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Office of the Minister for Climate Change Issues

Chair

Cabinet

Moderated Emissions Trading Scheme - proposed amendments to the Climate Change Response Act 2002

Proposal

1. This paper seeks agreement to modifications to the New Zealand Emissions Trading Scheme (NZ ETS).

Executive summary

2. The Emissions Trading Scheme Review Select Committee has reported back to Parliament. Decisions on amendments to the design of the NZ ETS are now required urgently so that legislation can be passed in the week beginning 8 December 2009 at the latest. The urgency relates to the international climate change negotiations taking place in Copenhagen from 7 to 18 December 2009, and the current entry date for the stationary energy and industrial processes sector of 1 January 2010.

3. In order to meet these timeframes, legislation will need to be introduced by the end of September. A truncated Select Committee process will be required.

4. A number of amendments are proposed for a moderated NZ ETS:

- The stationary energy, industrial processes and liquid fossil fuels sectors will enter[1] the NZ ETS on 1 July 2010. Monitoring and reporting requirements for these sectors will still commence on 1 January 2010.
- A transition phase will operate from July 2010 to December 2012. The transition phase will be implemented through a progressive obligation requiring participants to surrender only one unit for every two tonnes CO_2-e emitted, combined with a $25 fixed price option whereby participants can buy units from the Crown through this period for $25.[2]
- The export of New Zealand Units will not be permitted during the transition phase. However the prohibition on exports will not apply to forestry related units. There will be no restrictions on banking of units during the transition phase.
- Free allocation to emissions-intensive, trade-exposed industry will be provided on an intensity basis. Eligibility thresholds will be set to reduce trans-Tasman competitiveness risks. The number of units allocated to

[1] The terms 'enter' and 'entry' are used to refer to the commencement of unit surrender obligations and do not affect monitoring and reporting requirements.

[2] The $25 fixed price option will apply to liabilities from January 2008 to December 2012 for the pre-1990 and post-1989 forestry sectors. Units purchased can only be used to meet surrender obligations.

emissions-intensive, trade-exposed industry will be reduced by 50% during the transition phase when the progressive obligation is in place.

- The level of assistance will initially phase-out at a rate of 1.3% per annum beginning in 2013. The phase-out of allocation will also be considered through a five-yearly review of free allocation. The first review will be conducted in 2011. Any significant changes to the provision of free allocation will require a five year notice period.
- The progressive obligation will not apply to the forestry sector, but the $25 fixed price option will apply to deforestation liabilities before 1 January 2013.
- The entry of agriculture into the NZ ETS will be delayed until 1 January 2015.
- Free allocation to the agriculture sector will be provided on an intensity basis on a similar basis to industry and will phase out at 1.3% starting from 2015.
- An initial processor-level point of obligation will apply with flexibility to move to a farm-level point of obligation in the future.
- Free allocation to the fishing sector will be increased from the current level of 50% of 2005 emissions for three years, to 90% of 2005 emissions for two and a half years (July 2010 to December 2012).
- A domestic '50 by 50' emissions reduction target for New Zealand will be set.
- An approach to the processing of applications for allocation will be adopted that signals our intention to transfer functions to an Environmental Protection Agency.

5. A number of second order amendments are also proposed. These amendments are technical in nature and would be helpful to assist with the effective functioning of the Act.

6. Some further clarifying amendments, which are also mainly of a technical nature, are also proposed.

7. The proposed amendments are estimated to give rise to fiscal costs of approximately $415 million before 31 December 2012, with further costs from 2013 onwards. Economic costs are estimated to be minor in the short term, but moderate in the medium to long term.

8. Further to Cabinet's decision on 10 August [CAB Min (09) 28/10 refers], Parliamentary Counsel Office have begun drafting amendments to the Climate Change Response Act 2002 based on proposals set out in a paper submitted for consideration by Cabinet at its meeting on 10 August 2009 [CAB (09) 445 refers]. It is proposed that Parliamentary Counsel Office continue to draft amendments to give effect to the recommendations in this paper and further detailed policy that is developed.

9. Agreement to introduce a bill will be sought at Cabinet on 21 September together with any final policy decisions required.

10. Between now and 21 September there will be further engagement with the Climate Change Iwi Leadership Group and the Māori Reference Group. The Ministry for the Environment will also need to begin informal engagement with industry stakeholders in relation to free allocation to emissions-intensive, trade-exposed firms.

Background

11. A paper on Amendments for a Moderated NZ ETS [CAB (09) 445 refers] was submitted for consideration by Cabinet at its meeting on 10 August 2009. The paper proposed (among other things) that:

    a. a fixed price option of $25 would apply until 31 December 2012;
    b. stationary energy, industrial processes and liquid fossil fuels participants would be required to surrender one emission unit for every two tonnes carbon dioxide equivalent emitted from 1 July 2010 to 31 December 2012;
    c. intensity based allocation would apply to both the agriculture sector and the stationary energy and industrial processes sector; and
    d. the level of assistance for emissions-intensive, trade-exposed industry would be subject to a five-yearly review of free allocation, with the first review conducted in 2011.

12. Cabinet deferred consideration of the paper, but agreed that Parliamentary Counsel Office (PCO) should commence drafting a bill to give effect to the proposed amendments (CAB Min (09) 28/10 refers).

13. Cabinet invited the Minister for Climate Change Issues, in consultation with other Ministers as appropriate, to submit a revised paper to Cabinet which includes:

    a. The option of the agriculture sector entering the NZ ETS on 1 January 2015, including advice on the financial implications and options to offset the costs;

    b. Allowing the export of forestry-related New Zealand Units converted to assigned amount units, subject to further advice on the issue of arbitrage, the costs to the Crown, and the implications for compatibility with the Australian Carbon Pollution Reduction Scheme.

14. The National Party Manifesto includes a commitment to amend the NZ ETS, which as currently designed is inconsistent with principles set out in the Manifesto.

15. There are a number of concerns with the NZ ETS as currently designed:

- Firstly, there are concerns that the NZ ETS could have large initial impacts on businesses given the current economic climate.

- Secondly, the NZ ETS does not adequately protect against the loss of key industries that are exposed to a carbon price ahead of international competitors. In particular, the proposed Australian Carbon Pollution Reduction Scheme (CPRS) could provide greater free allocation to emissions-intensive, trade-exposed (EITE) industry than the NZ ETS. This could lead to trans-Tasman competitiveness risks.

- Finally, there are concerns about timeframes for implementing free allocation to industry. The Climate Change Response Act (Act) provides for the Stationary Energy and Industrial Processes (SEIP) sectors to enter the NZ ETS on 1 January 2010. It will not be possible to develop an allocation plan by this date. Therefore, increased costs will accrue to the industry sector from this date without certainty about their likely entitlements.

16. My key objectives in proposing changes to the NZ ETS are:

- To reduce competitiveness impacts and provide greater certainty for economic growth.
- To provide a smoother transition for participants into the scheme and protect against price volatility in early years.
- To ensure the scheme is affordable within current fiscal constraints.
- To maintain flexibility to respond to possible changes in the post-2012 international framework
- To maximise the degree of harmonisation with the CPRS, in particular to reduce trans-Tasman competitiveness risks.
- To fulfil National Party Manifesto commitments.
- To improve the administrative effectiveness of the NZ ETS.

17. The Emissions Trading Scheme Review Select Committee has now reported back to Parliament. Final policy decisions are urgently required so that amending legislation can be introduced by the end of September 2009.

Comment

18. This paper contains the proposals from the 10 August paper, and incorporates the further information requested regarding agriculture entry dates and export of forestry related New Zealand Units (NZUs).

19. This paper also proposes some further clarifying amendments that have been developed since the 10 August paper was submitted.

Entry dates and transition phase

20. The Act provides for the SEIP sectors and liquid fossil fuels (LFF) sectors to enter the NZ ETS on 1 January 2010 and 1 January 2011 respectively. I propose that the SEIP and LFF sectors will enter the NZ ETS on 1 July 2010 for unit surrender purposes (i.e. participants will be required to surrender units for emissions from 1 July 2010). Participants will still be required to monitor and report emissions from 1 January 2010, as currently provided for under the Act. This will enable them to prepare for surrender obligations accruing from 1 July 2010.

21. I also propose that a transition phase operates from July 2010 to December 2012. For those two and a half years the price of carbon in the NZ ETS will be moderated through the combination of two design changes:

- A progressive obligation, with participants required to surrender only one unit for every two tonnes CO_2-e emitted (effectively providing a 50% discount).
- A fixed price option of $25 per tonne CO_2-e.

22. Together, these two changes would ensure that the effective price of carbon facing participants in these sectors would never exceed $12.50 per tonne CO_2-e during the transition phase (until 1 January 2013), and may be lower if the international carbon price fell below $25 over that period.

23. These changes will substantially lessen the impact of the NZ ETS until the end of 2012, providing a far smoother transition for the industrial sector and the economy as a whole. In turn this will help to ensure that households do not face large price increases. The changes will therefore provide a significant improvement for the important first years of the scheme's operation, when participants are becoming familiar with their obligations and the operation of carbon markets. Given this, it is no longer considered necessary to provide an additional package of consumer assistance measures (beyond the usual inflation adjustment of benefits). I therefore propose to remove the household fund from the Act.

24. In keeping with the progressive obligation, it is proposed that the number of units allocated be reduced by 50% during the transition phase. Forestry, the only other sector that will be covered by the scheme before 1 January 2013, would only be covered by the $25 fixed price option; the progressive obligation would not apply to either pre 1990 or post 1989 forests. These issues are discussed in more detail below.

25. It is estimated that the total pre-2013 cost is $415 million, with a risk of increased costs if the international price of carbon rises above $25 per unit.

26. Economic costs arising from the transition phase are expected to be minor. Economic costs could arise where it is profitable for firms to increase emissions during the transition phase relative to emissions expected if the full price of carbon applies, at a cost to the economy. However given investment lead times, in general a reduced price for a short duration is unlikely to have a significant impact on emission levels.

Agriculture

27. Since 10 August I have discussed a number of options for entry dates for the agriculture sector with Ministerial colleagues; in the context of advice from officials on the fiscal implications of these options.

28. Agriculture makes up nearly 50% of New Zealand's emission profile. I therefore consider that it is important for it to be covered by the NZ ETS if we are to deal efficiently with New Zealand's international obligations post 2012.

29. However, given the limited abatement options available to agriculture I also believe that there is a strong case for giving the sector longer to prepare for entry into the NZ ETS than is currently proposed.

30. Based on discussions with Ministerial colleagues, and weighing up the fiscal costs against the benefits for agriculture, I therefore propose that:

- Agriculture's entry into the NZ ETS will be delayed by 2 years to 2015.
- Free allocation will be provided on an intensity basis, on a similar basis as EITE industry.
- The level of assistance will initially phase-out at a rate of 1.3% per annum beginning in 2015.
- Unlike industry, there will be no trade exposure or emissions intensity tests applied to free allocation to agriculture. However, only participants will be eligible.
- Allocation to agriculture should be based on the current year's output, rather than historic output levels[3]. To ensure that agriculture sector participants can receive allocation well in advance of surrendering units, the surrender obligation for all sectors should be extended from the end of April to the end of May.
- Phase-out of allocation will also be considered through a five-yearly review of free allocation. Any significant changes to the provision of free allocation will require a five year notice period. This is consistent with free allocation for EITE industry.
- An initial processor-level point of obligation will apply. The Act will be amended to keep open the option of a farm-level point of obligation, subject to stakeholder views and a number of key administrative challenges being successfully addressed. I also propose that the option of a hybrid point of obligation for the agriculture sector be removed from the Act, because it would be complex and potentially unworkable. However, the Government should have the option to stage the transition to farm level (e.g. sector by sector) if that proved feasible in future.

31. Currently, voluntary reporting by the agriculture sector is due to commence on 1 January 2011, followed by mandatory reporting in 2012. I propose to maintain these reporting dates as they are. Reporting at processor level is unlikely to be administratively costly, and maintaining the reporting date will maintain a valuable signal to participants about the need to begin managing emissions in advance of the delayed scheme obligation.

32. In terms of offsetting the costs of delaying the entry of the agriculture sector, the most obvious option would be to adjust entry dates for other sectors. Another option would be to adjust the ratio of units surrendered relative to emissions during the transition phase. Both these options have disadvantages.

Export and banking of units

33. Introducing a fixed price option into the NZ ETS will come with administrative implications. In particular it will influence policy settings

[3] It is not recommended that this be extended to other sectors. The case for basing allocation on current output is stronger in the agriculture sector than in industry.

regarding the export and banking of units. As a general rule, the greater the latitude towards export and banking the greater the risks of arbitrage, but also the stronger the economic incentives and market development opportunities.

34. I have considered arguments for there being a ban on exports of NZUs[4] in order to prevent arbitrage[5] occurring while the fixed price option is in place. A ban on exports would also be needed if the NZ ETS linked with the Australian CPRS before 2016 (given a price cap is proposed until 2016 under the CPRS).

