



PROACTIVE RELEASE COVERSHEET

Minister	Hon Simon Watts	Portfolio	Climate Change
Name of package	ETS settings framework review	Date to be published	20 August 2026

List of documents that have been proactively released

Date	Title	Author
9 June 2025	Final Climate Weekly Update week ending 13 June 2025	Ministry for Cities, Environment, Regions and Transport
29 May 2025	ETS framework review - ToR and deliverables	Ministry for Cities, Environment, Regions and Transport
5 June 2025	ETS framework review - workshop	Ministry for Cities, Environment, Regions and Transport
29 May 2025	BRF-6278 - Progressing a refresh of the NZ ETS Settings decision-making framework	Ministry for Cities, Environment, Regions and Transport
5 September 2025	ETS Market Model Workshop	Ministry for Cities, Environment, Regions and Transport
4 August 2025	ETS refresh cap workshop – pre-reading	Ministry for Cities, Environment, Regions and Transport
30 June 2025	Updated - ETS settings refresh workstream planning	Ministry for Cities, Environment, Regions and Transport
15 July 2025	Working doc - what is the leg, how are we giving effect to it and unresolved Qs	Ministry for Cities, Environment, Regions and Transport
8 August 2025	Workshop prep material on surplus	Ministry for Cities, Environment, Regions and Transport
11 August 2025	Surplus - Auction volume relationship	Matthew Cowie, EY
6 June 2025	Session with CCC	Ministry for Cities, Environment, Regions and Transport
30 September 2025	Joint memo on NZ ETS settings refresh project	Ministry for Cities, Environment, Regions and Transport

23 June 2025	BRF-6352 - Draft Terms of Reference for a refresh of the ETS Settings framework	Ministry for Cities, Environment, Regions and Transport
Information redacted YES Any information redacted in this document is redacted in accordance with the Ministry for Cities, Environment, Regions and Transport's policy on proactive release and is labelled with the reason for redaction. This may include information that would be redacted if this information was requested under Official Information Act 1982. Where this is the case, the reasons for withholding information are listed below. Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it. Summary of reasons for redaction Some information has been withheld for privacy reasons. Note • Characterisations of the Climate Change Commission's role or views within ETS settings framework review documents are authored by the Ministry for Cities, Environment, Regions and Transport and may differ from the Commission's views. • Draft versions of documents are not provided when final versions are available.		

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Climate Weekly Update

Pūrongo Ahuarangi ā-Wiki

For the week ending 13 June 2025

Hon. Simon Watts, Minister of Climate Change

Refresh of Emissions Trading Scheme Settings Decision Making Framework

BRF-6278 outlined our plans to refresh the Emissions Trading Scheme (ETS) settings decision-making framework. This item updates you on our planned “wise heads” to support the review

We intend to involve some external experts in the ETS to help test our thinking as the project progresses – our “wise heads”. We will ask the wise heads to operate in a flexible and informal way, supporting a rapid, focussed review. We will not ask them to present a report of their own or give a formal view on our final report. However, if they had concerns about our analysis, we would take those very seriously.

Few people have the deep technical knowledge of the ETS settings process, and the underlying frameworks, that we need from the wise heads. Many of the individuals who have the expertise we need, have some level of interest in the outcome of the project, given their specialisation in the ETS. We will ensure that any conflicts of interest are appropriately managed.

9(2)(a) Corina Comendant (Sapere), and Matthew Cowie (EY) have the skill sets we need. We are in the process of checking their availability over the July to September period. If they are unable to participate, we intend to approach 9(2)(a), and/or Catherine Leining (Motu). The Climate Change Commission is comfortable with all these names, and we hope to confirm the wise heads in the next week.

We expect to send you the draft Terms of Reference for your feedback by 19 June (BRF-6352 refers).

Business Group: Climate Change Mitigation and Resource Efficiency

Owner: Becky Prebble - 9(2)(a)

ETS framework refresh

Terms of Reference, external panel, deliverables, next steps

29 May

Proposed agenda

- Terms of Reference
- External advisory panel
- Project plan and deliverables
- Objectives for workshop with Commission

Terms of Reference – 1/3

Purpose, background

Purpose

- This project will evaluate the current NZ ETS settings decision-making framework and associated analytical tools and identify opportunities for improvement.

Background

- CCRA establishes advisory framework and role of Commission, officials.
- Commission and Ministry have used consistent approach since 2021.
- Framework has been broadly effective to date.
- But room for improvement and want to ensure it is positioned to handle future challenges.
- Commission statutorily independent, determines its analytical approach, not the Government.

Objective

- Ensure the framework supports robust decision making and market stability.
- Achieved by agreeing actionable improvements to the framework which would be applied by both the Commission and government officials.

Deliverables

- A final joint report will be provided to the Minister of Climate Change by September 2025, in time to inform next year's advice.
- This will be a departmental report. However, the Minister will have opportunities to provide feedback before being agreed.

Terms of Reference – 2/3

In scope - two proposed limbs of analysis

Limb 1: Analytical and technical tools

Seven-step methodology and associated tools

- **Evaluate the efficacy and limitations of the current seven-step methodology**, agree areas to improve.
- **Assess potential supplementary technical tools and models** that could enhance decision-making, including their strengths and limitations and how they interact (if at all) with the seven-step methodology.
- **Assess how prevailing ETS market conditions could be more systematically factored** into the settings analysis, and the advantages and disadvantages of doing this.
- **Identify which data or information gaps are most challenging** (particularly in forestry and the stockpile) and develop a plan to address these.

Limb 2: Decision-making framework

How analytical outputs and other information is brought together to inform advice.

- **Evaluate the efficacy and limitations of the current approach** to developing advice and agree areas that could be improved.
- **Identify other information, considerations or criteria** which could enhance the decision-making process, and agree how these could be incorporated.
- **If necessary, develop and propose changes** to the decision-making framework that incorporates multiple indicators and the appropriate role of judgement.

Terms of Reference – 3/3

Out of scope, roles and responsibilities

Exclusions

The project will not consider:

- improvements to current legislative provisions (ie, the role of the Commission, annual advice cycle) but where these are identified, they will be fed into the CCRA reform process; or
- broader adaptive management framework issues being addressed through CCRA reforms. However, we will consider any impacts changes to the adaptive management framework may have on analytical frameworks.

Roles and responsibilities

- Led by MfE with close participation by Commission officials.
- We will get input from Treasury, MPI and MBIE, and other expertise as appropriate.
- MfE officials will establish a small panel of independent experts to support the Project (see next slide).
- Will draw on other external information gathered through MfE and Commission's business-as-usual stakeholder engagement.

Independent external panel

Purpose and composition

Purpose

- To test the analysis and findings and provide targeted, high-quality advice to improve the overall outputs.
- It will challenge assumptions, identify gaps, and ensure the review and findings are grounded in sound evidence.
- The panel will provide an independent peer review of emerging findings and any reports. This will help to validate conclusions and strengthen the credibility of the final outputs.
- It will not produce its own report.

Panel composition

Three, four members (is a Chair desirable?)

Collectively, panel needs a deep knowledge of:

- ETS Settings process, including statutory framework.
- Methodologies underpinning advice, particularly the seven-step methodology and associated modelling.
- ETS market dynamics.

Other factors:

- Experience in technical peer review or advisory roles, particularly in climate policy, climate economics, or regulatory frameworks.

Budget, procurement, governance

TBC

Project plan and deliverables

Immediate next steps

Finalise Terms of Reference - to Minister by 19 June.

- Confirm internal MfE view, draft refinements based on initial Commission feedback
- Workshop with Commission next Thursday to align on scope, exclusions, and participation model
- Secure Minister's feedback (and approval?)

Develop analysis plan - draft by early June

- Agree planned analysis, and timing/sequencing and ownership of each piece.
- Approach for incorporating expert panel advice.

Stand up expert panel - by late June

- Agree panel scope and purpose, short list members – early June
- Get procurement process in train by mid June
- Formally stand up once MCC sighted members on 19 June?

Deliverables and advice

- To flesh out interim deliverables.
- Final report to MCC by September 2025.

Stakeholder management

- PMO interest in receiving updates on this?
- MCC via Weekly Update as required

Project team/resourcing

- To firm up in plan.

ETS framework refresh

MfE – Commission workshop

5 June

Proposed agenda

- Recap of context, including a readout from MCC-CCC meeting – 10 minutes
- Jointly assess status quo approach, including identifying current ‘envelope’ – 30 minutes
- Deep dive on analytical tools, role of judgement, other information – 30 minutes
- Process, resourcing, governance – 10 minutes
- Next steps – 10 minutes

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Briefing: Progressing a refresh of the NZ ETS Settings decision-making framework

Date submitted: 29 May 2025

Tracking number: BRF-6278

Security level: CLASSIFICATION

MfE priority: Urgent

Actions sought from ministers		
<i>Name and position</i>	<i>Action sought</i>	<i>Response by</i>
To Hon Simon Watts Minister of Climate Change	Agree recommendations in paper	5 June 2025

Actions for Minister's Office staff	
Return the signed briefing to Ministry for the Environment (ministerials@mfe.govt.nz)	

Appendices and attachments	
Appendix 1: Draft letter to the Chair of the Climate Change Commission	Refused in full under section 18(d)

Key contacts at Ministry for the Environment			
<i>Position</i>	<i>Name</i>	<i>Cell phone</i>	<i>First contact</i>
Principal Author	Josh Finegan	9(2)(a)	
Responsible Manager	Simon Mandal-Johnson		
Director	Mark Vink		✓

Minister's comments

Progressing a refresh of the NZ ETS Settings decision-making framework

Purpose

1. This briefing responds to your request for advice on a plan to refresh the analytical and decision-making frameworks for NZ ETS unit limits and price control settings (NZ ETS Settings).

Advice

Context and direction: A need to review the decision-making framework for NZ ETS Settings

2. In April 2025, the Climate Change Commission (Commission) published its advice for NZ ETS unit limits and price control settings 2026-30 (NZ ETS Settings). It advised limits on units available by auction could be substantially increased over 2028-30.
3. The Commission's advice was based on the established unit limits methodology first developed by the Ministry for the Environment (Ministry) in 2021 then refined by the Commission. However, the advice incorporated substantial methodological changes, and the results surprised some market commentators.
4. You have requested that we review both the analytical and decision-making frameworks for the annual NZ ETS Settings process to provide greater stability to the market.
5. The Ministry can see potential opportunities to strengthen the existing framework that flows from the Climate Change Response Act 2002 and ensure it is ready to address emerging challenges¹. In particular, next year is the first year that the third emissions budget period is captured within the regulated settings period, which New Zealand is not currently on track to meet.

Proposed approach: A review involving the Commission, Ministry, and other agencies, supported by independent experts

6. To progress this work, we recommend a focussed three-month project involving the Commission. The objective of the project would be to identify opportunities to improve the current frameworks, which would be applied by both the Commission and government officials. Completing the project by September 2025 will allow improvements to be incorporated into the 2026 NZ ETS Settings process.
7. The Commission has indicated it is open to participating in the project. However, the scope and nature of its involvement needs to be agreed by its Board. Reflecting its statutory independence, it is the Commission, not the Government, which determines

¹ The Climate Change Response Act 2002 sets out the requirements and matters that must be considered in developing the NZ ETS settings.

the methodology it uses to support its advice on NZ ETS Settings. The Government has limited power to direct the Commission to take a specific approach.

8. That said, the Commission shares the goal of ensuring that the framework supports robust decision making and market stability. It also sees benefits in having shared overall approach to advising on NZ ETS Settings.
9. We recommend a small panel of independent experts be appointed to support the review. The panel would help test problem definition, scope, and options but would not produce a report of its own.
10. This project will consist of two distinct, but interdependent, parts:
 - i. Evaluating the **technical tools** used to inform advice, such as the seven-step methodology, and identifying opportunities for improving and broadening these, including closing any data or analytical gaps; and
 - ii. Evaluating the **decision-making framework** used to combine analysis and other considerations together to inform advice, and identifying additional information, considerations or criteria which could enhance this process.
11. We do not anticipate focussing on proposals for legislative change. However, we will ensure any implications for the Climate Change Response Act efficiency review workstream are incorporated as required.

Approach to public input, balancing market sensitivity

12. The consultation document for this year's NZ ETS Settings process seeks feedback on a range of relevant issues to the review. We recommend that there is no announcement of this project at this point to avoid creating uncertainty in relation to this year's decisions on NZ ETS Settings. Input on changes proposed by the review can be sought as part of next year's consultation.

Next steps

13. We intend to finalise a Terms of Reference for the project in consultation with the Commission for your feedback and approval by 19 June. Meanwhile, we welcome any initial views you may have on the scope of the project.
14. You are meeting with the Chair of the Commission on Tuesday 3 June. This conversation is an opportunity to reiterate your desire that the Commission and Government works collaboratively to agree a common approach and deliver practical, actionable improvements. You received talking points to support this meeting on Thursday 29 May [BRF-6234 refers].
15. Following this meeting, there could be value in writing to the Chair to outline your priorities and objectives for the review. An initial draft letter is attached as Appendix 1 – we will provide you with a refined version after your meeting on 3 June. Before doing so, we will also confirm with the Commission that they will not publish the letter, in line with the broader approach to public input.
16. Will advise you further on timing, governance arrangements and the members of the external panel on 19 June.

Recommendations

We recommend that you:

- a. **confirm** your direction for Ministry officials to proceed with a three-month review of the NZ ETS Settings frameworks with the Climate Change Commission.

Yes | No

- b. **provide any feedback** on the initial proposed scope of the project.

Yes | No

- c. **note** your meeting with the Chair of the Climate Change Commission on 3 June 2025 is an opportunity to discuss this review.

Noted

- d. **agree** to write to the Chair of the Climate Change Commission to reiterate your priorities and objectives for this review after you meet them on 3 June 2025.

Yes | No

- e. **note** we will provide a draft Terms of Reference for your feedback and approval by 19 June.

Noted

Signatures



Mark Vink
General Manager

Markets

29 May 2025

Hon Simon Watts
Minister of Climate Change



Ministry for the
Environment
Manatū Mo Te Taiao

Modelling ETS Market Dynamics

5 September 2025

Plan for today

- Modelling ETS market dynamics
- What questions the ETS Market Model can help with
- Deep dive into the ETS Market Model
- Limitations and areas for improvement

Modelling ETS market dynamics

- The seven-step methodology and price controls analysis sets out what the ETS needs to do to meet budgets.
- This can be supplemented by modelling what the ETS might actually do under certain conditions.
- The policy goal is to minimise this gap between policy objective (budget accordance) and likely outcomes. Insights from modelling market dynamics can:
 - Help inform judgements and assumptions made elsewhere
 - Form part of the overall risk assessment
 - Inform assessments of main matters such as proper functioning of the market and household and economic impacts

ETS Market Model and Policy Advice

- The ETS Market Model was originally set up for the ETS review, to better understand the implications of the current ETS architecture.
- We have adapted it for supporting ETS settings advice. The Market model provides additional insights to the seven-step approach and price controls analysis:
 - Price implications (which can inform cost of living impacts)
 - Stockpile movements
 - Total net emissions projections (when combined with other data) – this is not the budget accordance test, but can help inform it
 - Fiscal implications (not a statutory requirement but requirement in all Cabinet decisions)
- We also use it to understand other ETS related policies e.g. LUC restrictions, default lookup table changes

ETS Market Model

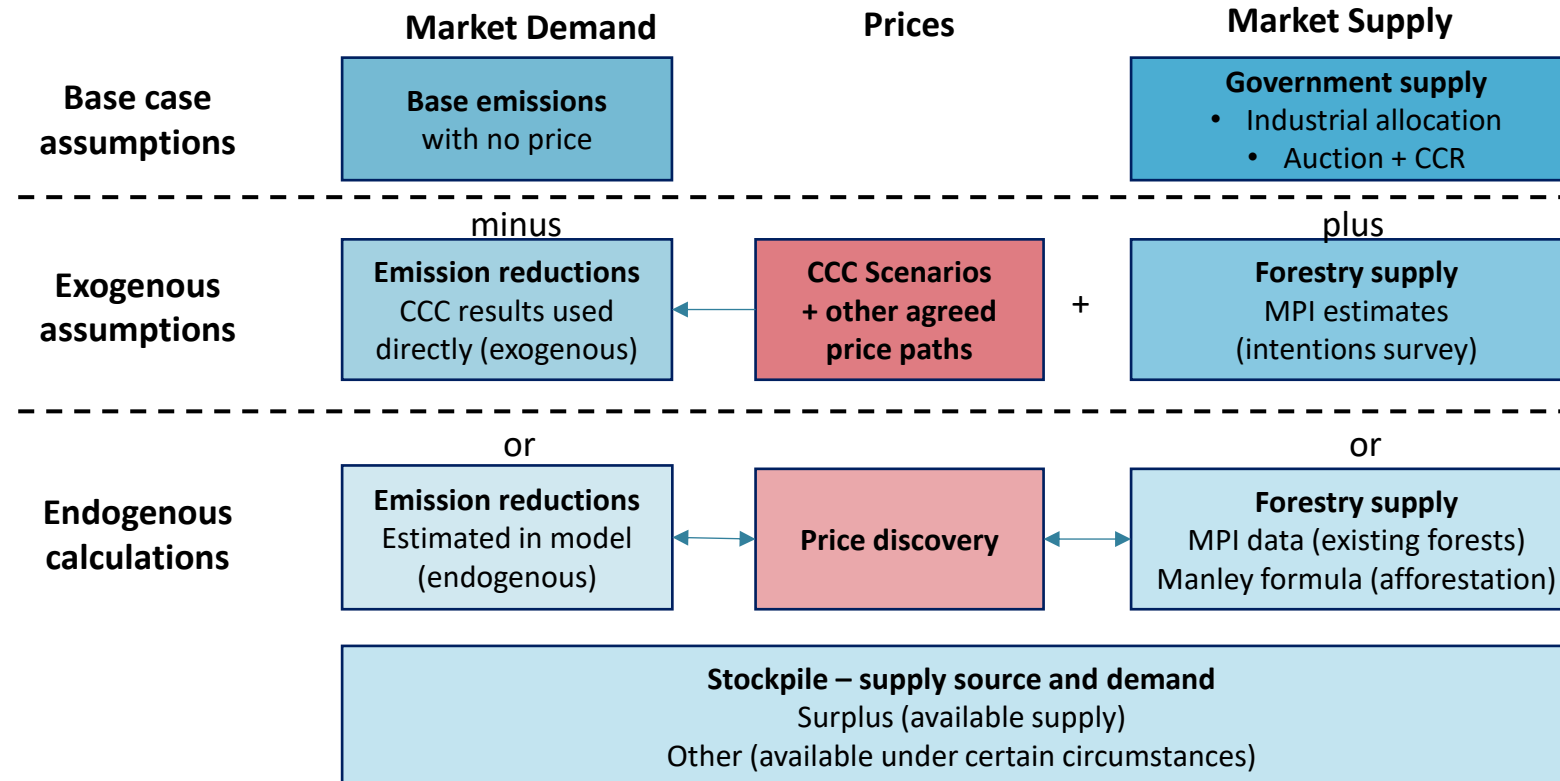


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Model Objectives

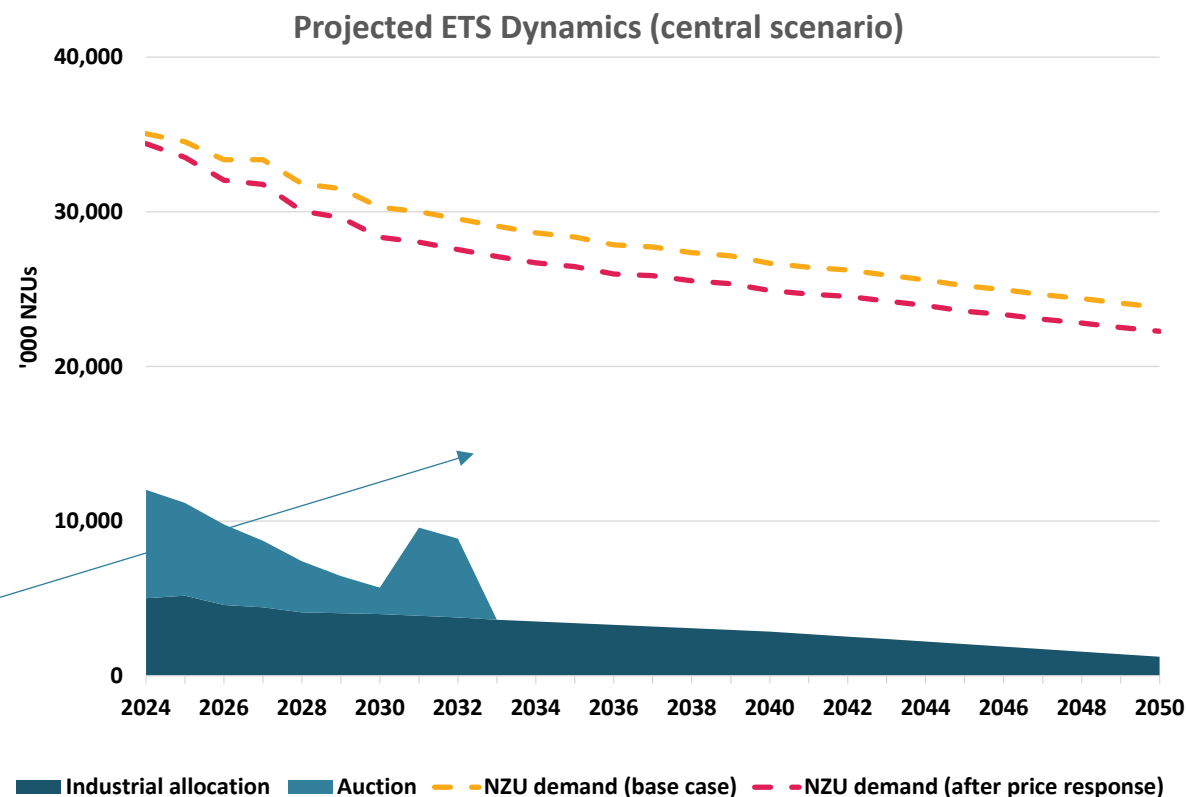
- To understand the implications of ETS architecture and settings on:
 - **NZU price;**
 - The **balance between reductions and removals;** and
 - The pattern of **use of the stockpile.**
- On the basis of current understanding of:
 - **NZU demand** and emission reductions in response to price
 - **NZU supply**, including Government supplies (auction, industrial allocation and CCR) and removals
 - **The stockpile**
- To analyse the impacts of changes to architecture and settings

