

In Confidence

Office of the Minister for Climate Change

Chair, Cabinet Environment, Energy and Climate Change Committee

Amendments to the Climate Change Response Act 2002: tranche two

Proposal

1. This paper informs Cabinet of how I plan to approach decisions on tranche two of amendments to the Climate Change Response Act 2002 (CCRA), to improve the New Zealand Emissions Trading Scheme (NZ ETS).
2. I will bring a series of specific papers to Cabinet over the next two months, so Cabinet can consider each proposal while legislative drafting continues. The results will combine with decisions from tranche one [CAB-18-MIN-0606.01 refers], to deliver a single bill to amend the CCRA.

Executive summary

3. The Government is taking a number of important decisions on climate change in the coming months. This includes the Climate Change Bill (CCB), responding to the Productivity Commission's 2018 Low-emissions Economy report, and deciding whether and how agricultural emissions could be brought into the NZ ETS. The timing reflects Cabinet's desire to conclude core Government legislation in 2019.
4. The reform of the NZ ETS is another vital part of the Government's programme of action on climate change. The NZ ETS is the key tool to support New Zealand in meeting emissions reduction targets and transitioning to a low-emission future. This reform requires amending the CCRA, the establishing legislation for the NZ ETS, to ensure the scheme is robust and fit-for-purpose.
5. The proposals to amend the CCRA aim to provide certainty to the market of the long-term credibility and effectiveness of the NZ ETS. They will help give clear signals on the trajectory of our transition to a low-emission economy, which is essential to support long-term investment in innovations and practices that reduce emissions.
6. At the same time the proposals afford the Government flexibility to manage the NZ ETS and ensure it can respond to changing circumstances.
7. Cabinet approved tranche one of amendments on 10 December 2018, [refer CAB-18-MIN-0606.01] and legislative drafting has started. Tranche one amendments included:
 - aligning the CCRA with the Paris Agreement and the CCB
 - enabling a cap on emissions covered by the NZ ETS (including auctioning, limiting international units, price controls and a coordinated decision-making process)
 - improving administration and operation
 - amending forestry settings to incentivise afforestation.

8. Together with Hon Shane Jones, the Minister of Forestry, I will bring a series of papers to Cabinet as part of tranche two, covering:
 - i. how to phase down industrial allocation
 - ii. strengthening compliance
 - iii. improving market governance
 - iv. improving transparency in the NZ ETS
 - v. addressing a legacy issue related to the Kyoto Protocol
 - vi. transitional measures to move from the fixed price option price ceiling to the cost containment reserve
 - vii. enabling a price floor to be implemented in future if desired
 - viii. further improvements to forestry operations (with Hon Jones)
 - ix. changing forestry accounting rules to help incentivise afforestation and better align with future international accounting rules (with Hon Jones).
9. Tranches one and two will form a single Climate Change Response Amendment Bill, to be introduced to the House in mid-2019 and be given effect in 2020.
10. Regulations will be required to fully implement many of the CCRA amendments. I expect to return to Cabinet by mid-2019 seeking approval to begin consultation on the regulations alongside select committee consultation on the Climate Change Response Amendment Bill. The regulations will include unit supply settings, which will have a direct impact on the emissions price.

Context - New Zealand's wider climate change ambitions

11. This Government is committed to taking decisive action on climate change and transitioning to a low-emission economy.
12. Progress is already underway in a number of areas, including agreement to progress the CCB, establishing an independent Climate Change Commission, establishing the Chief Executives Board to align climate change policies across the public sector, and welcoming the Productivity Commission's Low-emissions Economy report.
13. Internationally, New Zealand has signalled its commitment to global action on climate change by ratifying the Paris Agreement in 2016 and communicating our first international target for emissions reductions (Nationally Determined Contribution, or NDC). The Paris Agreement requires all Parties to put forward their best efforts through NDCs and strengthen these efforts in the years ahead.
14. We are committed to doing this, and have agreed an all-of-government framework for climate change [ENV-18-MIN-0011 refers] to understand the benefits and trade-offs across many portfolios and agencies, and ensure coherence in decisions. The three fundamental pillars underpinning the all-of-government framework are:
 - leadership at home and internationally;
 - a productive, sustainable and climate-resilient economy; and
 - a just and inclusive society.
15. Building on the above steps, I will bring a number of papers to Cabinet in the coming months on the CCB, responding to the Productivity Commission's Low-emissions

Economy report, and deciding whether and how to include agriculture in the NZ ETS.

