

In Confidence

Office of the Minister for Climate Change

Chair, Cabinet Environment Energy and Climate Change Committee

Amendments to the Climate Change Response Act 2002: tranche one

Proposal

1. I propose the first tranche of amendments to the Climate Change Response Act 2002 (CCRA) in order to improve the New Zealand Emissions Trading Scheme (NZ ETS) and support the implementation of the Paris Agreement.
2. I plan to return to Cabinet in March 2019 with further proposed amendments to the CCRA. I expect the full package of amendments to result in a single bill, to be introduced to the House of Representatives (the House) in mid-2019.

Executive summary

3. New Zealand is committed to taking action on climate change. In 2016, New Zealand ratified the Paris Agreement, which creates an expectation for all countries to reduce domestic emissions and transition to a low-emissions future. I am proposing a Climate Change Bill (CCB) to provide the framework for the transition to a low-emissions and climate-resilient New Zealand (Cabinet paper *Proposed Climate Change Bill* refers).
4. The NZ ETS is the Government's key tool that supports New Zealand to meet emission reduction targets and support the transition. If set up appropriately, the NZ ETS can play a critical role in signalling the Government's ambition to reduce emissions.
5. The 2015/16 NZ ETS review found that, without changes, the scheme will not effectively assist New Zealand to meet its emission reduction target under the Paris Agreement (or any new 2050 target under the proposed CCB). The review found that the Government does not have the tools to manage the supply of units in the NZ ETS, and that the operation of the scheme has created significant regulatory uncertainty.
6. In order to ensure that the NZ ETS is a strong, credible and fit-for-purpose tool, amendments are needed to its establishing legislation, the CCRA.
7. This paper provides the first tranche of proposed amendments to the CCRA. The tranche one proposals include improvements to the framework of the NZ ETS, which were consulted on over August and September of this year. Overall, submitters supported the proposals and they are not contentious.
8. The proposals are to:
 - i. align the CCRA with the Paris Agreement and the proposed CCB by:

- supporting implementation of New Zealand's Paris Agreement emission reduction and reporting commitments
 - refining the purpose of the CCRA to ensure it is able to assist with delivery of the CCB
- ii. enable a cap on emissions covered by the NZ ETS by establishing a unit supply decision-making framework in relation to:
- auctioning
 - limiting international units
 - price controls
 - coordinated decision-making
- iii. improve the administration and operation of the NZ ETS by:
- improving the compliance regime
 - strengthening market governance
 - making operational and technical improvements
9. I expect to bring further papers to Cabinet over the next six months with other proposed amendments to improve the CCRA, including forestry proposals. I expect these amendments will be part of a single amendment bill, which I intend to introduce to the House in mid-2019. I am seeking your agreement to the first tranche of amendments to enable legislative drafting to begin before the end of the year.
10. These changes must be considered in light of their impact on New Zealand's ability to link with emissions trading schemes in the future. Business's ability to access high-integrity international units may play an important role in meeting emission reduction targets under the Paris Agreement. s9(2)(j) and s6(a)
- The proposed changes, including enabling a stringent and declining cap, reduce barriers to creating such links.
11. The amendments to the CCRA will enable regulations to be made which will set the cap. I expect to return to Cabinet in mid-2019 seeking approval to consult on regulations that will set the level of the cap, alongside the Select Committee process for the amendment bill.
12. Alongside the CCB, the proposed amendments to the CCRA will provide a flexible and robust framework to support the transition to a low-emissions and climate-resilient New Zealand.

Context

All-of-Government framework for climate change policy

13. Cabinet has agreed an all-of-Government framework for climate change policy decisions [CAB-18-MIN-0218]. The framework has been used to guide the proposals in this paper. The three fundamental pillars of the framework are:
- leadership at home and internationally – setting a clear and ambitious goal which stimulates innovation and investment, and influences the global response

- a productive, sustainable and climate-resilient economy – understanding the benefits and trade-offs of the transition and identifying best-value opportunities
- a just and inclusive society – managing the pace and nature of the transition, and supporting affected regions, sectors and communities (including iwi, hapū and Māori)

New Zealand's response to the global challenge of climate change

14. New Zealand is committed to taking action on climate change. In 2016 New Zealand ratified the Paris Agreement and communicated its first international target for emission reductions under that Agreement (referred to as a Nationally Determined Contribution, or NDC). All Parties to the Paris Agreement are required to report regularly on their emissions and implementation.
15. The CCRA is New Zealand's primary statute to assist delivery of our emission reduction and reporting obligations under international climate change agreements. It is the legislative mechanism that manages New Zealand's progress under the Kyoto Protocol and supports our current 2020 target under the United Nations Framework Convention on Climate Change (the Convention). The CCRA now requires amending to reflect the Paris Agreement.
16. The CCRA established the NZ ETS in order to support New Zealand to meet its international emission reduction targets and to reduce emissions below business-as-usual levels. The NZ ETS does this by putting a price on greenhouse gas emissions and removals.

The NZ ETS needs to be improved in order to support New Zealand to meet its future emission reduction targets

17. The NZ ETS is the Government's key tool to help meet emission reduction targets and transition to a low-emissions and climate-resilient New Zealand. The price of carbon sends a signal to businesses and consumers to incentivise behaviour change and make low-emissions investments, including forestry. Therefore, if set up appropriately, the NZ ETS can play a critical role in signalling the Government's ambition to reduce emissions and support this transition.
18. In 2015, the previous Government initiated a review of the NZ ETS. This was undertaken in anticipation of the Paris Agreement and communication of New Zealand's emission reduction target to reduce emissions by 30 per cent below 2005 levels by 2030.¹
19. The review found that the NZ ETS is not fit-for-purpose for the 2020s and beyond. In particular, it found that the Government does not have the tools to manage the supply of units in the scheme and is therefore unable to cap emissions covered by the NZ ETS. A cap would set an overall limit on the number of units supplied into the scheme (excluding units provided for removals, including forestry). All other emissions trading schemes have a cap.
20. This means that without changes, the NZ ETS will not effectively assist New Zealand to meet emission reduction targets, including its 2030 NDC, or any new target under the CCB.

¹ This was communicated as an intended nationally determined contribution (iNDC) in 2015. New Zealand confirmed this as its NDC upon ratification of the Paris Agreement in 2016.

21. The outcomes of the review led to four in-principle decisions to strengthen the framework of the scheme [EGI-17-MIN-0369 refers]. The in-principle decisions are to:
- introduce auctioning of units to align the supply of units in the NZ ETS to our emission reduction targets
 - limit participants' use of international units when the NZ ETS reopens to international carbon markets²
 - develop a different price ceiling to eventually replace the current \$25 fixed price option
 - coordinate decisions on the supply settings in the NZ ETS over a five-year rolling period
22. Together, the in-principle decisions would enable a cap on emissions covered by the scheme and allow it to be aligned with New Zealand's emission reduction targets.
23. In December 2017, Cabinet noted that the in-principle decisions would be pursued through amendments to the CCRA by the end of 2019 [CAB-17-MIN-0547.01 refers].

International carbon markets

24. The ability to access international units with environmental integrity could play an important role in meeting New Zealand's NDCs. Earlier this year, Cabinet agreed to retain the option to use international carbon markets after 2020 [CAB-18-MIN-0248 refers]. s9(2)(j) and s6(a)
25. s9(2)(j) and s6(a) A robust and credible NZ ETS is vital to allow the scheme to drive domestic emission reductions and to support linking. All decisions about the design and operation of the NZ ETS have the potential to affect the credibility of our scheme and our ability to link to other established and credible emissions trading schemes.
26. A stringent and declining cap is a fundamental requirement for linking. Without a cap the effectiveness and stringency of the NZ ETS cannot be known in advance. The stringency of a cap is a critical issue for other jurisdictions; for s9(2)(j) and s6(a) An uncapped NZ ETS will compromise the ability to support meeting our NDC with high-integrity international units.

