

Office of the Minister for Climate Change Issues

Chair

Cabinet Economic Growth and Infrastructure Committee

Emissions Trading Scheme Review 2012 – proposed amendments to the Climate Change Response Act 2002

Proposal

1. This paper seeks Cabinet decisions to the most significant proposed amendments to the Climate Change Response Act 2002 (the Act) in response to the 2011 Review of the New Zealand Emissions Trading Scheme (ETS), National Party manifesto commitments, international developments (including developments in and with Australia) and further analysis.

Executive summary

2. I am proposing a range of amendments to the Act to:
 - implement key recommendations of the 2011 ETS Panel;
 - implement key commitments in the National Party's Manifesto;
 - ensure the ETS delivers an appropriate level of international emissions reduction effort (through both domestic emissions reductions and purchasing emissions reductions abroad) post-2012;
 - provide flexibility to link the ETS, if that should prove desirable, to the Australian Carbon Pricing Mechanism from 2015; and
 - improve the technical operation of a number of parts of the Act.
3. To enable amendments to be passed by the end of 2012, it is necessary for Cabinet to make decisions on the substantive legislative proposals contained in this paper, in order that legislative drafting may take place over March-April 2012.
4. Because of the number and complexity of changes, and the short timeframes in which to make changes to the legislation, I intend to submit further Cabinet papers over the next few months seeking approval for other specific more operational changes to the Act.
5. Key strategic drivers for my most significant proposals, outlined in this Cabinet paper are to:
 - ensure that the ETS more effectively supports the government's economic growth priorities: providing more flexibility and mitigating short term costs for business whilst ensuring clear long term price signals that encourage a smooth transition to a low carbon economy.

- ensure that the ETS is flexible enough to cater for a range of international outcomes in the period 2013 to 2020; and in particular can more precisely deliver whatever level of international emissions reduction effort New Zealand may wish to demonstrate in this period.
6. The proposals I set out in this Cabinet Paper are:
- the introduction of a mechanism to allow the auctioning of New Zealand Units (NZUs), a cap on the number of NZUs issued (allocated to non-forest sectors and auctioned) and a limit on the number of international units surrendered – this will ensure that Ministers can more precisely adjust the level of effort that the ETS achieves to New Zealand’s international or domestic commitments;
 - phasing out the ‘one-for-two’ obligation more slowly over 2 years from 2012 – this will mitigate short term costs and provide for a smoother transition into full obligations;
 - extending the \$25 fixed price option until 2015 – this will provide greater carbon price certainty to business;
 - a discretionary regulatory power to defer for a period of 3 years the entry of agriculture into the ETS, should a set of conditions not be met and subject to the outcome of a review in 2014 – this will provide additional flexibility to implement any outcome from the 2014 review, prior to the application of surrender obligations to agriculture in 2015. **[Withheld under s9(2)(h)]**;
 - the introduction of offsetting for pre-1990 forests, to mirror the international rules for Flexible Land Use successfully negotiated at Durban – this will provide more flexibility to ensure that land can be used for its highest value use;
 - consultation on the cancellation or reduction of the second tranche of allocation to pre-1990 forests - in recognition of the additional flexibility and reduction in deforestation liabilities provided by offsetting. I propose that the government consult on three options: full cancellation; adjustment so that all land owners receive the same allocation of 11 NZUs per ha; and cancellation only for those who take up offsetting.
 - confirmation that the ETS will apply the same Global Warming Potentials (GWPs) in obligations under the ETS that will apply to New Zealand’s international reporting and accounting after 2012.
7. The Government has previously signalled possible adjustments to the second tranche, including through the legislation, allocation plan consultations and letter to allocation recipients (appendix 3 sets out published statements). Given the scale of the reduction in deforestation liabilities provided by offsetting, a reduction of the second tranche by around 55% may be most reasonable, noting that these foresters have received the full first tranche. This could be achieved by awarding all land owners a common rate of 11 NZUs per hectare; or through a pro rata cancellation that reduces the second tranche in proportion to land owners’ existing entitlements

8. However, **[Withheld under s9(2)(h)]** consultation with foresters and iwi will be required before the final decision on the second tranche can be made. Iwi will be important stakeholders in this consultation. **[Withheld under s9(2)(g)(i)]**. I propose to launch the consultation at a hui to be organised by CCILG on 14th March 2012.
9. Given the need to consult on some or all of the second tranche, I propose that Cabinet make an 'in principle' decision on the transition phase (which has the most significant fiscal cost) -pending a final decision in May following consultation. Accordingly, I will also seek final decisions on appropriations in May.
10. I am also seeking agreement to undertake formal consultation on some regulatory and implementation matters in parallel to the legislative process, and to set up an informal stakeholder reference group in order to test current proposals and modifications as they arise and ensure a smoother select committee process.
11. Depending on the approach taken to the second tranche following consultation, the proposed amendments above are estimated to give rise to the following fiscal impacts over the period 2012/13 – 2015/16.
 - a net fiscal saving of approximately \$179.777 million if the second tranche were cancelled in full;
 - a net fiscal saving of around \$34.037 million if the second tranche were reduced to a common rate of 11 NZUs per hectare, or otherwise reduced by around 55%;
 - a net fiscal cost of up to \$140.192 million if the second tranche were cancelled only for those who take up offsetting.
12. The estimated fiscal impact includes the impact of applying revised GWPs. I note that the distribution of costs and savings are likely to mean that the majority of savings will fall in the 2011/12 financial year, whilst the majority of costs will fall in the 2012/13 to 2014/15 financial years (see Table 1).

