

In Confidence

Office of the Minister for Climate Change

Chair, Cabinet Environment, Energy and Climate Committee

Policy decisions for Climate Change Response (Emissions Trading Reform) Amendment Bill Departmental Report

Proposal

1. This paper seeks your agreement to policy changes to the Climate Change Response (Emissions Trading Reform) Amendment Bill (the Bill), which is currently being considered by the Environment Select Committee (the Select Committee).
2. A second Cabinet paper is being presented by myself and the Minister of Forestry seeking agreement to forestry policy changes to the Bill and extending the implementation date for the new forestry regulations.

Executive summary

3. The Bill is currently being considered by the Select Committee, which has now received written submissions and heard oral submissions on the Bill.
4. Following this input from submitters, I have refined a number of proposals to ensure that the objectives of the Bill and the Government's wider climate change goals are being achieved, and that the reforms to the New Zealand Emissions Trading Scheme (NZ ETS) can be implemented effectively.
5. However, for most of the issues and proposed changes presented to the Select Committee by submitters, I do not propose changes to the Bill. I consider the current draft of the Bill reflects policy decisions made by Cabinet.
6. The changes proposed in this paper will be presented to the Select Committee through the Departmental Report. The Departmental Report will be provided to the Select Committee by the Ministry for the Environment and the Ministry for Primary Industries in two parts. The first part was provided on 28 February 2020; it summarises feedback from written submissions and presents minor changes consistent with Cabinet's previous decisions. The second part is due to be provided to the Select Committee on 3 March 2020 following Cabinet's consideration of the proposals in this paper. The Select Committee is due to report back to the House on 2 April 2020.
7. There are two tranches of changes proposed: substantive policy changes I am proposing in response to issues either raised by submitters or proactively identified by officials; and technical changes to clarify how the Bill gives effect to Government policy.
8. The substantive policy changes I propose will:

- 8.1. allow the Minister to seek recent data from allocation recipients to inform a review of industrial allocation under section 160;
 - 8.2. introduce an ability for the Government to reduce the general phase out rate of industrial allocation for individual industrial activities at risk of emissions leakage, rather than having to reduce it across all industrial activities;
 - 8.3. introduce a requirement that any units provided through free allocation that exceed the NZ ETS cap be backed by equivalent emissions reductions or removals;
 - 8.4. require only volume units from the cost containment reserve that exceed the NZ ETS cap to be backed by additional emissions reductions or removals, rather than all reserve units released as currently drafted;
 - 8.5. require the Minister for Climate Change to consider future emissions budgets and Nationally Determined Contributions when making unit supply and price control settings;
 - 8.6. require the Environmental Protection Authority (EPA) to provide advance notice to the public of the publication of participant level emissions and removals data;
 - 8.7. provide for the Climate Change Commission to be able to make decisions on NZ ETS settings when the board has fewer than seven members; and
 - 8.8. change the requirements for the reporting and tabling in Parliament of advice given by the Climate Change Commission on the phase-out of industrial allocation so they are consistent with the Commission's reporting requirements established under the Zero Carbon Act
9. I am also seeking a decision to enable the introduction of a supplementary order paper to extend the fixed price option to 2021 at an increased rate of \$35. I am proposing that the Minister of Finance, the Minister of Forestry and myself make in-principle decisions so the supplementary order paper can be drafted in time for presentation to Cabinet as soon as practicable. This process decision does not directly relate to policy changes currently proposed in the Bill. I am not seeking further policy decisions on the fixed price option itself at this time.
10. Any changes to the fixed price option would be included as part of the supplementary order paper. This supplementary order paper will include the extension to the temporary adverse event exemption to all post-1989 forestry registered in the NZ ETS discussed in the Cabinet paper on forestry policy changes. It will also be needed for any policy changes that cannot be made through select committee due to there being insufficient time to prepare the Bill after Select Committee decisions.
11. Some submitters raised a number of concerns with the new compliance regime, in particular that the value of the new surrender/repayment penalty is too high and there is no discretion in its application. I propose that Cabinet direct officials from the Ministry for the Environment, Ministry for Primary Industries, and the Ministry of Foreign Affairs and Trade to explore potential options for a more flexible approach to applying the penalty to small forest owners 9(2)(f)
[REDACTED]

12. The substantive changes and fixed price option process decision will require careful consideration as they will likely have a material impact on the outcomes sought by the Bill and New Zealand's climate change response.
13. The technical amendments I propose that require Cabinet approval are outlined in Appendix 1. These changes relate purely to how the Bill is drafted and are not expected to substantially impact the outcomes sought by the Bill.
14. My officials inform me that a number of consequential changes will be needed to the Income Tax Act 2007 as a result of the Government cancelling certain Kyoto Protocol units. Cabinet should note amendments are necessary to avoid inequitable tax outcomes for holders of cancelled units arising from earlier Government's decisions
15. The Minister of Forestry and I are also presenting a paper to Cabinet with our changes to the forestry aspects of the Bill. A small number of changes are proposed that relate to the effective operation of NZ ETS forestry policy decisions which Cabinet has already agreed to. We are also seeking agreement to extend the implementation date that most new forestry regulations empowered in the Bill would come into effect to 1 January 2022. This is important as there is not enough time to develop regulations before the forestry provisions come into effect under the Bill's current implementation dates.
16. The forestry paper will also seek agreement to enable the introduction of the supplementary order paper to extend the temporary adverse event exemption to all post-1989 forests registered in the NZ ETS.

