Our approach to developing advice on policy direction

Our vision of a "thriving, climate-resilient and low emissions Aotearoa" guides our approach to developing advice on policy direction. The wellbeing of the people of Aotearoa and striving for an equitable and fair transition remains our focus for reaching a better future.

In developing policy, the Government needs to make sure that its approach supports and considers the wellbeing of iwi/Māori and the He Ara Waiora framework. This includes balancing what is good for tangata, the whenua and the wai, upholding whakapapa, enhancing whānaungatanga, and ensuring intergenerational sustainability and prosperity. These are values that are supported by many New Zealanders.

This paper presents the Commission's approach to developing its advice on the direction of policy for the Emissions Reduction Plan.

Introduction

A key part of Aotearoa's framework for achieving its climate targets is the requirement for the Government to develop an Emissions Reduction Plan. This must outline what the Government intends to do to make sure the next emissions budget (2022-2025) is met and can also include policies and strategies to meet the subsequent set of emissions budgets to 2035 (2026-2030, 2031-2035.)

Meeting emissions budgets over the coming decades will require fundamental changes to Aotearoa's economy and society. This includes changes to individual and corporate behaviour, changes to existing processes and ways of operating, as well as technological innovation.

It is critical that households, businesses and investors have confidence in emission budgets, which is why Government needs to develop a deliberate plan outlining the action it intends to take. This will support credibility and greater predictability.

In some areas, taking early action may have minimal impact on reducing emissions initially but may unlock the potential for significant reductions in future. It is important to identify these areas. It is also important to look beyond 2050. The Climate Change Response Act (CCRA) requires net emissions to remain at least net zero for every year after 2050; policies to meet emissions budgets must anticipate the need to "lock in net zero" beyond that date.

The Commission's approach and considerations

Our overall vision is of a "thriving, climate-resilient and low emissions Aotearoa". To achieve this, the wellbeing of the planet and the wellbeing of current and future generations in Aotearoa must remain at the centre of decision making as the Government develops the Emissions Reduction Plan and puts in places policies and measures to drive the necessary changes. Having that focus is crucial for an equitable and fair transition, and for ensuring the changes and reductions in emissions are sustained and enduring.

The wellbeing of iwi/Māori throughout the transition to low emissions is a core part of this. He Ara Waiora presents a Te Ao Māori approach to wellbeing, sourced in mātauranga Māori, and provides

valuable and appropriate framing to understand and assess impacts of climate policy for iwi/Māori.¹ It also provides a frame for ensuring that climate policies and approaches consider broader wellbeing of people and the environment, for current and future generations.

In developing and implementing our advice, we have considered impacts on the four dimensions of wellbeing identified in the He Ara Waiora framework (Mana Tuku Iho, Mana Tauutuutu, Mana Āheinga and Mana Whanake). We also looked at how the actions align with the values of kotahitanga, manaakitanga, tikanga and whanaungatanga.²

In developing the emission reduction plan, the Government needs to make sure any policies and approaches it undertakes to reduce emissions support these dimensions and values.

The Commission's role

The Minister for Climate Change is responsible for preparing the Emissions Reduction Plan, making the Minister ultimately accountable for the content of the plan and its delivery.

In contrast, the Commission's role is to provide the Minister with advice on the "direction of policy" required in the Emissions Reduction Plan.

This indicates that our advice should be high-level rather than prescriptive. In general, this is how the Commission has approached the development of draft advice on policy direction. It does not, however, prevent more detailed comments being made about specific policies or policy design, if the Commission judges that it would be appropriate to do so.

Under the legislation, in developing advice on policy direction the Commission must be guided by the same set of considerations as those that apply to advice on emissions budgets³. This has been articulated this through the vision and principles framework.

We are also required to regularly monitor and report on the government's progress towards meeting emissions budgets.⁴ The Government's emission reduction plan will provide accountability for delivery. The adequacy of the plan, the Government's progress in implementing it, and the emissions reductions achieved will be monitored by the Commission over time.

Our first annual monitoring report under the CCRA must be published in 2024, following the release of emissions data for 2022, the first year of the first emissions budget. The Commission may choose to comment on aspects of progress prior to this, focused on policy action and measures taken by the Government.

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¹ He Ara Waiora was initiated by the Tax Working Group, co-designed with Māori thought leaders and iwi representatives and is currently under the stewardship of the Treasury.

