

Commercial In Confidence

Office of the Minister of Climate Change

Chair, Cabinet Business Committee

Enabling a technical reserve price for auctions in the New Zealand Emissions Trading Scheme.

Proposal

- 1 This paper seeks your agreement to amend the Climate Change Response Act 2002, and make consequential amendments to the Climate Change (Auctions, Limits, and Price Control Settings for Units) Regulations 2020, to set a technical reserve price for auctions in the New Zealand Emissions Trading Scheme (NZ ETS). In order to make the amendments prior to the first auction on 17 March 2021, a highly accelerated and prioritised legislative process is required.

Relation to government priorities

- 2 This proposal relates to the Government's priority of 'laying the foundations for the future', including addressing key issues such as climate change response, housing and child poverty.

Executive Summary

- 3 A technical reserve price is a confidential reserve set to reflect prevailing secondary market prices. By preventing the sale of units significantly below prevailing market prices, it will ensure the auction does not unduly influence secondary market prices and it will protect the Crown against the fiscal cost of such under-pricing. For further details on the operation of the technical reserve price in the context of NZ ETS auctions, refer to Appendix 1 Operation of the technical reserve price for auctions in the New Zealand Emissions Trading Scheme.
- 4 In September 2020, regulations setting the rules for auctioning in the NZ ETS were set without a technical reserve price due to an issue with the recently reformed Climate Change Response Act 2002 (the Act), despite a previous Cabinet decision to set one.
- 5 At that time, officials advised that the absence of a technical reserve price posed a low risk to NZ ETS auctions. However, since then, public attention on this issue has increased the risk that a "self-fulfilling prophecy" may arise. Bidders may be encouraged to bid lower in the auction than they otherwise would have done, raising the likelihood of a lower auction clearing price and posing a risk to the integrity of the NZ ETS and incurring fiscal costs to the Crown.

- 6 Addressing this issue before the first auction in March 2021 requires urgent legislative amendment that risks creating further issues with the Act and may attract criticism.
- 7 However, the outcome of the first NZ ETS auction will be closely watched, both here and overseas. As a high-profile part of recently enacted NZ ETS reforms, a successful first auction will give confidence in the reforms and will support the effectiveness of the NZ ETS cap.
- 8 Therefore, in this paper I propose urgently amending the Act and relevant regulations to set a technical reserve price before the first auction in March 2021.

Background

- 9 The Climate Change Response Act 2002 was amended in June 2020 to ensure the Government has the tools to manage the supply of units into the NZ ETS market, by setting clear caps on emissions in line with our climate change targets and developing a robust auctioning system.
- 10 The Act provides an overall framework for auctioning in the NZ ETS, while regulations set specific details to give effect to the framework, including setting the rules for auctioning, price control values and the number of units available to sell at auction.
- 11 Auctioning is only one source of supply to the NZ ETS market. The majority of demand for units will continue to be supplied by the secondary market which is open for trading daily.

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

- 12 A technical reserve price is a reserve set to reflect prevailing secondary market prices and is kept confidential. By preventing the sale of units significantly below prevailing market prices, it will ensure the auction does not unduly influence secondary market prices and it will protect the Crown against the fiscal cost of such under-pricing.
- 13 Most of the trading in NZUs takes place on the secondary market that is open for trading daily. Therefore it is the operation of the secondary market that sets the price for emission units. Auctions, on the other hand, occur only four times a year and are designed to sell units from the Government into the secondary market without disrupting its operation.
- 14 If the technical reserve price prevents the sale of units at an NZ ETS auction, then the unsold units will be made available for sale at the next scheduled auction¹. Knowing that a technical reserve price exists should encourage

¹ Within the same calendar year only. If the technical reserve price is hit during the last auction of the year then the units remain unsold to avoid breaching the auction limit for the following year and hence the ETS cap.

bidders to bid for units at, or close to, the prevailing secondary market price so the units are actually sold at the auction.