Background

17. The Bill was introduced to the House on 24 October 2019, and contained proposals to improve the NZ ETS to enable it to be used to help New Zealand reach its domestic and international climate change targets.
18. As introduced, the Bill includes proposals to:
 - update the purpose of the Climate Change Response Act (the Act) to help New Zealand meet its international and domestic climate commitments;
 - enable a cap on emissions covered by the NZ ETS by setting an overall limit, for any given year, on the number of units supplied into the scheme;
 - allow for a cost containment reserve, which will operate through NZ ETS auctions, and remove the current \$25 fixed price option;
 - provide for robust and transparent auctions, including providing for regulations to be made to appoint an auction monitor;
 - phase out industrial allocation from 2021;
 - strengthen the compliance regime for the NZ ETS;
 - increase the transparency of the scheme;
 - introduce averaging accounting to the NZ ETS for post-1989 forests, optionally from 1 January 2019 and then applying to all new forests from 1 January 2021¹;

¹ The Bill currently sets 2021 as the date for the mandatory introduction of averaging for all new forests. The second Cabinet paper with changes to forestry recommends changing this date to 2022.

- introduce a new permanent forest activity into the NZ ETS;
 - put a price on agricultural emissions from 2025; and
 - make a range of operational and technical improvements to both the forestry and non-forestry sections of the Act.
19. The majority of these proposals were informed by public consultation undertaken in 2018 following a review of the NZ ETS in 2015 and 2016. The proposals to introduce pricing for agricultural emissions were consulted publicly in July and August 2019.
20. The Select Committee process has allowed further feedback on the proposed Bill. The Select Committee received submissions from November 2019 to mid-January 2020. Hearings were held in Wellington on 29 January, 30 January, 10 February and 13 February 2020 and in Auckland on 10 February 2020.
21. The Select Committee process has identified the desirability of changes in several areas to improve the implementation and workability of the Bill. Changes are also necessary to correct issues identified by officials through the drafting process.
22. Subject to your agreement, these changes will be included in part two of the Departmental Report, which is due to be provided to the Select Committee on 3 March 2020 for its consideration (part one of the Report only included changes consistent with previous Cabinet decisions and was provided to the Select Committee on 28 February 2020). The Select Committee is due to report back to the House on 2 April 2020.

Main issues highlighted by submitters

23. The Environment Select Committee received written submissions on the Bill from 170 organisations and individuals, and undertook oral hearings. Key issues raised by submitters include:

23.1. *Unit supply and price controls:* The majority of submitters who commented on unit supply and price controls supported the implementation of an overall cap of units. Many of these submitters called for action on reducing emissions and considered a limit on the supply of units as important for achieving this. Some held that an overall limit on units, removal of the fixed price option and implementation of a cost containment reserve, would cause NZU prices to rise, reduce liquidity and decrease the predictability of New Zealand's emissions price. While many submitters supported an increase in NZU prices, some industry groups were concerned with the associated impacts on business, households and rural communities. Allowing for the ability to implement a price floor through auctioning was largely supported.

Submitters expressed differing views on the Minister's role in determining unit supply and price control settings. Industry tended to call for more consideration of price impacts and restricting when changes are permitted, while others argued for greater ambition on domestic abatement and a stronger role for the Climate Change Commission.

- 23.2. *International units*: A common view from industry groups was that the NZ ETS should be open to international units so that emission reductions could occur at the lowest cost.
- 23.3. *Auctioning*: Most of the submissions that commented on the auctioning provisions were supportive of the introduction of auctioning in principle. There was acknowledgement that there will be subsequent development of auctioning and that it should be developed in a way that supports a transparent, accessible and efficient market for NZUs. Some submitters were concerned that regulations should be clear about when auctioning will start and how that relates to the removal of the fixed price option.
- 23.4. *Auction Monitor*: The majority of submissions on provisions to appoint an auction monitor were supportive. Reasons for support included that having an auction monitor in place could increase market transparency, reduce the risk of market manipulation and support continual improvement of the auctioning system.
- 23.5. *A phase-out of industrial allocation*: Submitters who commented on the phase out of industrial allocation were in two categories. The majority were either individuals or environmental organisations, who argued that industrial allocation is a subsidy and undermines the effectiveness of the NZ ETS. These submitters generally wanted the total elimination of allocation, or a more rapid phase-out than the Bill proposes. Industry and business organisations emphasised the potential risk of emission leakage and argued that any phase-out should only occur when competing jurisdictions have comparable emission costs.
- 23.6. *Review of industrial allocation*: Several industry submitters noted that in December, Cabinet approved a work programme on a review of the allocative baselines that determine the allocations received by eligible firms. These submitters suggested that this undermines the regulatory certainty that changes in the Bill would achieve, and argued that any review should take the phase-out into account or should be undertaken by the Commission as part of its role. Several large industrial allocation recipients supported removing the higher rates from 2031 until the review has taken place.
- 23.7. *Changing allocative baselines and eligibility criteria*: Other submitters, including the Parliamentary Commissioner for the Environment, made recommendations for changes to the basics of the allocation regime such as allocative baselines and eligibility criteria.
- 23.8. *New infringement penalties*: Submitters who commented on the new infringements regime were mostly supportive of the introduction of strict liability offences for low-level offending in preference to criminal offences, with some suggesting it should be clear that fees should not apply if reasonable care is taken. The few who did not support this were concerned about the impact of this regime on small landowners and foresters who may lack the resources to comply immediately with the requirements of what is perceived to be a complex scheme.
- 23.9. *Replacing the excess emissions penalty*: Some submitters commenting on the excess emissions penalty were specifically concerned about the new surrender/repayment penalty. While there was some support for

strengthening the compliance regime in general, it was clear that some submitters thought the new penalty was too high and/or lacked discretion. Several submitters were concerned that a lack of supply in the market may mean they could not access units to meet their surrender obligation and would then face large penalties.