² (McMeeking, Kahi and Kururangi, 2019)

³ Climate Change Response Act, sections 5ZH and 5ZC(2)

⁴ Climate Change Response Act, 2002. Section 5ZJ (1)

Elements of a comprehensive climate policy package

To drive the necessary changes and move towards meeting the 2050 target, the Government will need to put in place a comprehensive policy package. It will need to use a range of policy tools, including emissions pricing and other market incentives, regulation, and education.

There will need to be significant investments in the future, not only in technology and infrastructure, but also in people and communities. Skills will be needed to ready the workforce, and transition planning will be critical to support people through change. The Government also needs to consider how best to engage both the minds and hearts in individuals, business, institutions and wider society to support the necessary change over the long term.

Our approach to developing advice on policy direction is summarised in figure 17.1 below. It highlights elements an effective climate policy package ought to contain. The focus is on supporting the development of a comprehensive and mutually reinforcing package of government policies that can achieve and sustain emissions reductions, in line with Aotearoa's targets.

Partnership Approach with iwi/Māori. The Government must partner with iwi/Māori to develop approaches to meeting the emissions budgets, that balance different objectives and considerations, while aligning with the He Ara Wairoa framework. This includes, for example, balancing what is good for tangata, the whenua and wai, upholding whakapapa, enhancing whānaungatanga, and ensuring intergenerational sustainability and prosperity. This is important, both for the wellbeing of Māori and all New Zealanders, and also to make sure approaches to meeting climate change goals have longevity, balance different objectives, and do not lock in historic or contemporary disadvantage for iwi/Māori.

Clearly and credibly signal goals that align with targets. The Government must clearly and credibly signal the direction and scale of action required to meet emissions budgets and reduction targets. It must signal policy changes well in advance, while articulating a clear and credible vision for the future of different sectors, industries, and communities. Strong, consistent and clear signals would help provide certainty around the speed and direction of travel, as the transition to low emissions progresses. The case for action will be strengthened by making sure there is a clear link between the signals and the legislated targets, along with a transparent evidence base.

Manage challenges and impacts for an equitable transition. As the transition unfolds, challenges and impacts need to be acknowledged and managed to ensure that people remain the clear focus. This is crucial for ensuring Mana Tauutuutu and Mana Āheinga. This means routes to achieving emissions budgets and targets ought to be deliberately paced and planned to give households and firms certainty about the direction of change, and time to find the opportunities for transition.⁵

Effective governance structures to deliver the transition. Finally, the policy approach will need to be supported by effective governance structures and institutional arrangements. Climate change is a complex and dynamic issue that will require fundamental changes right across the economy and society. Developing effective policy approaches, implementing and monitoring those approaches,

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⁵ (New Zealand Productivity Commission, 2018)

and supporting an equitable transition will require coordination across a wide range of government agencies⁶, levels of government, and partnership with iwi/Māori.

Emissions pricing and other policies work together

In Aotearoa to date, the Emissions Trading Scheme (ETS) has been our primary policy response to climate change. This has sometimes been to the detriment of efforts to implement a wider suite of climate policies. This reflects a view, prevalent in the early years of climate policy implementation, that emissions pricing is the main solution and other policy interventions are costly, wasted efforts that do not contribute to additional emission reductions.

As international research and experience now shows, the most effective and efficient approach is to implement a much more comprehensive and diverse suite of climate policies. ⁷

A comprehensive policy approach includes three different types of interventions to enable change:

- I. Action to address barriers. There are a range of structural, political and behavioural barriers that prevent people and businesses making the most of opportunities to reduce emissions. Measures could include things like regulation to address split incentives,⁸ mandatory and voluntary standards to drive performance improvements, information and support to address knowledge and capacity gaps over time, or policies that help to nurture and sustain public engagement in climate efforts.
- II. Pricing to influence investments and choices. The costs of emissions must be internalised, where possible. Emissions pricing incentivises businesses and individuals to make choices that lower emissions. The main pricing tool in Aotearoa is the NZ ETS, but there are other pricing tools that can also be used to incentivise investments and choices such as taxation, electricity pricing and grants or subsidies. Incentives created by government policy that run counter to the goal of reducing emissions should be removed.
- III. **Investment to spur innovation and system transformation**. Targeted interventions would help speed up the transition and increase the emissions reductions that are achievable over the longer term. These interventions could include providing funding for research, development and deployment (RD&D) with spillover benefits, undertaking demonstration projects, and planning for and investing in infrastructure that can unlock deeper emissions reductions over time for example EV charging infrastructure.