Proposed Climate Change Bill

27. I have presented my proposal for a CCB [Cabinet paper *Proposed Climate Change Bill* refers]. The CCB will provide a flexible but robust framework to support the transition to a low-emissions and climate-resilient New Zealand. It will achieve this by:
- setting emission reduction targets
 - establishing a system of emissions budgets that will act as five-year milestones on the way to the targets

² Note that no decision has been made on when the NZ ETS could reopen to international units.

- introducing a requirement to develop a range of mitigation and adaptation measures
 - establishing a new independent Climate Change Commission (the Commission) to provide expert advice on key climate change issues
28. The unit supply proposals in this paper will help operationalise the CCB framework, in particular the achievement of domestic emissions budgets, which are expected to take effect from 2021.

Agriculture in the New Zealand Emissions Trading Scheme

29. This paper does not consider agricultural emissions or any agricultural allocation. The question of whether agricultural methane and nitrous oxide emissions should enter into the NZ ETS is currently being considered by the Interim Climate Change Committee (Interim Committee). I propose that Cabinet consider this issue after the Interim Committee reports its findings in April 2019.

Overview of the full package of proposals

30. The full package of proposed amendments to the CCRA are contained in several papers. This includes forestry proposals which I intend to lead jointly with Hon Shane Jones, Minister of Forestry.
31. As outlined above, this is part of a broader package of proposals to improve the NZ ETS and implement the Paris Agreement. The table below outlines the wider papers which are part of this package.

Title	Coverage	Date
<i>Amendments to the CCRA: tranche two</i>	<ul style="list-style-type: none"> • further amendments to operationalise the Paris Agreement following the conclusion of negotiations on the implementation guidelines for the Agreement, if needed • further implementation detail on auctioning and price controls, including whether to earmark auctioning proceeds for specific purposes • an approach to phasing-down industrial allocation • further improvements to the compliance regime • further strengthening market governance • improving market transparency 	March 2019
<i>NZ ETS forestry: part one</i> (led jointly with Hon Shane Jones, Minister of Forestry)	The part one forestry paper should be read alongside this paper. The amendments in the forestry paper are important to promote additional forest planting in New Zealand, with a focus on the planting of permanent forests.	November 2018
<i>NZ ETS forestry: part two</i> (led jointly with Hon Shane Jones, Minister of Forestry)	The part two forestry proposals are expected to include proposals on forestry accounting and harvested wood products.	March 2019

32. Together the proposals will be taken into a Climate Change Response Amendment Bill, expected to be introduced to the House in mid-2019. The Bill would:

- enable the CCRA to support implementation of the Paris Agreement and the objectives of the proposed CCB
- enable the Government to set a cap on emissions covered by the NZ ETS, by implementing the four in-principle decisions (see section 2)
- improve the NZ ETS for forestry and support afforestation
- improve the operation and administration of the NZ ETS
- reduce barriers to potential links with reputable emissions trading schemes

Proposals contained in this paper (Amendments to the CCRA: tranche one)

33. The specific proposals in this paper are described below.

SECTION 1: align the CCRA with the Paris Agreement and the proposed Climate Change Bill

This includes:

- A. supporting implementation of New Zealand's Paris Agreement emission reduction and reporting commitments
- B. refining the purpose of the CCRA to ensure it is able to assist with delivery of the CCB

SECTION 2: enable a cap on emissions covered by the NZ ETS by establishing a unit supply decision-making framework

This includes:

- A. auctioning
- B. limiting international units
- C. price controls
- D. coordinated decision-making

SECTION 3: improve the administration and operation of the NZ ETS

This includes:

- A. improving the compliance regime
- B. strengthening market governance
- C. making operational and technical improvements

34. Decisions are needed now on this first tranche of proposals. This is to allow sufficient drafting time to allow an amendment bill to enter the House in mid-2019.

TRANCHE ONE PROPOSALS

SECTION 1: align the CCRA with the Paris Agreement and the proposed Climate Change Bill

1.A. Supporting implementation of New Zealand's Paris Agreement emission reduction and reporting commitments

35. Currently, the CCRA enables New Zealand to comply with international obligations under the Convention and the Kyoto Protocol. I propose to amend

the CCRA to enable it to assist compliance with our obligations for the purposes of the Paris Agreement.

36. The amendments would mean that the CCRA also supports achievement of New Zealand's NDCs and enables the collection and reporting of information required for the purposes of the Paris Agreement.
37. Specifically, I propose to:
 - amend the purpose statement of the CCRA to include the Paris Agreement, alongside the Kyoto Protocol and the Convention (section 3)
 - include the text of the Paris Agreement as a schedule to the CCRA, like the Kyoto Protocol and the Convention
 - make other minor changes to reflect the Paris Agreement and to remove redundant aspects (including certain references to obligations under the Kyoto Protocol which have now been expended)

1.B. Refining the purpose of the CCRA to ensure it is able to assist with delivery of the Climate Change Bill

38. I propose that the purpose of the CCRA, in relation to the NZ ETS, be updated to assist New Zealand to meet its emission reduction target(s) under the CCB, once final policy decisions have been made on these.³ The purpose of the levy on synthetic greenhouse gases (SGG levy) will also be updated in line with this amendment.⁴
39. The current purpose of the CCRA, in relation to the NZ ETS and the synthetic greenhouse gas levy, is to support and encourage global efforts to reduce the emission of greenhouse gases by:
 - i. assisting New Zealand to meet its international obligations under the Convention and the Kyoto Protocol
 - ii. reducing net emissions below business-as-usual levels
40. It is important to establish a coherent and complementary system of climate change policy regulation to support the objective of the proposed CCB; to transition to a low-emissions and climate-resilient New Zealand [Cabinet paper *Proposed Climate Change Bill* refers].
41. In the CCB Cabinet paper we have agreed that the NZ ETS will play a key role in assisting with the achievement of New Zealand's domestic emissions budgets and the 2050 target(s). I propose to update the purpose of the NZ ETS to ensure its role is clear. This will provide the NZ ETS with credibility to incentivise emission reductions and help drive the transition.

SECTION 2: enable a cap on emissions covered by the NZ ETS by establishing a unit supply decision-making framework

42. This section relates to the implementation of Cabinet's four in-principle decisions following the NZ ETS 2015/16 review [EGI-17-MIN-0369 refers]. It is critical that the in-principle decisions are implemented together to effectively provide a cap on emissions covered by the NZ ETS.

³ Section 3(1)(b) of the CCRA.

⁴ Section 3(1)(c) of the CCRA.

43. Together, the proposals will provide a predictable framework for making unit supply decisions, improve the overall credibility of the scheme, support access to international carbon markets and support business investments in low-emissions technologies and practices, and in forestry.
44. The proposals relate to:
- A. auctioning – supporting the introduction of auctioning of New Zealand units (NZUs) in a way that aligns the supply of NZUs in the NZ ETS to our emission reduction targets
 - B. limiting international units – retaining the ability to limit international units if and when the NZ ETS reopens to international carbon markets⁵
 - C. price controls – replacing the current price ceiling (the \$25 fixed price option) with a cost containment reserve via auctioning, and investigating a price floor
 - D. coordinated decision-making – providing the framework for making unit supply settings in the NZ ETS over a five-year rolling period
45. Establishing this framework for unit supply decisions will support the NZ ETS to meet its updated objectives as it will allow unit supply to align with New Zealand’s emission reduction targets and support their achievement.
46. Progressing the four in-principle decisions is important for access to international carbon markets. Access to international units with environmental integrity will be important in giving flexibility to manage the economic cost of meeting NDCs.
47. s9(2)(j) and s6(a)
48. The proposed amendments will help to reduce barriers to potential linkages. To date, the most unusual feature of the NZ ETS is that it has not had a cap. A stringent and declining cap on the NZ ETS is needed to guarantee emission reductions (in line with increasingly ambitious NDCs and emissions budgets under the CCB) and have the option of linking to reputable emissions trading schemes.

