

EMILY J. SPEARS AND LOH HAO MING

# NEW ZEALAND'S EMISSIONS TRADING SYSTEM: THE THIRD REVIEW

The New Zealand Emissions Trading Scheme (ETS) has been fully operational since July 2010. Since its inception, the NZ ETS has seen its share of highs and lows, but it is widely acknowledged that despite accounting for just 0.15% of global emissions, New Zealand continues to exhibit true leadership internationally with respect to the development of carbon markets.

After reaching lows of NZ\$1.55 in 2013, New Zealand Unit (NZU) prices have well-and-truly rebounded, rising from around NZ\$8.50 at the end of 2015 to nearly NZ\$19 at the end of September 2016.

With an increased price comes a renewed interest from foresters (who can generate NZUs) and liable entities, however regulatory uncertainty and key fundamental traits still warrant caution. And, while some recent announcements have created more optimism in the market, some uncertainties still exist.

## BACKGROUND

The third New Zealand Government review of the ETS is currently underway and is split into two stages. Broadly speaking, these two stages could be considered to be split into demand side reform (stage one) and supply side reform (stage two).

In initiating the scheduled review, Ministry for the Environment officials were quite candid about the ETS' impact to date, reporting that "research for this evaluation, and evidence from the interviews, found no sector other than forestry made emissions reductions over the first Kyoto Protocol Commitment Period One (2008-12) that were directly caused by NZ ETS obligations". This was further enforced by Climate Change Minister Paula Bennett's repeated comments "it is abundantly clear that if the ETS is going to work, carbon must cost more than it does right now" (February 2, 2016) and "it is clear that if this ETS is going to seriously change

**TABLE 1:  
GOVERNMENT REVIEW OF THE ETS**

<p><b>STAGE 1: PRIORITY ISSUES</b></p>	<p>Stage one addressed two linked priority issues that were considered candidates for legislative change in 2016:</p> <ol style="list-style-type: none"> <li><u>Moving to full surrender obligations</u>: potentially removing the 'two-for-one' measure which enables compliance entities to only submit one unit for every two tonnes of CO2 equivalent emitted.</li> <li><u>Managing the costs of moving to full surrender obligations</u>: whether the current price cap of NZ\$25 should be changed (lifted or lowered) or removed.</li> </ol> <p>Note: Both the two-for-one and the price cap were initially introduced as transitional measures. They were widely expected to be removed in the 2011 ETS review but were instead extended indefinitely.</p>
<p><b>STAGE 2: OTHER ISSUES</b></p>	<p>Stage two considered other less urgent matters to help frame the future direction of the NZ ETS including free allocation, managing unit supply, issues related to forestry, international units, selling NZUs by auction and managing price stability.</p>

behaviour, the price of carbon needs to be higher than it is now" (April 26, 2016).

## UNDERSTANDING THE CONTEXT

While the objective of the Government to increase the carbon price signal appears clear, understanding its motives to do this yields insights into the deeper intricacies of this market.

It is important to note that a legacy from unlimited access to relatively cheaper international units remains. Until May 2015 ETS participants could utilise international units - whose prices fell to as low as approximately NZ \$0.10 - and bank their domestic NZUs that were allocated either freely or for sequestration activities during that same compliance period.

The arbitrage resulted in significant accumulation of NZUs, with Government estimates of current NZU holdings at around 140 million units, some seven times the total market size of today. However, understanding the exact volume of these holdings available to market is difficult, as the decision factors for these holders, for example if they are required for future harvest, are not necessarily known to the Government or market participants.

## DEMAND-SIDE REFORM

The stage one priority consultation on demand-side reform has already been concluded. On 26 May 2016, the New Zealand Federal Budget was released, confirming that the two-for-one measure would be phased out over the next three compliance years.

**TABLE 2:  
NZ ETS MARKET SIZE**

	2016	2017	2018	2019
Estimated Market Size (~mt)	19.6	26	33	40

## NEW ZEALAND CONTINUES TO EXHIBIT TRUE LEADERSHIP INTERNATIONALLY WITH RESPECT TO THE DEVELOPMENT OF CARBON MARKETS.

This means compliance obligations will increase from 50% in 2016 to 67% in 2017, 83% in 2018 and from 2019 full one-for-one surrender obligation will be restored. The fixed price compliance option of NZ\$25 was retained. Using the most recent ETS ‘Facts and Figures’ report (2014) market size (excluding forestry) is expected to grow as shown in Table 2.

The phase-out of the two-for-one compliance obligation was largely expected by the market, and the additional 60 million tonnes of compliance demand over the period 2018 to 2020 should, in theory, amount to a much tighter market than before. However, while industrial obligations will double over the next three years, so too will the free allocations made to industry, so while the excess supply of NZUs will reduce, it will likely be by a slower rate than the increase in demand shown in Table 2.

In the absence of clarity on exact timelines and specifics of phase two and the associated supply-side outlook, the market remains supported with onlookers forced to question whether this is due to an actual tightness of supply in the market or a lack of immediate incentives for sellers to rush to match buyers. The truth is most likely somewhere in the middle, as the volume of NZU’s held in registry accounts that are required by foresters to meet their post-2020 harvest liabilities are unknown.