The Climate Change Bill will provide the framework for New Zealand's transition

16. Cabinet agreed to progress the CCB as an enduring framework for transitioning to a low-emission, climate resilient New Zealand [ENV-19-MIN-0053 refers]. It will do this by:

- setting an emission reduction target to achieve:
 - net zero greenhouse gas emissions except for biogenic methane by 2050;
 - a reduction in emissions of biogenic methane by 2050.
- emissions budgets that will act as five-year milestones for achieving targets
- a requirement to develop a range of mitigation and adaptation measures
- establishing an independent Climate Change Commission to provide expert advice on key climate change issues.

17. Cabinet also agreed the NZ ETS will play a key role in reducing New Zealand's emissions, increasing removals, and meeting targets under the CCB [ENV-18-MIN-0053 refers]. Tranche one amendments to the CCRA agreed by Cabinet will effectively place a cap on emissions by establishing a unit supply framework that will enable the NZ ETS to assist New Zealand to meet targets and emissions budgets set under the CCB.

Our response to the Productivity Commission's Low-emissions Economy report will be the first step to support the transition

18. Confirming and issuing the response to the Productivity Commission's report, as part of a separate paper, will be the first key step to support a managed and just transition to a productive, low-emission economy. My officials are working with other agencies to ensure the response presents a strong and coherent picture of how the Government is addressing the challenge of reducing emissions.

19. The Productivity Commission's report included an assessment of the role of the NZ ETS and recommended that improvements focus on making the scheme effective in achieving New Zealand's emissions reduction targets and reducing domestic emissions. The recommendations to reform the NZ ETS were supported by the Tax Working Group.¹ Tranches one and two of amendments to the CCRA support these aims.

The treatment of agricultural emissions will be a key part of the transition

20. The Government has tasked the Interim Climate Change Committee (Interim Committee) to recommend how surrender obligations could best be arranged if agricultural emissions enter into the NZ ETS. The Interim Committee will consider a full suite of options to reduce agricultural emissions in a report by 30 April 2019².

¹ 'Future of Tax' Final Report Volume I: Recommendations, Tax Working Group, February 2019.

² The Interim Committee has also been tasked with providing advice on how New Zealand can transition to 100 per cent renewable electricity generation by 2035. The investigation is running on the same timeframes as work on agriculture. The Government's response to this is not expected to have implications for the Climate Change Response Amendment Bill.

21 s9(2)(f)(iv)

22. I will seek Cabinet's approval for final policy decisions in the middle of the year, to allow us to factor in feedback from consultation. My intention is to make the Cabinet decisions available to the select committee considering the Climate Change Response Amendment Bill, to enable them to also discuss and hear submissions on these decisions through the public submissions and hearing processes.

Overview of proposed amendments to the Climate Change Response Act 2002

Background to the proposals to amend the CCRA

23. The CCRA established the NZ ETS in 2008 to support New Zealand to meet international and domestic emissions targets by putting a price on emissions for all sectors of our economy, except agriculture. This creates a financial incentive to invest in innovations and practices that lower emissions.
24. The CCRA was designed to enable New Zealand to comply with international obligations under the United Nations Framework Convention on Climate Change and the Kyoto Protocol, with links to international carbon markets³. In 2016 New Zealand ratified the Paris Agreement. We have communicated our first international target for emissions reductions under the Paris Agreement⁴, and are required to report regularly on emissions and implementation progress.

A review found that the NZ ETS needs to be improved

25. The 2015/2016 review of the NZ ETS, undertaken in anticipation of the Paris Agreement, found that in its current form the NZ ETS will not be fit-for-purpose for 2020 and beyond. This is because the Government does not have the tools to effectively manage unit supply, and the operation of the scheme has created significant regulatory uncertainty.
26. In response, the previous Government agreed a number of in-principle decisions to strengthen the framework of the NZ ETS, effectively manage unit supply, and enhance regulatory certainty for the market [EGI-17-MIN-0369 refers]. Public consultation was undertaken in August and September 2018 on proposals to implement those decisions.
27. In December 2017, this Cabinet noted that the in-principle decisions would be pursued through amendments to the CCRA by the end of 2019 [CAB-17-MIN-0547.01 refers].

³ The NZ ETS became a domestic-only system on 1 June 2015.

⁴ New Zealand's NDC is to reduce greenhouse gas emissions by 30 per cent below 2005 levels by 2030.

Work has commenced to amend the CCRA

28. Proposals to amend the CCRA are being taken forward in two tranches.

29. The first tranche was agreed on 10 December 2018 [CAB-18-MIN-0606.01 refers]. The Parliamentary Counsel Office (PCO) has commenced drafting these amendments to:

- align the CCRA with the Paris Agreement and the CCB
- enable a cap on emissions covered by the NZ ETS by establishing a unit supply decision-making framework
- improve the administration and operation of the NZ ETS
- amend forestry settings to incentivise afforestation.