23.10. *Transparency*: Submitters broadly supported measures to enhance transparency. A number supported enhanced transparency in principle, but recommended conditions be placed on the new provision, for example publishing data after a sufficient time lag or providing advance notice to participants. Of the submitters who opposed the new provision, some had concerns relating to privacy and confidentiality. In their view, publishing this data would potentially give insights into commercially sensitive information, and could allow others to determine the position of individual participants in the market. Others considered that emissions data could be misunderstood by the public due to the point of obligation for the NZ ETS being largely upstream and not representative of the emissions for which companies are directly responsible. A few submitters recommend that context be provided for the publication of any data to mitigate this concern.

Other submitters, including companies with surrender obligations in the NZ ETS, noted that while individual businesses may be concerned about the increased transparency, they consider that climate related disclosures are best practice for all large businesses.

24. For most of the issues identified in submissions, I do not propose further changes to the Bill. I consider that the Bill as currently drafted reflects the policy decisions Cabinet has made.
25. However, there were a handful of issues raised which require Cabinet's consideration. I am proposing changes to the Bill to deal with these specific issues, as well as those identified by officials following the Bill's drafting.

Enabling the review of industrial allocation settings

26. Cabinet noted my concern in December 2019 that over-allocation was prevalent and ongoing in the NZ ETS and agreed to a review of industrial allocation policy [CAB-19-MIN-0598]. The first part of this review on the electricity allocation factor is already underway. As the review progresses, other industrial allocation settings will be considered, such as the allocative baselines for eligible industrial activities.
27. This Bill provides an opportunity to improve the evidence available to the policy review. Information on over-allocation is currently limited to a single firm, Refining NZ. The data from Refining NZ suggests that we should review all industrial allocation settings, and potentially update allocative baselines. Before I can recommend this to Cabinet more data is needed to assess the risk of over-allocation.
28. Increasing the quantity and quality of data allow the Minister for Climate Change to assess the amount of over-allocation existing within industries and consider policy options.

29. Currently, the Minister, by way of a data notice in the NZ Gazette under section 161D, is able to obtain production and emissions data to inform a review under section 160. This data is limited to the financial years 2006/07 to 2008/09 by section 161E(3). I seek agreement to prescribing that this limitation does not apply where the notice is to provide the Minister with the information necessary to consider a review under section 160².
30. I recognise the timing of the industrial allocation policy review has created significant cost and investment uncertainties for Refining NZ, as it enters the NZ ETS in 2023. Accordingly, I intend to take a Cabinet paper later this year on decisions regarding the allocative baseline of Refining NZ.
31. I also intend to provide Cabinet with more detailed information by June 2020 on the planned review of industrial allocation policy, including timeframes and a draft terms of reference under section 160.

Allowing for reductions in the general phase-out rate for specific eligible industrial activities

32. The Bill introduces a general phase-out rate for industrial allocation of 0.01 from 2021 to 2030, increasing to 0.02 from 2031 to 2040, and 0.03 from 2041 to 2050. The Bill also allows for the Minister for Climate Change to reduce the general phase-out rates after 2030 for *all* eligible industrial activities if the Commission advises there is still a risk of emissions leakage.
33. I propose introducing an ability for the Minister to reduce the general phase-out rate for *specific* eligible activities at risk of emissions leakage. This would still be based on only one consideration: the risk of emission leakage as advised by the Commission.
34. This change would mean that if the concern with emission leakage that drives the Commission's advice relates only to one or a few eligible industrial activities, they alone could have their general phase-out rate reduced. This would prevent a blanket general phase-out reduction aimed at helping 'at risk firms' from potentially over-allocating others that do not have the same risk of emissions leakage.
35. This proposed change would not affect the minimum general phase out rate for the periods 2031 to 2040 and 2041 to 2050, which would remain 0.01 and 0.02 respectively.
36. A number of submitters advocated for the ability to reduce the general phase-out rate for specific activities. The Interim Climate Change Committee, the Parliamentary Commissioner for the Environment and industry groups such as Refining NZ, New Zealand Steel, New Zealand Aluminium Smelters and Oji Fibre Solutions all specifically asked for some form of reduction of general phase-out rate for individual eligible activities.
37. The Bill also introduces activity specific phase-out rates, which allow the Government to apply higher rates for individual eligible activities, based on the recommendations of the Climate Change Commission. These activity specific rates must be higher than the general phase out rate for the period.

² Under section 160 of the Climate Change Response Act 2002 the Minister for Climate Change may, at any time, initiate a review of the operation and effectiveness of the NZ ETS.

38. My proposal to introduce an ability to reduce the general phase-out rate is distinct from activity specific rates. Activity specific rates come with their own set of factors, such as a requirement the Commission publishes and tables a report in Parliament on whether the phase-out rate for an eligible industrial activity should be set at a higher rate than the general rate. The timeframes for the general phase-out and activity specific rates are also different. The ability to reduce the general phase-out rate will apply over the periods 2031 to 2040 and 2041 to 2050. Activity specific rates will cover five year emissions budget periods starting in 2026.

Requiring units provided through free allocation that exceed an emissions budget to be backed

39. New section 30IA of the Bill requires that if the Government sells units from the cost containment reserve, the Minister for Climate Change must obtain equivalent emissions reductions or removals as the volume of NZUs released. I recommend this obligation be extended to include any units provided by the Government through free allocation that exceed an emissions budget.

40. The Bill implements emission budgets by providing for regulations to constrain the total supply of units into the NZ ETS each year. After accounting for emissions outside the scheme, that limit will be set as the sum of units available for auctioning, industrial allocation and any overseas units approved for use. This overall limit is the NZ ETS cap and under normal circumstances should not be exceeded.

41. To ensure the cap is met, the Bill prohibits auctioning of NZUs (or participants using approved overseas units) if doing so would exceed the overall limit in that budget year. However, freely allocated units are not similarly restricted, even if these would exceed the overall limit. Requiring free allocation that exceeds the overall limit to be backed maintains the cap's integrity.

