WESTPAC ECONOMIC BULLETIN

Emissions Trading Scheme primer.

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Kelly Eckhold, Chief Economist
+64 9 348 9382 | @kellyenz
kelly.eckhold@westpac.co.nz

Proposed Government reforms to New Zealand's Emissions Trading Scheme.

What's the issue?

The Government has come to the view that New Zealand is not taking sufficient action to bring the country in line with internationally agreed net emissions targets. The Government's view is that current Emissions Trading Scheme (ETS) settings don't provide sufficient incentives for businesses to reduce their emissions at source and instead encourages emitters to rely on carbon offsets generated through planting of forests.

This follows on from earlier recommendations by the Climate Change Commission, which expressed concern that current ETS settings excessively encourage the planting of exotic forests and forestry sequestration, but not actual emissions produced by firms themselves. New Zealand is one of only a few countries in the world that does not place a limit on the quantity of carbon credits that can be generated from forestry plantations.

The Government proposes to adjust the ETS to provide stronger incentives for individuals and businesses to transition away from fossil fuels while retaining some, albeit reduced, role for forestry-related carbon absorption.

The process.

The Government has invited public feedback with submissions due by the 11 August 2023. However, no changes to the ETS will be made before the general election. Another round of submissions is expected in 2024.

The options.

The Government has put forward four options which range from making small changes to the status quo to creating separate incentives for reducing actual emissions and pursuing forestry sequestration. The options canvassed are:

1. Reducing the supply of carbon credits available to ETS participants to cover their emissions. This would increase the price of carbon credits and encourage emitters to reduce emissions.
2. Allowing overseas buyers to purchase carbon credits generated from the planting of forests. This would raise the price of carbon and encourage the reduction of emissions at source.
3. Reducing incentives to plant trees by restricting the volume of carbon credits that can be generated by forestry or by imposing conditions on how they might be used. The likely outcome here is a separation in carbon pricing for forestry and emission reduction activities.
4. Creation of two ETS markets, one for emitters and one for forestry. The government would be the direct participant on the other side of both markets (although foreigners might be able to purchase forestry credits also). Under this option the Government could influence both markets by varying both prices and volumes as they would be the key supplier of credits to emitters and buyer of credits from foresters. This option implies the most comprehensive change to the ETS relative to the other options.

Market dynamics.

The price of carbon credits (the NZU price) has fallen significantly from their November 2022 highs of NZ$88.50 to NZ$38.50 last week as traded by Westpac.

A key catalyst for the drop in NZU prices was the decision by Government on the 15 December 2022 to decline the Climate Change Commission's price control recommendations for 2023-2027. The Commission had recommended auction settings that would have encouraged a relatively strong NZU price.[1] The Government surprised markets with auction settings that pushed NZU prices down.[2] NZU prices fell significantly from NZ$84.50 just prior to the announcement on the 15 December to around $75 the following day. The change in auction settings increased uncertainty in the minds of carbon market participants and ultimately was one of the factors that contributed to the failure of a carbon auction in mid-March 2023.[3]

Uncertainty grew further from 22 March when the Government announced a review of the ETS aimed at better incentivising the reduction of gross emissions. Demand from emitters fell and contributed to a steady fall in NZU prices to the low NZ$50's by the beginning of June. Auction demand for NZUs reduced and was reflected in a low bid/cover ratio in the failed June 2023 auction.

The government's announcement on 19 June 2023 of the details of the ETS consultation options further undermined market demand and sentiment. The NZU mid-price quoted by Westpac fell from NZ$61.50, to around 2 year lows at NZ$41.00 by 30 June (and around 47% lower than the highest price traded back in November 2022).

