



## PROACTIVE RELEASE COVERSHEET

<b>Minister</b>	Minister Shaw	<b>Portfolio</b>	Minister of Climate Change
<b>Name of package</b>	2023 update to the New Zealand Emissions Trading Scheme: limits and price control settings for New Zealand Units	<b>Date to be published</b>	30 August 2023

### List of documents that have been proactively released

<b>Date</b>	<b>Title</b>	<b>Author</b>
5 May 2023	Approval to consult on annual updates to New Zealand Emissions Trading Scheme limits and price control settings for units	Office of the Minister of Climate Change
10 May 2023	Minute of Decision	Cabinet Economic Development Committee
3 April 2023	Draft Cabinet paper, Approval to consult on the annual update to New Zealand Emissions Trading Scheme unit limit and price control settings	Ministry for the Environment
21 July 2023	2023 update to the New Zealand Emissions Trading Scheme: limits and price control settings for New Zealand Units	Office of the Minister of Climate Change
24 July 2023	Minute of Decision	Cabinet Office

### Information redacted

**YES**

Any information redacted in this document is redacted in accordance with the Ministry for the Environment's policy on proactive release and is labelled with the reason for redaction. This may include information that would be redacted if this information was requested under Official Information Act 1982. Where this is the case, the reasons for withholding information are listed below. Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

### Summary of reasons for redaction

The following redactions have been applied in these documents in line with the Act:

- S9(2)(f)(iv) - the confidentiality of advice tendered by Ministers of the Crown and officials.
- S9(2)(h) - maintain legal professional privilege.

## **Policy and Privacy**

### **In-Confidence**

### **Office of the Minister of Climate Change**

### **DEV - Cabinet Economic Development Committee**

## **Approval to consult on annual updates to New Zealand Emissions Trading Scheme limits and price control settings for units**

### **Proposal**

- 1 I seek Cabinet approval to publicly consult during May and June on updates to New Zealand's Emissions Trading Scheme (NZ ETS) limits and price control settings for units (unit settings). Amendments to regulations are required so that these unit settings continue to cover five calendar years at all times.

### **Relation to government priorities**

- 2 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].
- 3 Enabling a just transition to a low-emissions, climate resilient future is also a government priority. This was emphasised by the CBC when they noted the intention to "put the climate at the centre of government decision-making" and agreed that "climate change requires decisive action by all levels of government, the private sector, and communities" [CBC-20-MIN-0097 refers].
- 4 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 Act is an agreed area of cooperation.
- 5 The proposals in this paper relate to action 5.1 of New Zealand's first emissions reduction plan, aligning the NZ ETS settings with emissions budgets.

### **Executive Summary**

- 6 I seek Cabinet approval to publicly consult on updates to NZ ETS limits and price control settings for units. I have received advice from the Climate Change Commission (the Commission) on updates to these unit settings.

- 7 Updates to unit setting regulations are made annually to ensure that, at all times, they cover each of the next five calendar years, as required by the Climate Change Response Act 2002. Currently, unit settings are prescribed in regulations until 2027.
- 8 This year will be the third year that these settings have been updated since they were first prescribed in regulations.
- 9 There are two areas for updates. First, the unit limits, which update the number of units the Government can provide to the market annually. This caps the ETS, but does not include units transferred for removal activities (e.g. forestry sequestration), which are unlimited. Secondly, updates to price control settings are needed. These help manage unacceptably low or high prices in the NZ ETS.
- 10 Changes to the first two years of settings, 2024 and 2025, can only be made in special circumstances. The Commission does not consider that these circumstances exist. Consultation will inform my consideration of this.
- 11 The options presented for calculations of unit limits result in a range of possible auction volumes. These range from retention of status quo annual auction volumes through to significant reductions recommended by the Commission.
- 12 The options presented for price control settings are largely similar to those consulted on last year, and range from status quo settings through to those advised by the Commission. The Commission has repeated its advice that both the auction reserve price and cost containment reserve trigger price should be significantly increased.
- 13 I propose to publicly consult on the appended discussion document between May and early June 2023. I intend to seek Cabinet approval to issue drafting instructions for amendment regulations in August 2023, to ensure the regulations are updated by September 2023 to meet legislative requirements.

## **Background**

- 14 The Climate Change (Auctions, Limits, and Price Controls for Units) Regulations 2020 (Auctions and Unit Settings Regulations) prescribe the next five years of NZ ETS limits and auction price control settings for units (unit settings).
- 15 The Act requires those regulations to cover each of the next five calendar years. This means there will be annual amendments of these regulations.
- 16 The Act requires the Commission to provide recommendations on these settings. Their advice is one of the matters that must be considered as part of updating these settings.
- 17 The Act requires public consultation prior to making these updates. Under the Act, I must ensure representatives of iwi and Māori that appear likely to have

an interest, as well as persons likely to be substantially affected, have been consulted before recommending the making of amendment regulations.

- 18 This is the third year that these settings will be updated since they were first prescribed in regulations in 2020 in time for the introduction of NZ ETS auctions.
- 19 Unit settings were updated in 2021 to reflect recommendations from the Commission provided in Ināia tonu nei: a low emissions future for Aotearoa.
- 20 The settings were updated again at the end of 2022, although on this occasion departed from key components of the Commission's advice. This process included consideration of advice from the Commission following the setting of New Zealand's first emissions reduction plan and associated emissions budgets.
- 21 I received the Commission's advice for 2023 unit settings on Friday 31 March. The advice was subsequently tabled in the House on 13 April.
- 22 Timeframes for regulation updates in 2023 are very compressed for two reasons. Firstly, I have only recently received the Commission's advice. The Commission was unable to provide its advice to me earlier because 2022 amendments to NZ ETS unit settings only occurred in December 2022. Secondly, there are constraints on Cabinet availability in the lead up to the October election.
- 23 Amendment regulations need to be made by 30 September 2023 to meet legislative requirements. In 2022, amendment regulations were able to be made as late as 31 December. This was because the Act allowed a different timeframe in the year that emissions budgets are first set.

## Analysis

### *Updates are required to extend NZ ETS unit settings to include 2028*

- 24 Unit settings are prescribed in regulations for 2023-2027. The annual process is required this year to include settings for 2028.