Table 1: Net fiscal impact of proposed policy changes (\$ million)¹

	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

13. Timing will be tight for the introduction of legislation. Given that the transition phase will end soon and that obligations for the waste and synthetic greenhouse gases sectors begin in 2013, it is highly desirable to pass an amendment bill in November 2012. This will require introduction in June 2012.
14. Therefore, I am seeking Cabinet approval to delegate to the Minister for Climate Change Issues, in consultation with Minister of Primary Industries as appropriate, power to make final decisions to further clarify and develop policy matters in accordance with the amendments set out in this paper.

¹ Estimates have been calculated using IPCC AR2 global warming potentials.

Background

15. In December 2010, I appointed an independent panel (the Panel) to undertake a statutory review of the ETS, as required by the CCRA. The Review Panel delivered its final report to me on 30 June 2011.²
16. On 18 July 2011, Cabinet invited the Minister for Climate Change Issues to report to Cabinet by February 2012 (through the relevant Cabinet committee) with proposed changes to the ETS based on the Panel's recommendations, developments in and discussions with Australia and further analysis [Cab min (11) 27/15 refers].

Purpose and objective of the ETS

17. The ETS is currently New Zealand's primary tool to meet its international obligations to reduce greenhouse gas emissions, and assist the transition to a low carbon economy. The ETS incentivises businesses and households to reduce their greenhouse gas emissions by imposing a price on these emissions. It discourages deforestation and encourages afforestation. It also creates a market under which participants with obligations can source emissions reductions at least cost.
18. In November 2010, Cabinet agreed that the Panel should focus on the following objectives for the ETS with its terms of reference, specifically that the ETS should:
 - help New Zealand to deliver its 'fair share' of international action to reduce emissions, including meeting any international obligations;
 - deliver emission reductions in the most cost effective manner; and
 - support efforts to maximise the long term economic resilience of the New Zealand economy at least cost.
19. I consider that these objectives remain valid.

Operation of the scheme to date

20. Forestry entered the ETS on 1 January 2008, and emissions from liquid fossil fuels, stationary energy and industrial processes entered in July 2010. The waste and synthetic greenhouse gas sectors are due to enter the ETS in January 2013 and the agriculture sector in January 2015.
21. The implementation of the ETS has been complex but, in my view, highly successful. Feedback from participants with obligations indicates general comfort with the operation of the scheme to date, and a desire to maximise stability. Early signs are encouraging that businesses and foresters are factoring the carbon price into their long-term decisions.

2 Doing New Zealand's fair Share, ETS Review 2011: Final report, ETS Review Panel, 30 June 2011.

22. New Zealand is on target to meet its Kyoto obligations, largely because of post-1989 forest planting and deforestation controls. Whilst non-forestry emissions have grown over the last two decades, net emissions are down for two consecutive years, the first time since 1990. Without the scheme, the government (and taxpayer) could have faced a substantially greater cost of meeting New Zealand's obligations through paying for increased emissions.

Review of the ETS

23. A key focus for the ETS Review Panel was the international framework New Zealand would face after 2012 following the end of its Commitment Period 1 (CP1) commitments under the Kyoto Protocol.
24. The Panel found that, even without an international obligation to reduce emissions in the short term, it is in New Zealand's long-term economic interests to continue to change behaviour and that the incentives to do so should increase over time through a price on emissions.
25. However, the Panel agreed that there needs to be an appropriate balance between managing short-term uncertainties and competitiveness risks faced by New Zealand, with the need to provide certainty about the long term direction.
26. Accordingly, the Panel made 61 recommendations on the ETS (see Appendix 1), the most significant of which were:³
- the more gradual removal of the transition phase measures to help minimise the short-term impact of the ETS on the economy;
 - the agriculture sector to enter the ETS in 2015 as scheduled, but that a transition phase be applied for a smoother transition into the ETS;
 - the introduction of 'offsetting' for pre-1990 forests, which would allow emissions from deforestation to be 'offset' by equivalent forest plantings elsewhere.
27. Overall, I believe the Panel's recommendations are sensible and strike an appropriate balance between short-term costs and long-term economic resilience.

