

**In-Confidence**

Office of the Minister of Forestry

Office of the Minister of Climate Change

Chair, Cabinet Legislation Committee

**Climate Change Response (Late Payment Penalties and Industrial Allocation) Amendment Bill: Approval for Introduction**

**Proposal**

1. We propose to introduce the attached Climate Change Response (Late Payment Penalties and Industrial Allocation) Amendment Bill into the House of Representatives.
2. The Bill gives effect to Cabinet's decisions in July 2022 to update and increase the accuracy of the way the Government allocates free units under the NZ ETS to emissions intensive and trade exposed firms. It also replaces a transitional penalty arrangement for small forests registered in the NZ ETS with a permanent solution.
3. In addition, the Minister of Climate Change proposes including in the Bill one new policy decision to create a fit for purpose process by which new activities can apply for free allocation in the NZ ETS.
4. We also seek agreement to additional minor and technical clarifications in relation to the penalty for small forestry participants.

*Industrial allocation*

5. This Bill will amend industrial allocation policy under the Climate Change Response Act 2002 (the Act) to address the over-allocation of free emission units to emissions intensive and trade exposed activities.
6. Industrial allocation aims to mitigate the risk of emissions leakage (ie, firms closing in New Zealand to be replaced with increased production offshore) by supporting at-risk industry to meet some of its emissions costs. The changes to industrial allocation policy will ensure it aligns with New Zealand's broader climate change goals while continuing to prevent negative economic outcomes.
7. The primary changes are to enable an update to allocative baselines and a reassessment of eligibility with data from recent years. The Bill will also allow the Minister of Climate Change (the Minister) to review and update allocative baselines in the future, introduce some technical improvements, and a process for calculating the electricity allocation factor.
8. Most policy decisions were agreed by Cabinet in July 2022 [CAB-22-MIN-0250 refers]. The Minister seeks agreement to a proposed solution for a

remaining policy issue. It is likely that new activities will have insufficient data to assess eligibility and allocative baselines. The proposal is to allow the use of projected data to inform a provisional assessment which can then be corrected in the future once actual data has been collected. This proposal has been drafted into the Bill.

*Penalties and compliance for small forestry participants*

9. The Bill will also introduce a new penalty for forestry participants in the NZ ETS with 'low volume' liabilities under 25,000 units (small forestry participants), who fail to surrender or repay units by the due date, for forestry activities occurring from 1 January 2025. This penalty will replace the transitional arrangement currently in place for these participants<sup>1</sup> (which Cabinet recently agreed to extend to liabilities from forestry activities occurring up until 31 December 2024 [CAB-22-MIN-0293 refers]).<sup>2</sup>
10. In 2020, Cabinet agreed to the original transitional arrangement [ENV-20-MIN-0017 refers]. In July 2022, Cabinet agreed to extend the transitional arrangement, and delegated policy decision making powers to a sub-group of Ministers [CAB-22-MIN-0293 refers]. Those Ministers made policy decisions on a new penalty in October 2022 [BRF-2164 refers].
11. We seek agreement to additional minor and technical clarifications that have been identified through the Bill drafting process, which have been found to apply to the current transitional arrangement. These clarifications have not been included in the Bill due to drafting timeframes. We therefore propose that they are drafted into the Bill through the Select Committee process or via a Supplementary Order Paper.

**Relation to government priorities**

12. The Government declared a climate change emergency on 2 December 2020. The Cabinet Business Committee (CBC) agreed that climate change "demands a sufficiently ambitious, urgent, and coordinated response across government to meet the scale and complexity of the challenge" [CBC-20-MIN-0097 refers].
13. Enabling a just transition to a low-emissions, climate resilient future is a Government priority. CBC declared its intention to "put the climate at the centre of government decision-making" [CBC-20-MIN-0097 refers].
14. The proposals in this paper relate to the Cooperation Agreement between the Labour and Green Parties. Achieving the purpose and goals of the 2019 amendments to the Act is an agreed area of cooperation.

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<sup>1</sup> Under the transitional arrangement, small forestry participants are subject to the previous 'excess emissions' penalty set at \$30 per unpaid unit, with the ability to be reduced or waived in certain circumstances.

<sup>2</sup> The Climate Change Response (Extension of Penalty Transition for Forestry Activities with Low Volume Emissions Liabilities) Amendment Bill 2022 was recently introduced to the House to implement this change.

15. The proposals in this paper relate to action 5.1 of New Zealand's first emissions reduction plan (ERP), aligning the NZ ETS settings with emissions budgets.