35. Officials have advised that the fiscal risks associated with allowing the export of units from the forestry sector are relatively low and allowing banking is desirable to assist with managing the long term nature of forestry investments.[6] In order to further reduce the risks of arbitrage (assuming exports are allowed), Ministers could consider prohibiting the banking of units issued to the Stationary Energy and Industrial Processes (SEIP) and fishing sectors prior to 2012.

36. However, the downside of prohibiting banking for the SEIP and fishing sectors is that it will reduce the size of the market for these participants and may lead to opportunities for market manipulation. Sellers of units would be in a weak position with a limited market to sell to and a limited time period during which to sell.

37. In terms of linking with the Australian CPRS, allowing exports prior to linking will pose no barrier to a future linked scheme. However it is likely to be necessary to ban the export of units from the forestry sector in the event that the schemes are linked. Counterbalancing this, foresters would then be able to sell units in an Australasian market.

38. I recommend that the export of units from the forestry sector is allowed. I further recommend that it be clearly communicated that exporting of units may not be permitted if a future link with the CPRS occurs, although units would be able to be sold to Australia. The nature and timing of such a signal will need further consideration, with reference to the likely impact on forestry investments.

39. On balance, I do not recommend establishing any restrictions on banking of units by any sector.

Intensity-based allocation to industry

40. The Act provides for free allocation to 'trade-exposed' industry from a capped pool of units equivalent to 90% of 2005 emissions from eligible industry. Under the Act, free allocation is to be phased out from 2018-2030. As currently designed, free allocation under the NZ ETS could provide less protection for firms most at risk of suffering a substantial loss of

[4] The Act provides for NZUs to be converted to assigned amount units and exported.

[5] Arbitrage refers to the acquisition of emission units in one market and sale in another in order to profit from a price difference between markets.

6 Allowing unit exports may also reduce the risk of investment expropriation claims (obligations under some of our free trade agreements include investor compensation in the cases of expropriation, which carries a fiscal risk).

competitiveness, compared to the proposed intensity-based allocation approach under the CPRS. This could lead to trans-Tasman competitiveness risks.[7]

41. I propose that free allocation of units to emissions intensive trade exposed (EITE) industry in New Zealand be provided on an intensity basis. Under an intensity-based approach to allocation the number of units each firm receives will be updated each year to reflect changes in their output levels. This form of assistance takes into account expansion of production of EITE industries, supports growth in those industries and reduces the likelihood of carbon leakage.

42. The key elements of the proposed intensity-based approach are:

- Activities will only be eligible for free allocation if they meet trade exposure and emissions intensity tests (with thresholds set to reduce trans-Tasman competitiveness risks).
- More emissions-intensive activities will receive a higher level of assistance than less emissions-intensive ones. Initial levels of assistance under the CPRS have been increased to 94.5% and 66% respectively through the Global Recession Buffer mechanism. However, given the transition phase until December 2012 and absence of any initial phase-out of free allocation, initial levels of assistance of 90% and 60% respectively are appropriate under the NZ ETS.
- During the transition phase (see above) the number of units allocated will be reduced by 50%.
- The number of units each firm is eligible to receive will be calculated on the basis of the average emissions-intensity for each industry, not each firm's actual intensity. This will reward firms with lower than average emissions per unit of output, and ensure firms with higher than average emissions per unit of output are not rewarded for being less efficient.
- New entrants, or firms that are expanding, will automatically see their allocation increased, while shrinking firms will see their allocation decreased.
- Ministers will have the flexibility to use emissions and energy use data from Australia when assessing eligibility against thresholds or determining average emissions per unit of output.
- Only emissions for which assistance is given under the current Climate Change Response Act will be included in determining eligibility and the level of assistance. However, free allocation shall be given for the use of liquid fossil fuels where eligibility is conferred on the basis of eligibility in Australia (with the same approach to determining eligible emissions).
- Allocation will be based on the previous year's output with a true up payment once actual production is known
- The level of assistance will initially phase-out at a rate of 1.3% per annum beginning in 2013.

[7] The current approach to allocation could also lead to wider international competitiveness risks.

- Phase-out of allocation will also be considered through a five-yearly review of free allocation, which will consider progress in other countries (particularly Australia). It is intended the first review will be conducted as part of the general review of the NZ ETS scheduled in 2011. Any significant changes to the provision of free allocation will require a five year notice period, with any revision arising from the 2011 review applying from 2017.
- Following the first five-yearly review there shall be a constrained regulation making power to increase the rate of phase out.

43. Adoption of an intensity-based approach to free allocation will provide ongoing protection for the set of New Zealand firms that would otherwise be most at risk of suffering a substantial loss of competitiveness under the NZ ETS. An intensity-based approach to allocation will therefore help to avoid undue disruption to the economy, and maintain the ability of businesses in sectors where New Zealand currently has a clear competitive advantage to continue to grow.

44. The current Act provides for free allocation to 'trade-exposed' firms that meet any tests or thresholds that are specified in an allocation plan. It is likely that some firms who may expect free allocation under the current model will receive reduced allocation or no allocation at all under an intensity-based approach that reflects the CPRS by focusing allocation on the most at risk firms. This should be partially offset by initial protection through the transition phase.

45. I propose that the operational detail of free allocation be based on the CPRS approach as much as is sensible, bearing in mind the differences between New Zealand and Australia. The CPRS approach is based on extensive analysis, and drawing from the CPRS approach will assist in implementing intensity-based allocation within the limited time available. Furthermore, New Zealand's international trade obligations will be taken into account in the elaboration of an intensity-based approach. I also propose that the current Innovation Fund be removed from the Act.

Eligibility thresholds for free allocation

46. A key set of decisions for Cabinet in finalising the details of free allocation for industry will be around eligibility tests they apply to industry to determine whether they receive free allocation. Cabinet needs to decide:

- Whether to include such eligibility thresholds on the face of an amendment bill, or define them in later regulations;
- If they are to be included in the bill, the level at which to set such thresholds;
- Regardless of whether thresholds are specified on the face of the Bill, whether to include an additional mechanism which ensures that activities which are likely to or will receive allocation in Australia receive it also in New Zealand.

47. Determining whether to include eligibility tests on the face of legislation depends on a balance of a range of factors, including:

- The need to provide certainty: for businesses on whether they will receive an allocation; and for government on future fiscal costs. This suggests that thresholds should be specified in legislation.
- Flexibility for government to revise thresholds to take into account new developments - e.g. when the CPRS is finalised. This suggests that thresholds should be specified in regulations.
- Timing issues for legislation and for the process of determining allocations in time for the entry of the SEIP sector in July 2010. Eligibility tests are likely to be of the most controversial elements of the Bill, and will be subject to close scrutiny during the Select Committee process, which may threaten the tight timescale for the Bill. On the other hand, leaving the question of the level of thresholds to regulations will make it very difficult to complete the allocation process in time to ensure that persons will receive their units in a timely manner in 2010.
- Stakeholder management issues. Stakeholders will have a strong interest in the level at which eligibility thresholds are set. There will be limited opportunity for prior consultation if such thresholds are included in the Bill.
- Good legislative practice. Thresholds for eligibility will be a fundamental aspect of the allocation process in legislation. We may face strong criticism if we leave such aspects to regulation.

48. On balance, weighing up the factors above, I propose that both emissions intensity and trade exposure tests are included on the face of the Bill.

49. Trade exposure is a relatively straightforward issue and is likely to be less important than the emissions intensity test. I propose to adopt a trade exposure test in legislation that is closely based on the test recommended by the Stationary Energy and Industrial Processes Technical Advisory Group (SEIP TAG) that met during 2008. This test would identify trade exposed activities as all activities except:

    a. Electricity generation, or

    b. Activities where there is no current international trade of the product across oceans, or

    c. Activities where it is uneconomic to ship the product between New Zealand and another country

50. Regarding the emissions intensity test, there are a range of ways of emissions intensity can be measured[8]. I propose a test based on emissions per unit revenue. Such a test is the default test used under the proposed CPRS, is more simple and transparent to apply than alternatives and targets assistance to those for whom the cost of emissions in particular is significant.

51. Determining the level of such an emissions-intensity threshold is one of the most difficult issues in establishing an emissions trading scheme. There is no clear level at which the cost of emissions becomes significant to a producer and there are limitations on the data available. However, my view

[8] For example, emissions as a proportion of revenue, cost or value-added.

is that adopting the thresholds proposed under the CPRS should prove sufficient to provide protection to those trade-exposed producers in New Zealand who are most impacted by a price on emissions.

52. The provision of a transition phase (the 2:1 progressive obligation and $25 fixed price option) mitigates the risk that the proposed CPRS thresholds are inappropriate. The review of free allocation in 2011 will provide the opportunity to consider the appropriateness of the CPRS thresholds in light of the data gathered during the free allocation process.

53. **[withheld]**.

54. **[withheld]**.

Further details of free allocation to industry

55. In addition to the aspects of the industrial sector allocation listed in this section, I have developed further detail of the approach to free allocation to inform the drafting of an amendment Bill, as per the cabinet decision CAB Min (09) 28/10.

56. These details are contained in Appendix 2.

Fiscal and economic costs of an intensity based approach

57. The costs of adopting intensity-based free allocation for EITE industry depend on the details of allocation design (including eligibility thresholds) and the future emissions pathways of the sectors. Assuming that eligibility thresholds are set at levels which are consistent with the proposed CPRS, it is estimated it will provide fiscal savings of $177 million before 31 December 2012. It is also estimated that there will be savings of $181 - $351 million in 2013 and $49 - $221 million in 2020. Costs of $411 - $586 million are expected in 2030. If looser eligibility thresholds are set (or if other allocation parameters, like phase out rates, are altered), fiscal costs are likely to increase.

58. Fiscal estimates are relative to the current appropriations for free allocation. The current appropriations are based on a conservative assumption about the level of allocation to industry under the existing allocation model, so these figures may overstate the actual saving. Nevertheless, the existing allocation model under the Act is relatively open about the scope of activities that would be eligible for free allocation. Therefore, it is very likely that fewer activities will be eligible for free allocation under the proposed intensity-based approach than under the existing approach and significant savings relative to budget forecasts will accrue.

59. Economic costs are expected to be minor in the short term. Moderate economic costs are expected in the medium to long term, because firms receiving allocation will have less of an incentive to reduce emissions below business-as-usual. The review mechanism will allow for future changes to free allocation.

Forestry

60. I propose that the forestry sector is treated as follows:

- The progressive obligation will not apply to either pre 1990 or post 1989 forestry.
- The NZ$25 fixed price option will apply to any emission liabilities from pre 1990 or post 1989 forests (that accrue before 1 January 2013).[9]
- The Act provisions allowing domestic pre 1990 forestry offsetting after 2012 subject to New Zealand securing offsetting rules internationally will be retained.
- The forestry allocation plan process will be continued, but with the option to cancel the second tranche of 34 million units relating to the 2013-2021 period if offsetting is introduced from 2013.

61. Excluding the forestry sector from the progressive obligation is necessary to avoid fiscal and economic costs arising from deforestation being brought forward to take advantage of the transition phase. The $25 fixed price option will provide a modest benefit to forest owners wishing to deforest in CP1, through greater price certainty.

62. New Zealand is actively seeking changes to the international climate change rules to allow for more flexible land use. Providing for pre 1990 forestry offsetting prior to New Zealand securing a rule change internationally would give rise to significant fiscal and economic costs. **[withheld]**.

63. The Act provides for free allocation to the pre 1990 forestry sector: 21 million units from 2008 – 2012 and 34 million units from 2013 – 2021. A draft allocation plan has been prepared, providing for the allocation of all 55 million units.[10] If offsetting is introduced after 2012, it may be appropriate to alter the second tranche of pre 1990 forestry allocation (34 million units), because offsetting would significantly reduce the impact of the NZ ETS on pre 1990 forestry land values. I am committed to avoiding any disproportionate impacts on iwi arising from any review of the second tranche of pre 1990 forestry allocation. These issues may form part of engagement with the Climate Change Iwi Leadership Group and the Māori Reference Group referred to in the Publicity section below.

64. To reduce litigation risk and to retain flexibility over the second tranche of allocation, it is necessary to amend the draft allocation plan. I further propose to amend the Act to include as much detail as possible on forestry allocation; specifically to make explicit that only 21 million units will be transferred during CP1 and the approach to distributing units.

[9] This will avoid the need for any changes to reporting obligations. It also ensures the pre-1990 and post-1989 forestry sectors receive the benefit of the fixed price option from the commencement of their surrender obligations, consistent with the LFF and SEIP sectors

[10] The 21 million units issued for 2008-2012 will be able to be banked for use in future commitment periods if the forest owners desire.

Other changes

65. In addition to the key changes discussed above, two further changes to the NZ ETS are proposed to ensure consistency with National Party Manifesto commitments.

