



Minute of Decision

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Emissions Trading Scheme Review 2012: Proposed Amendments

Portfolio: Climate Change Issues

On 12 March 2012, following reference from the Cabinet Economic Growth and Infrastructure Committee, Cabinet:

Background

- 1 **noted** that:
 - 1.1 a statutory review of the New Zealand Emissions Trading Scheme (ETS) was completed in 2011;
 - 1.2 the ETS Review Panel made 61 recommendations, largely focused on improving the operation of the ETS and slowing the transition to full obligations under the scheme;
- 2 **noted** that on 18 July 2011, Cabinet invited the Minister for Climate Change Issues to report back to the Cabinet Economic Growth and Infrastructure Committee (EGI) by February 2012 with proposed changes to the ETS based on the ETS Review Panel's recommendations, developments in and discussions with Australia, and further analysis [CAB Min (11) 27/15];
- 3 **noted** that, in the paper under CAB (12) 76 [previously EGI (12) 16] and subsequent Cabinet papers, the Minister for Climate Change Issues intends to seek agreement to number of changes to the Climate Change Response Act 2002 (the Act) in order to:
 - 3.1 implement key recommendations of the 2011 ETS Review Panel;
 - 3.2 implement key commitments in the National Party's Manifesto;
 - 3.3 ensure the New Zealand ETS delivers an appropriate level of international emissions reduction effort post 2012;
 - 3.4 provide flexibility to link the ETS, if it should prove desirable, to the Australian Carbon Pricing Mechanism from 2015;
 - 3.5 improve the technical operation of a number of parts of the Act;

- 4 **noted** that to enable an Amendment Act to be passed by the end of 2012, it is necessary for Cabinet to make decisions in principle, subject to consultation on the policy proposals contained in the paper under CAB (12) 76 in March-June 2012, in order that legislative drafting may take place over March-June 2012;
- 5 **noted** that the paper under CAB (12) 76 is the first in a series of papers, and seeks Cabinet's agreement to the most significant policy changes;
- 6 **noted** that some of these policy changes are for "in principle" decisions where the final decision is dependent on the outcome of public consultation, and that Cabinet's final approval will be sought by July 2012;
- 7 **noted** that the Minister for Climate Change Issues will report back to EGI in late April 2012 on a further set of proposed technical and operational amendments to the Act, including supporting technical detail for the major proposals presented in the paper under CAB (12) 76, where needed;

CP2/Durban outcome implications

- 8 **noted** that the decisions reached at the recent United Nations Conference of the Parties in Durban provides more certainty about the potential international framework after 2012;
- 9 **noted** that separate advice will be provided to Cabinet on the outcomes and implications of the Durban decisions, and how New Zealand may wish to position itself internationally, including in relation to signing up to a second Commitment Period (CP2) under the Kyoto Protocol;
- 10 **noted** that that any package of amendments to the ETS will need to be tailored to deliver the level of effort Ministers wish New Zealand to demonstrate internationally in the period after 2013, regardless of whether New Zealand signs up to a CP2;
- 11 **noted** that changes to international rules agreed at Durban will have implications for ETS settings, in particular for the forestry sector;

ETS design amendments

- 12 **confirmed** that the government's objectives for the ETS are to:
- 12.1 help New Zealand to deliver its "fair share" of international action to reduce emissions, including meeting any international obligations;
 - 12.2 deliver emission reductions in the most cost effective manner;
 - 12.3 support efforts to maximise the long term economic resilience of the New Zealand economy at least cost;

Proposals for amendment to the Act in 2012

Auctioning

- 13 **noted** that the ETS as currently legislated does not have sufficient flexibility over the level of overseas purchasing, and is expected to deliver an excessive amount of emission reductions when the number of overseas units purchased and surrendered is taken into account;