## Policy

### *Industrial allocation*

16. Over-allocation of New Zealand Units (NZUs) to some<sup>3</sup> emissions intensive and trade exposed (EITE)<sup>4</sup> activities has been occurring due to current legislation that requires decade old data to be used for industrial allocation.<sup>5</sup> Since the initial settings in 2010, there has been a shift in energy and fuel profiles, and market players have changed, leading to baselines that do not reflect current emission costs.
17. The mismatch between the allocation provided and the emissions costs faced by activities is resulting in windfall gains to some businesses undertaking EITE activities. Over-allocation is a significant cost to the Crown.
18. Different handling of industrial emissions between countries requires an industrial allocation scheme that considers the risk of emissions leakage. The Bill balances this risk and the need to prevent over-allocation.
19. In 2021, the Climate Change Commission recommended the government consider over-allocation risks, eligibility rules, the electricity allocation factor, and allocative baselines. Cabinet approved the terms of reference for a review of industrial allocation policy in April 2021 [ENV-21-MIN-0009 refers].

### *Updating allocative baselines to address over-allocation*

20. The Bill allows all allocative baselines (the emission cost intensities of production) to be updated with data from new base years.
21. The Bill also adds a tool enabling the Minister to review, and update, activity-specific allocative baselines (only after at least five years) if there is evidence that allocations exceed emissions costs. Further, all allocative baselines will need to be reviewed every ten years following their most recent review to determine if they need updating.
22. It is anticipated that some industrial allocation recipients will oppose the introduction of future reviews and updates of allocative baselines. During a public consultation in 2021, some industrial allocation recipients stated that future updates would result in firms delaying investment in decarbonisation projects to avoid impacts on the firm's allocation. Successful decarbonisation

<sup>3</sup> A data collection in 2020 showed that four EITE activities were over-allocated to some degree. It is expected that other activities are also in a similar position where their rates of allocation exceed their emissions costs.

<sup>4</sup> For the purposes of calculating industrial allocation, emissions-intensive means the activity produces a significant portion of emissions per million dollars of revenue, and therefore there is a significant impact of an emissions price on profitability. Trade-exposure means the activity's output is exposed to international trade, and therefore it is assumed it is difficult to pass on additional costs (such as an emissions price).

<sup>5</sup> Data from the financial years 2006/07, 2007/08, and 2008/09 are currently used and therefore the settings do not accurately reflect current emissions costs.

could lead to a reduction of allocative baselines, affecting the firm's eligibility for industrial allocation.

23. Cabinet agreed to future reviews of allocative baselines no more than every five years to balance the risk that a firm receives allocation exceeding its emissions costs in future with the risk that a firm delays any decarbonisation projects.

*Reassessing eligibility to ensure appropriate levels of support to at-risk industries*

24. The Bill enables a reassessment of eligibility for industrial allocation using new base years and updated emissions intensity thresholds. This recognises that the significant increase in the emissions price in the last two years has led to an increased risk of emissions leakage.
25. Reassessing eligibility will ensure activities receive an appropriate level of assistance. Activities could either move up or down an eligibility category. Any possible increase in allocation is expected to be outweighed by the reduction in over-allocation from reassessing the allocative baselines [DEV-22-MIN-0159 refers].

*New base years for updating allocative baselines and reassessing eligibility*

26. Allocative baselines and eligibility reassessments will use emissions, production, and revenue data from the financial years between 2016/17 and 2020/21.
27. Firms undertaking eligible activities will be required to provide data for all years when calculating an activity's emissions and production (used to inform allocative baselines), and when calculating an activity's emissions and revenue (to inform the eligibility reassessment).
28. Firms will have the option to nominate the exclusion of data from one of either 2019/2020 or 2020/2021 financial year from the calculations of emissions, production, and revenue data across the entire period. This is to smooth out any distortions resulting from COVID-19 and the COVID-19 response.

*Changing the approach to assessing eligibility for new activities*

29. The process for new activities<sup>6</sup> to seek eligibility for industrial allocation will be amended. The Bill defines criteria the Minister must consider before recommending a new activity to be added, similar to section 84C(3) of the Act in relation to increases in phase-out rates.
30. Only new activities' eligibility, and not activities currently eligible, will be subject to the additional criteria the Minister must consider.
31. The Bill will not make changes to the process that is set out at section 161A(1) of the Act. A new activity will therefore be recognised as eligible for industrial

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<sup>6</sup> Note that "new activities" are defined as any activity not defined in Regulations at the time eligibility is sought.

allocation by the Governor General, via Order in Council, on the Minister's recommendation.