66. I propose that free allocation to the fishing sector is increased from the current level of 50% of 2005 emissions for three years, to 90% of 2005 emissions for two and a half years (July 2010 to December 2012). This means allocation to the fishing sector will begin at the same time the LFF sector enters the NZ ETS, and end at the close of the transition phase. Given the reduced impact of the NZ ETS during the transition phase, the number of units allocated will be reduced by 50% (consistent with EITE industry).

67. Following discussions with support parties, the recipient of free allocation in the fishing sector shall change from being registered fishing vessel operators, to the owners of fishing quota. To provide certainty the Bill should identify persons in the fishing sector eligible for free allocation as those persons owning quota on the date the Bill is introduced into the house. The method of dividing the free allocation among these quota owners will be an issue to be resolved in the development of a fisheries allocation plan.

68. Giving free allocation to quota owners may require a consequential amendment to the Maori Fisheries Act to extend the functions of Te Ohu Kai Moana (TOKM) to allow them to hold NZUs in trust. Officials are investigating this issue further with a view to informing the drafting process.

69. It is proposed that a domestic ‘50 by 50’ emissions reduction target for New Zealand is introduced. This target will be implemented through a regulation making power. It is proposed to also include further clarification around its status and details for monitoring and reporting on progress toward meeting the target.

Processing of applications for allocation and transfer of functions to an EPA

70. Under the Act, responsibility for the assessment and processing of individual applications for allocation lies with the Minister for Climate Change Issues. The assessment of participants' applications occurs in accordance with criteria that will be specified in regulations. Stakeholders have at various times submitted that this function should be carried out independent of the Minister. It is now proposed to separate this function from the rest of allocation (policy) functions and assign responsibility to the Chief Executive of the Ministry for the Environment, for later transfer to an Environmental Protection Agency. No changes are proposed to the responsibility for applications for allocation in the forestry sector.

71. I also propose that the General Policy Statement for the Amendment Bill signal that other NZ ETS administrative functions are likely to transfer to an Environmental Protection Agency when this is created in 2011.

Second order amendments

72. A list of the proposed second order amendments to the Act is attached as Appendix 1.

73. None of the proposed amendments represent major policy decisions. All of the proposed amendments would be helpful to assist with the effective functioning of the Act, reduce the risk of legal challenge to the exercise of administrative powers, and to avoid unintended liabilities or obligations for participants.

74. However, some of the proposed changes are considered a higher priority than others. For this reason, the attached list of proposed changes has been divided into the following priorities:

- High priority amendments: changes that are strongly recommended to ensure the effective functioning of the Act, reduce the risk of legal challenge, and avoid the risk of significant unintended liabilities or obligations for participants;
- Medium priority amendments: changes that would be highly desirable for the effective functioning of the Act;
- Lower priority amendments: changes that would be useful to the effective functioning of the Act but are not considered a priority at this stage.

75. All of the proposed second order amendments are aimed at improving the effective functioning of the Act. The nature of the amendments can be divided into the following broad categories:

- Clarification of included and excluded activities;
- Introduction of administrative powers and processes useful to the effective functioning of the Act;
- Clarification of administrative powers and processes.

76. The first reason for making amendments is to clarify that certain activities are or are not covered by the NZ ETS. These amendments are necessary to create certainty for participants and for departments administering the NZ ETS. It is proposed to clarify that emissions from solid biofuels combusted for electricity generation or industrial heat are included in the NZ ETS, as are emissions from egg production and live animals that are exported. It is also proposed to clarify that emissions from producing cable using a nitrogen cure process are not included in the NZ ETS.

77. A further reason for making amendments is to make the administration of the Act more straight forward. Although the Act is workable in its current form, there are a number of areas where administration of the Act is cumbersome and/or could prove costly or create unintended liabilities for participants. Some changes are therefore required to make the Act work more effectively.

78. The final reason for making amendments is to clarify certain provisions where the current wording could be considered to be ambiguous. These amendments are primarily recommended to reduce the risk of legal challenge to the exercise of administrative powers. Although in some cases

the risk of challenge is considered to be low, the consequences of a successful challenge would be serious. Clarifying the meaning of these provisions will create greater certainty which will be beneficial for both participants and administrators.

Further clarifying amendments

79. On 10 August Cabinet agreed that Parliamentary Counsel Office should commence drafting a bill to give effect to the proposed modifications to the NZ ETS [CAB Min (09) 28/10 refers]. In the course of issuing instructions over the last month I have clarified the detail behind policy decisions specified in the 10th August Cabinet Paper in a number of areas, in consultation with Ministerial colleagues as appropriate.

80. A full list of areas where policy has been further clarified since 10th August is set out at Appendix 2.

Next steps

81. Following agreement to the proposed modifications set out in this paper, Parliamentary Counsel Office can finalise drafting of amendments to the Act. It is possible that further policy development will be required on the detail of some of the proposed modifications. It is intended that final policy clearance and approval to introduce an amendment bill will be sought from Cabinet on 21 September.

82. Given entry dates for the stationary energy and industrial processes sectors and international climate change negotiations in Copenhagen (7-18 December), it is desirable to pass an amendment bill in the week beginning 8 December at the latest. Therefore, it is likely that a truncated select committee process will be required.

Risks

83. There is a risk of opposition to the proposed intensity-based approach to free allocation to EITE industry, from some industry stakeholders. This risk arises from the likelihood that some firms who may expect free allocation under the current model will receive reduced allocation or no allocation at all under an approach that reflects the proposed CPRS by focusing allocation on the most at risk firms. The risk is mitigated to some extent by the transition phase reducing the initial impact of the NZ ETS, but some opposition is likely to remain despite this. This will need careful handling.

84. It is intended that an amendment bill will be passed in December and the SEIP sectors will enter the NZ ETS on 1 July 2010. Therefore, there is a limited timeframe during which a large volume of detailed policy on intensity-based allocation is to be determined. This gives rise to a risk that on 1 July 2010 there will be a degree of uncertainty over the number of units individual firms will be allocated. However, I hope to give most industries a strong degree of certainty by then.

Consultation

85. This paper was prepared by the Ministry for the Environment. The Ministry of Economic Development, Ministry of Transport, Ministry of Agriculture and Forestry, Ministry of Fisheries, Ministry of Foreign Affairs and Trade, Inland Revenue Department, Te Puni Kōkiri and the Treasury were consulted on the major amendments in this paper.

86. While supportive of the general direction of the proposals, MED officials are concerned about the effect of the progressive obligation and staged entry of obligations on business compliance costs; economic risks associated with both high thresholds for eligibility for assistance and the long duration of that assistance; and implementation risks associated with the development of administrative systems.

87. While supportive of the general direction of the proposals MED is concerned about the affect of the proposal on business compliance costs, impacts on at risk firms, and implementation risks associated with the development of administrative systems.

88. MED proposes a delay to the monitoring, reporting and surrender obligations of the SEIP and LFF to 1 January 2011 and the removal of the transitional phase. MED believes that aligning all entry dates and a low price cap is easy to communicate and will allow business to adapt their systems to the new rules so ensuring compliance costs are minimised. Delaying the entry of the SEIP and LFF would also mitigate significant concerns held by MED regarding the time required to develop administrative systems necessary to implement the transitional low price phase.

89. MED proposes that economic risks be managed through targeting assistance rather than the application of a low price across the economy.

90. MED supports the review of eligibility thresholds in 2011, prior to the low price phase ending and propose this review mechanism be supported by a further provision in legislation for the thresholds to be altered at that time through Order in Council.

91. MED does not support the proposed phase out of industry assistance of 1.3% per annum as this both unnecessarily dulls the incentive for emission mitigation and is inconsistent with the Government's fiscal objectives.

92. The Department of Prime Minister and Cabinet was also informed.

Financial implications

93. The proposals in this paper give rise to significant fiscal impacts, which are detailed below. Fiscal impacts are shown as costs and savings relative to current legislation. They do not represent costs and savings of the overall NZ ETS or climate change policy as a whole. It is possible that as a result of any future international climate change agreement New Zealand will have a net surplus of emission units. In this instance costs shown below would represent a reduction of this surplus, instead of an overall net cost of climate change policy.

94. The table below does not present the fiscal risk associated with the proposed $25 fixed price option until 31 December 2012. Based on current international carbon prices, the current estimated cost of the $25 fixed price option is $0, but a significant cost could arise if the international price rises above $25. For this reason, it is recommended a new appropriation be established now and joint Ministers be authorised to approve the expenses to be incurred under the $25 fixed price option, when these expenses can be estimated.

95. The proposed mechanism allows participants to access the $25 fixed price option for the entirety of their surrender obligation, regardless of whether they hold emission units which could be surrendered. Therefore, the fiscal cost could be as great as the difference between the $25 fixed price option and higher international emission unit price, multiplied by the total surrender obligations of all participants. On the other hand, there may be fiscal savings if participants use the $25 fixed price option and the Crown is able to access emission units on the international market for less than $25 (as is currently the case).

96. For intensity-based allocation, though there are savings in the short term, the proposed policy settings potentially lead to large and growing fiscal costs in the long term, as shown in the table below. Fiscal impacts of intensity-based allocation to industry are very difficult to accurately estimate given the available data and uncertainty over eligibility requirements. The extent of the costs of intensity-based allocation will depend on the policy settings chosen, particularly on phase out rates for assistance. The fiscal costs will impact on the government's operating balance.

97. Treasury has modelled these costs and, while the model has limitations, they estimate that, if a 1.3% phase out rate is maintained into the long term, the proposed policy settings for intensity based allocation indicate a cumulative increase in Government debt of around 6-8% of GDP by 2050.

Fiscal cost of proposed amendments

($m, costs shown as positive and savings as negative)

	Pre-2013	2013	2015	2017	**2013-2017**	2020	2030
SEIP entry dates and p.o.	**588**	0	0	0	**0**	0	0
Ind allocation	**-177**	-181 to -351	-179 to -350	-177 to -348	**-896 to -1748**	-49 to -221	411 to 586
Ag entry date	**0**	281	0	0	**573**	0	0
Ag allocation	**0**	0	106	74	**270**	305	1,581
Fishing allocation	**4**	-14	0	0	**-14**	0	0
Total	**415**	86 to -84	-73 to -244	-103 to -274	**-67 to -919**	84 to 256	1992 to 2167

Note: Costs are based on a unit price of $25 until 31 December 2012 and $50 from 1 January 2013.

98. Note that currently, only pre-2013 fiscal impacts count against the budget allowance. When international obligations are agreed to for the period post-2012, the net fiscal impact of the NZ ETS will be considered as part of the budget, in conjunction with decisions on the treatment of NZ ETS net revenues or expenses.

99. Economic costs are estimated to be minor in the short term, but more significant economic costs are expected in the medium to long term. This is because firms receiving allocation will have less of an incentive to reduce emissions below business-as-usual, and consequently a greater volume of emission units will need to be purchased from offshore to meet international commitments. However, economic cost estimates are uncertain, because it is difficult to predict how firms will respond to intensity-based free allocation and the future international price of carbon is uncertain.

Human rights

100. There are no inconsistencies between the proposals in this paper and the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993.

Legislative implications

101. A bill will be required to implement a range of modifications to the NZ ETS. There is currently no provision for a Climate Change Response Amendment Bill on the 2009 Legislation Programme. It is intended that provision for a bill with a category 2 priority (must be passed in 2009) will be sought.

102. The Climate Change Response Act 2002 binds the Crown. The bill for the proposed amendments to the Act should also, if necessary, bind the Crown. Regulations will be required to specify details of intensity-based allocation for the industry and agriculture sectors.

Regulatory impact analysis

103. In respect of the proposed major amendments for a moderated NZ ETS, the Ministry for the Environment does not confirm that the principles of the code of Good Regulatory Practice and the regulatory impact analysis requirements, including the consultation RIA requirements, have been complied with. The final RIS was circulated with the Cabinet paper for departmental consultation.

104. A Regulatory Impact Statement (RIS) was prepared for these proposals, and independently reviewed by Treasury's Regulatory Impact Analysis Team (RIAT). RIAT has formed the view that the level and quality of analysis presented is not commensurate with the significance of the proposals, which represent major design changes to the Emissions Trading Scheme, and that the RIS does not provide an adequate basis for informed decision-making. Some key risks identified by RIAT include (but are not limited to) the following:

    - There is no clear analytical basis for the proposal to align some key design elements of the New Zealand ETS with those in the currently proposed Australian Carbon Pollution Reduction Scheme (CPRS). For

example, there is no discussion of the overall suitability or benefits of applying these elements to New Zealand's unique emissions profile and industrial structures;

- There is no discussion of the risks of harmonising with an overseas scheme that has not yet been finalised or agreed and may yet be subject to significant revision. Such risks may include the potential impacts on business certainty and investment decisions, and the overall credibility, sustainability and effectiveness of the NZ ETS; and

- There is no information on the implied transition path for firms over the medium-long term, particularly given that the proposal is for a temporary period of greater assistance coupled with an ambitious long-term emissions reduction target. Without this, it is hard to assess whether it is likely that the design changes will allow for a smoother transition for business.

