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Ministry for the Environment  
By email: [etsconsulting@mfe.govt.nz](mailto:etsconsulting@mfe.govt.nz)

## **LCANZI submission on the ‘Proposed changes to New Zealand Emissions Trading Scheme limit and price control settings for units 2022’**

Lawyers for Climate Action NZ Inc (**LCANZI**) is a not-for-profit incorporated society and registered charity made up of almost 500 lawyers and associate members. Our goals are to:

- (a) Raise public awareness and understanding of the threat of climate change;
- (b) Advocate for legislation and policies to ensure New Zealand meets or exceeds its commitment under the Paris Agreement and achieves net zero carbon emissions as soon as possible; and
- (c) Facilitate free or reduced cost legal assistance to community groups working to fight climate change.

More information about LCANZI can be found on our [website](#).

### **1. Introduction and summary**

Thank you for the opportunity to comment on the *Proposed changes to New Zealand Emissions Trading Scheme limit and price control settings for units 2022* released in September 2022 (**Consultation Paper**).

The Emissions Trading Scheme (**ETS**) is not presently fit for purpose. That is, it is not able to fulfil its intended role as a key tool to address climate change and ensure that New Zealand meets its international obligations, the emissions budget and the 2050 target. This is for two reasons.

First, the ETS fails to impose any appreciable limit on the quantity of emissions that emitters can emit. Over half of our emissions do not require units to be surrendered (agriculture). For the remainder, the number of units available for surrender vastly exceeds the budgeted quantities of net emissions, with units available from the free allocation to certain industries, the 144m unit stockpile,<sup>1</sup> the earning of units by forestry removals, and the release of further units through auctions and the cost containment reserve.

The supposed advantage of a “cap and trade” scheme over a carbon tax is that it should provide a quantitative limit on annual emissions with the market determining the price. However, the abundance of units in our ETS means that there is no cap. All the ETS presently does is put a price on a subset of our emissions, while attempting to guide the price through a complex set of regulatory controls. If this is the only ambition for our ETS, then it would be much simpler to have an

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<sup>1</sup> As noted at pp19-20 of the Consultation Paper, the Commission considered a number of these units are unavailable to the market as they are held for specific purposes. The Commission estimated that 49m units are genuinely “surplus”. In our view, units held for future surrender obligations or as an investment still undermine the ability of the ETS to act as a cap, and accordingly the full 144m units need to be addressed.

administratively set price through a tax than to try and reverse engineer an appropriate price path through unit and price limit settings.

We refer to our [submission from February 2020](#) on these problems.

Secondly, the symmetric treatment of removals and emissions is a critical design flaw in the sense that any price high enough to drive a meaningful reduction in gross emissions cannot be achieved because a vast increase in exotic pine forestry will occur at prices below this level. It is widely accepted that we must decrease our gross emissions and not rely on offsetting our emissions through a massive increase in forestry which cannot be guaranteed to be maintained in perpetuity. We discuss this pricing problem more fully in section 2 of this submission.

These problems are fundamental and demand urgent reform of the ETS. The stockpile and other quantity failings must either be addressed, or the ETS should be replaced with a tax which would be simpler and more certain. The treatment of gross emissions and removals must also be de-coupled so that appropriate policies can co-exist for each.

We do not understand any of these propositions to be particularly controversial. Yet, they are glossed over in the Consultation Paper. Not only is there little point in tinkering with settings in light of these root problems, the delay in addressing these issues makes them more difficult to resolve.

In terms of the settings themselves, the only aspect we wish to comment on is the quantity of units made available for auction. As with the other ETS settings, auction volumes must be set in accordance with our nationally determined contribution (**NDC**) under the Paris Agreement. As explained in section 3 of this submission, given that New Zealand has not yet secured any offshore mitigation, we consider that the presently proposed auction volumes are not in accordance with our NDC.

