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16 August 2022

Climate Change Commission releases advice on Emissions Trading Scheme unit limits and price control settings for 2023 - 2027

The Climate Change Commission has recommended changes to the way volume limits and prices are set in order to accelerate New Zealand's decarbonisation.

With New Zealand's proposed climate change policies and targets being set out in the recently released Emissions Reduction Plan (**ERP**), the Climate Change Commission (**Commission**) has provided its advice on how certain settings of the Emissions Trading Scheme (**ETS**) can be tweaked to better facilitate the policies and targets set out in the ERP.

The Commission's suggested changes also aim to reduce the surplus of approximately 144 million units that have been stockpiled in private accounts, and which may undermine the Government's ability to meet its future emissions budgets.

The Commission has recommended:

- a seven-step approach to determining the volume of units available at auction each year, intended to strike the balance between a suitable price signal to achieve our emissions budgets, while also creating demand that may spur the stockpiled units to be sold;
- increasing auction reserve prices, to mitigate the risk of surplus units driving the price down too low; and
- implementing a new two-tier system for trigger the cost containment reserve units, with both trigger prices being significantly higher than currently.

Advice on setting auction unit limits

Methodology to apply

The following seven step method is recommended to determine unit limits in a given year:

1. Consider New Zealand's national targets.
2. Allocate the emissions budgets between ETS and non-ETS sectors.
3. Make technical adjustments.
4. Account for free unit allocation volumes.
5. Set a target reduction volume to address the unit surplus.
6. Set the approved overseas unit limit.
7. Calculate the auction volume and assess sensitivity and risks.

The following key points can be drawn out of the Commission's suggested method.

Approved overseas units should be disregarded until further certainty is available

The Commission recommends that approved overseas units should be disregarded when setting unit limits, given that there is currently no certainty as to when these will be available.

Allocation of emissions budgets between ETS and non-ETS sectors

In order to calculate the appropriate emissions budget volume to allocate to the ETS, the Government must also calculate the appropriate volume to allocate to non-ETS sectors.

Currently, the Government allocates emissions volume to non-ETS sectors from the expected gross emissions based on current policy settings, not based on those sectors' targets in the ERP (which are substantially lower than those calculated from projections based on current policies).

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The Commission recommends that the predicted emissions of non-ETS sectors be calculated based on those sectors' sub targets specified in the ERP. This will prevent the ETS sector from having to compensate for non-ETS sectors failing to meet their targets.

Set a reduction volume to address the unit surplus

Currently, there is an estimated surplus of 144 million NZUs stockpiled in private accounts from previous years. The existence of this surplus risks undermining the Government's future emissions budgets, as these NZUs may be released into the market at any time at their owners' election.

The Commission recommends that this surplus be reduced by 2030. To achieve this, the Government should reduce auction volumes to incentivise the trading of the surplus units. These reductions should be in equal proportions each year from 2023 to 2030.

Suggested auction volumes

Units (millions)	2023	2024	2025	2026	2027	Total
Step 1: accord with emissions budgets and NDC	73.6	72.1	69.7	66.5	63.9	**345.9**
Step 2: allocate the emissions budget	-41.3	-41.0	-41.0	-40.3	-40.2	**-203.9**
Step 3: technical adjustments	-1.6	-1.4	-1.3	-1.3	-1.3	**-7.0**
Step 4: free allocation	-6.4	-6.3	-6.3	-6.2	-6.1	**-31.3**
Step 5: surplus reduction	-8.0	-7.7	-7.1	-6.5	-5.9	**-35.2**
Step 6: international unit limit	0.0	0.0	0.0	0.0	0.0	**0.0**
Step 7: planned NZU auction volumes	**16.3**	**15.6**	**14.0**	**12.2**	**10.4**	**68.5**

Source: Climate Change Commission

Advice on price controls

The price of units represents a price signal that is intended to encourage emitters to make low emissions choices and investment decisions.

It is important that the price is not too low, so that simply purchasing units rather than reducing emissions is not the best economic decision for emitters. Similarly, the price cannot be too high, or rise too fast, as it may cause emitters to simply shift offshore where they will face lower costs for the same practices (known as "emissions leakage").

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There are two price controls available to the Government in order to try and drive this cost signal:

- the cost containment reserve; and
- the auction reserve price.

The Climate Commission has made recommendations about both of these controls.

Auction reserve price

Unit prices have traded well above the auction reserve price ever since the introduction of the ETS, so there have not yet been any practical issues with the reserve prices to date (the most recent reserve price being $30 in June 2022, with the clearing price being $76).

The Commission believes that the reserve prices are currently tracking too low to adequately address the risk of potential future market oversupply should the privately held units be sold. Should the surplus units re-enter the market in bulk, the increased supply may significantly reduce the auction clearing price.

To address this, the Commission recommends that the reserve price simply be increased to align with a price path compatible with achieving our emissions budgets.

Cost containment reserve

The cost containment reserve (**CCR**) is a volume of units that is released when an auction trigger price is reached.

The CCR was adopted as a mechanism to prevent unsustainably high unit prices. It was intended to be used in extreme situations and only triggered rarely (if at all). However, the CCR has been triggered in half of the last six auctions, resulting in an additional 14m units being added to the market (despite the pre-existing surplus).

The Commission suggests that the CCR:

- be split into two tiers; and
- starting in 2023, the lower tier be triggered at $171 and the higher tier at $214.

The proposed increases are significant when compared with the CCR price for the next auction in September 2022, being $70. The increases would send a strong signal to the market about the desired price of units.

The intended effects of these proposals include that:

- as demand for units increases, there is more leeway for the true market price to be reached before adding extra supply; and
- assuming that prices rise, holders of the surplus units may be incentivized to sell.

Should the Commission's CCR recommendations be adopted, it expects that decarbonisation will be greatly accelerated.

Conclusion

It is yet to be seen whether the Government will adopt any or all of the Commission's recommendations. Based on the Governments previous record of accepting the Commission's advice, it is likely, however, that many of its suggestions will be adopted.

Want to know more?

If you have any questions about carbon trading, please contact our specialist carbon trading, emissions trading scheme and climate change team.