42. Some submitters identified this risk to the integrity of the NZ ETS. Conditions where the supply of NZUs exceed the cap in any year are not treated consistently. Any reserve units sold through the cost containment reserve must be 'backed' by matching emission reductions to compensate, but free units exceeding the cap are not. Such an outcome would not be aligned with New Zealand's emission reduction targets under the Zero Carbon Act or Paris Agreement.

Units from the cost containment reserve should only be backed if they exceed an emissions budget

43. Units in the cost containment reserve can come from within or outside of an emissions budget; however, the current drafting requires all units in the reserve to be backed by additional emissions reductions. This creates an unintended economic cost and fiscal risk from the Government procuring unnecessary additional emissions reductions domestically or from overseas. Only units in the reserve that exceed the emissions budget need to be backed by requiring the Government to obtain matching emission reductions. This is because reserve units only need to be backed to account for domestic emissions from outside a budget.

44. I therefore recommend amending the Bill to stipulate that only the fraction of reserve units resulting in total NZU supply exceeding the emission budget in any year must be backed by additional emission reductions.

Requiring future emission budgets and targets to be considered when making NZ ETS settings

45. The Bill obliges the Minister for Climate Change to consider the relevant emissions budget and Nationally Determined Contributions (NDC) under the Paris Agreement when making price control and unit supply settings. I recommend amending the Bill to clarify NZ ETS settings should also accord with future budgets and targets set under the Act.

46. Overseas experience with emissions trading schemes has shown initial settings were too generous, locking in surplus units and corresponding emissions that proved difficult to correct subsequently. This risk can be reduced by requiring the Minister for Climate Change to also consider future budgets and targets. While the Bill was not intended to limit consideration to only the current budget or NDC, this could be made explicit. Doing so may reduce the chance of making NZ ETS settings that overly favour shorter-term circumstances at the cost of greater difficulty (and higher NZ ETS prices, or increased use of the cost containment reserve) in meeting subsequent budgets.

Providing advance notice of publication of participant level emissions and removals data

47. New section 89A requires the EPA to publish participant-level emissions and removals data each year. The new provision will cover all participants in the NZ ETS who submit an emissions return. I propose the EPA should be required to provide notice of the intended date of publication of participant-level data.

48. There was general support for enhancing transparency from submitters, and mixed support for requiring the publication of participant-level data. One common concern was participants would have no forewarning of when the EPA would publish the data, making it difficult to plan any public response or to align the release of the information with their own business-driven reporting obligations. Submitters suggested various ways of notifying participants of when the data would be published, including setting down a publication date in legislation, direct notification to participants, and general notification on the EPA website.

49. I agree that participants would reasonably benefit from having a more accurate indication of when the EPA intends to publish participant level information on emissions and removals. The EPA frequently provides advance notice of its intended publication dates on its website, as a matter of good practice. Requiring a general notice on the organisation's website of their intended publication date would meet participants' needs without imposing unreasonable costs on the EPA.

50. I seek Cabinet approval to add a requirement that the EPA must provide notice on its website of its intended date of publication of participant level emissions and removals data at least ten working days before the publication date. The proposed new transparency provision would commence in 2021, with the

exception of forestry, which would commence in 2022 to align with the timing of their obligations to provide emissions returns.

Membership of Climate Change Commission

51. To ensure the objectives of the Bill align with the framework established by the Climate Change Response (Zero Carbon) Amendment Act 2019, I propose two 'tidy up' provisions that will clarify the decision-making process of the Commission, and the publication of its advice on industrial allocation regulations.
52. I seek agreement clarifying that the membership of the board of the Commission is a Chair, a Deputy Chair and three to seven other members.
53. The Zero Carbon Amendment Act establishes a Climate Change Commission. It requires the Commission's board to have seven members (a Chair, a Deputy Chair, and five other members). However, there might be times when the board has fewer than seven members, for example while new members are being selected (which involves a nominating committee and appointment process that takes some time). The intention is that the board may continue to make decisions in such a situation. However, this is not provided for in the Act.
54. It could be made clear by changing the membership requirements to a Chair, a Deputy Chair and three to seven other members. This range would provide limited flexibility in the membership of the Commission and is similar to the approach for many other statutory entities. Under existing legislation, the deputy chairperson may act for the chairperson if the chairperson is unavailable, and the board may appoint a temporary deputy chairperson if the deputy is unavailable.

Climate Change Commission's advice on industrial allocation

55. Under new section 84D, the Climate Change Commission will advise on regulations setting phase-out rates for industrial allocation. That section provides specific requirements for the Commission's report to be published and tabled in Parliament as soon as possible but within 16 weeks of the Government receiving the report. It would also require the responsible Minister to publish a response if he or she departs from the Commission's recommendations.
56. The Zero Carbon Amendment included provisions relating to other reports of the Commission. The Commission's reports must be tabled in Parliament by 10 working days after the document is provided to the Minister (or, if Parliament is not in session, as soon as practicable after the next session of Parliament).
57. For consistency, I recommend that the same reporting requirements under the Zero Carbon Amendment framework apply to the Commission's advice (and the Minister's response) about regulations setting phase-out rates for industrial allocation.

Process for changing the fixed price option

58. Cabinet agreed to consult on unit supply and price settings in December 2019 [CAB-19-MIN-0688 refers], including the proposal to amend the Act and the Bill so that the fixed price option is extended for all surrender obligations arising from

2020 activities at an increased rate of \$35 per NZU. Cabinet noted this proposal will provide certainty of unit supply for participants until government auctions are fully operational in 2021.

