

**Report on reasons for differences between
prescribed NZ ETS limits and price control
settings for units and the Climate Change
Commission's advice on these settings**

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Purpose

This report sets out the reasons for differences between the Climate Change Commission's (the Commission's) advice on limits and price control settings for units in the New Zealand Emissions Trading Scheme (NZ ETS unit settings) and the settings that are being prescribed.

Section 30GC(7) of the Climate Change Response Act 2002 (the Act) requires preparation of a report on the reasons for these differences.

Context

NZ ETS limits for units cap the supply of emissions units into the NZ ETS, other than New Zealand Units (NZUs) transferred for removal activities (e.g., for carbon sequestration by forests).

NZ ETS price control settings for units apply at NZ ETS auctions. They regulate the supply of NZUs at the auction clearing price. This additional or decreased supply is intended to affect NZU prices in the secondary market. The purposes of price controls are to:

- manage the risk of the NZU price at auction being inconsistent with what is required to meet emissions budgets and targets (including New Zealand's Nationally Determined Contributions)
- mitigate against unacceptably high and low prices and the risk of aberrant price spikes; and
- signal the upper and lower bounds of expected prices in the NZ ETS for the next five years.

Regulations prescribing limits and price control settings for units need to be amended each year. This is to meet the requirement that, at all times, settings are in place for each of the following five calendar years. Settings for earlier years can be updated in defined circumstances.

The prescribed NZ ETS settings for units differ from recommendations made by the Commission under section 5ZOA of the Act. This report describes the reasons for the differences.

Limits for units

The calculation of limits is dependent on first calculating auction volumes for each year, which itself involves a series of steps. The calculation of limits is also dependent on the decision on the volume of units prescribed in the cost containment reserve, and projections of units to be transferred for industrial allocation.

There is a single point of difference between the Commission's calculation steps and those used to inform the NZ ETS unit setting. This difference is in the treatment of an observed discrepancy between emissions reported into the NZ ETS and those reported in New Zealand's Greenhouse Gas Inventory.

The Commission recommended reducing auction volumes by the amount of this discrepancy in a technical adjustment step. This had flowed on to a reduction in the limits for units recommended by the Commission.

There is uncertainty regarding whether a reduction is appropriate. A decision on this is finely balanced. Due to the significant reduction in auction volumes, compared to the status quo, that this adjustment would result in, as well as the level of uncertainty, the limits in the NZ ETS unit settings do not include this adjustment.

It is expected that officials will work to identify the origin of this discrepancy so that a decision based on full information can be made when setting limits for units next year.

The limits for units incorporate all other calculations, including the stockpile adjustment approach, recommended by the Commission. The calculations for all years are shown in Appendix One, with the single difference highlighted.

Price control settings for units

Price control settings consist of:

- a lower price control, the auction reserve price (the minimum price below which units cannot be sold by auction)
- an upper price control, the cost containment reserve (CCR) (the trigger price for the release of a reserve amount of units)

Auction reserve price

The Commission’s advised auction reserve prices and those prescribed in regulations are compared in the table below.

Table 1: Auction reserve prices advised by the Commission compared to those recommended to be prescribed in regulations

	2023	2024	2025	2026	2027
Recommended	\$33.06	\$35.90	\$38.67	\$41.45	\$44.35
Commission’s advice	\$60.00	\$64.00	\$68.00	\$71.00	\$75.00

Cost containment reserve

The Commission’s advised CCR settings compared to those prescribed in regulations are described in the table below. In addition to the trigger prices and reserve NZU volumes, these regulations prescribe a single tier or multiple tiers CCR structure.

Table 2: CCR trigger prices and volumes advised by the Commission compared to those recommended to be prescribed in regulation.

Cost containment reserve	2023	2024	2025	2026	2027
Recommended					
Trigger price	\$80.64	\$91.61	\$103.24	\$115.84	129.97
Volume	8.0	7.7	7.2	6.5	5.9
Commission’s advice					
Tier 1					
Trigger price	\$171.00	\$182.00	\$193.00	\$203.00	\$214.00
Reserve volume, million NZUs	2.9	2.8	2.6	2.3	2.1
Tier 2					
Trigger price	\$214	\$228	\$241	\$254	\$268
Reserve volume, million NZUs	5.1	4.9	4.6	4.2	3.8
Total reserve volume, million NZUs	8.0	7.7	7.2	6.5	5.9

The price control settings adopted some of the Commission’s advice

The Commission recommended setting the CCR volume as equal to the stockpile adjustment amount used in the calculation of auction volumes. The NZ ETS unit settings took this approach.

The Commission recommended that annual increases to auction reserve and CCR trigger prices reflect updated projections of inflation. The settings in amendment regulations did this.

The price control settings differed from those advised by the Commission

As can be seen above, the price components of the price control regulation settings, vary from those advised by the Commission. Instead, they reflect the status quo, although adjusted to account for higher-than-expected inflation and extended to include settings for the 2027 year.

As the Minister of Climate Change, I have decided to prescribe these regulations following discussion at Cabinet.

There are two key reasons for these differences:

1. Increasing the upper price control settings (the CCR) may not mitigate any “magnet effect”¹ on market NZU prices.
 - a. If increasing the CCR failed to eliminate the magnet effect, then the risk existed of driving materially higher carbon prices in the short-term.
 - b. If NZU prices were to increase to levels approaching the Commission’s recommended CCR trigger prices, this could abruptly increase household costs through higher fuel and electricity prices.
2. The Government’s equitable transition strategy and associated policies to address the distributional impacts of potentially higher NZU prices in the future are still being developed.
 - a. The risk exists that, if increasing the upper price control exacerbated the magnet effect and lead to materially higher prices in the short term, then there would be insufficient policy settings in place to mitigate the immediate impact on household costs.²

¹ The “magnet effect” refers to a possible unintended effect of price controls settings, where market NZU prices are attracted to the level of the CCR trigger price prescribed at the time, rather than true price discovery based on supply and demand floating somewhere between the lower and upper price controls.

² Sections 30GC(6)(a) and 30GC(6)(c) require that the impacts of emissions prices on households and the economy, and inflation are considered when recommending price control settings for units.

Appendix One: Calculation of auction volumes and limits for units – recommended settings and Commission’s advice compared.

Step	2023		2024		2025		2026		2027	
	Commission advice	Amendment regulations	Commission advice	Amendment regulations	Commission advice	Amendment regulations	Commission advice	Amendment regulations	Commission advice	Amendment regulations
Accord with emissions budgets and NDC	73.6	73.6	72.1	72.1	69.7	69.7	66.5	66.5	63.9	63.9
Allocate emissions budget, subtract emissions not covered by NZ ETS	-41.3	-41.3	-41	-41	-41	-41	-40.3	-40.3	-40.2	-40.2
Technical adjustments	-1.6	0	-1.4	0	-1.3	0	-1.3	0	-1.3	0
industrial (free) allocation	-6.4	-6.4	-6.3	-6.3	-6.3	-6.3	-6.2	-6.2	-6.1	-6.1
surplus reduction = CCR volume	-8	-8	-7.7	-7.7	-7.2	-7.2	-6.5	-6.5	-5.9	-5.9
Planned NZU auction volumes	16.3	17.9	15.6	17.1	14	15.3	12.2	13.5	10.4	11.7
New Zealand units available by auction (millions) - auction volume + CCR volume	24.4	25.9	23.3	24.8	21.1	22.5	18.7	20	16.3	17.6
Overall limit on units (millions) - auction volume + CCR volume + industrial allocation projection	30.8	32.3	29.6	31.1	27.4	28.8	24.9	26.2	22.4	23.7