

Office of the Minister for Climate Change

Chair

Cabinet Environment, Energy and Climate Committee

A government position on international carbon markets

Proposal

1. I am proposing a Government position on international carbon markets, to be agreed prior to public consultation on the Zero Carbon Bill.
2. I propose that while New Zealand continues to focus on ambitious domestic action to meet our climate change targets, we should not close off the option of future governments having access to high-integrity international carbon markets after 2020, under certain circumstances.

Executive summary

3. I am seeking an agreed government position on international carbon markets. I propose an approach that keeps options open to allow flexibility for transitioning the economy to a net zero target.
4. We should be clear amongst ourselves and with market participants that we will only use international carbon markets after 2020 if we have assured ourselves:
 - 4.1. the credits/units are genuine and have environmental integrity;
 - 4.2. that by doing so, we will maintain progress towards our transition to a net zero target;
 - 4.3. that it makes economic sense to do so; and
 - 4.4. 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.
5. It is critical to the ongoing confidence in the New Zealand's Emissions Trading Scheme (NZ ETS) that our messaging on this is clear. There are legitimate concerns about the use of international units and their impact on the NZ ETS in the past. Because of this, NZ ETS participants will be sensitive to government messages about the potential use of international units in New Zealand. We want to provide policy stability and avoid price shocks.
6. It is therefore important that the Government is in agreement on our approach, and aligned on its messaging. This will be particularly important given the upcoming public consultation on the Zero Carbon Bill (beginning 7 June).

7. In the meantime, I am also proposing New Zealand continues to play a leadership role ensuring markets develop with environmental integrity as this is in the interests of all countries, regardless of whether New Zealand chooses to use them or not. We will keep our future options open without committing to do any international carbon trading, at least in the near term. It could take years to negotiate and implement an agreement to enable international units to be used in the NZ ETS. Therefore, I consider it prudent to continue to do this work to provide the flexibility for future decisions.
8. s9(2)(i)

Background

Our Paris Agreement target and the use of international carbon markets

9. The previous government set a target of 30% below our 2005 emission levels by 2030 for New Zealand's first 'nationally determined contribution' (the Paris target) under the Paris Agreement. It also stated that New Zealand would meet this target through a combination of domestic reductions, planting forests to absorb carbon dioxide, and buying emission reductions from overseas (i.e. via international carbon markets).¹
10. In round and approximate figures, our projected emissions in the period 2021-2030 are expected to be about 800 million tonnes (Mt). Our Paris target equates to around 600Mt which means that to meet our target we will need to reduce our emissions by 200Mt, or offset any emissions over 600Mt with trees or credits bought from overseas. The one billion trees might be expected to deliver around 10-30Mt over the period. This is on top of the 18Mt from forestry anticipated under the previous settings. It is clear that even with extensive tree planting, there will need to be significant other actions.
11. For example, New Zealand's transport emissions over the same 2021-2030 period are projected to be around 130Mt. This means that even if we reduced all transport emissions to zero prior to 2021, in addition to the one billion trees, we would still need to take further action.

Table 1: Summary of New Zealand's approximate emissions over 2021-2030

	Million tonnes of emissions
Projected emissions	804
2030 target "budget" (target)	601
Resulting abatement task	203
Sequestration in forestry (including billion trees)	28-48
Remainder to reduce	155- 175

¹ Emission reductions from other countries used towards a country's target are referred to as "internationally transferred mitigation outcomes" in the Paris Agreement. In accounting for Paris targets they are expected to be expressed as "tonnes" of emission reductions exchanged through a cooperation arrangement between two or more countries. They may be transferred as "units" from a national registry or, it is expected, as "units" from a United Nations body – whether bought by the government or (if a government allows it) by firms or individuals.

12. Under the Paris Agreement, countries are able to use reductions bought from other countries to help meet their targets. Australia, South Korea, Singapore and Canada are openly considering this option. In making a choice to use reductions from other countries, countries will weigh up the associated cost against the advantages of investing in transitioning their own economy (rather than funding others' transition). International carbon markets can provide flexibility to governments wanting to have alternatives to sharp domestic emission cuts to manage the pace of the transition for workers and communities.