- 14 **agreed in principle, subject to consultation**, to amend the Act to allow for an express regulation-making power to introduce auctioning of New Zealand Units (NZUs), within an overall cap on the number of NZUs issued (auctioned and allocated to sectors excluding forestry), to increase flexibility over the level of overseas purchasing;
- 15 **agreed in principle, subject to consultation**, to amend the Act to give the Minister for Climate Change Issues the power to sell units where such sale is by auction, and that that power is supported by any other powers that are necessary for the functioning of the auction;
- 16 **agreed in principle, subject to consultation**, to amend the Act so that the relevant regulation-making powers related to auctioning enable the regulations to provide for at least the following matters:
- 16.1 the year in which full auctioning will commence;
- 16.2 to allow for one or more pilot auctions to be held before a full auction commences;
- 16.3 the overall cap on the number of NZUs issued each year over a five year period (excluding forestry allocation);
- 16.4 the limit, if any, on the amount of eligible overseas units an ETS participant can surrender in each year;
- 16.5 the persons eligible to participate in the auction;
- 16.6 any other auction design features that the Minister considers relevant to ensure the effective operation of the auction;
- 16.7 any penalties for breaches of the regulation not already specified in the Act;
- 17 17.1 [*withheld under s 9(2)(f)(iv)*]
- 17.2 [*withheld under s 9(2)(f)(iv)*]
- 18 **agreed** that officials conduct further work and consult with affected parties during 2012 on whether an auctioning mechanism should be introduced, including the detailed auction design features to be introduced by regulations, including:
- 18.1 the level of any limit on the amount of eligible overseas units an ETS participant can surrender;
- 18.2 the frequency of the auction;
- 18.3 the type of auction process used;
- 18.4 the permitted participants in the auction;
- 18.5 any other aspects of auction design identified by the Minister for Climate Change Issues where consultation would be useful;

- 19 **agreed in principle, subject to consultation**, to amend the Act to specify the matters the Minister for Climate Change Issues must have regard to when determining the amount of NZUs to be auctioned and the overall cap on the amount of NZUs issued in each year, namely:
- 19.1 New Zealand's projected emission trends;
 - 19.2 any domestic target and/or obligation under an international agreement to reduce emissions;
 - 19.3 the expected amount of NZUs allocated;
 - 19.4 the limit, if any, on the amount of eligible overseas units an ETS participant can surrender;
 - 19.5 the objectives of the ETS;
 - 19.6 any other matters the Minister considers relevant;
- 20 **agreed in principle, subject to consultation**, to amend the Act to specify the process for amending the regulations related to auctioning, namely:
- 20.1 notice of one year must be given before the regulations can be amended;
 - 20.2 the cap on the amount of NZUs issued (auctioned and allocated to sectors excluding forestry) in the surrender period at the time notice is given cannot be amended;
 - 20.3 consultation is required with interested parties before any amendment can be made;
- 21 **agreed in principle, subject to consultation**, to amend the Act to specify the penalties incurred if a person is in breach of any limit specified in regulations on the amount of eligible overseas units an ETS participant can surrender in each year (these penalties will link to the existing penalties for the surrender of ineligible units);

Backing of NZUs issued

- 22 **noted** that the policy intent of Cabinet for the current legislation was to back all NZUs issued with Kyoto units, but that due to a drafting error in the Act this intent has not been given effect;
- 23 **noted** that New Zealand is expected to exceed its commitments under the first commitment period (CP1) of the Kyoto Protocol, and that therefore the need to back during this period is not required;
- 24 **noted** that the need for backing from 2013 is significantly reduced if a cap on the amount of NZUs issued is introduced;
- 25 **agreed in principle, subject to consultation**, to amend the Act to remove the requirement to back NZUs during CP1, subject to agreement to introduce auctioning with a cap on NZUs issue;