*Remaining policy issues for new activities*

32. Cabinet agreed that the eligibility assessment for new activities requires consideration against criteria outlined in section 84C(3) of the Act. However, the issue remains that new activities may not have sufficient actual emissions, production, or revenue data needed to determine the level of assistance and allocative baselines once eligible.
33. The Minister of Climate Change therefore proposes for new activities:
  - 33.1. the current emissions intensity and trade exposure tests are retained for determining the eligibility of a new activity, to enable government to determine an appropriate level of assistance for a new activity; in addition to the Minister being required to consider criteria outlined in section 84C(3) of the Act;
  - 33.2. applicants without data from the specified financial years are required to provide projected emissions, production, and revenue data for the emissions intensity test, and to calculate an initial allocative baseline (the rate of allocation for any eligible activity);
  - 33.3. where eligibility has been initially derived from any projections, the Minister of Climate Change sets the level of assistance<sup>7</sup> in line with that of moderately emissions-intensive activities, given the uncertainty associated with a firm's projected data;
  - 33.4. after a period of time (specified by the Minister), applicants that provided projected data will be required to submit actual operational data. This will be used to determine a final eligibility assessment and allocative baseline(s); and
  - 33.5. a wash-up is calculated following the reassessment using actual data to correct the initial allocations derived from projections.<sup>8</sup>
34. As this approach was not consulted on in 2021 along with the other policy proposals for new activities, this approach may need further refinement following introduction of the Bill, such as through the Select Committee process.

*Enabling easier updates to allocative baselines*

35. The Bill simplifies the process to update allocative baselines, using previously submitted data to reflect changes to NZ ETS emissions factors, the electricity allocation factor, or NZ ETS exemption thresholds. These changes do not require consultation. This is different from updating baselines using new base

<sup>7</sup>Any level of assistance is subject to the relevant phase-out rate. This is currently 0.01 per year.

<sup>8</sup>For example, if the Minister determines that the activity does not meet the moderate emissions intensity threshold based on actual data, the applicant is required to return all units that were allocated.

years as it is a merely technical adjustment to reflect changes occurring in the NZ ETS and electricity market.

*Enabling easier access to data*

36. Upon request, the Environmental Protection Authority will be required to share information, submitted in industrial allocation applications, with the Ministry for the Environment or the Climate Change Commission. This is to enable better access to this data and aid the monitoring of industrial allocation policy.
37. The data may meet the threshold of commercially sensitive information. The Ministry for the Environment has a protocol in place for managing commercially sensitive information.

*Setting up a new electricity allocation factor methodology*

38. The Bill will introduce a high-level framework for calculating the electricity allocation factor (EAF) used in allocative baselines. The EAF will be calculated by the Electricity Authority from an electricity market model that is publicly and freely available, including all input data.
39. The EAF set in regulations for a particular year is the average of the yearly ETS impact on the price of electricity from the last three years. A calculation based on a three-year rolling average will help reduce volatility and provide allocation recipients with a level of certainty. No public consultation on updating the three-year rolling average EAF annually will be required due to the regular and technical nature.
40. The Minister will be able to set modelling assumptions in regulations that are required to be used when calculating the EAF. Setting these in regulation will ensure that critical assumptions in the calculation are observed, while allowing the flexibility to update them if circumstances change. Prior consultation with those significantly affected is required, except for the first tranche of assumptions.

***Penalties and compliance for small forestry participants***

41. The Climate Change Response (Emissions Trading Reform) Amendment Act 2020 introduced a revised penalty and compliance regime that came into force for most NZ ETS participants and eligible persons on 1 January 2021.
42. This included strengthening the penalty that applies when a person fails to surrender or repay ('pay') units by the due date (the 'three to one' penalty). The 'three to one' penalty is an absolute liability penalty; set at three times the price of carbon (as set in regulations) for each unpaid unit. For forestry participants, this obligation usually arises when forest land in the NZ ETS is harvested, deforested, or deregistered.
43. The stringency and size of the 'three to one' penalty was influenced by New Zealand's interest in being able to link with international emissions trading schemes in the future. s 9(2)(j)