Our parties came into government with different positions on the use of international carbon markets

13. Our parties came into government with different policy positions on whether, to what extent, and under what conditions New Zealand should use international carbon markets to meet our climate change targets.

14. All three parties have been critical of international carbon markets, saying they:

- were discredited by 'dodgy units' – New Zealand business used cheap and often fraudulent Russian and Ukrainian units and flooded the New Zealand market;
- provided a 'get-out-of-jail-free' card for New Zealand – allowing us to avoid reducing our emissions at home by paying others to reduce theirs; and
- transferred wealth to other countries – allowing them to fund their economic transition, while that money may have been better spent upgrading the New Zealand economy.

15. We are all agreed that the focus of our climate policy should be on ambitious domestic action to reduce emissions over the coming three decades. At the same time, we are all committed to an effective and just transition of the New Zealand economy.

We will be asked about international carbon markets when consulting on our 2050 emissions reduction target and Zero Carbon Bill

16. Stakeholders will ask us our position on the use of international carbon markets when we consult on the Zero Carbon Bill, 2050 target and changes to the NZ ETS. I am already regularly approached by participants in the NZ ETS who are concerned that the price of carbon might rise sharply and suddenly without future international supply being part of the future mix.

The decision on using international carbon markets (or not) has a material impact on the operation of the NZ ETS

17. We have an operational emissions trading scheme in which participants have significant assets and liabilities. Any statement that the government makes on the potential future supply to that scheme – or conversely – indication that supply might be restricted may have material impacts on participants and lead to considerable fiscal risk to the Crown (see paragraph 41).

18. NZ ETS is not currently open to the use of international credits (i.e. it is currently a domestic market only). New Zealand also currently has no arrangements in place to access international carbon markets if we did want to make use of international credits in the future.

19. Nonetheless, to date I have felt it is prudent, when making public statements about the NZ ETS, not to close off the possibility of future use of international carbon markets, after 2020, provided those markets have high standards of environmental integrity and there is a robust case for their use.

Consistency with the all-of-government framework

20. Any position we take on international markets must be consistent with the all-of-government framework for climate change policy and decision-making, which I have proposed in a separate paper. An important pillar of the framework is leadership at home and internationally.

Comment

It is important for us to establish our government's position

21. It is important we have a government position on international carbon markets prior to public consultation. I am proposing a 'no-regrets' government position, which keeps our options open, but does not commit us, or a future government, to use international carbon markets. This will help us to have an open discussion about our ambitions for climate action and a just transition of the economy. Conversely, not having a joined-up and considered position will create perception risks and may risk public buy-in and the durability of climate policy.

22. I propose a position that:

- 22.1. we are committed to meeting ambitious international targets in 2030 and beyond;
- 22.2. we will do this first and foremost through ambitious climate change action at home and transitioning the New Zealand economy to a net zero target over the coming decades;
- 22.3. we are conscious of managing our climate action in ways that work for our economy and national circumstances, ensuring coordination between our climate change goals and our objectives around regional economic development and inclusive economic prosperity;
- 22.4. we retain future options and keep NZ "at the table" in international markets negotiations. This will allow us:
 - to continue helping to ensure international carbon markets that develop are transparent, rules based, and have environmental integrity, whether New Zealand itself chooses to use them in future or not; and
 - to maintain options of securing access to international carbon markets if this makes sense in the future.

23. We should be clear amongst ourselves and with market participants that we will only use international carbon markets after 2020 if we have assured ourselves:

- the credits/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 carbon price, to maintain incentives in domestic abatement opportunities, such as forestry.