An effective policy package would include measures focused in each of the three areas. Each works on a different time horizon and is focussed on different levels of decision making, from individual to

⁶ Including, for example, MfE, Treasury, MBIE, MPI, MOT, HUD, EECA, MSD, Ministry of Education.

⁷ See, for example (OECD, 2013a; Grubb, Hourcade and Neuhoff, 2014; Canada's Ecofiscal Commission, 2017; International Energy Agency, 2017)

⁸ Split incentives can be a barrier to action to reduce greenhouse gas emissions, because they refer to a scenario where the actors who pay for an action are not those who will benefit from that action. For example, landlords may pay for and make the decision to install insulation, but it will be tenants who benefit from the added warmth and reduction in power bills that insulation provides.

⁹ (International Energy Agency, 2017)

collective. Measures from all three areas of intervention must be integrated and used together in a mutually reinforcing way to meet emissions budgets.

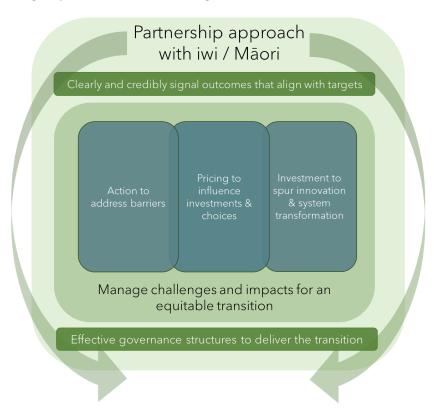


Figure 17.1: Elements of a comprehensive climate policy package

The nature of an effective policy package, and the balance between the three areas of intervention, is likely to vary over time and between sectors. The International Energy Agency highlights this point, noting "the importance of both short-term policy actions that deliver immediate results and those that support long-term mitigation ambitions, such as RDD&D investment in emerging technologies. The role of carbon pricing across sub-sectors differs based on their sensitivity to price". 10

Emissions pricing is one of the strongest and most flexible levers available for tackling climate change. It works by making the businesses and people who make the decisions that create emissions feel the costs associated with those emissions.

The power of emissions pricing comes from how it allows those driving emissions (both emitters and consumers) to find their own ways of reducing emissions. Given they know their business, needs and capabilities best, this promotes cost-effective outcomes as the price helps direct the allocation of resources towards lower emissions activities. With broad coverage, an emissions price can incrementally affect a much wider range of decisions across the economy, on both the demand and supply side, than would be possible with more targeted policy interventions. There is extensive

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¹⁰ RDD&D stands for research, development, demonstration and deployment. (International Energy Agency, 2017, p. 34)

empirical evidence showing emissions trading and other market-based measures are effective at helping to allocate financial resources efficiently and achieve reductions at low cost.¹¹

There are limits to the effectiveness of emissions pricing, however, which can be overcome with other policy interventions. For example, high and visible emissions prices can be unpalatable and struggle to gain public acceptance. There are also many other challenges associated with reducing emissions that are not strongly related to cost.

For example, not every decision made by individuals and firms is based on an economically rational optimisation of costs. In these cases, standards and information can be more effective than emissions pricing in steering choices towards lower emissions measures. Other market problems can also hinder the uptake of cost-effective emission reduction opportunities – for example, split incentives, network externalities, and policy coordination problems.¹² Removing these barriers would aid the supply and demand response to an emissions price – boosting the price signal.

The scale of innovation needed, also demands different approaches. Where viable low emissions solutions do not yet exist, emissions pricing provides some encouragement for their development. But it does not provide the 'full incentive' that would be justified when positive spill-overs and other social benefits of low emissions innovation are taken into account. In some cases, the emissions price required to drive the innovation needed at the margin may be so high that is not politically feasible to implement.

A long-term view of cost effectiveness must be taken, to not only consider just what emissions reductions are cheapest in the near-term but also how actions now can influence future costs. For example, investments in demand-side incentives for key low emissions technologies – such as financial support for electric vehicles (EVs) – can lead to improvements that reduce costs for future users of those technologies. These dynamic effects go beyond the life of a particular intervention and mean that some apparently very expensive actions contribute to a more economically efficient, socially equitable, transition over time.¹³

Measures are also required to overcome political economy barriers. Emissions pricing can be perceived as unfairly penalising certain individuals, communities or businesses. This limited public acceptance can make it difficult for governments to implement emissions pricing in the most effective way, such as in terms of sector coverage or price level. It may be a pragmatic necessity to use other policies to help compensate for these limitations.