Implementing the cap

49. The in-principle decisions need to be implemented in two stages:
- stage 1: amends the CCRA to put in place the framework to manage unit supply and provide for a cap on emissions covered by the NZ ETS
 - stage 2: decisions on regulations setting the level of the cap, the price control levels and the number of units supplied into the NZ ETS (regulations expected to be consulted on in mid-2019)
50. This paper deals with the framework stage and aims to establish a robust and simple legislated decision making framework for setting a cap on units supplied into the scheme. I have consulted on the implementation details for the four in-principle decisions and they are not contentious.

⁵ Note that no decision has been made on when the NZ ETS could reopen to international units.

51. I anticipate much greater interest from industry and the public in the stage 2 decisions on regulations as they would set the overall cap on the number of units supplied. This would involve decisions on the number of NZUs supplied through auctioning, the limit on international units and price control settings. I intend to consult the public on the second stage of decisions in mid-2019, and seek decisions from Cabinet by the end of 2019.
52. I recommend a series of decisions on the components of the overall package to manage unit supply decisions. This includes design details for an auctioning mechanism, the proposed alternate price ceiling and the process for coordinating decisions. These are outlined below:

2. A. Auctioning

53. I propose to implement the auctioning of NZUs in a way that aligns the supply of NZUs in the NZ ETS with our emission reduction targets.
54. The CCRA provides for the Minister for Climate Change to sell NZUs by auction within a prescribed overall limit, following the development of regulations. To date, the auctioning mechanism has not been utilised.
55. To inform the development of an auctioning platform, I seek your agreement to three aspects of the high-level auctioning design. These are the auction format, frequency and participation.
56. These decisions will eventually be reflected in regulations which will provide the operational detail for auctioning. I expect to return to Cabinet by the end of 2019 with these auctioning regulations. In the meantime, officials will use this policy agreement to develop the auctioning platform.
57. The table below outlines the key elements of the proposals on auctioning. Key characteristics of auction formats are whether bidding is open or sealed, and whether successful bidders pay what they have bid (discriminatory price) or the market-clearing price (uniform price).

Auction issue	Proposal	Rationale
Format	Implement auctions using a sealed-bid, single-round, uniformly priced format, and direct officials to begin developing an auctioning platform consistent with this format.	This format is used in all overseas emissions trading schemes that include auctioning. A sealed-bid, single-round auction, uniformly priced format, as proposed, is simple and has low risk of collusion. Uniform pricing is preferred because discriminatory pricing could disadvantage small participants and impact on market efficiency.
Frequency	The platform retains flexibility for auction frequency, so it can adapt to changing circumstances. I anticipate that auctions will initially be held either monthly or quarterly.	This will ensure auction frequency can adapt to changing circumstances as appropriate.
Participation	All New Zealand Emissions Trading Register (NZ ETR) account holders be eligible to participate in auctions.	As needed, further qualifications for auction participation can be implemented through regulations.

Proceeds	I have directed officials to undertake further analysis on whether auction proceeds should be set aside for a specific purpose. I will provide Cabinet with proposals on this in the second tranche in March 2019.	Public consultation considered whether auction proceeds should be ring-fenced by the Government and set aside for a specific purpose. I consider further analysis is needed before making any decisions.
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Stakeholder and iwi views on auctioning

58. There was clear support for the introduction of auctioning, however there were varying views from stakeholders as to their preferred format. The preferred option of a single-round, sealed-bid format with uniform pricing received support from 43 per cent of submitters, while 30 per cent preferred an ascending clock auction format.
59. Some submitters agreed with the consultation document's position that the preferred format is less complex and comes with a low risk of collusion. Others viewed it as more complex, less transparent and with a higher risk of collusion. There were also varying views regarding whether the extent of price discovery and liquidity in the secondary market would support this format.
60. I have taken these views into consideration. Officials advise that transparency is an important consideration and that the preferred auction format is less transparent than an ascending clock format. However, transparency is more relevant for unit supply decisions and the provision of market information, rather than the behaviour of individual bidders at auction. More transparency at auction increases collusion risks and shifts the focus onto the bidding behaviour of others.
61. For these reasons, I propose a single-round, sealed-bid format. I have directed officials to look at options to improve market transparency in the tranche two Cabinet paper expected in March 2019. The proposals in this paper will also improve the decision-making process for unit supply.

2.B. Limiting international units

62. International units with environmental integrity could play an important role in giving flexibility to manage the economic cost of meeting NDCs. If the NZ ETS were to reopen to international units, there will be a volume limit on their use. There are two modes through which international units could influence the NZ ETS:
 - market participants directly purchase, trade and surrender international units in the NZ ETS with the volume limit at the point of surrender or import
 - via government purchase of a limited number of international emission reductions, with the Government then auctioning a corresponding number of NZUs into the NZ ETS
63. It is not possible to make choices about the mode of purchase until we know more about which types of international carbon markets we would be engaging with. The rules for accounting for international units are also still being negotiated under the Paris Agreement.
64. Any international units that are used towards New Zealand's emission reduction targets would need to have environmental integrity. New Zealand is engaging

with both domestic experts and international partners to ensure that standards for environmental integrity can be developed and implemented.

2.C. Price controls

65. Price controls in emissions trading schemes, such as price ceilings, usually aim to limit unacceptably high or low prices, so are set at levels well outside of expected market prices. This is because if price controls are struck, they can shift responsibility away from emitters or increase the cost of meeting emission reduction targets.

Cost containment reserve - proposal

66. I propose to replace the current price ceiling in the NZ ETS with a new price ceiling, a cost containment reserve incorporated into auctioning. Amendments to the CCRA would provide for the implementation of the cost containment reserve.
67. A cost containment reserve is a type of price ceiling where the Government sets aside a specified number of units to be released for sale only if a specified trigger price is reached. If the sale price of NZUs reached the trigger price at an auction, additional supply from the cost containment reserve would be made available. As expectations around future supply influence prices, this would put downward pressure on the NZU price even before any additional units were actually sold.
68. The CCRA would be amended to allow Cabinet to replace the current price ceiling, the fixed price option, with a cost containment reserve once the cost containment reserve becomes fully operational.

Cost containment reserve - context

69. The NZ ETS currently has a price ceiling in the form of the \$25 fixed price option. It allows participants to meet their NZ ETS obligations by paying the Crown \$25 instead of surrendering a unit. This guarantees that \$25 is the maximum cost of compliance per unit for participants. There is no limit on the extent that participants can use the fixed price option.
70. The \$25 fixed price option was designed to be a temporary feature of the NZ ETS. The fixed price option is no longer sustainable as it is not volume-limited which creates significant risks to the Government, and international prices are expected to be above \$25 during the 2020s.
71. The NZ ETS needs to retain a price ceiling to manage the risk of short-term high prices negatively impacting the economy. If the market is operating as expected, and the price ceiling is set appropriately, it should be rare for the price ceiling to be reached.

Cost containment reserve - analysis

72. A cost containment reserve is volume-limited, so would provide a tool to balance fiscal risks for the Government with price risk for participants. It would be a 'softer' price ceiling compared to the fixed price option style, as it would not guarantee a maximum compliance cost for participants.
73. The effectiveness of the cost containment reserve in managing the risks of extremely high prices depends on the number of units that could be provided

via the reserve. The number of units available in the reserve and the trigger price they would be released at, would be set in advance by the Government through regulations.