Transition measures

- 26 **agreed in principle, subject to final decisions by July 2012**, to extend the current one-for-two surrender obligation over two years from the end of 2012, while phasing it out as a 67 percent surrender obligation in 2013, an 83 percent surrender obligation in 2014, and a full surrender obligation from 2015, as recommended by the ETS Review Panel;
- 27 **agreed in principle, subject to final decisions by July 2012**, to apply a 67 percent surrender obligation in 2013, an 83 percent surrender obligation in 2014, and a full surrender obligation in 2015 to the Waste and Synthetic Gases sectors, as recommended by the ETS Review Panel;
- 28 **agreed in principle, subject to consultation**, to amend the Act to extend the \$25 fixed price option to 2015, to provide additional price certainty for ETS participants during this period;
- 29 **agreed in principle, subject to consultation**, to amend the Act to extend the ban on exports of NZUs from non-forest sectors while a fixed price option remains in place, to reduce risks of arbitrage;
- 30 **agreed in principle, subject to consultation**, to amend the Act to provide a power for the Minister for Climate Change Issues to further extend the fixed price option and align it after 2015 with the level of any fixed price option in Australia, with the following conditions:
- 30.1 the power can only be exercised if linking with the Australian Carbon Pricing Mechanism has occurred;
- 30.2 any extended fixed price option must be set at the same level as any price ceiling in Australia;
- 30.3 the use of the power is subject to consultation with affected parties;

ETS sectoral changes: Agriculture

- 31 **noted** that the agricultural sector already has reporting obligations under the ETS and incurs emissions liabilities from 2015;
- 32 **agreed** to review in 2014 the date from which the agricultural sector will face liabilities;
- 33 **noted** that there will a fiscal cost associated with delaying liabilities for the agricultural sector of around 2 million units in 2014/15 and more than 4 million units per annum from 2015/16 onwards (based on a reduction in ETS revenue);
- 34 **agreed in principle, subject to consultation**, to amend the Act to include a discretionary power for the Minister for Climate Change Issues to defer the date from which the agricultural sector will incur emissions liabilities, and that this power will:
- 34.1 allow deferral of all liabilities, or for liabilities for particular agricultural greenhouse gases or particular activities;
- 34.2 require the Minister, if making a decision to defer, to be satisfied that there are insufficient practical technologies to reduce emissions and/or that trading partners have made insufficient progress on policies to reduce emissions;

- 34.3 require a prior independent review, which will assess the conditions above;
- 34.4 require prior consultation to be undertaken with interested parties;
- 34.5 allow a maximum deferral of 3 years;
- 34.6 require a decision on any deferral to be made no later than 30 November 2014 (to allow reasonable notice before the Act comes into force);

35 [withheld under s 9(2)(h)]

ETS sectoral changes: Forestry

Introduction of offsetting for pre-1990 forestry

- 36 **noted** that at Durban in December 2011, Parties to the United Nations Framework Convention on Climate Change agreed to introduce the Flexible Land Use rule into the international forest accounting rules, which significantly lessens the potential fiscal costs of introducing offsetting into the ETS under a second Kyoto commitment period (CP2);
- 37 **noted** that offsetting provides for greater land-use flexibility for pre-1990 exotic forestry through reducing the cost of land use conversion under the ETS by:
 - 37.1 waiving the cost of deforestation under the ETS provided that a forest is established elsewhere on post-1989 eligible land;
 - 37.2 transferring the ETS deforestation liability from existing pre-1990 forest land with higher economic uses to land more suited to forestry;
- 38 **agreed in principle, subject to consultation**, to enable offsetting for pre-1990 forest land consistent with the Flexible Land Use rules agreed for the Kyoto Protocol CP2 at Durban;
- 39 **agreed in principle, subject to consultation**, to amend the Act to build on existing ETS operational processes and systems when implementing offsetting, to provide for at least the following design features:
 - 39.1 the decision to deforest and take up offsetting will rest with the landowner;
 - 39.2 use of pre-1990 forest land look up tables to estimate the deforestation emissions of the cleared land;
 - 39.3 use of post-1989 forest land look up tables to estimate the carbon sequestration of the offset forest;
 - 39.4 the landowner will be responsible for self-assessing and declaring non-compliance of his or her offsetting obligation, with the Ministry of Agriculture and Forestry conducting risk-based audits as necessary to monitor and enforce compliance;
 - 39.5 if a landowner does not establish an offset forest of sufficient area or carbon equivalent, they will be required to file an emissions return and must surrender NZUs (or other eligible units) to meet any carbon shortfall (after this, offsetting obligations from the participant are completed);

