

In Confidence

Office of the Minister for Climate Change

Chair, Cabinet Environment, Energy and Climate Committee

New Zealand Emissions Trading Scheme Tranche Two: Enabling future price controls

Proposal

1. This paper seeks decisions to amend the Climate Change Response Act 2002 (CCRA). It is part of tranche two of amendments designed to improve the New Zealand Emissions Trading Scheme (NZ ETS).
2. In December last year, Cabinet agreed to implement a new price ceiling (a 'cost containment reserve'). I am now seeking agreement to amend the CCRA to enable the transition from the current NZ ETS price ceiling (the fixed price option or 'FPO') to this new price ceiling.
3. I also propose to amend the CCRA to enable a price floor in the NZ ETS, via an auction reserve price.

Executive summary

4. The Government is reforming the NZ ETS to ensure the scheme is effective in assisting to meet emission reduction targets and in supporting the transition to a low-emission and climate-resilient New Zealand. This requires amending the CCRA to provide:
 - 4.1. certainty to the market of the long-term credibility and effectiveness of the NZ ETS by signalling the trajectory of our transition to a low-emissions economy
 - 4.2. flexibility for the government to manage the NZ ETS in changing circumstances.
5. I am in the process of bringing the tranche two amendments to Cabinet via a series of separate papers [CAB-19-MIN-0089 refers]. These decisions will combine with tranche one to form a single bill amending the CCRA, to be introduced to the House in mid-2019 and to enter into force in 2020.
6. In tranche one, Cabinet agreed to replace the current price ceiling (the FPO) with a new price ceiling (the cost containment reserve). Cabinet also directed officials to investigate the potential introduction of a price floor in the NZ ETS.
7. This paper is part of tranche two and seeks decisions to amend the CCRA to enable price control tools (via price floors and ceilings). I seek agreement to:
 - i. allow for the transition from the current FPO to the new price ceiling, 'a cost containment reserve'
 - ii. enable a price floor to be implemented via an auction reserve price in future, if desired.

8. Price control tools can be used to manage unacceptably low or high prices in the NZ ETS. In this paper, I am not seeking decisions on what an unacceptably high or low price would be. The NZ ETS 'coordinated decision-making process', which Cabinet agreed to in December 2018, will set in regulations an overall limit on unit supply in the NZ ETS and can include price control settings [CAB-18-MIN-0606.01 refers].
9. I expect to return to Cabinet by July 2019 for approval to consult on regulations relating to the coordinated decision-making process and auctioning in July/August 2019. This will include options on price control settings and auction details.

Context

Reform of the NZ ETS is underway

10. As part of the Government's programme of action on climate change, the NZ ETS is being reformed through amendments to the CCRA. The reforms will provide us with an effective tool to assist New Zealand in meeting emission reduction targets, increase removals, and transition to a low-emission future.
11. Proposals to amend the CCRA are being progressed in two tranches, which will form a single amendment bill, to be introduced to the House in mid-2019 and to enter into force in 2020:
 - 11.1. Tranche one was agreed by Cabinet in December 2018 [CAB-18-MIN-0606.01 refers] and the Parliamentary Counsel Office (PCO) has commenced drafting.
 - 11.2. I am currently seeking tranche two decisions through a series of papers I am bringing to Cabinet in March to May 2019 (forestry papers are being co-led with Hon Shane Jones, Minister of Forestry).
12. This paper comprises part of tranche two, and focuses on enabling price controls in the NZ ETS.

Price controls in the NZ ETS

13. Price control features in emissions trading schemes work by either increasing supply in the market, creating downwards pressure on the price (ceiling) or restricting supply into the market, creating upwards pressure on the price (floor).
14. Different emissions trading schemes have different price control or stability features. Decisions about the design and operation of the NZ ETS should be considered in light of their potential impact on New Zealand's ability to access international carbon markets with environmental integrity. Cabinet has agreed to retain the option to use international carbon markets after 2020 [CAB-18-MIN-0248 refers]. Officials are engaging with our most promising linking partners¹, and will report back if any price control features will pose a barrier to our ability to link with these schemes.
15. In December 2018, Cabinet agreed to a coordinated decision-making process. This will require the government to make annual regulation updates, setting the supply of units in the NZ ETS on a five-year horizon [CAB-18-MIN-0606.01 refers].

