

## **In Confidence**

### **Office of the Minister for Climate Change**

### **Chair, Cabinet Environment, Energy and Climate Committee**

### **Proceeds from the New Zealand Emissions Trading Scheme**

#### **Proposal**

- 1 This paper responds to a request from this Committee for information on why the New Zealand Emissions Trading Scheme increases the cash balance of the Crown and how this cash could be used [ENV-20-MIN-0017].

#### **Relation to government priorities**

- 2 The proposals in this paper relate to the Government's priority to transition to a clean, green, carbon neutral economy.

#### **Executive Summary**

- 3 The NZ ETS has and will continue to create cash for the Crown. To date, use of the fixed price option has raised \$635 million in cash. Auctions of emission units (NZUs) are currently forecast to provide at least \$2.5 billion over the next five years.
- 4 This cash inflow has no immediate impact on the operating statement because the Crown is exchanging one asset (an NZU) for another (cash). The loss of the asset is recorded as an increase in the ETS provision liability. When the NZUs are surrendered, revenue is recognised, the NZ ETS liability decreases, and the Crown's net worth increases as it is left with the cash obtained from the earlier sale of those NZUs.
- 5 No decisions have been made on the use of this cash, so it has been retained by the centre in accordance with fiscal policy practices. Other uses include:
  - 5.1 targeted investments in emissions mitigation (to enable current and future emissions reductions in New Zealand)
  - 5.2 adaptation (to deal with the current impacts and future risks of climate change)
  - 5.3 enabling a more just transition (compensatory policies to mitigate any disproportionately negative impacts of climate change policies)

- 5.4 purchasing mitigation offshore to meet any shortfalls in delivering on our Nationally Determined Contribution (NDC) target and domestic emissions budgets.
- 6 I acknowledge the significant interest our Te Tiriti partners have in emissions mitigation, climate change adaptation and specific initiatives such as the NZ ETS. Consideration of our ability to partner with iwi/Māori on the use of the proceeds in emissions mitigation, adaptation and just transitions initiatives will be explored in future papers.
- 7 There is international evidence that targeting the use of such proceeds increases public support for cost-imposing climate change policies. Most emissions trading and carbon tax schemes include some form of revenue recycling.
- 8 The fiscal risk from the expected future purchase of international units is not quantified in the fiscal forecasts or the financial statements because, in the Treasury's view, there is currently no robust way of measuring the expected net outflow required by the Crown.
- 9 Climate change presents significant challenges for the long term fiscal and economic outlook and to our effective Budget and economic management over decades. The Crown's financial reporting on the NZ ETS can only cover a subset of the fiscal and economic impacts of climate change. I therefore recommend further work on a broader framework of carbon financial reporting. One option is an information set with our fiscal updates to cover NZ ETS income and costs, tracking progress regarding our NDC target and its fiscal risks, and reporting on emissions reduction investments, and adaptation funding, amongst other things. I will report back progress on this work in 2021.

## **Background**

- 10 On 14 May 2020, this Committee noted that the Minister for Climate Change will report back to ENV with an update on financial accounting treatment of New Zealand's climate change-related revenues and obligations and ways to effect reduction of future emissions, including the possible use of ETS revenues [ENV-20-MIN-0017 refers].
- 11 Historically, the NZ ETS has allowed participants to meet surrender obligations using cash instead of emission units. To date, \$635M has been raised by the 'fixed price option'.
- 12 Assuming emission unit auctions are running as planned from March 2021, this will be the last compliance year for which the fixed price option can be used. This Committee agreed to the amount of NZUs to be auctioned each year on 14 May 2020 [ENV-20-MIN-16 refers].