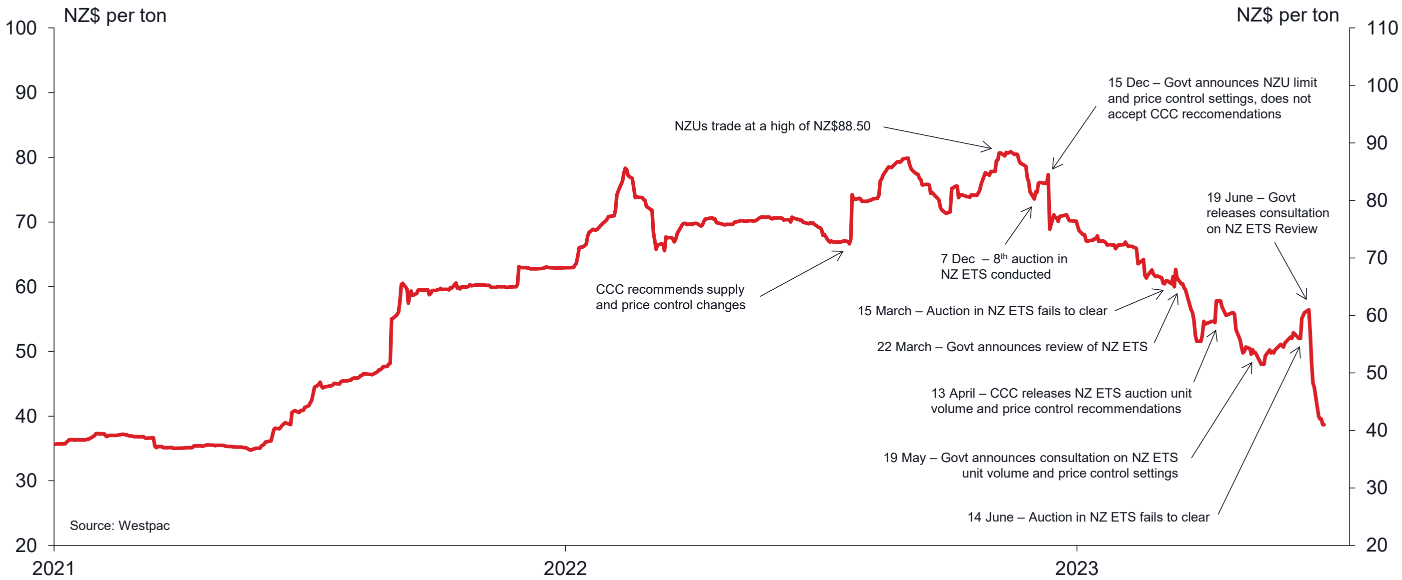
A key reason undermining sentiment is the potentially far-reaching consequences of some of the options the government is consulting on. While options 1 and 2 are seen as tinkering at the edges, options 3 and 4 imply major changes to the structure of the markets and greater uncertainty for market participants. Significant questions remain for market participants around the NZU-related contractual arrangements they have entered into (including for example long-term offtake agreements and forward contracts). Additionally, it is not clear how the current stockpile of units will be treated and whether any grandfathering of arrangements will be implemented for existing contracts and NZU's generated from forestry.

Westpac's trading team's view is that the degree of uncertainty is such that, while the Government is required to make decisions on the next set of ETS auction settings to be in place from 2026-28 by 30 September, these decisions are unlikely to have any material effect on NZU prices in general over the balance of this year. This is because the outcome of the ETS consultation will not be known until after another round of consultation in early 2024. Hence uncertainty will persist until then meaning that NZU prices will likely continue to languish between NZ$35 – NZ$$55. There is some possibility of a gap opening up between the price of NZU's derived from forestry compared to other types of units (although it's difficult to forecast the extent of any such pricing gaps).

Westpac Economics preliminary view and next steps.

Westpac Economics preliminary view is that it is not clear that any of the options presented in the consultation document are as efficient or desirable as they could be. We plan to prepare a submission to the Government on the options they have presented and potentially offer a superior alternative option.

Westpac NZU prices



1 The Government's NZU auctions include a reserve price (designed to place a floor on NZU prices) and a cost containment mechanism (extra supply of NZU's designed to prevent excessive price spikes). The Commission proposed a two-tier trigger price for the cost containment reserve mechanism at NZ$171 and NZ$214 as well as an auction reserve price of NZ$60 for 2023.

2 The cost containment reserve trigger price was set at NZ$80.64 and a reserve floor of NZ$33.06.

3 A failed auction in this context refers to an auction that doesn't clear as opposed to some other kind of technical problem which might cause an auction to not operate as expected.

Contact the Westpac economics team

Kelly Eckhold, Chief Economist
+64 9 348 9382

Michael Gordon, Senior Economist
+64 9 336 5670

Satish Ranchhod, Senior Economist
+64 9 336 5668

Nathan Penny, Senior Agri Economist
+64 9 348 9114

Paul Clark, Industry Economist
+64 9 336 5656

Any questions email:
economics@westpac.co.nz

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