44. In 2020, Cabinet agreed to defer the introduction of the 'three to one' penalty for forestry participants with low volume liabilities of less than 25,000 units on average per year (small forestry participants) occurring up until 31 December 2022. This was because the impacts of applying this penalty were considered disproportionate to the level of non-compliance, as they could lead to serious financial hardship, potentially putting personal assets such as homes or farms at risk.
45. Cabinet agreed that the previous 'excess emissions' penalty would continue to apply to small forestry participants while officials investigated the full-scale impacts of applying the 'three to one' penalty to small forestry participants (the 'transitional arrangement') [ENV-20-MIN-007 refers].
46. After having investigated the full-scale impacts, officials consider that the risks of applying the new 'three to one' penalty to small forestry participants persist. Furthermore, given the sharp increase in the carbon price, these risks are likely to be exacerbated. Cabinet has not agreed to any changes to the penalties faced by participants in other sectors at this time. The Ministry for the Environment will continue to monitor the effectiveness and appropriateness of the 'three to one' penalty for other NZ ETS participants.
47. Therefore, Cabinet has recently agreed to extend the transitional arrangement currently in place for small forestry participants until 31 December 2024 [CAB-22-MIN-0293 refers]. This was to allow time for a new penalty to be introduced from 1 January 2025, and for participants to be educated on this change.

*Introducing a new penalty for small forestry participants who fail to pay units*

48. The Bill will introduce a new, more proportionate penalty for small forestry participants who fail to pay units by the due date for forestry activities occurring from 1 January 2025. This new penalty will apply in addition to the original obligation for participants to pay units.
49. The new penalty is a strict liability penalty, set at half the price of carbon (as set in regulations) for each unpaid unit. The total penalty is halved for small forestry participants who deforest pre-1990 forest land. This is to recognise important differences between pre-1990 participants, who become mandatory NZ ETS participants if they deforest their land and post-1989 participants, who voluntarily choose to register in the NZ ETS to earn units for carbon sequestration. Like all strict liability regimes, the penalty will be waived when small forestry participants can prove total absence of fault.<sup>9</sup>
50. The new penalty is designed to effectively deter non-compliance while treating participants fairly and equitably, including helping to protect the rights and interests of Māori. It is intended to be straightforward for the regulator to apply consistently and transparently, creating certainty for participants to help them understand their obligations and minimise administrative costs.

<sup>9</sup> The 'total absence of fault' provision will align with the standard 'total absence of fault' defence defined by the New Zealand courts. MPI will continue to work with the Environmental Protection Authority (as the regulator) to develop operational guidance on how the 'total absence of fault' provision will apply in practice.

51. As most international schemes do not include forestry, and often exclude emitters who emit less than 25,000 tonnes of carbon dioxide equivalent per year, the new penalty is not expected to impact on New Zealand's ability to link with international carbon markets in the future.
52. Several alternative options for the new penalty were considered, including variations of a strict liability penalty with differing penalty rates, as well as a discretionary penalty based on the participant's level of culpability. However, these options were considered less suitable as they did not best achieve the intended outcomes.

*Legislative clarification required to implement the new penalty*

53. Implementing the new penalty will require additional clarifications to the legislation to ensure that the regulator can apply the penalty without ambiguity.
54. The Bill will introduce minor and technical amendments to clarify how the 25,000-unit penalty threshold (which determines whether a participant is a 'small forestry participant') applies to forestry participants who submit:
  - 54.1. emissions returns containing part years (for example, if NZ ETS registered land is sold part way through the year, the emissions return period would cover part years); and
  - 54.2. incorrect emissions returns that are subsequently corrected by the regulator.
55. The Bill will also clarify which penalty (the 'excess emissions' penalty or the new penalty) will apply to small forestry participants who submit emissions returns including liabilities from forestry activities occurring both before and after 1 January 2025.

*Extending legislative clarifications to the current transitional arrangement*

56. In October, the sub-group of Ministers agreed to implement the minor and technical clarifications to the legislation outlined in paragraph 54 above in relation to the new penalty.
57. These clarified how the 25,000-unit penalty threshold (which determines what penalty applies) will apply to forestry participants who submit emissions returns containing part-years, and incorrect emissions returns.
58. It has been identified through the drafting process for the Bill that the same ambiguities leading to those changes apply when implementing the transitional arrangement (excess emissions penalty) currently in place for small forestry participants.<sup>10</sup>
59. We propose that these previously agreed minor and technical clarifications be extended to the provisions giving effect to the transitional arrangement. They will take effect from the day after the Bill receives Royal assent (before the

<sup>10</sup> Set out in Clause 17, Schedule 1AA of the Act.



new penalty comes into force on 1 January 2025). The clarifications will apply to penalties issued from this date onwards, including penalties relating to forestry activities carried out prior to this date (from 1 January 2021 onwards, the date the transitional arrangement first came into force).

## Impact analysis

### *Industrial allocation*

60. A regulatory impact statement<sup>11</sup> was prepared in accordance with Cabinet's impact analysis requirements and was submitted at the time that Cabinet approval was sought to the reform of industrial allocation in the NZ ETS [CAB-MIN-22-0250 refers].

