup>1</sup> You have already given your in-principle approval to extend the FPO to cover 2020 emission activities, raising the price from \$25 to \$35. A second briefing (2020-B-06585) seeks further approval from yourself and the Ministers for Forestry and Finance to extend this \$35 period beyond 2020 as a backstop in case auctioning does not start in early 2021 as planned.

**Analysis**

- 17. There are significant challenges in predicting the impact COVID-19 will have on emissions and emissions costs.
- 18. MfE officials have worked with our colleagues in other agencies to produce a range of emissions scenarios for 2020-25. These examples come with a number of important caveats:
  - a. there is a substantial uncertainty at this stage about both the duration and severity of the COVID-19 impact
  - b. while agencies have well-developed understandings about emissions within their sectors, this expertise isn't able to offset the overall COVID-19 "duration and severity" uncertainty
  - c. the high impact scenario should not be viewed as a 'worst-case' scenario.
- 19. The impact (and uncertainty) from COVID-19 has short-, med- and long-term consequences. While the economy remains at Level 4, the emissions from many sectors will be substantially suppressed in the short-term (such as transport). In the medium-term, it is likely to take time for some sectors to come back to normal, particularly if some physical distancing rules are kept in place. In the longer-term, there may be material changes to the structure of the economy – for example, if any major industrial facilities close and/or international tourism fails to rebound
- 20. Figure 1 below shows the current net emissions projections based on New Zealand's fourth biennial report, as well as three potential COVID-19 impact scenarios (note, there was already projected to be significantly lower emissions in 2020 than in 2021 in the pre-COVID-19 projections due to variations within forestry harvesting).

**Figure 1 Current net emissions projections and potential COVID-19 impact scenarios**



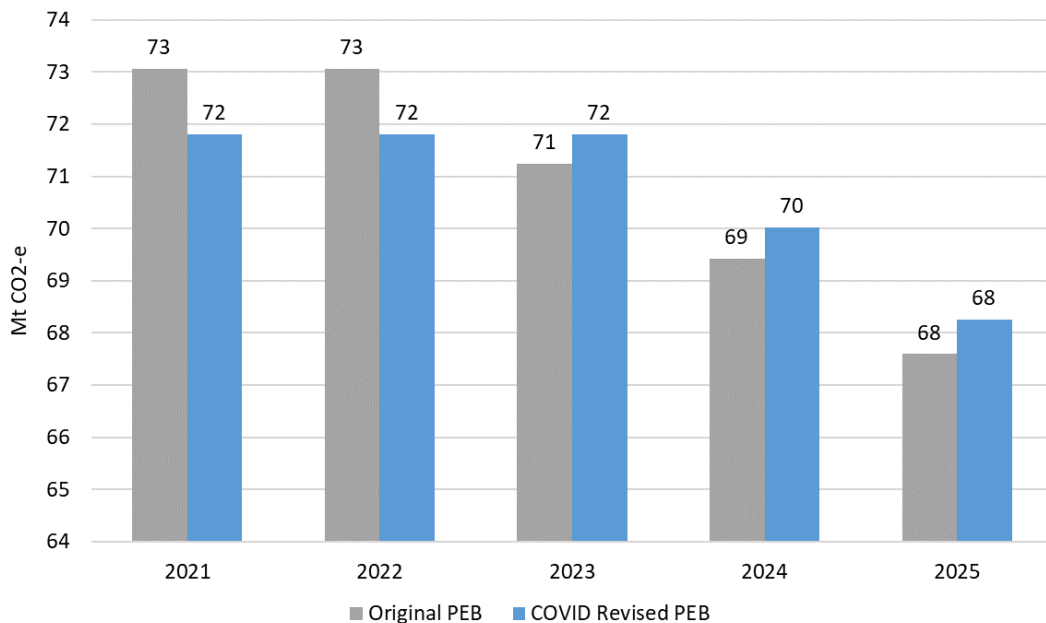
21. The following sections of this briefing identify the specific recommendations for the provisional emissions budget, FPO and NZ ETS price control settings. Overall, we recommend no significant change to the decision making timing, or the proposals that were originally consulted on. This is because:

- a. Delaying NZ ETS settings regulation decisions will postpone the start of NZU auctioning until 2022, increasing the risks of having an NZ ETS with no cap on emissions, increasing the already oversupplied stockpile, and removing the safety valve of having an auction reserve price floor to protect against sudden or significant drops in the NZU price.
- b. The NZ ETS, particularly post the passing of the reforms within the ETR Bill, should automatically adjust in response to the state of the economy. For example, if the outlook for the economy worsens, then NZU prices are likely to drop further, 'automatically' alleviating financial pressure on emitting firms and households (and vice versa if the economic outlook improves).
- c. The NZ ETS proposals contain safety valves such as the auction price floor of \$20 and the cost containment reserve trigger price of \$50. Another is that the Climate Change Commission will advise on emissions budgets in 2021 and re-consider the NZ ETS settings.
- d. Maintaining the previous proposals indicates the Government's commitment to regulatory certainty. The Government needs to assure both high- and low-emitting firms that it will always maintain our transition towards a low-emissions economy.
- e. Adjusting the previously proposed NZ ETS settings because of COVID-19 may make it harder to ensure a smooth and just transition to a low emissions economy, or achieve our long term emissions reductions targets, such as our Nationally Determined Contribution under the Paris agreement and the 2050 target under the Zero Carbon Act (ZCA).
- f. Gradual and predictable increases in the emissions price will encourage more immediate investments in low emissions technologies and practices and lower the overall economic costs in the future.

*The volume of the provisional emissions budget*

22. The provisional emissions budget itself is not a statutory decision. However, it is a key factor in determining the related NZ ETS unit supply and price control setting regulations required under section 30GC of the ETR Bill.
23. The proposal consulted on for the provisional emissions budget was that it should be set in line with a linear reduction between near-term emissions levels and the 2050 ZCA target. Using the numbers available to us in late 2019, this resulted in a proposal for a provisional emissions budget of 354 Mt CO<sub>2</sub>-e over the 2021-25 period.
24. Following consideration of the impacts of COVID-19 on forecast emissions, we recommend that the proposal for the overall volume of the provisional emissions budget is adopted, but with minor adjustments to the annual volumes. We recommend some of the emissions volume that was proposed for the earlier two years be spread differently over the five years, as illustrated in Figure 2.

**Figure 2 Original provisional emissions budget vs. revised budget proposal**



25. The proposal consulted on forecast higher emissions than are likely under COVID-19. We recommend the above adjustment be made in order to reduce the possibility of oversupplying the market through NZU auctions in the early part of the period.
26. Reducing supply in the first two years of the provisional emissions budget period carries some risks associated with increasing pressure on supply, and driving an increase in the NZU price. However, we believe that this is unlikely to occur due to the impact of COVID-19 on reducing emissions (and therefore demand for units) at the beginning of the period.
27. By keeping the proposed provisional emissions budget of 354 Mt CO<sub>2</sub>-e over the 2021-25 period, this allows the NZ ETS to assist the economy to recover without forcing greater emission reductions and pressure on unit supply in response to the forecast economic slowdown.
28. The Climate Change Commission will advise on any potential for emission unit oversupply in 2021, so the emissions volume that is pushed back within the budget time period has more opportunity to be subject to review.
29. An alternative option, which we do not recommend, is to use a methodology that results in a larger provisional emissions budget volume due to public concerns around the potential pressure the NZ ETS could place on firms in times of economic challenge. This would likely over-supply the NZ ETS with units, slow down the transition to a low-emissions economy and put New Zealand further off-track towards meeting the 2021-30 Nationally Determined Contribution.

*The fixed price option*

30. The existing fixed price option is closely related to the NZ ETS price controls, but is set in the Act directly. Any changes to the fixed price option therefore require further changes through the ETR Bill. We propose these changes to the FPO in the ETR Bill are confirmed by Cabinet and made through a supplementary order paper.

31. The proposal consulted on was to extend the fixed price option to cover emission activities in the 2020 calendar year, raising its price from the current \$25 to \$35. This decision has already been made by Ministers in line with delegated authority (subject to confirmation by Cabinet when it approves the supplementary order paper). We recommend that this decision remain in place.
32. In addition, we recommend the ETR Bill is further modified through the supplementary order paper to extend the \$35 fixed price option as a 'backstop' approach for activities in years beyond 2020 if auctioning doesn't start as planned. This contingency measure ensures a long-term supply option remains in place in the event auctioning does not begin in 2021. We have prepared a separate briefing for you and the Ministers for Forestry and Finance seeking agreement in-principle for this further policy change (2020-B-06585).
33. We do not recommend reducing the extended fixed price option below \$35 as a means to address potential concerns regarding the NZ ETS costs to the economy over 2020. This is because:
  - a. it is only available as a backstop – there is currently ample liquidity in the market and participants are able to purchase units for significantly less than \$35 on the secondary market
  - b. a lower price would encourage greater use, which will further contribute to the significant oversupply of units within the NZ ETS stockpile
  - c. some participants may have already included \$35 in their contractual and supply arrangements for the year and reducing it mid-way through the year may have limited economic benefit to downstream consumers
  - d. it maintains the signal to the market of Government's continued commitment to emissions reduction policies and steadily increasing emissions prices
  - e. diverging from the \$35 proposed in the consultation document introduces further regulatory uncertainty into the operation of the NZ ETS
34. If Ministers wished to consider a price below \$35 regardless of the considerations listed above, our advice is that the fixed price option should still be set above \$25 to indicate that businesses and consumers need to continue to consider their long-term emissions reduction transition and the likely need for steadily increasing emission prices.