24. I have come to this proposal after carefully considering four key factors:

- 24.1. the importance of consulting on the Zero Carbon Bill with a considered view of the issue of international carbon markets in meeting climate change targets;
- 24.2. the inherent uncertainty of the economic impact of meeting emissions reduction targets (noting that further in-depth economic analysis of targets is being undertaken by officials);
- 24.3. the flexibility that international carbon markets can provide (if needed) to balance ambitious domestic climate action, a just transition and economic impacts, and ensuring New Zealand meets its emission reduction targets; and
- 24.4. the need for careful messaging to manage potential economic and fiscal impacts due to the ongoing operation of the NZ ETS, while work is underway to improve the scheme.

Consultation on the Zero Carbon Bill

25. We are all committed to strong domestic climate change action and a just transition of our economy. We know that policy durability and strong public buy-in will be key if this vision is to guide New Zealand over the decades between now and 2050.
26. To get this, we know that we must have well-considered positions informed by the public. We will be consulting on our long-term vision over the coming weeks and months with the Zero Carbon Bill. It will be important that this feedback, as well as good quality economic analysis feeds into our policy choices and plans to transform the New Zealand economy.
27. Robust economic analysis of costs and opportunities and the pathways New Zealand could take is underway. This, alongside work assessing potential options for international carbon market cooperation, will give us better information on the economic impact of meeting our emissions reduction targets, and provide a better basis for future decisions about the use of international carbon markets. Until such time, we are not in a position, in my view, to be categorical about how much we may use international markets – if we use them at all.
28. The appropriate time to think about whether we might want or need to supplement what we do domestically to ensure we meet our international target is once the numbers are in. We also need to hear what New Zealanders say about how ambitious they want to be in setting pace of our economic transition, and in particular, our 2050 target.

Flexibility to meet emissions reduction targets

29. The picture of what we might want or need to use from international carbon markets will emerge over time. Modelling being undertaken for the Ministry for the Environment as part of the Zero Carbon Bill process will give us some initial direction for the early 2020s but over the decade we will be able to observe how

this early phase of the transition plays out. The uptake of technology, the development of new technology and the way the economy adapts will all have a bearing on how close we come to meeting our international target and the extent to which we might need to supplement our domestic action.

30. Ultimately, any need to purchase reductions from other countries to satisfy requirements associated with the Paris Agreement won't arise until the 2020s, if at all. It will take time to negotiate high quality options to do so, however. There is no international carbon market we can seek to purchase reductions from at short notice.
31. I have considered the alternatives to choosing not to close the door to the possibility of using international markets in the future. Choosing a domestic action only approach to meeting climate change targets has some big advantages: with all the reductions would occur at home making greater progress towards a net zero target and no money would go off-shore to buy reductions to meet the target.
32. On the negative side, domestic-only action may be a greater burden to the economy than necessary to meet the target. If emission reductions are more expensive in New Zealand (than in other countries) the carbon price here will rise and the costs imposed on businesses, may be higher than those faced by their overseas competitors. Some production may re-locate offshore to economies with a lower cost of carbon, which can be expected to have a negative impact on jobs in New Zealand but no reduction – or potentially an increase – in global emissions. And, if at the end of the period of the target New Zealand hasn't reduced its emissions sufficiently, it risks failing to meet its international commitment.
33. Alternatively, a country can be completely open to cooperation with other countries in reducing emissions and allow reductions, wherever they occur, to be counted towards the target. Maximising the use of international carbon markets would keep the cost of meeting the target down if it is economically rational to do so. Businesses would be more likely to face a similar carbon cost to the countries they trade or compete with and the country could be confident it will be able to meet its international commitment. On the down side, much less would change domestically and the transition the economy inevitably needs to grapple with would happen more slowly or be delayed. This would mean the transition required in the coming decades would be more abrupt.
34. Keeping open a middle ground option, limited use of international emission reductions in specified circumstances could position us to manage the down sides of the “domestic-only” or “completely open” approaches. This is on the premise that international carbon markets would only be used to supplement domestic action if required to meet our objectives in managing the pace and impact of the transition and to ensure we meet our international commitments.
35. We would have a number of effective options for controlling the volume of supply from international carbon markets. The government could either purchase the units itself and then re-sell them domestically, or rules could be put in place to

ensure that NZ ETS participants were only allowed to surrender a certain proportion of their obligations with overseas units.