61. The Panel's initial statement said:

*"The Ministry for the Environment's Regulatory Impact Analysis Panel has reviewed this Regulatory Impact Statement and considers it partially meets the quality assurance criteria for Regulatory Impact Assessments.*

*The Regulatory Impact Statement makes a good case for change. The underlying analysis is robust, complete, and shows adequate consultation with affected parties. However, the analysis section does not communicate in a way that is easily understandable by decision makers or the public and could be shortened and simplified."*

62. The regulatory impact statement has been revised to reflect the proposed approach for assessing eligibility for new activities. The Panel has made an additional statement:

*"The Ministry for the Environment's Regulatory Impact Analysis Panel has reviewed the update to this Regulatory Impact Statement, which now considers an additional option for decision 2, Section 2.4. The panel's previous assessment remains unchanged following this update."*

63. There are no additional financial implications of the proposed approach as these changes seek to clarify an existing process for new activities to seek eligibility for industrial allocation. There are financial implications for any new activity being granted eligibility for industrial allocation, as is the case under current policy settings.

64. The Treasury's Regulatory Impact Analysis team has determined that the proposal regarding implementation of the revised electricity allocation factor is exempt from the requirement to provide a Regulatory Impact Statement on the grounds that it has been addressed by existing impact analysis<sup>12</sup> [ENV-21-MIN-0041].

<sup>11</sup> <https://www.treasury.govt.nz/publications/risa/regulatory-impact-statement-reform-industrial-allocation-policy-nz-ets>

<sup>12</sup> <https://www.treasury.govt.nz/publications/risa/regulatory-impact-statement-updating-electricity-allocation-factor-used-nz-ets>

*Penalties and compliance for small forestry participants*

65. A regulatory impact statement<sup>13</sup> was prepared in accordance with Cabinet's impact analysis requirements and was submitted at the time that Cabinet approval was sought for consultation on options to amend the surrender or repayment penalty for small forestry participants in the NZ ETS [CAB-22-MIN-0293 refers].
66. This regulatory impact statement has been revised to incorporate the final proposal for the new penalty. The MPI Regulatory Impact Analysis Panel has reviewed the Regulatory Impact Statement: *Changing the surrender/repayment penalty for small forestry participants in the New Zealand Emissions Trading Scheme* produced by MPI dated 14 November 2022. The review team considers that it partially meets the Quality Assurance criteria.
67. The review team has commented: "The Regulatory Impact Statement: *Changing the surrender/repayment penalty for small forestry participants in the New Zealand Emissions Trading Scheme* produced by MPI is a clear and concise document, setting out the limitations of the assessment undertaken and providing clear recommendations within the scope of the consideration undertaken. The proposals have benefited from public engagement and options considered, developed and refined in response to this engagement. However, the RIA does not fully show how the status quo 3:1 penalty disproportionately affects smaller forestry participants as against larger participants. Given the limitations around this proposal, it is unlikely that the RIA could make this clear."

**Climate Implications of Policy Assessment**

*Industrial allocation*

68. The Climate Implications of Policy Assessment (CIPA) team confirmed that the CIPA requirements did not apply to the policy proposal approved by Cabinet in July 2022 [CAB-MIN-22-0250 refers]. This was because there is either no direct impact on emissions or because the threshold for significance was not met.

*Penalties and compliance for small forestry participants*

69. The Climate Implications of Policy Assessment (CIPA) team has been consulted and confirms that the CIPA requirements do not apply to this proposal as the threshold for significance is not met. Any climate implications would be indirect and not quantifiable at this moment.

**Compliance**

70. The Bill complies with:

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<sup>13</sup> <https://www.mpi.govt.nz/dmsdocument/52462-Interim-regulatory-impact-statement-Consultation-on-options-to-amend-the-surrenderrepayment-penalty-for-small-forestry-participants-in-the-New-Zealand-ETS>

- 70.1. the principles of the Treaty of Waitangi;
- 70.2. the rights and freedoms contained in the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993;
- 70.3. the disclosure statement requirements;
- 70.4. the principles and guidelines set out in the Privacy Act 2020;
- 70.5. relevant international standards and obligations, including human rights obligations;
- 70.6. the Legislation Guidelines (2021 edition), which are maintained by the Legislation Design and Advisory Committee.