Model Structure & Data Sources



Government Unit Supply + Demand

- Base case emissions & demand = current policy reference (i.e. ERP2) with zero price from 2023
 - These build in some additional policies and other actions (e.g. NZ Steel, Methanex)
- Government supply includes
 - Industrial allocation
 - Auction volumes
 - CCR
- Meeting the gap via mix of:
 - Reductions
 - Removals
 - Stockpile



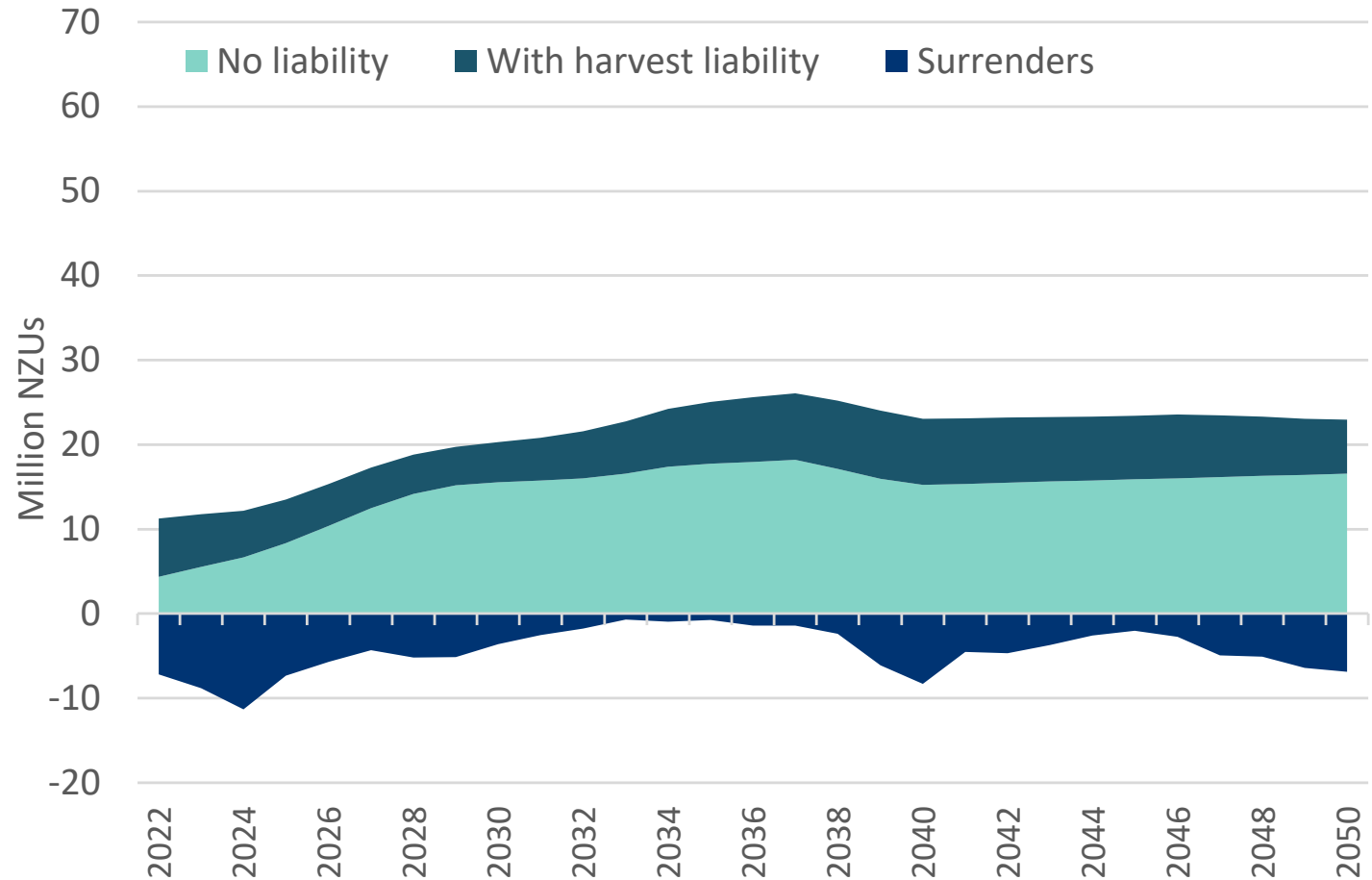
Forest Supply - Exogenous

MPI makes forestry projections using an Afforestation and Deforestation Intentions Survey.

It includes:

- Supplies with harvest liability - plantation forests (using stock change accounting) for which NZUs are unlikely to be made available
- Supplies with no liability – those made available to the market including permanent forests and those from averaging

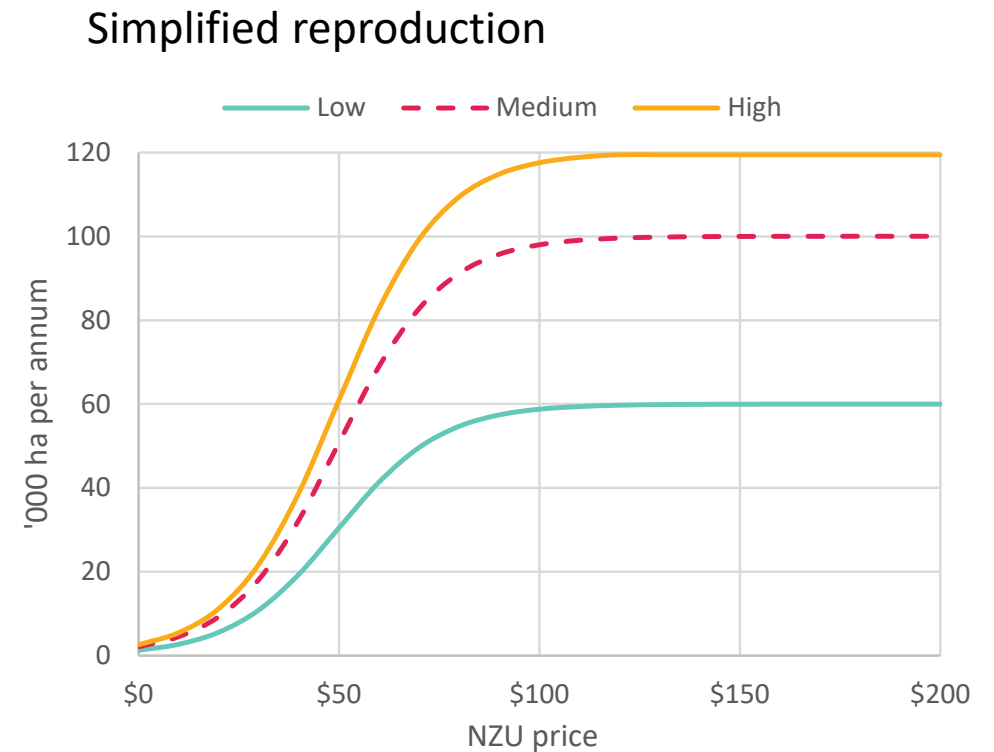
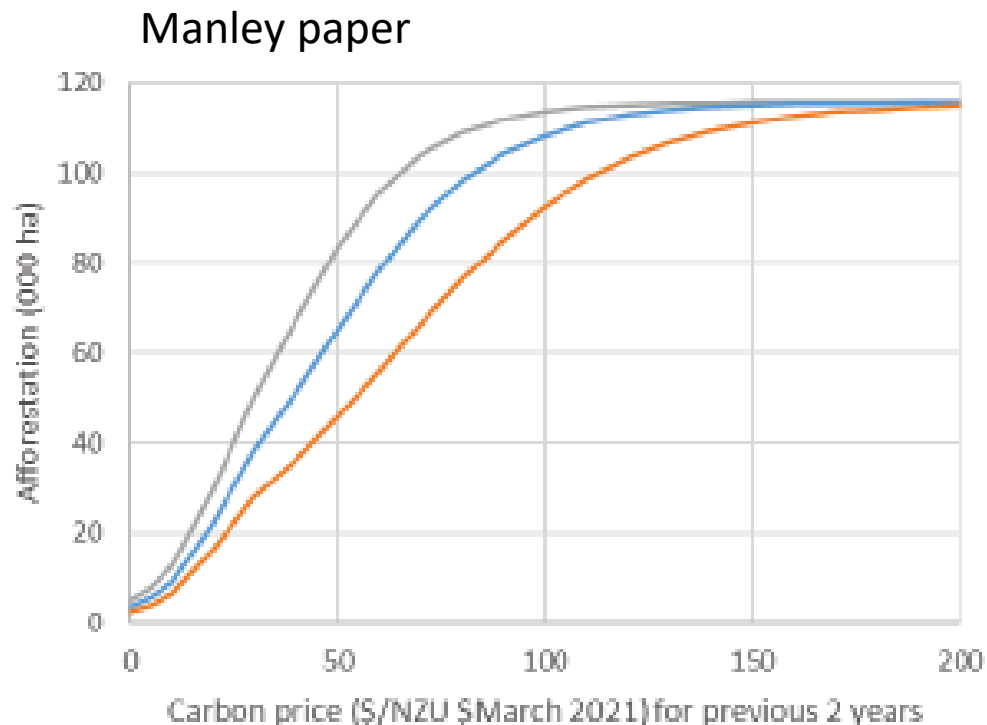
These have a current price expectation built in and assume historical percentage contributions from permanent forests



Forestry Supply - Endogenous (the Manley Formula)

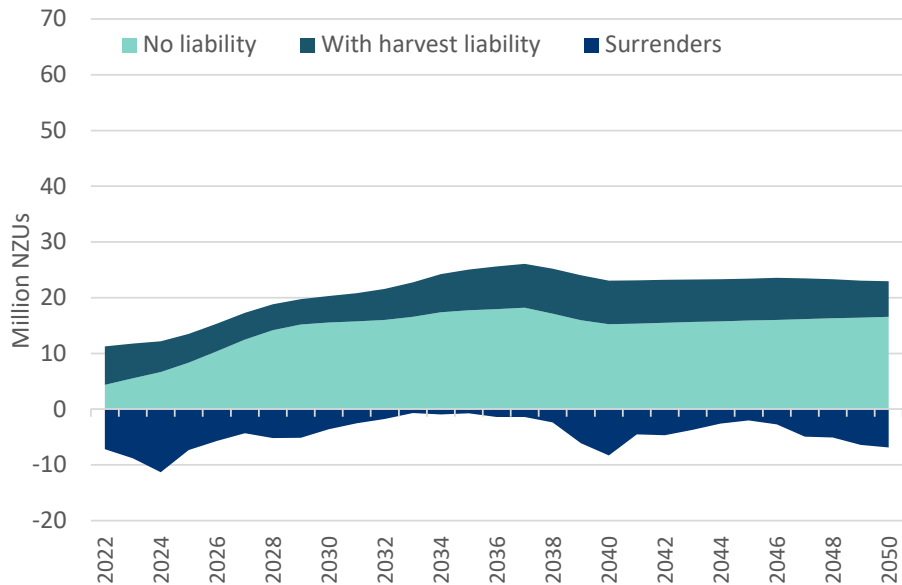
Predicts afforestation in response to price. We combine this with a limit on total planting area and (more recently) assumed LUC limits.

In comparison, MPI projections currently assume 27,000 ha of new forestry per annum



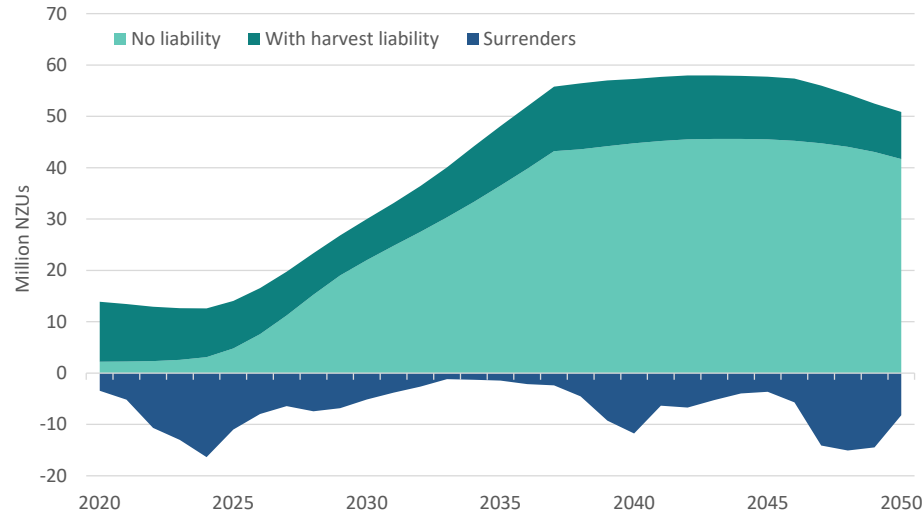
Forestry Supply with Manley Formula

MPI central projection

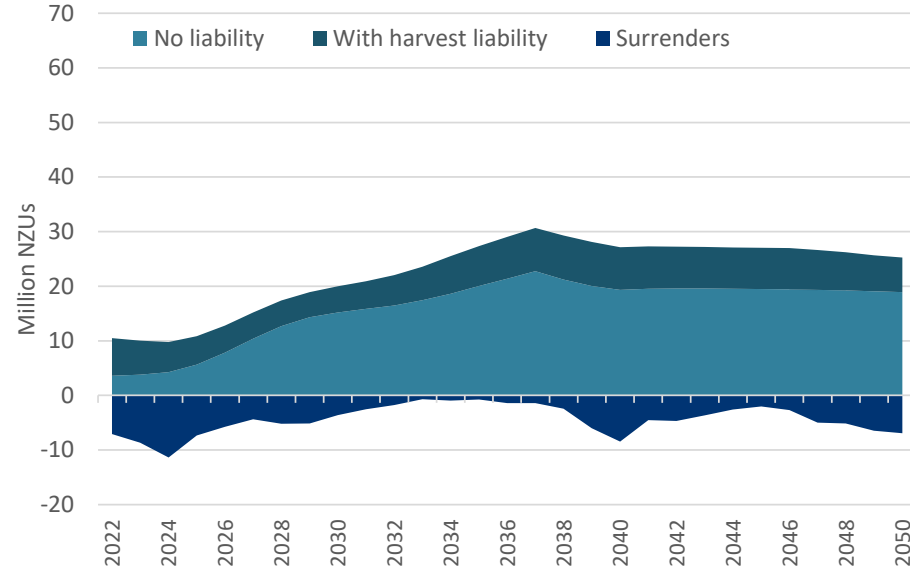


- MPI projections simulated by assuming current prices continue (consistent with MPI view that this is how landowners make forestry decisions)