74. Decisions on the trigger price and the reserve volume will be made as part of the coordinated decision making process. Setting the reserve volume will need to balance fiscal risks for the Government with the economic risks associated with extremely high carbon prices. This balance is reflected in the considerations for setting price controls, provided in section D: coordinated decision making.
75. The volume in the reserve and the trigger price would be set in regulations. These regulations would also provide further operational detail on the cost containment reserve, including when NZUs would be released, and whether there would be a single trigger level, or multiple trigger levels.
76. Determining the number of units that will be available in the reserve in advance means it forms part of the overall 'limit/cap' on the total number of units available in the NZ ETS. This differs from the current volume-unlimited fixed price option.

Cost containment reserve – backing units held in the reserve

77. Any NZUs sold via the reserve will need to be 'backed' to ensure the NZ ETS supports the achievement of emission reduction targets. Without this feature the overall limit/cap on emissions covered by the NZ ETS could exceed New Zealand's emission reduction targets.
78. This would require the Minister to secure a corresponding emission reduction equivalent to any NZUs sold from the reserve at least once per emissions budget period.
79. One way of 'backing' NZUs would be through the purchase of a corresponding number of international units. Alternatively, the Government could fund domestic emission reductions, such as tree planting. Holding back an equivalent tonne of emissions from emissions budgets is not recommended as this effectively increases the ambition of emission reduction targets, resulting in an increased economic cost to meet emission reduction targets.

Cost containment reserve - stakeholder and iwi views

80. A majority of submitters supported the cost containment reserve. Submitters were clear that adjustments to the settings of the cost containment reserve, including the trigger price and volume, should be signalled in advance and follow clear and transparent processes in order to support market confidence.

Price floor - proposal

81. I propose to investigate further the introduction of a price floor in the NZ ETS, including an option to set a reserve price through auctioning. I will report back to Cabinet on whether to introduce a price floor in the second tranche of proposals.
82. The auctioning platform will be designed so that it could enable a price floor by setting an auction reserve price should a decision be taken to have a price floor.

Price floor - analysis

83. The 2015/16 review considered the introduction of a price floor as many submitters pointed to low carbon prices in the past as impacting investments in abatement opportunities. At that time, a strong case could not be made for a price floor because a limit on the use of international units was considered the most effective way to address this issue.
84. There is merit in reconsidering this issue in order to future-proof the NZ ETS. With the proposed CCB, it may be prudent for the Government to have a tool to ensure that prices are consistent with its long term ambition. There may also be factors outside of the control of the Government that could lead to lower than expected prices or short term irregularities in the NZ ETS.
85. A number of submitters supported the introduction of a price floor during the 2015/16 NZ ETS review and these views were repeated during the August/September 2018 consultation on improvements to the NZ ETS. Submitters suggested a price floor would provide a safeguard against low emissions prices that could reduce confidence for low-emissions investments or forests.
86. I intend to report back to Cabinet on whether to introduce a price floor in the second tranche of proposals. Initial analysis by officials suggests a reserve price at auction is likely to be the most administratively simple option. However it should also be noted that its effectiveness would be related to the proportion of NZUs available through auctions.
87. If a price floor were to be implemented, it would form part of the coordinated decision making process. This means price floor settings would be consulted on and set annually via the regulation process.

2.D. Coordinated decision making

88. The coordinated decision making process provides the framework for making unit supply decisions. It would require the Government to make annual regulatory updates to set the supply of units into the NZ ETS on a five-year rolling basis. This would set an overall limit (a cap) on units supplied into the NZ ETS (excluding units from removal activities, like forestry).
89. The strength of the coordinated decision-making process is that it provides a balance between predictability for market participants, with flexibility for the Government to manage how the NZ ETS aligns with emissions budgets and targets.

Proposal

90. The CCRA currently requires that the Minister for Climate Change must, if implementing auctioning regulations, set and announce an overall limit on NZUs per year for a period of five years, which must be extended annually (section 30GA), providing a five-year 'look ahead'.
91. I propose to decouple this process from auctioning regulations, and instead apply it to all unit supply decisions. Note that this would not put a limit on NZUs provided for removals, including from forestry.

92. The overall limit/cap would be recorded in regulations, including the:
- limit on the use of international units by participants
 - number of NZUs to be auctioned
 - number of NZUs expected to be provided through free allocation⁶
 - number of NZUs available in the cost containment reserve
 - price trigger values for the price ceiling and floor (if applicable) would also be provided in these regulations
93. I plan to return to Cabinet in 2019 with more information on the rate of phase-down of free allocation for industry, and potentially decisions on free allocation in relation to agriculture, if it were to come into the NZ ETS.
94. The CCRA currently outlines considerations the Minister must have regard to when setting an overall limit. I propose that these considerations be extended to support the NZ ETS to meet its updated purpose.
95. Emission budgets for the CCB, and NDCs for the purposes of the Paris Agreement, are expected to be more ambitious over time. This increase in ambition will need to be reflected in the unit supply decisions for the NZ ETS, meaning that the NZ ETS cap would decline over time.
96. To reflect the updated objectives of the NZ ETS and support it to meet New Zealand's emission reduction targets, I propose that the CCRA is amended so that unit supply decisions are made in accordance with the table below.

⁶ Note that free allocation decisions would be made separately as methodologies and phase-down rates are provided in the CCRA.

Decision	Considerations for making unit supply decisions	Rationale
<p>1. International unit limit</p>	<p>Decisions must generally not be inconsistent with:</p> <ul style="list-style-type: none"> • the relevant emissions budgets set under the CCB • the relevant NDCs for the purposes of the Paris Agreement <p>In addition, the Minister must have regard to:</p> <ul style="list-style-type: none"> • New Zealand’s projected emission trends, including as measured in our NDC, for the relevant five year period • the greenhouse gas emissions to which the NZ ETS applies • the proper functioning of the NZ ETS • agreements and arrangements for access to international emission reductions • the forecast range of abatement costs that may be needed in order to deliver New Zealand’s emission reduction targets • recommendations of the Commission, including a desirable carbon price path • international emission reductions purchased for subsequent auction into the NZ ETS as an equivalent number of NZUs • any other matters that the Minister considers relevant 	<p>This decision would determine the number of international units that participants may purchase. This decision will factor in the abatement required to meet the relevant NDC compared with the domestic abatement that will be necessary in order to meet the relevant emissions budget.</p> <p>In effect, the international unit limit would reflect the additional abatement required above the emissions budget to meet the NDC.</p>
<p>2. Allocating the domestic budget</p>	<p>As per the considerations above, plus:</p> <ul style="list-style-type: none"> • the limit on the number of international units that a participant may surrender • the number of NZUs expected to be allocated (through free allocation or under negotiated greenhouse gas agreements) 	<p>The domestic budget that is unallocated (for example not allocated through free allocation or non-NZ ETS sectors) will be auctioned into the NZ ETS as NZUs. This will include equivalent NZUs representing international units that the Government has purchased for subsequent auction into the NZ ETS.</p> <p>It should be noted that (as per current settings) free allocation levels are not prevented from exceeding the overall limit, because allocation is intensity based and changes with production volumes.⁷ However if the overall limit is exceeded, no further NZUs would be auctioned.</p>
<p>3. Price controls</p>	<p>As per considerations in 1 and 2, plus:</p> <ul style="list-style-type: none"> • the impact of emissions prices on households and the economy • the level and trajectory of international emission unit prices (including price controls in linked markets) • inflation 	<p>The trigger price for price controls and volume of NZUs available via the cost containment reserve are ‘safe guards’ to manage the risk of prices reaching unacceptable levels. Therefore, additional factors need to be considered.</p>

97. In the CCB Cabinet paper I propose that the Commission would provide a recommendation to the Minister for Climate Change on the annual NZ ETS unit

⁷ The decision-making process for phasing-down free allocation will be made through a separate provision. The second tranche Cabinet paper in March 2019 is expected to consider how the decision to phase-down industrial allocation would be made.

supply settings [Cabinet paper *Proposed Climate Change Bill* refers]. The Minister would then recommend the making of regulations, either giving effect to the Commission's advised settings, or providing alternative settings.

