

In-Confidence

Office of the Minister of Climate Change

Cabinet Economic Development Committee

A review of the New Zealand Emissions Trading Scheme

Proposal

- 1 This paper seeks agreement to the scope and process of a review of the New Zealand Emissions Trading Scheme (NZ ETS). This review is in response to Cabinet's decision to prioritise gross emissions reductions in New Zealand's first emissions reduction plan (ERP), and Cabinet's in-principle decision to agree to the Climate Change Commission's recommendations to strengthen the incentives for gross emissions reductions in the NZ ETS.
- 2 The review will consider the role of emissions pricing as part of New Zealand's climate change response and how to shift the balance of gross emissions reductions and removals incentivised by the NZ ETS in the future.

Relation to government priorities

- 3 The Government declared a climate change emergency on 2 December 2020. The Cabinet Business Committee (CBC) agreed that climate change "demands a sufficiently ambitious, urgent, and coordinated response across government to meet the scale and complexity of the challenge" [CBC-20-MIN-0097 refers].
- 4 Enabling a just transition to a low-emissions, climate resilient future is a Government priority. CBC declared its intention to "put the climate at the centre of government decision-making" [CBC-20-MIN-0097 refers].
- 5 The proposals in this paper relate to the Cooperation Agreement between the Labour and Green Parties. Achieving the purpose and goals of the 2019 zero carbon amendments to the Climate Change Response Act 2002 is an agreed area of cooperation.
- 6 New Zealand's first ERP was recently published, outlining the actions, policies, and strategies to achieve the first emissions budget. In it, the Government committed to further policy analysis on unit supply in the NZ ETS to assess whether additional changes are needed to the NZ ETS to balance gross and net emissions reductions (Action 5.2.1).

Executive Summary

- 7 Emissions pricing is a vital component of New Zealand's climate change response. The NZ ETS is the Government's main emissions pricing tool and

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is expected to make a significant contribution to meeting our domestic emissions budgets, 2050 targets, and 2030 Nationally Determined Contribution (NDC) under the Paris Agreement.

- 8 The NZ ETS is intended to support both emissions reductions at their sources (gross emissions reductions) and emissions removals (net emissions reductions).
- 9 Under current settings, the NZ ETS is expected to drive considerable net emissions reductions, mainly through carbon sequestration from forests.
- 10 However, the NZ ETS is not expected to drive material gross emissions reductions in the energy, transport, industrial processes, and waste sectors. This risks delaying meaningful decarbonisation in New Zealand and a successful and just transition to a low-emissions economy.
- 11 It will also not drive the level of native restoration recommended by the Climate Change Commission to create a long-term carbon sink for hard to abate emissions post 2025, nor help us go net negative in the second half of this century as required by the Paris Agreement.
- 12 Last year, Cabinet agreed to prioritise gross emissions reductions in the ERP, alongside maintaining support for net emissions reductions, in line with the Commission's analysis and advice on emissions budgets [DEV-21-MIN-0277 refers].
- 13 Implied in this decision was Cabinet's intention these objectives apply to all key strategic setting of the ERP and aligned actions, including emissions pricing through the NZ ETS. Given the NZ ETS is not expected to materially reduce gross emissions in its current form, amendments to the scheme are required to achieve Cabinet's direction.
- 14 In addition to this, the Commission recommended in *Ināia tonu nei: a low emissions future for Aotearoa* that the Government amend the NZ ETS to strengthen the incentives for gross emissions reductions and manage the amount of exotic forestry driven by the scheme (recommendations 11.1 and 25.2a). They recently reiterated this advice in *Advice on NZ ETS unit limits and price control settings for 2023-2027*.
- 15 In May 2022, Cabinet agreed in-principle to the Commission's recommendations, subject to the outcomes of a review of the NZ ETS. I was invited, in consultation with the Minister of Energy and Resources and Minister of Forestry, to report back to Cabinet on the scope of the review [CAB-22-MIN-0152 refers].
- 16 I seek agreement to the scope and process for a review of the NZ ETS. The review will consider the role of emissions pricing as part of New Zealand's climate change response and how we can shift, in an effective, sustainable, and enduring manner, the balance of emissions reductions incentivised by the NZ ETS from predominantly net emissions reductions to gross emissions reductions.

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Background

- 20 New Zealand has recently adopted domestic emissions budgets out to 2035 and launched the first ERP to meet those budgets and put us on track to achieve the 2050 emissions reduction target.
- 21 Emissions pricing is a fundamental component of our emissions reduction strategy. It is an economy-wide tool that supports businesses, households, and the public sector to incorporate the costs of emissions or the benefits of reducing or removing emissions into day-to-day decisions.
- 22 Our primary emissions pricing tool is the NZ ETS. The NZ ETS puts a price on the emissions from all sectors of the economy, except for emissions from the agriculture sector. It also incentivises activities that remove emissions from the atmosphere.
- 23 Under current settings proposed in the ERP¹, the NZ ETS is expected to contribute between 0.6 – 3.1 Mt CO₂e net emissions reductions to the first emissions budget, 11.6 – 15.8 Mt CO₂e for the second emissions budget, and 54.3 – 61.2 Mt CO₂e for the third emissions budget.² This represents 5 – 27 percent of the abatement needed to meet the first emissions budget, 27 – 36 percent of second emissions budget, and 74 – 83 percent of the third emissions budget.
- 24 The ERP recognises that reducing emissions through pricing alone will be insufficient to meet New Zealand's climate goals, owing to the presence of market barriers and failures. The approach in the ERP identifies actions and measures that complement the NZ ETS.

¹ These are the NZ ETS price control settings put in place in 2021. It also assumes no changes are made to the permanent post-1989 forestry category restricting exotic forests.

² New Zealand's first emissions budget is set for period 2022-2025, while the second and third budgets are set for the periods 2026-2030 and 2031-2035 respectively.

- 25 Cash proceeds from NZ ETS auctions also play an important role in funding the Climate Emergency Response Fund, which is a core source of support for policies and actions in the ERP.
- 26 As part of the 2020 reforms to the NZ ETS, an ongoing process was established to align the supply of emissions units in the scheme with New Zealand's domestic emissions budgets and the 2050 target for long-lived gases.
- 27 While emissions reductions and removals driven by the NZ ETS will help us meet the 2030 NDC, it is currently anticipated there will be an abatement deficit. This is a result of New Zealand's NDC requiring greater emissions reductions and removals in the short-term than our domestic targets.