- 39.6 any subsequent deforestation of the offset planting will be subject to the normal ETS deforestation liability;
- 39.7 the ability to set reporting and other thresholds through regulations;
- 40 **noted** that should New Zealand sign up to CP2, or take an emissions reduction target for the period to 2020 based on CP2 accounting rules, then New Zealand's pre-1990 forestry emissions will be accounted for in the Crown Accounts based on its internationally-agreed "reference level" for pre-1990 forest land;
- 41 **noted** that:
- 41.1 it is not possible to predict forest owners' demand for offsetting, as the economics for land conversion may change in the future;
- 41.2 based on current information, the uptake could be between 16,000 hectares (based on owners intentions) and 70,000 hectares (based on an estimate of pre-1990 forest land which has a higher economic use than forestry);
- 42 **noted** that the introduction of offsetting creates a fiscal risk in the range of \$2.1 million to \$69.5 million over 2012/13 to 2015/16, depending on the uptake and design of offsetting¹ ;
- 43 **agreed in principle, subject to consultation:**
- 43.1 to amend the Act to include a power for the Minister of Climate Change Issues, in consultation with the Minister for Primary Industries and the Minister of Finance as appropriate, to place a limit on offsetting either on the age of the trees to be deforested or the requirements to maintain the offset forest for a full rotation, should that prove necessary to mitigate any fiscal risks of exceeding the reference level;
- 43.2 that this power would be used subject to prior consultation with the affected parties;

Proposal to change the second tranche of pre-1990 forestry allocation

- 44 **noted** that the free allocation to pre-1990 forest landowners was provided as partial compensation for the loss of land value landowners were expected to face because of the ETS deforestation liability;
- 45 **noted** that offsetting reduces the costs of the deforestation liabilities (potentially by 50 percent to 75 percent, depending on the price of carbon), and provides greater land-use flexibility for pre-1990 forest land, thereby reducing the ETS deforestation liability and the impact of the ETS on land values;
- 46 **noted** that, in recognition of this, the ETS Review Panel recommended that if offsetting is introduced, the second tranche of allocation to pre-1990 forests be cancelled for landowners who take up offsetting;

¹ The estimated fiscal costs associated with offsetting presented in the paper under CAB (12) 76 are based on the assumptions that: (1) These are potential fiscal costs under a CP2 accounting. (2) Costs from forests are estimated against forest management accounting (Article 3.4). (3) Harvest for offsetting occurs at an average age of 20 years. (4) Future New Zealand's timber harvest (outside of offsetting harvest) will be 26 million m³/year. (5) 87 percent of the forest conversion is to dairy and 13 percent to sheep and beef. (6) The estimated fiscal impact does not include any credits that may be generated from Article 3.4.