98. In preparing its advice, the Commission would consider the same issues that the Minister is required to consider, as proposed above. If the Commission's advised settings are given effect to, the Minister does not need to reconsider these same requirements proposed above. If the Minister provides alternative settings, the Minister would need to consider the requirements of the CCRA afresh.

Flexibility to adjust unit supply decisions

99. Consistent with the current approach in the CCRA, unit supply decisions should continue to be made annually, looking out five years. As per the current approach, the first two years of each period would be set, with no changes able to be made, except in specific circumstances provided below in relation to price control settings.
100. It is prudent to have the ability to reassess price control settings in certain circumstances. This reflects the objective of price controls; that they are to manage the risk of extremely high or low prices.
101. I propose that price control settings (that is, the trigger price for a floor or ceiling, and the volume of NZUs that could be provided by a cost containment reserve) could be reassessed:
- if price controls are utilised; or
 - in special circumstances, for example, in relation to linking with other international carbon markets, a change in emissions budgets or a force majeure event

Announcing unit supply decisions

102. Regulations setting unit supply volumes and price control levels would be published in the New Zealand Gazette at least three months before they come into force. It is expected that a calendar would also be published announcing auction dates, and the number of NZUs available.

Stakeholder and iwi views on coordinated decision-making process

103. The proposals are consistent with the consultation feedback. When asked about the issues that should be considered by the decision-maker when making unit supply decisions, submitters supported issues related to the proper functioning of the NZ ETS, emissions budgets and recommendations from the Commission.
104. Many submitters supported the current approach of one year advance notice of any changes and specifying that changes should apply from the beginning of a compliance year.
105. A number of submitters thought that changes to unit supply decisions should only be made in special circumstances or a force majeure event. This is consistent with the approach to changes in the price control measures; the price control settings can be reviewed in special circumstances or if the price controls are utilised.

SECTION 3: improve the administration and operation of the NZ ETS

3.A. Improving the compliance regime

106. I propose to establish a set of infringement offences targeted at low-level non-compliance issues within the NZ ETS and SGG levy.⁸ The proposed infringement offences could impose maximum fees of \$1,000 for an individual and \$2,000 for body corporates, and fines to a maximum value of \$3,000 for an individual and \$6,000 for a body corporate.
107. I propose to amend the CCRA to enable regulations to determine which offences in the Act are infringement offences.

Analysis

108. Prosecution is the only available penalty for low-level offending, however it is used rarely, due to the significant costs involved with pursuing prosecution. Attempts to deter low-level offending through educating participants on their obligations or issuing warning notices have not succeeded in reversing trends of non-compliance. Some NZ ETS participants have become repeat low-level offenders and continue to contravene the rules without sanctions.
109. If existing trends of non-compliance are not addressed, it may affect the integrity of the NZ ETS and dissuade participants from taking the necessary care to comply with their obligations. Ultimately, this could affect the Government's ability to meet domestic and international emission reduction targets.
110. An infringement regime is expected to improve compliance outcomes while reducing administrative costs and complexity. These lower-level offences will result in a financial sanction but not convictions.
111. In the case of more serious offending, prosecution will still be available to enforcement agencies, enabling criminal proceedings to be pursued when necessary; for example in the case of evasion under section 133 of the CCRA.
112. The administration process for infringement offences will be governed by the Summary Proceedings Act 1957. This is consistent with the administration of infringement regimes across legislation.

Stakeholder and iwi views on the infringement regime

113. Most submissions supported the proposal to introduce an infringement regime. Some of these submitters also requested that the rules should be simplified and that prosecution should remain an option for serious offending.
114. Some submitters were concerned that the introduction of a strict liability infringement regime would not allow for discretion to be applied, especially in cases of reasonable error.
115. Infringement offences are strict liability offences and they are largely administrative in nature. As with all infringement schemes, participants have the right to challenge the infringement. The fees and fines are also intended to be set at a level that will encourage compliance while not being overly burdensome. They are expected to reduce the operational costs of the NZ ETS to participants over time.

Further compliance improvements may be required

⁸ i.e. low-level offending under sections 129, 131, 259 and 260 of the CCRA.

116. Changes to the NZ ETS for forestry may mean new penalties are needed. These will be part of the advice in March 2019.
117. I will return to Cabinet in March 2019 on further improvements to the penalty regime including potential changes to penalties for errors in reporting, claiming allocations and failing to surrender or repay units.

3.B. Strengthening market governance

118. Good governance of the NZ ETS is important because it can help to ensure the integrity, efficiency and confidence in market trading, and it can reduce the risks of misconduct, which can distort the NZ ETS price and reduce the confidence in the NZ ETS.
119. Public consultation sought feedback on the extent to which seven misconduct risks⁹ may exist at the moment in the NZ ETS market and/or may become more prevalent in future.
120. The risk of misconduct is increasing. This is due to the introduction of auctioning, higher NZU prices, the potential inclusion of additional participants and the potential reopening of the NZ ETS to international units. These could increase the incentives for misconduct and the range of actors who might be able to benefit from such misconduct.

Proposal

121. I consider that these risks would be best governed as a coherent package. The most effective way to achieve this would be through an overarching governance framework. However, at this point I am unable to make recommendations regarding the whole framework as the work is not yet complete. Therefore, I consider it appropriate to prioritise two issues now and continue work on a broader framework. I aim to make decisions on that framework in the next tranche of proposals.
122. I seek your agreement to prohibit market manipulation and insider trading through the CCRA now. These two behaviours have been identified as priority issues because the risks will increase once auctioning begins and there are clear gaps in the existing legislation.

Analysis

123. Insider trading includes trading on the basis of material non-public information which, if it were made public, would likely have a significant effect on the price of NZUs. For example, this could occur if a participant had information that a large emitter planned to shut down their entire operation, or substantively reduce their emissions, and then used that non-public information to trade NZUs in order to make a profit.
124. Market manipulation includes spreading false market information, cornering or squeezing the market, or giving false impressions of market conditions, typically with the aim to influence the market price for profit.

⁹ The risks include: false or misleading advice provided to participants, a potential lack of transparency, monitoring and oversight of trades in the secondary market, manipulation of the NZU price (referred to as market manipulation), insider trading, money laundering/financing of terrorism, credit and counterparty risks, and conflicts of interest.

125. Both behaviours could distort the market price and reduce the overall efficiency and effectiveness of the NZ ETS. Prohibiting them in the NZ ETS will bring their treatment in line with how they are treated in other New Zealand financial markets (that is, those that fall within the remit of the Financial Markets Conduct Act 2013 (FMCA)). It will also help to achieve a safe and efficient trading environment and to enhance confidence in the NZ ETS market.
126. These two types of behaviour are also prohibited in emissions trading schemes in other jurisdictions. I expect that these proposals will improve how other international markets view how we safeguard our market and subsequently improve our chances of being able to link with those markets.
127. In relation to enforcing the necessary offences and penalties associated with these behaviours. I propose to replicate the relevant offences and penalties from the FMCA, with necessary modifications in consultation with the Ministry of Justice. I have also directed officials to undertake further work to determine the regulator that would enforce the new prohibitions, including any necessary new powers and/or infrastructure or funding changes.

Other options are considered to be overly complex, costly and do not adequately deal with the problem

128. I have been advised by officials that treating NZUs as financial products or financial advice products for the purposes of the FMCA and its related systems¹⁰ is not a natural regulatory fit, would be complex to design and likely impose significant compliance costs on NZ ETS market participants, for example providers of advice to small participants.
129. Another key option considered was to attempt to deal with these two forms of conduct through the auctioning regulation. This option does not capture the secondary market and is unlikely to send the same deterrence signal and ability to sanction instances of this misconduct. It was discounted on this basis.