### *Updates to prior years can also be made*

- 25 The Act allows updates to settings for the two years immediately following the current year (2024 and 2025 in this case) only in certain circumstances. The Commission recommends that no updates to unit settings are made for 2024 and 2025 as it does not consider that any such circumstances apply.
- 26 I propose to consult to inform my consideration of whether any of these circumstances have been met this year, and, if so, whether they would justify updating settings for 2024 and 2025.

### ***Summary of options to be consulted on***

27 The Commission's recommendations on unit settings are presented in the discussion document. Consultation feedback is sought on:

27.1 whether to make changes to unit settings for 2024 and 2025

*calculation of auction volumes and limits for units:*

27.2 whether to make adjustments to auction volumes as a result of an increase in post-1989 forest land registration in the NZ ETS

27.3 how to address an observed technical discrepancy between emissions reported in the inventory and reported into the NZ ETS

27.4 how to address stockpile impacts that may result from decisions made previously or a decision not to update settings for 2024 and 2025

*and in relation to price control settings:*

27.5 auction reserve prices

27.6 cost containment reserve structure and volume of units

27.7 cost containment reserve trigger prices.

### ***Limit settings for units***

28 Unit settings include the following three limits for units:

28.1 A limit on the NZUs available by auction, which is comprised of the annual auction volume and the volume available within the cost containment reserve (CCR).

28.2 A limit on approved overseas units.

28.3 An overall limit on units, which is the sum of the annual auction volume, the CCR volume, the projected volume of units allocated to emissions intensive and trade exposed firms, and the volume of approved overseas units.

### ***Calculating limits for units uses a well understood methodology***

29 The first step in calculating limits for units is calculating auction volumes.

30 In its 2023 advice, the Commission has recommended using the same broad method to calculate auction volumes as was followed in 2022. This method involves an initial step to consider how auction volumes should accord with emissions budgets, the first NDC and the 2050 targets, followed by a series of six calculation steps.

31 The six calculation steps are:

- 31.1 Allocate the emissions budgets to NZ ETS and non-NZ ETS sectors
  - 31.2 Make technical adjustments
  - 31.3 Account for industrial allocation volumes
  - 31.4 Set a reduction volume to address the unit stockpile
  - 31.5 Set approved overseas unit limit
  - 31.6 Calculate the auction volume.
- 32 Consultation feedback is sought on alternatives to status quo calculations at several of these steps.

*Different options for allocating the emissions budget to NZ ETS sectors*

- 33 In its 2022 advice, the Commission recommended apportioning emissions budget volumes to NZ ETS and non-ETS covered sectors in accordance with the demonstration path used to inform emissions budgets and the ERP. This was implemented as part of updates to unit settings made in 2022.
- 34 This year, the Commission is recommending using updated estimates of the proportion of forestry emissions that are outside of the NZ ETS. These updates are to reflect the impact of an increase in post-1989 forest land registrations in the NZ ETS. This would result in significantly decreased limits for units and annual auction volumes.

*Different options for technical adjustments*

- 35 In its 2022 advice, the Commission identified what appears to be a discrepancy between emissions reported in New Zealand's greenhouse gas inventory and the NZ ETS.
- 36 The discrepancy relates to energy sector emissions for coal and liquid fossil fuels. Officials have not yet been able to confirm the basis for the discrepancy and whether addressing it will require adjustments to the inventory and/or NZ ETS technical adjustments to emissions factors or calculations.
- 37 Feedback is sought on whether to adjust auction volumes in reference to this discrepancy before it is fully understood. Last year, no such adjustment was made. This was the only difference between the Commission's 2022 advice on setting limits for units, and auction volumes, and what was prescribed in regulations.

*Different options for addressing the stockpile of privately held units*

- 38 A large quantity of units has accumulated in private accounts. This 'stockpile' of units provides essential liquidity in the market, but it could also dampen the NZU price.
- 39 Units move into the stockpile as they are:

- 39.1 sold by auction
- 39.2 transferred for industrial allocation
- 39.3 transferred for removal activities.
- 40 Units move out of the stockpile as they are:
  - 40.1 surrendered to the Crown by NZ ETS participants to meet their ETS obligations.
- 41 The stockpile could cause significant challenges in meeting emissions budgets. This is because of the current size of the stockpile and large number of 'surplus' units that are not held against future surrender liabilities. The stockpile at 1 June 2022 was 144 million units, approximately four times as many units as were surrendered for 2021 emissions.
- 42 In 2022 the Commission recommended a stockpile adjustment calculation that reduced annual auction volumes to remove the 'surplus' component of this stockpile by 2030. This recommendation was agreed to and implemented into regulations last year.
- 43 This year, the Commission has recommended retaining this surplus reduction component of the stockpile adjustment, and introducing an additional step.
- 44 This additional step seeks to make further stockpile adjustments that are new in this year's advice. The outcome of this would be an abrupt change in annual auction volumes between 2025 and 2026, from 15.3 million units to 8.5 million units. The consultation document asks for feedback on this additional step proposed by the Commission.

*Alternative approaches affect annual auction volumes*

- 45 There is a range of annual auction volumes resulting from choices of different options for addressing the technical adjustments and stockpile reduction steps described immediately above. Some are presented in Table 1 below for context.

Table 1 – Range of annual auction volumes<sup>1</sup> under status quo settings, the Commission's advice, and the Commission's advice applied to making updates to unit settings for all years.

Origin of auction volume	Auction volumes (million units)				
	Year				
	2024	2025	2026	2027	2028
Status quo	17.1	15.3	13.5	11.7	(not set 9.6)
If updates are made to all years, based on steps proposed by Commission	13.6	12	10.2	8.7	6.6
Commission advice, including not to	17.1	15.3	8.5	7.1	5.2

<sup>1</sup> Auction volumes are the prescribed limit on units available to be auctioned less the volume of units in the cost containment reserve

Origin of auction volume	Auction volumes (million units)				
update settings for 2024 and 2025					

### *Impacts of auction volumes*

- 46 Auctions are a key source of NZU supply into the NZ ETS. New units transferred for forest sequestration also enter the stockpile of units. Reductions in auction supply requires NZ ETS participants to acquire units from the stockpile to meet their surrender obligations. Any failure to meet surrender obligations results in significant financial penalties.
- 47 Reductions in auction volumes lowers total market supply and is expected to result in an increase in price, which increases the incentive to reduce emissions.