- 47 **noted** that cancelling the second tranche only for those who take up offsetting would produce fiscal savings of \$1.7 million to \$27 million in 2011/12;
- 48 **noted** that there is an in principle argument for the government to cancel or reduce the second tranche of allocation to all pre-1990 forest owners in light of the introduction of offsetting;
- 49 **noted** that the possible adjustment or cancellation of the second tranche (if offsetting is introduced, if deforestation liabilities are removed or if international rules change) has already been widely signaled to landowners; including through the Act, consultations on pre-1990 forest allocations, and letters to land owners;
- 50 **noted** that small landowners, landowners whose land is best suited to forestry, and landowners who have sold long-term cutting rights to third parties are less likely to benefit from offsetting, and are likely to resist a proposal to cancel the second tranche;
- 51 **noted** that a significant amount of Maori-owned pre-1990 forest land is likely to fall into the category of land unlikely to benefit from the introduction of offsetting;
- 52 **noted** that the cancellation of the second tranche would produce fiscal savings of \$321.669 million in 2011/12;
- 53 **noted** that the second tranche of allocation to pre-1990 forest land is to be provided in three categories:
 - 53.1 37 NZUs per hectare for eligible pre-1990 forest land acquired prior to 1 November 2002;
 - 53.2 24 NZUs per hectare for eligible pre-1990 forest land acquired on or after 1 November 2002;
 - 53.3 11 NZUs per hectare for eligible pre-1990 forest land that was Crown forest licence land on 1 January 2008, including that transferred under a Treaty of Waitangi settlement after that date;
- 54 **noted** that, as all categories of pre-1990 forest land will benefit equally from offsetting, one option would be to allocate 11 NZUs to all landowners;
- 55 **noted** that this approach would:
 - 55.1 reduce the second tranche by around 55 percent, or in total by around 33 percent if tranche one is included, which is commensurate with the reduction in conversion costs provided by offsetting;
 - 55.2 produce fiscal savings of \$175.929 million in 2011/12;

56 [withheld under s 9(2)(h)]

57 [withheld under s 9(2)(h)]

58

[withheld under s 9(2)(h)]

59 **agreed, subject to Cabinet's agreement to introduce offsetting**, that officials consult on the following three options to change the second tranche in March and April 2012:

59.1 cancellation of the second tranche only for those who take up offsetting;

59.2 reduction of the second tranche, including (but not limited to) the option of reducing the second tranche so that all landowners receive 11 NZUs per hectare or an equivalent pro rata cancellation that reduces landowners' second tranche in proportion to their existing entitlements;

59.3 cancellation of the second tranche in full;

60 **agreed** that any consultation should also include the option of allowing landowners to take up the under 50 hectare exemption for deforestation liabilities, in exchange for forfeiting the second tranche of allocation and surrendering the equivalent number of units issued under the first tranche;

61 **noted** that the proposal in paragraph 60 above would potentially generate fiscal savings of \$2.249 million over 2012/13 to 2014/15;

Global Warming Potentials (GWPs)

62 **noted** that it was agreed at Durban that from 1 January 2013, the accounting of greenhouse gases will use the updated global warming potentials (GWPs) from the IPCC's 4th Assessment report;

63 **noted** that the updated GWPs will increase costs for some ETS participants and result in fiscal savings of about \$18.823 million over the forecast period up to 2015/16;

64 **agreed in principle, subject to consultation**, that the Act be amended to ensure that the GWPs used to calculate obligations under the ETS after 2012 are aligned with those that will be used by New Zealand to account and report its national emissions;

Fiscals costs and implications

65 noted the following indicative fiscal implications of paragraphs 14–21, 25–30, 38–39, 60 and 64 above as follows, with further details on these changes included in Appendix 2 to the paper under CAB (12) 76:

\$ million	Increase/(decrease) in operating balance					
	2011/12	2012/13	2013/14	2014/15	2015/16	Total
Transition phase — gradual phase-out of 2:1 surrender obligation	-	(34.268)	(80.609)	(32.854)	-	(147.731)
Updating emissions projections with new Global Warming Potentials	-	1.203	2.707	5.973	8.940	18.823
Option subject to consultation: savings from full cancellation of second tranche	321.669	-	-	-	-	321.669
Option subject to consultation: savings from a common rate of 11 NZUs per hectare for all land owners	175.929	-	-	-	-	175.929
Option subject to consultation: savings from cancellation of the second tranche only for those who take up offsetting.	1.700 – 27.000	-	-	-	-	1.700 – 27.000
Landowners with <50 ha swapping allocation for exemption (i.e. return of 1st tranche of pre-1990 forest allocation)	-	0.562	1.124	0.562	-	2.249
Emissions Trading Scheme Review implementation contingency	-	(8.745)	(2.095)	(2.213)	(2.180)	(15.233)
Net impact on operating balance (\$ million)	1.700 - 321.669	(41.247)	(78.872)	(28.532)	6.760	(140.192) - 179.777