### **Te Tiriti o Waitangi / Treaty of Waitangi implications**

71. Te Tiriti/Treaty principles require that the Crown be properly informed of Māori interests and act reasonably and with the utmost good faith towards Māori. Māori have a significant stake in climate policy.
72. There is a strong Māori interest in the NZ ETS. This is driven by a commitment to reduce emissions and address climate change, but also by the potential impacts of emissions pricing on Māori involvement in forestry and agriculture as these sectors particularly dominate Māori economic development and employment. In particular, forestry can support the social, environmental, and economic aspirations of Māori whānau, hapū and iwi.
73. An immediate interest in industrial allocation lies with firms receiving an allocation and many of which are owned or majority-owned by overseas entities. Māori interests may be affected rather as a result of changes in industrial allocations: for example, when the closure of a firm leads to significant job loss in regions with a high proportion of Māori.
74. An immediate interest in the new penalty lies with Māori forest owners whose forest land is subject to the NZ ETS, as many of them fall within the 'small forestry participant' category.
75. Small forestry participants are often individual persons with lower financial capabilities as opposed to well-established and sophisticated corporations, such as small farm foresters or small Māori trusts. The new penalty that will apply to small forestry participants if they fail to pay units by the due date for forestry activities occurring from 1 January 2025, is intended to mitigate the risk of serious hardship that the 'three to one' penalty poses to these participants.
76. In addition, nearly half of Māori freehold land and most production forestry land returned as part of Treaty of Waitangi settlements is likely to be considered pre-1990 forest land that is subject to NZ ETS liabilities if that land is deforested. Where these liabilities are not met on time, the penalty for failing to pay units (covered by the Bill) arises.

77. To recognise important differences between pre-1990 forestry participants (who become mandatory NZ ETS participants if they deforest their land) and post-1989 forestry participants (who voluntarily choose to register in the NZ ETS to earn units for carbon sequestration), and to further mitigate the risk of serious hardship arising from that penalty for pre-1990 forestry participants, a penalty rate that is half that for post-1989 forestry participants, will apply to pre-1990 forestry participants.
78. The development of the new penalty took into consideration feedback received through public consultation, which involved holding webinars with key stakeholders and other interested parties, 36 percent of whom indicated they represented the interests of Māori/iwi (9 submitters).
79. Of the submitters who indicated they represented the interests of Māori, some stated that a lack of awareness of NZ ETS obligations among small forestry participants means that unit liabilities can be unexpected. This feedback was taken into consideration when developing the new penalty, by applying a significantly lower rate in comparison to the “three to one” penalty, and as noted, applying a reduced penalty rate for pre-1990 forestry participants, in recognition of their particular circumstances when interacting with the NZ ETS, compared with post-1989 participants.
80. The new penalty will not be introduced until 1 January 2025, to allow officials time to deliver an education package about the new penalty. This is intended to ensure that participants have the time and resources required to understand their obligations and the penalties involved if they fail to meet them. A focus of this work will be raising awareness and understanding of the NZ ETS obligations by owners of pre-1990 forest land.

### Consultation

81. This Cabinet paper has been drafted by the Ministry for the Environment and the Ministry for Primary Industries. The following agencies were consulted<sup>14</sup>: Ministry of Business, Innovation and Employment, the Treasury, the Ministry of Foreign Affairs and Trade, the Ministry for Primary Industries, the Ministry of Justice, Te Manatū Waka Ministry of Transport, the Inland Revenue Department, the New Zealand Customs Service, the Electricity Authority and the Environmental Protection Authority. Their feedback has been incorporated. Te Puni Kōkiri and the Department of the Prime Minister and Cabinet were informed.

### Binding on the Crown

82. The Bill is binding on the Crown.
83. The Act binds the Crown (section 5), and the Bill does not change this.

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<sup>14</sup> At the time of agency consultation, a draft version of the Bill containing provisions on the new penalty for small forestry participants amendment was not available.

### **Associated regulations**

84. Subject to amendments to the Act, changes are needed to the Climate Change (Eligible Industrial Activities) Regulations 2010.

#### *Regulations set input assumptions for modelling the electricity allocation factor*

85. Modelling assumptions for the electricity allocation factor are to be placed in Regulations.<sup>15</sup> The first two assumptions will be:
- 85.1. thermal generation would be offered at lower prices than the prices currently offered to sell thermally generated electricity on the basis that liabilities to surrender units to cover emissions result in offers at relatively high prices; and
  - 85.2. hydroelectric generation plants with controllable storage would subsequently reduce their offer prices in response to assumption 1 due to lower opportunity costs associated with hydroelectric generation where thermal offer prices are lower.
86. The changes to the Regulations will enter into force immediately upon the Royal assent of the Bill.