Analysis

The ERP aims to achieve gross and net emissions reductions

- 28 New Zealand's net emissions reduction targets³ can be met by reducing emissions at their sources (*gross emissions reductions* through fuel switching, greater electric vehicle uptake, replacing carbon-intensive plant and equipment's with low-emissions alternatives etc.) and/or removing emissions from the atmosphere elsewhere (*net emissions reductions* from forestry and some industrial activities).
- 29 The ERP includes a range of actions to reduce gross and net emissions. This includes sub-sector policies to reduce gross emissions (such as the Clean Car Discount and GIDI fund) and increase carbon sequestration in forests (such as reducing the cost of native afforestation by investing in the nursery sector).
- 30 Among these policies, the NZ ETS is an important, cross-sector tool that is intended to support both gross and net emissions reductions. The ERP includes several actions designed to strengthen incentives in the NZ ETS for emissions reductions and support New Zealand's transition to a low-emissions economy.

The NZ ETS is structured to incentivise least-cost emissions reductions across the economy to meet net climate change targets

- 31 The design principles of the current NZ ETS were established under the Kyoto Protocol. These have remained for New Zealand's current international and domestic net climate change targets.
- 32 An emissions price incentivises businesses and consumers to make their own decisions about how and whether to reduce emissions or acquire emission units to account for their emissions, based on the relative costs of these investments.

³ Except New Zealand's biogenic methane target, which is gross.

- 33 The structure of the NZ ETS supports investment in the lowest-cost sources for emissions reductions first, theoretically supporting an economically efficient approach to achieving our climate change targets.
- 34 This means the NZ ETS is currently neutral about where emissions reductions come from in the economy. This is reflected in there being one emissions price that applies to emissions and emissions removals equally.
- 35 One distinction, however, is that investors in emissions removals from forestry receive a highly visible capital return in the form of emissions units, whereas emitters only receive a reduced NZ ETS liability for gross emissions reductions. This means investment capital is highly incentivised to move towards net removals rather than gross reductions.

Emission removals from forestry will play a vital role in meeting New Zealand's climate targets

- 36 In New Zealand, forestry is currently one of the lowest cost and scalable sources of abatement. Under current settings and expected NZ ETS prices, both production and permanent forestry⁴ are highly profitable land uses as a result of the carbon returns generated through the NZ ETS.
- 37 Given the current relative costs of gross and net emissions reductions, it is expected the NZ ETS will incentivise significant net emissions reductions through afforestation. The NZ ETS is forecast to drive between 410,000 and 670,000 hectares of new forests by 2035. Forestry could contribute between 121 to 169 Mt CO₂e emissions removals over the three emissions budgets periods.
- 38 There is a clear role for forests to reduce net emissions. Not only are forests needed to achieve our short-term emissions budgets and contribute to our 2030 NDC, but also to support New Zealand's long-term transition by providing a carbon sink for hard-to-abate gross emissions beyond 2050.
- 39 Choices around future NZ ETS incentives for forestry are critical for Māori as they have significant interests in forests as rangatira, kaitiaki, land and forest owners, workers, and business owners. In 2018, Māori were estimated to own \$4.3 billion of forestry assets and some 2,200 Māori were employed in the sector.
- 40 The Crown has Treaty obligations relevant to NZ ETS forestry settings. The ERP committed to embed partnership in the Crown's climate response and develop forestry policies that support Māori rights to exercise kaitiakitanga and rangatiratanga.

⁴ Permanent forests are those planted without the intention to be harvested, and often for sole purpose of carbon sequestration.

There is a risk the NZ ETS may play a limited role in reducing gross emissions

- 41 Existing analysis shows that gross emissions reductions likely to be incentivised by the NZ ETS tend to have higher costs than emissions removals through forestry.
- 42 Typically, emissions reduction opportunities in the transport, industry, industrial processes, and waste sectors are often less responsive to carbon pricing. Gross emissions reductions opportunities may also be capital intensive or require highly specialised investments. They may not be able to be scaled in the same manner as exotic afforestation and information on opportunities and returns on investment may be less transparent for external investors.
- 43 To meet the 2050 target, the Climate Change Commission's modelling suggested that based on the current mix of emissions mitigations technologies that are available, sustained increases in New Zealand's carbon prices will be needed over time to reduce levels of gross emissions.
- 44 While New Zealand's emissions price has nearly trebled in the past three years, there is uncertainty in the trajectory of future prices, particularly as increasing numbers of emissions units from forestry come into the market and affect supply and demand.
- 45 In its current design, the NZ ETS is not expected to play a significant role in incentivising gross emission reductions, even while it contributes emissions removals to our climate change targets.

Cabinet has agreed to prioritise gross emissions reductions in the ERP

- 46 In December 2021, Cabinet agreed to the high-level strategy for New Zealand's first ERP. A tenet of this strategy was to prioritise gross emissions reductions in the ERP, alongside maintaining support for net emissions reductions, in line with the Commission's analysis and advice on emissions budgets.
- 47 Ongoing work can inform Cabinet on the extent these objectives could or should apply to actions and policy tools within the ERP.
- 48 As emissions pricing is a key strategic setting of the ERP, it follows that the NZ ETS and the aligned ERP actions should prioritise gross emissions reductions, while continuing to support net reductions through forestry and other removal activities.
- 49 Given the NZ ETS does not currently support such outcomes, amendments will be required that progressively shift the balance of emissions reductions incentivised by the scheme to ensure the pre-eminence of gross reductions in the future, while also increasingly driving future net emissions reductions through indigenous forests.

The Climate Change Commission has provided strong advice and recommendations to strengthen NZ ETS incentives to drive low-emissions choices

- 50 In their 2021 advice, the Commission highlighted the risk that the NZ ETS would drive relatively low-cost net emission reductions through exotic forests, rather than gross emissions reductions needed to put us on track to net zero by 2050.
- 51 The Commission recommended the Government amend the NZ ETS to strengthen incentives for gross emissions reductions and manage the amount of exotic forest planting driven by the scheme (recommendations 11.1 and 25.2a).
- 52 The Commission, however, did not recommend what balance should be driven by the NZ ETS, nor how the NZ ETS could be amended to drive gross emissions reductions.
- 53 The Commission also recommended the Government commit to establish a long-term carbon sink by incentivising the reversion and planting of new indigenous forests to maintain net zero long-lived greenhouse gases by 2050 (Action 25.1). This would see future net emissions reductions coming increasingly from native forests.
- 54 In May 2022, Cabinet made an in-principle decision to agree to the Commission's recommendations 11.1 and 25.2a, subject to the outcomes of a review of the NZ ETS.
- 55 In July 2022, the Commission provided advice on the NZ ETS unit and price control settings for the period 2023-2027, and related NZ ETS matters. They recommended price control settings that differ significantly from current settings and include much higher and wider auction price control settings for units.
- 56 In this advice, the Commission repeated their assessment that the NZ ETS would drive large-scale exotic afforestation, which would displace and delay gross emissions reductions in New Zealand.