National Party Manifesto

28. Subsequent to the release of the Review Panel's report, the National Party Manifesto included a commitment to slow the phasing in of the ETS and to further amend the ETS as follows:
- extend the transitional implementation phase for the electricity, industrial, and transport sectors;
 - maintain the fixed-price option at \$25 per tonne of CO₂-equivalent (t/CO₂-e) until 2015;

3 Not all of the Panel's recommendations require legislative amendment.

- introduce offsetting for pre-1990 forest land owners from 1 January 2013;
- in light of the introduction of offsetting, review the second tranche of compensation for pre-1990 forest land owners faced with a loss of value because of restricted land use;
- review the 1 January 2015 legislated entry of agricultural emissions into the ETS in 2014 and only impose a liability if there are practical technologies to reduce emissions and if our trading partners have made further progress with their climate change policies;
- explore the 2011 Review Panel recommendations on providing the option of an averaging approach to carbon credits for post-1989 forest owners;
- advance trans-Tasman discussions on linking the New Zealand and Australian carbon markets for the post-2015 period;
- work with Local Government New Zealand on ETS exemptions for small landfills; and
- work with the refrigeration industry on the lowest-cost method of including synthetic greenhouse gases in the ETS alongside existing ozone protection regulations.

29. The National Party manifesto states that any changes to the ETS will be fiscally neutral.

Implications of recent Durban decisions

30. The decisions reached at the December 2011 UN Conference of the Parties in Durban provides more certainty about the potential international framework after 2012 than was available when the Panel made its recommendations.

31. The main relevant features of the Durban decisions are:

- A new agreement to apply with 'legal force' to developed and developing countries will be agreed by 2015 and enter into force by 2020.
- A second commitment period (CP2) under the Kyoto Protocol will run from 1 January 2013 to either 2017 or 2020. Annex 1 countries are invited to confirm emissions reduction targets under CP2 this year. The EU has indicated that it will join a CP2. The USA, Canada, Japan and Russia will take commitments outside the Kyoto Protocol. Australia and New Zealand have not yet indicated whether they will join a CP2. Cabinet will receive separate advice on this issue.
- Confirmation of the continuation of the Clean Development Mechanism (CDM) after 2012 and the development of new market mechanisms
- In relation to forestry under the Kyoto Protocol: the inclusion of New Zealand's preferred rules on flexible land use, harvested wood products and the reference level accounting approach for forest management; and the loss of the Aforestation-Reforestation Debit-Credit (ARDC) rule.

32. **[Withheld under 9(2)(j)].**
33. **[Withheld under ss6(a), 6(e) and 9(2)(j)].**
34. Cabinet will need to discuss this further in the context of its CP2 decision over the course of the year. However, a critical priority for a package of amendments to the ETS is to ensure that it can be tailored to deliver the level of effort Ministers wish New Zealand to demonstrate in this period.

Comment

Objectives for an Amendment Bill

35. In this context, I am proposing a number of amendments to the Act to implement key recommendations of the 2011 ETS Review Panel and key commitments in the National Party's Manifesto. Key objectives for my proposals are as follows.
36. Firstly, *to ensure that the ETS more effectively supports the government's economic growth priorities*. In particular, the ETS Review Panel and National manifesto identify:
 - the need to provide more flexibility to ensure that land can be used for its highest value use; and
 - the need to mitigate short term costs for participants during the current period of economic uncertainty, whilst still ensuring clear long term price signals that will encourage a smooth transition to a low carbon economy.
37. Secondly, in the context of the Durban decisions, *to ensure that the ETS is flexible enough to cater for a range of international outcomes in the period 2013 to 2020*. In particular, it is important that the ETS is able to deliver whatever level of international emissions reduction effort New Zealand may wish to demonstrate in this period; but that it does not impose costs and reductions in economic welfare that are over and above this level.
38. The ETS currently enables participants to source overseas emission reductions to offset their obligations. This openness ensures emissions reductions can be delivered at lowest cost. **[Withheld under ss9(2)(g)(i) and 9(2)(j)]**. This represents a net offshore cash flow from New Zealand. I therefore propose a number of amendments to address this.
39. Thirdly, *to improve the operation and administration of the ETS* to reflect feedback from the Panel and stakeholders in the light of practical experience of the ETS's operation, and analysis by officials.

Prospects for linking with the Australian Carbon Pricing Mechanism

40. Officials in Australia and New Zealand have been working together over the last few months to scope the issues that would need to be addressed to allow the ETS to link to the Australian Carbon Pricing Mechanism (CPM), when the latter moves from a fixed price scheme into full trading from 2015.
41. **[Withheld under ss6(a) and 6(b)(i)].**

42. [Withheld under ss6(a) and 6(b)(i)].
43. [Withheld under ss6(a) and 6(b)(i)].