## 2. Gross emissions versus removals

A price for carbon under the ETS ('NZU price') is a key component of the Government's strategy to address climate change.<sup>2</sup> As the Climate Change Commission (**Commission**) notes, the ETS "is designed to put a price on emissions in order to incentivise a shift to low emissions alternatives."<sup>3</sup>

The current structure of the ETS does not distinguish between emission reductions and carbon removals by forests;<sup>4</sup> the NZU price paid for a forest sequestering carbon is equivalent to the NZU price paid by an emitter of greenhouse gases. There is no limit to the number of NZUs that can be produced through removing carbon through forestry. Nor does it distinguish between different types of removal activity (for example, exotic pines or natives).

In our [April 2022 submission](#) we summarised the problem as an inability to incentivise gross emissions reductions over removals or to incentivise mitigation measures/removals with the greatest co-benefits/least negative impacts.

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<sup>2</sup> Ministry for the Environment. 2022. *Proposed changes to New Zealand Emissions Trading Scheme limit and price control settings for units 2022: Consultation document*. Wellington: Ministry for the Environment at 5.

<sup>3</sup> Climate Change Commission. 2022. *Advice on NZ ETS unit limits and price control settings for 2023-2027*. Wellington: Climate Change Commission at 67.

<sup>4</sup> Climate Change Commission. 2022. *Advice on NZ ETS unit limits and price control settings for 2023-2027*. Wellington: Climate Change Commission at 24.

The Commission, in its first report in 2021, was clear that unconstrained removals through forestry would limit New Zealand's ability to reach its climate change goals.<sup>5</sup>

An approach that does not constrain carbon removals by forests would not drive meaningful decarbonisation before 2050 and would instead use up land resources for the purpose of offsetting emissions in areas where there are proven options to reduce gross emissions.

The Commission repeated its warning in its advice on the current proposed changes to ETS pricing:<sup>6</sup>

Maintaining a common emissions price for carbon removals by forests and gross emissions reductions risks a downwards correction back to an NZU price that would be insufficient to drive meaningful decarbonisation. This would undermine investments in reducing gross emissions, erode market participants' confidence, and severely damage the scheme's effectiveness.... Without changes, future emissions budgets would likely deliver a far smaller reduction in gross emissions than currently planned by the Government in the emissions reduction plan.

In other words, the NZU price sends a signal to both those emitting carbon and those removing it via forestry. The price needed to deter emitters from sending carbon into the atmosphere exceeds the price at which forestry companies will simply plant more forests to produce and sell offsetting NZUs. The NZU price will never be high enough to change the behaviour of emitters as more and more forests will be planted.

The Commission has already found evidence that excessive afforestation, driven by the ETS, is occurring. 60,000 ha of exotic trees is expected to be planted in 2022, double the yearly rate expected in the Commission's demonstration path.<sup>7</sup>

While the ETS treats emissions and removals equally, there are substantial differences in their place in the carbon cycle. Fossil fuels are part of the slow carbon cycle, where compressed biomass has been stored underground for millions of years.<sup>8</sup> When those fuels are burned, the carbon released into the atmosphere lasts for thousands of years. In contrast, carbon captured by trees is part of the fast carbon cycle, which is measured in a lifespan and consequently the risk of reversal is high.<sup>9</sup> Trees are vulnerable to forest fires, disease and pests, and further, as the Commission has noted, "changes in climate may affect tree growth rates, increase wind throw and wildfire, and enable more pathogens to spread."<sup>10</sup> The costs of maintaining or replanting these forest carbon sinks fall on future generations, while the 'savings' of not curtailing current emissions is enjoyed by the current generation.

Increased afforestation, driven by the NZ ETS, is also problematic in terms of the social opportunity cost of locking land in to permanent forestry. While there are clear emissions benefits from converting agricultural land to forestry, this should occur in a way that takes into account the impact

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<sup>5</sup> Climate Change Commission. 2021. *Ināia tonu nei: a low emissions future for Aotearoa*. Wellington: Climate Change Commission at 91.

<sup>6</sup> Climate Change Commission. 2022. *Advice on NZ ETS unit limits and price control settings for 2023-2027*. Wellington: Climate Change Commission at 25.