### **Relation to nationally determined contribution and offshore mitigation**

- 48 The Commission has highlighted the need for the Government to clarify what role the NZ ETS will have in delivering the offshore mitigation required to meet the first NDC. Recommendations currently do not consider how this might be done. Future decisions on this topic are not anticipated to influence decisions this year, but could have a significant impact on unit settings in future.

### ***Price control settings for units***

- 49 Price controls provide the government with a mechanism to help manage unacceptably low or high prices in the NZ ETS. This range of prices reflects the contribution of emissions pricing to achieving emissions budgets and targets as well as concerns over the potential economic impacts of the NZ ETS at high prices.
- 50 For meeting targets, the strongest signal is sent when prices are on a credible rising trajectory. All other international emissions trading schemes currently include some price control features.
- 51 Price controls can also enable businesses to develop long-term expectations of their costs of participating in the NZ ETS to better inform their investment decisions and business planning.
- 52 The price control settings consist of:
- 52.1 a minimum price that units can be sold at auction (price floor)
  - 52.2 a cost containment reserve (CCR) trigger price or prices (often referred to as a 'price ceiling')
  - 52.3 CCR unit volume or volumes.



*The Commission has provided recommendations on price control settings*

- 53 The Commission's recommended price control settings differ significantly from current settings and include much higher and wider auction price control settings for units.
- 54 The Commission's recommendations are largely unchanged from its recommendations in 2022. However, it has recommended minor updates to reflect changes in inflation projections, and recommends not updating settings for 2024 and 2025.
- 55 Price control settings are not intended to directly determine secondary market prices. However they, alongside limits for units, may have a significant influence on price expectations either directly or via changes to supply expectations. As context, in 2023 assigned auction volumes represent close to 50% of estimated unit demand for NZ ETS obligations and the CCR volume is equivalent to approximately 20% of estimated 2023 demand.
- 56 On the day that the Commission's advice was released in 2022, prices on the NZ ETS secondary market rose eleven percent, from \$73 to \$83. Prices then remained relatively stable in a range from \$80-\$88 until the decision to largely retain status quo price control settings was announced. The price immediately declined in response. NZUs have recently been trading as low as \$54.
- 57 Demand at auctions has also declined, and no units were sold at the March 2023 NZ ETS auction as the clearing price was below the confidential reserve price. This confidential reserve price is not a price control setting, instead being an additional mechanism to prevent sales by auction at prices significantly below prices of NZUs on secondary markets.
- 58 This observed relationship between price control settings and secondary market prices reflects the change in market supply. Demand for units to meet immediate NZ ETS obligations is relatively fixed, regardless of changes in price. NZ ETS participants need to acquire and surrender NZUs to meet NZ ETS obligations. However there are reasons, including hedging behaviour, why demand might be relatively greater or lesser at any given point in time.
- 59 Failure to surrender NZUs by the deadline results in a financial penalty of three times the price of carbon. This price is prescribed in regulations and used for assessing penalties and calculating synthetic greenhouse gas levy rates. This penalty is unable to be discounted, and is additional to the ongoing requirement to meet the original obligation to surrender units.<sup>2</sup>
- 60 For 2023, this penalty is approximately \$200 per unit, which influences the price that NZ ETS participants are prepared to pay to acquire units needed to meet surrender liabilities.

*Consideration of gross and net emissions reductions in the Commission's advice*

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<sup>2</sup> Small forestry obligations face a different penalty for failure to surrender units as a transitional measure; a Bill is currently being progressed through the House to provide different penalties for small forestry obligations.

- 61 The Commission modelled prices that would meet gross emissions reduction targets implied by the ERP to inform its recommendations. This has involved use of the sector sub-targets in the ERP which were set as a tool for monitoring sectoral progress.
- 62 Updates to unit settings are required to be in accordance with net emissions budgets and targets legislated in the Act. The stockpile of privately held units poses risks to meeting emissions budgets. Sale of units from the CCR would mean that the stockpile is not reduced as intended.
- 63 The Commission suggests current trigger prices are too close to market prices so that the CCR is too likely to be released. The consultation document asks for feedback on the Commission's approach.
- 64 Decisions made on settings later this year will need to reflect the requirements of the Act.

#### *The NZ ETS Review and permanent forestry settings*

- 65 The role of the NZ ETS in driving gross emissions reductions is being considered via a review of the NZ ETS which was publicly announced in May 2023. Redesign of the permanent forestry NZ ETS category is also being considered. Consultation on these two issues is expected to commence in June 2023.
- 66 Cabinet's choices on the balance of gross and net emissions reductions in the NZ ETS may have significant implications for unit supply and price settings in future.

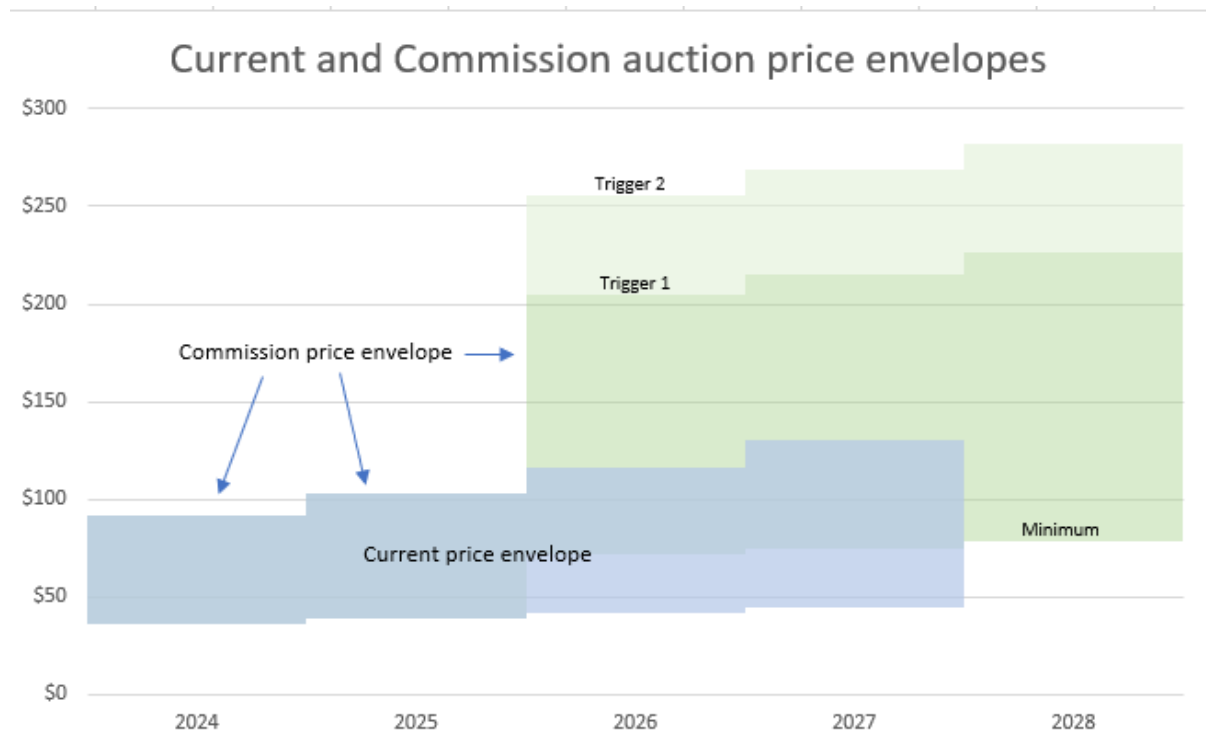
#### *Commission recommendations on price control settings*