For these reasons, emissions pricing works better when accompanied by other policies that address the full range of market or policy failures. For Aotearoa, this means that as well as continuing with efforts to improve the NZ ETS, the government should develop a comprehensive and mutually reinforcing policy package that spans all three areas of intervention outlined in our policy approach.

Does the waterbed effect prevent additional policies from driving overall emissions reductions?

The "waterbed effect" is an objection frequently raised against using policies, such as regulation or targeted investment, alongside an ETS.

12 (Verde and Kardish, 2020)

¹¹ For example, (OECD, 2013b)

¹³ (Gillingham and Stock, 2018)

It refers to the idea that emissions reductions achieved through other policies displace more costeffective reductions that would have otherwise occurred due to the ETS. This is akin to the way pushing down on a waterbed causes a bulge on the other side.

The assumption is that in a system with an emissions cap (a limit on total emissions imposed by the ETS), each tonne of emissions not emitted by one party will be available for someone else to emit. It follows that reduction measures induced by non-ETS actions will simply increase costs for some and make it cheaper for others to keep emitting, rather than contributing to more reductions overall.

The way the New Zealand ETS is managed, however, can prevent this scenario. The design of the scheme's cap, enabled by recent reforms, is flexible. The unit volumes are set on a five-year rolling basis, which gives two avenues to adjust for the impact of other policies or investments on emissions:

- **1.** Anticipated emissions reductions can be factored in upfront. This can be seen in the way the first five-year NZ ETS cap was set in 2020, covering the 2021-2025 period. The cap volumes are informed by the government's emissions projections. Where possible, the projections include the expected, modelled effects of other policies on emissions, and this flows through to the setting of a lower cap for the NZ ETS. This includes where emission reductions are a co-benefit rather than the main aim, such as in the case of freshwater policy. This approach is now also common practice in the way emissions caps are set in other systems, such as the European Union ETS.
- 2. The cap can be adjusted over time to reflect observed emission reductions due to other polices. The rolling five-year process for the NZ ETS cap means that each year, a further year of unit volumes is added and the volumes for some other years can be updated. For example, in 2021 the government must extend the cap to cover the 2026 year. It can also update the unit volumes for the 2024 and 2025 years. The volumes for 2022 and 2023 can be updated if certain circumstances arise. This allows for adaptive management of the cap, amending it as more concrete data becomes available about the emissions impacts of other interventions, to avoid reductions being cancelled out.

These approaches are illustrated by the diagram below.

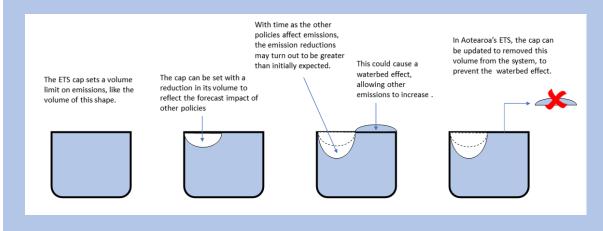


Figure 17.2: An explanation for the ETS cap

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¹⁴ (Ministry for the Environment, 2020)

It remains important, nevertheless, to carefully consider the rationale for policies outside the NZ ETS and to design them carefully. It also highlights the importance of ongoing efforts to improve forecasts of Aotearoa's emissions, to assess the emissions impacts of policies, and to refine the method for setting and updating the NZ ETS cap. Together, this supports policy coherence, so that the NZ ETS and other policies can work together in a mutually supportive way.

Building on existing advice

In the last five years, detailed advice has been developed by a wide range of government agencies and private companies on things we can do to reduce emissions, including policy approaches.

Government has collated independent expert advice from the Productivity Commission, Parliamentary Commissioner for the Environment, the Interim Climate Change Committee, the Prime Minister's Chief Science Adviser, and the Royal Society Te Apārangi.

Relevant to our work is the Productivity Commission's 2018 report on transitioning to a low emissions economy.¹⁵ The Productivity Commission made 76 recommendations across the economy, requiring implementation by multiple government agencies.

The Productivity Commission identified some immediate priorities for Government. These included reforming the NZ ETS, devoting significantly more resource to low emissions innovation, prioritising policies to avoid high emissions lock-in (including introducing a feebate scheme to incentivise electric vehicles) and amending electricity pricing regulation to facilitate expansion of low emissions electricity. Some recommendations have already been implemented, including legislating targets and establishing the Commission.