<sup>7</sup> Climate Change Commission. 2022. *Advice on NZ ETS unit limits and price control settings for 2023-2027*. Wellington: Climate Change Commission at 25.

<sup>8</sup> NASA. *The Carbon Cycle*. [www.nasa.gov](http://www.nasa.gov). See also Høglund et al. 2022. *Nature restoration and carbon removal are not the same*. [www.climatechangenews.com](http://www.climatechangenews.com).

<sup>9</sup> NASA. *The Carbon Cycle*. [www.nasa.gov](http://www.nasa.gov). See also Høglund et al. 2022. *Nature restoration and carbon removal are not the same*. [www.climatechangenews.com](http://www.climatechangenews.com).

<sup>10</sup> Climate Change Commission. 2021. *Ināia tonu nei: a low emissions future for Aotearoa*. Wellington: Climate Change Commission at 316.

on rural communities. We are also concerned with the idea that land will be locked into a single use for perpetuity because of this generation's use of fossil fuels when significant reductions in gross emissions are feasible.

A second concern is the long-term economic viability of the legal owners of these permanent forests, many of which are single purpose entities. In 2021 BDO wrote a report outlining how a company could simply pay out its carbon earnings as dividends, and close up once the carbon credits ran out.<sup>11</sup> The result would be land on which rates would no longer be paid, and that could not be used for anything else, given the carbon liability of cutting down the trees.

The problem with the NZU price and forest removals receives scant attention in the Consultation Paper. That paper states that the ETS unit settings are only required to accord with the emissions budgets, NDC and the 2050 target, all of which are defined in terms of net emissions.<sup>12</sup> We note though that, according to the first emissions reduction plan, the first emissions budget "requires Aotearoa to make sustained cuts in our gross emissions."<sup>13</sup> Given the central importance of the ETS to the reduction plan, it is difficult to see how sustained cuts in gross emissions can be made without an NZU price that reduces gross emissions. The Commission confirms this.<sup>14</sup>

An NZU price high enough to accomplish gross emission reduction, however, requires a decoupling of the NZU price from removals by growing forests.<sup>15</sup> This decoupling would also assist rural communities, the intergenerational equity of the cost of reduced emissions, and New Zealand's obligations under the Paris Agreement.

In our view, the reduction of gross emissions and the incentivisation of carbon removals through forestry are separate policy goals that cannot be met by the current ETS. One way to address this defect is by removing the ability to earn units from removals so that the ETS properly controls gross emissions at price levels high enough to drive energy transformation. Forestry (and potentially other removal activities in the future) should still be incentivised, we consider that this is best achieved by payments from the Government, and that such payments are tailored to reflect co-benefits (for example, for native forests) and made on terms which ensure that removals are maintained in perpetuity rather than relying on the solvency of corporate entities. Other options should be developed and compared.

The Consultation Paper admits there is a problem with the imbalance between gross reductions and removals, and that the Commission has "repeatedly urged the Government to develop a credible response" to the issue.<sup>16</sup> Unfortunately the paper says little more about this fundamental, critical issue and it is difficult to see how the Consultation Paper can achieve an appropriate level of consultation without discussing it.

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<sup>11</sup> BDO *Report on the Impacts of Permanent Carbon Farming in the Te Tairāwhiti Region* (BDO, July 2021) at 17.

<sup>12</sup> Ministry for the Environment. 2022. *Proposed changes to New Zealand Emissions Trading Scheme limit and price control settings for units 2022: Consultation document*. Wellington: Ministry for the Environment at 27.

<sup>13</sup> Minister of Climate Change. 2022. *Te hau mārohi ki anamata. Towards a productive, sustainable and inclusive economy. AOTEAROA NEW ZEALAND'S FIRST EMISSIONS REDUCTION PLAN*. Ministry for the Environment, Wellington at 35.

<sup>14</sup> Climate Change Commission. 2022. *Advice on NZ ETS unit limits and price control settings for 2023-2027*. Wellington: Climate Change Commission at 25.