59. I consider this change is best enacted by the supplementary order paper to the Bill. I am not seeking policy approval to change the rate of the fixed price option in this paper. This is to give full consideration to submissions made through the unit supply and price control settings consultation, which are not due until 28 February.
60. I propose two elements of the process for introducing the supplementary order paper to the Committee of the whole (House) stage of the Bill. There is a short amount of time between the closure of consultation on NZ ETS settings and the Committee of the whole stage. This means preliminary decisions will be needed to ensure the supplementary orders paper can be drafted and implemented, if Cabinet decides to change the fixed price option.
61. Firstly, in order to provide policy decisions to enable drafting of the supplementary order paper, I propose that the Minister of Finance, the Minister for Forestry, and myself take preliminary decisions on the proposals. This group will consider the views of submitters and make in principal policy decisions so the supplementary order paper can be drafted, if that is the decision of the group.
62. Secondly, I seek approval to take the supplementary order paper directly to Cabinet as soon as practicable. Cabinet will be asked to confirm the in-principle policy decisions of the delegated Ministers, assisted by a regulatory impact analysis, and approve the introduction of the supplementary order paper.
63. An alternative to the above process is enacting the change through Budget night legislation. This will increase Cabinet oversight of the policy decision. However, given the proposal has no relevance to Budget '20, there is a risk of postponing the change in order to advance Budget decisions.
64. Some submissions to the Environment Select Committee addressed the proposed fixed price option policy change, despite this not being part of the current Bill. Submissions from industry mostly supported the extension and increase to the fixed price option, noting the Bill would consequently need amendment.

Further work on the surrender/repayment penalty

65. The Bill amends the existing penalty that applies when a participant fails to pay³ units by a due date (within 60 working days). In this case, the participant will be required to pay a penalty equivalent to three times the current market price of carbon for each outstanding unit, as well as make good on their original obligation.
66. Cabinet decided to set the penalty at this level to reflect the potential fiscal risk to the Crown created when a participant fails to pay units for their emissions, and to be consistent with international practice (including not foreclosing options of linking to international carbon markets in the future). A key consideration in the selection of this penalty (a non-discretionary 3x multiplier) was the minimum

³ 'pay' here refers to either the surrender of units to meet an obligation or repayment of units that may have been transferred in excess of what the person was eligible to receive.

credible threshold to allow the enforcement of the NZ ETS to be equivalent to that of prospective linking partners.

67. Some submitters (38 out of 180), from different sectors, submitted on the form and potential impact of the new surrender/repayment penalty. Of these, 19 expressed concerns about the impact of the new penalties. Officials have heard similar concerns during discussions with stakeholders. The two major concerns were:

- that there is no flexibility available to regulators applying the new surrender/repayment penalty to mitigate it in certain limited circumstances, e.g. in case of a force majeure event meaning that people cannot meet their surrender obligations on the due date; and
- that the size of the penalty is excessive and poses a risk to participants who may be having trouble meeting their surrender obligation due to no fault of their own

68. The NZ ETS is unique in that it has a large number of smaller participants, particularly within the forestry sector⁴. Some submissions have highlighted a potential issue whereby applying the penalty to smaller participants may result in a substantial and disproportionate impact on individuals that does not reflect the scale of their non-compliance⁵.

69. I have considered the concerns raised by stakeholders, and the need for an effective compliance scheme to enable the NZ ETS to meet its policy objectives. I recommend that Cabinet direct officials from the Ministry for the Environment, Ministry for Primary Industries, and the Ministry of Foreign Affairs and Trade to explore potential options for a more flexible approach to applying the penalty to small foresters 9(2)(j).

70. I recommend that Cabinet direct officials to report back to the Minister for Climate Change and the Minister of Forestry with any potential amendments to penalties in the Bill.

Proposed technical amendments

71. Proposed technical amendments are set out in Appendix 1. These deal with:

- updating the purpose of the Climate Change Response Act to include meeting New Zealand's domestic climate change targets and emissions budgets set under the Act;
- clarifying the application of reporting penalties for submitting too many units, or receiving too few so they are based on culpability, carbon price and the size of error before the maximum \$1000 penalty is applied;
- updating enactment dates for the compliance and penalties regime;

⁴ Approximately 75 percent (~1,700) of voluntary forestry sector participants are small-scale forest owners with less than 100 hectares registered. These participants make up about 20% of the post-1989 registered forest area.

⁵ For example, a farmer who deforests two hectares of pre-1990 forest will incur a surrender obligation of approximately 1600 units (about \$42,000 at a unit price of \$26). If they fail to pay within the timeframe they will also incur a penalty of up to \$126,000. The total value of \$168,000 will then be due within 20 working days. This compares to the average annual profit of a North Island hill country farm of approximately \$90,000 (Beef + Lamb NZ).

- extending the notice period to comply with requirements to submit an annual or closing allocation request;
- clarifying that the EPA cannot make decisions on agricultural allocations until an emissions return is also submitted;
- amending section 89A to include permanent forestry clear fell and deforestation penalties in EPA publications of significant non-compliance in the NZ ETS;
- clarifying the transitional provisions for penalties for farm level participants in their first year of surrender obligations;
- clarifying the date to apply the relevant carbon price for penalties incurred when a non-compliance price is triggered;
- clarifying that members of consolidated groups are jointly and severally liable to pay penalties and infringements incurred by the group; and
- clarifying the time restrictions for amending an emissions return under section 127 will not prevent the EPA from amending a late emissions return.

Consequential income tax amendments

72. Officials recommend a number of technical changes to the Income Tax Act 2007 as a consequence of the rationalisation of Kyoto units. Other changes to the Income Tax Act due to the new permanent forestry scheme are addressed in the forestry Cabinet paper.
73. The cancellation of certain Kyoto units (overseas Assigned Amount Units, Certified Emissions Reductions Units, Emissions Reductions Units, and Removal Units) from the first commitment period and the replacement of New Zealand-issued Assigned Amount Units with an equivalent number of New Zealand Units involves some legislative changes in the Income Tax Act.
74. These amendments are necessary as it would be unfair for a taxable event to arise simply as a result of a Government administrative decision that involves the swapping of units to rationalise the types of emissions units that are available. There are no fiscal costs to the Crown and minimal administrative impacts as a consequence of these unit swaps and Kyoto unit cancellations.
75. Note that further changes to the tax treatment of emissions units may be needed to accommodate agricultural emissions if the sector enters the NZ ETS in 2025. At this stage the existing framework of rules seem sufficient to accommodate agricultural emissions.