- 13 Forecast cash inflows from auctions over the next five years totals at least \$2.5 billion. This is likely to be a lower bound because of the inherent price and volume uncertainty from auctions.<sup>1</sup>

## **Analysis**

### *The NZ ETS will generate unencumbered cash for the Crown*

- 14 Sales of NZUs to participants through auctions will have no immediate impact on the Crown's operating statement. This is because the Crown would be exchanging one asset (an NZU) for another (cash) with no gain or loss. As a result, no expense or revenue would be recorded in the operating statement.
- 15 NZU sales are also recorded as an increase in the ETS provision liability. This liability represents the number of outstanding NZUs issued by the government (the stockpile of NZUs). It is analogous to the stock of currency issued by the Reserve Bank. As the market price of NZUs increases or decreases, the gain or loss to holders of emission units is also reflected as a loss or gain by the government and has an operating balance impact, but no OBEGAL impact. Monthly revaluations of NZ ETS liability are based on the most recent carbon price. This provision stood at \$2.937 billion at the end of May with an NZU price of \$25.05.
- 16 When the NZUs are surrendered, revenue is recognised and the NZ ETS liability decreases. The Crown's net worth increases by the net amount of the revenue from NZUs surrendered with the expense of those NZUs issued without consideration. This is represented by the cash obtained from the earlier sale by auction of those NZUs.
- 17 Under the reformed emissions trading scheme, the government can reduce the amount of emissions in the economy to meet emissions budgets by controlling the supply of NZUs into the market. Fewer NZUs will be auctioned over time in order to achieve this outcome. Consequently, the longer term cash receipts from auctioning have high uncertainty.

### *No decisions have been made on the use of the cash*

- 18 Because no policy decision has yet been taken to use the cash obtained from selling NZUs for a specific purpose, under current fiscal policy practices it is being retained by the centre and allocated across the full range of competing Budget priorities, including the reduction of debt.
- 19 This includes allowing the Government to reduce distortionary taxes or to provide other economic relief, thereby maintaining Government revenue while improving environmental outcomes and general economic conditions.
- 20 I acknowledge the view that revenue recycling is generally inconsistent with the objective of directing the Government's revenue towards its highest value

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<sup>1</sup> The estimate provided assumes all forecast auction volume is sold at \$27.55 per emission unit, which was the 31 January 2020 price used for the Budget Economic and Fiscal Update. The current secondary market price is approximately \$32.

use. Presently, the Government does not link its expenditure in a wide range of activities that reduce emissions to income from the NZ ETS. There is no doubt that expenditure on a range of complimentary measure is necessary to support the effectiveness of emissions pricing. However, there is a risk that strong, direct hypothecation will create economic and social opportunity costs that will need to be considered and mitigated particularly if New Zealand were to enter a period of fiscal consolidation.

- 21 There is a range of possible climate change targeted uses for the NZ ETS proceeds, including
  - 21.1 Investments in emissions mitigation to enable current and future emissions reductions. For example, the Crown may take on a greater share of the costs associated with investments needed to reduce emissions and investing in the wider infrastructure needed to support low-emissions technologies. One option could be to develop a 'mitigation fund' that would allow the Government to set aside funding for expenditure on high value proposals when they emerge, with clarity about the management and treatment of this fund, and clear criteria for spending from the fund.
  - 21.2 Assisting whānau, communities and local authorities with the costs of adapting to the current impacts and future risks of climate change. Currently, these matters are primarily addressed by local government and the private sector. The Crown could take a more direct role, including planning for the fiscal impacts from climate-related floods and droughts, and the impacts of sea level rise on rising groundwater and salinization, erosion, and coastal flooding. The Crown may be exposed to compensation for homeowners and commercial buildings in the event of managed retreat from landslide areas and coastal or river flood plains. At present, there are over 72,000 people and 49,700 buildings exposed to coastal flooding.
  - 21.3 Developing and implementing compensatory policies to mitigate any disproportionately negative impacts of climate change policies, where needed, beyond the balancing effect of indexation of benefits and transfers. This would provide direct compensation for the financial impacts of the NZ ETS flowing through to higher prices for greenhouse gas intensive goods and services. Such payments may boost public support for the NZ ETS and gain acceptance of a rising emissions price path over time. I note the Climate Change Response Act 2002 requires that the Government's Emissions Reduction Plan explicitly includes a funded strategy for addressing any disproportionate impacts of climate change mitigation policies on employees and employers, regions, iwi and Māori, and wider communities.
  - 21.4 Purchasing international units to make up the difference between domestic emissions reductions and our Nationally Determined Contribution (NDC) under the Paris Agreement, which covers the period 2021 to 2030. Under the current 'provisional' emissions budget, the NZ

ETS has been set to allow more domestic emissions than that implied by the NDC; this will require either a step-change in the rate of domestic emissions reductions from 2026-2030, or procuring offshore mitigation to make up the difference.

