



Enabling a technical reserve price for NZ Emissions Trading Scheme auctions

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Security Level	In confidence	MfE Priority:	Non-Urgent

	Action sought:	Response by:
To Hon James Shaw, Minister of Climate Change	Agree to enable a technical reserve price for NZ ETS auctions before the first auction on 17 March 2021	16 November 2020

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

Ministry for the Environment contacts

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Director	Matthew Cowie		

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Enabling a technical reserve price for NZ Emissions Trading Scheme auctions

Key Messages

1. This briefing advises that the absence of a technical reserve price for NZ ETS auctions poses an increasing risk to the integrity NZ ETS. We seek your agreement to address this risk and take action to enable a technical reserve price prior to the first auction, scheduled for 17 March 2021.
2. Cabinet agreed to set a technical reserve price for auctioning in March 2020. However, due to an issue with recent reforms to the Climate Change Response Act 2002 (the Act), regulations had to be set without one. Setting a technical reserve price now requires an amendment to the Act and related regulations.
3. Taking action to amend the Act to enable a technical reserve price before March 2021 would require prioritisation on the Government's legislative agenda.
4. In September 2020, we advised that the lack of a technical reserve price posed a low risk to auctions clearing significantly below the prevailing secondary market price.
5. Since then, increasing attention has been given to the lack of a technical reserve price by the media and market commentators, which has greatly increased this risk. It is likely that this public discussion will influence bidder behaviour at auctions and may encourage them to bid at lower prices than they would have otherwise.
6. The increasing risk that the first auction may clear significantly below the secondary market price creates risks to the reputation of the NZ ETS, to market certainty and poses a fiscal risk for the Government.
7. The outcome of the first NZ ETS auction will be closely watched, both here and overseas. A successful first auction will support market stability and will contribute to the reputation of the NZ ETS.
8. Progressing an accelerated and technical legislative amendment will require prioritising this change above other items on the legislative agenda and risks introducing further error.
9. On balance, we recommend that you direct officials to proceed with options to make legislative amendments to the Act and related regulations to set a technical reserve price for NZ ETS auctions before the first auction in March 2021.

Recommendations

10. We recommend that you:

- a. **Note** that the risk of NZ ETS auctions clearing significantly below the secondary market price has increased due to media attention on the lack of a technical reserve price.
- b. **Note** that an issue with the recent reforms to the Climate Change Response Act 2002 (the Act) meant we were unable to set a technical reserve price for NZ ETS auctions.
- c. **Note** that amending the Act prior to the first auction in March 2021 will require a

highly accelerated and technical legislative amendment process

- d. **Agree** it is important to enable a technical reserve price before the first auction in March 2021

Yes/No

- e. **Direct** officials to provide further advice on options to amend the Climate Change Response Act 2002 and related regulations to enable the technical reserve price for NZ ETS auctions in time for the first auction.

Yes/No

- f. **Agree** that this briefing and appendices will be released proactively on the Ministry for the Environment's website subject to redactions as appropriate under the Official Information Act 1982 once the technical reserve price is in place.

Yes/No

Signature



Matthew Cowie
Director
Climate Change Directorate

Hon James Shaw
Minister of Climate Change

Date

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Supporting material

Purpose

1. To seek your agreement to progress with a technical reserve price for NZ ETS auctions before the first auction on 17 March 2021.

Context

The technical reserve price prevents the sale of units significantly below the prevailing secondary market price

1. The purpose of the technical reserve price is to prevent the sale of units significantly below the prevailing secondary market price at the time of each individual auction.
2. 9(2)(i)
[Redacted]
3. As decided by Cabinet, if the auction clearing price is less than the technical reserve price then the Government would not sell any units at that auction. Instead, all units would be treated as unsold. Unsold units from any one auction are added to the number of units for sale at the next auction except from if it is the last auction of the calendar year when units remain unsold.
4. The technical reserve price is distinct from the minimum price set in regulations (otherwise known as the price floor), which is published in advance and is intended to set a clear expectation in the market that the government will not accept bids below that price level. For 2021, the auctioning regulations state the price floor is \$20.

Original regulatory proposals included provision to set a technical reserve price

5. In August 2020 the Climate Change Response Act 2002 (the Act) was reformed via the Climate Change Response (Emissions Trading Reform) Amendment Act 2020 (the Bill). Among these reforms were provisions to set regulations for auctioning.
6. 9(2)(g)(i)
[Redacted]
7. The original proposal to set a technical reserve price for auctions was included in consultation on Reforming the NZ ETS: rules for auctioning that opened in November 2019. Most submitters who commented on this were supportive of the introduction of a technical reserve price.
8. Cabinet subsequently decided, in March 2020 immediately prior to the first COVID-19 lockdown, to set regulations for auctioning that included setting a technical reserve price [DEV-20-MIN-0047 refers].
9. These decisions were taken to Cabinet in March 2020, before the Bill had been enacted, to ensure that there was enough time to draft the regulations and put them in place to take effect before the first auction in early 2021.

COVID-19 impact on timelines

10. Following the March Cabinet decision, drafting was delayed due to the need to prioritise COVID-19 legislation. Therefore we planned to present these regulations to Cabinet for authorisation in November 2020, after the September election.
11. Following Royal Assent for the Bill in June 2020, the Parliamentary Counsel Office (PCO) started to draft the auctioning regulations and we received the first draft for review in the first week of August 2020.
12. On 17 August 2020, due to the COVID-19 lockdown in Auckland, the Prime Minister delayed the general election from September to October. The delay put our original timeline at risk because of the uncertainty regarding Cabinet decision-making in the immediate post-election period. If these regulations could not be gazetted before the end of 2020 then the first auction date in March was at risk. Consequently we worked with PCO to compress the original timeframes for drafting to complete the regulations before the election constraint period.