Manley formula (central) plus demonstration path price

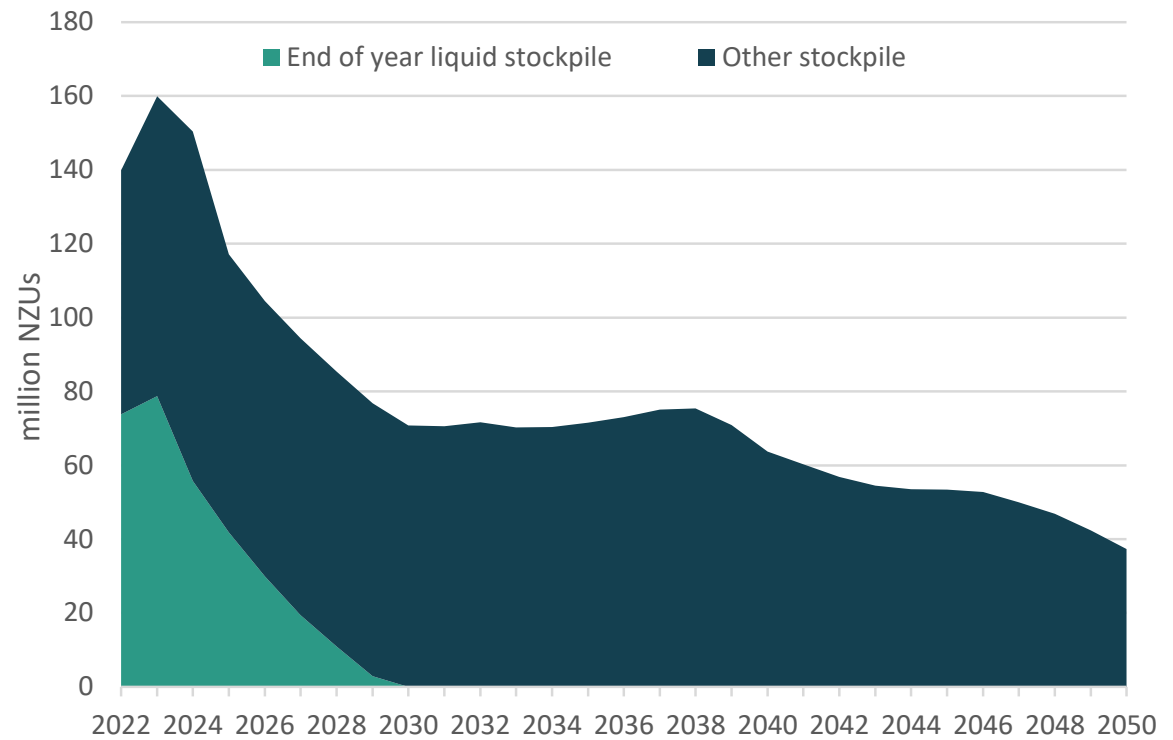


Manley formula (low) plus rising/falling price



Stockpile

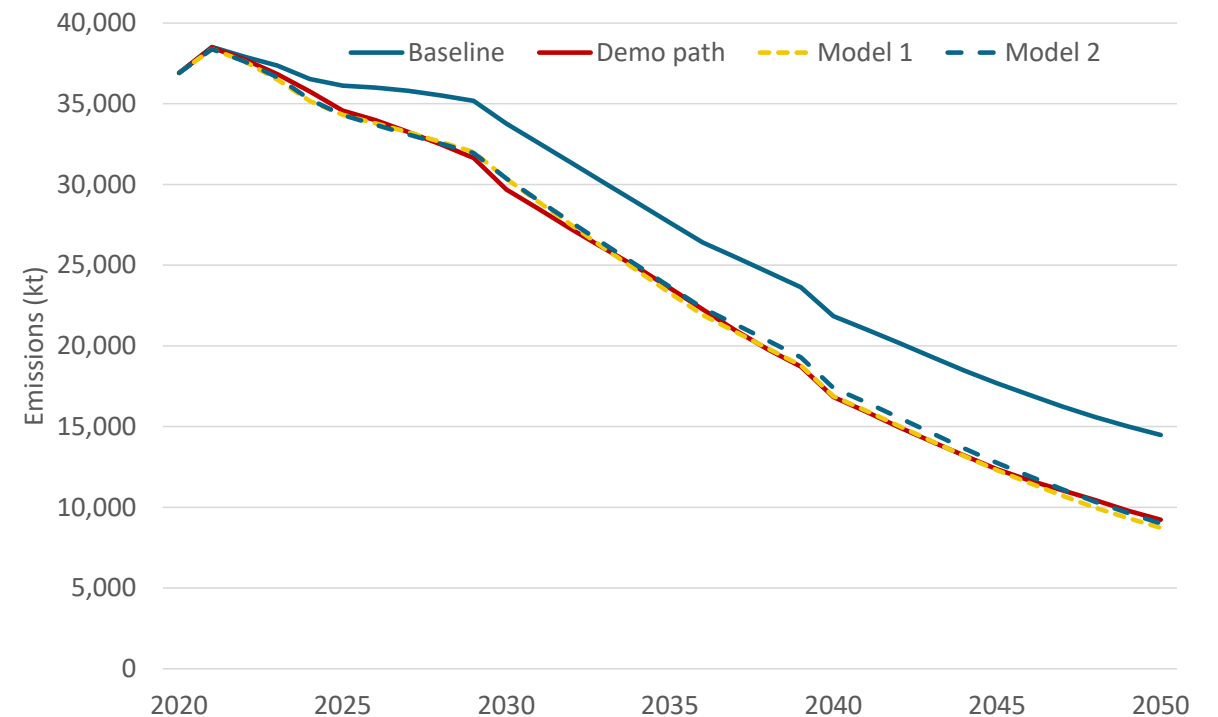
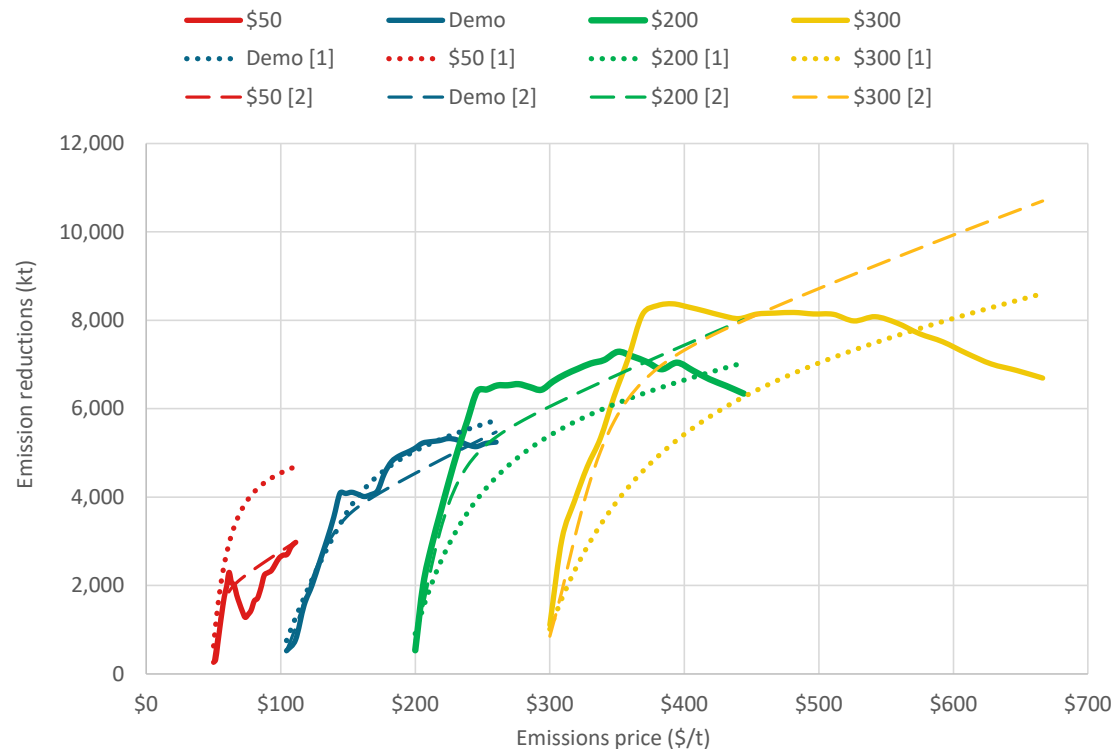
- Includes liquid or surplus (available to market) and obligated components
 - Currently liquid component estimated at 56Mt (29-78 Mt range)
- Stockpile behaviour assumes:
 - **Surplus units** are released when the price is not increasing as fast as the opportunity cost of capital/discount rate
 - They may also be released to meet supply gap. But this results in a short run price increase.
 - **Non-surplus units** may also be released if price is flat/falling, under the assumption that participants can buy at lower cost later. This is limited, eg to 10% of the non-surplus units.



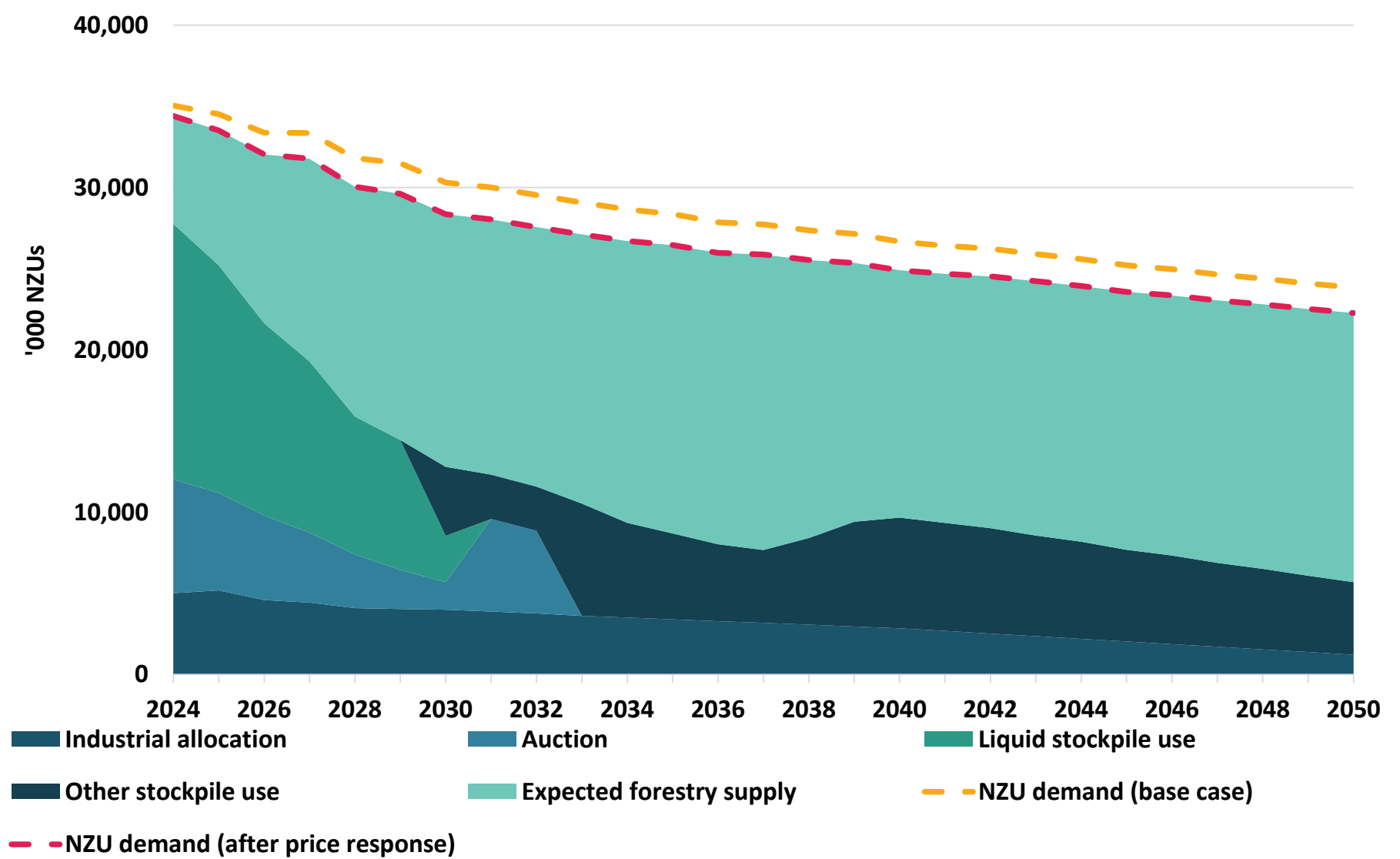
Demand Response to Price

- To estimate the price response, we use statistical analysis of the results from the ENZ model
- We estimate the difference between the demo path with (1) a zero price from 2023 and (2) with rising price from different 2023 starting prices (these results were released with the Commission's first advice)
- Regression analysis of relationship using (1) simple and (2) log relationships:

Emission Reduction (ER) = f(10-yr forward price, last year's ER)



Putting it altogether

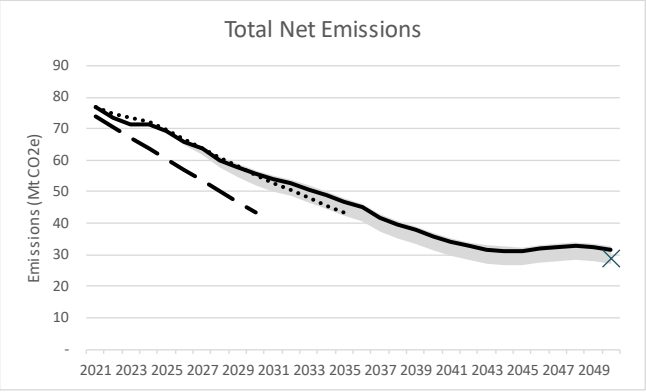
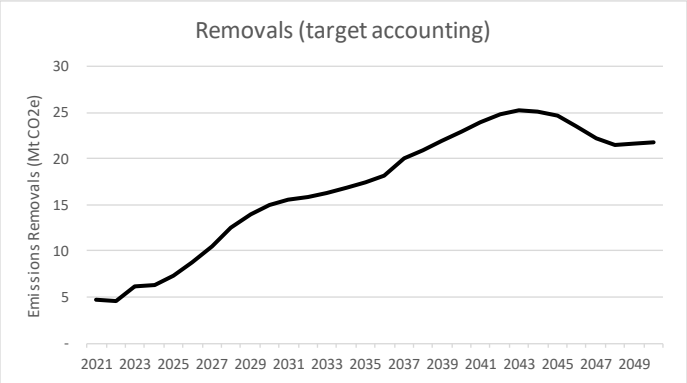
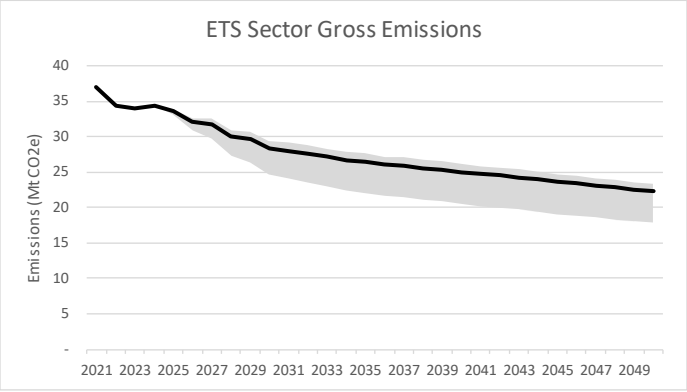
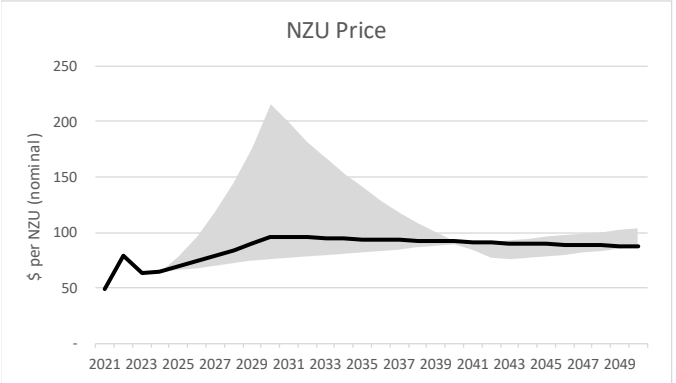
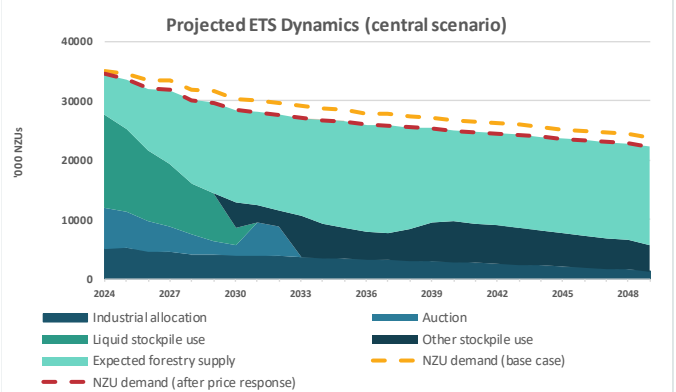


Total net emissions projection

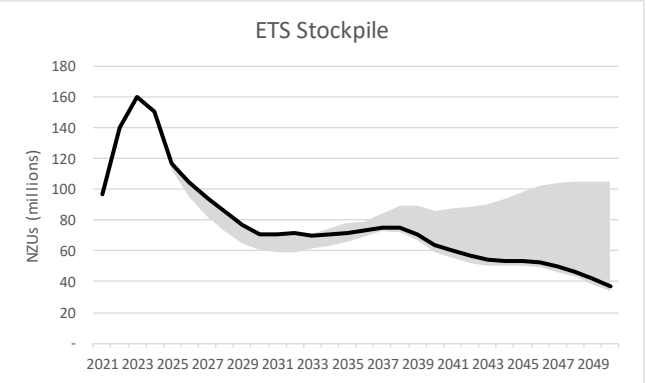
- The NZ ETS Market Model was not originally designed to estimate total net emissions; its focus is on net emissions covered by the NZ ETS. However, the projections from the model can be combined with other information to make a high-level projection of total net emissions.
- Two additional sources of information/assumptions are needed:
 - An estimate of emissions outside of the NZ ETS (mostly agriculture).
 - A conversion of 'low risk' forestry NZUs to total 'target' accounting removals.
- Net emissions are calculated as the total demand for NZUs (i.e., gross emissions in NZ ETS sectors) plus non-ETS sector emissions, less total removals.

ETS Market Model - Dashboard

Scenario: 2025 ETS Settings Decision with cyclical price and 2025 auction clearance
Version:
Date:



Note: Dotted line is consistent with emission budgets, dashed with NDC, cross with 2050 net zero target (lower biogenic methane target)



ETS Auctions (Central)			
	Volume		Revenue (\$b)
	Offered	Sold ¹	
2024 ²	7.0	7.0	0.4
2025	6.0	6.0	0.4
2026	5.2	5.2	0.4
2027	4.3	4.3	0.3
2028	3.3	3.3	0.3
2029	2.4	2.4	0.2
2030	1.7	1.7	0.2
2031	5.7	5.7	0.5
2032	5.1	5.1	0.5
2033	4.4	-	-
2034	3.5	-	-
2035	2.7	-	-

Notes: 1 As projected by model
2 Assumes 2024 auctions partially clear

	Total Net Emissions (CO2e Mt)			
	Budget	Lower	Central	Upper
EB1	290	285.4	285.2	284.7
EB2	305	307.4	303.3	290.5
EB3	240	258.8	253.0	232.1
NDC1	586	670	666	652

Notes: 1 Lower and upper estimates based on 95% confidence intervals of price response
2 Does not include ERP2 policy impacts

Limitations and areas for improvement



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Stockpile behaviour

- Limitations and issues
 - The model is quite sensitive to the stockpile liquidity parameter, which is ultimately not empirically testable.
- Current mitigants
 - Recent practice has been to set it at a rate that generates a stable ratio of other stockpile units to compliance demand in the near term (up to 2035).
 - The liquidity parameter is also always part of sensitivity analysis.
- Potential improvements
 - Ideal solution would be to develop a more sophisticated stockpile function that relates stockpile drawdown to price expectations (and other variables?)
 - Developing a better estimate of the optimal ratio of stockpile to compliance demand (also relevant to ENZ)

Forestry

- Limitations and issues
 - The market model assumes forestry units become available to the market in the year they occur i.e. ignores MERPs, does not reflect foresters ability to hold and sell later.
 - The Manley afforestation response function has a range of issues, and its also unclear how LUC limits will play out.
- Current mitigants
 - Mainly used MPI afforestation and unit flow projections for the most recent settings advice (which reduces the endogeneity in the model)
- Potential improvements
 - Would it make sense to integrate the ETS forestry model more directly into the market model?
 - Update with new Manley formula when available
 - Update with new carbon sequestration tables (if default lookup changes go ahead)

Demand response

- Limitations and issues
 - Demand response is a simplified version of the ENZ response
- Current mitigants
- Potential improvements
 - Historical elasticity estimates when available could form the basis of an alternative demand response function

Price pathway and optimisation

- Limitations and issues
 - Current optimisation macro generates a single price change applied to the full period
 - This is sometimes manually modified by imposing a cyclical pattern (up then down) and introducing some stickiness to prices, and/or imposing a minimum price (usually the LRMC of forestry)
- Current mitigants
 - Sensitivity analysis using different profile assumptions (constant vs cyclical, cyclical with different turning points)
- Potential improvements

Supporting transparency

- The ETS Market model has been available in the public domain since late 2023. We have released new versions and accompanying documentation on a regular basis, most recently alongside consultation this year.
- Around 50 firms and individuals are now on the mailing list.
- Kristen Green has turned the Market model into a code-based version. Jarden Commtrade have built their own ETS model using a similar structure.
- Together with Commission's forestry model it should help participants better undertake their own analysis of long run ETS S&D. **Could we do / release more to help?**

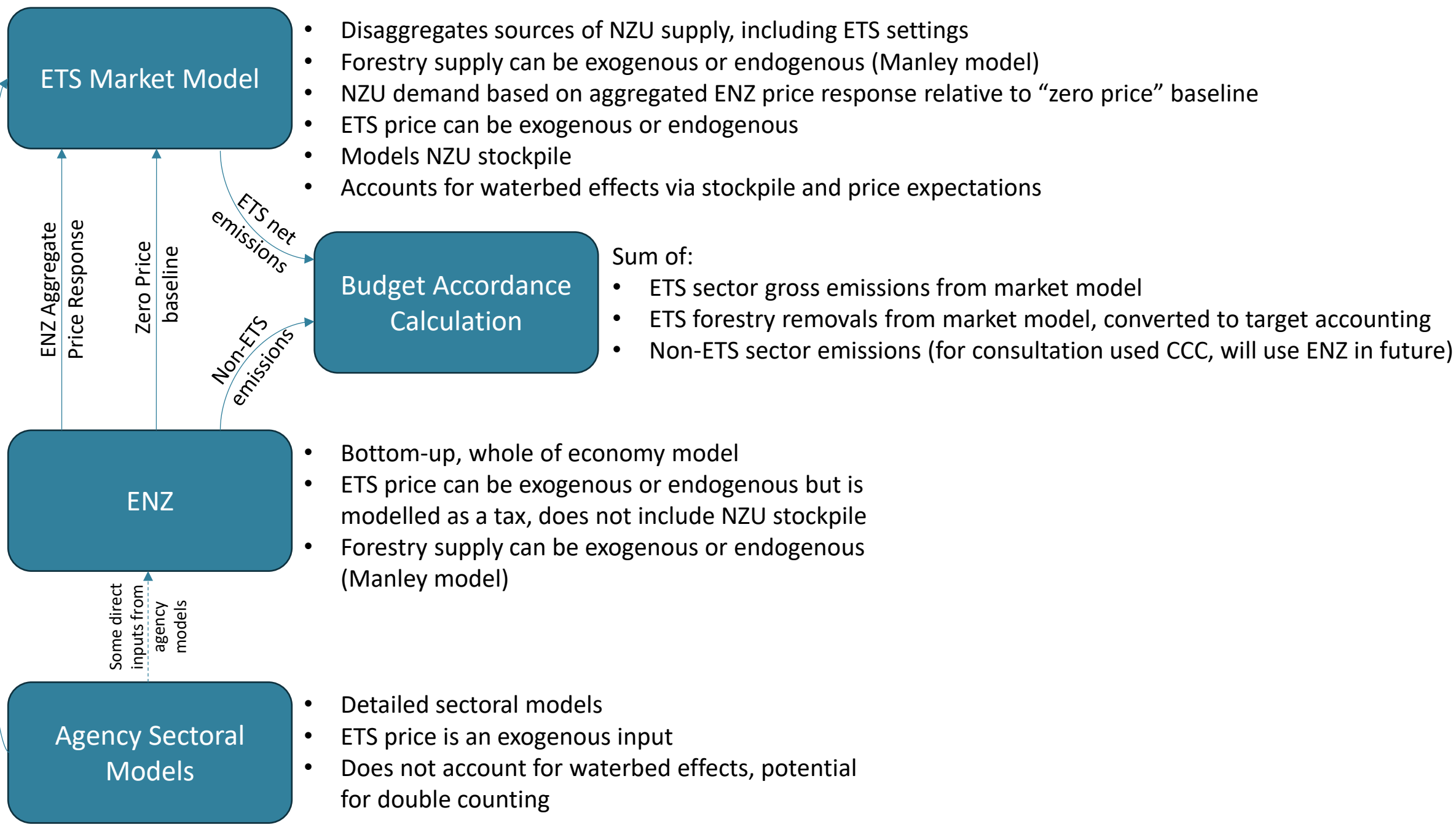
ENZ

- ENZ uses a broadly similar approach to the market model, but with a more granular demand-side function. Both can use the Manley function for endogenous forestry response. Government supply is exogenous to both.
- The main difference is that ENZ optimises the price pathway by targeting the level of the stockpile in the long-run. (The market model seeks to minimise annual differences between supply and demand, with a strong penalty on supply shortfall).
- The timing of turning points in the price pathway is also endogenous in ENZ. (The timing is by assumption in the market model).
- Set against these advantages, ENZ is complex and time consuming to run.