105. In respect of the proposed second order amendments, the Ministry for the Environment confirms that the principles of the code of Good Regulatory Practice and the regulatory impact analysis requirements, including the consultation RIA requirements, have been complied with. A RIS was prepared and, given the purpose and scale of the proposals, the Ministry for the Environment considers it to be adequate. The draft RIS was circulated with the Cabinet paper for departmental consultation.

Publicity

106. It will be necessary to manage public announcements on policy decisions for amendments to the NZ ETS through a coordinated strategy. Authorisation is sought for the Minister for Climate Change Issues to manage public announcements/engagement on the proposed package of amendments prior to the finalisation of Cabinet's deliberations on amendments to the NZ ETS.

107. Between now and 21 September there will be further engagement with the Climate Change Iwi Leadership Group and the Māori Reference Group. Cabinet may be invited to consider any significant feedback received at its meeting on 21 September. The amendment bill could be introduced, with Cabinet having been asked to note areas where further work is required. These areas could be identified in the first reading speech as appropriate areas for consideration at the Committee stage.

108. The Ministry for the Environment will need to begin informal engagement with industry stakeholders in relation to free allocation to emissions-intensive, trade-exposed firms. The Minister for Climate Change Issues may also wish to undertake engagement with industry stakeholders regarding the proposed changes to the NZ ETS.

Recommendations

109. The Minister for Climate Change Issues recommends that Cabinet:

1. note that the Emissions Trading Scheme Review Select Committee has now reported back to Parliament

Entry dates and transition phase, including the treatment of agriculture

2. agree that the stationary energy, industrial processes and liquid fossil fuels sectors shall commence to accrue surrender obligations in the New Zealand Emissions Trading Scheme (NZ ETS) from 1 July 2010
3. note that the Climate Change Response Act requires participants in the stationary energy, industrial processes and liquid fossil fuels sectors to monitor and report on emissions from 1 January 2010
4. agree that stationary energy, industrial processes and liquid fossil fuels participants shall be required to surrender one emission unit for every two tonnes carbon dioxide equivalent emitted from 1 July 2010 to 31 December 2012
5. agree to adopt a fixed price option of NZ$25 per unit from 1 July 2010 to 31 December 2012 (which, in the case of forestry will apply to deforestation liabilities from January 2008 to December 2012)
6. agree that, with the exception of units from the forestry sector, the export of New Zealand Units converted to Assigned Amount Units should not be permitted while the fixed price option is in place
7. agree that there will be no prohibition on banking, for any sector, while the fixed price option is in place
8. agree that agriculture's entry into the NZ ETS be delayed by 2 years to 2015
9. agree to adopt an intensity-based approach to free allocation to the agriculture sector with the following design features:
    9.1. only participants will be eligible, but no trade exposure or emissions intensity tests will apply
    9.2. the level of assistance will phase-out at a rate of 1.3 per cent per annum beginning in 2015 subject to a five-yearly review of free allocation (any significant changes to the provision of free allocation will require a five year notice period)
    9.3. allocation will be based on the current year's output
10. agree that the surrender obligation for all sectors should be extended from the end of April to the end of May
11. note that the Climate Change Response Act 2002 (Act) provides for a processor-level point of obligation for the agriculture sector
12. agree to keep open the option of a farm-level point of obligation for the agriculture sector in the future and remove the potential for a hybrid point of obligation; but to retain the option to stage the transition to farm level

Intensity-based allocation to industry

13. agree to adopt an intensity-based approach to free allocation to emissions-intensive, trade-exposed industry with the following design features:

13.1. eligible activities will be required to meet trade exposure and emissions intensity tests

13.2. more emissions-intensive activities will receive a higher level of assistance than less emissions-intensive activities (with initial rates set at 90% and 60% respectively)

13.3. subject to approval of recommendation 4, from 1 July 2010 to 31 December 2012 the level of assistance will be reduced by 50%

13.4. the number of units individual firms are entitled to receive will be calculated on the basis of industry average emissions-intensity for each activity

13.5. Ministers will have the flexibility to use emissions and energy use data from Australia when assessing eligibility against thresholds or determining average emissions per unit of output

13.6. only emissions for which assistance is given under the current Climate Change Response Act will be included in determining eligibility and the level of assistance; free allocation shall be given for the use of liquid fossil fuels where eligibility is conferred on the basis of eligibility in Australia (with the same approach to determining eligible emissions)

13.7. allocation will be based on the previous year's output with a true up payment once actual production is known

13.8. the level of assistance will phase-out at a rate of 1.3 per cent per annum beginning in 2013 subject to a five-yearly review of free allocation, with the first review conducted in 2011 (any significant changes to the provision of free allocation will require a five year notice period), and any changes from the 2011 review will apply from 2017

13.9. following the first five-yearly review there shall be constrained regulation making powers to increase the rate of phase out.

14. agree that eligibility thresholds for emissions intensity and trade exposure should be included on the face of the Bill;

15. agree that the trade exposure test included in the Bill shall identify trade exposed activities as all activities except:

    a. Electricity generation, or

    b. Activities where there is no current international trade of the product across oceans; or

    c. Activities where it is uneconomic to ship the product between New Zealand and another country

16. agree that the Bill shall specify a revenue based emissions intensity test with thresholds set at the same level as those in the Carbon Pollution Reduction Scheme, expressed in New Zealand currency

17. agree the 2011 review of the NZ ETS should examine whether the emissions intensity thresholds should be altered, based on activity-level data collected during the allocation process.

18. agree that, regardless of whether eligibility thresholds are specified, the Bill should specify that the Minister for Climate Change Issues has the flexibility to make activities which are eligible for free allocation in Australia eligible in New Zealand, at the same rate of assistance, whether or not they meet emissions intensity tests in New Zealand

19. agree to remove the requirement for an Innovation Fund provided for in the Act

Forestry

20. agree that emission liabilities from the pre 1990 forestry and post 1989 forestry sectors will be covered by a fixed price option of NZ$25 per unit from 1 January 2008 to 31 December 2012

21. note that the Act provides for offsetting after 2012 for the pre 1990 forestry sector, subject to international offsetting rules permitting New Zealand to offset deforestation of pre 1990 forest land by the planting of new forest land

22. agree to allow the export of units from the forestry sector while a fixed price option is in place

23. agree that it be clearly communicated to the forestry sector that exporting of units may not be permitted if a future link with the Australian Carbon Pollution Reduction Scheme occurs, although units would be able to be sold to Australia

24. agree to include as much detail on forestry allocation as practical in primary legislation; specifically to state that only 21 million units will be transferred during CP1, and to set out the approach to distributing units

25. agree to run an 'exposure draft allocation process' concurrently with the Amendment bill select committee process

26. note that the exposure draft allocation process is likely to prompt a negative response from stakeholders, including Māori

Other changes

27. agree to increase the total pool of free allocation to the fishing sector from being equivalent to 50% of 2005 emissions for three years, to being equivalent to 90% of 2005 emissions for number of years that the fixed price period applies to liquid fossil fuels (2.5 years – July 2010 to December 2012)

28. agree that the number of units allocated to the fishing sector will be reduced by 50% reflecting the transition phase

29. agree that legislation shall specify 700,000 NZU for free allocation to the fishing sector as specified in Appendix 2 of this paper, as opposed to including a formula in legislation

30. agree that the recipients of free allocation shall be the owners of fishing quota rather than registered fishing vessel operators.

31. agree to introduce a New Zealand target of a 50% reduction of net greenhouse gases from 1990 levels by 2050 through regulation

32. agree that, if necessary, the bill amending the Climate Change Response Act 2002 should include a provision stating that the Act will bind the Crown

Processing of applications for allocation

33. agree that the processing of participants' applications for allocation (excluding forestry) be assigned to the Chief Executive of the Ministry for the Environment rather than the Minister of Climate Change Issues

Fiscal impacts

Entry dates and transition phase for the stationary energy, industrial processes and liquid fossil fuels sectors

34. note the following forecast change in non-tax revenue resulting from the proposed changes to the entry date and progressive obligation for the stationary energy, industrial processes and liquid fossil fuels sectors:

	$m – increase/ (decrease)				
	2009/10	**2010/11**	**2011/12**	**2012/13**	**2013/14 and outyears**
Vote Climate Change					
Non-Tax Revenue:					
Emissions Trading	(88)	(88)	(275)	(138)	0
Total	(88)	(88)	(275)	(138)	0

35. note that these reductions in revenue will reduce the between Budget contingency

36. agree to establish in Vote Energy a new non-departmental other expense appropriation “Fixed Price Option” to be the responsibility of the Minister for Climate Change Issues

37. agree that the scope of this appropriation will be “This appropriation is limited to the expenses incurred in relation to the fixed price option provided for in the Climate Change Response Act 2002 if and when the international price exceeds $25 per tonne carbon dioxide equivalent”

38. note that it is not known if and when the international price will exceed $25 per tonne carbon dioxide equivalent and therefore in which financial year this appropriation will first be required

39. authorise the Minister of Finance and the Minister for Climate Change Issues after the fixed price option comes into force jointly to activate this appropriation if and when it is required and to agree the amounts of this appropriation

40. agree that any amounts of this appropriation agreed jointly by the Minister of Finance and the Minister for Climate Change Issues be included in the Supplementary Estimates for the relevant financial year and, in the interim, the expenses be met from Imprest Supply

41. approve the following changes to appropriations to implement the proposed fixed price option:

	$m – increase/ (decrease)				
	2009/10	**2010/11**	**2011/12**	**2012/13**	**2013/14 and outyears**
Vote Energy Non-Departmental Other Expense: Fixed Price Option	0	0	0	0	0
Total	0	0	0	0	0

42. agree the changes to appropriations for 2009/10 above be included in the 2009/10 Supplementary Estimates and that, in the interim, the changes be met from Imprest Supply

43. note that these costs will reduce the between Budget contingency

Intensity-based allocation to industry

44. approve the following changes to appropriations to implement intensity-based allocation to industry:

	$m – increase/ (decrease)			
	2009/10	**2010/11**	**2011/12**	**2012/13**
Vote Climate Change Non-Departmental Other Expense: Allocation of New Zealand Units	0	(72)	(70)	(35)
Total	0	(72)	(70)	(35)

45. note that these savings will increase the between Budget contingency

46. note that the additional fiscal impacts of intensity-based allocation to industry, relative to current legislation (adjusted for the proposed entry date and progressive obligation for the stationary energy, industrial processes and liquid fossil fuels sectors) are as follows:

Fiscal cost ($m, costs shown as positive and savings as negative)

2013	2015	2017	2013-2017	2020	2030
-181 to -351	-179 to -350	-177 to -348	**-896 to -1748**	-49 to -221	411 to 586

47. note that the costs of the New Zealand Emissions Trading Scheme post-2012 have yet to be budgeted for, so the additional fiscal costs post-2012 currently do not count against the budget allowance

48. note that when international obligations are agreed to for the period post-2012, the net fiscal impact of the New Zealand Emissions Trading Scheme will be considered as part of the budget, in conjunction with decisions on the treatment of New Zealand Emissions Trading Scheme net revenues or expenses

Agriculture

49. note that the fiscal costs of the proposed 2015 entry date for agriculture, relative to current legislation are:

Fiscal cost ($m, costs shown as positive and savings as negative)

2013	2014	2015-2017	2013-2017	2020	2030
281	292	0	**573**	0	0

50. note that the fiscal costs of intensity-based allocation to agriculture, relative to current legislation (adjusted for the proposed entry date) are:

Fiscal cost ($m, costs shown as positive and savings as negative)

2013	2015	2017	2013-2017	2020	2030
0	106	74	**270**	305	1,581

51. note that the costs of the New Zealand Emissions Trading Scheme post-2012 have yet to be budgeted for, so the additional fiscal costs post-2012 currently do not count against the budget allowance

52. note that when international obligations are agreed to for the period post-2012, the net fiscal impact of the New Zealand Emissions Trading Scheme will be considered as part of the budget, in conjunction with decisions on the treatment of New Zealand Emissions Trading Scheme net revenues or expenses

Other changes

53. approve the following changes to appropriations to implement proposed changes to allocation to the fishing sector:

	$m – increase/ (decrease)			
	2009/10	**2010/11**	**2011/12**	**2012/13**
Vote Climate Change Non-Departmental Other Expense: Allocation of New Zealand Units	0	4	0	0
Total	0	4	0	0

54. note that these costs will reduce the between Budget contingency

55. note that changes to free allocation to the fishing sector also generate a $14 million saving in 2013

56. note that the costs of the New Zealand Emissions Trading Scheme post-2012 have yet to be budgeted for, so the fiscal savings post-2012 currently do not count against the budget allowance

57. note that when international obligations are agreed to for the period post-2012, the net fiscal impact of the New Zealand Emissions Trading Scheme will be considered as part of the budget, in conjunction with decisions on the treatment of New Zealand Emissions Trading Scheme net revenues or expenses