Over-relying on forestry in the NZ ETS could impact New Zealand's transition to a low-emissions economy

- 57 Forestry is essential to New Zealand's climate change response and is a key lever that provides flexibility to achieve the Government's emissions reductions objectives at relatively low-economic cost. The NZ ETS must continue to support afforestation, and over the long-term become more effective at incentivising indigenous forest planting.
- 58 However, there are risks from over-relying on exotic forestry to offset gross emissions, in lieu of cutting emissions.
- 59 In both *Ināia tonu nei* and *Advice on NZ ETS unit limits and price control settings for 2023-2027*, the Commission warned that an over-reliance on exotic forestry removals incentivised through the NZ ETS risks a downward

correction of NZU prices over time. Driving down the emissions price in the future could prevent meaningful decarbonisation and transition to a low-emissions economy, as it would undermine investments in sectors covered by the NZ ETS to reduce gross emissions and erode confidence in the scheme.

- 60 Relying entirely on net emissions reductions through exotic forestry has material risks:
 - 60.1 failing to constrain forestry in the NZ ETS would risk meaningful decarbonisation before 2050
 - 60.2 forests may not permanently remove and store emissions, as they are vulnerable to impacts of climate change
 - 60.3 it requires increasingly greater areas of land to be converted and remain as forests, which can result in economic and distributional impacts for rural communities
 - 60.4 it would be out of step with other countries, which are prioritising gross reductions
 - 60.5 it leaves future generations with the costs of having to reduce gross emissions; and
 - 60.6 large scale exotic afforestation could lead to greater wilding pine spread.
- 61 However, there would be trade-offs from shifting the balance of emissions reductions the NZ ETS drives. Constraining exotic forestry in the NZ ETS and potentially driving higher carbon prices would incur costs to the economy, government, households, and communities.
- 62 The Commission identified the potential impacts of a rising carbon price⁵:
 - 62.1 New Zealand's economy would continue to grow in the future, but economic growth would be slightly slower than it otherwise would have been. GDP could be around 0.5 percent lower in 2035 and 1.2 percent lower in 2050 than it would be otherwise. However, there would also be substantial cost savings across the economy from increased investments in emissions reductions and improvements in New Zealand's energy system.
 - 62.2 An increase in residential and commercial electricity prices while fossil fuels generation remains in New Zealand. However, rising carbon prices would also support investment in renewable energy, which would reduce the proportion of electricity derived from fossil fuels and the attendant cost impact of the NZ ETS. Expected improvements in energy efficiency would also mitigate the impact on electricity prices

⁵ The Climate Change Commission recently proposed new NZ ETS price control settings for the period 2023-2027 that would provide a corridor for New Zealand's emissions price: \$60-214 in 2023, increasing to \$75-268 in 2027.

- 62.3 An increase in the price of petrol and other fossil fuels. However, these impacts would be moderated over time by fuel switching driven by stronger NZ ETS incentives.
- 63 Some sectors would be disproportionately affected by changes to the NZ ETS gross-net balance. For example, if the Government intended to drive greater gross emissions reductions predominantly through higher carbon prices, this could increase the risk of some firms in highly trade-exposed and emissions intensive industries closing or shifting overseas.
- 64 Also, if new limits on forestry carbon sequestration were implemented in the NZ ETS, this could undermine investment in the forestry sector and the incentives for New Zealand's emergent bioeconomy.
- 65 However, these costs do not fully account for the interactions between New Zealand and the changing global economy. If emission prices here are lower than in other countries, there are potential economic regrets from investments continuing to be made in emissions-intensive transport, industrial plants, and activities. These regrets arise if our economy has not developed such that it can benefit from technological innovations made in other countries, or if it fails to encourage innovations that could be exported to low-emission economies abroad.
- 66 There could also be some risk of losing access to international markets or to capital from not acting to reduce gross emissions. Consumers are increasingly demanding products that meet specific environmental standards and financial institutions are factoring climate risk into their decisions. New Zealand businesses may be at a competitive disadvantage in the future if we fail to achieve meaningful decarbonisation across the economy.
- 67 Some reductions in emissions may be achieved via complementary measures to the NZ ETS, enabling some of the transformation to a low-carbon economy to be made without a high NZU price. However, these other measures may not be sufficient or optimal.
- 68 The NZ ETS forms the backbone of the mitigation policy response for good reasons. A price on all sources of emissions provides incentives for reductions wherever they occur and for emissions to be reduced via changes in behaviour or activity that cannot be identified in advance. A rising carbon price enables the least-cost response to be discovered.
- 69 In contrast, complementary measures are best focussed on the limited barriers to a price response, such as transport sector interventions that address the failure of purchasers to fully consider the lifetime costs of vehicle options.

A review of the NZ ETS will help determine what role emissions pricing should play in reducing gross emissions

- 70 For the NZ ETS to help deliver an effective and equitable transition for New Zealand over time, it is urgent that Cabinet consider the balance of gross and net emissions reductions it would like to incentivise in the future.
- 71 To that end, the review of the NZ ETS will develop advice and recommendations for Ministers on:
- 71.1 how to shift the balance of gross and net emissions reductions in the NZ ETS
 - 71.2 the impacts, trade-offs, and risks of options for shifting the balance of gross and net emissions reductions; and
 - 71.3 policy proposals to prioritise gross emissions reductions in the NZ ETS, while continuing to support emissions removals through forestry and other removal activities.
- 72 I understand that some agencies would like the review to have a wider scope and consider what balance of gross and net emissions reductions the NZ ETS should drive in the future. While I agree this question is important and should be addressed as part of the review's analysis, the review must be focussed on giving effect to Cabinet's direction to prioritise gross emissions reductions, and the Commission's recommendations to strengthen the NZ ETS incentives for gross emissions reductions.
- 73 Furthermore, if the review fails to effectively respond to the Commission's recommendations or give effect to Action 5.2.1 of New Zealand's first ERP, this could have profound implications for the credibility of the ERP and the role of emissions pricing within New Zealand's emissions reduction strategy.
- 74 In my view, the proposed scope of the review is broad enough to consider what balance of emissions reductions the NZ ETS should drive, while still being sufficiently targeted that its outcomes can give effect to the Commission's advice and previously agreed to Cabinet decisions.