Different pathways to meet our target will have different costs and opportunities

36. As described above, officials have work programmes underway to ensure we have the best possible information to make decisions about New Zealand's economic transition.
37. Previous modelling suggested that access to international carbon markets may have a large impact on the economic cost of meeting New Zealand's current NDC. Conducting the same analysis, but with the target met solely through domestic action – resulted in roughly double the economic cost. The concern this raises is that this would flow on into negative impacts on jobs, household costs, development and other socio-economic objectives.
38. This type of modelling is mostly useful for showing the broad scale and direction of impacts, and officials are undertaking more in-depth economic analysis; however these existing numbers show that we need to consider the role international carbon markets may play in supplementing strong domestic action.

Risks posed by the ongoing 'live' operation of the NZ ETS market

39. Another reason for careful consideration of our messaging around international carbon markets is the NZ ETS. The NZ ETS is an operational market, with trades happening every day.
40. There is currently a large bank of around 140 million New Zealand Units (NZUs)² held in NZ ETS private accounts. These units provide a substantial buffer against supply and liquidity shocks, particularly in the period leading up to the 2020s. However, like all markets the NZ ETS is forward-looking and NZU prices will reflect information and expectations about future supply.
41. Price volatility such as a strong spike³ in the price of NZUs is undesirable, not only because it would cause a shock to the economy but also because it would likely delay action on climate change by the private sector. This is because sudden price movements, in either direction, make it more difficult for businesses to make judgements about future emission prices, making investments in emission reductions more risky and therefore expensive. More gradual and stable development in emissions prices is likely to better support businesses to make a low emissions transition over time.

42. s9(2)(d)

43. A rise in prices above \$25/tonne would present a fiscal risk to the Crown. At present, emitters have the option of paying the Government \$25/tonne, rather than surrendering an NZU, known as the "fixed price option". Widespread use of this option may occur once the carbon price gets near to or exceeds \$25/tonne (currently NZUs are trading at about \$21). This creates a risk to the Crown

² As at the end of March 2018.

³ A \$4 increase in the carbon price in a short space of time would be considered to be a strong spike in an emissions trading scheme.

s9(2)(d)

44. The NZ ETS could be oversupplied with units in the 2020s, if participants use the \$25 fixed price option rather than surrendering the NZUs that the government allocates or which are already in the market (due to participants' banking of NZUs from previous years). This will constrain our ability to use the NZ ETS to meet emissions reduction targets by controlling the number of NZUs in the market and aligning this with our carbon budgets.
45. Officials are working on changes to the NZ ETS to allow it to be a strong and credible tool for us going in to the 2020s, including a proposal for replacing the \$25 fixed price option. I expect to consult on these changes later this year after the Zero Carbon Bill consultation, and introduce the necessary legislative changes to the Climate Change Response Act 2002 early next year. These changes are intended to strengthen the NZ ETS, and make the scheme operate in a well-signalled and predictable manner. However, until these changes are in place we need to be cautious about our messaging to the market in order to manage the risks described above.
46. Managing these risks is another reason that I consider it necessary to come to a 'no-regrets' government position on the use of international carbon markets, which we can use in our messaging.

Other benefits and risks

47. In addition to the four considerations in paragraph 23 there are other benefits to this proposal.
48. It will allow us to be open to stakeholders and emphasise our commitment first and foremost to domestic action while allowing us to retain flexibility and mitigate potential risks.
49. This approach will also retain New Zealand's leadership role in ensuring that markets developed to support the Paris Agreement will have environmental integrity, without having to commit to using them. Influencing the global system to ensure that it has integrity and delivers real reduction in emissions is important to the effectiveness of the Paris Agreement. We can continue to play this role without committing at this stage to using international markets ourselves.