Second order amendments

58. note that a number of further amendments to the Act of a more administrative nature have been identified that would improve the effective functioning of the Act

59. agree to make the following amendments as described in Appendix 1 to this paper:

<u>High priority amendments</u>

59.1. Clarifying that the Chief Executive has power to specify and approve locations in the forest area where information will be collected

59.2. Creating the ability to apply for a tree weed exemption for deforestation between 1 January 2008 and the date exemptions are granted

59.3. Enabling the delegation of the Registrar's Powers

59.4. Creating the ability to waive fees and charges

59.5. Creating the ability to charge fees for emissions rulings

59.6. Requiring record keeping by primary participant following opt-in

59.7. Clarifying the inclusion of emissions from solid biofuels combusted for electricity generation or industrial heat

59.8. Removing "Producing cable using a nitrogen cure process" as a mandatory activity

59.9. Clarifying ability to make changes to composition of joint participant registrations

59.10. Defining farming in relation to land ownership

59.11. Including egg producers and live animal exporters in the scheme

59.12. Clarifying ability to specify the "Land Transfer Date" in the Forestry Allocation Plan

59.13. Clarifying cost benefit analysis requirements in exemption provision

<u>Medium priority amendments</u>

59.14. Clarifying of the treatment of mining natural gas within the exclusive economic zone (EEZ)

59.15. Clarifying that section 64 directions will not be published

59.16. Clarifying the Chief Executive's forestry-related reporting obligations

59.17. Clarifying the ability to delay registration of forestry participant until fees and charges paid

59.18. Confirming pro rata approach for New Zealand units earned when land within a Carbon Accounting Area is transferred

59.19. Providing for removal from the Register of Participants after obligations have been met

59.20. Clarifying that only a nominated entity can submit a return for a consolidated group

59.21. Restricting timing for electing to have activities removed from consolidated group

59.22. Clarifying when forest land is treated as being deforested before 1 January 2008

59.23. Amendment to the definition of forest land

<u>Lower priority amendments</u>

59.24. Requiring the Registrar to give effect to directions

59.25. Inserting and applying a definition of "Crown holding account"

59.26. Clarifying relevance of subsequent commitment periods to New Zealand unit issuance

59.27. Streamline the process for updating the schedules to the Climate Change Response Act to reflect amendments to the Kyoto Protocol and the United Nations Framework Convention on Climate Change that are in force for New Zealand

59.28. Providing for authorised representatives in respect of joint activities

59.29. Clarifying obligation to retain records

59.30. Clarifying that one emissions return only to be filed per year

59.31. Clarifying treatment of returns in respect of less than a hectare

59.32. Amending timing of surrender relative to date of emissions return

59.33. Clarifying timing for notification of ceasing to carry out activity

Further clarifying amendments

60. note that a number of further second order amendments have been identified

61. agree to make amendments in relation to the following matters, as described in Appendix 2 of this paper:

61.1. Fishing sector allocation

61.2. Point of obligation for agriculture

61.3. Intensity based allocation for agriculture

61.4. Nitrogen fertilisers

61.5. Fixed price option mechanism

61.6. Consequential changes to other removal activities

61.7. NZ ETS review

61.8. Setting a fixed price option post 2012

61.9. 50 by 50 target

61.10. Household fund

61.11. Joint venture participants in the natural gas sector and coal sector

61.12. July to December 2010 surrender obligation

61.13. Further details of free allocation to industry

61.14. Forestry allocation

61.15. Pre-1990 tree weed exemption

61.16. Further amendments to Carbon Accounting Areas

Next steps

62. authorise the Minister for Climate Change Issues and the Emissions Trading Scheme Ministerial Group to undertake further engagement with the Climate Change Iwi Leadership Group and the Māori Reference Group Executive on the proposals in this paper

63. note that Cabinet may be invited to consider any significant feedback from the Climate Change Iwi Leadership Group and the Māori Reference Group Executive received at its meeting on 21 September.

64. direct the Ministry for the Environment to begin engagement with industry stakeholders in relation to free allocation for emissions-intensive, trade-exposed industry

65. invite the Minister for Climate Change issues to undertake engagement with industry stakeholders regarding the proposed changes to the NZ ETS

66. agree that the Minister for Climate Change Issues, working with the Ministerial colleagues, shall further develop detailed policy to be implemented through an amendment bill

67. note that Cabinet agreed on 10 August 2009 that Parliamentary Counsel Office should commence drafting a bill to give effect to the proposed modifications to the NZ ETS before Cabinet has taken final decisions [Cab Min (09) 28/10 refers]

68. agree that the Minister for Climate Change Issues should continue to issue drafting instructions to Parliamentary Counsel Office to give effect to the recommendations in this paper and further detailed policy that is developed

69. invite the Minister for Climate Change Issues to seek provision on the 2009 Legislation Programme for a bill to amend the Climate Change Response Act 2002 with a category 2 priority (must be passed in 2009)

70. agree that the Minister for Climate Change Issues should return to Cabinet on 21 September for final policy approval and agreement to introduce a bill

71. note that given entry dates for the Stationary Energy and Industrial processes sectors and international climate change negotiations in Copenhagen in December, it is desirable to pass an amendment bill in the week beginning 8 December at the latest

72. authorise the Minister for Climate Change Issues to manage public announcements on the proposed package of amendments prior to the finalisation of Cabinet's deliberations on amendments to the NZ ETS

_____

Hon Dr Nick Smith
Minister for the Environment
Minister for Climate Change Issues
_____ /_____ /_____

Appendix 1

PROPOSED "SECOND ORDER" AMENDMENTS TO THE CLIMATE CHANGE RESPONSE ACT 2002

A. High priority: Changes that are strongly recommended to ensure efficient functioning of Act, reduce risk of legal challenge, and to avoid significant unintended liabilities/obligations for participants

1. Clarifying that the Chief Executive has power to specify and approve locations in the forest area where information will be collected

MAF is developing methodology to measure emissions and removals for forest land, rather than relying on generalised lookup tables. This methodology will be reflected in the forestry sector regulations. One of the features of this measurement approach is the requirement that an applicant's forest land-holding be divided, and information collected at locations within each divided area, in a manner to be further prescribed in regulations and/or standards. Information collected at the specified locations will be used to calculate forest emissions and removals.

The Act does not currently provide the chief executive with a clear authority to specify either how an applicant's land-holding should be divided, or the locations in the forest where prescribed information should be collected. The division of forest land area and the location of the information collected will have a significant impact on the carbon measurement accuracy. This power is therefore crucial to ensuring that the areas and locations within which the information is collected are not the subject of debate or challenge by participants, nor to arbitrary relocation, say to a less representative forest area. This issue can be addressed by making a small amendment to the regulation making power, to make it clear that the chief executive can specify the areas and locations from which data must be collected.

2. Creating the ability to apply for a tree weed exemption for deforestation between 1 January 2008 and the date exemptions are granted

The NZ ETS contains provisions to allow deforestation of "tree weeds" (e.g. wilding pines) to apply for and receive an exemption from the deforestation provisions of the Act (becoming a mandatory participant, filing an emissions return and surrendering emissions units). These exemption provisions were inserted so that efforts to eradicate tree weeds would not be discouraged by the NZ ETS.

As currently drafted, the Act restricts the availability of exemptions to land that was forested at the time the exemption is granted. Exemptions therefore cannot be granted to landowners who have already deforested since 1 January 2008 (this amounts to an estimated 800ha to date). This situation means that land owners may be penalised for carrying out weed eradication activities because, due to timing issues, the tree weed exemption is not available to them. This is particularly concerning because landowners are often required to deforest weed trees by regional councils as part of the regional pest management strategy to manage the spread of the trees. Further, it affects the ability of government departments like DOC and LINZ to pursue their mandates of removing tree weeds under other legislation and government policy.

The existing situation is unfair to those landowners who have continued their efforts to eradicate tree weeds and now face a liability. It also risks worsening the spread of tree weeds where control programmes have ceased.

Accordingly, it is proposed that the Act be amended to allow tree weed forest land that has been deforested since 1 January 2008 to be eligible for an exemption (once an

exemption process is available). This does not result in an increased level of deforestation or increased fiscal costs over and above what was estimated to be incurred by the tree weed exemption overall – as the area of pre-1990 tree weed forest is finite.

3. Enabling the delegation of the Registrar's Powers

Under the Act as currently drafted, the Registrar of the Emission Unit Register cannot delegate his or her powers.

Officials consider that a delegation of the Registrar's powers is critical for the workability of implementing the NZ ETS. The complexity and volume of work required of the Registrar means that these tasks will need to be completed by staff reporting to the Registrar.

It is therefore recommended that the Act be amended to include the ability for the Registrar to delegate his or her powers. If no ability to delegate powers is included in the Bill, either the Registrar's responsibilities will go unfulfilled or there will be a question about the validity of the Registrar's actions (e.g. transfers of emission units).

4. Creating the ability to waive fees and charges

It is proposed to introduce regulation making powers that provide a power to exempt, waive and refund fees and charges to correct administrative errors (e.g. inadvertent double payments by an ETS participant). Similar powers exist under many enactments including the Biosecurity Regulations. **[withheld]**. This has already raised issues of equity and fairness in one case. While this is a minor technical amendment it is important to avoid any risk of bringing the ETS into disrepute through perceptions of inequity or unfairness in the administration of the ETS.

5. Creating the ability to charge fees for emissions rulings

The Act currently provides for fees to be charged in respect of persons who opt-in to the NZ ETS. However, the Act does not currently provide for fees to be charged in respect of persons who are mandatory participants in the NZ ETS. This presents a problem because mandatory participants are able to make binding ruling applications. These applications are likely to be complex and will require significant time to process. It is also likely that external legal advice (from Crown law) and expert technical advice may be required in respect of some or all applications. Accordingly, it is strongly recommended that the Act be amended to allow for cost recovery in respect of applications for binding rulings by mandatory participants.

6. Requiring record keeping by primary participant following opt-in

Section 212 of the Act provides that a mandatory participant who mines coal or natural gas (a primary participant) is not required to comply with the requirements of section 62 or file an emissions return in respect of coal or gas that is purchased by an opt-in participant. Section 62 requires a participant to maintain records relevant to emissions and removals associated with the relevant activity (in this case mining coal or natural gas), and calculate the emissions and removals from the relevant activity. An emissions return reports on those emission and contains an assessment of liability to surrender units.

A primary participant should not be required to surrender units in respect of coal or gas that is purchased by an opt-in participant. However, officials consider it important that the primary participant be required to report on and keep relevant records regarding all coal or gas produced. In the absence of such an obligation, it will be very difficult to reconcile data provided by primary and opt-in participants. There is a real risk that gaps will emerge than cannot be verified and compliance cannot be enforced.

Under the Act as currently drafted, it is not entirely clear whether a primary participant can be required to keep records regarding the coal or gas that is produced and on-sold to op-in participants. Accordingly it is proposed that the Act be amended to clarify that record keeping and reporting obligations do apply in respect of all gas and coal mined, including that purchased by opt-in participants.

A similar issue arises under section 201 in respect of the liquid fossil fuels sector. Accordingly, it is proposed that a similar amendment be made to section 201.

7. Clarifying the inclusion of emissions from biofuels combusted for electricity generation or industrial heat

The Act is currently ambiguous regarding coverage of emissions from combustion of biofuels. It is unclear whether or not these emissions are covered by Schedule 3, Part 3, which includes emissions from the combustion of "…waste for the purpose of generating electricity or industrial heat".

It is proposed that the Act be amended to clarify that emissions from solid biofuels combusted for electricity generation or industrial heat are covered by the Act. This amendment will also require the SEIP regulations to be amended to ensure that the solid biofuels sector will have sufficient details on how to report at the SEIP entry date.

8. Removing "Producing cable using a nitrogen cure process" as a mandatory activity

Independent expert advice has been obtained on the industrial process of "producing cable using a nitrogen cure process". This advice states that nitrogen used in the production of cable does not, of itself, generate greenhouse gas emissions.

New Zealand does not report any emissions from this source in the national GHG inventory. Officials made inquiries internationally last year and did not find any other developed parties (to the Kyoto Protocol) explicitly reporting emissions from this source in their inventories.

Consequently the activity of producing cable using a nitrogen cure process should be removed from the scope of the Act.

9. Clarifying ability to make changes to composition of joint participant registrations

Under the Act, a participant can be made up of more than one person (natural or corporate). All of these persons are jointly and severally liable for the obligations of the "participant". The Act does not contain provisions specifying how the Chief Executive is to manage changes to the composition of a multi-person participant. A risk exists that the adding of people to, or removing of people from, a participant by the Chief Executive is unlawful and not valid. The risk of invalidity:

i. to people leaving the participant is that they remain liable for the other people who continue to be the participant;

ii. to people remaining the participant is that the leaving person continues to have rights to participant benefits;

iii. to the Government is that if a person suffers loss due to an unlawful process, then that person may seek to recover that costs from the Government.