The amendments to the CCRA will create a more effective NZ ETS

30. Improving the NZ ETS will assist New Zealand to achieve its international and domestic emissions targets, and ensure a just and inclusive transition to a low-emission economy.

31. In addition, these amendments must be considered in light of their impact on New Zealand's ability to access international units with environmental integrity. Cabinet has agreed to retain the option to use international carbon markets after 2020 [CAB-18-MIN-0248 refers], as high-integrity international units may play an important role in New Zealand meeting its NDCs.

32. The most promising options for accessing high-integrity international units are through linking the NZ ETS to other mature and credible emission trading schemes. All decisions about the design and operation of the NZ ETS have the potential to affect the credibility and compatibility of our scheme and our ability to link to other established emission trading schemes. The proposed changes to the CCRA, contained in tranches one and two, will reduce barriers to creating such links.

33. Table I provides details on tranche two proposals that will be brought to Cabinet over the next two months. These cover a range of discrete issues, so require individual consideration. I will therefore be seeking decisions on these proposals through separate Cabinet papers. The forestry papers will be co-led with Hon Shane Jones, Minister of Forestry.

Table 1 Details on tranche two amendments to the Climate Change Response Act

Theme	Decisions	Stakeholder interest
Industrial allocation	How to phase down industrial allocation	Of significant interest to NZ ETS participants engaged in emissions intensive and trade exposed activities that receive free allocation of New Zealand Units (eg NZ Steel, New Zealand Aluminium Smelter, Methanex)
Compliance regime	Improvements to the penalties regime	Some stakeholder interest
Paris Agreement and Kyoto Protocol	Addressing a legacy issue related to Kyoto Protocol units held in private accounts	Relevant to a limited number of stakeholders
Price ceiling (fixed price option) and price floor	Transitional measures for moving from the fixed price option price ceiling to the cost containment reserve price ceiling Enabling the Government to introduce a price floor, via a reserve price at auction, if it chooses to do so in the future (note this will not consider whether there should be a price floor in the NZ ETS)	Wide stakeholder interest The price floor is of significant interest to iwi/Māori and forestry stakeholders
Market governance	Decisions on progressing the broader governance framework, including the role of the auction monitor (some of which may be in-principle)	NZ ETS participants, and the wider market, particularly market intermediaries and regulators
NZ ETS transparency	Options to improve transparency in the NZ ETS	Some stakeholder interest
NZ ETS operational forestry proposals (led jointly with Hon Shane Jones, Minister of Forestry)	Operational improvements for forestry, including: - improving the certainty of NZ ETS land status - enabling provisions to allow future improvements to NZ ETS operation - forestry specific compliance provisions	Considerable interest from forestry sector, and iwi/Māori involved in this sector
NZ ETS forestry accounting for 2019 planting (led jointly with Hon Shane Jones, Minister of Forestry)	Enabling forests established in 2019 to use averaging accounting, if agreed in the next decision	Considerable interest from forestry sector, and iwi/Māori involved in this sector
NZ ETS forestry accounting proposals (led jointly with Hon Shane Jones, Minister of Forestry)	Introduction of averaging accounting for new forests Implementing transitional measures for existing post-1989 forests Harvested wood products provisions	Considerable interest from forestry sector, and iwi/Māori involved in this sector

The use of auctioning proceeds will be considered later

34. The introduction of auctioning of New Zealand Units (NZUs) will generate funds for Government in the future, the use of which will be part of a wider discussion on climate change spending priorities within the Government's Budget process. Decisions are not yet required on whether to amend the CCRA to specify how auction proceeds will be used. I intend that these decisions be taken following wider discussion with Ministers.

Further work required for market governance framework

35. Officials are investigating options to develop a broader NZ ETS market governance framework, which will be considered as part of a wider, long term programme to address significant market risks. Good governance will help ensure the integrity and efficiency of the scheme, promote confidence in market trading, and reduce risks of misconduct distorting the NZ ETS price. I intend to bring a paper to Cabinet in May 2019 seeking decisions on the role of the auction monitor and to provide an update on next steps.

Next steps

Process for decisions on tranche two amendments to the CCRA

36. As noted above, I intend to return to Cabinet with a series of papers on discrete issues (all of which have been publically consulted) for tranche two. Once agreed these amendments, alongside the decisions in tranche one, will be incorporated into the Climate Change Response Amendment Bill. I expect that this will be introduced to the House in mid-2019.
37. Cabinet has noted that the amendments to the CCRA should be passed by the end of 2019 (CAB-17-MIN-0547.01 refers). In order for this to occur, the select committee process will need to be four months only.