- 15 The technical reserve price is kept confidential so that it doesn't become the target of bidding behaviour. It is based on recent secondary market price(s), taking into account market volatility and includes a margin, or buffer, that captures the government's definition of "significantly below".
- 16 The confidential technical reserve price is distinct from the published auction price floor. The price floor is designed to set a clear expectation in advance with the market that the Government will not accept bids below a stated price level as a long-term price signal. For 2021, the auctioning price floor is \$20.

Regulations were set without a technical reserve price due to an issue with the recently reformed Act

- 17 Cabinet decided, in March 2020 immediately prior to the first COVID-19 lockdown, to set regulations for auctioning. These regulations included provision for a technical reserve price [DEV-20-MIN-0047 refers].
- 18 The drafted regulations came back to Cabinet for approval without regulations to set a technical reserve price due to an issue with the Act that arose after enactment of the reforms. Cabinet approved those regulations in September 2020 [CAB-20-MIN-0046 refers].

19 9(2)(h)
[Redacted text]

20 Official advice to Cabinet at that time was that the absence of a technical reserve price posed a low risk to auctions and it was important to set the regulations then to avoid putting the date of the first scheduled auction at risk.

21 To monitor the risk, I was invited by Cabinet to report back in 2021 regarding possible amendments to the Act to address the absence of a technical reserve price [CAB-20-MIN-0046 refers].

Analysis

Public commentary on the absence of a technical reserve has increased the risk to auctions

22 Following the proactive release of Cabinet decisions on the auctioning regulations, several market experts and other commentators, including the Opposition climate spokesperson, have raised public concerns about the absence of a technical reserve price for NZ ETS auctions. Some market commentary has specifically described this to the market as an opportunity to purchase cheap NZUs.

23 I have been advised that the more attention that is paid to this issue, the more danger there is that a “self-fulfilling prophecy” will arise. Bidders may be encouraged to bid lower in the auction than they otherwise would have done, raising the likelihood of a lower auction clearing price.

A lower clearing price poses reputational and financial risks

24 A significant divergence between auction prices and the prevailing secondary market price could cause reduced or volatile prices on the secondary market. This poses a significant risk to the integrity of auctioning specifically and the scheme as a whole.

25 Furthermore, a significant divergence may impact on perceptions of the robustness, transparency, or efficacy of the NZ ETS. This may pose a risk to the ability to link the NZ ETS to other schemes, if this proves desirable in the future.

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

27 In financial terms, if the first auction clears significantly below the secondary market price then the difference between the two represents a loss in auction proceeds. For instance, if the secondary market price is \$35 then the first auction would be expected to realise approximately \$166.25 million². If however, the auction clears significantly below this then the loss could be significant. If the auction cleared at \$30 there would be a loss of \$23.75 million. If the auction cleared at the price floor (set to \$20) then the loss could be \$71.25 million.

Urgent legislative change also poses risks

■ 9(2)(h) [Redacted]

■ [Redacted]

■ [Redacted]

² Assuming all 4.75 million units are sold, and the auction clears approximately at the secondary market price of \$35.

[REDACTED]

[REDACTED]

[REDACTED]

Postponing the first scheduled auction is not recommended

33 Despite the risk of an accelerated legislative process, I have been advised that postponing the date of the first scheduled auction is also challenging and poses significant risks.

34 Cabinet decided to approve regulations to set the auction schedule in July 2020, including setting the first auction date to 17 March 2021 [LEG-20-MIN-0125 refers]. These regulations were published in the gazette on 3 August 2020. The first auction date is now well known and highly anticipated by market participants who are looking forward to being able to participate, and may already have built the expectation of bidding at the first auction into their plans for 2021, including needing to meet their surrender obligations by 31 May 2021.

35 Furthermore, the project to develop the auction platform is well underway and on track to run the first auction in March 2021. Any delay to the timetable risks imposing extra costs to implement this project.