- 67 Current price settings and Commission recommendations are illustrated in figure 1 below. The Commission has recommended retaining status quo settings for 2024 and 2025 unless circumstances allow settings for these years to be updated.
- 68 The Commission has then recommended the following changes for 2026 and out-years, which repeat its 2022 advice with only minor changes to reflect updated inflation projections:
  - 68.1 Increasing the price floor for 2026 from \$41.45 to \$72
  - 68.2 Changing the price floor trajectory, resulting in a 2028 price floor of \$79, in contrast to current rate and start point which results in a 2028 price floor of \$48
  - 68.3 Moving away from the current cost containment reserve trigger price of \$115.84 in 2026, and current trajectory that has this trigger price increasing to \$146 in 2028
  - 68.4 Moving from one to two cost containment reserve volumes

## 68.5 Implementing two new trigger prices:

- 68.5.1 a lower tier CCR trigger price of \$205 for 2026, increasing to \$226 by 2028; and
- 68.5.2 a higher tier CCR trigger price of \$256 for 2026, increasing to \$282 in 2028.

**Figure 1 - Price control settings for units – Commission recommendations (green) and current settings (blue). Note, the Commission recommends status quo settings for 2024 and 2025 unless circumstances allow settings for these years to be updated**



69 In making these recommendations, the Commission notes that it is unlikely that any magnet effect that may be operating would be sufficiently strong to cause prices to rise to the levels it recommends. Rather, these price settings would enable the market to set price through supply-demand dynamics alone, and in the short-run this would be expected to be similar to current market prices.

*Alternative options for price control settings are also presented in the consultation document*

70 The Commission's recommendations for price control settings are presented as options in the consultation document. Additional options are also presented. Options are assessed against the status quo.

### *Implications of updates to price control settings*

71 The price of NZUs has a direct impact on the costs of electricity, petrol, and other energy sources. The Commission leverages work undertaken by the

Treasury to present impacts at various price points. Any increase in the prices of goods has a corresponding cost-of-living and inflationary impact.

- 72 Impacts of different NZU prices on electricity and fossil fuel costs are displayed in the table below. A range of prices is included, and this range includes both prices below current secondary market prices for NZUs and the upper price control settings recommended by the Commission. The Commission does not expect prices to rise to these levels for many years.

Table 2: Impacts of various NZU prices on electricity (c/kWh) and fossil fuels

electricity	Sector	2021 price (c/kWh) <sup>3</sup>	\$50	\$75	\$100	\$150	\$200	\$250
High impact	Residential	30.6	1.9	2.9	3.8	5.7	7.6	9.5
	Commercial	18.5	1.7	2.5	3.3	5.0	6.6	8.3
	Industrial	17.1	1.6	2.4	3.1	4.7	6.2	7.8
Low impact	Residential	30.6	1.1	1.7	2.2	3.3	4.4	5.5
	Commercial	18.5	1.0	1.5	1.9	2.9	3.8	4.8
	Industrial	17.1	0.9	1.4	1.8	2.7	3.6	4.5

fossil fuels			Emissions price					
	Sector	2021 price	\$50	\$75	\$100	\$150	\$200	\$250
Fossil gas (c/kWh)	Residential	14.7	1.2	1.8	2.3	3.5	4.6	5.8
	Commercial	6.6	1.0	1.5	2.0	3.0	4.0	5.0
	Industrial	3.2	1.0	1.5	2.0	3.0	4.0	5.0
Diesel (c/l)	Residential	150.6	15.4	23.1	30.7	46.1	61.5	76.8
Petrol (c/l)	Commercial	224.7	13.4	20.2	26.9	40.3	53.8	67.2
Coal (c/GJ)	Industrial	10.0	4.5	6.8	9.0	13.6	18.1	22.6

- 73 The price of NZUs also affects the financial viability of emissions intensive and trade exposed industries. This is addressed by industrial allocation; however, at some price point the industrial allocation settings become insufficient to prevent emissions leakage.<sup>4</sup> However, I consider it important that NZU prices are sufficient to incentivise decarbonisation. Lower prices are likely to delay decisions by firms to invest in lower emissions technologies and fuels.

<sup>3</sup> All prices in the table are in cents per kilowatt hour for electricity and fossil gas, cents per litre for petrol and diesel, and cents per gigajoule for coal

<sup>4</sup> For industries including production of burnt lime, cartonboard, cement, and potentially urea and ethanol, industrial allocation is insufficient to prevent becoming unprofitable at prices from around \$200

- 74 The recently announced ETS Review considers what balance of gross and net emissions the NZ ETS should incentivise.
- 75 Higher prices affect land-use decisions and incentivise conversion of farmland to forestry for carbon farming while sequestration units remain unlimited. If unconstrained, prices could result in afforestation continuing at rates beyond previously anticipated levels.
- 76 The consultation document describes these impacts and then seeks feedback.

### **Impacts on emissions reductions**

- 77 Detail on the emissions reductions expected at different price points will be provided in the consultation report-back when I seek policy decisions. This will draw from the Commission's modelling and other sources.