Stakeholder and iwi views on market governance

130. The majority of submitters acknowledged that the risks outlined in the consultation document are things that should be addressed by the Government, and noted that these risks are likely to increase in the future. However there was a strong indication that any design changes should be carefully considered and well signalled, as they are likely to be disruptive to market intermediaries.
131. Submitters assessed that the risks of market manipulation will be particularly important in the future, particularly at auction, but noted that these risks are generally not problematic in the current market environment. Very few submitters provided evidence that the risks had materialised to date. This can be read as a positive signal of good market behaviour, although it should be noted that these risks are very difficult to detect and unlikely to be self-reported.

Next steps

132. In relation to the prohibitions on insider trading and market manipulation, I propose that Cabinet agree to prohibit these conducts and emulate relevant

¹⁰ Other legislation that is related to the FMCA includes the Financial Advisers Act 2008, Financial Service Providers Act 2008 and the Anti-Money Laundering and Countering Financing of Terrorism Act 2009, among others.

offences for them. I will further consider the remaining enforcement options needed to implement the prohibitions. This will enable the Parliamentary Counsel Office to begin drafting the technical aspects of the prohibitions and offences as soon as possible, while I direct officials to prepare the remaining enforcement decisions.

133. I will return to Cabinet with further information in the next tranche of proposals on the broader governance framework for market conduct.

3.C. Making operational and technical improvements

134. Consultation included several proposed operational and technical improvements to address administrative inefficiencies and loopholes. Overall, submitters supported the proposals. The table below describes the issue, the preferred proposal, who would be impacted and submission feedback.

Issue	Proposal	Persons impacted	Submissions
Receiving units where there are overdue obligations	When an entitlement to units is approved, these units are used first to repay any overdue unit obligation, before any remaining balance is transferred to the person.	Those who owe emissions units and are also eligible for receiving units	Unanimous support from submissions
Closing a loophole related to coal stockpiles in all coal activities	Require the reporting of all coal sold or used from a person's stockpile in the year, regardless of whether the person meets the threshold for coal importing, purchasing or mining.	Coal importers, purchasers and miners who stockpile	Significant support for loophole closing across sectors, although a few submitters considered administrative costs would be burdensome
Ability to amend errors in unique emissions factors (UEFs) from previous years	For regulators to be able to amend UEFs from previous years if an error is found.	Participants with UEFs	Majority support, with some opposition based on precedence concerns and undermining integrity of existing regulatory and verification processes
Repayments for industrial allocation (s 125) and forestry (s 189)	To allow participants to repay emission units of any eligible type or origin, instead of the exact same units that were issued by the Crown.	Forestry and industrial allocation participants	Unanimous support
Allowing consolidated groups to apply for an industrial allocation	To allow industrial allocations to be transferred to a consolidated group account.	Industrial allocation participants	Unanimous support
Inconsistencies with the Companies Act 1993	To amend the CCRA to make clear that when a company is removed from the Companies Register (the 'New Zealand Register' in the Companies Act), ownership of the property (the units) in a New Zealand Emissions Trading Register account vests in the Crown in accordance with section 324 of the Companies Act and the regulator is empowered to close the account (despite anything in section 18D of the CCRA).	All participants being removed from the New Zealand Companies Office Register	Some support, but consultation document contained inaccurately worded questions about the issues, so submissions were largely on other topics.

135. I recommend Cabinet support the above policy proposals.

Next steps

Legislative amendments

136. The policy decisions outlined in this paper will provide the basis for drafting instructions for the Parliamentary Counsel Office.

137. I intend to bring a second tranche of proposals to Cabinet for consideration in March 2019, to further strengthen the NZ ETS framework. I intend for these two tranches and the NZ ETS forestry proposals to culminate into a single amendment bill to the CCRA, expected to be introduced by mid-2019.

Regulation developments

138. Regulations will be needed to fully implement the final policy decisions. These include technical details and setting unit supply volumes. I expect to return to Cabinet by mid-2019 to begin developing the regulations. I would expect public consultation to follow this, and take place alongside the Select Committee process for the proposed CCRA bill, with the aim of having the regulations come into effect in 2020.

139. The unit supply regulations will be developed to align with a 'provisional emissions allowance', as proposed in the CCB paper [Cabinet paper *Proposed Climate Change Bill* refers]. The provisional emissions allowance would be in advance of a first emissions budget, and would specify the total volume of emissions allowed over 2020-2024.

Consultation

Public consultation

140. In July, Cabinet approved public consultation on proposals for improving the NZ ETS [CAB-18-MIN-0374]. From 13 August 2018 to 21 September 2018, officials from the Ministry for the Environment (MfE), the Ministry for Primary Industries (MPI) and Te Uru Rākau conducted a joint public consultation on the proposed improvements. A summary of submissions will be published in early 2019.

141. To ensure widespread engagement with the proposals, officials organised a national roadshow for stakeholders and Māori in ten locations across New Zealand. A separate Māori Leaders hui was held in Wellington. A total of nearly 600 people attended, representing a range of sector groups including transport, electricity, energy, forestry, local government and agriculture. Individuals and stakeholders from business associations, community groups, NGOs, and academics also attended.

142. 253 submissions were received during the consultation period; 162 submissions on the NZ ETS framework improvement proposals and 147 on the forestry proposals. Approximately 60 submitters commented on both sets of proposals.

143. Submissions were generally very supportive of the proposals we are focusing on in this paper. Measures to create new permanent forest activity in the NZ ETS and the introduction of operational changes to improve the functioning of

the NZ ETS received high levels of support. My proposals draw on these submissions.



Māori and iwi consultation

144. A separate Māori Leaders hui was held in Wellington and several key points were raised that are relevant to the decisions proposed in this paper. Attendees at the Māori Leaders hui held as part of the consultation emphasized the importance of considering the impacts on Māori of these proposals with a particular focus on those living in rural communities. They stated that the Government should ensure that Māori are not disadvantaged in any way. They requested that Māori should be involved, represented and influential in all decision-making arrangements and noted that stable and enduring policies are required to support investment decisions.
145. Submissions from iwi/Māori expressed a range of views on the detailed proposals, and included similar messages to those heard at the hui regarding consideration of impact on Māori and the importance of involving Māori in decision-making. As outlined in paragraph 157, it will be critical to maintain Te Ao Māori principles and a genuine Crown-Māori partnership approach.

Agency consultation

146. The following agencies were consulted on this paper: the Ministry of Business, Innovation and Employment, the Ministry for Primary Industries, the Ministry of Foreign Affairs and Trade, Te Uru Rākau, the Treasury, Te Puni Kōkiri, the Department of Conservation, the Energy Efficiency and Conservation Authority and the Environmental Protection Authority (EPA). The Department of the Prime Minister and Cabinet was informed.

Financial implications

147. I am not seeking approval for any new funding in this paper. Where funding is required to operationalise the proposals, I will seek funding alongside those implementation decisions. This is likely to include funding for operationalising any new market governance requirements in regulation.
148. s9(2)(f)(iv) 
149. There will also be financial implications associated with the requirement to 'back' NZUs sold via the cost containment reserve. The size of this cost depends on the volume of NZUs sold from the reserve, and the cost to fund the associated emission reductions.
150. s9(2)(f)(iv) 
151. Over time, implementing the auctioning of NZUs will positively impact the Crown's operating statement and balance sheet, contributing cash to the

Crown's consolidated fund. I will return to Cabinet in March 2019 to seek a decision on whether those funds would be hypothecated for specific purposes.

Legislative implications

152. The policy decisions from this paper will require legislative amendments to the Climate Change Response Act 2002 (CCRA).
153. Subject to the usual process for agreeing the next Legislation Programme, the amendment bill is expected to be given a category 2 priority on the 2019 Legislation Programme (meaning the bill must be passed by the end of 2019).