## SUPPLY-SIDE REFORM

The timing and degree of supply-side reform through auctioning, international units or accounting rule changes are less well-anticipated but will have a major influence over the next five to ten year market outlook. The Government itself stated within the consultation document that “these issues require further analysis before potential solutions or approaches can be identified and considered... [and]...may need to take into account developments connected with the new [Paris] climate change agreement”.

The following provides an overview of some of the elements that could stand to significantly change the long-term structure of the ETS.

### AUCTIONING

The ability for the Government to offer further supply into the market via auctioning already exists in legislation, and the current review has confirmed that the Government remains interested in its ability to “maximise the fiscal benefits of the ETS by selling NZUs at auction”.

To be effective the Government will need to be clear on the current supply and demand balance. The new demand settings will help the Government to gain a better handle on this, but it still remains a difficult task considering that the supply and demand of the forestry sector is relatively unknown.

Just as balancing the pH in a small fish tank presents its challenges, so too is determining the amount of units to auction in a market the size of New Zealand. In any case, the potential threat of auctioning and associated supply competition to existing

holders of NZUs may be one tool the Government could use to help reduce the current balance of NZUs before 2020.

### ACCESS TO INTERNATIONAL UNITS

New Zealand has consistently acknowledged the important role that international market mechanisms can play in enhancing mitigation ambition and facilitating the delivery of mitigation contributions under the Paris Agreement. Evidence of their leadership can be seen in the New Zealand-led Ministerial Declaration on Carbon Markets which highlighted the “important role for markets in the post-2020 period”.

Governments everywhere are likely to face pressure to ensure that costs faced by business and society as a whole are not out of step with those faced by other countries. The World Bank’s 2015 ‘State of the Carbon Market’ noted that while existing carbon prices vary significantly—from less than US\$1 per tonne of CO<sub>2</sub>e to US\$130/tCO<sub>2</sub>e, the majority of emissions (85%) are priced at less than US\$10/tCO<sub>2</sub>e. With current prices of near NZ\$19 (US\$13.50) already placing Kiwi carbon in the top echelon of global carbon prices, it’s not surprising that New Zealand’s self-claimed ‘ambitious’ target of 30% below 2005 levels by 2030 remains, as stated within its Intended Nationally Determined Contribution (INDC) under the Paris Agreement, conditional on access to international markets.

Following the Paris Agreement, when considering the avenues that New Zealand could take with respect to linkage, there are two broad paths it could follow (and of course, many variations):

1. Enabling decentralised ‘clubs’ of markets to form, taking lessons from the Clean Development Mechanism (CDM) and Joint Initiative (JI) markets of the past.

## UNDER ARTICLE 5, GOVERNMENTS ARE ENCOURAGED TO “TAKE ACTION TO CONSERVE AND ENHANCE, AS APPROPRIATE, SINKS... INCLUDING FORESTS”.

In this path, markets could expand gradually through a broadening of existing markets such as EU ETS or California-Québec through the Western Climate Initiative, or other new clubs could emerge such as a one between those countries who signed the New Zealand Declaration on carbon markets. Eventually, these decentralised clubs could find linkages through common recognition of offsets or direct connections of registries.

2. Establishing a 'hub' for carbon markets at UN level and drawing together a reformed project offsetting system with an international registry.

Under Article 5, governments are encouraged to “take action to conserve and enhance, as appropriate, sinks...

including forests”. Accessing a hub of international offsets may be appealing, modelled off, for example, the Verified Carbon Standards Reduced Emissions from Deforestation and Degradation (REDD+) which places a heavy emphasis on sustainable management of forests, maintaining current forests to foster conservation, and enhancing forest carbon stocks. This would potentially support a more level playing field allowing domestic generators of NZUs to compete with offsets from a similar sector.

Either approach would need standards and rules to provide transparency and to guard against double-counting. The New Zealand Declaration on Carbon Markets demonstrates that the market need not wait on UNFCCC processes to determine the rules and guidelines of which timelines may be drawn out. Under a decentralised model, these carbon clubs may form their own rules and trading mechanisms irrespective of what happens with the implementation of Article 6.

## CONCLUSION

While the more than 220% price increase for NZUs since the start of the year, and the recent two-for-one announcement have certainly led to increased optimism for NZU generators as investment in carbon forestry once again become a credible prospect, uncertainties still exist.

The current registry stockpile and the potential for auctioning and international linkage signal that the recent price rise may not equate to a permanent price recovery. Regardless of where you sit on the supply or demand fence, the end goal is the same, and the New Zealand Government's resolve for supporting international carbon markets warrants optimism.

Despite accounting for just 0.15% of global emissions, New Zealand continues to exhibit true leadership in the emissions trading space. Through linked systems, greater emissions reductions can be achieved faster and at lower cost than if each country acts in isolation. In turn more ambitious targets can be put forward to support action at a scale equal to the 2°C challenge.

**Emily J. Spears** is emissions strategy lead, and **Loh Hao Ming** is emissions trader at BP Energy Asia.