### **Impacts on other work programmes**

- 78 There are several work programmes underway that have some relationship with emission unit prices, and therefore decisions on unit settings. These include:
  - 78.1 Pricing of agricultural emissions/He Waka Eke Noa
  - 78.2 The redesign of the permanent forestry category in the NZ ETS
  - 78.3 A targeted review of the NZ ETS considering the balance of gross and net emissions reductions incentivised by the scheme
  - 78.4 The portfolio of overseas mitigation required to meet New Zealand's first NDC
  - 78.5 Implementation of industrial allocation reform decisions
  - 78.6 Implementation and funding of ERP actions and other climate initiatives.
- 79 In particular, I expect the redesign of the permanent forestry category in the NZ ETS and the NZ ETS review to be publicly consulted on from June 2023.
- 80 This will be further described in the consultation report-back.

### **Timing pressures in delivering these updates**

- 81 There are significant timing pressures in meeting the legal requirement to deliver these updates in 2023. Public consultation will need to be limited to four weeks, and Ministerial consultation for the legislative cabinet paper will need to be reduced to one week.

## Proposal to consult

- 82 I have appended the consultation document, *annual updates to NZ ETS limits and price control settings for units 2023*. I propose to consult on the proposals outlined in this paper during May and early June 2023.

## Financial Implications

- 83 There are no financial implications of approving consultation. Financial implications of any updates proposed will be provided in the post-consultation report back Cabinet paper seeking policy decisions.
- 84 Amendments to unit and price settings within the NZ ETS will have fiscal implications since the NZ ETS is a source of revenue to the Crown. Given the current relationship between NZ ETS forecast proceeds and the size of the Climate Emergency Response Fund (CERF), unit and price setting changes are also therefore anticipated to have implications for the CERF.
- 85 Implications for the CERF will depend on the nature of final settings decisions and market reaction to these decisions.

## Legislative Implications

- 86 Regulatory amendments will be required to implement the proposals. Drafting approval for these would be sought at the time of policy decisions in early August 2023. The Climate Change (Auctions, Limits, and Price Controls for Units) Regulations 2022 will need to be amended to update the prescribed unit settings.

## Impact Analysis

### *Regulatory Impact Statement*

- 87 The Treasury's Regulatory Impact Analysis team has determined that the proposal to release the discussion document on updates to the Climate Change (Auctions, Limits, and Price Controls for Units) Regulations 2020 is exempt from the requirement to provide a Regulatory Impact Statement (RIS). The exemption is based on advice that the discussion document includes the key features of an interim RIS.
- 88 The Ministry for the Environment's quality assurance panel has reviewed the discussion document and considers that it meets the effective consultation requirements and can function as an interim RIS. The document addresses all feasible options, contains interim analysis of these options, and contains questions that will improve the information and evidence base for the future RIS. A full RIS will be completed at a later date to inform Cabinet's final decisions on this proposal once it returns from consultation.

### *Climate Implications of Policy Assessment*

- 89 Climate Implications of Policy Assessment (CIPA) team has been consulted and confirm that the CIPA requirements do not apply as there is no decision

at this stage with direct emissions impacts. This proposal is an annual update to the unit limits and price control settings for auctions in the NZ ETS, which will support the effectiveness of the ETS but will not have a specific direct impact on emissions.

### **Population Implications**

- 90 The decision to undertake public consultation involves no population implications. Population implications of any updates proposed after consultation will be provided in the post-consultation report back Cabinet paper seeking policy decisions.

### **Te Tiriti o Waitangi Implications**

- 91 Māori have a significant interest in climate change action and the NZ ETS, particularly in the forestry sector. There are no direct Te Tiriti o Waitangi implications from consulting on unit settings. Impacts of recommended proposals will be described in the consultation report-back.

### **Human Rights**

- 92 There are no inconsistencies between these proposals and the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993.

### **Next steps**

- 93 After analysing submissions, I will seek Cabinet agreement to amend the Auctions and Unit Settings regulations and issue drafting instructions to the Parliamentary Counsel Office in August 2023.
- 94 Regulations come into force three months after their publication. This means that the amendment regulations need to be published in the New Zealand Gazette no later than the end of September 2023. This is to align with the statutory requirement that NZ ETS unit settings at all times prescribe unit settings for each of the next five calendar years.

### **Consultation**

- 95 The Treasury, Ministry of Foreign Affairs and Trade, Ministry for Primary Industries, Ministry for Business, Innovation and Employment, Environmental Protection Authority, the New Zealand Customs Service, the Ministry of Transport, and Te Puni Kōkiri were consulted on this paper. The Department of Prime Minister and Cabinet was informed.
- 96 Where feedback has been received, it has been considered and incorporated as appropriate.

### **Communications**

- 97 Notification of consultation will be sent to NZ ETS stakeholders the day before release. It will then be published on the Ministry's website prior to market opening the following day.

## Proactive Release

- 98 I propose to proactively release this paper on the Ministry's website, subject to redactions as appropriate under the Official Information Act 1982, once consultation has begun.

## Recommendations

The Minister of Climate Change recommends that the Committee:

- 1 **note** that amendments to the Climate Change (Auctions, Limits, and Price Controls for Units) Regulations 2020 are required to update NZ ETS limit and price control settings and extend them to 2028
- 2 **note** that timeframes are compressed as the amendments to the Climate Change (Auctions, Limits, and Price Controls for Units) Regulations 2020 are required to be made by 30 September to meet statutory requirements
- 3 **note** that the Climate Change Commission has provided advice on unit settings for the years 2024 to 2028
- 4 **note** that the advice from the Climate Change Commission must be considered when making updates to unit settings
- 5 **note** there is a statutory requirement for public consultation before making amendments to unit settings

### *Limits settings for units*

- 6 **note** that limits for units control the annual supply of units into the NZ ETS, other than units transferred for 'emissions removal activities' such as forestry
- 7 **note** that the impacts of the volume of privately owned units and required secondary market liquidity are key considerations in setting these limits and auction volumes

### *Price control settings for units*

- 8 **note** that price controls provide the government with a mechanism to help manage unacceptably low or high prices in the NZ ETS
- 9 **note** that price controls can also enable businesses to develop long-term expectations of their costs of participating in the NZ ETS to better inform their investment decisions and business planning