Scope of the NZ ETS review

- 75 I propose the review consider the following key questions:
- 75.1 what balance of gross and net emissions reductions is expected to be driven by the current design and settings of the NZ ETS, and what are the economic, environmental, and distributional impacts of this balance?
 - 75.2 how can we shift the balance of emissions reductions in the NZ ETS to prioritise gross emissions reductions, while maintaining levels of net emissions reductions, in line with the Commission's analysis and advice on emissions budgets?
 - 75.3 how would the balance of emissions reductions incentivised by the NZ ETS change over time?

- 75.4 what are the potential impacts, trade-offs, and risks to society and the economy of shifting the balance of gross and net emissions reductions?
 - 75.5 what are the options to amend the design and settings of the NZ ETS and strengthen incentives for gross emissions reductions?
 - 75.6 what levels of net emissions reductions should be from exotic forests and indigenous forests, and how to improve NZ ETS incentives for indigenous afforestation?
 - 75.7 what role does the NZ ETS currently play in meeting New Zealand's NDC and what role should it play in the future?⁶
 - 76 In addition to these key questions, I propose the following issues to be in-scope of the review:
 - 76.1 how to include additional sources of emissions removals in the NZ ETS and what the impacts would be; and
 - 76.2 the extent to which the design of the NZ ETS should support emissions reductions or a range of co-benefits (such as improving indigenous biodiversity, a just transition, regional economic development etc.).
 - 77 The review will develop advice and recommendations based on the key questions and matters in scope of the review. To support this and provide a simple framework for Ministers to assess the outcomes of the review, I propose using the following high-level objectives for the NZ ETS:
 - 77.1 predictable – the NZ ETS plays a clear and central role in New Zealand's climate change response
 - 77.2 stable – the NZ ETS price signal is stable and reflects the marginal costs of gross emissions reductions in New Zealand
 - 77.3 effective – the NZ ETS drives a balance of gross and net emissions reductions in line with the Commission's demonstration pathway to meet our 2050 target, while supporting an equitable transition to a low-emissions economy.
- There are different options to amend the NZ ETS and strengthen incentives for gross emissions reductions that could be developed through the review*
- 78 The purpose of this paper is to establish the scope of the review and not select, develop, or assess amendments to the NZ ETS that may be progressed through the review – as doing so could risk pre-empting the review itself.
 - 79 However, in my view there is value in identifying some of the potential, high-level options Ministers may be presented as an output of the review. This will help give a sense of the kinds of options that could support balancing gross and net emissions reductions in the NZ ETS.

⁶ Section 30GC(2)(a) of the Climate Change Response Act 2002 requires the NZ ETS unit limits and price control settings are in accordance with both emissions budgets and New Zealand's NDC.

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[REDACTED]

83 My expectation is the review will surface all relevant questions, considerations, and trade-offs Ministers must weigh before making any decisions on amending the NZ ETS in the future. This will inform effective decision-making and allow the costs and benefits of driving gross emissions reductions through the NZ ETS to be readily identified and understood.

84 Emissions pricing, along with targeted sectoral policies and regulation, form a strategic package of measures designed to reduce gross emissions and support our transition in an equitable way. The NZ ETS is not expected to be the sole driver of gross emissions reductions in New Zealand; however, it should play a central role given emissions pricing is a key system setting of the ERP.

85 Changes to the balance of emissions reductions in the NZ ETS need to be considered alongside complementary policies. The review will help consider the interactions of emissions pricing and complementary policies and their relative contributions to supporting future gross emissions reductions.

Process and next steps for the review of the NZ ETS

An inter-agency team of officials carry out the review

- 86 I propose an inter-agency team of officials carry out the review in the second half of 2022 and the first half of 2023.
- 87 An inter-agency team, led by the Ministry for the Environment, will be well-placed to harness the resources and expertise that exist across government and provide advice to Ministers on the key questions and issues canvassed through the review. It will also help ensure the review outcomes are reflective of the positions held and priorities of different Ministers with responsibilities for New Zealand's climate change response.
- 88 I considered having an independent panel carry out the review; however, this option risks delaying the start of the review. I consider it of primary importance for the review to be carried out expeditiously over the next several months to ensure a timely response to the Commission's advice.
- 89 In lieu of an independent panel, I have asked the Ministry for the Environment to investigate establishing a reference group to provide input to the review and independent assessments of its advice and recommendations.
- 90 If a reference group is formed, it will be important to include Māori representatives, particularly those with expertise in climate policy and the forestry sector.
- 91 The inter-agency team will also engage with key stakeholders to inform the advice and recommendations developed through the review. This will include Iwi/Māori, major NZ ETS participants, forestry interests, local government, and other groups affected by the NZ ETS.

Proposed governance of the review

- 92 As discussed earlier in this paper, Cabinet directed me, as the Minister of Climate Change, to report back on the scope of the review, and consult with the Minister of Energy and Resources and the Minister of Forestry on this paper, which I have done.
- 93 I propose this arrangement continues, with the Minister of Climate Change leading the review in close consultation with the Minister of Energy and Resources and the Minister Forestry on all aspects of the work and public communications.
- 94 This arrangement is consistent with the ERP, which gives the Minister of Climate Change overall responsibility for the emissions pricing chapter and actions. It also provides for the Minister of Energy and Resources and the Minister Forestry to support emissions pricing policy, alongside the Minister for the Environment, the Minister of Agriculture, and the Minister for Transport.
- 95 However, I acknowledge that the Ministers of Energy and Resources and Forestry would prefer the review progress as a joint work programme. Cabinet will need to agree to the appropriate governance arrangements for the review.

- 96 While I accept that these Ministers have substantive interests in the outcomes of the review, having a clear line of Ministerial responsibility for the review, as described in the ERP emissions pricing chapter, would support a more efficient review process that can deliver clear advice and analysis in a timely manner. A requirement for me to consult with those two Ministers would ensure their input to and influence over the advice and recommendations Cabinet receives.
- 97 Given the breadth of issues and potential impacts covered by this review, it may become necessary to involve Ministers with responsibility for other parts of New Zealand's climate change response. I will consult with other Ministers throughout the review process as the need arises.
- 98 I also envisage an ongoing governance role for the newly formed Interdepartmental Executive Board (IEB) given that it has identified emissions leakage and forestry incentives as strategic priorities.
- 99 I asked officials to draft a Terms of Reference outlining the inter-agency governance arrangements for the review, including:
- 99.1 a decision-making framework for the inter-agency group
 - 99.2 the governance structure and inter-agency process; and
 - 99.3 the principles for resourcing and sharing information and data across government.
- 100 I propose Cabinet agree to the attached governance Terms of Reference for the review. The Interdepartmental Executive Board has reviewed and endorsed the Terms of Reference.