- 22 The availability of these funds represents an opportunity for the Crown to partner with iwi/Māori on our response to climate change. Officials will explore this opportunity with iwi partners and present options on this in future papers.
- 23 There is strong international evidence for the benefits from targeting proceeds from climate change policies to sustainability projects.
- 24 Various reports by key international agencies (eg. OECD, IEA, IMF) and the Productivity Commission in New Zealand have highlighted the importance of public perceptions of fairness in ensuring the success and durability of climate policies.
- 25 The Climate Change Commission's recent submission on the NZ ETS reforms refers to international experience that indicates emissions pricing policies in particular are likely to be better supported by stakeholders when the funds generated are recycled.
- 26 The majority of jurisdictions, including the EU member states, have implemented some form of revenue recycling. One survey found 28 percent of global carbon pricing revenues were applied to 'green spending' such as emissions reduction R&D and clean energy programmes, while 34 percent were recycled directly to individuals, households or businesses, often through tax rebates. The remaining third of revenues are retained for general expenditure.

*Climate change presents wider implications for fiscal management than just use of NZ ETS cash*

- 27 The Government does not report the fiscal costs of meeting our NDC commitment target or the legislated 2050 emissions targets as liabilities. Treasury has noted that where there is no binding agreement that a reliably measurable economic sacrifice must be paid by the government to a third party, for which the government has little discretion to avoid, generally accepted accounting policies does not permit a liability to be reported. Reliable measurement, particularly of the cost per emission unit to be purchased, is difficult at this stage. Further, the government through emissions budgets and the NZ ETS cap can transfer its economic sacrifice to the private sector, and no decisions have been made for the second half of the NDC period yet (2026-2030).
- 28 There are challenges for the Government in monitoring and managing the fiscal risk of the NDC. I note the NDC we have now is from 2021 to 2030, and New Zealand is required under the Paris Agreement to communicate a subsequent NDC in 2025, for the next period starting in 2031. Each successive NDC is to represent a progression and reflect the highest possible ambition.

- 29 There will be a significant fiscal outflow in meeting these commitments, noting that these costs can be recovered from emitters under the NZ ETS.
- 30 It is crucial that we consider the impacts of relevant policy decisions on this ongoing, long term, cost.
- 31 A first step is to explore the benefits of a fiscal information report, outside the financial statements, on our management of climate-related fiscals. This may be as simple as an explanatory page in every fiscal update, noting key climate change fiscal risks alongside forecasting incomes and expenditures. This page may contain information reported elsewhere by the Government, but I consider having it also collected in one place, with appropriate explanations, will increase transparency and assist decisions.
- 32 I do not intend to duplicate climate change reporting already performed by the government. It is important the solution addresses the problem, which is specific to decisions that impact our fiscal management of climate change.
- 33 I note that, under the CCRA, the Climate Change Commission must make an annual report three months after the publication of the National Greenhouse Gas Inventory on how NZ is tracking towards emissions budgets and the 2050 target. That report must also assess the adequacy of the emissions reduction plan and progress in its implementation. The Commission will provide this report to the Minister who must then present it to the House and respond to the Commission's report.
- 34 Additionally, under the Paris Agreement, the Government will communicate New Zealand's progress towards meeting NDC commitments every two years, including actual (historic) and projected emissions, and policies together with their effects. I expect this progress communication, plus the Inventory, will provide increasing certainty over the number of emission units New Zealand will need to meet the NDC.
- 35 There is still a reporting gap however, and it has implications for how NZ ETS proceeds are managed. The Crown's financial reporting on the NZ ETS can only cover a subset of the fiscal and economic impacts of climate change. Additionally, we will be requiring certain business types to publicly disclose their climate change risks in their financial reports. Rightly, in my opinion, stakeholders have asked the Government to do the same.

*Improvements to how climate change is considered in all policy decisions is needed*

- 36 The discussion above links to the work already underway on determining the best approach for associating a 'shadow price' to the effects of climate change in investment and policy decisions (both new and existing) and in regulatory system reviews. A report to Cabinet on this informational aid to our decision-making, will follow in due course.
- 37 It also links to the required use of the Climate Impacts of Policy Assessment tool for significant policy decisions, including those for "Wave 3" submissions for funding through the COVID-19 Response and Recovery Fund.