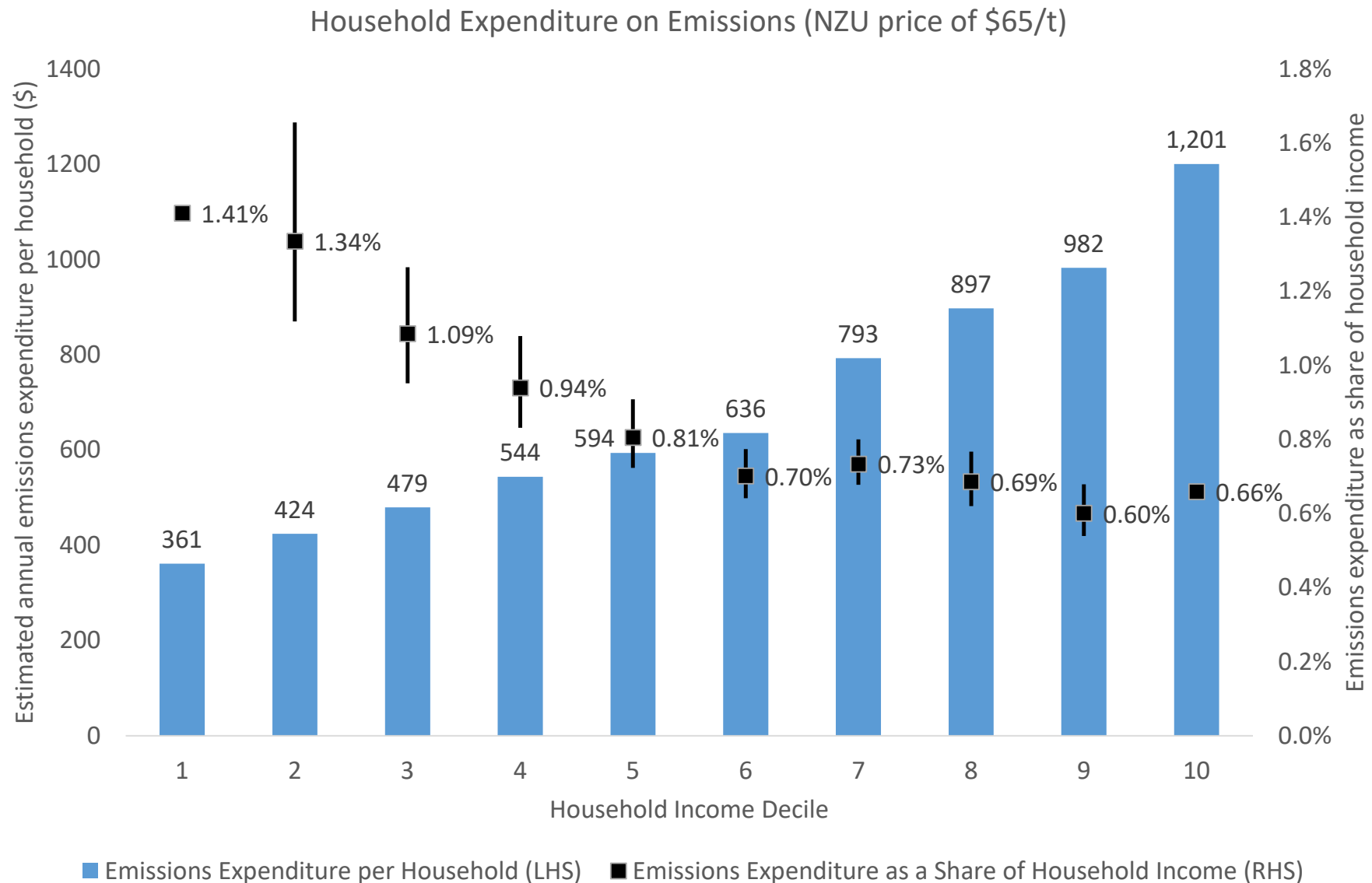
Extra Material



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Household Impacts Model



ETS advisory frameworks refresh workshop 3: Cap

1. This note sets out key considerations on step 2 of the seven-step method, setting the NZ ETS cap, to support an MfE-Commission (and friends) workshop on the topic. It covers how we approach the cap conceptually, how to manage the cap over time, including when it might be appropriate to adjust the cap, how to treat the issue of unsold units within the cap, and integrating unit limits with price controls.
2. Through the workshop, we intend to reach a shared understanding of one another's positions and rationale. This will ideally result in consistent analysis and advice on the cap, or clarity on what the other party is likely to advise and why. MfE also aims to provide greater clarity for the CCC and market in how the cap will be managed over time/how unsold auction volumes could be treated, to feed in to analysis and pricing expectations.
3. Note that although this workstream includes consideration of forestry accounting approaches, it is out of scope for this note and will be covered in another paper by the Commission in mid-August.

Context

4. The cap is intended to provide a clear signal to the market, supporting investment decisions and market credibility. The flexible design of the NZ ETS cap has potential for cap adjustments over time to factor in forecast emissions or removals, and amendments to take into account actual emissions performance and revisions to forecasts. While the flexibility is useful, it also poses risks to market certainty. The CCC has been seeking clarity on management of the cap for several years [refer 2021 advice]. How we treat the cap has a significant impact on market confidence and certainty.
5. The CCC's 2025 advice on ETS settings and MfE's subsequent consultation has given rise to several questions:
 - a. In its consultation on ETS settings, MfE presented a status quo option, which the CCC has raised could be seen as a de facto lowering of the cap – note however, MfE does not consider this a lowering of the cap (see discussion below)
 - b. Treatment of unsold auction units under the cap - Some commentators argued that volume should be withheld to correspond to unsold units, in effect a 7m tonne reduction in the cap, and that not doing so is a backdoor reintroduction of unsold units
 - c.
 - d. The market has expressed it seeks clarity on the issue of unsold auction units, via a market forum and the ETS settings consultation 2025
 - e. The CCC has also raised that it needs clarity on the EB3 cap, as the next settings advice period moves in to EB3
6. In addition, provisional 2025 emissions projections are looking different to the ERP2 projections used to calculate the current ETS cap (particularly for EB3) and the first

adaptive management approach will play out over next few months to respond to this. Upcoming 2050 target and future emissions budgets decisions also introduce policy ambiguity for the CCC's analysis of the cap. We expect it would be helpful for the Government to give the CCC a steer on how to deal with this ambiguity in its advice.

Status quo

7. Determining the appropriate share of emissions reductions to come from ETS sectors is primarily a political judgement, supported by modelling. The Government set a provisional cap within ERP2, in the form of an absolute number (91 Mt CO₂-e), representing the maximum allowable volume of emissions within the ETS. This was based on the projected emissions from NZ ETS sectors. ERP2 included a note that “future settings decisions may also need to consider net emissions reductions arising from any new complementary policies. This includes considering whether the NZ ETS cap should be tightened to lock in those emissions reductions and prevent those policies from disrupting market dynamics” (ie, to mitigate the waterbed effect).
8. The Commission based its most recent settings advice on the provisional emissions cap in the second emissions reduction plan, with some minor adjustments for more granular projections of non-covered sectors. This leaves an EB2 cap of 89.4Mt. It did not make settings recommendations that would have implications for the level of the cap. In the past, the Commission has provided advice on the Government's choices in adjusting the cap (2024 advice, box 2).
9. There is no explicit framework or guiding principles which set out when the Government should/might adjust the cap, leading to potential ad hoc decisions and unpredictability. MfE's advice has been that the NZ ETS cap (based on ERP2 projections) was intended to inform future NZ ETS settings decisions but not to bind regulatory decision-making if they are at odds with the accordance test. There is therefore a potential tension for MfE between providing clarity to the market and meeting accordance requirements.

What do we mean by the cap?

10. There may be a slight difference in how we each see the cap¹:
 - a. the CCC consider the cap “the targeted level of net emissions the Government is seeking to achieve from sectors covered by the NZ ETS.”
 - b. MfE sees it as “the minimum level of fixed emissions budgets that are expected to be covered by the NZ ETS (the NZ ETS cap)” (BRF-5318), or expressed another way, the maximum allowable volume of emissions from the NZ ETS within the emissions budgets.

¹ Note, in the past MfE has communicated the cap as solely made up of units supplied via auction and industrial allocation (i.e. the overall limit on units as set out in legislation) without accounting for stockpile units, which may cause some confusion

11. It is unclear whether this distinction has any implications for our respective advice (for example, when it comes to cap adjustments). This may be worth discussing in the workshop, for clarity.

Treatment of the cap in the 2025 consultation

12. MfE does not see the status quo option consulted on as lowering the cap, but rather changing the mix of units surrendered under the cap (ie more from stockpile, less from auction volumes). This reflects our risk tolerance for the uncertainty within the stockpile liquidity estimates, as discussed in the Surplus workshop. MfE's perspective is that if the surplus is in fact significantly smaller than implied by the status quo option, then the market will draw down more liquid units from the stockpile, which is less consequential than the alternative. There is a point at which unit limits would be sufficiently tight to actually result in a tightening of the cap, but we do not consider the status quo option consulted on meets that threshold.
13. Note that MfE's ETS team does not see the NZ ETS as an emissions reduction backstop for the rest of the economy, and therefore in recommending settings under that cap it does not seek to rebalance effort across sectors. We note that the ETS is relatively slow to adjust, so tightening the cap may be a less useful tool for addressing near-term risks to meeting budgets; it would result in faster stockpile drawdown, likely supporting achievement of EB3.² and perhaps higher prices. An area for discussion in this workshop is how ETS settings work as a lever to manage delivery risk within the adaptive management.

How should the cap be managed over time?

14. Both parties agree that allocating the effort between ETS and non-ETS sectors is a key strategic decision for the Government that should align with its wider climate strategy and other goals. The allocation of effort has equity implications as it directs where the burden of net emissions reductions should fall in the economy. We all agree that any decision on adjusting the cap should be taken in the round, reflecting underlying trade-offs and considering unintended consequences.
15. There are a number of ways the cap might be managed:
- a. Status quo: determine the cap ex-ante, based on ERP projections, without scope for changing the cap beyond minor methodological changes. This supports market certainty, but may dull price signals if oversupply exists
 - b. Option 1: Update the cap annually based on the latest non-ETS sector projections. This treats emissions as interchangeable across sectors and sets up

² Although settings changes may reduce the uncertainty band around surplus estimates

the ETS as a 'backstop' for emissions reductions. It reduces predictability for ETS participants. *Neither the Commission nor MfE favour this approach.*³

- c. Option 2: Determine an indicative cap ex-ante with periodic updates, justified transparently and in well-understood circumstances. This could be done via the annual ETS settings process, adaptive management process, or legislative change. The extent to which this is an attractive alternative to the status quo depends on the reasons cap changes might be justified.
16. Note that Catherine Leining has suggested that locking the cap for a five year period in an ERP adds further risk to accordance, effective market operation and s5M considerations. There may be merit in independent assessment of the ETS cap by both the CCC and the Minister on an annual basis to support (at least) general accordance.
17. Key considerations in how the cap should be managed over time include:
- a. A principled, transparent framework can help avoid ad hoc adjustments
 - b. Accordance with emissions budgets should be the first principle
 - c. Adjustments should not undermine market stability or shift effort arbitrarily between sectors
 - d. Proper functioning of the market, which may include many dimensions, eg greater predictability in the market, retaining a consistent direction of travel, credibility of scarcity, etc.
18. MfE hypothesizes the market may find a clear trajectory more compatible with predictability and stability than strict adherence to the cap (noting we do think we've adhered to the cap), particularly in the short-term. This is one reason why, although we agree the price controls help to manage the risk of oversupply, we have a preference for not making the volume available to the market. It would be interesting to discuss this point further with the Commission.

Adjustments to the cap

19. The purpose of getting clear on this point is twofold:
- a. To communicate clearly (even if at a high level) to the market how it can expect the Government to treat the cap in different circumstances, and build that into their supply and pricing expectations.
 - b. To provide clarity to the Commission on how it should model and reflect decisions about this in their calculations – for example, if major industrial closures result in a big change in IA volumes, should the Commission assume the cap remains the same and provide advice on that basis, or should it be assessing against a lower cap?

³ MfE has previously advised Ministers (2024) that a process which adjusts the cap each year based on most recent projections is not recommended, as it would reduce certainty for NZ ETS participants

In principle, when might we make adjustments?

20. There is a spectrum of options as to when the CCC might consider advising on/Government might consider making adjustments to the cap, some of which are already done. For example:
- a. **in line with methodological changes.** These updates are refinements to emissions calculations that bring estimated emissions down because of better data and information, rather than because of actions that reduce emissions. There are questions about what constitutes valid changes and how to deal with them. Our budgets are fixed amounts while the GHG inventory changes from year to year, which then flows into projections. There may be a certain amount that we 'look through' to maintain stability; it may also be worth considering some kind of ratchet mechanism, where we would permit downward revisions to cap from inventory changes but not the other way.
 - b. **Lower industrial allocation** as a result of no longer needing IA units, for example because of unexpected industrial closures. In this situation the Government has a choice about whether to remove those units, as the initial purpose of the free allocation no longer exists, or whether to keep the units in the system. Treatment of this may vary depending on your consideration of the cap as a target or maximum level.
 - c. **as a result of unanticipated 'real world' changes (eg, industrial exits, major new technology breakthroughs & complementary policies).** These changes create permanent emissions reductions that enable emissions budgets to be met without imposing additional effort on NZ ETS sectors/non-covered sectors. Locking in the emissions reductions achieved by complementary policy measures or 'real world' events can avoid the waterbed effect and maintain incentives for other NZ ETS participants. However, a major challenge is distinguishing between emissions reduction from the ETS doing its job (which could be a firm exit or some tech uptake) and something that was unanticipated when the cap was set. For example, the cap bakes in NZ Steel & Methanex, so these shouldn't be adjusted for again.
 - d. **In the case of unsold auction volumes** – see section below (paras 26-33). Where successive auctions do not clear and there is strong evidence that that is because of a permanent change in supply & demand, the Government could decide to reduce the cap.
 - e. **To overachieve budgets.** Any emissions reductions beyond the minimum required by budgets increases the likelihood of meeting later emissions budgets, the 2050 target and the NDC. The cap could be tightened to achieve this if the impacts of doing so are manageable, but this is a highly political decision.

See [appendix 1](#) below for a fuller list (for discussion).

When might be the appropriate point in the cycle to consider and decide to adjust the cap?

21. A key issue which has emerged is whether making adjustments to the cap (de facto or explicit) is appropriate through the annual ETS settings process. MfE and the CCC agree that setting the cap requires political judgement and due consideration of distributional impacts and equity.
22. It is not the intention of Government to take strategic decisions via the ETS settings process without transparency and due consideration of the trade-offs and consequences. However, any decisions which impact on unit limits, price controls must be made through the annual settings process, and the annual process provides a timely, existing Cabinet and legislative vehicle for the Government to make cap adjustments.

Should the Commission recommend a cap adjustment as part of its settings advice, and if so, how?

23. Due to the political dimensions to setting the cap, it may not be appropriate for the Commission to give a firm view on changing the cap (within settings advice) in the absence of a clear ex ante government position. This is particularly the case for some of the more political judgements, eg to overachieve budgets.
24. The Commission is likely to give advice that prioritises alignment with an explicit cap, but it may also be useful for the Commission to give advice on technical/methodological changes to the cap, and to point out (as it did with NZ Steel) where there may be choices or benefits in cap adjustment for achievement of budgets or to account for other factors.
25. The Government could then decide to amend the cap if it wishes, after considering the full range of factors. That could happen as part of that year's adaptive management process, to be incorporated into settings advice the following year. For example, the adaptive management framework could say something like 'the government has considered the risks and considers the current cap appropriate/ judges the cap should be tightened by xx to [achieve xyz result]'.

The treatment of unsold units in preparing settings advice

26. In recent years, a number of NZ ETS auctions have not cleared, or partially cleared, resulting in a large carry forward of units within a calendar year. Unsold auction volume is cancelled at the end of the year. Market participants are seeking clarity on how unsold units will be treated going forwards.
27. This matters for this project because it meaningfully impacts assumptions about the surplus volume – when setting unit limits, all upcoming auctions are assumed to clear. When auctions do not fully clear in a calendar year, this means less supply has entered the market than expected, which reduces future estimates of the size of the surplus. It may also suggest that the original starting point for the surplus was higher than estimated.

What do non-clearing auctions tell us?

28. An unresolved issue is what the repeated non-clearing of auctions signals. MfE's view is that it signals the market doesn't need those units, whereas the Commission's analysis suggests a less clear cut picture. Reasons which might explain the declined auctions include lower than projected emissions (as borne out by the annual monitoring advice); a greater surplus than estimated; and less hedging.
29. The reasons for these may also be temporary, and the Commission feels it is unclear what the impact of cancelling volume will be in that case. Their recommendation was to hold the volume until the end of the settings period to 'wait and see' and allow more information to come to light (+ use price controls to manage risk), and withhold the volume later if it becomes clear it was not needed.
30. MfE's view is that the risk of over-supply is greater and harder to fix than undersupply, so it prefers operating on the basis of withholding volume, and auctioning it back in if required later on. Both approaches have the same effect – but may be perceived by market participants as sending different messages. The preferred approach depends on your assessment of which is more likely to provide predictability and stability for the market (ie, sticking with the number, or sticking with the trajectory).
31. The CCC and market have expressed the need for clearer direction from Government on how unsold volumes should be interpreted and treated in future settings. If the Government could give further direction about what it expects to happen, the Commission's advice could more explicitly respond to the government's preferences.

Treatment of unsold units in future years

32. It's probably not appropriate to make a hard & fast rule about how unsold units will be treated, as there are myriad reasons for auctions not clearing. Instead, what is most important is understanding why auctions have not cleared, and what that tells you about whether or not the units are needed for proper market function.
33. However, there may be some rules of thumb that the Commission can incorporate into their analysis – eg,
 - a. If we think the auctions are not selling because of temporary factors driving temporary oversupply, keeping the cap unchanged and displacing the units to the end of the settings period would be appropriate. This is a change in the timing of the supply mix (more surplus drawdown now and less later, auctions vice versa) but not the overall quantum (i.e. cap). This is CCC advice this year.
 - b. However, if we think auctions are not clearing because of a permanent change in supply & demand (i.e. fundamental repricing), then the govt has a legitimate choice over whether to:

- i. adjust the cap downwards (reduce overall supply) - appropriate if confident about permanence and wanting to overachieve budgets (subject to discussion above)
 - ii. retain the cap but revise the surplus upwards (change the supply mix from auction to stockpile use) - appropriate if not confident about permanence but taking a conservative approach to risk. This is our SQ option this year
 - iii. retain the cap and surplus estimate and auction more later - appropriate if confident about permanence and wanting to achieve budgets at lower cost
34. There may be different interpretations of what non-clearing auctions are telling us (as with this year 2025). We can share information and analysis across MfE & the Commission to improve our shared understanding of the market conditions and/or our analytical judgements. This does not preclude us making different judgements. The judgements (and how they impact on the advice) can usefully be made transparent to the market, so the reasons for any decision are clear.

Integrating the development of unit limits and price control settings

35. This refresh project has focused on the unit limits aspect of the settings process, with limited attention on price controls. Matt Cowie has argued that the auction volume settings aren't that influential on market prices at the moment, and that price settings hold the most market power; and that there is an increasing disconnect over time between how prices settings provide for accordance vs. unit limits, as price settings focus on gross reductions but volumes are dominated by forestry supply.
36. The CCC's advice on unit limits and price controls are provided as a package. It was clear that "changes to the price control settings could have implications for unit limit settings, and vice versa. The settings are inter-related and need to be considered together". MfE's 'status quo' consultation option consulted on different unit limits, but agreed with the CCC on price controls.
37. In earlier workshops, the CCC has noted that the risks of oversupply raised by MfE are mitigated by the price floor. Although the volume looks like it's there in later years, if the stockpile is greater than expected and secondary market prices are lower, the market will not purchase those additional units if they don't need them. MfE acknowledges this point, but as above, considers it sends a different signal to the market than withholding volume now and reintroducing it later if needed.
38. Key issues for discussion include what the purpose is of price controls in a net-based strategy, whether there is scope to achieve budgets/targets at a lower cost than originally thought through a lower floor price, and what the risks/impacts of that would be. The Commission has noted impacts on the incentives of forestry and existing decarbonization projects as a result of lowering the floor price.