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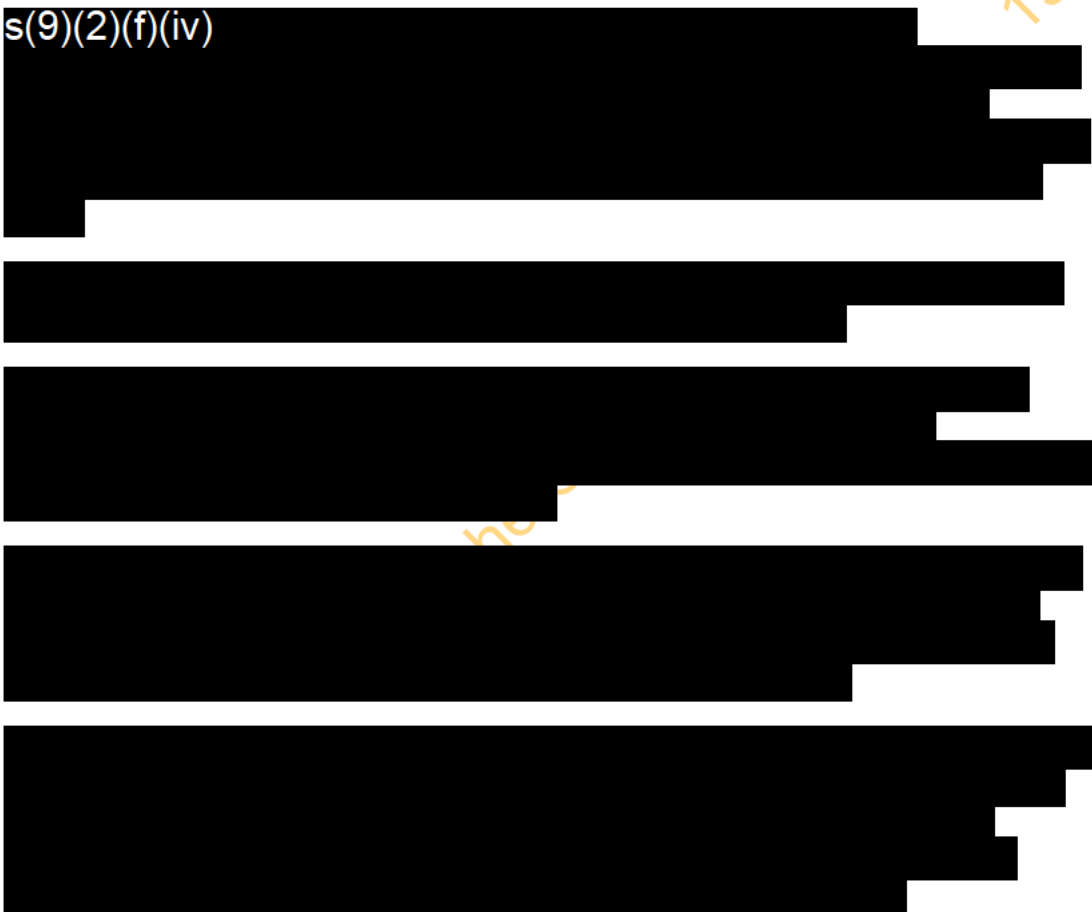
105 I propose returning to Cabinet in the first quarter of 2023, in consultation with the Minister of Energy and Resources and the Minister of Forestry, on the outcomes of the second stage of the review.

106 Through this Cabinet report back decisions will be sought on:

106.1 a package of proposals to amend the NZ ETS to drive gross and net emissions reductions in line with Cabinet's preferred balance; and

106.2 agreement to publicly consult on this package in the second quarter of 2023.

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Iwi/Māori engagement

112 The review will need to carefully consider the role, impacts, opportunities for Māori from changes to the NZ ETS.

113 It will therefore be critical to engage with Iwi/Māori throughout the review process given their significant interest and role in the land-use sector and the potential they have to make financial gain from sequestering carbon through forestry.

114 I have asked my officials to work with other agencies and develop an engagement plan for the review. It will need to align our engagement with Māori across multiple climate change workstreams, including permanent

forestry and NDC, and embed within the review process the principles of partnership and Māori representation.

Interactions with the climate work programmes

- 115 The review of the NZ ETS will be carried out in parallel with other climate work programmes, including the redesign of the permanent post-1989 forestry category, proposed amendments to the National Environmental Standards for Plantation Forestry (NES-PF), He Waka Eke Noa, and the upcoming consultation on the NZ ETS unit and price control settings. The process and outcomes of the review may have implications for this work.
- 116 Earlier in September, the Minister of Forestry and I brought a paper to Cabinet on the outcomes of the recent consultation on managing permanent exotic forestry in the NZ ETS and our proposals to redesign the permanent post-1989 forestry category.
- 117 Given the linkages between forestry and questions around balancing gross and net emissions reductions in the NZ ETS, a high degree of alignment between the permanent forestry and NES-PF work programmes and the review will be necessary. This will include ensuring the public communications for these pieces of work are well-aligned, and that our engagement with Māori and key stakeholders is joined-up.
- 118 Carrying out parallel and interconnected work programmes will have resourcing implications for agencies and may require reprioritisation of some work without new funding or allocation or additional resources. There will need to be ongoing discussions among Ministers and officials to ensure the review is appropriately resourced, and where necessary, prioritised over other work programmes.

Consultation with the Minister of Energy and Resources and the Minister of Forestry

- 119 As directed by Cabinet, I have consulted with Minister of Energy and Resources and the Minister of Forestry on my proposals for the scope and process of the review.
- 120 The Minister of Energy and Resources identified potential risks with carrying out and completing the review in 2022, and recommended sequencing the work so that Ministers considered first what balance of gross and net emissions reductions the NZ ETS should drive and then options to amend the scheme.
- 121 The Minister of Forestry raised concerns that the proposed scope of the review could pre-determine its outcomes, and in particular lead to changes to NZ ETS forestry settings that would affect future incentives for afforestation. Doing so could impact investment in forestry, risking the multiple and significant climate, economic, and environmental benefits derived from the sector. The Minister strongly recommended the review's scope should be such to ensure the maintenance of NZ ETS incentives for forestry, and that

careful considerations is given to any changes to balance of gross and net incentives in the scheme.

- 122 Both Ministers recommended the review progress with them having joint-responsibility for the policy work and communications.

Financial Implications

- 123 There are no financial implications from the decisions in this paper.