Therefore it is recommended that the Act be amended to specify the process for changing the people who make up a multi-person participant.

10. Defining farming in relation to land ownership

If the participant in the agriculture sector is at farm level rather than processor level, the subpart 4 of Part 5 of Schedule 3 currently defines the activity as farming, raising or growing animals for reward or trade. This definition identifies farmers operating under a range of farm ownership structures and contractual arrangements. For example it identifies both farmer landowners and farmers who do not own land, but do raise livestock. For simplification of administration, an amendment would be desirable to make it clear that the participant is the person owning land on which animals are farmed. An amendment would provide the ability to move the obligation to another party in the event of land use agreements.

The amendment would significantly enhance the ability to cross check legal participants against registrations to ensure full participation, and improve consistency with treatment of the forestry sector. This is important given the number of farm level agriculture participants. This Agriculture Technical Advisory Group on emissions trading also recommended this amendment in order to minimise the compliance costs of the scheme and ensure comprehensive coverage of emissions.

11. Including egg producers and live animal exporters in the scheme

Subpart 3 of Part 5 of Schedule 3 currently does not include egg producers because chickens are not commercially slaughtered and so the emissions will not be captured by the agricultural processor participants. Subpart 3 of Part 5 of Schedule 3 also does not include the emissions from animals that are then exported as live animals. The policy aims to cover poultry emissions comprehensively but egg producers were inadvertently excluded. Although this does not have large fiscal implications (~$0.5 million at $25/tonne), it would be highly inequitable for poultry meat producers.

Excluding the export of live animals may create an incentive to slaughter animals off-shore in countries not facing a price on carbon. An amendment is required to close this loophole.

12. Clarifying ability to specify the "Land Transfer Date" in the Forestry Allocation Plan

Section 71 of the Act sets out the issues that must or may be set out in the Forestry Allocation Plan. One of the issues that may be covered in the Draft Allocation Plan is a date or event on which the land is to be treated as transferred.

The proposal set out in the Draft Allocation Plan confirms the Act's default that the land is to be treated as transferred on the "settlement date", which in a sale and purchase situation would have been agreed by the seller and purchaser. This is effectively the date when the new owner would have taken control of the land and paid any outstanding monies.

The transfer date is important because it affects the amount of allocation that pre-1990 land receives. The rationale behind the decreased allocation for land that was transferred after 31 October 2002 was that once the previous government first announced its intention to introduce policies to control rates of deforestation, a willing buyer could have factored that into the purchase price they were willing to pay for the land. However, this rationale does not apply to land that was transferred after 31 October 2002 by operation of law, for example by order of the Court, or by transmission on the death of a joint owner.

The drafting of section 71 may inadvertently catch such situations and could result in such a new owner receiving a reduced allocation. Recent legal advice casts doubt over whether the wording of section 71 unambiguously gives the Minister the power to clarify the meaning of "transfer" via the Allocation Plan to ensure that the above policy intent is met, and that land that has been transferred by operation of law is not automatically ineligible for a higher allocation of units.

In order to remove the risk of legal challenge on this point, it would be desirable to amend the Act to clarify that the Forestry Allocation Plan whether issued before or after the amendment may define what is meant by the concept of 'transfer' for the purposes of allocation.

13. Clarifying cost benefit analysis requirements in exemption provision

Section 60 provides for exempting persons from NZ ETS obligations by Order in Council. Amongst other things, the process under section 60 requires the Minister to be satisfied of certain matters before recommending the making of an order, and includes requirements for a comparison of costs and benefits. However, as currently drafted the cost-benefit analysis requirements are unclear. Consequently, there is a high risk that it will not be possible to satisfy the process requirements for making an exemption.

It is recommended that section 60 is amended to clarify the Minister must be satisfied the costs of an exemption do not exceed the benefits of an exemption. Costs may include economic costs as a result of exempted persons not facing incentives for mitigation. Benefits may include reduced administrative and compliance costs from not requiring exempted participants to monitor and report emissions.

B. Medium priority: Changes that would be highly desirable for effective functioning of Act

1. Clarifying of the treatment of mining natural gas within the exclusive economic zone (EEZ)

It is necessary to amend the Act to clarify that a person carrying out the activity of mining natural gas, other than for export, within the exclusive economic zone (EEZ) or in, on or above the continental shelf is not also carrying out the activity of "importing" natural gas under Part 3 of Schedule 3.

The Act, as currently drafted, is ambiguous on this point as the provisions regarding the activity of 'importation' are defined by reference to the Customs and Excise Act 1996 which could result in gas mined in New Zealand's gas fields located outside a 12 nautical mile limit being considered to be 'imported'. However, Section 205 of the Act expressly provides that the activity of mining natural gas that occurs in the EEZ is mining activity for the purposes of the Act. There is an argument that a person mining gas in the EEZ falls under both the activity of mining and is also technically importing gas which would require that person to register as an importer of gas and comply with the provisions of the Act.

This ambiguity should be clarified by an amendment to provide that a person carrying out the activity of mining natural gas that occurs in the EEZ does not also carry out the activity of "importing" natural gas simply because it is mining gas from a field located outside the 12 nautical mile limit.

2. Clarifying that section 64 directions will not be published

Section 64 is concerned with the entitlement of a participant to receive units in respect of removal activities. Under section 64(3), the Minister of Finance directs the Registrar on how many units to transfer to a particular participant's holding account.

As presently drafted, the Act is ambiguous as to whether directions made under section 64 should be published on the Registrar's Internet site. It is recommended that the Act be amended to clarify the position. On balance, officials recommend that directions made under section 64 should not be published.

Although principles of transparency would suggest that directions should be published, officials consider that concerns about commercial sensitivity support non-publication of section 64(3) directions. Stakeholders raised concerns regarding commercial sensitivity of emissions and removals information when the NZ ETS was being established. These concerns are reflected in a number of provisions of the Act which protect against disclosure of potentially commercially sensitive information regarding emissions and removals activity (see section 89(3)). Similarly, while the Act requires information to be available regarding individual holdings of Kyoto units, information regarding holdings of NZUs is only required to be made available in aggregate (see section 27(2) and (3)).

3. Clarifying the Chief Executive's forestry-related reporting obligations

Section 89 requires the Chief Executive to report information separately for each of the activities in Part 1 of Schedule 4 (which covers removal activities in post-1989 forests). There are four forest removal activities listed under that Schedule: owning post-1989 forest land; holding a registered forestry right or being the leaseholder under a registered lease of post-1989 forest land; and being a party to a Crown conservation contract).

A number of parties are likely to undertake more than one of those four activities, but only provide one combined emissions return. The Chief Executive will in practice therefore not have sufficient information to meet an obligation to report separately for each of these activities.

An amendment is desirable to specify that the Chief Executive only needs to report emissions and removals in relation to the four activities in Part 1 of Schedule 4 in aggregate, rather than separately for each activity.

4. Clarifying the ability to delay registration of forestry participant until fees and charges paid

Section 167 empowers the making of regulations to prescribe fees and charges. Regulations under this section have already been brought into force for post-1989 forest participants. Those regulations specify that an applicant wanting to join the scheme must pay an upfront fee with his or her application. If the processing of their application is particularly time consuming, they will then be charged an additional amount based on the number of hours worked.

Under the Act as currently drafted it is not clear that the scheme administrator has the ability not to register a forestry participant in the scheme if that participant has failed to pay any additional amount charged. This is likely to make it more difficult for the administrator to recover any outstanding charges.

An amendment is desirable to make it clear that the administrator is not required to register a participant until all fees and charges relating to the application have been paid.

5. Confirming pro rata approach for NZUs earned when land within a Carbon Accounting Area is transferred

NZUs are earned for increases in carbon stocks in a Carbon Accounting Area (CAA). Where part of the land of a CAA is transferred to another participant it is necessary to apportion NZUs earned between the transferor and transferee. It was always envisaged that the apportionment should be made on a pro rata per hectare basis. As drafted, the Act permits a pro rata apportionment, but does not exclude the possibility of another basis for apportionment and officials consider that the Act should be amended to explicitly provide that the apportionment will only be made on a pro rata per hectare basis.

6. Providing for removal from the Register of Participants after obligations have been met

Persons who become mandatory participants of the NZ ETS are obliged to notify that they should be entered on the Register of Participants by the administrator. They then have an obligation to file an emissions return and surrender emissions units to satisfy their obligations.

Under section 59 a participant is entitled to notify the administrator that the participant has ceased to be a participant and should be removed from the Register of Participants, regardless of whether or not the participant has yet filed their emissions return and/or surrendered sufficient emissions units to meet the participant's liabilities.

A more efficient and effective de-registration mechanism would be for the participant to remain on the Register of Participants until such time as the participant has met all the obligations. At that time the administrator would initiate the de-registration. It is recommended that the Act be amended accordingly.

7. Clarifying that only a nominated entity can submit a return for a consolidated group

The consolidated group provisions are proving very difficult for MAF and MED to operationalise for what is likely to be a very small number of participants who would qualify, and elect to form, a consolidated group for emissions reporting purposes. Allowing multiple corporate entities that are participants in multiple sectors with different reporting timetables and bases is proving unworkable.

At the very least, the Act should be amended to clarify that only the nominated entity can submit an emissions return on behalf of the members of the consolidated group, and that only one emissions return per calendar year can be submitted for the consolidated group.

8. Restricting timing for electing to have activities removed from consolidated group

To reduce administrative complexity, it is proposed to restrict the timing for members of consolidated groups to elect to cease being a member of that group. It is proposed that elections received by 30 September in a given year would be effective from the beginning of the following year, and elections received after 30 September in a given year would be effective from the beginning of the year following the next year. This is consistent with the timing constraints for entities to join consolidated groups, and would avoid part year reporting – bringing administrative benefits for the groups themselves as well as for the Chief Executive.

9. Clarifying when forest land is treated as being deforested before 1 January 2008

The current wording in the Act results in an interpretation contrary to the previously announced policy intent of treating as deforested on 31 December 2007 any area which meets solely the conditions in s4(5)(a) and (b), namely where:

(a) no standing exotic forest species (dead or alive), other than a strip of standing exotic forest species that had, or was likely at maturity to have, tree crown cover of an average width of less than 30 metres; and

(b) no other merchantable timber from exotic forest species.

The Act adds in an additional test by requiring that where land-use change has not commenced prior to 31 December 2007, an area that is cleared and meets section 4(5) of the Act should not be regarded as deforested unless independent evidence exists that deforestation had commenced prior to 31 December 2007. This interpretation is proving difficult for Participants to prove and MAF to verify.

To minimise confusion and provide clarity for participants it is recommended the Act be amended to clarify that deforestation is deemed to have occurred before 1 January 2008 if on 31 December 2007 the land had—

(a) No standing exotic forest species (dead or alive), other than a strip of standing exotic forest species that had, or were likely to have, tree crown cover of an average width of less than 30 metres; and

(b) No other merchantable timber from exotic forest species; and

(c) Conversion to land that is not forest land is complete within four years of the date of clearing.

Advice from the national Kyoto inventory agency is that New Zealand will not incur any cost under Kyoto from this amendment.

10. Amendment to the definition of forest land

The current interpretation of the definition of forest land under the Act unnecessarily disadvantages participants compared with interpretation under the Kyoto Protocol, and is also more difficult to implement operationally than the Kyoto definition. This is because the existing definition of forest land is satisfied by relatively small numbers of juvenile trees being forest species. That is, it does not take many trees to meet the crown cover threshold test at maturity and therefore become forest land.

It is proposed to amend the definition of forest land in the Act to remove problematic and unnecessary differences with the international rules.

C. Lower priority: Changes that would be useful to the effective functioning of the Act but are not considered a priority at this stage

1. Requiring the Registrar to give effect to directions

While it is implicit in the Act that the Registrar must follow a Chief Executive's direction under section 18B, unlike every other direction from ministers and the Chief Executive referred to in the Act, it is not explicitly stated that the Registrar must follow the direction. Clarity, and consistency with all other directions in the Act, is important here because section 18B directions can relate to actions that include closing a person's holding account and potential forfeit of that person's emission units to the Crown.

2. Inserting and applying a definition of "Crown holding account"

It would be desirable for the Act to distinguish between (i) holding accounts held by the Crown and controlled by the Minister of Finance ("Administrative Accounts") and (ii) accounts held by Ministers (e.g. Minister of Conservation) as participants in the ETS ("Participant Accounts").

Administrative Accounts are held by the Crown for:

(a) Kyoto compliance; and

(b) administrative aspects of the ETS (i.e., surrender accounts, conversion accounts, holding accounts for pools of NZUs, etc).

Inserting a definition distinguishing Administrative Accounts from Participant Accounts is desirable because a number of sections in the Act refer to Crown Accounts. These sections contemplate Administrative Accounts, but do not contemplate, and should not apply to, Participant Accounts.