### *Impacts of unit prices*



10 **note** that NZU prices directly affect electricity, petrol, and natural gas prices. At prices of \$75, this is estimated to have the following impacts:

10.1 1.7-2.9c/kWh on residential electricity (approximately ten percent of cost)

10.2 23c/l for diesel (just over ten percent of cost)

10.3 20c/l for petrol (around eight percent of cost)

11 **note** that NZU prices also affect the ability of industrial allocation to prevent emissions leakage – the risk of New Zealand companies losing market share or shifting overseas to avoid emissions pricing

12 **note** that at some price point the industrial allocation settings become insufficient to prevent emissions leakage

13 **note** that NZU prices affect land-use decisions, including afforestation

#### *ETS Review and permanent forestry*

14 **note** that the Government is progressing other work considering changes to the NZ ETS

15 **note** that this includes undertaking a review on the balance of gross- and net-emissions reductions incentivised by the NZ ETS, and considering redesign of NZ ETS permanent forestry settings

16 **note** that decisions on the balance of gross- and net-emissions reductions, and forestry settings within the NZ ETS could have significant implications on NZ ETS unit settings in future

17 **note** that public consultation for the review of the NZ ETS is expected to commence after consultation on NZ ETS unit settings is completed

#### *Content of Climate Change Commission advice*

18 **note** that the Commission has highlighted the prioritisation of gross emissions reductions to meet emissions budgets and 2050 emissions targets

19 **note** that this advice is being considered in the review of the NZ ETS

20 **note** that the Commission concludes that NZ ETS settings are not the appropriate tool for managing distributional and other equity considerations in the just transition

21 **note** that the Commission's recommendations on price control settings drew heavily on the prices needed to deliver gross emissions reductions that reflect the aggregate of sector sub-targets referenced in table one of the ERP

### *Consultation*

22 **agree** to release the attached discussion document, *Annual updates to NZETS Limits and Price Control Settings for Units 2023*, to support consultation on updates to these settings

23 **agree** that I can make minor design, editorial and technical changes to the consultation document as needed prior to its release

24 **note** that I will seek policy decisions and Cabinet approval for issuing drafting instructions for amendment regulations in August.

Authorised for lodgement

Hon James Shaw

Minister of Climate Change

**Appendix: Discussion document - *Annual updates to NZ ETS limits and price control settings for units 2023***



# Draft Cabinet Paper: Approval to consult on the annual update to New Zealand Emissions Trading Scheme unit limit and price control settings

Date Submitted:	3 April	Tracking#: BRF-2992	
Security Level	Policy and Privacy In-Confidence	MfE Priority:	Urgent

	Action sought:	Response by:
Hon James SHAW, Minister of Climate Change	<p><b>Provide</b> feedback on the attached documents</p> <p><b>Meet</b> with officials to discuss your feedback and next steps in the process</p> <p><b>Note</b> that prior to lodging, the consultation document will be formatted and edited to the required standard for publication</p>	Wednesday 5 April

Actions for Minister's Office Staff	<b>Return</b> the signed report to MfE.
Number of appendices and attachments #3	<ol style="list-style-type: none"><li>1. Draft Cabinet paper: <i>Approval to consult on annual update to New Zealand Emissions Trading Scheme limits and price control settings for units 2023</i></li><li>2. Draft consultation document: <i>annual update to New Zealand Emissions Trading Scheme limits and price control settings for units 2023</i></li><li>3. Requirements for regulation</li></ol>

## Key contacts

Position	Name	Cell phone	1st contact
Principal Author	Dave Hodson		
Responsible Manager	Kate Whitwell	022 137 5939	../
Director	Melody Guy		

# Draft Cabinet Paper: Approval to consult on the annual update to New Zealand Emissions Trading Scheme limit and price control settings for units

## Key Messages

1. This briefing seeks your feedback on the draft Cabinet paper *Approval to consult on the annual update to New Zealand Emissions Trading Scheme limit and price control settings for units* (Attachment 1) and draft consultation document *Annual update to New Zealand Emissions Trading Scheme limit and price control settings for units 2023* (Attachment 2).
2. The options in the draft discussion document attached are informed by preliminary advice included in the Commission's final board paper provided to MfE on Tuesday 21 March and an early draft of the final advice received 28 March.
3. You received the Commission's full advice on 31 March. We will review the final advice and incorporate any further changes into later versions of the discussion document as required.
4. The analysis underpinning much of the Commission's advice is similar to the advice it provided in 2022. However, there are some significant changes to the recommendations for auction volumes and limits based on some additional calculation steps.
5. Your feedback is required now so the Cabinet paper and discussion document can be lodged by 3 May 2023 for consideration at the Cabinet Economic Development Committee (DEV) on 10 May.
6. Review, including legal review, of these draft documents has been limited as we have had to bring forward delivery by a week from what had been previously communicated to you. We have incorporated the Commission's draft final advice into these papers as thoroughly as has been possible since receiving it late on Tuesday 28 March.
7. Timeframes remain tight, and decisions will need to be made quickly to ensure that amendments to regulations are made by 30 September.
8. s9(2)(f)(iv)

## Recommendations

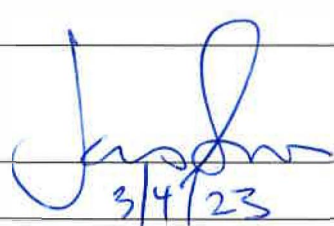
We recommend that you:

- a. **Note** options presented in the draft discussion document include the Commission's recommendations

- b. **Note** the draft Cabinet paper and discussion document have not yet been circulated to agencies for feedback and that this is intended to occur in the week starting 3 April
- c. **Agree** to the draft discussion document and Cabinet paper being circulated to agencies from 3 April ahead of publicly releasing the Commission's advice Yes/No
- d. **Agree** to table the Commission's advice early next week Yes/No
- e. **Note** that we intend to follow the standard process for market sensitive announcements for the public release of the Commission's advice
- f. **Provide** feedback on the draft Cabinet paper and discussion document by 5 A tyP<f
- g. **Note** that Ministerial consultation needs to be underway by 13 April.
- h. **Note** that prior to lodging, the discussion document will be formatted and edited to the required standard for publication
- i. **Note** that the timeline for this work remains constrained and there is no room for slippage

j. s9(2)(f)(iv)

## Signature

Melody Guy Director Climate Change Directorate	
Hon James SHAW, Minister of Climate Change	
Date	3/4/23

## Purpose

9. This briefing seeks your feedback on the draft Cabinet paper *Approval to consult on annual update to New Zealand Emissions Trading Scheme limits and price control settings for units 2023* (Attachment 1) and draft discussion document *Annual update to New Zealand Emissions Trading Scheme limits and price control settings for units 2023* (Attachment 2).