Legislative Implications

- 124 There are no legislative implications from the decisions in this paper.
- 125 However, the review could lead to legislative changes to the Climate Change Response Act 2002 in the future. s(9)(2)(f)(iv)
- [REDACTED]

Impact Analysis

Regulatory Impact Statement

- 126 As this paper contains no regulatory proposals, Cabinet's impact analysis requirements do not apply.

Climate Implications of Policy Assessment

- 127 As this paper contains no regulatory proposals, a Climate Implications of Policy Assessment is not required.

Population Implications

- 128 As this paper contains no policy proposals, there are no immediate impacts on population groups.
- 129 The review will place emphasis on Māori rights and interests in forestry. Māori have a significant interest in the NZ ETS and NZ ETS forestry settings. The review will need to consider the impact on Māori of changes to the role of the NZ ETS in incentivising different balances of gross and net emissions reductions and include early engagement with our Treaty of Waitangi partners and inclusion of their rights and interests in the analysis.

Human Rights

- 130 As this paper contains no policy proposals, it has no impacts on human rights or interactions with New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Consultation

- 131 The following agencies were consulted on this paper: the Treasury, Ministry of Business, Innovation and Employment, the Ministry for Primary Industries, the Ministry of Foreign Affairs and Trade, the Department of Conservation, Te Arawhiti, and Te Puni Kōkiri. The Department of the Prime Minister and Cabinet was informed.
- 132 As directed by Cabinet, I have consulted with the Minister of Energy and Resources and the Minister of Forestry on the scope of the review. I have also received and incorporated feedback from the Prime Minister, the Minister of Finance, the Minister of Foreign Affairs and Trade and Minister of Local Government, and the Minister of Māori Development.

Communications

- 133 The ERP signalled that the Government would investigate options for adjusting the NZ ETS to drive an appropriate balance of gross and net emissions reductions. I expect key stakeholders to be deeply interested in the outcomes of this work and aware of its implications. It will be important to provide them certainty as is practicable, particularly of the possibility of changes to the NZ ETS in the future.
- 134 Furthermore, publicly signalling the review will be important to ensure the Crown acts consistently with the principles of Te Tiriti. The principle of partnership requires both the Crown and Māori have a positive duty to act in good faith, fairly, reasonably, and honourably towards the other. In the interest of transparency and acting in good faith, we need to announce the review of the NZ ETS will be carried out, alongside other climate work programmes.
- 135 I therefore intend to make public announcements on the review following Cabinet decisions and in consultation with the Minister of Energy and Resources and the Minister Forestry.
- 136 Announcements about the NZ ETS review need to be managed carefully to avoid any inconsistencies and market risks, including sudden impacts on the emissions price. In addition, information should not be disseminated in a way that advantages some market participants over others and compromises NZ ETS investments.
- 137 It will be important to align the communications for the review with other major climate work programmes. Officials are developing a communications strategy that will sequence announcements for the review with those for the redesigned permanent post-1989 forestry category and amendments to the NES-PF.

Proactive Release

- 138 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, once public announcements have been made.

Recommendations

The Minister of Climate Change recommends that the Committee:

- 1 **Note** that in *Ināia tonu nei: a low emissions future for Aotearoa*, the Climate Change Commission recommended the Government amend the NZ ETS to strengthen incentives for gross emissions reductions and to manage the amount of exotic forest planting the scheme drives, in line with its advice on the emission reductions and removals needed to meet emissions budgets (recommendations 11.1 and 25.2a)
- 2 **Note** Cabinet has previously agreed to prioritise gross emissions reductions in the ERP, alongside maintaining support for net emissions reductions, in line with the Commission's analysis and advice on emissions budgets [DEV-21-MIN-0277]
- 3 **Note** as part of the ERP, Cabinet agreed in principle to the recommendations of the Commission to amend the NZ ETS to strengthen the incentives for gross emissions reductions and manage the amount of exotic forests driven by the scheme, subject to the outcomes a targeted review of the NZ ETS [CAB-22-MIN-0152]

Purpose of the review of the NZ ETS

- 4 **Agree** that the first phase of the review will consider what balance of gross and net emissions reductions should be incentivised through the NZ ETS and develop recommendations on a preferred balance of both gross emissions reductions and emissions removals required to meet our emissions budgets
- 5 **Agree** that the second phase of the review will include proposals to amend the NZ ETS to drive gross and net emissions reductions in line with the Government's preferred balance
- 6 **Agree** the other matters in-scope of the review described in recommendations 8.1 and 8.2 will be considered alongside the balance of emissions reductions incentivised by the NZ ETS in the first phase of the review

Scope of the review

- 7 **Agree** the review of the NZ ETS should consider the following questions:
 - 7.1 what balance of gross and net emissions reductions is expected to be driven by the current design and settings of the NZ ETS, and what are the economic, environmental, and distributional impacts of this balance?
 - 7.2 what balance of gross and net emissions reductions should the NZ ETS incentivise in the future?
 - 7.3 How could the NZ ETS be amended to support the Government's preferred balance of gross and net emissions reductions?

- 7.4 how would the balance of emissions reductions incentivised by the NZ ETS change over time?
- 7.5 what are the potential impacts, trade-offs, and risks to society and the economy of the options for shifting the balance of gross and net emissions reductions?
- 7.6 what are the options to amend the design and settings of the NZ ETS and strengthen incentives for gross emissions reductions?
- 7.7 what levels of net emissions reductions should be from exotic forests and indigenous forests, and how to improve NZ ETS incentives for indigenous afforestation?
- 7.8 what role does the NZ ETS currently play in meeting New Zealand's NDC and what role should it play in the future?
- 8 **Agree** the following issues are also in-scope of the review:
- 8.1 how to include additional sources of emissions removals in the NZ ETS; and
- 8.2 the extent to which the design of the NZ ETS should support emissions reductions or a range of co-benefits
- 9 **Agree** the review will use the following high-level objectives for the NZ ETS to assess the outcomes of the review:
- 9.1 predictable – the NZ ETS plays a clear and central role in New Zealand's climate change response
- 9.2 stable – the NZ ETS price signal is stable and reflects the marginal costs of gross emissions reductions; and
- 9.3 effective – the NZ ETS drives a balance of gross and net emissions reductions in line with the Commission's demonstration pathway to meet our 2050 target, while supporting an equitable transition to a low-emissions economy
- s(9)(2)(f)(iv)
- 11 **Agree** to the attached Governance Terms of Reference for the review, which has been endorsed by the Interdepartmental Executive Board
- 12 s(9)(2)(f)(iv)
- 13 **Agree** to a report back to Cabinet in the first quarter of 2023 on:
- 13.1 a package of proposals to amend the NZ ETS to drive gross and net emissions reductions in line with Cabinet's preferred balance; and