An issue with the Act

9(2)(h)

16. Based on this advice, and on official advice that the absence of a technical reserve price posed a low risk to the integrity of auctions, Cabinet approved the auctioning regulations in September 2020 without the ability to set this reserve price [CAB-20-MIN-0046 refers].
17. In late September 2020 the regulations were gazetted, we proactively released the related Cabinet papers and updated the MfE website accordingly.

Analysis and Advice

Our original advice was that the absence of technical reserve price posed a low risk

18. When Cabinet approved the auctioning regulations, we advised that the absence of a technical reserve price posed a low risk to auctions clearing significantly below the secondary market price. It was important to ensure that NZ ETS auctions started on schedule on 17 March 2021, as publicly announced.
19. We evaluated this as low risk for two reasons. Firstly, where a technical reserve price has been set in other international ETS markets, it has only been hit in very rare circumstances. Also at that time, our advice was that the technical reserve price is set as a 'safety net' as it should not be needed under normal circumstances. In other words, we expected the secondary market would remain the primary price signal for bidding at auction.
20. At that time it was also unclear what opportunities could be available to amend the legislation, given the uncertainty around election outcomes.

21. Cabinet invited the Minister for Climate Change to report back regarding possible amendments to the Act to address the absence of a technical reserve price in 2021 [CAB-20-MIN-0046 refers].

Public commentary has increased this risk

22. Following the proactive release of Cabinet decisions on the auctioning regulations, several market experts and other commentators, including the Opposition climate spokesperson, raised public concerns regarding the risk posed by the absence of a technical reserve price to auctioning. Some commentators also shared their concerns directly with officials.
23. Market commentators have described the risk as an opportunity to purchase units at prices lower than the secondary market price, sharing this advice with market participants.
24. The more attention that is paid to this issue, the more danger that a “self-fulfilling prophecy” arises because people are encouraged to bid lower in the auction than they otherwise would have done.
25. At present, there is no evidence that this discussion is affecting existing prices in the secondary market. NZ ETS prices are still at approximately \$35, close to the level of the fixed price option. So the market has not yet built any expectation of lower prices into the market price.

A low auction price poses reputational and fiscal risks

26. However, if the first auction does clear significantly below the secondary market price due to an increase in the number of ‘bargain hunting’ bids then this poses a significant risk to the integrity of the NZ ETS. A low auction clearing price could lead to reduced prices on the secondary market and impact the integrity of auctioning specifically and the scheme as a whole.
27. Furthermore, if auctions do clear significantly below the market price then this may have an impact on the international reputation of the NZ ETS and pose a risk to international linking arrangements, if the Government should decide to pursue this option in the future.

28. 9(2)(g)(i)

29. Further analysis of other international ETS’s shows that although technical reserve prices are, in general, only hit rarely, this can be more likely when auctioning is first introduced. For example, only nine auctions out of the 1,800 auctions held so far in the EU ETS have been cancelled because of the action of their technical reserve price (0.5% of all auctions). While this number is small, three of these cancelled auctions were in the first three months of auctioning, which is about 5% of the auctions held over that early period.

Progressing changes through other planned legislative processes would not allow the technical reserve price to be in place for the first auction

30. 9(2)(f)(iv)

9(2)(g)(i)

31. 9(2)(f)(iv)

32. Another option to consider is to introduce this amendment as a stand-alone legislative process during 2021. This would also need to be approved onto the legislative agenda, however may be able to be progressed more rapidly than if packaged with other regulatory systems amendments. This option too would not progress quickly enough to enable a technical reserve price to be set for the first few auctions.

We recommend progressing a technical reserve price now

33. We recommend taking action to amend the Act and related regulations to enable a technical reserve price to be set now based on the increased risk and the potential impact on the integrity of the NZ ETS.

34. The outcome of the first NZ ETS auction will be closely watched, both here and overseas. A successful auction the first time will support market stability and contribute to the reputation of the NZ ETS.

35. There are legislative options available to address the issue in the Act and we are working to evaluate the possible pathways, should you decide to take action.

36. Any legislative change will require prioritisation on the Government's legislative agenda. An expedited legislative process will require resource from both policy development and drafting personnel, as well as high priority on the legislative agenda. This highly accelerated process also creates risks, noted in more detail in the legal issues section below.

Risks and mitigations

37. The risks of not taking action to set a technical reserve price now are outlined in the analysis section.

38. There is a risk that even if a decision is made now, and the legislative amendment can be prioritised, that the change is not made in time for the first auction. We intend to evaluate the options available to minimise this risk. Another possible mitigation is to postpone the date of the first auction, however that would require careful consideration and a change to the regulations.

Legal issues

9(2)(h)

[Redacted content]

9(2)(h)

Financial, regulatory and legislative implications

44. Taking action to set a technical reserve price requires legislative amendment to the Climate Change Response Act 2002 and the Climate Change (Auctions, Limits, and Price Controls for Units) Regulations 2020.

Next Steps

45. Officials will come back to you with further advice on how to enable the technical reserve price for NZ ETS auctions, including timeframes.

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