#### *Regulations for prescribing updated allocative baselines and levels of emissions intensity*

87. Once a data collection has been undertaken to attain updated data and recalculate eligibility decisions and allocative baselines, these will need to be placed in the Climate Change (Eligible Industrial Activities) Regulations 2010. Depending on eligibility sought by new activities – new activity definitions and baselines will be needed in these regulations.
88. Cabinet approval will be sought for these regulation updates in 2024.

### **Other instruments**

89. The Bill does not include any provision empowering the making of other instruments that are deemed to be legislative instruments or disallowable instruments.
90. The Bill will make some changes to sections 161A and 161D of the Act that allow for making regulations and issuing notices. However, these changes do not include new empowering provisions.

### **Commencement of legislation**

91. The Bill will come into force on the day after the date of Royal assent.

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<sup>15</sup> The electricity allocation factor reflects the cost impact of the NZ ETS on electricity prices and is used when determining how much support to provide via industrial allocation.

**Parliamentary stages**

92. We propose that the Bill should be introduced in December 2022 and passed by July 2023.
93. We propose that the Bill be referred to the Environment Select Committee for consideration.

**Proactive Release**

94. We propose to proactively release this Cabinet paper on the Ministry for the Environment's and the Ministry for Primary Industries' websites, following introduction of the Bill. Redactions will be made consistent with the Official Information Act 1982.

Proactively released under the provisions of the Official Information Act 1982

## Recommendations

The Minister of Climate Change recommends that the Committee:

1. **Note** that the Climate Change Response (Late Payment Penalties and Industrial Allocation) Amendment Bill (the Bill) will amend industrial allocation policy in the New Zealand Emissions Trading Scheme (NZ ETS).
2. **Note** that most policy decisions for the Bill were agreed by Cabinet in July 2022 [CAB-MIN-22-0250 refers].
3. **Note** that a remaining issue requires a decision from Cabinet, which is being sought in this paper, alongside approval to introduce the Bill.
4. **Note** that based on July's policy decisions, the Bill:
  - 4.1. enables a review and update of allocative baselines using new base years, and the framework for potential updates in the future
  - 4.2. enables a reassessment of the eligibility for industrial allocation using new base years, and updated emissions intensity thresholds
  - 4.3. updates some technical areas of industrial allocation policy, including the modelling framework for the electricity allocation factor, amending the eligibility process for new activities, simplifying the process for updating allocative baselines, and enabling easy access to information submitted to the Environmental Protection Agency.

### *Additional policy decision for new activities' eligibility process*

5. **Note** that policy decisions taken by Cabinet in July allow new activities existing after the financial year 2020/21 to seek eligibility via the assessment of criteria under section 84C(3) of the Climate Change Response Act 2002 (the Act).
6. **Note** that the intent of using these criteria is to provide a more rigorous test for prospective activities to ensure eligibility for industrial allocation is weighed against both the risk of emissions leakage and meeting New Zealand's broader climate goals.
7. **Note** that a level of assistance (percentage of emissions costs covered by industrial allocation) and a new activity's allocative baseline are both required for calculating the industrial allocation to a firm undertaking a new activity.
8. **Note** that criteria in section 84C(3) of the Act cannot be used to calculate an activity's level of assistance or allocative baseline because new activities will not have actual emissions, production, or revenue data needed to determine them.
9. **Agree** to retain the emissions intensity and trade exposure test for the purpose of new activities seeking eligibility.

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10. **Agree** that the Minister of Climate Change will still be required to assess the criteria of section 84C(3) of the Act in addition to the emissions intensity and trade exposure test for determining the eligibility of a new activity.
11. **Agree** that any new applicant must provide projections of its expected annual emissions costs, production, and revenue, to enable a tentative calculation of both their emissions intensity for the purpose of eligibility and its allocative baseline(s).
12. **Agree** that if a new activity is found to be eligible, the initial level of assistance will be set at the moderately emissions intensive level, subject to the relevant phase-out rate.
13. **Note** that applicants carrying out a new eligible activity are entitled to receive a final allocation for the relevant year and a provisional allocation for the following year.
14. **Agree** that for any new activity, a specified amount of actual financial-year data must be provided before a specific period of operation is complete (amounts and periods to be specified by the Minister) to:
  - 14.1. inform a reassessment of emissions intensity against the emissions intensity thresholds, and
  - 14.2. recalculate the allocative baselines as appropriate.
15. **Agree** that the activity's eligibility (and therefore the appropriate level of assistance), and its allocative baseline(s) will be updated using actual data.
16. **Agree** that if the new activity was found to be ineligible based on actual data – any firm undertaking the activity would be liable to repay the units received to the Crown.
17. **Agree** that if the new activity is found to remain eligible but has been under or over-allocated, a wash-up will occur which requires firms undertaking the new activity to either repay units received to the Crown, or the Crown to allocate more units.
18. **Note** that subject to your agreement, the Bill enables this process for assessing eligibility for new activities.

