**Terms of Reference - Refresh of the NZ ETS Settings frameworks and tools**

**Background**

**The Climate Change Response Act sets out roles and requirements**

The Minister of Climate Change (the Minister) is required under the Climate Change Response Act 2002 (the CCRA) to make regulations each year for unit limits and price controls under the New Zealand Emissions Trading Scheme (NZ ETS Settings).

A reasonable time before the regulations are made, the Climate Change Commission (the Commission) is required under the CCRA to provide annual independent advice to the Minister on NZ ETS Settings.

The Minister must consider the Commission’s advice when making Settings decisions. The Ministry for the Environment (MfE) advises the Minister on NZ ETS Settings decisions.

The key legal test for both the Minister and the Commission (and by extension MfE as an advisor to the Minister) is whether the NZ ETS Settings accord with New Zealand’s climate change targets. Other matters must also be considered, such as the proper functioning of the NZ ETS[[1]](#footnote-1).

**The current approach to advising on NZ ETS Settings involves various elements and inputs**

Since the 2020 NZ ETS reforms established the system for the NZ ETS Settings, a methodology has been used to develop the unit limit settings. This was first developed and used by MfE when the NZ ETS settings regulations were put in place in 2020 and to update them in 2021. The Commission then evolved the methodology into its current seven steps when it started to provide annual advice on the NZ ETS settings in 2022.

MfE uses the seven-step methodology for its own advice, as well as incorporating insights from the NZ ETS Market Model since 2024.

Since it began providing this advice in 2022, the Commission has also used analysis from the Emissions in New Zealand model (ENZ) as an input into its recommendations on the price control settings, alongside the emissions cap determined as part of the seven-step methodology for the unit limits and other relevant considerations as required under the CCRA.

**Recent developments and anticipated future** **challenges** **have prompted a need to ensure that the frameworks and tools both organisations are using are still fit-for-purpose**

It is timely to review the overall frameworks within which the Commission and MfE give advice and ensure that there is a way for all relevant factors to be incorporated.

The seven-step method is intended to align unit limits with emissions reduction targets and reflect matters to be considered under the Act. However, there is significant uncertainty in estimates at key steps within the method. There are also additional considerations which may usefully inform NZ ETS Settings that could be explored.

Additionally, 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. Based on the current NZ ETS structure, auction volumes will fall to zero in the mid-2030s.

New analytical tools such as MfE’s NZ ETS market model have been developed, and different versions of the ENZ model now exist. There may be other types of models or tools that could be used to inform the NZ ETS Settings.

While analysis can help identify and reduce uncertainty, it cannot eliminate it. Future NZ ETS market dynamics (eg, demand for NZUs, forestry supply) are inherently uncertain, as they depend on future decisions by emitters and other market participants and a range of external factors. The ability to adaptively manage the NZ ETS Settings through the annual updates to regulations will remain important to managing this residual uncertainty.

**Purpose and objectives**

This project will:

* evaluate the current decision-making frameworks (meaning the overall approaches to developing advice to support decisions) and associated analytical tools that MfE and the Commission use to support their NZ ETS Settings advice, and
* identify opportunities for improvement (the Project).

The objective is to ensure these tools and frameworks remain fit-for-purpose and support a robust and predictable decision-making process, supporting market stability.

A key outcome of the review will be to crystallise as far as possible a shared understanding of the appropriate decision-making frameworks to support the NZ ETS Settings process. The intent is that the two agencies will incorporate those shared understandings into their internal processes.

Ultimately, the Commission and MfE will use their best judgement about what the appropriate methods, tools, and overall approaches are in different circumstances for their respective advice to the Minister on NZ ETS Settings. However, there are benefits to both agencies working from a shared understanding about what factors a robust process should incorporate, and what tools are helpful to support that process.

While different agencies may always reach different conclusions, it is undesirable if the Commission and MfE frequently give advice based on different understandings of the appropriate legislative framework that advice sits within. This can reduce the predictability of the annual settings process, potentially undermining market confidence.

**Scope**

The Project will be a short, targeted review focussing on the overarching tools and frameworks used to develop analysis and advice on NZ ETS Settings. While this Project may reveal opportunities for further detailed analysis or investigation, it is not the aim of this Project to complete this work.

The Project will:

* evaluate the **decision-making frameworks** used to develop NZ ETS Settings advice (meaning the overall approaches to developing advice to support decisions).
* evaluate the **analytical and technical tools** used to inform advice, including models and methodologies.