Proposals for amendment to the Act in 2012

44. I have considered the Panel's recommendations and other issues arising in the context of the ETS objectives and wider international developments described above.
45. Based on this analysis and my understanding of the Government's priorities, I have identified the primary policy problems with the ETS that would require an amendment to the Act and/or regulations to implement an alternative approach to that under the ETS as currently legislated.
46. I now ask that Ministers consider the following proposals for amendment to the Act, which have been grouped as follows:
 - Group 1: Design, ambition and future positioning of the ETS
 - Group 2: Significant sector specific policy changes
 - Group 3: Overarching changes relating to the link between the ETS and the international framework
 - Group 4: Specific policy changes for Synthetic Greenhouse Gases and Waste sectors
 - Group 5: Technical and operational changes,
47. This paper addresses amendments in Groups 1 and 2, and one proposal from Group 3. The most significant policy proposals contained in this paper are the introduction of auctioning, extending the transition phase measures, the introduction of offsetting for pre-1990 forests and the option of cancellation or reduction of the second tranche. The remainder of Group 3 and the Group 4 to 5 proposals will be presented to Cabinet in late March.

Group 1: Design, ambition and future positioning of the ETS

Introduction of auctioning

Addressing the lack of flexibility over the level of ambition achieved by the ETS

48. Under the ETS, participants are obliged to surrender to the Government eligible emission units to cover their emissions. Eligible units include domestic emission units (NZUs) and certain types of overseas units created under the Kyoto Protocol. While the Government supplies NZUs to the market in the form of allocations, such as to forestry or industry, if ETS participant's demand exceeds this then they have to purchase overseas units to make up the shortfall. The ETS is designed in this way because it was originally envisaged that there would be a continuing international framework beyond CP1 and that the Government would be able to sell any surplus units to achieve its emission reduction target.
49. Under current settings, the ETS is estimated to result in ETS participants purchasing significant amounts of overseas units (about [Withheld under s9(2)(j)] between 2015 and 2020) to meet their ETS obligations. This

purchasing would represent an overseas cash flow (worth about **[Withheld under s9(2)(j)]**)⁴ and a loss of economic welfare.⁵

50. The ETS as currently legislated provides limited flexibility to reduce this level of overseas purchasing and hence the loss of economic welfare. Overseas purchasing also means ETS participants will be dependent on the supply of overseas units in the international market.
51. While the Durban agreement provides certainty that the international supply of units through the Clean Development Mechanism (CDM) will continue after 2012, there remains considerable international market uncertainty in terms of the likely levels of supply, demand and price. In recent months, the price of overseas units has fallen considerably due to over-supply. This has impacted on the price of NZUs. It is likely that the price of overseas units will remain low in the period to 2015. Beyond 2015 (when the true-up period under CP1 is complete) there is greater market uncertainty.
52. This uncertainty creates risks for the Government and for ETS participants. For example, ETS participants may not be able to buy all the overseas units they need to meet their ETS obligations due to a lack of supply and/or could face significant price volatility. The limited flexibility in the ETS to reduce the level of overseas purchasing also means there is limited flexibility over the level of emission reductions the ETS achieves. Based on the number of overseas units surrendered, the Government could claim 'responsibility' for reducing emissions in excess of New Zealand's conditional, responsibility target of a 10-20 per cent emissions reduction from 1990 levels by 2020. **[Withheld under s6(a)]**.
53. The Government could in theory sell surplus overseas units surrendered to it to achieve a lower level of ambition and lessen the impact on economic welfare. In practice this is not possible as the way the Act is drafted currently prohibits this. Even if this restriction was removed, the Government may not be able to sell surplus units due to international perception and environmental integrity concerns, or due to the risk that an uncertain international market means there are few buyers.

4 These estimates are illustrative only as they are based on a range of assumptions, including emission projections based on a \$25 carbon price, on the ETS as currently legislated and IPCC AR2 GWPs. Note that overseas units have been valued at the current prevailing price of \$10.41. One key assumption is that all NZUs allocated in a particular year are also surrendered in that same year. However, if this is not the case (i.e. some people hold on to their allocations) then more overseas units need to be purchased by ETS participants. For example, if all post-1989 forestry owners keep their allocation then **[Withheld under s9(2)(j)]** overseas units will be surrendered instead (worth about **[Withheld under s9(2)(j)]**). Another key assumption is the ETS settings that apply. For example, if the agriculture sector does not join the ETS between 2015 and 2020 then fewer (i.e. **[Withheld under s9(2)(j)]**) overseas units will be surrendered (worth about **[Withheld under s9(2)(j)]**). Other assumptions that also affect the level of overseas purchasing include the carbon price (this affects the level of domestic emissions) and the assumed levels of afforestation and deforestation. These estimates will change if IPCC AR4 GWPs are used instead. **[Withheld under s9(2)(j)]**

5 Overseas purchasing is reflected as a loss to New Zealand's real gross national disposable income (GNDI), a measure of economic welfare. The impact on real GNDI varies according to the level of overseas purchasing and the prevailing carbon price. See NZIER and Infometrics, *Macroeconomic impacts of climate change policy*, July 2009 and *Macroeconomic Impacts of the New Zealand Emissions Trading Scheme*, March 2011. Both reports were prepared for the Ministry for the Environment.