<sup>15</sup> Climate Change Commission. 2021. *Ināia tonu nei: a low emissions future for Aotearoa*. Wellington: Climate Change Commission at 240.

<sup>16</sup> Ministry for the Environment. 2022. *Proposed changes to New Zealand Emissions Trading Scheme limit and price control settings for units 2022: Consultation document*. Wellington: Ministry for the Environment at 40.

This issue must be confronted and addressed with urgency. The problem grows bigger the longer it is left. We consider that signalling that significant reform is likely to be required is important to the proper functioning of the emissions trading scheme over the medium term.

### **3. Auction volumes are legally required to be zero to be in accordance with our NDC**

The Minister cannot set auction volumes (or other limits and price control settings) unless he is first satisfied that they are in accordance with the relevant emissions budget and our NDC.<sup>17</sup>

Over the NDC period (2021-30), the NDC will require approximately 100 Mt of greenhouse gas reductions in addition to those which are built into the emissions budgets. That is, the NDC is considerably more stringent than our emissions budgets and accordingly is the governing factor in terms of this legislative requirement.

There are three broad means of achieving this:

- (a) making additional domestic reductions (and aligning ETS auction volumes to accord with this);
- (b) allowing use of approved overseas units via the ETS; and/or
- (c) purchases of offshore cooperation by the Government outside of the ETS.

The Government envisages that these additional reductions will be achieved through the purchase of offshore mitigation, but has not specified whether this would be via the ETS (as “approved overseas units” entering the scheme) or outside the ETS.<sup>18</sup> (We note for the avoidance of doubt that we consider that New Zealand is excessively relying on offshore mitigation rather than domestic reduction to show climate change action. We also note the absence of any cost benefit analysis between greater domestic ambition and purchasing offshore mitigation.)

The possibility of offshore mitigation contributing to the NDC is recognised by the Climate Change Response Act 2002. In general, the auction volumes must “strictly accord” with the NDC. However, an exception is provided where a discrepancy is justified by another relevant factor including “instruments or contracts that New Zealand has with other jurisdictions to access emissions reductions in their carbon markets”.<sup>19</sup>

What this means is that, when making the ETS settings, the Minister must be satisfied that the NDC can be met through domestic reductions — that is, by aligning ETS quantities to NDC quantities to the greatest extent possible — unless New Zealand has agreements with other countries to purchase and rely on their reductions. This applies whether or not the intention is that these are brought into New Zealand via the ETS (as “approved overseas units”) or to be used outside of the ETS.

We are not aware of any instruments or contracts that New Zealand has to access reductions from other countries. Nor are we aware of any reason to believe that such access is sufficiently certain to be taken into account at the present time.

This is consistent with the Commission’s finding that:<sup>20</sup> “There is currently no clarity about when or how access to offshore mitigation will be obtained to meet the international component of the NDC,

<sup>17</sup> Climate Change Response Act 2002, section 30GC(2)(a).

<sup>18</sup> See <https://www.newsroom.co.nz/govt-seeks-overseas-trees-to-meet-paris-climate-pledge>

<sup>19</sup> Climate Change Response Act 2002, section 30GC(5)(c).

<sup>20</sup> Climate Change Commission. 2022. *Advice on NZ ETS unit limits and price control settings for 2023-2027*. Wellington: Climate Change Commission at p34.

nor has the Government decided how the cost of offshore mitigation will be funded, or whether and how it will be allowed into the NZ ETS.”

In fact, we are not aware of any international carbon markets that have been put in place under Article 6 of the Paris Agreement.

We are also unaware of any reason to believe that sectors outside the ETS (notably agriculture) will reduce domestic emissions beyond the level indicated in the ERP to align with the domestic Budgets. The development of an agricultural pricing mechanism is aligned with delivery of these domestic targets, not their over-achievement.

Accordingly, in our view, the auction quantities must be set so that the ETS quantities align as closely as possible to the NDC quantities.