The Minister of Forestry and the Minister of Climate Change recommend that the Committee:

19. **Note** that the Bill will introduce a new penalty that will apply to forestry participants in the NZ ETS with low volume liabilities of less than 25,000 units on average per year (small forestry participants) who fail to surrender or repay units by the due date for liabilities occurring from 1 January 2025. The new penalty is:
  - 19.1. a strict liability penalty that may be waived by the EPA where 'total absence of fault' applies



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- 19.2. set at half the price of carbon (as set in regulations) for each unpaid unit.
- 19.3. halved for small forestry participants who deforest pre-1990 forest land.
20. **Note** that the Bill will also make minor amendments to the legislation to clarify how the penalty will apply in practice. These amendments are:
- 20.1. where a participant files an emissions return containing part-years, that part-years will be treated as full years for the purpose of calculating whether a liability exceeds the 25,000 unit threshold, rather than pro-rating this threshold across part-years
- 20.2. where an emissions return that has already received a penalty notice relating to the new penalty is amended by the regulator to correct a unit obligation, and a subsequent penalty is incurred for any additional units owing as a result of the amendment, the subsequent penalty will be based on the subsequent unit amount only for the purpose of determining whether the liability exceeds the 25,000 unit threshold
- 20.3. where an emissions return covers activities occurring both before and after 1 January 2025, to prevent situations arising where two different penalty regimes apply to a single emissions return, the excess emissions penalty currently in place under the transitional arrangement will apply to the entire emissions return, meaning it will effectively be extended to activities occurring up until 31 December 2025.
21. **Note** that policy decisions made on the new penalty (recommendation 19) and legislative clarifications (recommendation 20) were agreed by a sub-group of Ministers (Minister of Forestry, Minister of Climate Change, Minister of Finance and Minister for the Environment), given delegated authority for that purpose by Cabinet [CAB-22-MIN-0293 refers].
22. **Note** that the transitional arrangement currently in place for small forestry participants who fail to surrender or repay units by the due date is being extended to cover liabilities from forestry activities occurring up until 31 December 2024. This process is underway separately via the Climate Change Response (Extension of Penalty Transition for Forestry Activities with Low Volume Emissions Liabilities) Amendment Bill 2022, which was introduced into the House on 4 October 2022.
- Additional policy decision to extend legislative clarifications*
23. **Note** that the Bill will make minor amendments to the legislation to clarify how the penalty will apply in practice, including how the 25,000-unit penalty threshold applies to forestry participants who submit emissions returns containing part-years, and incorrect emissions returns (recommendations 20.1 and 20.2 above).
24. **Agree** to extend these minor and technical clarifications to apply to the provisions giving effect to the transitional arrangement, effective from the day

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after the Bill receives Royal assent (applicable to penalties issued from this date onwards, including penalties relating to forestry activities carried out prior to this date). These amendments are:

- 24.1. where a participant files an emissions return containing part-years, that part-years will be treated as full years for the purpose of calculating whether a liability exceeds the 25,000 unit threshold, rather than pro-rating this threshold across part-years; and
  - 24.2. where an emissions return that has already received a penalty notice relating to the 'excess emissions' penalty is amended by the regulator to correct a unit obligation, and a subsequent penalty is incurred for any additional units owing as a result of the amendment, the subsequent penalty will be based on the subsequent unit amount only for the purpose of determining whether the liability exceeds the 25,000 unit threshold.
25. **Note** that we will seek to implement these clarifications through the Select Committee process or through a Supplementary Order Paper.
  26. **Approve** the Climate Change Response (Late Payment Penalties and Industrial Allocation) Amendment Bill for introduction, subject to the final approval of the Government caucus and sufficient support in the House of Representatives.
  27. **Agree** that the Bill be introduced by early December 2022 and referred to select committee before the end of year recess.
  28. **Agree** that the Government propose that:
    - 28.1. The Climate Change Response (Late Payment Penalties and Industrial Allocation) Amendment Bill be referred to the Environment Select Committee for consideration
    - 28.2. The Environment Select Committee be given a deadline to report back on the Climate Change Response (Late Payment Penalties and Industrial Allocation) Amendment Bill by 2 May 2023
    - 28.3. The Climate Change Response (Late Payment Penalties and Industrial Allocation) Amendment Bill be enacted by 1 July 2023.

Authorised for lodgement

Hon Stuart Nash  
**Minister of Forestry**

Hon James Shaw  
**Minister of Climate Change**