36 Postponing the date of the first auction now would require Cabinet approval to amend the regulations, would have a significant negative impact on market certainty and confidence, and would add to the cost of implementing the auction platform. Therefore, I do not recommend this course of action.

The technical reserve price will be set to function as previously agreed

37 I propose that the technical reserve price for NZ ETS auctions be set to function as previously agreed by Cabinet. Therefore I propose to set a technical reserve price relative to the secondary market price of NZUs before each auction using a prescribed methodology that is kept confidential, in consultation with the Minister of Finance. If the clearing price of any particular auction does not reach the technical reserve price for that auction then no units will be sold [DEV-20-MIN-0047 refers].

- 38 Public consultation on proposals to set a confidential technical reserve price occurred during consultation on the proposed rules for auctioning in the NZ ETS held in November and December 2019³.
- 39 To clarify, I propose that the Act is amended to enable the Minister for Climate Change to set a confidential technical reserve price methodology in addition to the existing price controls. The prescribed methodology to be used would be determined by the Minister in accordance with specified criteria and then shared with the auction operator to apply.
- 40 Setting the methodology must give due consideration to the existing criteria in the Act (s 30GC (5)) that are applicable when setting regulations for price controls, including considering the proper functioning of the emissions trading scheme. In addition, the Minister must consider the following:
- 40.1 the purpose of the technical reserve price to act as a 'safety net' against the risk of auction prices clearing significantly below the secondary market price
 - 40.2 the basis for determining recent secondary market price
 - 40.3 the basis for determining an offset from secondary market price that is 'significant'
 - 40.4 recent market price volatility.
- 41 Once determined, the auction operator is responsible for applying the methodology to determine the technical reserve price for each auction and will be required to report regularly to the auction monitor and the Ministry for the Environment on its operation.
- 42 To clarify reporting requirements, the auction operator will be required to share anonymised auction data, including bid information and details of the calculation of the technical reserve price, with both the auction monitor and the Ministry for the Environment. This ensures all parties clearly understand the operation of the technical reserve price in practice to support them to provide evidence-based advice when required.

Urgent legislative change is required to address this risk prior to the first NZ ETS auction

- 43 The outcome of the first NZ ETS auction will be closely watched, both here and overseas. An auction price that is in line with the prevailing secondary market price will be integral to market perceptions of a successful first auction. As a high profile part of recently enacted ETS reforms, a successful first auction will give confidence in the reforms and support the effectiveness of the NZ ETS cap.
- 44 I therefore recommend, acknowledging the risks that urgent legislative and regulatory change poses, that Cabinet support the proposal to urgently amend

³ Reforming the New Zealand Emissions Trading Scheme: Rules for auctioning

the Act to set a technical reserve price for auctioning prior to the first auction in March 2020 as outlined above.

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

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Financial Implications

- 46 This proposal does not require any change to the funding arrangements to deliver the auctioning platform in time for the first auction. The auctioning platform has been designed to enable the use of an auctioning technical reserve price, if required by legislation.
- 47 When NZUs are sold at auction the Crown liability increases until those NZUs are surrendered at a later date. The Crown receives cash in return, increasing the Crown's assets, but technically there is no change in net worth provided the cash received is equivalent to the value of the NZUs at the time. If the price received for NZUs at auction is significantly below the current market price at which they are valued, then this represents a loss to the Crown. Until the amendments recommended in this paper are put in place, auctions represent a fiscal risk to the Crown. While it is difficult to quantify the likelihood of this risk eventuating, if it did occur, the upper bound of the potential loss per auction is the difference between the expected secondary market price and the value of the price floor (\$20 in 2021). If prices remain at \$35 in March 2021 then if all 4.75 million units are sold at the first auction the maximum value of this loss would be \$71.25 million.