66 noted that final decisions on appropriations will therefore not be possible until after consultation on proposals to cancel the second tranche;

67 noted that further technical and other decisions to be considered by Cabinet in March-April 2012 will have fiscal implications and also be incorporated into the final package of decisions;

68 noted that the Minister for Climate Change Issues will propose changes to appropriations when Cabinet makes decisions on the final package of ETS changes by July 2012, following public consultation on some decisions;

- 69 **noted** that the Ministry for the Environment and the Ministry of Agriculture and Forestry advise that the package of decisions will give rise to operating costs that cannot be met through current baselines, totalling \$15.233 million over the forecast period;
- 70 **agreed** that a “Emissions Trading Scheme Review implementation contingency” of \$15.233 million in 2012/13 be established from the Budget 2012 operating allowance, to fund implementation costs that cannot be met through existing agency baselines;
- 71 **authorised** the Minister of Finance, the Minister for Climate Change Issues, and the Minister for Primary Industries, to jointly make decisions on the use of the Emissions Trading Scheme Review implementation contingency, subject to receiving a business cases for funding that has been reviewed by the Treasury;
- 72 **agreed** that decisions in the paper under CAB (12) 76 be subject to funding being available through the Budget 2012 process;

Process and timeline

- 73 **invited** the Minister for Climate Change Issues to issue drafting instructions to the Parliamentary Counsel Office, based on Cabinet’s final and “in principle” decisions on the policy proposals presented in the paper under CAB (12) 76;
- 74 **authorised** the Minister for Climate Change Issues, in consultation with the Minister for Primary Industries as appropriate, to further clarify and develop policy matters relating to the amendments proposed in the paper under CAB (12) 76, in a way that is consistent with Cabinet’s decisions;
- 75 **noted** that the Minister for Climate Change Issues intends to share the paper under CAB (12) 76, drafts of further Cabinet papers on related issues, drafting instructions to the Parliamentary Counsel Office, subsequent drafts of amendments to the Act, and related documents, with the Environmental Protection Agency, as a key agency in the proposed amendments;

Communication and public consultation

- 76 **authorised** the Minister for Climate Change Issues to be responsible for communication and consultation with stakeholders and iwi regarding the proposed amendments and response to the Review Panel’s recommendations;
- 77 **noted** that the consultation will include material outlining the options for offsetting and possible changes to the second tranche of pre-1990 forestry allocation, developed in consultation with the Minister for Economic Development, the Minister and Associate Minister for Primary Industries and the Minister of Maori Affairs;
- 78 **noted** that this consultation will cover decisions made by Cabinet on ETS amendments, prior to the introduction of legislation;
- 79 **invited** the Minister for Climate Change Issues to report back to Cabinet by July 2012 on the results of the consultation and seeking final decisions on the second tranche;

- 80 **noted** that the Minister for Climate Change Issues also intends to submit further papers to Cabinet seeking agreement to changes to synthetic greenhouse gases and waste sectors, and some additional operational and technical changes, in line with the Panel's recommendations and the National Party manifesto, and that these proposed changes may also need consultation;
- 81 **authorised** the Minister for Climate Change Issues to consult on parallel regulatory provisions in relation to:
- 81.1 detailed auction design (in consultation with the Minister of Finance);
 - 81.2 the operation of offsetting (in conjunction with the Minister for Primary Industries).

Secretary of the Cabinet

Reference: CAB (12) 76; EGI Min (12) 3/6; EGI (12) 16