## **Financial Implications**

- 38 The proposals in this paper have no financial implications.
- 39 I note any new policy decisions involving recycling NZ ETS proceeds would not have a direct impact on the Government's overall fiscal forecasts, because this spending amounts to a redirection of existing Budget allowances.

## **Legislative Implications**

- 40 The proposals in this paper have no legislative implications.

## **Impact Analysis**

### **Regulatory Impact Statement and Climate Implications of Policy Assessment**

- 41 The Regulatory Impact Analysis and Climate Implications of Policy Assessment requirements do not apply to the proposals in this paper.

## **Te Tiriti o Waitangi**

- 42 I acknowledge the significant interest our Te Tiriti partners (whānau, marae, hapū, iwi and Māori entities) have in emissions mitigation, climate change adaptation and specific initiatives such as the NZ ETS. To respond to this interest, my climate change officials will be guided by the Ministry for the Environment's Treaty Partnerships Group on appropriate times and approaches for engaging and seeking feedback from our Te Tiriti partners as the work on the proposals in this paper progress.
- 43 Climate change response presents a significant opportunity for the Crown to advance partnership with iwi/Māori to achieve shared, sustainable outcomes which work for all of our communities. Climate change has long term impacts on the kaitiakitanga of iwi/Māori and I acknowledge iwi/Māori need to be at the forefront of our response.
- 44 Officials are receiving clear messaging from iwi/Māori around the desire to partner with the Crown across all areas of the response to climate change. I intend to explore these opportunities further with regard to this proposal.

## **Human Rights**

- 45 The proposals in this paper have no inconsistencies with the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993.

## **Consultation**

- 46 This paper was prepared by the Ministry for the Environment. The Treasury, Te Puni Kōkiri, the Environmental Protection Authority, Ministry of Business, Innovation and Employment, Ministry for Primary Industries, Ministry of Foreign Affairs and Trade, Ministry of Justice, and Ministry of Transport were consulted in preparation of the paper. All comments received have been incorporated in this paper.

47 The Department of Prime Minister and Cabinet was informed.

## **Communications**

48 No communication of the proposals in this paper are planned.

## **Proactive Release**

49 This paper will be proactively released within 30 business days of decisions being confirmed by Cabinet, with redactions as appropriate under the Official Information Act 1982.

## **Recommendations**

The Minister for Climate Change recommends that the Committee:

- 1 note the fixed price option and emission unit auction mechanisms of the New Zealand Emissions Trading Scheme (NZ ETS) will provide unencumbered cash to the Crown every year
- 2 note this cash inflow has no impact on the operating statement because the transaction is accounted as a cash increase and an increase in the NZ ETS provision liability
- 3 note when emission units are surrendered, revenue is recognised, the NZ ETS liability decreases, and the Crown's net worth increases as it is left with the cash obtained from the earlier sale of those NZUs
- 4 note under current fiscal policy practices this cash is retained by the centre and allocated through Budget processes
- 5 note revenue recycling could boost public support for the NZ ETS scheme and gain acceptance of a rising emissions price path over time
- 6 note specific targeted uses of NZ ETS proceeds include:
  - 6.1 Investing directly in emissions mitigation proposals and infrastructure
  - 6.2 Assisting communities and local authorities with the costs of adapting to the current impacts and future risks of climate change
  - 6.3 Providing direct compensation for the higher costs of greenhouse gas intensive goods and services
  - 6.4 purchasing international units to make up the difference between domestic emissions reductions and our Nationally Determined Contribution under the Paris Agreement
- 7 invite the Minister for Climate Change to examine the benefits and options for establishing a scheme to recycle some or all proceeds from emission unit auctions and report back to Cabinet with a proposed approach before the end of 2020

- 8 note the fiscal risk of purchasing offshore emissions mitigation is not recorded in any Crown fiscal reports
- 9 invite the Minister for Climate Change to report on progress in increasing and improving Crown financial information on climate change commitments and measures by July 2021

Authorised for lodgement

Hon James Shaw

**Minister for Climate Change**