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- 13.2 agreement to publicly consult on this package in the second quarter of 2023.
- 14 **Agree** to either:
- 14.1 **Invite** the Minister of Climate Change to report back on recommendations 12 and 13 and be responsible for the communications for the review, in consultation with the Minister of Energy and Resources and the Minister of Forestry
- OR
- 14.2 **Invite** the Minister of Climate Change, the Minister of Energy and Resources and the Minister of Forestry, to jointly report back on recommendations 12 and 13 and be responsible for the communications for the review
- 15 **Note** the Minister of Climate Change proposes to publicly consult on Cabinet's preferred proposals to prioritise gross emissions reductions in the NZ ETS in the second quarter of 2023, s(9)(2)(f)(iv) [REDACTED]
- 16 s(9)(2)(f)(iv) [REDACTED]
- 17 **Note** the proposed timeframes are ambitious but achievable as the Commission has provided a strong foundation for officials to assess the balance of gross and net emissions reductions in the NZ ETS
- 18 **Note** this timing aligns with the Commission's recommendations to have developed and implemented proposals to strengthen the NZ ETS incentive for gross emissions reductions and manage the amount of exotic forest planting driven by the scheme by 31 December 2024
- 19 **Note** the review will be carried out in parallel with other climate work programmes, including changes to the permanent post-1989 forestry category, and alignment between work programmes is necessary
- 20 **Note** it will be critical to engage with Iwi/Māori throughout the review process and officials are exploring options to facilitate this and are developing an engagement plan
- 21 **Note** the Minister of Climate Change has consulted with the Minister of Energy and Resources and the Minister of Forestry on the proposed scope of the review, as directed by Cabinet
- 22 **Agree** to publicly announce the scope, process, and timing for the review following Cabinet decisions on these matters
- 23 **Agree** to proactively release this paper once public announcements have been made

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Authorised for lodgement

Hon James Shaw

Minister of Climate Change

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REVIEW OF THE NEW ZEALAND EMISSIONS TRADING SCHEME

GOVERNANCE TERMS OF REFERENCE

1. Background and context

Emissions pricing is a key and powerful tool within New Zealand's climate change response. The New Zealand Emissions Trading Scheme (NZ ETS) incentivises businesses and consumers to reduce gross emissions, and eligible activities that remove and store emissions (such as forestry) and contribute net emissions reductions.

In their 2021 advice, the Climate Change Commission recommended the Government amend the NZ ETS to strengthen the incentives for gross emissions reductions and to manage the amount of exotic forest planting the scheme drives, in line with their advice on the proportion of emissions reductions and removals necessary to meet emissions budget (Recommendations 11.1 and 25.2.a).

Cabinet has agreed, in principle, to the Commission's recommendations, subject to the outcomes of a targeted review of the NZ ETS. In New Zealand's first emissions reduction plan (ERP), the Government committed to investigate options for adjusting the NZ ETS to drive an appropriate balance of gross and net emissions reductions (Action 5.2.1).

s(9)(2)(f)(iv)

The review will consider the role of emissions pricing as part of New Zealand's climate change response and the balance of gross and net emissions reductions incentivised through the NZ ETS in the future.

Establishing formal governance arrangements for the review is required to provide leadership, accountability, and strategic oversight of its decision-making processes. It is also needed to formalise the roles, responsibilities, and expectations of the broader Governance Group convened for the review. Defining the governance arrangements for the review is especially timely given its significance, the complexity of the issues canvassed through the review, and the tight timeframes required to complete it.

2. Purpose

The purpose of this Terms of Reference is to:

- Establish a decision-making framework for the review
- Set out the structure for a Governance Group and inter-agency process for the review
- Assign and confirm the roles and responsibilities of the Governance Group
- Prescribe principles for procuring information and data for the review

3. Governance structure

A tiered Governance Group is proposed, with each tier carrying out specific roles and responsibilities within the review:

- **Climate Response Ministerial Group/ Cabinet.** The Climate Response Ministerial Group (CRMG) will consider advice and recommendations developed through the review process. Ministers' will provide direction on the areas of work they would like progressed.

Cabinet will consider the outcomes of the review and provide direction on policy proposals recommended through the review.

- **Ministerial sub-group.** Cabinet agreed the Minister of Climate Change, in consultation with the Minister of Energy and Resources and the Minister of Forestry, would have responsibility for the review. This arrangement will apply for the governance of the review, with the Minister of Climate Change, in consultation with the Minister of Energy and Resources and the Minister of Forestry, providing advice and recommendations to CRMG and Cabinet.
- **Interdepartmental Executive Board.** The Interdepartmental Executive Board (IEB) will provide strategic direction and oversight of the review. It will approve advice and recommendations going to the Ministerial sub-group and CRMG developed through the review. This will occur 1) in October 2022 through an interim report back and 2) when key milestones in the review are met and need to be reported back to CRMG. The IEB will also provide a mechanism to surface key opportunities and risks in the review work programme.
- **NZ ETS Review Lead Group.** A tier 2 / 3 NZ ETS Review Lead Group will provide guidance and direction for the review. It will convene regularly to receive updates on the review and endorse any advice and recommendations for the IEB to consider.

This group will need a way to decide on a consensus position for challenging policy proposals. Where consensus cannot be reached across the group, a quorum should be used to provide joined up and agreed to advice among agencies. The NZ ETS Review Lead Group will be chaired by someone from MfE.

The NZ ETS Review Lead Group will be responsible for the allocation of, and monitoring of resourcing for the review.

- **Reference Group.** A Reference Group will provide expert advice to the NZ ETS Review Lead Group and collaborate with the Interagency Working Group on the development of advice and recommendations. This group will convene regularly to consider key deliverables before progressing to the IEB.

Members of the Reference Group will be drawn from different areas, including climate policy, industry and energy, forestry, and Iwi/Māori.

- **Inter-agency Working Group.** The inter-agency working group will complete the Policy Design, Data and Evidence, and Engagement workstreams to progress the review. This group will include officials from MfE, MPI, TSY, MBIE and DPMC, and chaired by MfE, with the Manager ETS Policy and MFE Principal Economist leading the work and deliverables. Other entities may participate in the inter-agency working group as is deemed appropriate, such as the Climate Change Commission or the Parliamentary Commissioner for the Environment.