Next Steps

76. A Departmental Report will be provided to the Select Committee in two parts on 28 February and 3 March 2020. This will contain a summary and analysis of written submissions received on the Bill and recommendations for changes, including those agreed to through this paper. The first part, provided to the Select Committee on 28 February 2020, summarises feedback from written submissions and presents minor changes consistent with Cabinet's previous decisions. The

second part will be provided to the Select Committee on 3 March 2020 following Cabinet's consideration of the proposals in this paper.

77. The Select Committee is due to report back to the house on 2 April 2020. I expect the Bill to pass in the first part of the year, provided the remainder of the process proceeds in a timely manner.
78. The supplementary order paper which I expect to be presented to Cabinet as soon practicable, will include decisions Cabinet has yet to consider, such as changes to the fixed price option and extending the temporary adverse event exemption to all post-1989 forestry in the NZ ETS. The supplementary order paper may also be used to implement some of the decisions Cabinet has agreed to, but were unable to be included in time for this Bill.

Consultation

79. The following agencies were consulted on this paper: the Treasury, Ministry of Business, Innovation and Employment, Department of Prime Minister and Cabinet, Ministry of Foreign Affairs and Trade, Ministry of Justice, Ministry of Transport, Department of Conservation and the Ministry for Primary Industries. Te Puni Kōkiri was informed of the paper.

Financial implications

80. There are no immediate financial implications from any of the proposed policy changes to the Bill.
81. Allowing for reductions in the general phase out rate for individual activities would have a fiscal cost to the Crown. However, as this provision would not take effect before 2031 there are no immediate financial implications.
82. There are hypothetical financial implications of requiring the Government to 'back' free allocation. However, the risk of free allocation needing to be backed for New Zealand's first emissions budget (which covers the period 2021-2025) is low. Officials have calculated a provisional emissions budget which indicates that free allocation will not exceed the NZ ETS cap in the first budget period.
83. The proposal to only require units from the cost containment reserve that exceed the NZ ETS cap to be backed will minimise the Crown's fiscal risk from having to back reserve units. This policy change could reduce the number of reserve units requiring backing with equivalent emissions reductions if the cost containment reserve is used.
84. Increasing the level of the fixed price option would have financial implications. However, this paper does not seek decisions on changing the fixed price option; rather it seeks agreement on enabling a process to change the fixed price option.

Legislative implications

85. These proposals require legislative change to the Climate Change Response Act, which will be progressed through the Bill, currently before the Environment Select Committee.

86. Any changes to the fixed price option will be progressed through the supplementary order paper which I intend to present to Cabinet for decisions as soon as practicable.

Regulatory impact analysis

87. Most of the changes proposed in this paper are consistent with previous regulatory impact analyses for decisions in the Climate Change Response (Emissions Trading Reform) Amendment Bill.

88. The regulatory impact statement “A phase-down of industrial allocation” was updated to include the policy change to enable a review of industrial allocation. The Regulatory Impact Assessment panel at the Ministry for the Environment considered the proposal and determined that it did not change the initial RIA quality assurance assessment.

Treaty of Waitangi

89. Engagement with Māori was carried out throughout the policy development process, including six regional hui for Māori/iwi representatives in 2016 and a Māori leaders hui in September 2018.

90. Submissions received from iwi/Māori expressed a range of views on the detailed proposals, and including consideration of impact on Māori and the importance of involving Māori in decision-making.

91. Issues raised by Māori during consultation and in submissions were primarily focused on forestry provisions in the Bill, including recognising above business as usual carbon storage for pre-1990 forests, and better encouraging the regeneration of native forests.

92. I am satisfied that both the forestry and non-forestry proposals in the Bill will not disadvantage Māori.

Climate implications of policy assessment

93. The Ministry for the Environment has been consulted and confirms that the CIPA requirements do not apply to this proposal as the emissions impacts are indirect.

Human rights

94. The proposals in this paper are consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Gender implications

95. There are no immediate gender implications of the proposals in this paper.

Disability implications

96. There are no immediate disability implications of the proposals in this paper.

Publicity and proactive release

97. I recommend that announcement of the proposed changes to the Bill be delayed until the Select Committee has reported back to the House. This allows time for the Committee to appropriately consider and approve the changes.

Proactive Release

98. I intend to proactively release this paper on the Ministry for the Environment's website after the Committee has reported back to the House, subject to appropriate withholdings that are consistent with the Official Information Act 1982.

Recommendations

I recommend that Cabinet:

1. **note** that the Climate Change Response (Emissions Trading Reform) Amendment Bill (the Bill) is currently being considered by the Environment Select Committee (the Select Committee)
2. **note** that, following input from submitters and officials, I have refined a number of proposals to ensure that the objectives of the Bill and the Government's wider climate change goals are being achieved, and that the reforms to the New Zealand Emissions Trading Scheme can be implemented effectively
3. **note** a range of issues were canvassed by submitters during select committee, and a variety of proposals were made to change different parts of the Bill
4. **note** that a number of changes to the Bill are proposed to address both substantive and technical issues raised by submitters, as well as those identified by officials after the Bill's drafting

Enabling the review of industrial allocation settings

5. **agree** that the limitation in section 161E(3) to specific financial years does not apply where a data notice under section 161D is to provide the Minister with information to inform a review under section 160
6. **invite** the Minister for Climate Change to report back to Cabinet by June 2020 on a planned review of industrial allocation policy, including proposed timeframes and a draft terms of reference