S9(2)(f)(iv)

## Context

### *NZ ETS unit settings*

11. Limits for units describe the volume of new NZUs the Government can provide to the market annually, other than units transferred for removal activities, which are unlimited. Price control settings provide the government with a mechanism to help manage unacceptably low or high prices in the NZ ETS.
12. Updates to unit setting regulations are required annually to ensure that, at all times, they cover each of the next five calendar years. This requires amendment regulations that must be made this year for the period 2024-2028. The Climate Change Commission (the Commission) provided advice on these settings, and this advice must be considered when making these updates.
13. Updates to unit settings for 2024 and 2025 cannot be made except under special circumstances as outlined in section 30GB(S) of the Climate Change Response Act 2002. In 2022, updates to 2023 and 2024 were enabled by both the setting of emissions budgets and the sale of units from the cost containment reserve. This year, neither of these have occurred. However, other circumstances including significant changes to any of the matters that must be considered when updating unit settings<sup>1</sup>, can be enough to justify updating settings for 2024 and 2025.
14. This is the third year that these settings will be updated since they were prescribed in regulations in 2020, and the second since emissions budgets were set.
15. The Commission is required to give you formal advice on these unit settings on an annual basis. The Commission's advice is one of the matters that must be considered as part of updating these settings. A preliminary paper outlining likely recommendations was provided to officials on 21 March, and a draft of the final advice was provided on 28 March. The final advice was provided to you on 31 March.

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<sup>1</sup>These are listed in (5) and (6) in Appendix 3

s9(2)(f)(iv)

## Analysis and advice

### *Summary of Commission recommendations*

17. The analysis underpinning much of the Commission's advice remains similar to that provided in 2022. However, there are some significant changes to the recommendations for auction volumes and limits based on some additional calculation steps. Areas of difference include:

- a. A recommendation to retain status quo settings for 2024 and 2025 unless the CCR is triggered.
- b. Adjustment to the proportion of emissions budgets allocated to the NZ ETS (referred to by the Commission as the 'ETS cap') to reflect the Commission's estimates of afforestation rates and the impacts of increasing area of forest land registered in the ETS.
- c. Changes to the stockpile adjustment reduction calculations to address any discrepancies that might result from adjustments to limits that have not occurred or are unable to occur due to restrictions on updating unit settings for 2024 and 2025.
- d. Minor updates (ranging from \$1-\$3) to the auction reserve price and CCR trigger price recommendations to reflect updated inflation projections from the Treasury's December 2022 Half Yearly Economic and Fiscal Update.

18. Additional option sets are provided for the situation where the CCR volume is sold at the June auction. These option sets may also be relevant if unit settings for 2024 and 2025 can be updated for other reasons, and they are therefore presented in the discussion document.

*We recommend tabling the Commission's advice as soon as possible*

19. You are required to table the Commission's advice within ten working days of receiving it.
20. We recommend that you do this as soon as possible following the Commission providing you with its advice. We intend to follow the standard process for market sensitive announcements for the public release of the Commission's advice.



*It is unclear whether updates to settings for 2024 and 2025 should occur*

21. The Commission has recommended that status quo unit settings are retained for 2024 and 2025 unless sale of units from the cost containment reserve occurs during 2023.
22. Elsewhere in its advice, the Commission has identified what it considers a significant change to the anticipated volumes of greenhouse gas emissions to which the emissions trading scheme does not apply. A significant change here would allow you to amend unit settings for 2024 and 2025 if you are satisfied that this is justified. The Commission is silent on this in its advice.
23. We have not yet reached an agency position on whether this change is sufficient to justify amendments to unit settings for 2024 and 2025. We will provide further advice on this when we provide an updated copy of the Cabinet paper and discussion document.

*New approaches to calculating auction volumes*

24. The Commission has recommended three changes to calculations used to generate current auction volumes. These changes are to:
  - a. Apply advice from last year to adjust auction volumes in response to a technical discrepancy between emissions reported in the NZ ETS and then greenhouse gas inventory
  - b. Vary the approach to apportioning emissions budgets to NZ ETS and non-ETS covered sectors
  - c. Add a stockpile adjustment step that seeks to address predicted future impacts of decisions made in 2022 or delays in implementing changes in future.
25. The first of these was expected, as it repeats advice provided previously.
26. The second and third suggested changes were unexpected and relate largely to forestry. We expect they may elicit significant feedback.
27. Officials have identified possible gaps in the analysis, evidence, and assumptions made by the Commission in arriving at these latter two recommendations. Feedback from agencies, in particular MPI and the Treasury, and via public consultation will be critical to our assessment of these recommendations.

*The Commission continues to consider gross emissions reductions as a key input to its advice on price settings*

28. The Commission's decision to consider gross emissions reductions in its previous advice on unit settings remains unchanged for its advice in 2023. The established target level of gross NZ ETS emissions remains in place. This is based on its demonstration path and aligns with the sector sub-targets described in Table 1.2 of the emissions reduction plan (ERP).

29. This approach was controversial last year and responses from submitters were polarised. We expect the similar feedback this year due to differing opinions among stakeholders regarding the purpose of the ETS.
30. Recommendations on NZ ETS unit settings are required to be in accordance with emissions budgets, New Zealand's Nationally Determined Contribution under the Paris Agreement (NDC), and 2050 emissions targets. These are all set in reference to net emissions.
31. The ERP sub-sector targets were not intended to be used as gross emissions reductions targets but rather as indicators for the progress of different sectors reducing emissions. Concerns about this approach taken by the Commission was a common theme of feedback from agencies last year.
32. If any changes are made to the NZ ETS in future, as a result of the ETS review, it would be appropriate to update NZ ETS unit settings, as required, to reflect such changes. Updating unit settings now with reference to gross emissions reductions is pre-empting decisions that have not yet been made, and does not reflect requirements in current legislation.