39. Linked to the unsold unit issue, there's a question of whether auctions declining is a sign that price controls are doing what they are intended to do, or if they are not set at the optimum level, and whether as more successive auctions don't clear, you get to a breaking point in the logic of the floor price.

Discussion prompts for workshop

1. How do we each think about the cap and what implications does that have for our advice?
2. Should there be an independent assessment of the ETS cap on an annual basis to support accordance?
3. How far do we agree on when you might adjust the cap? What still needs to be worked through? How can that
4. What are the pros/cons of the Government taking an explicit position on unsold units? What impact does that have on our advice?
5. What do non-clearing auctions tell us about price controls, and what is the purpose of price controls in a net-based strategy?

Appendix 1 – potentially for working through in workshop

Circumstance	CCC view	MfE view (<i>initial & untested</i>)
<i>No adjustment for any reason</i>		Do not support – insufficiently flexible
<i>Methodological reasons (eg inventory updates)</i>		Support in theory, but may include threshold to avoid too much variation year to year (as with uncertainty band). May consider downward ratchet mechanism.
<i>IA forecast changes (eg IA emitter closing)</i>		Support in theory – to maintain incentives for other participants
<i>Non-clearing auctions</i>		Support only when confident about permanence of oversupply and wanting to overachieve budgets
<i>Other market dynamics (eg significant forestry)</i>		This runs counter to the Government's net-based approach, so we are unlikely to support. Instead, forestry units can be considered via step 5
<i>New technology development</i>		
<i>Complementary policies (eg, GIDI, public transport)</i>		
<i>To support domestic overachievement</i>		Highly dependent on Government intent, expected impacts on firms, households etc.
<i>One-off shock (eg COVID-like event)</i>		

ETS settings refresh - workstream planning Draft for comment

Last updated 30 June 2025

Purpose: The purpose of this note is to set out a proposal for how MfE and the Commission break down the work agreed under the ETS settings refresh project Terms of Reference. This note has been drafted by MfE with input from the Commission.

MfE has included detail of our current thinking process in the interests of being as clear as possible as to the nature of the questions we'd like the analytical work to tackle, and to draw out any areas of disagreement or differences in understanding at the outset. Any words that could be read as inconsistent with the TOR are unintentional.

Proposed breakdown of work:

We propose organising the work into 4 analytical workstreams (below), which will each include four stages:

- i. Drafting a strawman for pre-reading;
- ii. Hosting a workshop;
- iii. Writing up workshop outcomes; and
- iv. Seeking feedback and refinement on the workshop material from workshop attendees and the 'wise heads'

In some cases (eg, on the overall 7-step method and tools/models) an additional initial step to cover what has been done to date may be helpful.

The outputs of each workstream will feed into a final report, which will be circulated again to MfE, CCC, wise heads and other agencies involved in this project for further comment. It is expected that as far as possible the report will reflect shared understandings between MfE and the Commission, and both agencies will subsequently make changes to their own processes/frameworks leading into the 2026 settings advice process. MfE will deliver the report to the Minister of Climate Change in September 2025. The report is expected to be published, with timing TBD after considering market sensitivity implications.

MfE will hold the pen on the report. The Commission will participate in workshops and input into workshop notes & outputs, and lead particular aspects of the work – notably around explaining the 7-step methodology and the CCC's legislative requirements, the tools & modelling workstream, and on forestry accounting. These will be agreed at the working level where necessary.

Note on sequencing

The four workstreams will need to overlap so we can meet project milestones. Concurrently, at the project mid-point we will begin drafting a report, to be provided to the Minister in mid-September.

Scoping analytical workstreams:

Note that as we work through each workstream there is potential for change in focus as our understanding evolves and new questions arise. The below captures both MfE & the CCC's understanding of the key issues at the time of writing.

1. Legislative requirements

The key analytical questions we're trying to answer are: How do we assess accordance within the ETS cap and at an aggregate level, and What is the appropriate way to approach addressing the legislative requirements for the development of the NZ ETS settings, in light of the wider CCRA framework for climate policy and the role of the NZ ETS?

Or, given the legislative requirements about accordance (and conscious of challenges in the policy landscape), what are the risks/benefits of using the ETS settings process, and what are the other options?

Part of the context for this is that the Minister (on MfE's advice) is consulting on two options for 2025 settings. The first is the Commission's recommendation, including the results of methodological improvements this year, which prioritised consistency of the settings with the emissions cap the Government had set out in ERP2. The second is a status quo option, which prioritises consistency with settings currently in regulation, and more strongly weights delivery of emissions budgets (EB3 particularly), and recent market dynamics

Issues this workstream will consider:

- the relevant requirements and matters to be considered under the CCRA, including:
 - how they are currently addressed in the seven-step methodology used to develop the unit limits
 - how they are currently addressed in the development of the price control settings.
- How the NZ ETS settings update process should be approached, in light of the other processes in the CCRA framework for climate policy (to advise on and set emissions budgets and emission reduction plans, and to monitor progress towards meeting emissions budgets).
- How and to what extent can the ETS settings process contribute to stability, predictability and credibility in the NZ ETS market, given the scheme's current design? How might those factors be in tension and traded off against one another?
- how we define and implement accordance in respect of the unit limits and price control settings
 - what do the judicial review decision and Crown Law advice mean for how we should understand the Act's accordance requirements.
- what paths forwards or different approaches could be taken when current Government policy prevents the settings from strictly according with emissions budgets and NDCs, but may generally accord. the relative importance of different dimensions of the proper functioning of the NZ ETS and other mandatory considerations under the Act, and where in the existing analytical process these are considered.
- Investigate and assess the different ways that alternative approaches could contribute to or detract from a predictable and coherent approach to the NZ ETS settings updates.

- Whether the Commission and Minister have the same decision-making parameters, or can/should consider different aspects (including political decisions).

2. Tools & models –

The key analytical question we're trying to answer is: what are the most appropriate models, tools or data inputs to inform advice on ETS settings within and alongside the 7-step process (subject in part to findings to workstreams 1 – 3).

The main models to consider are the ETS Market model, the forestry model and ENZ but other models could be included if relevant. Models assessing the impacts of the ETS (MfE Household Impacts Model, TSY TAWA) are also in scope.

Issues this workstream will consider:

- As a first step:
 - identifying or assessing which questions in the NZ ETS settings analysis are amenable to being informed by modelling.
 - a stocktake of what models have been used in the development of the NZ ETS settings so far.
- Identifying data and information gaps, such as for forestry (units held for harvest etc) and NZU prices], including which gaps are most challenging and developing a plan to address these
- Identifying the different models and other inputs that could be relevant tools for developing advice on the NZ ETS settings
- the strengths and limitations of the different models, including how they could be appropriately used in analysis to inform both the NZ ETS unit limits and price control settings.

3. 7 steps: surplus – how to calculate, factor in liquidity, price dynamics etc

The key analytical questions we're trying to answer are: (1) how best to calculate the size and liquidity of the surplus and stockpile (acknowledging uncertainties and that there is likely no perfect answer) and (2) how best to reflect the uncertainty associated with the surplus size in settings decisions.

Issues this workstream will consider:

Understanding the surplus estimate

- What are the largest and most variable sources of uncertainty affecting the estimate of the total surplus?
- What are some options for reducing those uncertainties? – eg, data/evidence or different analytical approaches
- How does the carbon price affect the size and liquidity of the surplus and stockpile and how should it be taken into account in the methodology?

- Given that methods and information change over time, potentially changing estimates of the surplus, how should method updates be balanced against the resulting uncertainty for market participants?

Managing the surplus

- Government policy is to manage down the surplus over time. Given that:
 - What are the key judgements and trade-offs in considering how to manage down the surplus that impact on settings advice?
 - To what extent and how should uncertainty about the surplus estimate and drawdown be addressed or factored into annual NZ ETS settings decisions?
- Does the answer to the questions above change once the settings period moves into the start of EB3, which it will from next year. In particular, how assumptions around the role of the stockpile may need to be treated differently.

4. **7 steps: ETS cap and subsequent steps** related to the impact of forestry accounting, industrial allocation, unsold units and adaptive management)

The key analytical questions we're trying to answer are: How do we balance managing shocks to demand/supply (such as the shuttering of an industrial emitter receiving free industrial allocations, or declined/failed auctions) against maintaining market stability and proper function through the 'cap'? Under what circumstances (if any) would it be appropriate to recommend total effort be adjusted upwards or downwards?

Issues this workstream will consider:

- The options for different approaches to setting and managing the emissions cap over time, including:
 - basing the emissions cap on emissions projections, versus on an up-front effort sharing decision
 - considering sound bases for adjustments to the cap, and treatment of issues like changes in (a) IA policy (b) unsold units (c) market dynamics (d) technological development
 - implications of both for accordance, equity, distributional impacts, providing advance information on the reductions required and market functioning (predictability, stability, credibility & coherence)
 - where in the 7-step process or other processes any changes might be given effect
 - Identifying other factors which may usefully be considered by the Minister in taking decisions
- the forestry accounting approaches used in the NZ ETS and target accounting, including assessing the scale and direction of any misalignments that could affect the ability of the NZ ETS settings to accord with emissions reduction targets.
 - The Commission is leading a piece of analysis on these issues that will contribute to this process.
 - It will draft a short paper for discussion laying out a qualitative description of the differences between NZ ETS and target accounting and explaining how they affect the accordance of the settings with

NDCs emissions budgets and the 2050 target (tentatively in mid-August).

- exploring different ways to integrate the development of the unit limits and price control settings.
- understanding appropriate differences in how MfE vs the Commission might approach advising on this question

Refer to [Gantt chart](#) for workshops for detailed task breakdown.

Workstream 1: Legislative requirements

Purpose

1. This note is intended to support a discussion between the Climate Change Commission and MfE to examine each organisation's approach to implementing the relevant statutory framework when giving advice on annual ETS settings. From initial discussions, there seem to be some differences between the two organisations in terms of implementation of the legal requirements, but the exact nature of the disagreement – if there actually is any – is not clear. This note is intended to help clarify our mutual understanding and isolate any areas where we have different views.
2. Consequently this note sets out:
 - the statutory framework that governs annual decisions on ETS settings (unit supply and price control);
 - how the Climate Change Commission and MfE respectively give effect to that statutory framework when developing advice for the Minister of Climate Change, and
 - questions that arise that the two organisations may have different perspectives on.

Statutory framework

3. The Climate Change Response Act 2002 (the Act) contains the statutory framework that the Minister for Climate Change (MCC) must work within when making settings decisions, and by extension the statutory framework that both MfE and the Commission must work within. The full set of statutory provisions are appended in table 1 and 2, but the key elements are:
 - Accordance: the main test for decision making under the statutory framework is that the Minister is satisfied that the unit supply limits, and price control settings are in accordance with the emissions budgets, nationally determined contributions and the 2050 target (s 30GC(2)).
 - Note, under s5ZOA(3), the Commission's recommendations to the Minister must meet the same requirements as the Minister's decision making in s30GB and 30GC and so must also satisfy the accordance test.
 - Strict vs general accordance: while the Act requires strict accordance with the 2050 target (interpreted as a very high probability that the settings constrain emissions to levels necessary to meet the target), the settings do not need to strictly accord to EBs and NDCs if, after taking account of matters specified in s30GC of the Act, the Minister is satisfied that a discrepancy is justified. However, even when a discrepancy is justified, the Minister must still be satisfied that the settings still accord, meaning there is a good probability that settings constrain emissions to the levels necessary to meet the targets.
4. Giving advice on ETS settings is one of the Climate Change Commission's statutory functions. As the advisor to the MCC, who must make settings decisions, MfE also

has the role of giving advice on settings decisions - although that is implicit rather than set out in legislation.

5. S 5ZOA(3) of the Act requires the Commission's recommendations to align with the requirements of the MCC's decisions under s 30GC, implying a level of overlap in the decision-making parameters between MfE and the Commission. However, as detailed below, there are underlying differences to the role the Commission and MfE play in providing advice (i.e. political, legal, etc) that inform the ultimate recommendations.
6. Procedurally, the Commission starts considering its advice and engaging externally (under s 5N) in September (following MfE's publication of ETS settings regulations). The Commission then publishes its advice early the next year. The MCC/MfE then consult (under s 3B) on options for updating the ETS settings regulations – which may or may not include the approach recommended by the Commission – over the middle of the year, with decisions in approximately August and amending regulations published by the end of September.
7. The annual ETS settings advice is one part of the overall framework for climate policy established by the Act, with the 2050 Target as the overall emissions reduction target (s 5Q). Emissions budgets are then set as a way to give effect to the 2050 Target and the Paris Agreement (s5W).
8. The Commission has broader statutory functions under the Act's framework, including advising on emission budgets, advising on direction of policy in emissions reduction plans to meet emission budgets, and monitoring progress towards meeting budgets and 2050 Target. Note these functions are separate from the Commission's statutory ETS settings advice function and are treated as such by the Commission. This is not required by legislation, but there are reasons to keep these separate – for example, advice on emissions budgets and emissions reduction plans requires consideration of equity, impacts and effort sharing and thus should be subject to a longer and more extensive consultation period.

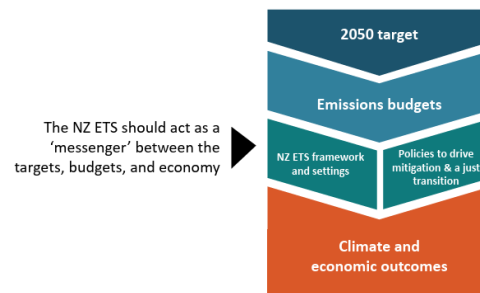


Figure 1 - How targets, budgets and the NZ ETS fit together

CCC's approach to implementation

9. The Commission uses a 7-step methodology to satisfy the legislative requirements and show the settings they recommend are in accordance with New Zealand's emissions reduction targets. The Commission has provided slides that set out the 7-step process.

The first 2 steps of the 7-step method apply to the settings overall, while the other steps are relevant to the unit limits

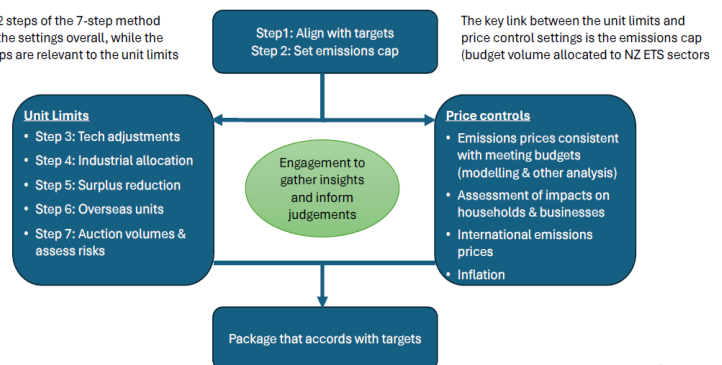


Figure 2 - the CCC's overall approach to developing NZ ETS settings advice

10. *[Drafting note: Commission, we've tried to encapsulate our understanding of your approach in the paras below but there is likely some nuance we have missed – keen to make sure we get it right]*
11. The Commission's advice takes government policy decisions (eg setting EBs) as read for the purpose of its analysis, then identifies the amount of emissions reduction expected to be carried out by ETS covered sectors (this year taking the provisional cap set in ERP2) and then calculates ETS settings within those parameters.
12. Consequently, the practical application of the accordance test normally¹ requires satisfying accordance with the amount of the emissions budget apportioned to sectors covered by the ETS (the ETS cap). The 7-step method is how the Commission gives effect to the emissions goal the NZ ETS is designed to support. It assumes, for analytical reasons, that reductions in the non-ETS sectors are delivered as projected – unless it has clear reasons to assume otherwise (ie, there is a lack of plausible plan or action).
13. In discharging its other functions, in particular its annual monitoring reports, the Commission may come to a view that the Government is off track to meet various budgets and targets. That view could be perceived as sitting oddly with earlier advice that ETS settings would accord with targets, budgets, and the NDC.
14. These two views are reconcilable because the Commission's accordance judgement relates to accordance with the ETS cap, assuming that the cap is set at the appropriate level within budgets & targets, and that interventions will be introduced to address shortfalls outside of the ETS.
15. However, it gives rise to the challenge of how the Commission should advise on settings if current Government policy gaps prevent the overall emissions profile from according with targets.

¹ The word "normally" here is meant to acknowledge that there may be situations where a government's plan for non-covered sectors is not plausibly achievable, and consequently difficult for the Commission to take as read.

MfE's approach to implementation

16. MfE supports the use of the 7-step method to reach an analytically robust answer to the unit limits within the agreed ETS cap.

17. However, MfE may more highly prioritise delivery of future EBs and potential market impacts, which influences its advice on the appropriate ETS settings to reach those targets.

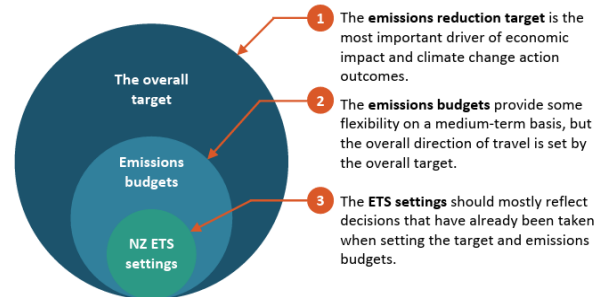


Figure 3 - ETS settings should mostly reflect decisions already made

18. The ETS is the government's main tool to meet targets and budgets, as set out in ERP2. The

ETS settings process is an existing annual process, which the Government can use (alongside additional and complementary policy measures) to manage risks with meeting EBs, so this factors into MfE's thinking when making recommendations on settings.

19. MfE considers the ETS cap as the *maximum* allowable level of emissions for sectors covered by the NZ ETS. As a result, MfE's view is that the Minister of Climate Change can set auction unit limits below the point required to 'accord' without implying a reduction in the agreed burden for NZ ETS-covered sectors - for example, if there is evidence of unit oversupply.

20. One reason the Minister might not use the full headroom available is to manage uncertainty about meeting targets. That may be because of the inherent and high range of uncertainty around the liquidity of the stockpile, or because of emerging risks in the trajectory of actual emissions reductions in non-covered sectors. Other factors include maintaining stability and predictability in the market and market signals (i.e. auction patterns/demand).

21. The MCC must also balance his broader legislative duties when making decision on settings. The Minister must be cognisant of his s5X(4) duty to ensure EBs are met and the purpose of the ETS (i.e. drive behaviour change through cost impacts).

22. We are likely off track for EB3 and one potential consequence is that the government may lower the ETS cap for 2030 onwards, in which case it seems undesirable to have an increase in auction volumes in 2028 and 2029. This consideration means that MfE is more conservative in its approach to auction volumes than it might otherwise be.

23. MfE recognises that doing so carries risks for market predictability. The 2025 settings discussion document sets this out (see [Table 4](#)). However, it balances this risk against the potential for longer-term uncertainty and significant oversupply, which is harder to adjust for than undersupply.

24. MfE also recognises that decisions which imply a rebalance in the share of effort need to be appropriately considered. This will be tackled in a separate workstream (7-step process pt.1).

25. MfE does not necessarily take previous government policy decisions as read in giving settings advice, and the adaptive management approach specifically envisages that the annual settings process may be used for overall risk management. Whether this difference is about the different roles that MfE and the

Commission play in the system versus fundamental different views about what the settings process is appropriately used for is a key question to tease out.

Key judgement calls

26. Both the Commission & MfE incorporate information and make judgement calls about a broad suite of considerations when providing their advice, within and in addition to the 7-step methodology. These include but are not limited to:
 - Market certainty and predictability,
 - Increased ability/certainty of meeting EB,
 - ETS market model,
 - Market insights (i.e. current market pricing implies more oversupply than initially anticipated),
 - Optimal balance/cost implications, and
 - Stockpile liquidity issues.
27. Each party may reasonably reach a different conclusion in the judgements they make. For example, in 2025 both parties considered delivery of budgets and recent market dynamics, but reached different conclusions about what that information means and what the appropriate course of action is. Each party may also weight those considerations differently to reach different conclusions.
28. A key point of difference may be in how we are weighting the different elements of a 'proper functioning' market – ie, how to ensure stability, predictability and credibility of the NZ ETS, within the scheme's current design. Specifically, this has arisen in the question of whether to implement the emissions cap (providing greater predictability), or if retaining a clear direction of travel is the more important factor in providing credibility.

Questions for discussion (from MfE)

[Drafting note: Commission, we've noted that some of the questions below don't reflect how you see the issue – however, it would be very helpful for us if we can talk through them as it's still how we're thinking about it. Our intention is that by addressing both our approaches to the issue we'll find a productive middle ground].