¹ s6(a)

This will set an overall limit on unit supply and can include price control settings. There are a number of issues that the Minister for Climate Change must have regard to when making these decisions, including emission budgets, emission projections and impacts of emissions prices on households and the economy.

16. The coordinated decision-making process will be informed by annual recommendations from the Climate Change Commission on NZ ETS unit supply settings, including price controls (for example, the volume of units to be sold at auction and the trigger price for the cost containment reserve).
17. This approach is in line with the Productivity Commission's Low-emissions economy report (August 2018) and the Tax Working Group's Future of Tax report (February 2019), which both supported mechanisms that would provide guidance about the path of future emissions pricing.

NZ ETS price ceiling – the current fixed price option and the new cost containment reserve

18. The current NZ ETS price ceiling is the \$25 FPO.² It allows participants to meet their NZ ETS obligations by paying \$25 cash to the Crown instead of surrendering a unit. In December 2018, Cabinet agreed that a price ceiling should remain in the NZ ETS to manage the risk of prices reaching unacceptable levels [CAB-18-Min-0606.01 refers].
19. Cabinet also agreed that a new type of price ceiling, a cost containment reserve, will replace the FPO when the cost containment reserve is fully operational. The cost containment reserve will be implemented as part of the auctioning system, which is expected to be ready for the end of 2020. It allows the government to release a specified number of additional units for sale at auction if a specified trigger price is reached.
20. Settings for the cost containment reserve can be set as part of overall NZ ETS unit supply decisions, in regulations, on a five-year rolling period basis. This may include setting the number of additional units for sale at zero, if appropriate.
21. The Government has also agreed, and signalled to the market, that the FPO will remain in place until the auction and associated cost containment reserve functionality is operational, and that it would stay at \$25 for surrenders due in 2019. This was publicly communicated in December 2018 alongside tranche one proposals to amend the CCRA.
22. In this paper, I am seeking approval for operational decisions that are now required to enable the transition from the FPO to the cost containment reserve.

NZ ETS price floor

23. To date, the NZ ETS has not had a price floor. The 2015/2016 review of the NZ ETS considered whether a price floor was desirable. There was significant stakeholder support for a price floor, due to previously low prices impacting investment decisions, including forestry.
24. A price floor was not progressed because the root cause of previously low prices was identified as access to an unlimited volume of international units for use in the

² The FPO is provided for in section 178A of the CCRA.

NZ ETS and steps were taken to address that issue with a decision to limit the use of international units if the NZ ETS reopens to international carbon markets in the future [CAB-18-MIN-0606.01 refers].

25. As part of tranche one, Cabinet directed officials to investigate the potential introduction of a price floor, including an option to set a reserve price through auctioning [CAB-18-MIN-0606.01 refers]. This direction was given in light of developments in climate change policy, including the climate change bill. 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 NZ ETS pricing.