The settings recommended by the Climate Change Commission would result in around 90 Mt of units being auctioned for the remainder of the NDC period. This suggests that the closest alignment between ETS auction volumes and the NDC budget (100Mt below the currently-proposed settings) will be achieved if zero new units are made available for auction.

Given the 144m stockpile of units, there is ample scope to reduce auction volume to zero, until such a time as the government has contracted offshore mitigation. This would also assist the proper functioning of the ETS by reducing the extent of the stockpile.

We note that the Consultation Paper appears to acknowledge the potential issues and says that (at p16):

The Act requires the NZ ETS limits for units to accord with the emissions budgets, NDC and 2050 target. However, they need not strictly accord with these if the Minister is satisfied that any discrepancy is justified after considering other prescribed matters.

The Commission has recommended that: “The overall unit limit and the limit on units available by auction are set in line with the emissions budgets, as stepping-stones to the 2050 target and the Government’s intended domestic contribution to the NDC.”

This additional step has no impact on the auction volumes calculated in 2022 compared with the existing methodology.

This explanation does not, however, meet the requirements of the Act. In our view, the auction volumes must “strictly accord” with the NDC except where a departure is justified by instruments or contracts that New Zealand has with other jurisdictions to access emissions reductions in their carbon markets. This carefully calibrated legislative scheme is being overridden by the introduction of the concept of “the Government’s intended domestic contribution to the NDC”. That concept has no basis in the legislation.

We also do not consider that this is an accurate reflection of the Commission’s position: its recommended settings were on the assumption that offshore mitigation would be obtained to meet the international component of the NDC. That condition has not been met.

On the approach taken in the Consultation Paper, the references in the statute to “the Minister [being] satisfied that the limits and price control settings are in accordance with ... the nationally determined contribution for New Zealand under the Paris Agreement” and to “instruments or contracts that New Zealand has with other jurisdictions to access emissions reductions in their

carbon markets” have no effect. Instead, the Consultation Paper treats settings which are consistent with our domestic emissions budgets as being appropriate *regardless* of our NDC and *regardless* of whether we have secured any offshore mitigation.

We consider that this is an implausible interpretation as it implies that Parliament’s references to our NDC and contracted offshore mitigation were mere window dressing that was not intended to add any constraint beyond the reference to our emissions budgets.

We would expect a consultation document to raise an issue such as this and discuss alternative approaches so that they can be commented on by submitters.

In any event, on our view, the Act requires the Minister to be able to show how the NDC can realistically be achieved having regard to:

- (a) the level of domestic emissions implied by the ETS settings and the existing stockpile;
- (b) offshore mitigation that New Zealand has actually secured.

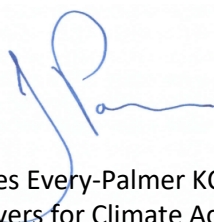
We consider that in the absence of any instruments or contracts that give New Zealand access to offshore mitigation, the presently proposed auction volumes would be susceptible to judicial review.<sup>21</sup>

#### 4. Conclusion

In light of these issues, LCANZI supports a more fundamental review of the ETS, including consideration of whether it should be supplemented or replaced with a tax on gross emissions and a separate incentive framework for removals. The 144m unit stockpile must also be addressed for the ETS to have any quantitative effect (beyond putting a price on emissions).

We are extremely concerned that our key tool to address climate change and ensure that New Zealand meets its international obligations, the emissions budget and the 2050 target is not fit for purpose. Furthermore, the longer these issues go unaddressed, the more difficult they will be to resolve.

In terms of the ETS setting themselves, given the stockpile and the absence of any secured offshore mitigation, we do not consider the presently proposed auction volumes are in accordance with our NDC.



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<sup>21</sup> In addition to being a misapplication of the Climate Change Response Act, we consider that relying on offshore mitigation which has not been secured would make the decision susceptible to review on the same basis as *R (on the application of (1) Friends of the Earth Limited (2) ClientEarth (3) Good Law Project and Joanna Wheatley) v Secretary of State for Business, Energy and Industrial Strategy* [2022] EWHC 1841 (Admin).