Proposal to introduce auctioning within a cap on the amount of NZUs issued

54. There remain strong reasons to retain access to international markets under the ETS in order to provide flexibility for participants (and, through them, New Zealand) to meet obligations at least cost. Flexibility is important because the level of ambition is likely to change over time to reflect changing circumstances, such as the future international framework or other design settings for the ETS (e.g. decisions on the entry of agriculture).
55. I consider that the best way of providing greater flexibility in the ETS is to auction a fixed amount of NZUs each year, over and above those allocated (excluding forestry), up to an overall cap on the amount of NZUs issued (excluding forestry). The more NZUs auctioned, the fewer overseas units are likely to be surrendered. This would reduce the loss of economic welfare by reducing the amount of overseas purchasing and provide greater flexibility to achieve any desired level of ambition through adjustments to the amount of NZUs auctioned.
56. I note that providing explicitly for an overall cap on the amount of NZUs issued will also provide flexibility to link with the Australian CPM from 2015, should that prove desirable.
57. I therefore propose that Cabinet agree to amend the Act to allow auctioning of a fixed amount of NZUs, within an overall cap on the amount of NZUs issued (excluding forestry) to be implemented through the introduction of regulations.
58. I do not propose that Cabinet agree now on the exact levels of the cap on NZUs issued and the amount auctioned as further work is required. Decisions on this will need to reflect decisions made on the level of emission reductions New Zealand will make after 2012 (whether this is within a second commitment period under the Kyoto Protocol or outside).
59. I propose that the Act is amended to specify the matters I must have regard to when determining the overall cap on the amount of NZUs issued (excluding forestry) in each year, namely:
 - New Zealand's projected emission trends.
 - Any domestic target and/or obligation under an international agreement to reduce emissions.
 - The expected amount of NZUs allocated.
 - The limit, if any, on the amount of eligible overseas units an ETS participant can surrender.
 - The objectives of the ETS.
 - Any other matters the Minister considers relevant.

[Withheld under s9(2)(f)(iv)]

60. **[Withheld under s9(2)(f)(iv)].**
61. **[Withheld under s9(2)(f)(iv)].**

Limit on the amount of overseas units permitted

62. If auctioning were introduced there is a risk that ETS participants may continue to buy overseas units rather than NZUs at the auction. This risk would be mitigated by imposing a limit on the amount of overseas units permitted. This would ensure ETS participants source part of their unit requirements through the auction. Such a limit (combined with an overall cap on the amount of NZUs issued) would also provide an overall emissions cap for the ETS. This would provide greater environmental integrity of the ETS.
63. There are a range of options over the level of such a limit, from no limit to a complete ban. While I believe that a limit is likely to be necessary, I do not propose a complete ban, for the reasons of flexibility given above. However I note that:
- the supplementary principle under the Kyoto Protocol states that “the acquisition of emission reduction units shall be supplemental to domestic actions for the purposes of meeting commitments”;
 - the Australian Carbon Pricing Mechanism restricts the use of overseas international units to 50% of each participant’s obligations; and
 - Phase 3 of the EU Emissions Trading Scheme (2013-2020) places quantitative limits on the use of international units equivalent to around 50% of the reductions in emissions required by participants.
64. I do not propose that Cabinet agree now on the specific level of any limit on the amount overseas units permitted as further work and consultation is required. As with the cap on the amount of NZUs issued, the level of any limit on the amount of overseas units permitted will need to be specified in the regulations.

Process for amending the proposed regulations

65. There is a need to provide ETS participants with a degree of market certainty in terms of the future supply of NZUs and eligible international units. The limit on the use of international units and the cap on the number of NZUs issued should be pre-determined with sufficient advance notice to provide market certainty to ETS participants and ensure environmental integrity of the ETS. At the same time, having flexibility to periodically change the regulations to reflect changing international circumstances is likely to be desirable.
66. Under the Australian Carbon Pricing Mechanism, a cap on units issued will be set in regulations from 2015 for the next 5 years, and updated each year.
67. To provide market certainty I propose that the regulations specify the overall cap on the amount of NZUs issued (excluding forestry) in each year over a five year period.
68. To ensure ETS participants have reasonable notice of changes in the supply of NZUs, I further propose that the Act is amended to specify a process for amending the regulations establishing both a cap on the number of NZUs issued and the limit on the number of overseas units permitted, as follows:
- notice of one year must be given before the regulations can be amended;

- the cap on the amount of NZUs issued in the surrender period at the time notice is given cannot be changed; and
- consultation is required with interested parties before any amendment can be made.

69. I believe that these requirements strike an appropriate balance between providing market certainty and achieving flexibility.