*The Commission has reiterated its position that impacts of emissions pricing should be addressed by complementary measures*

33. Impacts on households and the economy are required to be considered as part of making recommendations on price control settings. Emissions pricing has a direct impact on energy prices, household costs, and the ongoing viability of emissions-intensive trade-exposed firms.
34. The primary intended purpose of price control settings is to help manage unacceptably low or high prices in the NZ ETS. What determines acceptability is the level, scale, and types of impacts that these prices cause, including on the ability to meet emissions budgets and targets.
35. The Commission has presented a contrary view. The Commission has, as required, considered the impact of prices on households and the economy. Having considered these impacts, as well as the nature of the NZ ETS as a market mechanism, its view is that these impacts should not be a primary determinant for the NZ ETS price control settings.
36. Although price controls aren't the place to address household and economic impacts of higher prices, they are the place to limit these impacts occurring. This is achieved by setting automatic mechanisms to dampen prices if they reach unacceptably high levels.

*Feedback is being sought as part of the consultation process*


37. Input from agencies is expected to improve and clarify both the Cabinet paper and the consultation document. We aim to largely address this feedback prior to ministerial consultation, while noting that further feedback may also come in during this period.
38. As noted above, you must be satisfied the limits and price control settings are in accordance with the emissions budgets and NDC applying to 2024-2028, and the 2050

target. However, they need not strictly accord if you are satisfied the discrepancy is justified, after considering the other matters required to be considered.

39. These other matters include the impact of emissions prices and households and the economy (when setting the price control settings). You must also consider the matters set out in Attachment 3 to this briefing. Detail on consideration of these matters will be provided as part of the consultation report-back. There is also reference to these matters in the assessment of options in the attached draft consultation paper.

40. In addition, under s SZN the emissions reduction plan and emissions budgets for future periods can also be considered when making these decisions. Further advice on these matters will be provided to you following consultation.

s9(2)(f)(iv)



## Other considerations

### *Consultation and collaboration*

48. The drafts of the consultation document and Cabinet paper will be circulated for agency feedback in the week starting Monday 3 April with feedback expected in time to inform the next draft of these papers that we will provide to you.

### *Risks and mitigations*

49. There are significant timing risks associated with delivering the regulation updates this year. We have briefed you on this previously [BRF-2637: *Annual updates for New Zealand Emissions Trading Scheme regulations - topics and timing*]. This risk can be partially mitigated by notifying the consultation through appropriate channels, providing clear information to support understanding of the proposals, and actively seeking the views of significant stakeholders before and during the consultation period. The Ministry will provide further advice setting out a consultation plan to assist in meeting these requirements.
50. Feedback during ministerial and agency consultation could further affect delivery timeframes.

### *Legal issues*

51. s9(2)(h)

52.

### *Financial, regulatory and legislative implications*

53. There are no financial, regulatory and legislative implications associated with the proposals in this briefing note. Regulatory amendments will be required to implement the proposals. Drafting approval for these will be sought at the time of policy decisions in August 2023. The Climate Change (Auctions, Limits, and Price Controls for Units) Regulations 2020 will need to be amended to update the prescribed unit settings. Financial implications of any updates proposed will be provided in the post-consultation report back Cabinet paper seeking policy decisions.

## Next steps

54. Indicative timelines are provided in the table below. Decisions will need to be made quickly to enable the legislative deadline to be met.

**Table 1: Indicative timelines for this work**

Commission advice provided to you/draft discussion document and Cabinet paper provided to you	31 March/3 April
Updated Discussion document and Cabinet paper provided for approval to commence Ministerial consultation	Wednesday 12 April
Ministerial consultation	13-27 April
Lodgement	4 May
Paper considered at DEV	10 May
Public consultation	17 May-16 June
Draft policy decisions Cabinet paper to Minister	6 July
Ministerial consultation	11-25 July
Policy decisions considered at ENV	3 August
PCO drafting, draft LEG paper to Minister	To be advised
Ministerial consultation (5 days)	To be advised
Paper considered at LEG	To be advised
Statutory deadline - making of amendment regulations	30 September

# **Attachment 1: Draft Cabinet paper: Approval to consult on proposed changes to New Zealand Emissions Trading Scheme limit and price control settings for units 2023**

## **Attachment 2: Draft consultation document: Proposed changes to New Zealand Emissions Trading Scheme limit and price control settings for units 2023**

ATTACHMENT WITHHELD - ALREADY PUBLICLY AVAILABLE

## Attachment 3: Requirements for regulations

### Climate Change Response Act 2002, section 30GC Requirements for regulations about limits and price control settings for units (excerpt)

- (2) The Minister must be satisfied that the limits and price control settings are in accordance with-
- (a) the emissions budget, and the nationally determined contribution for New Zealand under the Paris Agreement, that applies to -
    - (i) the period for which the limits or price control settings are being prescribed; or
    - (ii) any period after that, if a budget or contribution exists for that period; and
  - (b) the 2050 target.
- (3) However, they need not strictly accord with the budgets or contributions as long as the Minister is satisfied that the discrepancy is justified, after considering the other matters under this section.
- (4) The Minister must consider-
- (a) the main matters; and
  - (b) the additional matters, but only in relation to the price control settings.
- (5) The main matters are as follows:
- (a) the projected trends for New Zealand's greenhouse gas emissions in the 5 years after the current year, including-
    - (i) the anticipated volumes of greenhouse gas emissions to which the emissions trading scheme applies (meaning emissions for which participants are required to submit returns or surrender units under this Act); and
    - (ii) the anticipated volumes of greenhouse gas emissions to which the emissions trading scheme does not apply;
  - (b) the proper functioning of the emissions trading scheme;
  - (c) international climate change obligations and instruments or contracts that New Zealand has with other jurisdictions to access emissions reductions in their carbon markets;
  - (d) the forecast availability and cost of ways to reduce greenhouse gas emissions that may be needed for New Zealand to meet its targets for the reduction of emissions;
  - (e) the recommendations made by the Climate Change Commission under section 5ZOA;
  - (f) any other matters that the Minister considers relevant.
- (6) The additional matters are as follows:
- (a) the impact of emissions prices on households and the economy;
  - (b) the level and trajectory of international emissions prices (including price controls in linked markets);
  - (c) inflation.