Analysis

Price ceiling transition

26. Following Cabinet's decision to replace the FPO with a cost containment reserve [CAB-18-MIN-0606.01 refers], I am seeking agreement to amend to the CCRA to enable this transition.
27. I propose amending the CCRA to provide for the FPO to be removed upon the making of an Order in Council. The Minister for Climate Change will be required to make a recommendation for the Order in Council once:
- i. auctioning is operational (that is, the day the first auction is held); and
 - ii. in any event, no later than 31 December 2022.
28. In line with Cabinet's previous decision, the FPO should remain in place until the cost containment reserve is operational. This means the auction system and associated cost containment reserve functionality would need to be fully operational (i.e. the first auction has been held) before the FPO is removed. The auctioning system is currently expected to be implemented in late 2020.
29. I propose that the Minister for Climate Change must make the recommendation for the FPO to cease when satisfied that auctioning (including the ability to set a cost containment reserve) is operational. The removal of the FPO would be implemented via an Order in Council based on a recommendation from the Minister for Climate Change.
30. I further propose to specify that, in any event, the FPO will cease to have effect no later than 31 December 2022. This provides a backstop date to ensure the FPO is eventually removed while allowing for unexpected events, such as a delay in the implementation of auctioning.
31. I am also seeking agreement to two consequential decisions in order to provide consistency across the CCRA. These are that:
- 31.1. the \$25 maximum carbon price for the Synthetic Greenhouse Gas Levy (SGG Levy) should cease to have effect alongside the FPO.³ There is currently a maximum carbon price of \$25 for the SGG Levy scheme in line with FPO⁴, and this should cease to have effect at the same time as the FPO.

³ The SGG Levy scheme puts an emissions price at our border on imported vehicles and goods that contain synthetic greenhouse gases.

⁴ The \$25 maximum carbon price for the SGG Levy is provided for in Section 236 of the CCRA.

31.2. the Environmental Protection Authority (EPA) will continue to have the option to satisfy a requirement to reimburse units by paying \$25, but only if the reimbursement relates to a surrender or repayment where the FPO was originally used. The EPA may be required to reimburse a participant if, for example, an audit reveals that a participant surrendered too many units to the Crown. This proposal will allow the EPA to process reimbursements on a 'like for like' basis.

Price floor

32. I consider it prudent to enable regulations for a price floor via a reserve price at auction. This will give the government a tool to manage extremely low prices in the NZ ETS, if considered necessary.

33. I am not seeking agreement on whether a price floor is desirable at this stage as I consider further consultation and analysis is needed. Consultation on a price floor could occur as part of the regulation-making process for unit supply, expected in mid-2019.

34. Enabling a price floor will future-proof the scheme against unforeseen events and could provide confidence for low-emissions investments, including forestry. It would also mean the Climate Change Commission is not restricted in the recommendations it gives on NZ ETS unit supply settings. The Commission is expected to provide recommendations on desirable NZ ETS settings to help meet emissions budgets.

35. I am recommending a price floor via an auction reserve price because it is administratively simple to implement. It would mean that the government would not sell units at auction if the auction price drops below the specified price level, thereby restricting supply of units at a specific low price. The price floor could be set at zero if appropriate.

36. This would send a clear signal to the market that the government does not expect the price of units in the NZ ETS to drop below its level, even if the volume of units sold at auction is a small proportion of overall supply.

37. I have considered other options including requiring that all trades occur above a certain level⁵, or a top-up fee. I consider these to be unnecessarily complex and interventionist. I also considered an option for the Crown to buy units from participants. This option is already enabled in the CCRA. I note that this could still happen in future but would require funding.

Price controls and the coordinated decision-making process

38. I consider that the CCRA should be amended to enable a price floor (via a reserve price at auction) and a price ceiling (via a cost-containment reserve) to be set in regulations.

39. The CCRA will not require the government to set a price floor or a price ceiling. However, Cabinet has agreed, and clearly signalled to the market, that a price ceiling should remain in the NZ ETS to manage the risk of prices reaching

⁵ This includes trades in the secondary market.

unacceptable levels. This decision could be revisited in future as part of the regulation-making process, if this risk has been substantially reduced.

40. The regulations setting price controls will be part of the coordinated decision-making process, agreed in tranche one [CAB-18-MIN-0606.01 refers]. The coordinated decision-making process requires the government to make annual regulations looking out five years which set an overall limit on units in the NZ ETS (excluding forestry). This includes setting the number of units to be auctioned, access to international units and price control settings.