3. Clarifying relevance of subsequent commitment periods to NZU issuance

Section 69 prescribes the process for the issuance of NZUs into a Crown holding account, in accordance with a direction from the Minister for Climate Change Issues to the New Zealand Emissions Unit Registrar. Section 69(2)(c)(i)-(iv) lists a number of matters the Minister must have regard to if there is no subsequent commitment period specified or determined under the Protocol or no successor international agreement to the Protocol. This subsection was only intended to guide the issuance of units in subsequent commitment periods (rather than be considered as part of the CP1 issuance process). The section needs to be amended to clarify this policy intention.

4. Streamline the process for updating the schedules to the CCRA to reflect amendments to the KP and the UNFCCC that are in force for New Zealand

The UNFCCC and Kyoto Protocol are included in the Act as Schedules I and II.

It would be desirable to have a streamlined procedure (for example through Order in Council) for updating the Schedules of the Act to reflect changes in the international instruments that are already in force in New Zealand.

For example, the annexes to the UNFCCC set out the developed country Parties with specific obligations under the UNFCCC (Annex I), some of which have additional financial obligations (Annex II). The binding emissions reduction commitments for Annex I Parties are reflected in Annex B to the Kyoto Protocol. As new parties join these Annexes, this will need to be reflected in the Schedules to the Act.

5. Providing for authorised representatives in respect of joint activities

Under the Act, landowners who are joint participants may be recorded on the register of participants in the manner prescribed in regulations. From an ease-of-implementation perspective it is preferable to require one of the joint participants to be appointed when

there are more than 25 joint participants. This person will be an authorised representative and will be entered on the Register of Participants ("on behalf of" all joint owners). This will mean the Chief Executive can deal with that person in relation to all matters relating to the participation of those persons in the ETS.

6. Clarifying obligation to retain records

For the avoidance of doubt, it should be made clear that the obligation in section 67(2) to retain records continues whether or not the person continues to be a participant.

7. Clarifying that one emissions return only to be filed per year

For the avoidance of doubt, it should be made clear in section 189 that a specific post-1989 participant can only file one emissions return per year (this reduces implementation complexity), albeit that they can still mix and match the Carbon Accounting Areas they include in each return.

8. Clarifying treatment of returns in respect of less than a hectare

Clarify the Act so that a person must calculate the number of units to be surrendered where the area of post -1989 forest land is being deregistered by making the calculation in relation to a whole or part of a hectare. Current section 190 (2) assumes that the areas of post -1989 forest land being deregistered are whole hectares when this will not always be the case.

9. Amending timing of surrender relative to date of emissions return

In section 191(3), replace “by the same” with “within 20 working days of” (at present the final surrender date is the same as the final date for submission of the emissions return).

10. Clarifying timing for notification of ceasing to carry out activity

Insert “as soon as practicable” after “must notify” in section 188(3)(b) (at present the timing for notification is not specified).

Appendix 2.

Fishing sector allocation

In the 10 August 2009 Cabinet paper, it was proposed that legislation will specify a total number of units for free allocation to the fishing sector and that this number will be equivalent to 90% of 2005 emissions for two and a half years (i.e. to match the transition phase), adjusted for a 2:1 progressive obligation being in place.

It is further recommended that the number placed in legislation is based on a Ministry of Fisheries fuel consumption estimate for 2005 of 216 million litres. This is believed to be the best available estimate. This amount of fuel use would result in 700,000 emissions units being granted to the sector. To maintain consistency, should the liquid fossil fuels entry date shift from 1 July 2010, this amount of units would be adjusted to match the fixed price period that applies to liquid fossil fuels. For example, if the entry date for liquid fossil fuels was moved to 1 January 2010, it would be consistent to increase this number to 840,000.

In addition, to stating the amount of fishing free allocation in the legislation, I propose to truncate and simplify the process for making free allocation to the fishing sector. The existing process was designed for the more complex, uncertain and ongoing allocation process to the industrial and agricultural sectors. Now that the allocation plan process will only apply to the fishing sector, there is no need for the relatively small and straightforward fishing allocation to follow this process. The following changes are proposed:

- Halving the statutory timeframes for submissions and applications;
- Removing the need for parliamentary scrutiny of the allocation plan; and
- Removing the required content for allocation plans that is not relevant to the fishing sector allocation.

Point of obligation for agriculture

In the 10 August 2009 Cabinet paper, it was proposed that the initial point of obligation will be at processor level and the Government will have the ability, via Order in Council, to change to a farm level obligation subject to stakeholder views and successful resolution of administrative challenges. The option for a hybrid point of obligation would be also removed from the legislation.

The following further recommendations are made:

a. The legislation would specify certain criteria to which the Minister must have before making an Order in Council moving the point of obligation, including:
    - The ability to enforce compliance;
    - The costs including administrative and compliance costs;
    - The benefits in terms of additional mitigation.

b. The legislation would provide the Government with the ability to stage the transition to the farm level. A staged approach might involve, for example, beginning reporting and surrender obligations for one sector at a time. A staged approach to the transition would not currently be recommended for a number of reasons but it is possible that these will be resolved in the future. The voluntary reporting year would also become a mandatory registration/voluntary reporting year. This would allow farmers 12 months to become registered in the scheme and the option to report in that year.

c. There would be a minimum 12 month lead in-period from the passing of the Order in Council regarding reporting obligations to the time that reporting obligations begin.

Intensity based allocation for agriculture

In the 10 August 2009 Cabinet paper, it was proposed that free allocation will be provided on an intensity basis, on a similar basis as Energy Intensive and Trade Exposed industry.

Further detailed decisions relating to allocation to agriculture include the content of the legislation in relation to the following design features:

- Eligibility;
- The methodology for calculating a participant's allocation;
- The allocative baseline; and
- The level of assistance.

The current framework assumes that the whole of the agriculture sector is trade exposed with the costs of the ETS largely being borne by farmers as opposed to processors passing the costs back through lower product prices. Therefore there are no trade exposure tests or eligibility requirements. This approach remains appropriate and it is recommended that there be no trade exposure tests or thresholds specified in the legislation. However, the current legislation allows allocation to be provided to non-participants. This provision was to allow flexibility while more work was done on the appropriate point of obligation and is therefore no longer necessary. It is recommended that the legislation be clarified so that only participants are eligible for free allocation.

Nitrogen fertilisers

Currently, the activity description attributes a nitrous oxide emission to all imported and manufactured nitrogen fertilisers. However, fertiliser imported or manufactured for industrial purposes would not have an agricultural nitrous oxide emission and should not be included. Clarifying that the use of fertiliser in manufacturing and industrial processes is not subject to obligations under the Act would resolve this.

Fixed price option mechanism

The Australian Carbon Pollution Reduction Scheme (CPRS) provides for a price cap until the end of June 2016. To maintain the option of linking with the CPRS an NZ ETS fixed price option mechanism that is consistent with the CPRS would be desirable.

The CPRS price cap mechanism is summarised as follows:

d. Participants have the option of purchasing Australian emissions units (AEUs) from the Crown at a fixed price.
e. A participant may apply for the issue of fixed price AEUs from the time a participant's emissions return has been processed until the deadline for surrendering units.
f. The Australian Climate Change Regulatory Authority can immediately issue fixed price AEUs, provided the number of AEUs does not exceed the CPRS national scheme cap.
g. Once fixed price AEUs are issued they are automatically surrendered by a participant, thus fulfilling a participant's obligations. Fixed price AEUs cannot be traded or banked.
h. The price of fixed price AEUs will initially be set at around A$46 per tonne in 2012/13, rising at 5 per cent real per annum until 2015/16.

A fixed price option mechanism for the NZ ETS could be designed to broadly reflect the CPRS mechanism. However while the CPRS provides for the immediate issue of AEUs, the NZ ETS involves a lengthier and more complex process to issue New Zealand units (NZUs).[11] A fixed price option could be implemented through providing participants with the option to pay a fee in satisfaction of surrender obligations, instead of surrendering units; and with transitional provisions for unit issuance, transfer and surrender. This will require an accelerated, specific issuance process for fixed price units.

It is proposed that an NZ ETS mechanism is designed as follows:

a. Participants have the option of paying a fee, surrendering units, or a combination of these methods to satisfy surrender obligations.
b. A participant may pay a fee in satisfaction of surrender obligations from the time a participant has submitted an annual emissions return until 31 May of the relevant year (the revised deadline for surrendering units).
c. The fee shall amount to $25 per tCO2-equivalent emitted from 1 July 2010 until 31 December 2012.

It is noted that further details are required on how this arrangement will be administered.

Consequential changes to other removal activities

As a result of the proposed transition phase for the stationary energy and industrial processes sectors, consequential changes to provisions for other removal activities[12] are necessary.

During the transition phase, participants (other than forestry sector participants) would be required to surrender only one unit for every two tonnes CO_2-e emitted. A corresponding adjustment should be made to the number of units to which participants would be entitled in respect of removal activities other than forestry. Note also that it is proposed to align the commencement date for the right to receive emission units for other removal activities to the commencement of surrender obligations in relation to stationary energy and industrial processes.

NZ ETS review

Under the Act, a review of the NZ ETS may be undertaken at any time using any method of review. Section 160 requires a general review of the NZ ETS to be completed by the end of 2011 (and at regular intervals beyond then), which includes consideration of international obligations, targets, linking with other emissions trading schemes, calculation methodologies, coverage of activities, and penalties. The general review must also consider issues relating to free allocation. The Act makes it clear that the review must be carried out by an appointed panel, the majority of which must be independent.

The Cabinet paper considered on 10 August proposed a five-yearly review of free allocation, with the first review conducted in 2012. A review of free allocation in 2012 may not provide substantial benefit if a general review of the NZ ETS which also covers free allocation is conducted in 2011. One option is to exclude free allocation from the general review in 2011. A further option is amending the Act to postpone the first mandatory review to 2012.

[11] Section 69 of the Climate Change Response Act requires the Minister to consult with the Minister of Finance and have regard to certain matters before directing the Registrar to issue NZUs.

[12] "Other removal activities" refers to the production of products that embed carbon, where an upstream supplier is required to surrender units in respect of that carbon. Other removal activities participants are entitled to receive units to offset pass through costs from the coverage of the stationary energy and industrial processes sectors in the NZ ETS. Initially, the only qualifying other removal activity is methanol production.

It is recommended that the status quo be retained including free allocation as part of a general review in 2011. A review in 2011 is preferable to allow for any consequential legislative amendments in 2012, prior to the commencement of any future international commitments and the entry of the agriculture, waste and synthetic gases sectors into the NZ ETS. Furthermore, there would be nothing to preclude an additional review of free allocation in 2012.

Setting a fixed price option post 2012

It is not proposed that that there would be any legislative provision for a fixed price option post 2012. However, the 2011 general review could consider whether a fixed price option post 2012 should be introduced through legislative amendment.

50 by 50 target

The 10 August 2009 Cabinet paper proposed the introduction of a New Zealand target of a 50% reduction of net greenhouse gases from 1990 levels by 2050 (the 50 by 50 target).

It is proposed that a regulation making power for setting targets be introduced. The regulation making power would also require the target to be reviewed following the release of future Intergovernmental Panel on Climate Change Assessment Reports. The introduction of a regulation making power might not the usual mechanism for setting targets but it has some advantages. It would have the same legal effect as a target under the existing gazette mechanism but has the benefit of having a perceived a higher status than a target set under the existing mechanism. Furthermore, a regulation making power would provide flexibility to amend the target in response to future IPCC Assessment Reports.

Household fund

Section 223 of the Act provides for the Household Fund. The key features of section 223 are that:

a. A total of $1 billion must be paid into the Household Fund by 2024.
b. The Household Fund may be used for purposes including household insulation and clean heat retrofits, energy efficient appliances and lighting, and space and water heating efficiency programmes.
c. The Minister must, on the advice of the Energy Efficiency and Conservation Authority, determine criteria for the use of the Household Fund.

The changes being made to the NZ ETS will substantially lessen the impact of the NZ ETS until the end of 2012, providing a far smoother transition for the industry sector and the economy as a whole. In turn this will ensure that households do not face large price increases. Given this, it is no longer considered necessary to provide an additional package of consumer assistance measures (beyond the usual inflation adjustment of benefits) and it is proposed that section 223 be deleted accordingly.

Joint venture participants in the natural gas sector and coal sector

Under the current provisions of Act, persons who carry out activities jointly are together treated as being the participant for the purposes of the NZ ETS. The joint participants are required to report jointly on their emissions, and have joint and several liability for the participant's obligations under the NZ ETS.

The oil and gas sector has advised that requiring joint venture partners carrying out the activity of mining natural gas to be joint participants under the NZ ETS would create a number of problems. The sector argues that the current rules would:

a. result in confidential information being disclosed to the other joint venture partners;

b. require a level of cooperation that joint venture partners in this industry do not usually undertake (because joint venture partners would have to manage their liabilities jointly under the NZ ETS); and
c. give rise to difficulties around opt-in by downstream purchasers (as joint venture parties often separately market their respective offtake).