#### *NZ ETS price controls*

35. The NZU price is predominantly determined by principles of supply and demand, and therefore flows through from decisions related to the provisional emissions budget and NZU auction supply. The market price for units will adjust as the outlook for the economy and emissions evolves. For example, if the outlook for the economy worsens then NZU prices are likely to drop further, 'automatically' alleviating financial pressure on emitting firms and households (and vice versa if the economic outlook improves).
36. COVID-19 has already had a material impact on the market price for units as it has dropped below \$25 over recent weeks as the forecast demand for units has reduced. In addition, some market participants may be selling units in order to replace the cashflow lost elsewhere in their business.

37. However, in addition to market supply and demand fundamentals, price controls can influence trends in price and are visible signals to the public of the Government's strategy to the NZ ETS and emissions pricing in times of economic challenge.
38. Given the significant uncertainty relating to the impact of COVID-19 on both the economy and emissions, price controls also provide important safety valves against unforeseen consequences on price and functioning of the market.
39. The NZ ETS price controls discussed here are statutory decisions that will be enacted through regulations set out in Section 30GC of the ETR Bill.

#### *Auction price floor*

40. An auction price floor only puts a lower limit on the price at which the Government is willing to sell units to the market. Units would still be able to be traded at less than this price on the secondary market if participants thought that their value was actually even lower than the auction floor price. So while the auction price floor is likely to be a strong source of support to help keep unit prices above the auction price floor level, it does not provide a guarantee that prices trade above that level.
41. The proposal consulted on was for an auction reserve price to be set at \$20 over the 2021-2025 period.
42. We recommend the consultation proposal for a \$20 price floor in 2021 is adopted. The auction price floor is very important to maintain in case we have a severe recession, as this will ensure that the Government doesn't sell NZUs substantially below their likely long-term value. This price floor at auction is also likely to be a key source of financial support for foresters and new forest planters and investors in low emissions infrastructure through its influence on supporting secondary market prices.
43. We recommend that if any change to the price floor proposal is made, it would be to increase the price annually, for example, by the rate of inflation. This was a common view received from consultation submissions, including from the Climate Change Commission. The Commission stated that the flat price controls do not reflect the factors the Minister is required to consider when recommending price controls defined in Section 30GC of the ETR Bill, highlighting the lack of adjustment for inflation at a minimum.

#### *Cost containment reserve*

44. The cost containment reserve releases additional NZUs onto the market if the trigger price is reached at auction. This would increase supply to the market and reduce pressure on price. Any reserve units sold on the market above the NZ ETS cap on emissions must be backed by the Government with equivalent emissions reductions, such as international units.
45. The cost containment reserve works to assure the market that unacceptably high prices will not occur during times of high market demand.
46. The value of the cost containment reserve trigger is intended to be set outside of the range of expected market prices, but may sometimes be seen by the market as the expected direction that NZU prices will take.
47. The proposal consulted on was that the cost containment reserve trigger price is set at \$50 over the 2021-25 period.

48. We do not recommend reducing the 2021-25 \$50 trigger price proposed in the consultation document, despite consideration of the potential economic recession brought on by the COVID-19 pandemic.
49. The trigger price is less likely to impact the market in times of economic downturn as it is unlikely to be reached, particularly while there remains a substantial surplus of units stockpiled by participants. However, a high trigger price can still have the impact of signalling higher prices to the market, which could potentially exert upward pressure on the NZU price.
50. Despite this, we believe lowering the trigger price has more significant risks, including:
- a. reducing incentives for long-term investments in low emissions technologies, therefore limiting our ability to reach our emissions reductions targets and transition to a low-emissions economy
  - b. the significant fiscal risk to the Government of having to 'back' any units that are released from the cost containment reserve above the NZ ETS emissions cap if the trigger price is reached
51. We recommend that if any changes to the cost containment reserve trigger price were to be made, it would be for prices to increase annually. As discussed above in regard to the price floor, this was a common view received from submissions regarding the price controls, including from the Climate Change Commission, Citizen's Climate Lobby, Compass Climate, New Zealand Wind and Energy Association and the Office of the Māori Climate Commission.
52. If a reduction in the cost containment reserve trigger price is something the Government wishes to pursue, we would recommend using multiple price triggers, whereby a smaller volume from the reserve is initially released at the lower price (which could come from inside the budget, not requiring them to be to be 'backed'), and a larger volume if a higher trigger price was reached.

## **Next Steps**

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53. Following your approval and discussion of these proposals with you, a draft Cabinet paper seeking policy approvals will be provided to your office on Thursday 23 April.
54. We anticipate an early May Cabinet decision, followed by drafting of the regulations. We will work towards seeking further Cabinet decisions before the House rises for the general election.