Other auctioning matters

70. Under current legislation, the Minister of Finance has the power to sell NZUs. Whilst this power impliedly includes the power to sell by auction I propose that the Act is amended to expressly provide for the Minister for Climate Change Issues to sell NZUs where such sale is by auction. I also propose that that power is supported by any other powers that are necessary for the functioning of the auction. For example, those supporting powers would include:

- enter into agreements to sell units with any person
- appoint agents to conduct the auction.

71. I also propose that an express regulation making power be inserted in the Act to introduce auctioning.

72. In addition, besides the issues identified above, the regulations should also specify, subject to consultation with interested parties, other aspects of auction design, such as:

- the frequency of the auction, e.g. every month, quarter or year;
- who can participate in the auction, e.g. ETS participants, financial institutions; and
- the type of auction used, e.g. sealed bid auction, ascending clock auction.

73. I propose that, if the regulation specifies a limit on the amount of overseas units permitted, the penalty if an ETS participant breaches this cap should be linked to the existing penalties in the Act for the surrender of ineligible units. I also propose that the regulation specifies the penalties for breaches of any other aspects of the regulation.

Backing of NZUs issued and the conversion of NZUs to AAUs

74. In 2007, Cabinet linked the net Kyoto position to the ETS, by deciding that all NZUs issued should be backed with Kyoto units held in Crown accounts [CBC Minute (07) 24/1 refers]. The backing policy was drafted to ensure that the Crown could meet its Kyoto Protocol commitments and to support the environmental integrity of the ETS by constraining the Crown from issuing an unlimited number of NZUs.

75. Section 86F of the Act requires the Crown to hold a number of Kyoto units equal to the number of NZUs in circulation in CP1 at the end of the true-up period (expected to be mid 2015). Officials understand the intention of this section was

to give effect to the policy to back NZUs with Kyoto units. **[Withheld under s9(2)(h)].**

76. The rationale for backing during CP1 may no longer be relevant as New Zealand is expected to achieve its Kyoto Protocol commitments for CP1. Therefore retaining backing is unlikely to provide any additional environmental integrity benefits in CP1. If a backing policy was retained for CP1, with appropriate legislative backing, then the Government would have to buy additional overseas units. The estimated fiscal costs to the Crown of this could be as high as \$260 million in the period 2012/13 – 2015/16. Accordingly, I propose that the current backing provisions for CP1 are removed.
77. Whether a backing policy is required after CP1 depends on the decisions made on other ETS settings. In particular, I am proposing a cap on the amount of NZUs issued. This would provide a degree of environmental integrity for the ETS. If a limit on the level of overseas units permitted was also introduced then this would set an overall emissions cap for the ETS and provide greater environmental integrity of the ETS. Accordingly, if Ministers agree to introduce auctioning within an overall cap on the number of NZUs issued, I propose that there is no need to back NZUs after CP1.

Extension to the transition measures

One-for-two surrender obligation

78. Under the ETS as currently legislated, participants in the liquid fossil fuels, stationary energy and industrial processes sectors are required to surrender only one eligible emission unit for every two tonnes of carbon dioxide equivalent (tCO₂-e) produced until the end of 2012; they will assume full surrender obligation from 2013.
79. I propose to gradually phase out the one-for-two surrender obligation between 1 January 2013 and 31 December 2014, rather than scale up the one-for-two surrender obligation to full surrender obligation instantaneously on 1 January 2013. This means that for the liquid fossil fuels, stationary energy and industrial processes sectors, the one-for-two surrender obligation would scale up to a 67 percent surrender obligation in 2013 and an 83 percent surrender obligation in 2014, and a full surrender obligation from 2015. To ensure equal treatment, I propose that the synthetic greenhouse gases and waste sectors will also assume a 67 percent surrender obligation in 2013 upon their entry into the ETS, an 83 percent surrender obligation in 2014, and full surrender obligation from 2015.
80. I note that this proposal would have a fiscal cost of 14.191 million units or \$147.731 million in total between the 2012/13 and 2014/15 financial years (assuming a carbon price of \$10.41 per unit). I also note that scaling up the one-for-two surrender obligation to a full surrender obligation in 2013 is not expected to have a significant impact on business and household costs because carbon prices are expected to remain low in the period to 2015. However, this is

uncertain, particularly in light of potential political decisions in Europe to reduce the supply of units in the EU ETS.⁶

81. On balance, this proposal is a National Manifesto commitment and, in my view, signals our determination to balance short-term business and household costs with incentives to reduce emissions in the long term.