Allowing for reductions in the general phase-out rate for specific eligible industrial activities

7. **note** that a range of submitters supported enabling a reduction of the general phase-out rate for specific individual activities at risk of emissions leakage

8. **agree** to the addition in section 84A(1) of the Bill, the ability to reduce the general phase-out rate for individual eligible activities
Requiring units provided through free allocation that exceed an emissions budget to be backed
9. **note** the Bill prohibits auctioning NZUs and using international units if doing so would exceed the NZ ETS cap in a budget year
10. **note** this same restriction does not apply to free allocation, creating a risk it may exceed the NZ ETS cap in a budget year
11. **agree** to amend section 30IA to include free allocation so that NZUs provided through industrial allocation that exceed the overall limit are backed by additional emissions reductions or removals
Units from the cost containment reserve should only be backed if they exceed an emissions budget
12. **note** there is fiscal risk in requiring units from the cost containment reserve to be backed with additional emissions reductions
13. **agree** that the fraction of reserve units resulting in total NZU supply exceeding the emission budget in any year must be backed by additional emission reductions
Requiring future emission budgets and targets to be considered when making NZ ETS settings
14. **note** the Bill requires the Minister for Climate Change to consider relevant emissions budget and NDC under the Paris Agreement when making overall unit and auction settings and price control settings, but not explicitly future budgets and targets established under the Act
15. **agree** to amend section 30GC requiring the Minister to consider future budgets and targets when making regulations for unit supply and price control settings
Providing advance notice of the publication of participant level emissions and removals data
16. **note** new section 89A requires the EPA to publish participant level emissions and removals data each year
17. **note** there was concern from some submitters that they would have no forewarning of when the EPA would publish the data
18. **agree** to require the EPA to provide notice on its website of its intended date of publication of participant level emissions and removals data, at least ten working days before the publication date
Membership of Climate Change Commission
19. **note** that under section 5D Climate Change Response (Zero Carbon) Amendment Act (Zero Carbon Amendment) requires the board of the Climate Change Commission to have seven members
20. **note** there may be times when the Commission's board has fewer than seven members and it is unclear in these circumstances if it can make decisions

34. **report back** to the Minister for Climate Change and Minister of Forestry with any potential amendments to penalties in the Bill

Proposed technical amendments

35. **note** the proposed technical amendments listed in Appendix 1 clarify how the Bill gives effect to government policy and will not substantially impact the outcomes sought by the Bill

36. **agree** to the technical amendments outlined in Appendix 1

37. **agree** that if these agreed substantive and technical changes are not adopted by the Environment Select Committee, then the Minister of Forestry and the Minister for Climate Change will introduce them through the supplementary order paper for consideration by the Committee of the whole (House)

38. **authorise** the Minister of Forestry and the Minister for Climate Change to instruct the Parliamentary Counsel Office to draft these agreed changes as a supplementary order paper if the Environment Select Committee does not include them in its reported back version of the Bill

39. **note** there are consequential changes to the Income Tax Act 2007 due to the rationalisation of Kyoto Units

Authorised for lodgement.

Hon. James Shaw

Minister for Climate Change

Appendix 1: Proposed technical amendments

Number	Bill Section	Policy Recommendation	Existing position in Bill	Comments
1	Purpose 3	<p>Amend purpose of the Act to include meeting New Zealand's emissions reduction targets and budgets set under the Zero Carbon framework.</p> <p>Replace existing parts of the purpose that refer to reducing New Zealand's net emissions to below business as usual levels.</p>	<p>The Bill does not currently make reference to the targets and emissions budgets established by the Zero Carbon Act.</p>	<p>Cabinet has already agreed to amend the purpose of the Act to include assisting New Zealand to meet the domestic target(s) and budgets set under the Act. This amendment was not included in the Bill on introduction because the Climate Change Response (Zero Carbon) Amendment Bill 2019 had not been enacted at the time of drafting. The amendment requires consequential further amendments to section 3 that we wish to draw to Cabinet's attention.</p>
2	Compliance and Penalties 134A, B, C and D <i>Reporting Penalty</i>	<p>Clarify in the Bill that reporting penalties that result in a person being owed units by the Crown, should be calculated using the formula based on culpability factor, carbon price and the size of the error (in units or tonnes of carbon) and only then have the maximum value of \$1,000 applied.</p>	<p>If a calculation/recalculation results in a person being owed units by the Crown, or there is no change to the surrender/repayment value then a penalty of \$1,000 is applied.</p>	<p>In all situations, including where a calculation/recalculation results in a person being owed units by the Crown, the penalty to be applied under these sections should be calculated using the formula as stated in the Bill and therefore be scalable, but only up to a maximum value of \$1000. No maximum should apply if the units are owed to the Crown. If the calculation results in no change to liability then the calculation will be zero and therefore no penalty will be applied.</p>

Number	Bill Section	Policy Recommendation	Existing position in Bill	Comments
3	Compliance and Penalties enactment date	The new penalties regime should apply from 1 January 2021 rather than from the date the Bill is enacted.	The new penalty regime will apply from the date of enactment because no start date was specified in Bill.	This was overlooked in the original drafting of the Bill.
4	Compliance and Penalties 134A Penalty for failing to submit emissions return by due date 134B <i>Penalty for failing to submit annual or closing allocation by due date</i>	The notice periods given to people to comply with the requirement to submit an annual or closing allocation adjustment request, and for failing to submit an emissions return are currently set at ten working days. We recommend this timeframe be extended to 20 working days.	Existing notice period in the Bill is ten working days.	After further discussions with enforcement agencies, ten working days is not considered long enough to enable people to submit an accurate return. The timeframe will be extended to give people more time to provide accurate information and reduce the likelihood of incorrect information being provided that may in turn incur further penalties.
5	Unit supply and price controls 30IA	Amend section 30IA to allow for equivalent emissions reductions to match an amount released from the cost containment reserve to also be obtained within the same budget period as the release.	Equivalent emissions reductions must be obtained <i>after</i> the end of the emissions budget period that includes the year that the cost containment reserve is released.	Specifically stating that the equivalent emissions reductions must be obtained after the budget period restricts flexibility for the Government in meeting this obligation. Allowing for increased flexibility, such as obtaining the equivalent reductions on an annual basis, may provide financial benefits if more economical equivalent reductions are able to be obtained in the short-term. Other benefits may include