Regulatory impact analysis

154. The Regulatory Impact Analysis requirements apply to the proposals in this paper. Ten Regulatory Impact Statements have been prepared and are attached as appendices.
155. A Quality Assurance Panel with representatives from the Ministry for the Environment and the Treasury Regulatory Quality Team has reviewed the ten Regulatory Impact Assessments (RIAs) that comprise "Climate Change Response Act 2002: tranche one" produced by the Ministry for the Environment and dated November 2018.
156. The panel considers that **the 'auctioning' RIA partially meets** the Quality Assurance criteria. **The other nine RIAs meet the** Quality Assurance criteria.
157. Although the RIAs are not always easy to read, this is largely due to the nature of the proposals which are often technical or, in the case of the 'unit supply' RIA, complex and lengthy. All of the RIAs canvass a wide range of options and the analysis is generally robust. The proposals have generally been well consulted and the feedback from stakeholders is reflected in the analysis.
158. The Panel assessed the 'auctioning' RIA as partially meets primarily because the analysis was not always complete and some key parts were hard to understand, including how bid shading happens and how uniform pricing reduces the risk of hoarding. We also did not think the reasons for rejecting the descending clock option early in the analysis were convincing. However, the RIA notes other auction types are generally favoured internationally, so we suspect there are good reasons why the descending clock can be safely disregarded.

Human rights

159. The proposals in this paper are consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Crown-Māori Partnership

160. Māori have a significant stake in climate change action, and a significant interest in the NZ ETS. Māori have a large economy and asset base sitting largely in the primary industries, as well as Treaty-based rights and interests in natural resource use and management. It will be critical to maintain Te Ao Māori principles, including as provided by section 3A of the CCRA and a genuine Crown-Māori partnership approach.

International obligations

161. The proposed amendments are consistent with New Zealand's obligations under the Paris Agreement and other international commitments.

Publicity

162. Announcements about the NZ ETS need to be managed carefully to avoid any inconsistencies and market risks, including sudden rises of NZU prices in the NZ ETS. In addition, information should not be disseminated in a way that advantages some market participants over others and compromises NZ ETS investments.

163. It is important to manage the release of information on these proposals and those contained in the *Proposed Climate Change Bill* Cabinet paper. Officials have developed communication material to support these announcements.

Proactive Release

164. I propose to release this paper and attached Regulatory Impact Statements on the Ministry for the Environment's website, subject to redactions as appropriate equivalent to those under the Official Information Act 1982.

Recommendations

The Minister for Climate Change recommends that the Committee:

1. **note** that this paper provides a first tranche of proposals to amend the Climate Change Response Act 2002 (CCRA) to support New Zealand's implementation of the Paris Agreement and improve the New Zealand Emissions Trading Scheme (NZ ETS)
2. **note** that the NZ ETS is the Government's key policy tool to reduce greenhouse gas emissions and support New Zealand to meet its emission reduction targets
3. **note** that the 2015/16 NZ ETS review found that, without changes, the NZ ETS will not effectively assist New Zealand to meet emission reduction targets, including the 2030 Nationally Determined Contribution (NDC) for the purposes of the Paris Agreement, and any new target under the proposed Climate Change Bill (CCB)
4. **note** that all decisions about the design and operation of the NZ ETS have the potential to affect the credibility of our scheme and ability to link to other emissions trading schemes

Aligning the Climate Change Response Act with the Paris Agreement and the Climate Change Bill

5. **note** that the purpose statement of the CCRA needs to be updated to reflect the Paris Agreement and the proposed CCB
6. **agree** to amend the purpose section of the CCRA to assist New Zealand to comply with its emission reduction and reporting commitments for the purposes of the Paris Agreement

7. **agree** to include the text of the Paris Agreement as a schedule to the CCRA, alongside the Kyoto Protocol and the United Nations Framework Convention on Climate Change (the Convention)
8. **agree** to make other minor changes to the CCRA to reflect the Paris Agreement and remove now redundant aspects of the CCRA (including certain references to obligations under the Kyoto Protocol which have now been expended)
9. **agree in principle**, subject to final decisions on the CCB, to amend the purpose of the CCRA to assist New Zealand to meet target(s) and emissions budgets set under the CCB

Establishing a NZ ETS unit supply framework

10. **note** that in December 2017 this Cabinet noted four in-principle decisions made by the previous Government to:
 - 10.1. introduce auctioning of units to align the supply of units in the NZ ETS to our emission reduction targets
 - 10.2. limit participants' use of international units when the NZ ETS reopens to international carbon markets
 - 10.3. develop a different price ceiling to eventually replace the current \$25 fixed price option
 - 10.4. coordinate decisions on the supply settings in the NZ ETS over a five-year rolling period
11. **note** that implementing the four in-principle decisions will provide a framework for making unit supply decisions, and they need to be implemented together to enable a cap on emissions covered by the NZ ETS
12. **note** that progressing the four in-principle decisions is important for accessing high-integrity international carbon markets to support New Zealand meeting emission reduction targets for the purposes of the Paris Agreement and emissions budgets under the CCB
13. **note** that the unit supply framework will support the updated objectives of the NZ ETS by allowing unit supply to align with New Zealand's emission reduction targets
14. **note** that public consultation was recently completed on implementation details for the four in-principle decisions, and submitters were broadly supportive of the proposals
15. **note** that the in-principle decisions need to be implemented in two stages; the first stage will amend the CCRA to put in place a new unit supply framework and enable a cap; the second stage to make regulations on the level of the cap

Auctioning

16. **note** that the CCRA enables the Minister for Climate Change to sell New Zealand Units (NZUs) by auction, but to date, an auctioning mechanism has not been utilised
17. **agree** to begin developing an auction platform and regulations to implement auctioning of NZUs to align the supply of NZUs in the NZ ETS with emission reduction targets

18. **agree** to the development of an auctioning platform:
- 18.1. with a sealed-bid, single-round, uniform priced format because it is less complex and has lower risk of collusion
 - 18.2. with flexibility for monthly or quarterly auctions
 - 18.3. that all New Zealand Emissions Trading Register account holders are eligible to participate in, subject to further qualifications provided in regulations
19. **note** that the current regulation making power is sufficient to enable the development of the above recommendations (recs 17 and 18)
20. **note** that the current statutory prerequisites for auctioning regulations include an overall limit on the number of NZUs and a five-year rolling unit supply decision-making process
21. **agree** that this prerequisite (recommendation 20) will no longer be relevant for auctioning regulations, given the new coordinated decision-making process

Limiting international units

22. **note** that there will be a limit on the use of international units in the NZ ETS if and when it reopens to international carbon markets which will be able to be amended as part of the coordinated decision-making process
23. **note** that international units could influence the NZ ETS either directly through participant purchase, or government purchase of international units, with a corresponding amount of NZUs auctioned into the NZ ETS
24. **note** that it is not possible to make a choice on the mode of purchase at this time as international carbon markets are still developing
25. **note** that no decision has been made on when the NZ ETS could reopen to international units

Price controls - cost containment reserve

26. **note** that price controls in emissions trading schemes aim to limit unacceptably high or low prices and are normally set well outside of expected market price ranges
27. **agree** that the NZ ETS should retain a price ceiling to manage the risk of prices reaching unacceptable levels
28. **note** that the current price ceiling, the \$25 fixed price option, is volume-unlimited and creates significant risks to the Government
29. **agree** to implement a new price ceiling through a volume-limited cost containment reserve which would be incorporated into auctioning
30. **agree** the cost containment reserve will replace the fixed price option
31. **note** that the Minister for Climate Change will report back in March 2019 on interim decisions for the fixed price option
32. **agree** that the volume of units available via the cost containment reserve, the trigger price(s) these are released at, and operational detail, will be set in regulations as part of the coordinated decision-making process