Legislative Implications

- 48 The policy decision from this paper will require legislative amendments to the Climate Change Response Act 2002 and regulatory amendments to the Climate Change (Auctions, Limits, and Price Control Settings for Units) Regulations 2020.
- 49 The details of the proposed Bill are as follows:
- 49.1 The Minister for Climate Change will be the responsible Minister;
 - 49.2 The Ministry for the Environment will be the department responsible (include a departmental contact name and phone number);
 - 49.3 The title of the proposed Bill will be the Climate Change Response (Auctioning Reserve Price) Amendment Bill;
 - 49.4 The Bill is estimated to be small and of medium complexity; and
 - 49.5 The proposed priority is category 2: must be passed in the year.
 - 49.6 The Climate Change Response (Auctioning Reserve Price) Amendment Bill will bind the Crown.
- 50 For regulatory amendments to be in place before the first auction, transitional provisions will be required to enable any consequential changes to the Climate Change (Auctions, Limits, and Price Control Settings for Units) Regulations 2020 to enter into force immediately upon publication in the New Zealand Gazette.

Te Tiriti o Waitangi Implications

- 51 I acknowledge the significant interest iwi/Māori, including Māori entities, have in the NZ ETS, particularly as much of the Māori economy is involved in natural resource management, including forestry.
- 52 Iwi/Māori were invited to participate in the original public consultation on these regulatory proposals and notice of the consultation was included in a regular Ministry iwi newsletter during December 2019.

Impact Analysis

Regulatory Impact Statement

- 53 The Regulatory Quality Team at the Treasury has determined that the regulatory proposals in this paper are exempt from the requirement to provide a Regulatory Impact Statement on the basis that the substantive issues have been addressed by previous impact analysis. A Regulatory Impact Statement was provided in March 2020 to support the original Cabinet decisions [DEV - 20-MIN-0047] on the wider set of auctioning rules.
- 54 (Refer Impact Statement: Rules for Auctioning in the NZ ETS : <https://www.mfe.govt.nz/more/briefings-cabinet-papers-and-related-material-search/regulatory-impact-statements/impact-5>).

Climate Implications of Policy Assessment

- 55 The Climate Implications of Policy Assessment (CIPA) team has been consulted and confirms that the CIPA requirements do not apply to this proposal as there is no direct impact on emissions beyond the estimated emissions impact disclosed when Cabinet considered ETS settings regulations in June 2020.⁴
- 56 This proposal will indirectly help to support emissions reductions as the inclusion of a technical reserve will help to support the overall effectiveness of the NZ ETS.

Human Rights

- 57 The proposals in this paper are consistent with the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993.

Gender implications

- 58 There are no immediate gender implications arising from this paper.

⁴ A CIPA disclosure including quantified emissions estimates was included with the ETS settings regulations proposals Cabinet considered in June 2020. These estimates included the assumption of a technical reserve price for NZ ETS auctions.

Consultation

59 The Ministry of Foreign Affairs and Trade, the Ministry for Primary Industries, the Ministry of Business, Innovation and Employment, the Treasury, the Parliamentary Counsel Office, Te Arawhiti and the Environmental Protection Authority were consulted on this paper. Where feedback was provided, it has been reflected in this paper. The Department of the Prime Minister and Cabinet was informed.

Communications

60 I intend to communicate Cabinet's decision to proceed with an urgent legislative change to enable a technical reserve price for NZ ETS auctions to stakeholders before the end of the year, to give them as much certainty as possible that the Government is taking action to address this matter.

Proactive Release

61 I intend to proactively release this paper on the Ministry for the Environment's website subject to redactions as appropriate equivalent to those under the Official Information Act 1982 after an announcement of the decision.