- What are some examples of situations where the Commission might recommend something different than the outcome of the 7-step process, or qualify its recommendations? How do non-ETS sector emissions and the achievement of future budgets inform the process, and what weighting is given to these factors?
- What does S50 of the Act (have regard to government policy) mean in practice? What challenges does it create for the Commission, and what mitigants could be put in place? More generally, what paths forward are there when current Government policy prevents the settings from strictly according with emissions budgets and NDCs, but may generally accord?
- What are the options for addressing projected underachievement of budgets, and what are the risks/benefits of using the settings process to address this? How does the Commission think about the government's adaptive management process in its settings advice, and in particular does/could the fact that the government has explicitly identified

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the ETS as a risk management tool make a difference to the Commission's recommendations?

- What are the key factors for maintaining the proper functioning of the market and how might they be weighted or balanced against each other?

Appendix 1: the statutory framework

Table 1 - statutory provisions for recommendations on price control settings:

Section	Relevant Provision	What it means
S 5ZOA Recommendations about limits and price control settings for units	(2) The Commission must recommend to the Minister limits and price control settings, including any desirable emissions price path, each time the Minister is required to recommend the making of regulations under section 30GB . (3) The Commission's recommendations must— a) cover the limits and price control settings for each year that the Minister's recommendation must cover; and b) be made in accordance with— (i) the same requirements under sections 30GB and 30GC (except section 30GC(5)(e)) that apply to the making of the Minister's recommendations; and (ii) its other duties (see sections 5M to 5O , for example);	When making recs to MCC on price control settings, the CCC's recommendations must be in accordance with s 30GB and s 30GC (same decision-making parameters as MCC) PLUS the CCC's duties in s 5M to 5O.
S 30GB Regulations about limits and price control settings for units	(2) If regulations are to be made under section 30GA , the Minister must recommend the making of regulations under this section that— e) prescribe the following price control settings: (i) the reserve amount of New Zealand units for each trigger price, which may be a single reserve amount of zero: (ii) the 1 or more trigger prices, unless the reserve amount is zero: (iii) the minimum price below which units must not be sold by auction, which may be zero.	Under s 5ZO(3)(b)(i) the CCC's recs must meet the requirements of MCC's decisions in s 30GB. This is the empowering provision on CCC's recs on price control settings.
S 30GC Requirements for regulations about limits and price control settings for units	(2) The Minister must be satisfied that the limits and price control settings are in accordance with— a) the emissions budget, and the nationally determined contribution for New Zealand under the Paris Agreement (<i>for the period the price control settings are being prescribed</i>) b) the 2050 target. (3) However, they need not strictly accord with the budgets or contributions as long as the Minister is satisfied that the discrepancy is justified, after considering the other matters under this section. (4) The Minister must consider— a) the main matters; and b) the additional matters, but only in relation to the price control settings. (5) The main matters are as follows: a) the projected trends for New Zealand's greenhouse gas emissions in the 5 years after the current year, including—	Under s 5ZO(3)(b)(i) the CCC's recs must meet the requirements of MCC's decisions in s 30GC. CCC's must be satisfied their recs on unit supply settings accord w/ the relevant EB and NDC. If CCC's recs are not in strict accordance w/ the relevant EB and NDC, will be sufficient to generally accord – but CCC must consider main matters and

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	(i) the anticipated volumes of greenhouse gas emissions to which the emissions trading scheme applies (meaning emissions for which participants are required to submit returns or surrender units under this Act); and (ii) the anticipated volumes of greenhouse gas emissions to which the emissions trading scheme does not apply: b) the proper functioning of the emissions trading scheme; c) international climate change obligations and instruments or contracts that New Zealand has with other jurisdictions to access emissions reductions in their carbon markets; d) the forecast availability and cost of ways to reduce greenhouse gas emissions that may be needed for New Zealand to meet its targets for the reduction of emissions; f) any other matters that the Minister considers relevant. (6) The additional matters are as follows: a) the impact of emissions prices on households and the economy; b) the level and trajectory of international emissions prices (including price controls in linked markets); c) inflation.	additional matters as justification for this discrepancy. CCC's recs on unit supply settings must always be in strict accordance w/ 2050 target.
S 5M Matters Commission must consider	In performing its functions and duties and exercising its powers under this Act, the Commission must consider, where relevant,— a) current available scientific knowledge; and b) existing technology and anticipated technological developments, including the costs and benefits of early adoption of these in New Zealand; and c) the likely economic effects; and d) social, cultural, environmental, and ecological circumstances, including differences between sectors and regions; and e) the distribution of benefits, costs, and risks between generations; and f) the Crown-Māori relationship, te ao Māori (as defined in section 5H(2)), and specific effects on iwi and Māori; and g) responses to climate change taken or planned by parties to the Paris Agreement or to the Convention.	This also provides a list of mandatory considerations (potentially outside of the 7-step process) that the CCC must consider in providing its recs on price setting (and empowers discretion in CCC's recs, because are considerations to be applied in the development of recs that are strict accordance).
S 5N Consultation	N/A	<i>Not relevant to this work.</i>
S 5O Commission must act independently	N/A	<i>Not relevant to price control aspect of this work.</i>

Table 2 - statutory provisions for recommendations on unit limits:

Section	Relevant Provision	What it means
S 5ZOA Recommendations about limits and price control settings for units	(2) The Commission must recommend to the Minister limits and price control settings, including any desirable emissions price path, each time the Minister is required to recommend the making of regulations under section 30GB. (3) The Commission's recommendations must— c) cover the limits and price control settings for each year that the Minister's recommendation must cover; and d) be made in accordance with— (iii) the same requirements under sections 30GB and 30GC (except section 30GC(5)(e)) that apply to the making of the Minister's recommendations; and (iv) its other duties (see sections 5M to 5O, for example);	When making recs to MCC on unit limit settings, the CCC's recommendations must be in accordance with s 30GB and s 30GC (same decision-making parameters as MCC) PLUS the CCC's duties in s 5M to 5O.
S 30GB	(2) If regulations are to be made under section 30GA, the Minister must recommend the making of regulations under this section that— a) prescribe the following limits for a calendar year: (i) a limit on the New Zealand units available by auction (an individual limit); and (ii) a limit on the approved overseas units used (another individual limit); and (iii) a limit on the sum of the following (the overall limit): (A) the New Zealand units available by auction; (B) the New Zealand units available by other means; (C) the approved overseas units used; and b) provide that— (i) the individual limits must not be exceeded; and (ii) the overall limit— (A) restricts both the New Zealand units available by auction and the approved overseas units used, in that neither must cause the overall limit to be exceeded; but (B) does not restrict the New Zealand units available by other means, in that they may cause the overall limit to be exceeded; and c) provide that any additional units that are allocated under section 86C(5)(b) are not counted as New Zealand units available by other means; and d) provide for how a reserve amount of New Zealand units is to be released for sale at auction if a trigger price is reached or exceeded by bidding at an auction, unless the reserve amount and minimum price are set at zero under paragraph (e); and e) <i>prescribe price control settings – refer to s30GB in price control table</i>	Under s 5ZO(3)(b)(i) the CCC's recs must meet the requirements of MCC's decisions in s 30GB. Empowering provision for unit supply recs (7-step process methodology).

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S 30GC	(2) The Minister must be satisfied that the limits and price control settings are in accordance with— a) the emissions budget, and the nationally determined contribution for New Zealand under the Paris Agreement (<i>for the period the price control settings are being prescribed</i>) b) the 2050 target. (3) However, they need not strictly accord with the budgets or contributions as long as the Minister is satisfied that the discrepancy is justified, after considering the other matters under this section. (4) The Minister must consider— a) the main matters; (5) The main matters are as follows: a) the projected trends for New Zealand's greenhouse gas emissions in the 5 years after the current year, including— (iii) the anticipated volumes of greenhouse gas emissions to which the emissions trading scheme applies (meaning emissions for which participants are required to submit returns or surrender units under this Act); and (iv) the anticipated volumes of greenhouse gas emissions to which the emissions trading scheme does not apply; b) the proper functioning of the emissions trading scheme; c) international climate change obligations and instruments or contracts that New Zealand has with other jurisdictions to access emissions reductions in their carbon markets; d) the forecast availability and cost of ways to reduce greenhouse gas emissions that may be needed for New Zealand to meet its targets for the reduction of emissions; e) the recommendations made by the Climate Change Commission under section 5ZOA; f) any other matters that the Minister considers relevant.	Under s 5ZO(3)(b)(i) the CCC's recs must meet the requirements of MCC's decisions in s 30GC. CCC's must be satisfied their recs on unit supply settings accord w/ the relevant EB and NDC. If CCC's recs on unit supply settings are not in strict accordance w/ the relevant EB and NDC, they must consider main matters. S 30GC(5)(b) and (f) empowers discretion into CCC's recs. CCC's recs on unit supply settings must always be in strict accordance w/ 2050 target.
S 5M Matters Commission must consider	In performing its functions and duties and exercising its powers under this Act, the Commission must consider, where relevant,— h) current available scientific knowledge; and i) existing technology and anticipated technological developments, including the costs and benefits of early adoption of these in New Zealand; and j) the likely economic effects; and k) social, cultural, environmental, and ecological circumstances, including differences between sectors and regions; and l) the distribution of benefits, costs, and risks between generations; and m) the Crown-Māori relationship, te ao Māori (as defined in section 5H(2)), and specific effects on iwi and Māori; and n) responses to climate change taken or planned by parties to the Paris Agreement or to the Convention.	This also provides a list of mandatory considerations (potentially outside of the 7-step process) that the CCC must consider in providing its recs on unit supply setting (and potentially empowers more discretion in CCC's recs than 30GC(5), because are considerations to be applied in the development of recs that are strict accordance.

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S 5N Consultation	N/A	<i>Not relevant to this work.</i>
S 5O Commission must act independently	(1) The Commission must act independently in performing its functions and duties and exercising its powers under this Act. (2) However, the Minister may direct the Commission to have regard to Government policy for the purposes of the Commission— a) recommending unit supply settings of the New Zealand emissions trading scheme; and	MCC can direct CCC to have regard to specific government policy in their unit supply settings rec – but needs to be led by MfE/MCC (ie CCC won't consider broader policy w/o Government direction)

Table 3 - How does the 7-step methodology reflect the legislative requirements above?

7-step methodology	Corresponding legislative requirement in the Climate Change Response Act 2002
1. Align with emissions reduction targets.	<u>S 30GC(2)</u> - The Minister must be satisfied that the limits and price control settings are in accordance with EB, NDC (<i>both for the period of which the limits/price control settings are being prescribe – ie not future EBs</i>) and 2050 target. <u>S 30GC(5)</u> – one of the main matters the Minister must consider in justifying discrepancy: • International climate change obligations and contracts New Zealand may have for accessing offshore mitigation from other carbon markets • The forecast availability and costs of ways to reduce greenhouse gas emissions, that may be needed for New Zealand to meet its emissions reduction targets <u>S5M</u> – matters the Commission must consider when performing their duties: • Likely economic effects • Social, cultural, environmental, and ecological circumstances, including differences between sectors and regions
2. Allocate the emissions budgets to NZ ETS and non-NZ ETS sectors.	<u>S 30GC(2)</u> - The Minister must be satisfied that the limits and price control settings are in accordance with EB, NDC (<i>both for the period of which the limits/price control settings are being prescribe – ie not future EBs</i>) and 2050 target. <u>S 30GC(5)</u> – main matters the Minister must consider • the projected trends for New Zealand's greenhouse gas emissions in the 5 years after the current year, including (i) the anticipated volumes of greenhouse gas emissions to which the emissions trading scheme applies (<i>NZ ETS sectors</i>); and (ii) the anticipated volumes of greenhouse gas emissions to which the emissions trading scheme does not apply (<i>non-NZ ETS sectors</i>) • the forecast availability and costs of ways to reduce greenhouse gas emissions, that may be needed for New Zealand to meet its emissions reduction targets • the proper functioning of the emissions trading scheme

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	- any other matters that the Minister considers relevant (ie incorporating info from ERP2 to ensure the settings align with the Government strategy to meet budgets and targets). <i>Discretion/judgement - emission budgets should be allocated between NZ ETS and non-NZ ETS sectors on the basis of the sectoral gross emissions reductions implied by the sector targets laid out in the emissions reduction plan.</i> <u>S5M</u> – matters the Commission must consider when performing their duties: - Likely economic effects - Social, cultural, environmental, and ecological circumstances, including differences between sectors and regions
3. Make technical adjustments.	<u>S 30GC(2)</u> - The Minister must be satisfied that the limits and price control settings are in accordance with EB, NDC (<i>both for the period of which the limits/price control settings are being prescribe – ie not future EBs</i>) and 2050 target. <u>S 30GC(5)</u> – main matters the Minister must consider - the projected trends for New Zealand’s greenhouse gas emissions in the 5 years after the current year, including (iii) the anticipated volumes of greenhouse gas emissions to which the emissions trading scheme applies (NZ ETS sectors); and (iv) the anticipated volumes of greenhouse gas emissions to which the emissions trading scheme does not apply (non-NZ ETS sectors)
4. Account for industrial allocation volumes.	<u>S 30GB(2)(a)</u> - the Minister must recommend the making of regulations under this section that prescribe the following limits for a calendar year: (iii) <i>IA included as part of the overall limit</i> (B) the New Zealand units available by other means <u>S 30GB(2)(b)(ii)</u> – the overall limit must restrict the NZUs available by auction and the approved overseas unit used, in that neither must cause the overall limit to be exceed but does not restrict the NZUs available by other means.
5.a. Set the reduction volume to address the New Zealand Unit (NZU or unit) surplus. 5.b. Adjust for discrepancies.	<u>S 30GC(2)</u> - The Minister must be satisfied that the limits and price control settings are in accordance with EB, NDC (<i>both for the period of which the limits/price control settings are being prescribe – ie not future EBs</i>) and 2050 target. <u>S 30GC(5)</u> – main matters the Minister must consider the proper functioning of the emissions trading scheme
6. Set the approved overseas unit limit.	<u>S 30GB(2)(a)</u> - the Minister must recommend the making of regulations under this section that prescribe the following limits for a calendar year: (ii) a limit on the approved overseas units used (another individual limit); and (iii) <i>as part of the overall limit</i> (C) the approved overseas units used

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7. Calculate the base auction volumes of NZUs.	<u>S 30GB(2)(a)</u> – the Minister must recommend the making of regulations under this section that prescribe the following limits for a calendar year: (i) a limit on the New Zealand units available by auction (iii) <i>as part of the overall limit (A)</i> the New Zealand units available by auction <u>S 30GC(5)</u> – main matters the Minister must consider • the proper functioning of the emissions trading scheme • other relevant matters
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ETS advisory frameworks refresh Workshop 3: Surplus

1. This note sets out preliminary thinking on step 5 of the seven-step method, calculating the surplus, with the aim of supporting an MfE-Commission (and friends) workshop on that point. The key questions are:
 - (1) how best to calculate the size and liquidity of the surplus and stockpile (acknowledging uncertainties and that there is likely no perfect answer) and
 - (2) how best to reflect the uncertainty associated with the surplus size in settings decisions.
2. To support working through those questions, this note sets out some context – hopefully generally agreed – and then sets out some questions that arise. Where relevant, this note seeks to reflect different perspectives that MfE and the Commission may have.

Context

1. Step 5 of the 7-step methodology is an assessment of how many units that are currently held in private accounts are “surplus”. The stockpile refers to units currently held in private accounts. Units that are not held for any particular purpose (for example, future expected surrender obligations) are considered “surplus”. The stockpile number is known with some certainty, but the size of the surplus is uncertain and involves making various assumptions and estimates.
2. The surplus presents a risk to achieving emissions budgets as the ability of emitters to purchase units drawn out of the surplus can mean that they are able to emit more than we had expected, exceeding emissions budgets. The bigger the surplus, the bigger the risk. Given the risk that the surplus presents,¹ government policy is for ETS auction settings to support a complete drawdown of the surplus to zero by 2030. In the context of the seven steps, auction volumes are set at a level that is expected to draw units out of the surplus and be surrendered at a rate consistent with that goal.
3. The size of the surplus is significant in overall settings decisions. Units in the surplus are by definition not held to meet any actual or expected need of the firm/person that holds them, so could be sold at any point, increasing total supply in the market. All else being equal, the more surplus units we think there are, the lower auction volumes should be, to keep to a given level of units in the market.
4. The surplus is currently estimated to be around 50-56 million units, with wide margins of uncertainty. Total auction volumes over the next 5 year period will likely be somewhere between 17-31 million units. So the surplus estimate is a non-trivial element of the overall judgement about auction volumes.
5. To estimate the size of the surplus, the basic approach is to take the stockpile number and subtract estimates of various categories of unit holdings that we would

¹ There are also risks on the other side, ie if the surplus is smaller than we think then we could draw it down too quickly, leading to the risk that ETS prices are higher than they need to be.

not expect to come to the market because they are held for particular reasons. That is:

- Pre-1990 forest allocation units held long term
 - Units held for post-1989 forest harvest liabilities
 - Units held for hedging purposes by emitters
 - Units held by emitters for emissions that have already occurred (holding volumes)
6. Post-1989 forestry units relating to MERP4 that may be carried over to the EB2 period are then added on.
7. In 2024, the Climate Change Commission advised that the surplus was bigger than previously thought, at 67.9 million units, and recommended that auction volumes be reduced accordingly. The Government took that advice and reduced auction volumes. In 2025, the Commission's surplus estimate reduced to 50 million units, which was a key factor in its recommendation to increase auction volumes.

Areas where MfE and the Commission potentially see things differently

8. There are two key areas relating to the surplus where the Commission and MfE may have different perspectives.

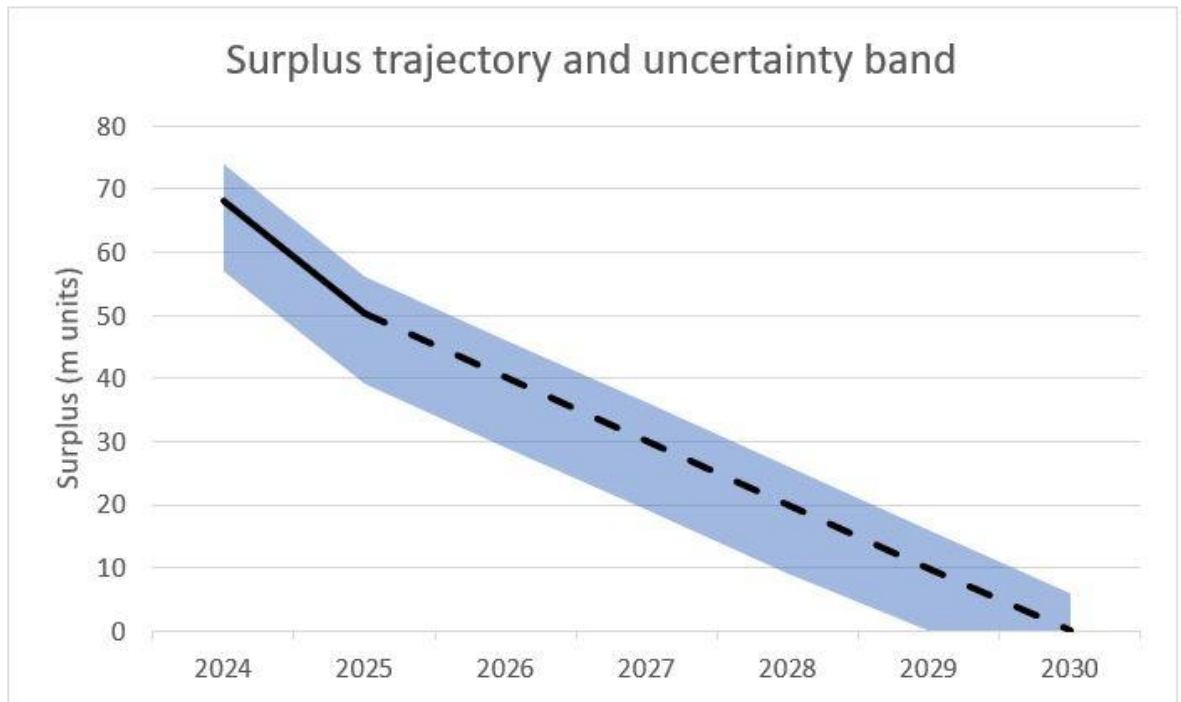
How big is it and how do we know?

9. The first possible area of difference is about how to think about how big it is.
10. There is a distinction between the surplus, or the liquid bit of the stockpile, and the rest of it, which is less liquid. The Commission tends to assume that the non-surplus part of the stockpile is illiquid, that is, there are no or at least few plausible scenarios where units in the non-surplus part of the stockpile might flow into the market (effectively behaving like surplus units). MfE, in contrast, thinks that there are situations where non-surplus stockpile units may flow into the market² – becoming surplus for all intents and purposes - and settings decisions should take this potential risk into account.
11. There is also some possible overlap between the “hedging” and “holding” categories that are subtracted from the stockpile to reveal a surplus estimate. If these categories overlap to any extent, subtracting them singly will lead to a surplus estimate that is smaller than it actually is. Two questions are (1) how to get an estimate of the size of this overlap and (2) how to treat the resulting uncertainty?
12. This year, MfE also interpreted the frequently non-clearing auctions as a sign that the surplus might be bigger than we thought. The Commission saw this as evidence of the surplus being reduced faster than expected, and methodological changes affected the Commission's estimate of surplus size. There is a question both about how to communicate methodological changes that affect the surplus estimate, and also how to treat them in terms of feeding into overall recommendations.