Table 2: Estimated impacts on business and consumers

Impact	Status Quo (i.e. full surrender obligation from 2013)	Government's preferred option (i.e. gradual phase-out of one-for-two surrender obligation, full surrender obligation from 2015)
Impact on total business expenditure on electricity and fuels		
\$ million (% GDP)		
2012	\$146m (0.1% GDP)	\$146m (0.1% GDP)
2013	\$293m (0.2% GDP)	\$196m (0.1% GDP)
2014	\$293m (0.2% GDP)	\$243m (0.1% GDP)
2015	\$293m (0.2% GDP)	\$293m (0.2% GDP)
Impact on average household expenditure on electricity and fuels		
\$ per annum (% gross income)		
2012	\$55 (0.1%)	\$55 (0.1%)
2013	\$111 (0.1%)	\$74 (0.1%)
2014	\$111 (0.1%)	\$92 (0.1%)
2015	\$111 (0.1%)	\$111 (0.1%)

Note: The estimates in the table above are based on the assumption that carbon price is \$10.41.

Note: These are annual, not cumulative, costs.

Fixed price option

82. Under the ETS as currently legislated, there is a fixed price option (or price cap) of \$25 per emission unit until the end of 2012. This provides the option for ETS participants to discharge their ETS liability at a maximum of \$25 per tonne during the transition period.
83. I propose to maintain the fixed price option at \$25 per emission unit until 2015. This would provide business with certainty about the upper end of the carbon price in the period to 2015, and would protect businesses from sudden and unexpected spikes in unit prices, which remain possible in the short term, given the international carbon market uncertainty. This could mitigate the risk that the ETS could impose excessive costs on New Zealand businesses.

⁶ The price of NZUs ranged from \$17 to \$21 between July 2010 and July 2011, but dropped significantly to \$6.70 by 12 January 2012. Officials expect NZU price to remain low in the period to 2015, given the weak world economy and uncertainties in international carbon market developments. However, it is possible that current discussions in Europe on withholding a portion of the units expected to be supplied to phase 3 of the EU ETS may have some upward impact on global carbon prices immediately after 2013.

84. There are fiscal risks associated with this proposal. It would not result in any fiscal cost if the international carbon price were below the \$25 fixed price option until 2015. However, the Government would incur a significant fiscal cost if the international carbon price rose above a fixed price option, and the Government was subject to an international obligation that required purchasing international units or the Government backed domestic units (NZUs) with international units.
85. This proposal could dampen the incentives to reduce emissions in the short term but is unlikely to have a significant impact on emission levels. The fixed price option is not expected to suppress carbon prices in New Zealand for an extended period.
86. I note that the Panel recommended increasing the fixed price option to \$30 in 2013, \$35 in 2014, \$40 in 2015, \$45 in 2016, and \$50 in 2017. This would bring the fixed price option closer to the price ceiling in Australia. Furthermore, the fiscal risk would be lower, as the likelihood of the international carbon price exceeding the fixed price recommended by the Panel would be relatively low.
87. However, given the current low carbon price, and National's manifesto commitment, I consider the risks and impacts associated with maintaining the fixed price option at \$25 until 2015 to be low.

Ban on exports of NZUs from non-forestry sectors

88. There is a ban on export of NZUs from the non-forestry sectors until the end of 2012 to mitigate the arbitrage risk created by the fixed price option. The arbitrage risk will arise if the price of overseas units is above the fixed price option. This is because ETS participants could buy NZUs from the Government at the fixed price and then sell them overseas at the higher overseas unit price. This could create a significant fiscal risk for Government and could undermine the integrity of the ETS.
89. I propose to extend the ban on the export of NZUs from non-forest sectors until 2015 so that the arbitrage risk associated with my proposal to extend the fixed price option until 2015 can be mitigated.

Group 2: Significant sector specific policy changes

Agriculture

90. Under current ETS settings, agriculture sector participants must report their emissions from 2012 and face full surrender obligations from 2015. The government has indicated its intention to review (in 2014) the 1 January 2015 date on which the sector incurs surrender obligations. Particular considerations for this review will be the existence of practical technologies to reduce emissions and whether our trading partners have made progress on policies to reduce emissions.

91. Delaying liabilities for agriculture would have a fiscal cost in the order of 2.0 million units (\$21.090 million) in the 2014/15 financial year, 3.9 million units (\$41.015 million) in the 2015/16 financial year, and more than 4 million units (\$45 million) per annum from 2016/17 onwards (based on a reduction in current estimates of ETS revenue).⁷
92. On the basis that I consider that there will be only one opportunity to amend the ETS in this term of government, I propose to introduce a discretionary regulatory power for the Minister for Climate Change Issues to defer the January 2015 date from which the agriculture sector incurs surrender obligations, based on the outcome of the 2014 review.
93. I propose that this regulatory power would enable the deferral of all or part of the agriculture sector liabilities – in particular, deferral of liabilities for particular agricultural greenhouse gases (e.g. methane or nitrous oxide), particular activities prescribed in the Act (e.g. manufacturing or importing nitrogen fertiliser for application to land) or particular sub-sets of these activities (e.g. slaughtering of a particular species of animal).
94. In order to ensure that the power is suitably constrained and provides an appropriate level of certainty for participants, I propose that it be limited in the following ways:
 - In order to use his power to defer, the Minister will need to be satisfied that certain conditions are not met: specifically, that there are insufficient practical technologies to reduce emissions and / or that trading partners have made insufficient progress on policies to reduce emissions.
 - Any decision to defer will be taken following an independent review, which will assess these conditions.
 - Consultation will need to be undertaken with interested parties. This could be undertaken as part of the 2014 review.
 - Any deferral will have a maximum timeframe of 3 years.
 - A decision on any deferral will need to be made no later than 30 November 2014 (to allow reasonable notice before the decision comes into force)
95. Whilst I consider this power to be necessary, I note that this change would mean that, following the 2014 review, the Minister for Climate Change Issues will be obliged to make a decision to either use or not use the deferral power, having regard to the matters in the empowering provision. **[Withheld under s9(2)(h)]**.
96. Irrespective of whether the agriculture sector incurs full surrender obligations in 2015, I propose to progress several technical amendments to the ETS's agriculture settings. These changes will be proposed in a further Cabinet paper on operational and technical amendments to the Act, in late March 2012.