It is proposed to amend the Act to address these concerns. There remain strong policy reasons for retaining the joint participant requirements in respect of other activities. However these policy reasons do not apply to the same extent to persons mining natural gas through the vehicle of an unincorporated joint venture. Notably, the number of participants is likely to be manageable and there will be ways to ensure that all emissions are accounted for.

It is therefore recommended that the Act be amended to provide that where more than one person is named on a permit relating to mining natural gas, each of the permit holders is to be treated as the person carrying out the activity of mining natural gas and must comply with the obligations of a participant under the Act. Following this amendment, joint venture participants would no longer be required to be joint participants under the NZ ETS, although related companies appearing on the same permit would still have the option to do so.

If the Act is amended as proposed (to provide for individual permit holders to be the participant under the NZ ETS) a number of consequential changes will also be required. These consequential amendments include providing sufficient flexibility regarding joint reporting for related companies carrying out the activity of mining natural gas, as well as ensuring that opt-in provisions work effectively where gas is purchased from a member of the group which is not in fact the participant, such as a parent company of the company carrying out the mining activity.

The coal sector has not made representations on these issues. However, officials have advised that it would be appropriate to extend the proposed amendments to include the coal sector. The problems identified by the natural gas sector are likely to be applicable, at least to some extent, to participants in the coal sector – although the problems are likely to be less widespread because joint ventures are a much less common arrangement in the coal sector. As in the natural gas sector, the proposed amendments would not result in a large increase in participant numbers (at present, the increase in participant numbers in the coal sector would be negligible) and there will be ways to ensure that all emissions are accounted for.

July to December 2010 surrender obligation

A 1 July 2010 entry date for the SEIP sector would require introduction of a mechanism to determine surrender obligations over a six month period. There are two main options available. One option would be to require participants to separately report their July to December 2010 emissions separately as part of their 2010 emissions return. The second option would be to halve the emissions for the entire year in 2010. The second option would marginally reduce compliance costs for some participants, but would raise accounting, tax and cash flow issues (including negative fiscal implications in the 2009/10 financial year). The first option is therefore recommended.

Emissions rulings

The Act contains provisions under which persons can apply for rulings from the Chief Executive on a number of matters. Rulings can cover whether something a person is doing is an activity listed in Schedule 3 or 4 of the Act, and whether the person is a participant in respect of an activity listed in Schedule 3 or 4 of the Act. Rulings can also cover the correct application of certain regulations made under the Act.

As presently drafted, the Act is not entirely clear regarding the scope of the rulings that can be obtained. In particular, the Act can be interpreted to mean that a ruling could be obtained

in respect of technical questions prior to a person's compliance with the Act. This would be an inappropriate use of the rulings process as it would effectively be a request to verify information prior to compliance. Further, it would be time consuming and technically challenging for the Chief Executive to provide such a ruling.

Accordingly, it is proposed that the Act be amended to clarify the scope of the binding rulings regime. In particular, it is proposed that the Act be amended to specify that the Chief Executive will not make an emissions ruling where doing so would require the Chief Executive to determine questions of fact contained in the information supplied by the person requesting the ruling.

Streamlining access to consolidated groups

The Act makes provision for participants who are members of the same group of companies to form a "consolidated group". Formation of a consolidated group allows members to submit a single emissions return, operate a joint holding account, and jointly meet their surrender liabilities under the Act. It is expected that the consolidated group provisions will simplify compliance for groups of companies with a large number of subsidiaries carrying out activities under the NZ ETS.

As presently drafted, the rules regarding formation of consolidated groups are reasonably restrictive. To some degree, this is necessary in order to ensure administrative efficiency. However, there are some areas where the rules could be relaxed or amended to make it easier to form, become part of, and leave a consolidated group. It would also be possible to reduce the time delays that currently apply to the formation or joining of a consolidated group in certain circumstances.

It is proposed to amend the Act to streamline the consolidated group provisions to facilitate use of these provisions whilst maintaining administrative efficiency.

Post 1989 forestry – wilding pines

Under current provisions, the Act requires applicants who register as a participant in respect of post-1989 forest land to declare that any action taken by the applicant after 1 January 2008 in relation to that land (including, but not limited to, removal of any existing vegetation prior to planting of the forest species on the land) complied with the provisions of the Resource Management Act 1991, including any plan under that Act, and the Forests Act 1949, as in force at the time that the action was taken. It is proposed that the Act also require applicants to declare their compliance with a pest management strategy in relation to that land under the Biosecurity Act 1993 in the same way that the Act currently reinforces the need to comply with Resource Management Act and Forestry Act requirements.

The basis for this proposal is that district plans under the Resource Management Act 1991 do not generally require the natural spread of wilding trees to be controlled, whereas pest management strategies under the Biosecurity Act may do so. The proposed change does not introduce additional compliance issues, but reinforces the need to comply with pest management strategies.

Further details of free allocation to industry

In addition to the major aspects of free allocation policy already discussed in the body of this cabinet paper, further detail on free allocation to industry has been developed as follows:

<u>Applying tests and thresholds</u>

- Whether an activity exceeds emissions intensity thresholds will be determined by comparing the threshold with:
    - The weighted average emissions intensity of the activity in New Zealand;
    or
    - Evidence on emissions intensity from Australia.

- There shall be powers for the chief executive to gazette guidance on the collection and submission of data for the purposes of determining eligibility and data collected shall be from the 60/07, 07/08 & 08/09 financial years.

- Only emissions for which assistance is given shall be included in determining the average emissions intensity of activities and the emissions for which assistance shall be given are as per the existing act except that free allocation will be given for the use of liquid fossil fuels where eligibility is conferred on the basis of eligibility in Australia.

<u>Activities and persons eligible for assistance</u>

- Activity definitions will be developed for activities that are potentially emissions intensive and trade exposed and the principles guiding these definitions and their content will be similar to those adopted in the proposed CPRS

- The person eligible for free allocation shall be the person undertaking the activity in the year prior and there will be provisions to receive applications from persons who undertake activities jointly

<u>Intensity based approach</u>

- The benchmark number of emission units per unit of production (allocative baselines) that is awarded shall be based on:

    a. the average emissions from the direct use of natural gas, geothermal steam, used or waste oil, coal and from the processes listed in the CCRA Part 4 Schedule 3 per unit of production across all entities conducting the specified activity in New Zealand in the 06/07, 07/08 & 08/09 financial years;

    b. the average electricity use per unit of production across all entities conducting the specified activity in the 06/07, 07/08 & 08/09 financial years and an electricity allocation factor set to represent the cost increases from the use of electricity (with enough flexibility for protection from pass through of costs provided by large electricity contracts in New Zealand to be considered); or

    c. Evidence on the above emissions and electricity use per unit of production from Australia (also with flexibility to take into account large electricity contracts and the difference in electricity generation mixes in the two countries)

    d. Evidence on liquid fossil fuel use per unit of production from Australia where eligibility is conferred on the basis of eligibility in Australia

- Allocative baselines will be set out in regulations. Applications will be made under these regulations for free allocation and the chief executive will have the ability to gazette guidance on the content of applications

- The allocation that each eligible person receives will be based on their previous year's production with a true up payment once production is known. The price cap mechanisms will be able to be used for the true-up if required. Where persons stop

conducting an eligible activity the true-up will be brought forward and that persons will not be eligible for free allocation in the following year

Allocation process

- The existing process to develop an allocation plan will be replaced with the power to make regulations that set out allocative baselines and process for eligible activities summarised as follows:

    i. Draft activity definitions produced
    ii. Draft activity definitions consulted
    iii. Activity definitions finalised
    iv. Necessary data called for, if required, and submitted by industry
    v. Data considered
    vi. Eligibility decisions made
    vii. Allocative baselines developed in the form of regulations for each eligible activity
    viii. An annual application process under the regulations

- The application process would involve:
    - Persons carrying out an eligible activity would submit applications containing specified information about last year's output by a certain date (4 months into the obligation year (i.e. 30 April)). Applications received after this date would not need to be considered
    - Decisions on applications would then be made
    - If an application is accepted then units would be transferred into the specified account
    - If an application is rejected the applicant must be notified with reasons
    - If an application is rejected an applicant can apply for reconsideration once.

- Persons who were conducting an activity in one of the financial years 06/07, 07/08 & 08/09 but decline to provide data when asked will not be eligible for free allocation

- Transitional provisions will provide for initial applications to be due 4 months after the relevant activity's regulations are gazetted

Allocation review

- The proposed changes from the five–yearly review will be reported to Parliament for Parliament to take a decision whether to accept or reject these changes.

Forestry allocation

The current draft forestry allocation plan proposes to transfer 55 million units (less units deducted to cover deforestation of exempt land) in a single transfer to eligible pre-1990 forest landowners, as partial compensation for loss of land value due to the introduction of the ETS. The 55 million is composed of two tranches: 21 million for Commitment Period 1 (CP1) and 34 million for CP2, with the second tranche of units only able to be surrendered or converted after 31 December 2012. The current draft forestry allocation plan uses a forest age-class methodology be used to determine how many units certain landowners will receive.

It is recommended to change the draft forestry allocation plan so that only the first tranche of 21 million units (less units deducted to cover deforestation of exempt land) is transferred to landowners, and to delay the transfer of the remaining 34 million units until CP2. This would allow consideration of whether or not transferring the second tranche of units is still required in the event that forest offset planting arrangements are agreed internationally. This approach would require moving to a simple pro-rata forest area basis to determine how many units landowners will receive. To minimise the risk of legal challenge and to manage timing constraints, it is also recommended that these changes be incorporated into the primary legislation.

The revised approach to forestry allocation would be released in the form of an 'exposure draft allocation plan' once the amendment Bill is introduced to Parliament. Although this is likely to prompt a negative response from stakeholders, including Māori, it is recommended as preferable to the alternative of issuing a new forestry allocation plan after the legislation is enacted. Disclosing the revised policy position in the Bill would allow more time for landowners to choose their preferred approach: applying for an allocation or an exemption from the deforestation obligations of the ETS.

The elements of the policy recommended for incorporation into the legislation (to minimise the potential for legal challenge) are as follows:

- make explicit that only 21 million units will be transferred during CP1;
- state that the distribution of units will be on a simple pro-rata approach based on forest land area;
- clarify that the decision to only allocate 21 million units (less units deducted to cover deforestation of exempt land) in CP1 will equally affect all eligible recipients regardless of the type of pre-1990 land they own (in other words the current levels of 18, 39 and ~60 units per hectare will each be reduced to approximately 7, 15 and ~23[13] units per hectare in CP1, with the balance possibly transferred in CP2);
- allow for the concept of individual determinations to be made for the fixed unit allocations (i.e., 18 and 39 units per hectare). This will help to ensure that at least some forestry units are distributed prior to the first surrender date for the forestry, fossil fuel and stationary energy sectors (30 April 2011), which would assist the domestic supply of units to meet demand, necessitating less importing of units into the scheme from international sources and/or less need to use the fixed price option mechanism;
- allow for the concept of an initial individual determination to be made for those eligible to receive ~60 units per hectare, but initially at the rate of the 39 units per hectare landowners. The remainder could occur later once allowance for exemptions has been made;
- revoke the current draft forestry allocation plan to allow for consultation on an exposure draft forestry allocation plan; and
- include a provision in the amendment Bill that consultation on the exposure draft forestry allocation plan can occur prior to enactment of the Bill.

Pre-1990 Tree Weed Exemption

Deforestation liabilities that accrue under the pre-1990 tree weed exemption will be funded from the forestry allocation pool. Accordingly, the number of units required for the exemption

[13] These reduced values are based on estimates of the number of units required to be held back for exemptions and as a proportion (38%) of total allocation pool.

must be estimated and deducted at the time(s) the allocation is made. Amendments are required to ensure the exemption's effective operation and relate to:

- extending the time limits on the tree weed exemption so that the current requirement to complete deforestation within 24 months is extended to within the first commitment period; and
- enabling the Chief Executive to maintain control over the level of liabilities under this exemption by limiting tree weed exemption approvals per commitment period within a fixed budget.

Carbon Accounting Areas

A carbon accounting area (CAA) is the area of forest land for which a post-1989 Participant is required to report the change in forest carbon stocks over time. Currently, a Participant can only define a CAA when they first register the forest land into the ETS. Early implementation experience is that some aspects of the provisions relating to CAAs are overly cumbersome, likely to lead to unnecessarily high transaction costs, and could create unintended liabilities for participants. Amendments are therefore proposed to:

- ensure that an existing participant is able to redefine the way in which their forest land is assigned to CAAs without incurring any additional obligation to surrender emissions units or having to pay any fee for reapplication;
- clarify that the Chief Executive must keep an up-to-date record of the net balance of units in relation to a CAA including one that is redefined; and
- make the process of transfers and carbon accounting more transparent and simpler for both a vendor and purchaser. Specifically, the area of land transferred must be an entire CAA, and the transferor will submit an emissions return that accounts for emissions or removals from the date of the last return to the date of transfer. This will be submitted within 20 working days of transfer and surrender any units in accordance with the Act.