Consultation

Public consultation

38. A joint consultation on proposals to improve the NZ ETS was conducted by officials from the Ministry for the Environment, Ministry for Primary Industries, and Te Uru Rākau from 13 August to 21 September 2018. 253 submissions were received from a range of sector groups. Submissions were broadly supportive. The proposals contained in tranches one and two draw on these submissions. The submissions have been released on the website of the Ministry for Environment and a Summary of Submissions will be published in March 2019.

Agency consultation

39. The following agencies were consulted on this paper and expressed broad support: the Ministry of Business, Innovation and Employment, the Ministry for Primary Industries, Te Uru Rākau, Treasury, the Ministry for Foreign Affairs and Trade, the Energy Efficiency and Conservation Authority, the Environmental Protection Authority, the Department of Conservation, and the Ministry of Transport. Te Puni Kōkiri and the Department of the Prime Minister and Cabinet were informed.

Financial implications

40. There are no immediate financial implications for the Government resulting from this overview Cabinet paper. The financial implications of each proposal will be presented in the relevant Cabinet papers.

Legislative implications

Legislative amendments

41. There are no immediate legislative implications resulting from this paper. The detailed Cabinet papers explaining the policies outlined in this tranche two paper will provide the basis for drafting instructions for the PCO to amend the CCRA.
42. The PCO has already begun drafting amendments contained in the tranche one paper, approved by Cabinet in December 2018 [refer CAB-18-MIN-0606.01].
43. I intend for these two tranches to culminate into a single Climate Change Response Amendment Bill, expected to be introduced by mid-2019.
44. The amendments were given a category 2 priority on the 2019 Legislation Programme (meaning the bill must be passed by the end of 2019).

Regulations will be needed to give effect to the decisions to improve the NZ ETS

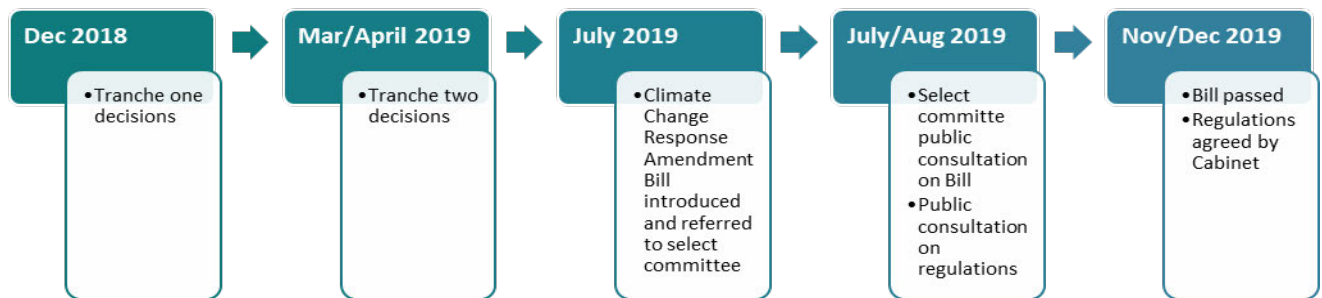
45. The amendments to the CCRA aim to improve the framework and operation of the NZ ETS. Many of the amendments will give Cabinet the power to create regulations which will give effect to the framework. Table 2 describes the areas that will require regulations:

Table 2 Areas requiring regulations

Area	What this will include in regulations
Unit supply settings (capping the NZ ETS)	For 2020-2024: <ul style="list-style-type: none">• annual limit on international units• annual auction volumes• annual level of the price controls, and volume in reserve
Auctioning	Detailed auctioning regulations
Compliance	Specifying infringement offences and penalties
Industrial allocation	TBC following decisions, likely to include operational detail
Market governance	
Forestry	

46. I expect to return to Cabinet by July 2019 for approval to begin consultation on proposals for the regulations, which will take place alongside select committee consultation on the Climate Change Response Amendment Bill. The aim of combining the timing of the consultation periods is to allow the impacts of the amendments to be more fully considered and to limit stakeholder fatigue.

47. I expect to return to Cabinet to approve the regulations by the end of 2019, so they can come into effect with the passing of the Climate Change Response Amendment Bill. This process is shown in the figure below.



Human rights

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

Crown-Māori Partnership

49. Māori have a significant stake in climate change action and in the NZ ETS. Māori have a large economy and asset base sitting largely in the primary industries, as well as Treaty-based rights and interests in natural resource use and management. It will be critical to maintain te ao Māori principles, including as provided by section 3A of the CCRA, and a genuine Crown-Māori partnership approach.