33. **agree** to require the Minister for Climate Change to, at least once per emissions budget, secure a corresponding emission reduction equivalent to any NZUs sold from the cost containment reserve (for example, by obtaining international units)

Price controls - price floor

34. **note** that the CCRA does not currently explicitly provide for a price floor in the NZ ETS
35. **note** that there may be a case to reassess the use of a price floor in the NZ ETS to future-proof the scheme
36. **direct** Ministry for the Environment officials to investigate the potential introduction of a price floor in the NZ ETS, including an option to set a reserve price through auctioning, and report back by March 2019
37. **direct** Ministry for the Environment officials to develop an auctioning platform that retains flexibility to set a reserve price through auctioning

Coordinated decision making

38. **agree** that there will be a coordinated decision-making process that will require the Government to make annual regulation updates setting the supply of units into the NZ ETS on a five-year rolling basis
39. **note** that the coordinated decision-making process will implement the in-principle decisions (noted in recommendation 10) to provide a framework for unit supply decisions
40. **agree** that the coordinated decision-making process will set an overall limit on the number of NZUs to be auctioned, the access to international units, and price control settings (including the trigger price(s) and the volume of NZUs available via the cost containment reserve), taking into account any expected volumes for free allocation and negotiated greenhouse gas agreements
41. **note** that the NZ ETS cap is designed to decline over time, consistent with expectations that emissions budgets under the CCB and future NDCs for the Paris Agreement, will be increasingly ambitious over time
42. **note** that a stringent and declining NZ ETS cap is key for enabling linkages to other established and credible schemes
43. **agree** that unit supply decisions must generally not be inconsistent with the relevant emissions budget or the relevant NDC
44. **agree** that when making unit supply decisions, the Minister for Climate Change must also have regard to:
- 44.1. New Zealand's projected emission trends for the relevant five-year period
 - 44.2. the greenhouse gas emissions to which the NZ ETS applies
 - 44.3. the proper functioning of the NZ ETS
 - 44.4. agreements and arrangements for international emission reductions
 - 44.5. the forecast range of abatement costs that may be needed in order to deliver New Zealand's emission reduction targets
 - 44.6. any international emission reductions obtained by the Government for the purposes of enabling NZUs to be auctioned into the NZ ETS

- 44.7. recommendations of the Climate Change Commission, including a desirable carbon price path
- 44.8. any other matters that the Minister for Climate Change considers relevant
- 45. **agree** that when deciding the number of NZUs to be auctioned that as well as the considerations listed in recommendation 43 and 44 above, the Minister for Climate Change will also have regard to:
 - 45.1. the limit on the number of international units that a participant may surrender
 - 45.2. the number of NZUs expected to be allocated through free allocation or provided under negotiated greenhouse gas agreements
- 46. **agree** that in making decisions on price control settings, including the trigger prices, and the number of NZUs that could be provided via the cost containment reserve, as well as the considerations listed in recommendations 43, 44 and 45, the Minister for Climate Change must also have regard to:
 - 46.1. the impact of emissions prices on households and the economy
 - 46.2. the level and trajectory of international emissions prices (including price controls in linked markets)
 - 46.3. inflation
- 47. **agree** that, to provide predictability to participants, once unit supply decisions are made, years one and two of this period can only be changed in accordance with recommendation 48
- 48. **agree** that, unit supply decisions in relation to price control settings are able to be adjusted in years one and two:
 - 48.1. if they are utilised
 - 48.2. in special circumstances, including in relation to linking with other international carbon markets, a change in emissions budgets or a force majeure event
- 49. **note** that other relevant procedural requirements of the current unit supply regulation making power will continue to apply
- 50. **agree** that in the transitional period, prior to the first emissions budget being set, the Minister for Climate Change will make unit supply decisions for 2020-2024 to support meeting a provisional emissions allowance, following the coordinated decision-making process

Compliance regime

- 51. **note** that low-level offending in the NZ ETS is common, but has often gone unsanctioned
- 52. **agree** to amend the CCRA to enable regulations that establish a set of infringement offences targeted at low-level compliance issues, including defining which offences in the Act are infringement offences and requiring consultation
- 53. **note** that prosecution would still be available for more serious non-compliance
- 54. **note** changes to forestry in the NZ ETS may mean new penalties are needed, which will be part of the advice in March 2019

55. **note** further improvements to the penalty regime including potential changes to penalties for errors in reporting, claiming allocations, and failing to surrender or repay units will be part of the advice in March 2019

Market governance

56. **agree in principle**, subject to final decisions on the broader, coherent market governance framework, to prohibit insider trading and market manipulation in the NZ ETS market

57. **agree in principle**, subject to final decisions on the broader, coherent market governance framework to, as much as is practical and appropriate, approach insider trading and market manipulation in the same manner as they are treated in the Financial Markets Conduct Act 2013 (FMCA)

58. **agree in principle**, subject to final decisions on the broader, coherent market governance framework to, as much as is practical and appropriate, have penalties and offences for insider trading and market manipulation in the NZ ETS mirror the equivalent relevant penalties and offences in the FMCA

59. **note** that Ministry for the Environment officials will do further work determining the most appropriate regulator to enforce this conduct, including careful consideration of which regulator is most appropriate and ensuring that regulator is adequately resourced to deal with this conduct

60. **invite** the Minister for Climate Change, in consultation with the Minister of Forestry as appropriate, to recommend final decisions on the broader, coherent market governance framework in the next tranche of NZ ETS decisions

Operational and technical improvements

61. **agree** that the CCRA is amended so that

61.1. when an entitlement to units is approved, these units are used first to repay any overdue unit obligation, before any remaining balance is transferred to the person

61.2. the reporting of all coal sold or used from a person's stockpile in the year is required, regardless of whether the person meets the threshold for coal importing, purchasing or mining

61.3. regulators are able to amend unique emissions factors from previous years if an error is found

61.4. a participant is able to use any eligible emission units to repay the Crown

61.5. industrial allocations can be transferred to a consolidated group account

61.6. an account holder's representative cannot operate a New Zealand Emissions Trading Register account after the account holder has been removed from the New Zealand Companies Register, and any units in that account are vested in the Crown, in accordance with section 324 of the Companies Act 1993

Next steps

62. **note** any new funding required to implement the final policy decisions noted above will be sought through a separate Cabinet paper or through Budget 2019

63. **agree** that the Minister for Climate Change will proactively release this paper on the Ministry for the Environment's website, subject to redactions equivalent to withholdings under the Official Information Act 1982
64. **note** that the Minister for Climate Change intends to bring the second tranche of proposals to amend the CCRA to Cabinet for consideration in March 2019
65. **note** that these two tranches and the forestry proposals are intended to culminate in a single amendment bill to the CCRA expected to be introduced in mid-2019
66. **note** that the timeframes for progressing this bill are tighter than usual timeframes for legislative drafting
67. **note** that the Minister for Climate Change intends to return to Cabinet by July 2019 to begin developing regulations needed to implement the final policy decisions
68. **note** that public consultation on regulations is expected to occur alongside the Select Committee process for the proposed CCRA bill, with the aim of having regulations in effect in 2020
69. **invite** the Minister for Climate Change to issue drafting instructions to the Parliamentary Counsel Office based on the agreed and "in principle" decisions presented in this paper
70. **authorise** the Minister for Climate Change, in consultation with the Minister of Forestry as appropriate, to further clarify and develop policy matters relating to the amendments proposed in this paper, in a way not inconsistent with Cabinet's decisions
71. **agree** that the Minister for Climate Change may share this Cabinet paper, drafts of further Cabinet papers on related issues, drafting instructions to the PCO, subsequent drafts of amendments to the CCRA or regulations, and related documents, with the Environmental Protection Authority, as a key agency in the proposed amendments

Authorised for lodgement.

Hon James Shaw

Minister for Climate Change