50. s9(2)(j), s6(a)

Conclusion and next steps

51. Officials have established effective technical exchanges with jurisdictions with high integrity markets – the European Union s9(2)(j), s6(a)

s9(2)(j), s6(a)

In addition, officials are exploring non-ETS forms of government to government cooperation that could be developed.

52. A future government may want to use the option of international carbon markets or cooperation to help manage transition impacts and avoid significant price rises in the NZ ETS. Establishing market cooperation arrangements can take some years, however, and we should prepare to have an option available for the 2020s if it is required.
53. I will come back to Cabinet if any of the potential arrangements come to the point at which formal negotiations may be ready to begin. s9(2)(j)

Consultation

54. I have discussed this approach with the Minister of Finance, the Minister of Foreign Affairs, the Minister of Forestry, the Minister for the Environment, and the Minister for Energy and Resources.
55. The following government agencies have been consulted on the contents of this paper: the Ministry of Foreign Affairs and Trade, the Ministry for Primary Industries and the Ministry of Business Innovation and Employment. The Treasury and the Department of the Prime Minister and Cabinet have been informed of the contents of the paper.
56. The NZ First and Green Party caucuses have been consulted.

Financial implications

57. This paper has no financial implications.

Human rights

58. No inconsistencies have been identified between the proposal in this paper and the New Zealand Bill of Rights Act 1990 or Human Rights Act 1993.

Legislative implications and regulatory impact analysis

59. No legislative implications result from the proposal in this paper and there is no Regulatory Impact Analysis required.

Gender implications and Disability Perspective

60. A gender implications and disability perspective analysis has not been undertaken, because the proposals will not affect people differently based on gender or disability.

⁴ s9(2)(j)

Treaty of Waitangi implications

61. There are no Treaty of Waitangi implications resulting from the proposal in this paper.

Publicity

62. I propose communicating this agreed position, and proactively releasing this paper, as part of the upcoming consultation on the Zero Carbon Bill. The consultation document on the Zero Carbon Bill will include information on the development and ability of New Zealand to use international carbon markets, if it wishes to do so. It will also invite feedback on the role (if any) that international carbon markets should play in New Zealand's achievement of a net zero target.

Recommendations

The Minister for Climate Change recommends that the Committee:

1. **Note** that public consultation on the Zero Carbon Bill will begin on 7 June.
2. **Note** that consultation on the Zero Carbon Bill will likely result in Ministers and officials being asked about the Government's position on the use of international carbon markets.
3. **Agree** on the importance of having a government position on international carbon markets that does not commit us to using international carbon markets, but retains the option for future governments to use them after 2020 under certain circumstances.
4. **Agree** that our government position is that:
 - we are committed to meeting ambitious emission reduction targets in 2030 and beyond;
 - we will do this first and foremost through ambitious climate change action at home and transitioning New Zealand to a net zero target over the coming decades;
 - we are conscious of managing our climate action in ways that work for our economy and national circumstances, ensuring coordination between our climate goals and our objectives around regional economic development and inclusive economic prosperity;
 - we retain future options and keep New Zealand "at the table" of international markets negotiations. This will allow us:
 - to continue helping to ensure international carbon markets that develop are transparent, rules based, and have environmental integrity, whether New Zealand itself chooses to use them in future or not; and
 - to maintain options of securing access to international carbon markets if this makes sense in the future.
 - We should be clear amongst ourselves and with market participants that we will only use international carbon markets after 2020 if we have assured ourselves:

- the credits/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.
5. **Note** that this position will be used as the basis for responding to stakeholders about international carbon markets.
 6. **Note** this position does not commit New Zealand to any future use of international carbon markets.
 7. **Note** that I will report back to Cabinet if any of the potential arrangements come to the point at which formal negotiations may be ready to begin.
 8. **Note** that I will present Cabinet with further information on the economic implications of using, or not using, international carbon markets in order to assist with decision-making around the 2050 target and the Zero Carbon Bill.

Authorised for lodgement.

Hon James Shaw

Minister for Climate Change