Recommendations

The Minister of Climate Change recommends that the Committee:

- 1 **note** that a technical reserve price is a reserve set to reflect prevailing secondary market prices and is kept confidential. By preventing the sale of units significantly below prevailing market prices, it will ensure the auction does not unduly influence secondary market prices, and protect the Crown against the fiscal cost of such under-pricing;
- 2 **note** that Cabinet has previously agreed to set a technical reserve price for NZ ETS auctions [DEV-20-MIN-0047 refers];
- 3 **note** that regulations setting the rules for auctioning in the NZ ETS were set without a technical reserve price due to an issue with the Climate Change Response Act 2002, despite the earlier Cabinet decision to set one [CAB-20-MIN-0046 refers];
- 4 **note** that public commentary on the absence of a technical reserve price has increased the risk of a 'self-fulfilling prophecy' arising where bidders may be encouraged to bid lower in the auction than they otherwise would have done, raising the likelihood of a lower auction clearing price and risking the reputation of the NZ ETS;
- 5 **note** that addressing this issue before the first auction in March 2021 requires urgent legislative amendment that risks creating further issues with the Climate Change Response Act 2002 and may attract criticism;
- 6 **note** that the outcome of the first NZ ETS auction will be closely watched, both here and overseas. As a high profile part of recently enacted ETS

reforms, a successful first auction will give confidence in the reforms and will support the effectiveness of the NZ ETS cap;

- 7 **agree** to amend the Climate Change Response Act 2002 (with consequential changes to the Climate Change (Auctions, Limits, and Price Control Settings for Units) Regulations 2020) to enable the Minister of Climate Change to set a confidential technical reserve price methodology, in consultation with the Minister of Finance, in addition to the existing price controls;
- 8 **agree** that the auction operator will set a confidential technical reserve price for each auction relative to the market price of NZUs, using the prescribed confidential methodology;
- 9 **agree** that if the clearing price of the auction does not reach or exceed the technical reserve price then no units will be sold;
- 10 **agree** that when setting the prescribed methodology, the Minister must give due consideration to the existing criteria in the Act for setting price controls, and in addition the Minister must consider:
 - 10.1 the purpose of the technical reserve price to act as a 'safety net' against the risk of auction prices clearing significantly below the secondary market price
 - 10.2 the basis for determining recent secondary market price
 - 10.3 the basis for determining an offset from secondary market price that is 'significant'
 - 10.4 recent market price volatility;
- 11 **agree** that the auction operator is required to report regularly to the auction monitor on the operation of the technical reserve price;
- 12 **agree** that for the purposes of understanding the operation of the technical reserve price in practice and providing evidence-based advice to the Minister regarding the confidential methodology, the auction operator will be required to share anonymised auction data, including bid information and details of the calculation of the technical reserve price, with both the auction monitor and the Ministry for the Environment;
- 13 **agree** that transitional provisions will be required to enable any consequential changes to the Climate Change (Auctions, Limits, and Price Control Settings for Units) Regulations 2020 to enter into force immediately upon publication in the New Zealand Gazette;
- 14 **note** that despite the risk of an accelerated legislative process, postponing the date of the first scheduled auction is not recommended as it would have a significant negative impact on market certainty and confidence and would add to the cost of implementing the auction platform;

- 15 **agree** that the proposed priority for the Climate Change Response (Auctioning Reserve Price) Amendment Bill on the 2021 Legislative Programme is 2 (must be passed in 2021);
- 16 **note** that this Bill will need to be progressed through the House under urgency in order to receive Royal assent and enter into force by the date of the first auction on 17 March 2021;
- 17 **authorise** the Minister of Climate Change to further clarify policy decisions relating to the amendments proposed in this paper, in a way consistent with Cabinet's decisions;
- 18 **invite** the Minister of Climate Change to issue any necessary drafting instructions to the Parliamentary Counsel Office based on the decisions in this paper;
- 19 **agree** the Minister of Climate Change publicly communicate the government's intention to proceed with an urgent legislative change to enable a technical reserve price in time for the start of auctioning for the NZ ETS.

Authorised for lodgement

Hon James Shaw

Minister for Climate Change

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