The Government has accepted all but one of the recommendations¹⁶ and last year began a work program (the Climate Action Plan) to implement the recommendations.¹⁷ The Government has indicated that their response to the Productivity Commission's report will lead into the development of a low emissions development strategy, and that the findings and recommendations of the Productivity Commission will inform the development of the Government's Emissions Reduction Plan.¹⁸

The Parliamentary Commissioner for the Environment released a report in 2019 presenting a climate policy approach that deals with biological emissions from agriculture and carbon sequestration by forests together. The Commissioner supported a separate target for carbon dioxide emissions from fossil fuels, and proposed a landscape approach to managing Aotearoa's climate and environmental issues.

Other advice was provided by the Interim Climate Change Committee, which made 13 recommendations in relation to electrification and agriculture in 2019. The Government has consulted on measures for encouraging energy efficiency and the uptake of renewable fuels in

As at 11 December 2020

¹⁵ (New Zealand Productivity Commission, 2018)

¹⁶ The one recommendation the Government disagreed with was the recommendation to investigate incentivizing wastewater treatment plants.

¹⁷ (Ministry for the Environment, 2019b)

¹⁸ (Ministry for the Environment, 2019a)

industry, and accelerating renewable electricity generation and infrastructure. In response to the report on agriculture, it has also initiated a process to measure and reduce emissions at a farm level – setting up a public-private partnership He Waka Eke Noa as the delivery vehicle. Milestones around farm emissions reporting and farm plans have been set in legislation.¹⁹

Some recent private sector initiatives also offer advice and recommendations. Earlier this year, the Aotearoa Circle hosted the Fenwick Forum, which brought together over 200 senior leaders from across the public and private sector to explore how Aotearoa's COVID-19 recovery could support transition to a more sustainable and lower emissions future. The resulting report highlights three areas of focus for government action: a productive, sustainable and inclusive food system; an efficient, sustainable and inclusive transport system; and a productive, sustainable and inclusive energy system. For each of these, the report presents 'required outcomes', and recommends interventions and investments.

The Sustainable Business Council and the Climate Leaders Coalition also recently released a 'Briefing to incoming ministers', focused on initiatives the incoming government can do to accelerate the transition to net zero by 2050. Three key recommendations from the report were to prioritise investing in low carbon transport, reducing emissions from process heat, and accelerating the development and adoption of methane reduction technologies.

Modelling by the Business New Zealand Energy Council has also explored elements that might influence Aotearoa's future energy mix under different situations. The modelling indicates that electrifying the economy and increasing renewable electricity could create significant security of supply issues by 2050, meaning Aotearoa would need considerably more storable energy capability.

There is also a substantial body of expert advice from international institutions. The Energy Transition Commission released a report in September 2020 outlining three "critical priorities" for nations in the 2020s, in the run up to the United Nations Framework Convention on Climate Change (UNFCCC) Conference of the Parties (COP) 26 in November 2021.²¹ The priorities identified are:

- Speed up deployment of proven zero carbon solutions;
- Create the right policy and investment environment for technology diffusion; and
- Enable the emergence of the next wave of zero carbon technologies.

The above are a selection of the many reports that have been developed, not an exhaustive list. There are many other useful sources of information. However, these reports offer a combination of insightful recommendations to government, and others, for how Aotearoa could transition to a low emissions economy.

Conclusion

Our advice on policy direction is primarily concerned with the policies and strategies needed to meet the first emissions budget (2022-2025). However, it also considers policies and strategies that are

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¹⁹ These include: "A system for farm-level accounting and reporting of 2024 agricultural greenhouse gas emissions at farm level is in use by all farms by 1 January 2025" and "All farms have a written plan in place to measure and manage their greenhouse gas emissions by 1 January 2025" (He Waka Eke Noa, 2020)
²⁰ (The Aotearoa Circle, 2020)

²¹ (Energy Transitions Commission, 2020)

needed now to put Aotearoa on a firm footing for meeting the second and third emissions budgets, and for meeting the 2050 target and beyond.

Meeting the budgets and the 2050 target will require a wide range of actions in every sector of the economy, across the three policy areas highlighted above – action to address barriers, pricing, and investment to spur innovation and system transformation. It is also important to make sure climate policies and approaches consider broader wellbeing of people and the environment, for current and future generations.

In its package of advice, the Commission will provide specific advice on the direction of policy needed to meet the emissions budgets and Aotearoa's emissions reduction targets. This will include advice on policy action within different sectors, and on action that cuts across multiple sectors.

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