² For example, an emitter might be holding units for expected future surrender obligations, but if the price is quite high right now and they think they might invest in new technology in the near future then they might just decide to sell.

How should the inherent uncertainty re surplus size be reflected in recommendations?

13. The second possible area of difference is about how the uncertainty associated with the size of the surplus should be taken into account in settings decisions, and contextual factors that might affect how we treat that uncertainty.
14. For example, MfE's view is that since the size of the surplus is a risk to meeting emissions budgets, in a situation where meeting emissions budgets is expected to be challenging, as is the case now for EB3, it may be sensible to be conservative when considering the risk the surplus poses. That is particularly the case where there are signs suggesting that the risks are more on the "bigger" side, like auctions not clearing. That is, this year we have been more concerned about the risk that the surplus might be bigger than expected and therefore could mean we miss emissions budgets than we were about the risk that it could be smaller than expected and therefore ETS-covered sectors would pay more than necessary for their emissions – hence consulting on a status quo option as well as the Commission-recommended option. A different underlying context could change how we see the balance of risks, however.
15. One way of building the uncertainty about surplus size more explicitly into the advisory framework would be to manage to a band rather than a single trajectory. (this idea came from Matt, all errors in recording it are mine!). That is:
 - set a trajectory for managing the surplus down over a period of time,
 - set an uncertainty band around that trajectory,
 - so long as each year's updated surplus estimate is within the band for that point in time there would be no need to adjust auction volumes (all else being equal).
16. The uncertainty band could be asymmetric. Given the accordance requirement, there are reasons to be more comfortable with the surplus being lower than expected than higher than expected. This approach could help to reduce the changes to the volumes on a year-to-year basis, particularly where auctions have declined, as volumes would only need to be reduced/increase if the surplus estimate is outside of the band. The graph below illustrates the idea (thanks again Matt):



17. In addition, MfE has the idea of having a very short term surplus forecast, as at the end of the current year, which could be added to the uncertainty band idea.

- Do these ideas seem practical? What are some drawbacks?
- Does the Commission think it could implement these suggestions now, or would it need some sort of direction from the government?

Managing the surplus

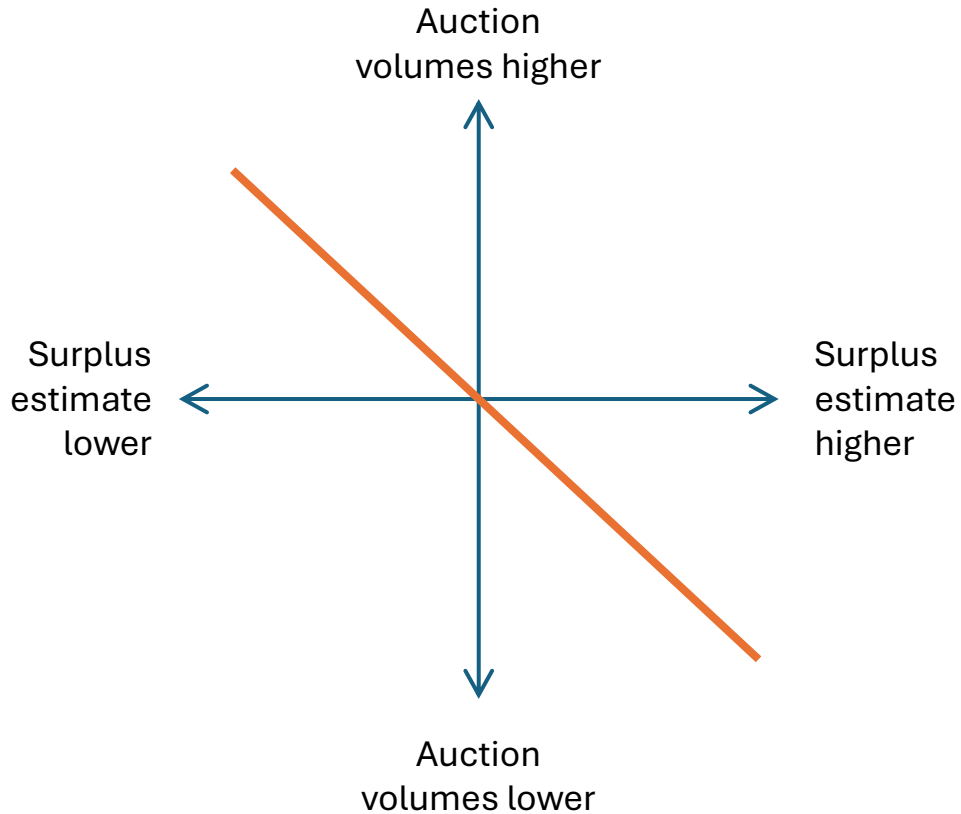
18. The Commission's advice, which the government has implicitly (don't think explicitly but correct me if I am wrong!) adopted, is to manage the surplus down to zero by 2030. That position has been built into the Commission's advice and the Government's decisions so far. As far as current settings periods are concerned this position is reasonably well established and there is no obvious presenting issue with it.

19. However, once the settings period moves past 2030 and into EB3, a slightly different set of questions arise:

- Is there an ongoing need for "drawdown" at the post-2030 point? The surplus will hopefully be gone by then but the stockpile will still be there.
- Does the Commission need some sort of direction or indication from the government about what to do here in order to formulate advice?
- The drawdown of the surplus until 2030 has a big impact on auction volumes, and once that element is removed, all else being equal they will increase again reasonably significantly. Is that a good thing in terms of overall market functioning?

1

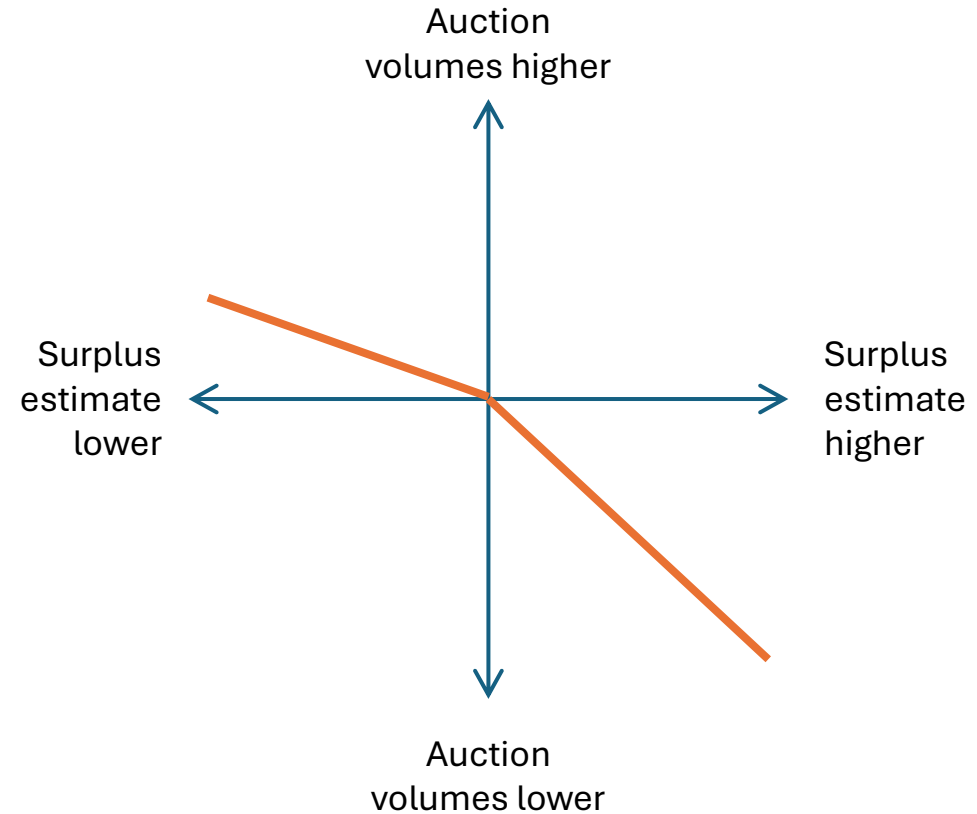
Current status quo



In this structure, there is a one-to-one relationship between changes in the surplus estimate and changes in auction volume. For every NZU that the surplus estimate reduces by, the auction volume increases. This appears to be the current status quo informing auction volume settings decisions.

2

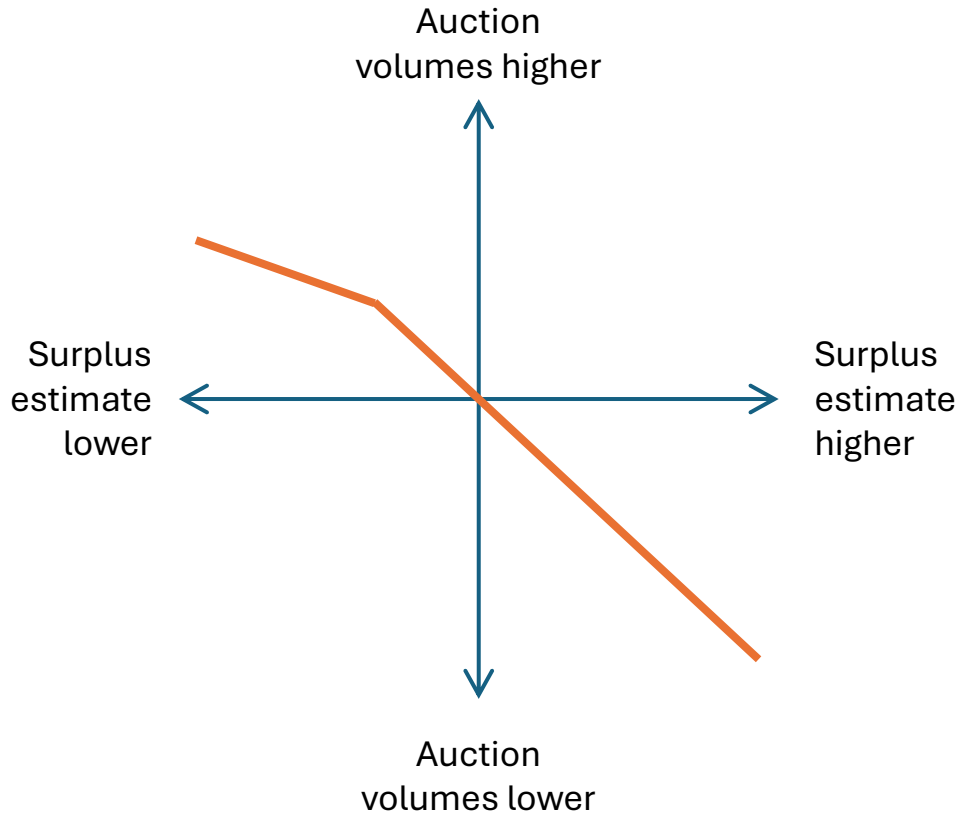
Risk averse to oversupply



Here the response to changes in surplus estimate which would increase auction volumes are dampened by lowering the “pay-off” relationship. For every NZU of surplus estimate which is lowered, only (for example) 0.5 NZUs are added to the auction volumes.

3

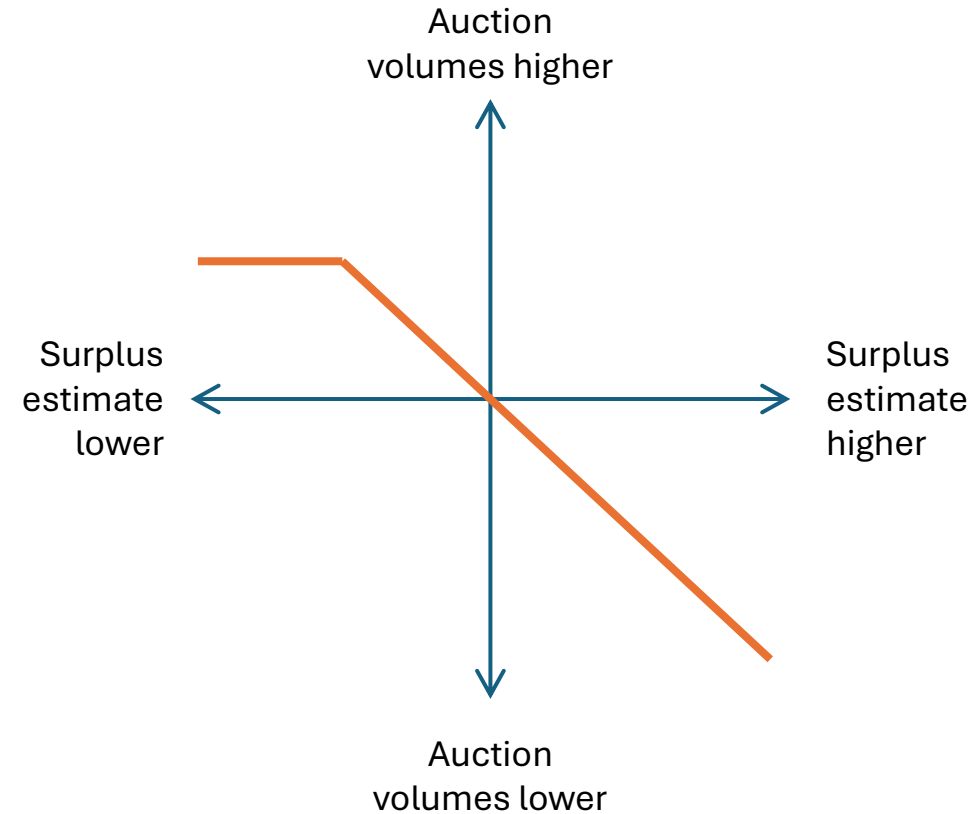
Risk averse to large changes that could lead to oversupply



Here small changes in surplus either up or down produce a 1-2-1 change in auction volumes, but larger increases in surplus estimate are dampened to reduce their effect.

4

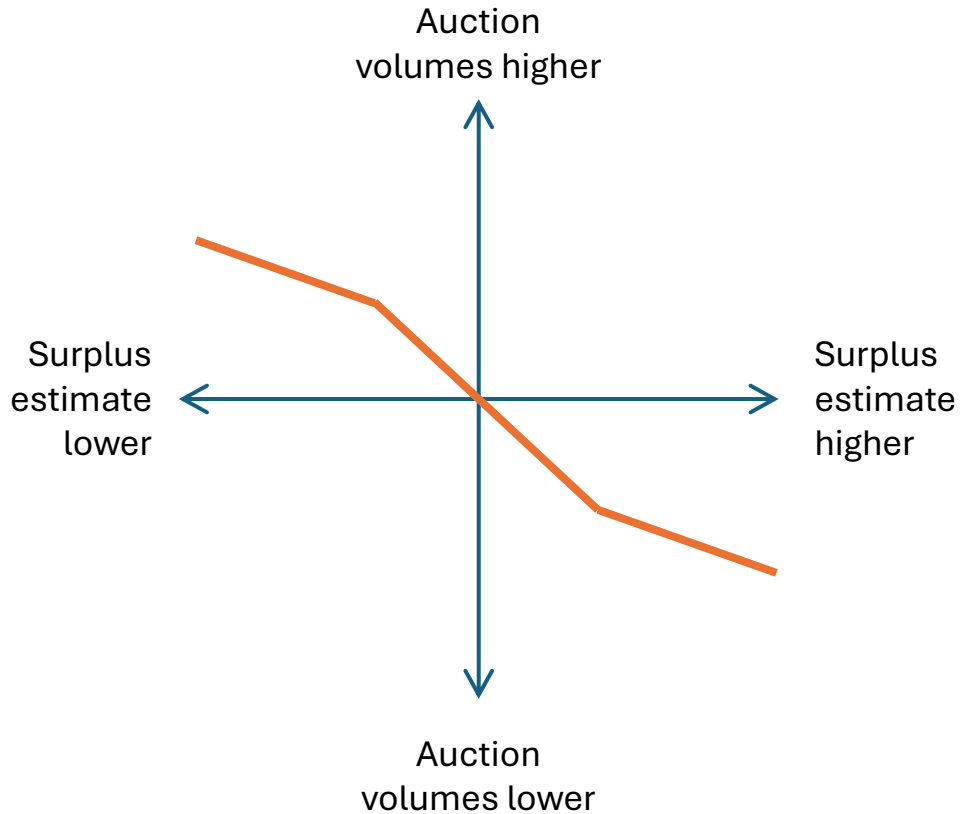
Highly risk averse to large changes that could lead to oversupply



This scenario goes further than dampening any large increases in auction volume, by capping them completely beyond a certain volume.

5

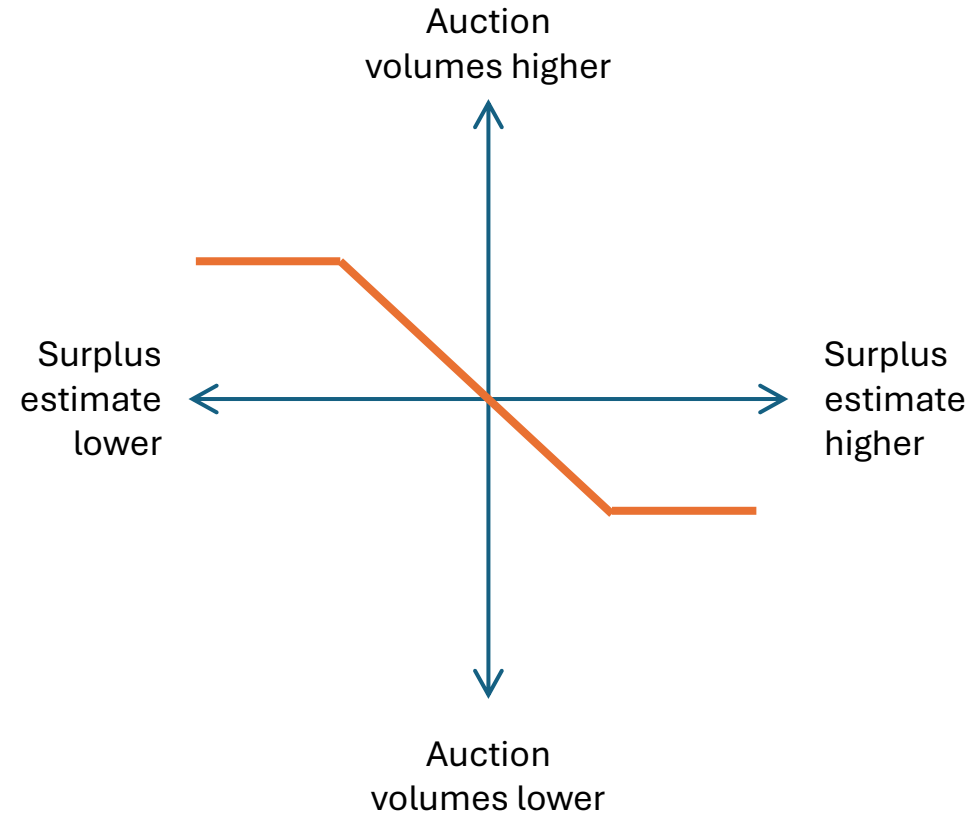
Risk averse to large changes in any direction



This format dampens the effect of any large change in surplus/auction volume estimate, but allows small changes to be reflected on at 1-2-1 basis. The points at which the gradient changes could be aligned with the 'tolerance band' in the market

6

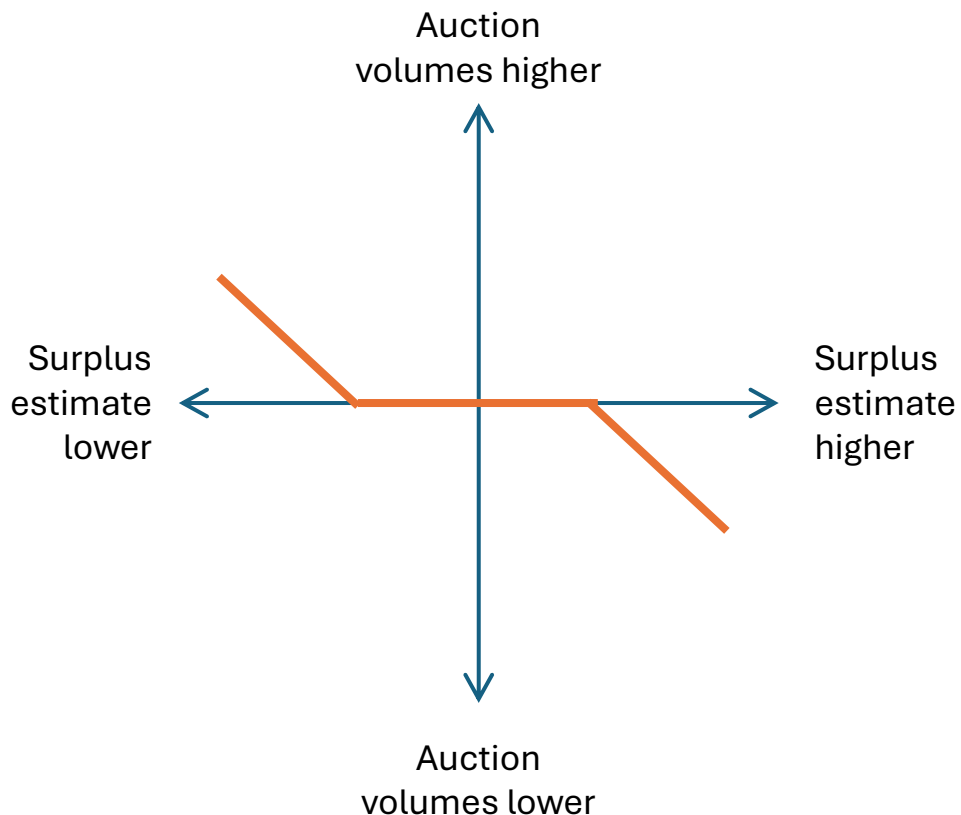
Highly risk averse to large changes in any direction



This structure caps the potential change in auction volume on both the increasing and decreasing sides of the chart.