Consultation

Public consultation

41. During the 2015/16 NZ ETS review, a number of submitters, particularly from the forestry sector and NGOs, supported the introduction of a price floor. 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.

Agency consultation

42. This paper was prepared by the Ministry for the Environment. The Treasury, the EPA, the Ministry of Foreign Affairs and Trade, the Ministry for Primary Industries, the Department of Conservation, the Ministry of Transport, the Ministry of Business, Innovation and Employment and the Ministry of Justice were consulted in the preparation of this paper. Where feedback was received it is reflected in this paper. The Department of Prime Minister and Cabinet and Te Puni Kōkiri were informed.

Financial implications

43. I am not seeking any additional funding in this paper. Additional funding may be required to operationalise the proposals in this paper, which will be from 2020 onwards. Additional funding, if required, will be sought through further implementation decisions or through Budget.

44. s9(2)(f)(iv)

Legislative implications

45. The policy decisions from this paper will require legislative amendments to the CCRA.
46. The amendments were given a category 2 priority on the 2019 Legislation Programme (meaning the bill must be passed by the end of 2019). The PCO has already commenced drafting tranche one amendments.

Regulation development

47. Regulations enabled by the CCRA will provide for the ability to set price controls (if any) as part of the coordinated decision-making process. This may include the price level of the price floor (that is, at what low price the government will not sell units at auction), the trigger price for the price ceiling (the cost containment reserve) (that is, the auction price upon which the government will release more units for sale) and the volume of units that will be released if the trigger price for the cost containment reserve is reached.
48. I expect to return to Cabinet by July 2019 for approval to consult on proposals for regulations relating to the coordinated decision-making process and auctioning in July/August 2019. This consultation would include detail for price controls (e.g. the trigger price for the cost containment reserve).

Regulatory impact analysis

49. The Regulatory Quality Team has determined that a Regulatory Impact Assessment (RIA) is not required for the price ceiling proposals in this paper. This is because the relevant issues are addressed in the RIA that accompanied the previous Cabinet paper *Amendments to the Climate Change Response Act: tranche one*. The 'Improving the NZ ETS Framework for Unit Supply' RIA is attached to this Cabinet paper.
50. The Regulatory Impact Analysis requirements apply to the proposal to enable a price floor. A Regulatory Impact Statement has been prepared and is attached.
51. A Quality Assurance Panel with representatives from the Ministry for the Environment and the Treasury Regulatory Quality Team has reviewed the *Enabling a price floor in the NZ ETS* RIA produced by the Ministry for the Environment and dated March 2019.
52. The Panel considers that the RIA **meets** the Quality Assurance criteria. The Panel notes that while the nature of the policy area means that the analysis can be complex, the analysis is sound.

Human rights

53. 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

54. 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 when implementing the proposals to continue to adhere to Treaty of Waitangi principles as provided by section 3A of the CCRA.
55. A Māori Leaders' Forum was held in Wellington on 17 September 2018 as part of consultation on improvements to the NZ ETS. The Ministry for the Environment plans to further engage with iwi/Māori on a range of environmental issues through a series of hui in April. This will include discussions on the NZ ETS and seek

views on how we can best support iwi/Māori ahead of consultation on regulations anticipated for the second half of this year.

International obligations

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

Gender implications

57. There are no gender implications arising from this paper.

Disability perspective

58. There are no disability implications arising from this paper.

Publicity

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

60. I intend to make public announcements on the proposed amendments to the CCRA and the amendment bill. It is expected that these announcements will form part of a wider climate change communications plan.

Proactive Release

61. I propose to proactively release this paper on the Ministry for the Environment's website in whole, subject to redactions as appropriate equivalent to those under the Official Information Act 1982, once public announcements have been made.