Number	Bill Section	Policy Recommendation	Existing position in Bill	Comments
				improved accounting towards meeting the Paris agreement target.
6	Transfer of allocated units 86BAA	Amend new section 86BAA to clarify that the EPA cannot make decisions on agricultural allocations until an emissions return is also submitted	In the agriculture supplementary order paper, as currently drafted, there is no specific legal requirement for allocation applications and emission returns to be submitted within a timeframe which ensures they can be calculated at the same time.	Amend agricultural allocation provisions to require allocation entitlements to be calculated only once an emissions return has been submitted (in order to allow it to be 'netted off'). Cabinet decisions have already been made in support of 'netting off' to avoid large volumes of units entering and exiting the market and disrupting unit supply. However, in the agriculture supplementary order paper, as currently drafted, there is no specific legal requirement for allocation applications and emission returns to be submitted within a timeframe which ensures they can be calculated at the same time. The proposed change will fix this and avoid the transfer of units to agricultural participants (except in the rare scenario where there is a net positive allocation).

Number	Bill Section	Policy Recommendation	Existing position in Bill	Comments
7	EPA publication of participant data on emissions and removals 89	Amend section 89 regarding publication of penalties to include new permanent forestry penalties	The EPA must publish a list that records the following significant penalties imposed during the year: the surrender/repayment penalty and reporting penalties imposed for behaviour that was either grossly careless or knowing.	<p>Cabinet has agreed that the EPA will publish occurrences of significant non-compliance within the NZ ETS, including penalties applied for failure to surrender units and the two most severe levels of the new reporting and allocation penalties.</p> <p>The new penalties created for permanent forestry are not currently captured by this provision.</p> <p>For the sake of consistency, the permanent forestry excess harvest/clear fell and deforestation penalties should be included in this publication.</p> <p>However, as the penalty level for permanent forestry is determined by the court, the EPA will be required to publish the penalty details once the court has determined the final penalty.</p>
8	217	Amend section 217 to clarify that the transitional provisions for penalties that apply to farm level participants in their first year of surrender obligations, should not only apply to penalties for offences related to surrender obligations but those related to infringement offences and allocation penalties as well.	The Bill applies the transitional provisions for penalties for farmers level participants in their first year of surrender obligations, to only those penalties directly related to surrender obligations	Cabinet has already agreed to apply a penalty holiday to the first year of surrender obligations to farm level participants in the scheme. It is intended that this penalty holiday apply to all types of penalties farmers may face in their first year of obligations, including infringement offences and allocation penalties.

Number	Bill Section	Policy Recommendation	Existing position in Bill	Comments
				This requires clarification in the cabinet decision and drafting.
9	Carbon Price calculation 134, 134A-D	Clarify that the date on which a non-compliance process is triggered for the relevant penalties should be used to apply the relevant carbon price from regulations, i.e. the date the person/ participant originally failed to take action. Any date that results from subsequent notice periods provided to participants should not be used.	The carbon price used to calculate penalties under these sections will be set in Regulations and may change over time. In the Bill it is not clear which carbon price should be applied for the purposes of penalty calculation.	<p>When participants are penalised under sections 134, 134A-D they are given notice that if they fail to comply with requirements in a specific period of time then penalties will apply. Penalties are calculated using a carbon price set in regulations that can change over time. If a penalty process is underway when new regulations are being set then it is unclear which price should be used.</p> <p>I recommend that in this case the earliest date should be used to apply to the carbon price for the penalty, specifically the original date of the offence. This allows the enforcement agencies to know what price to use when creating the notice. It is also fair to participants to use the carbon price that is in force at the time of the offence to calculate the penalty.</p>
10	Penalties and consolidated groups 150(4)(c)	Clarify in the Bill that members of consolidated groups are jointly and severally liable to pay any penalties and infringements incurred by the activities of the consolidated group.	The Bill amends the section covering the liability of members of consolidated groups to say that members will be liable for “the NZ ETS participant provisions in respect of emissions, removals, and allocations”. The Bill does not	The amendments in the Bill do not currently mention liabilities for any penalties or infringements incurred by consolidated groups, only obligations for the NZ ETS participant provisions in respect of emissions, removals and

Number	Bill Section	Policy Recommendation	Existing position in Bill	Comments
			specifically mention the liability of members in relation to penalties and infringements.	allocations. However, consolidated groups may include members that are not participants. It should be clear to all members that agree to be in a consolidated group, that they are joint and severally liable for any penalties imposed.
11	Compliance and Penalties	Clarify that the time restrictions that apply to amending an emissions return under section 127 will not prevent the EPA from amending a late return submitted under section 134A. Instead, it will apply from when the return was actually submitted, rather than when it was due.	The section 127 time restriction would prevent the EPA from correcting an incorrect return under section 134 if the return was covering an obligation to surrender or receive units which was older than dates laid out in section 127 (either 4, or 7 years before the late return, depending on the activity).	Cabinet already agreed to allow late returns under section 134. However, during drafting a loophole was identified which needs closing. This loophole would prevent the EPA from correcting historic non-compliance, if the participant submitted a late return under this section. This is because the time restriction for correcting returns is based on the time period when the surrender obligation or entitlement relates to, rather than when the return was submitted.