7

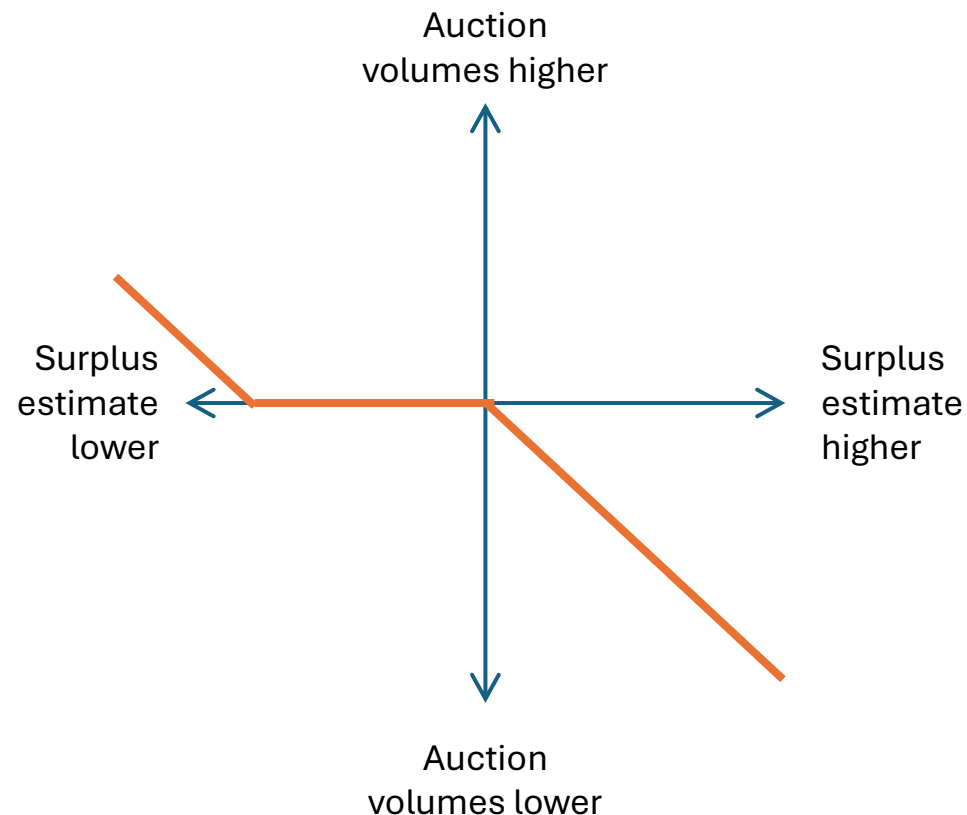
Small changes in estimate don't result in changes (a 'collar')



This structure sees auction volumes insulated from small changes in surplus estimate, but a 1-2-1 relationship beyond this channel. This could be a structure which is compatible with the “tolerance band” suggested in the surplus workshop.

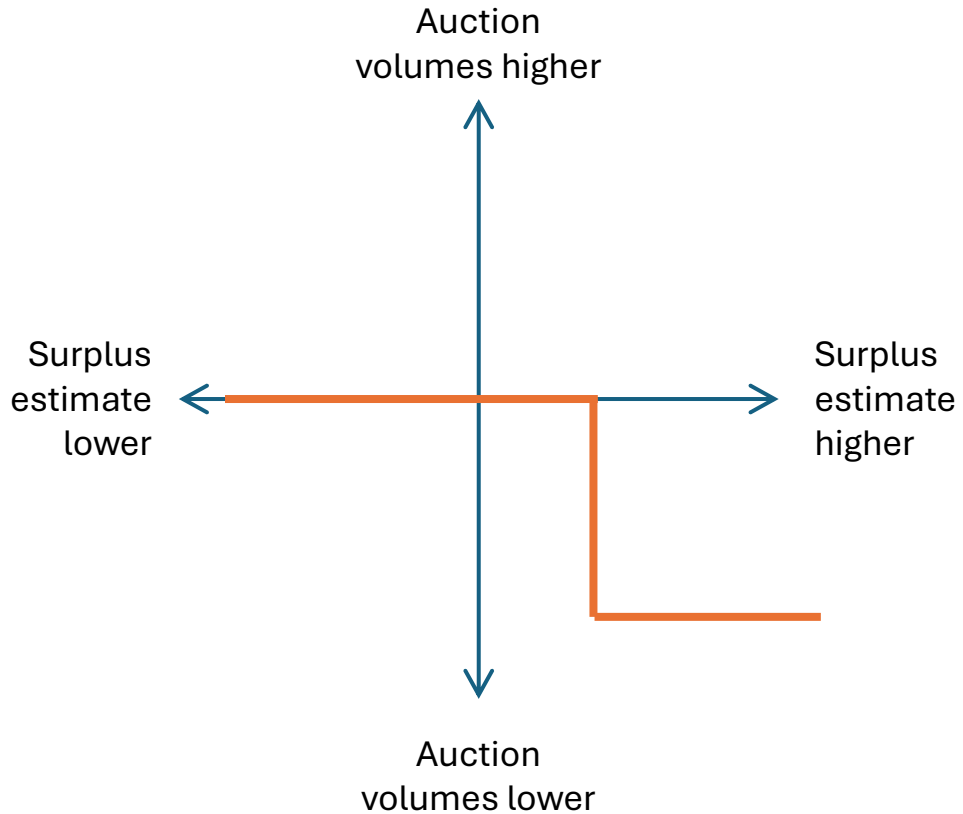
8

Particular care over small estimate changes which lower surplus



This structure differentiates between increases and decreases in surplus estimate. Higher surplus estimates produce a 1-2-1 decrease in auction volume, but lower surplus estimates don't impact auction volumes until they are over a set threshold.

EU ETS Market Stability Reserve



This structure represents the design of the Market Stability Reserve (MSR) within the EU ETS. When the surplus gets too large, a fixed volume of units are removed from auctions in the following year. We can see from this chart how blunt that its response can/has been.

NZ ETS Settings Framework Review – Initial joint meeting - 6 June

This session is an opportunity to shape and agree the direction of the review collaboratively before drafting a Terms of Reference.

Proposed agenda

1. Recap of context, including a readout from MCC-CCC meeting – 10 minutes
2. Jointly assess status quo approach, including identifying current ‘envelope’ – 30 minutes
3. Deep dive on analytical tools, role of judgement, other information – 30 minutes
4. Process, resourcing, governance – 10 minutes
5. Next steps – 10 minutes

Key areas and questions for discussion

Here is a list of areas we are considering, to provide a starting point for the discussion. We don't propose trying to answer all of these within this session.

- **What is it we are reviewing?**
 - What are do we see as the ‘envelope’ of the analytical and decision-making frameworks? Broader than just the seven-step methodology?
 - What other inputs and considerations are part of the advice cycle (eg, ETS Market model, market information)?
 - How do we currently incorporate qualitative considerations (ie, judgement)?
- **What does ‘good’ look like?**
 - What opportunities does this review present?
 - What are the risks and benefits of methodological alignment vs. diversity?
- **What's working well?**
 - What are the strengths of the current approach (eg, transparency, alignment with legal requirements)?
 - How well does the current process handle uncertainty and new information?
- **What could be improved?**
 - Are there limitations or rigidities in the current approach that could be improved?
- **What analytical considerations and assumptions are worth testing?**
 - How are different information sources integrated to form final advice?
 - What are the limitations of MfE's current use of ETS Market Model?
 - Are there opportunities to more systematically incorporate the surplus estimate uncertainty range into advice?
 - Are other underlying surplus assumptions appropriate (eg, MfE assumption on post-2030 liquidity)?
- **What is the role of decision-making and judgement?**

- What role should qualitative considerations play beyond the core methodology?
- Should market pricing or behavioural information be factored in more systematically into advice?

Process, resourcing and governance

- The Minister of Climate Change has indicated this project is a priority for him.
- MfE have resourced this project accordingly:
 - Becky Prebble – our Climate Chief Advisor – will be our project lead
 - Expert support from principal policy advisors and market economics
 - In total, a team of about 5 FTE
- Do you have views on the composition of the independent expert panel?
- How should governance oversight from senior leadership and the Board be managed?

Delivery and next steps

- Terms of Reference is first deliverable – have indicated to Minister of Climate Change we will provide a draft by 19 June.
- Immediate next step to agree scope and shared problem definition; agree on tools and frameworks to examine.
- Subsequent phases: analysis, options development, external panel input.
- Final report delivered before end of September 2025.



Ministry for the
Environment
Manatū Mō Te Taiao



Joint Memo between the Ministry for the Environment and Climate Change Commission

Date:

To:

Jo Hendy
Chief Executive
He Pou a Rangi Climate Change Commission

Sam Buckle
Deputy Secretary
Ministry for the Environment

Refresh of the NZ ETS settings frameworks and tools

Purpose

- To sign-off on the completion of the NZ ETS settings frameworks and tools refresh project, now that the Ministry for the Environment's (MfE) final report on the project (attached) has been prepared, and
- To set out the implications for future advice flowing from the project that MfE and He Pou a Rangi Climate Change Commission (CCC) intend to consider in the development of future NZ ETS settings advice.

Background

Over July to September 2025, MfE undertook a project to refresh the frameworks and tools used to develop the advice on the NZ ETS unit limits and price control settings (NZ ETS settings), with input from relevant staff from the CCC.

This project sought to evaluate the decision-making frameworks, and analytical tools used to inform the NZ ETS settings advice. It aimed to develop a shared understanding of the appropriate frameworks and tools to support the NZ ETS settings update process, with the intent that both agencies would incorporate those shared understandings into their internal processes.

An objective was to explore how the frameworks and tools used for the advice could contribute to a robust and potentially more predictable decision-making process for the settings. The system for annually updating NZ ETS settings was established to enable them to be adjusted regularly to maintain accordance with emissions reduction targets. The system seeks to balance flexibility with stability, so it is valuable to consider whether the management of the settings can be made more predictable and transparent, while recognising the uncertainties and that change over time is necessary.

The output of the project is the attached MfE final report, for your final review. As set out in the project's Terms of Reference (ToR), the report has been prepared by MfE and is not binding on the Commission. The report has now been completed as the output of the project per the Terms of Reference, so we recommend you approve the NZ ETS settings refresh project as concluded.

This memo sets out a summary of the project's findings and records the implications identified by the project that MfE and CCC intend to take forward in their development of further NZ ETS settings advice.

Findings

The project revealed a high degree of alignment in MfE and the Commission's understanding of the statutory requirements for the NZ ETS settings. Differences in advice have not arisen from different assumptions about what is required, but due to different analytical judgements.

Overall, the decision-making frameworks and analytical tools used for the advice were found to be fit-for-purpose. In particular, the seven-step method used to develop the unit limit settings was confirmed as providing a useful and adaptable organising framework for considering matters in the Act and demonstrating how unit limits might accord with emissions reduction targets.

MfE and CCC each have specific roles in the climate policy system, which affects their approach to the NZ ETS settings advice and can result in different analysis and advice. These differences are a strength and can provide valuable insights, so long as they are transparent and well understood.

The project's discussions highlighted that in 2025, CCC and MfE advice to Government diverged primarily due to different perspectives on some key issues:

- The balance of risks between over- and under-supply of units under the emissions cap, and how best to manage those.
- The conclusions to be drawn from recent NZU prices¹ about the size of the surplus and outlook for supply and demand over the next 5 years.
- The approach to regulatory predictability.

This illustrates that the development of the settings advice is subject to significant uncertainty and there is wide scope for making different judgements and conclusions.

Implications for future advice from both agencies

At a high level, the project identified the following opportunities for improvement that can be made as part of developing and delivering future advice:

- Enhance communication around key judgments and assumptions.
- Improve clarity in how market conditions have been considered and address potential sources of confusion.
- Managing surplus uncertainty and addressing risk
- Continually improve analytical approaches and tools.

These can be translated into the following areas of further work and focus which both MfE and CCC undertake to pursue in the development of their future NZ ETS settings advice. The implementation of these will be subject to the capacity, capability and time each agency has available to prepare the advice.

- CCC undertakes to more clearly bring to the fore the aspects of its analysis which are subject to significant uncertainty or where policy choices are available to Ministers. Where there is reasonable scope for different judgements to be made, CCC will seek to discuss these and highlight trade-offs, risks or other implications of departing from its advice to support Ministers to make more informed decisions. CCC considers it would be valuable for its advice

¹ This refers to both the secondary market spot price as well as recent auctions not clearing, which reflect that spot prices are below the auction reserve price.

to provide an integrated risk assessment across the both the unit limits and price control settings and will explore options for how that can be best achieved.

- Similarly, MfE will seek to make clear in its advice where it has made different judgements from the Commission, and the reasons why, and support the Government to make clear the rationale for its decisions on the NZ ETS and other areas of climate policy that could have implications for the NZ ETS settings. This can occur through consultation documents, the publication of final decision documents, and the report on the reasons for differences.² Transparency in the rationale for Government decisions will better enable the Commission to consider and appropriately reflect them in its future NZ ETS settings advice, and also better inform market participants.
- CCC will also consider options for more directly addressing and incorporating the uncertainty in the estimate of the unit surplus in its advice and will test those options as it develops its 2026 advice. The existing surplus of units in the NZ ETS market poses a risk to meeting emissions reduction targets but is inherently uncertain. The Commission already presents an uncertainty range around its central estimate of the surplus and uses that to test its approach to drawing it down. It will also look to identify and consider other options that could help manage risks from the surplus uncertainty that would support Ministers to understand it and how they can manage it, in relation to their policy objectives.
- Both agencies will continue to discuss, identify and improve the data and evidence that can aid in interpretation of activity in the NZ ETS market. Recognising the limited information available and uncertainties inherent in analysing markets, the aim would be to develop structure around and a more common understanding of how to interpret market signals as well as to consider how to gather relevant information and improve the evidence base.
- Both agencies will endeavour to improve communications and education around the system for unit supply and updating NZ ETS settings. This year, it became apparent that there is some confusion about the meaning of parts of the auction regulations and how auctions not clearing feeds into forward looking settings advice. As the lead Ministry on NZ ETS policy, MfE has the lead role together with MPI and EPA to proactively support market participants' understanding of NZ ETS regulations and legislation, and address misunderstandings or misinformation about the operation of the NZ ETS. CCC can support these efforts through its advice related to the NZ ETS settings and associated communications activities.
- CCC and MfE will both aim to make data and analysis relevant to the NZ ETS settings public in a timely manner. This will benefit market participants by enabling them to better analyse the NZ ETS market and make informed judgements about the fair value of NZUs. Where government-led or commissioned analysis has an impact on the settings advice, publication will enable the Commission to test that analysis through its engagement with market participants, which is challenging when relevant information is not in the public domain.
- CCC and MfE will continue to work together to develop shared and improved modelling and other analytical tools for use in developing NZ ETS settings advice. One of the benefits of this project has been a deepened understanding of how each organisation approaches advice and there is value in continuing that. The CCC and MfE agree to establish regular working-

² Required by section 30GC(7) of the Climate Change Response Act 2002 to be tabled in the House of Representatives, if the Minister's recommendations about the unit limits and price control settings differ from the Commission's recommendations.

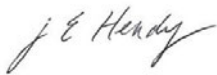
level meetings about the technical analysis for the NZ ETS settings, with the objectives of sharing insights, testing new approaches, and resolving concerns as they arise. There are a number of topics that could benefit from further collaboration, in particular the situations in which it may be appropriate to consider adjusting the emissions cap, potential applications of the ETS Market Model within the NZ settings advice process, and methodological updates. The collaboration will continue to occur on the basis of the established Memorandum of Understanding between the Commission and Government agencies on the development of a shared evidence base on climate change.

Recommendation

We recommend that you:

- **Approve** the NZ ETS settings refresh project as completed, based on the attached MfE final report of the project.
- **Approve** the implications for further advice from the project set out in this memo for each agency to pursue as they develop future NZ ETS settings advice.

Signed



Jo Hendy
Chief Executive
He Pou a Rangi Climate Change Commission



Sam Buckle
Deputy Secretary
Ministry for the Environment



Briefing: Feedback on Terms of Reference for a refresh of the NZ ETS Settings decision-making framework

Date submitted: 23 June 2025

Tracking number: BRF-6352

Security level: Classification

MfE priority: Non urgent

Actions sought from ministers		
<i>Name and position</i>	<i>Action sought</i>	<i>Response by</i>
To Hon Simon Watts Minister of Climate Change	Provide feedback on the draft Terms of Reference attached at Appendix 1	27 June 2025

Actions for Minister's Office staff	
Return the signed briefing to Ministry for the Environment (ministerials@mfe.govt.nz)	

Appendices and attachments	
Appendix 1: Draft Terms of Reference for project Refused in full under section 18(d)	

Key contacts at Ministry for the Environment			
<i>Position</i>	<i>Name</i>	<i>Cell phone</i>	<i>First contact</i>
Principal Author	Becky Prebble	9(2)(a)	✓
Responsible Manager	Simon Mandal-Johnson		
General Manager	Mark Vink		

Minister's comments

Feedback on Terms of Reference for a refresh of the NZ ETS Settings advisory frameworks

Purpose

1. This briefing seeks your feedback on draft Terms of Reference for a refresh of frameworks that support advice on NZ ETS Settings.

Advice

2. On 29 May, we advised you on our plan to refresh the analytical and decision-making frameworks for NZ ETS unit limits and price control settings (NZ ETS Settings) [BRF-6278 refers]. The draft Terms of Reference attached at Appendix 1 set out the purpose, scope and timing for this project.

The project seeks to enhance the predictability and robustness of advice on NZ ETS Settings

3. The project is a short, targeted review of how the Ministry and the Climate Change Commission (Commission) develop their respective advice. It will assess the advisory frameworks and underlying analytical tools used to form advice consistent with the Climate Change Response Act 2002 (CCRA).
4. The project will not review the NZ ETS Settings themselves and it is not expected to lead to legislative change. If legislative improvement opportunities arise, these will be fed into the separate CCRA reform process.
5. We developed the Terms of Reference collaboratively with the Commission and the Commission is comfortable participating in the review as scoped. The Treasury also provided input. We shared the draft with MPI and MBIE and will involve those agencies in the project.

The final report will reflect shared understandings between agencies

6. The Ministry will lead the review with close participation from Commission officials, consistent with our inter-agency Memorandum of Understanding. The report will reflect shared understandings between the Ministry and the Commission.
7. The Commission is statutorily independent, so it will not be bound to the final report. However, the intent is that both the Ministry and the Commission will consider the review's findings and incorporate any subsequent changes into their processes.

The project's findings can be consulted on in next year's advice

8. We will complete the final report in September 2025. This timing will enable the Commission to consult on any possible changes during the development of its next round of advice on NZ ETS Settings.

Update on involvement of external experts

9. As signalled in the 12 June Weekly Report, we will also involve some external experts to help test our thinking throughout this project. We have finalised a short list and are in the process of confirming these.

Next steps

10. Once you have provided any feedback, we will finalise the Terms of Reference and begin the project. We have already completed initial scoping and project planning.
11. We will provide you updates on progress as necessary. We plan to provide you a draft report for visibility and feedback in August.

Recommendations

We recommend that you:

- a. **provide feedback** on the draft Terms of Reference attached at Appendix 1.

Yes | No

- b. **note** the Ministry for the Environment will author the final report, with close input from the Climate Change Commission.

Yes | No

Signatures



Mark Vink
General Manager

Markets

23 June 2025

Hon Simon Watts
Minister of Climate Change