The Project will accomplish this through the following, interlinked areas of work:

* Legislative requirements:
  + 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.
  + Seek to develop a shared understanding of the CCRA requirement for accordance in respect of the unit limits and price control settings.
  + Identify and consider 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.
* Framework for developing advice to meet legislative requirements, particularly the role of the emissions cap, the unit surplus and their management over time:
  + Identify key uncertainties affecting the settings and the market (e.g. uncertainties affecting surplus units, uncertainty about factors influencing emissions levels and NZU prices). Assess the extent to which it is possible and/or appropriate to reduce, address or factor in these uncertainties through the annual NZ ETS settings regulations update process.
  + Consider the respective roles and features of key elements in the existing decision-making frameworks and assess how they do or do not contribute (or should contribute) to a predictable and coherent approach to the NZ ETS settings updates, including but not necessarily limited to:
    - the emissions cap, and how it could be managed over time,
    - the unit surplus, and how it could be managed over time,
    - 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.
  + Identify possible alternatives or additions to decision making frameworks that could be compatible with meeting the Act’s accordance and other requirements. Investigate and assess the different ways that they could contribute to or detract from a predictable and coherent approach to the NZ ETS settings updates.
  + Identify information, considerations or criteria which could enhance the NZ ETS Settings decision-making process. This could include, for example:
    - identifying data and information gaps, including which gaps are most challenging and developing a plan to address these.
    - considering the advantages or disadvantages of factoring into analysis prevailing NZ ETS market conditions such as price.
    - exploring different ways to integrate the development of the unit limits and price control settings.
* Models:
  + Identify the different models and other inputs that could be relevant tools for developing advice on the NZ ETS settings, such as:
    - ENZ, including the different versions now available.
    - MfE’s NZ ETS market model.
    - the official projections.
    - Any other types of models that may be relevant.
  + Evaluate 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.

The Project will not consider:

* Substantive changes to current legislative provisions (ie, the role of the Commission, annual advice cycle) but where efficiencies or useful legislative clarifications are identified, they could be fed into the CCRA efficiency review.

**Roles and responsibilities**

The Commission and MfE are signatories to a Memorandum of Understanding (MoU) which aims to support Government agencies to develop a shared evidence base relating to climate change. The MoU aims to establish a common understanding of expectations, and a foundation for good working relationships.

The MoU agrees agencies will endeavour to take a collaborative approach to data, information, modelling, research and qualitative evidence. This can help develop a shared evidence base and reduce duplication. It does not oblige parties to jointly agree on advice or conclusions.

The Project will be undertaken in a manner that is consistent with the MoU. The Project will be led by MfE with close participation by Commission officials. However, certain aspects such as models and work on forestry accounting, may be led primarily by the Commission. This will be confirmed through project planning. We will also get input from Treasury, MPI and MBIE, and other expertise as appropriate.

**External advice and engagement**

MfE, in consultation with the Commission, will contract up to three external expert advisors as “wise heads” to support the project. The wise heads will provide high-quality analytical testing and feedback into the Project. They will be selected for their expertise and strategic insight. They will not be Ministerially appointed.

The wise heads will be adaptable, aimed at helping shape thinking quickly and effectively, without requiring formal servicing or a need to reach a consensus. The wise heads will work flexibly, engaging with draft material, offering timely feedback, and contributing to analysis developed by agencies.

We also will draw on other external information gathered through MfE and Commission’s business-as-usual stakeholder engagement.

**Timing and deliverables**

A final report will be completed in September 2025, in time to inform next year’s advice. The final report will be led by MfE, but to the extent possible is expected to reflect a shared understanding of the legislative framework for advising on NZ ETS Settings across both MfE and the Commission. The report may also record areas where there are differences of view, including the different perspectives and rationale for them. It may also set out areas where further exploration or consideration of issues is needed.

The Commission’s statutory independence is a key characteristic of its advisory role, and important to maintaining trust in its advice and in the system for updating the NZ ETS Settings. This means it, not the Government, determines the method and tools it uses to advise on NZ ETS Settings.

Consequently, the report is not binding on the Commission. We expect each agency will take various actions to operationalise the shared understandings set out in the report. However, what specific actions are appropriate is a matter for each agency.

The final report’s primary purpose will be to clarify a shared understanding of the frameworks and tools used for the NZ ETS Settings, for use by agencies and the Minister. However, there is likely value in publishing the final report, given possible interest from market participants and other stakeholders.

It is therefore expected that the final report will be published. Before doing so, MfE and the Commission will consider any potential market sensitives regarding the timing and handling of the report’s publication. There is also an opportunity to consult on any potential improvements through next year’s annual Settings process.

1. Sections 30GB and 30GC of the CCRA set out the matters that must be considered. [↑](#footnote-ref-1)