50. To foster the Crown-Māori engagement on the NZ ETS, a Māori Leaders' Forum was held in Wellington on 17 September 2018 as part of consultation on improvements to the NZ ETS. The hui was an opportunity to build on the existing relationship between the Ministry and iwi/Māori, and to further conversations around the Government's climate change work programme. Ways to ensure there are strong processes in place to value iwi/Māori input into policy-making were also discussed.

51. The Ministry for the Environment plans to engage with iwi/Māori on a range of environmental issues through a series of hui. This will include discussions on the NZ ETS. My officials and I will be asking iwi/Māori how we can best support them during the upcoming consultations. There will be an Iwi Chairs' Forum conducted in May, which presents another opportunity for iwi input into climate change policy.

International obligations

52. The proposed amendments are consistent with New Zealand's obligations under the Paris Agreement and other international commitments.

Gender implications

53. There are no gender implications for the proposed amendments.

Disability perspective

54. There are no disability implications arising from this paper.

Publicity

55. Announcements about the NZ ETS need to be managed carefully to avoid any inconsistencies and market risks, including sudden NZU price rises in the NZ ETS. In addition, information should not be disseminated in a way that advantages some markets participants over others and compromises NZ ETS investments.
56. I intend to make public announcements on the proposed amendments to the CCRA and the Climate Change Response Amendment Bill as part of a wider climate change communications plan, in consultation with other Ministers.

Proactive Release

57. Once public announcements have been made, I propose to proactively release this paper on the Ministry for the Environment's website in whole, subject to redactions as appropriate and equivalent to those under the Official Information Act 1982.

Recommendations

The Minister for Climate Change recommends that the Committee:

1. **Note** the New Zealand Emissions Trading Scheme (NZ ETS) is the Government's key tool to support New Zealand to meet emissions reduction targets and transition to a low-emission future
2. **Note** Cabinet has agreed to tranche one amendments to the Climate Change Response Act 2002 and these amendments are currently being drafted
3. **Note** the improvements to the NZ ETS will assist New Zealand to achieve its international and domestic emissions targets, and help ensure a just and inclusive transition to a low-emission economy
4. **Note** the Government response to the Productivity Commission's Low-emissions Economy report will outline the Government's strategy, priorities, and sequencing for the transition to a low-emission economy
5. **Note** the improvements to the NZ ETS broadly support the recommendations of the Productivity Commission's Low-emissions Economy Final Report and the Tax Working Group report
6. **Note** the Minister for Climate Change and the Minister of Forestry (in relation to forestry proposals) will present a series of papers to Cabinet over the next two months on the issues comprising tranche two amendments
7. **Note** tranches one and two will form a single Climate Change Response Amendment Bill, to be introduced to the House in mid-2019
8. **Note** tranche two will include:
 - how to phase down industrial allocation
 - strengthening the compliance regime
 - improving market governance of the NZ ETS
 - improving transparency in the NZ ETS
 - addressing a legacy issue related to the Kyoto Protocol
 - transitional measures to move from the fixed price option price ceiling to the cost containment reserve

- enabling a price floor to be implemented in future if desired
 - further improvements to forestry operations in the NZ ETS
 - changes to NZ ETS forestry accounting rules that will help incentivise afforestation and better align with future international accounting rules
9. **Note** many of the amendments to the CCRA will give Cabinet the power to create regulations giving effect to the decisions made in tranches one and two
 10. **Note** the introduction of auctioning, as agreed in tranche one, will generate funds for the Government in future
 11. **Note** decisions on how to use the funds generated from auctioning should be considered alongside a wider discussion by Ministers on climate change spending priorities within the Government's Budget process
 12. **Note** the Minister for Climate Change intends to return to Cabinet in early April seeking approval to consult on the Interim Climate Change Committee's recommendations on agricultural emissions
 13. **Note** the Minister for Climate Change will return to Cabinet by:
 - 13.1. July 2019 to seek approval for consultation on proposals for the NZ ETS regulations, intended to take place alongside select committee consultation on the CCRA amendment bill
 - 13.2. the end of 2019 to approve the regulations, so they can come into effect with the passing of the CCRA amendment bill
 14. **Note** in order to pass the CCRA amendment bill by the end of 2019, the select committee period will be four months
 15. **Note** the Minister for Climate Change will manage public announcements on the proposed amendments to the CCRA and the CCRA amendment bill, in consultation with other Ministers

Authorised for lodgement.

Hon James Shaw
Minister for Climate Change