Recommendations

The Minister for Climate Change recommends that the Committee:

1. **note** the New Zealand Emissions Trading Scheme (NZ ETS) is the Government's key tool to assist New Zealand to meet its climate change targets, and that:
 - 1.1. the Government is reforming the NZ ETS to ensure it can support the transition to a low-emissions and climate resilient New Zealand
 - 1.2. this requires amendments to the Climate Change Response Act 2002 (CCRA)
2. **note** these amendments are being developed in tranches:
 - 2.1. in December 2018 Cabinet agreed to tranche one of amendments to the CCRA and drafting has commenced [CAB-18-MIN-0606.01]
 - 2.2. tranche two comprises of a series of papers with discrete proposals which will be considered by Cabinet over March to May 2019
 - 2.3. tranches one and two will result in a single bill amending the CCRA to be introduced to the House in mid-2019, and to enter into force in 2020

3. **note** price controls, that is price floors and price ceilings, aim to manage unacceptably low or high prices in the NZ ETS
4. **note** this paper focuses on how to enable price controls to future-proof the NZ ETS and does not consider what an unacceptable high or low price would be

Price ceiling

5. **note** the NZ ETS has a price ceiling in the form of a \$25 fixed price option (FPO) which allows participants to meet their NZ ETS obligations by paying \$25 cash to the Crown instead of surrendering a unit
6. **note** Cabinet agreed that a price ceiling should remain in the NZ ETS [CAB-18-MIN-0606.01]
7. **note** Cabinet agreed that a cost containment reserve via auctioning will replace the FPO [CAB-18-MIN-0606.01]
8. **note** further operational decisions are needed to enable the transition from the FPO to the cost containment reserve, as set out in this paper
9. **agree** the CCRA should be amended to provide for the Minister for Climate Change to be required to recommend the making of an Order in Council to remove the FPO once:
 - 9.1. auctioning is operational (that is, the day the first auction is held); and
 - 9.2. in any event, no later than 31 December 2022 (to provide a backstop and ensure the FPO is eventually removed while allowing for unexpected events)
10. **agree** to ensure consistency across the CCRA, in that:
 - 10.1. the \$25 maximum carbon price for the Synthetic Greenhouse Gas Levy (SGG Levy) will cease to have effect alongside the FPO following the making of the Order in Council removing the FPO
 - 10.2. despite the removal of the FPO via an Order in Council, the Environmental Protection Authority (EPA) will continue to have the option to reimburse units by paying \$25 if the reimbursement relates to a surrender or repayment which used the FPO

Price floor

11. **note** the NZ ETS does not currently have a price floor, but there has been significant stakeholder support for a price floor
12. **note** Cabinet directed officials to investigate options for a price floor, including an option to set a reserve price at auction to future-proof the NZ ETS, in light of the expected role of the Climate Change Commission and to respond to unexpected prices [CAB-18-MIN-0606.01 refers]
13. **note** a price floor via a reserve price at auction is the most administratively simple option and would send a signal to the market that the government would not sell units below this price, but its effectiveness would be limited by the volume of units available at auction

14. **note** that enabling a price floor via a reserve price at auction does not preclude the Minister of Finance from buying back units
15. **note** Cabinet agreed to 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, including price control settings [CAB-18-MIN-0606.01 refers]
16. **note** no decision is being sought on whether a price floor is desirable at this stage, or the level of a possible price floor, as this requires further consultation and analysis, which could occur as part of consultation for regulations as part of the coordinated decision-making process.

Price controls in the coordinated decision-making process

17. **note** price controls need to be considered as part of the coordinated decision-making process as they have a direct impact on unit supply
18. **note** the CCRA will not require the Government to make regulations setting price controls
19. **agree** the Government may set price controls (i.e. a price floor via a reserve price at auction and/or a cost containment reserve) in regulations as part of the coordinated decision-making process (agreed in tranche one [CAB-18-MIN-0606.01 refers])
20. **authorise** the Minister for Climate Change to further clarify policy decisions relating to the amendments proposed in this paper, in a way not inconsistent with Cabinet's decisions

Authorised for lodgement

Hon James Shaw

Minister for Climate Change