MfE will provide secretariat support for the IEB, NZ ETS Review Lead Group, and Reference Group.

s(9)(2)(f)(iv)

[REDACTED]

[REDACTED]

2) s(9)(2)(f)(iv)

Public consultation on proposals that come from the review would likely occur in the second quarter of 2023.

s(9)(2)(f)(iv)

5. Procurement of information and data

To deliver the proposed outcomes for the review, officials will need to accumulate new emissions, economic, and distributional impact data and develop a robust evidence base. To that end, the Terms of Reference sets out the principles for which information and data will be procured for the review:

- Agencies will commit to sharing existing information and data they hold that is required for the review.
- For the purposes of the review, agencies will carry out modelling and data analysis where they have particular expertise and resources.
- Agencies will contribute, where appropriate, to the procurement of new information and data from outside contractors.



Cabinet

Minute of Decision

This document contains information for the New Zealand Cabinet. It must be treated in confidence and handled in accordance with any security classification, or other endorsement. The information can only be released, including under the Official Information Act 1982, by persons with the appropriate authority.

Review of the New Zealand Emissions Trading Scheme

Portfolio Climate Change

On 27 September 2022, following reference from the Cabinet Economic Development Committee, Cabinet:

Background

- 1 **noted** that in *Ināia tonu nei: a low emissions future for Aotearoa*, the Climate Change Commission (the Commission) recommended that the government amend the New Zealand Emissions Trading Scheme (NZ ETS) to strengthen incentives for gross emissions reductions and to manage the amount of exotic forest planting the scheme drives, in line with its advice on the emission reductions and removals needed to meet emissions budgets (recommendations 11.1 and 25.2a);
- 2 **noted** that in December 2021, Cabinet agreed to prioritise gross emissions reductions in the emissions reduction plan (ERP), alongside maintaining support for net emissions reductions, in line with the Commission's analysis and advice on emissions budgets [CAB-21-MIN-0547.02];
- 3 **noted** that in May 2022, as part of the ERP, Cabinet agreed in principle to the recommendations of the Commission to amend the NZ ETS to strengthen the incentives for gross emissions reductions and to manage the amount of exotic forests driven by the scheme, subject to the outcomes of a targeted review of the NZ ETS [CAB-22-MIN-0152];

Purpose of the review of the NZ ETS

- 4 **agreed** that the first phase of the review will consider what balance of gross and net emissions reductions should be incentivised through the NZ ETS, and will develop recommendations on a preferred balance of both gross emissions reductions and emissions removals required to meet the emissions budgets;
- 5 **agreed** that the second phase of the review will include proposals to amend the NZ ETS to drive gross and net emissions reductions in line with the government's preferred balance;
- 6 **agreed** that the other matters in-scope of the review, described in paragraphs 8.1 and 8.2 below, will be considered alongside the balance of emissions reductions incentivised by the NZ ETS in the first phase of the review;

Scope of the review

- 7 **agreed** the review of the NZ ETS should consider the following questions:
- 7.1 what balance of gross and net emissions reductions is expected to be driven by the current design and settings of the NZ ETS, and what are the economic, environmental, and distributional impacts of this balance;
 - 7.2 what balance of gross and net emissions reductions should the NZ ETS incentivise in the future;
 - 7.3 how could the NZ ETS be amended to support the government's preferred balance of gross and net emissions reductions;
 - 7.4 how would the balance of emissions reductions incentivised by the NZ ETS change over time;
 - 7.5 what are the potential impacts, trade-offs, and risks to society and the economy of the options for shifting the balance of gross and net emissions reductions;
 - 7.6 what are the options to amend the design and settings of the NZ ETS and strengthen incentives for gross emissions reductions;
 - 7.7 what levels of net emissions reductions should be from exotic forests and indigenous forests, and how to improve NZ ETS incentives for indigenous afforestation;
 - 7.8 what role does the NZ ETS currently play in meeting New Zealand's nationally determined contribution, and what role should it play in the future;
- 8 **agreed** that the following issues are also in-scope of the review:
- 8.1 how to include additional sources of emissions removals in the NZ ETS;
 - 8.2 the extent to which the design of the NZ ETS should support emissions reductions or a range of co-benefits;
- 9 **agreed** that the review will use the following high-level objectives for the NZ ETS to assess the outcomes of the review:
- 9.1 predictable – the NZ ETS plays a clear and central role in New Zealand's climate change response;
 - 9.2 stable – the NZ ETS price signal is stable and reflects the marginal costs of gross emissions reductions;
 - 9.3 effective – the NZ ETS drives a balance of gross and net emissions reductions in line with the Commission's demonstration pathway to meet the 2050 target, while supporting an equitable transition to a low-emissions economy;

s(9)(2)(f)(iv)

agreed to the Governance Terms of Reference for the review, attached to the paper under CAB-22-SUB-0412, which have been endorsed by the Interdepartmental Executive Board;

- 12 s(9)(2)(f)(iv) [REDACTED]
- 13 **agreed** to a report back to Cabinet in the first quarter of 2023 seeking agreement to:
- 13.1 a package of proposals to amend the NZ ETS to drive gross and net emissions reductions in line with Cabinet's preferred balance;
- 13.2 publicly consult on this package in the second quarter of 2023;
- 14 **invited** the Minister of Climate Change, the Minister of Energy and Resources, the Minister for the Environment, and the Minister of Forestry to jointly report back in accordance with paragraphs 12 and 13 above, and to be responsible for the communications for the review;
- 15 **noted** that the Minister of Climate Change proposes to publicly consult on Cabinet's preferred proposals to prioritise gross emissions reductions in the NZ ETS in the second quarter of 2023, s(9)(2)(f)(iv) [REDACTED]
- 16 [REDACTED]
- 17 **noted** that the proposed timeframes are ambitious but achievable, as the Commission has provided a strong foundation for officials to assess the balance of gross and net emissions reductions in the NZ ETS;
- 18 **noted** that this timing aligns with the Commission's recommendations to have developed and implemented proposals to strengthen the NZ ETS incentive for gross emissions reductions and manage the amount of exotic forest planting driven by the scheme by 31 December 2024;
- 19 **noted** that the review will be carried out in parallel with other climate work programmes, including changes to the permanent post-1989 forestry category, and that alignment between the work programmes is necessary;
- 20 **noted** that it will be critical to engage with Iwi/Māori throughout the review process, and that officials are exploring options to facilitate this and are developing an engagement plan;
- 21 **noted** that the Minister of Climate Change has consulted the Minister of Energy and Resources and the Minister of Forestry on the proposed scope of the review, as directed by Cabinet;
- 22 **agreed** to publicly announce the scope, process, and timing for the review following Cabinet's decisions on these matters.

Rachel Hayward
Acting Secretary of the Cabinet