⁷ These fiscal estimates are based on IPCC AR2 GWPs, but would be higher once the AR4 GWPs are applied to greenhouse gas accounting from 2013.

Forestry

Proposal to introduce offsetting for pre-1990 forestry

97. The National Party manifesto commits to introducing offsetting for pre-1990 forestry from 2013. Offsetting provides owners of pre-1990 forest land with greater land-use flexibility by reducing the costs of deforestation under the ETS.
98. Some pre-1990 forest is on land that could potentially be more productive in a non-forestry land use. At a high carbon price (e.g., \$25), ETS deforestation liabilities effectively limit forest owners' ability to convert forest to a more productive land use. Offset planting in the ETS would allow more land use flexibility for pre-1990 exotic forest land.
99. I note that, at the current carbon price (around \$10) it may be more viable to convert high value land to dairy and pay the ETS liability than apply an offsetting approach. However, I still consider it important to provide this flexibility to foresters, further noting that this would be available to New Zealand in a CP2 setting following the successful negotiation of the flexible land use (FLU) rule at Durban.
100. Any departure from the requirements of the international FLU rule by the ETS could create liabilities should New Zealand sign up to a CP2. If New Zealand makes other, non-binding commitments from 2013, the FLU rule will be seen by our trading partners as the baseline for acceptable treatment of forestry emissions. Departure from this rule may therefore affect the perceived environmental integrity of the ETS and constrain our ability to link to other domestic ETSs.
101. I therefore propose that Cabinet approve the introduction of a domestic pre-1990 forest offsetting policy, consistent with the FLU rule, namely:
 - Only pre-1990 exotic forests cleared from 2013 are eligible for offsetting.
 - The offset planting (i.e. the new forest) must be established in 2013 or later on post-1989 forest eligible land (i.e. land that did not contain forest in 1990).
 - The offset planting must be established by direct planting activities (i.e. human induced promotion of natural forest regeneration is not permitted).
 - The offset planting needs to be at least the same area as the cleared forest and achieve the same carbon stock level as the cleared forest at the time of harvest within a usual rotation length.
 - The harvested forest must have been replanted after 1960.
 - The offset planting would be classified as pre-1990 forest and therefore cannot earn carbon credits in its own right.
 - All lands and associated carbon pools shall be identified, monitored, and reported, including geo-referenced location and the year of conversion.

102. I note that the proposal to introduce offsetting will be of particular interest to Māori, who are a major stakeholder in pre-1990 forests. A number of other issues were identified by the Panel in relation to Māori forestry interests under the ETS, and will be addressed in a further paper to Cabinet on proposed technical and operational changes to the Act.

Proposal to investigate a cap on offsetting

103. An offsetting policy imposes no direct costs on the Crown, but may give rise to costs if the harvesting emissions associated with offsetting, or the resulting increased agricultural emissions from land-use conversion, impact on New Zealand's net position under a future climate change agreement.
104. The FLU rule is part of the new Kyoto Protocol Article 3.4 Forest management (ie, pre-1990 forest) accounting rules for CP2, and is required to be accounted for within a "reference level", which is based on a projection of our expected business-as-usual net emissions from pre-1990 exotic forests for the 2013-2017/20 period. If New Zealand's actual net emissions from pre-1990 forests exceed the reference level, New Zealand faces a liability.
105. Emissions from offsetting could push New Zealand's net emissions above the reference level. As future emission projections are inevitably uncertain, the Crown could minimise any fiscal risk from exceeding the reference level by limiting the amount of permitted offsetting.
106. Fiscal risks also arise from the increased emissions from agriculture due to land use change away from forestry into pastoral farming, and would range from approximately 0.46 to 2 Mt CO₂⁸ over 2013-2020 for 16,000 to 70,000 hectares offset (giving rise to costs of \$4.8 million - \$21.0 million at a carbon price of \$10.41⁹). New Zealand would be liable for these additional emissions under any commitments taken after 2012.
107. Further work is required to analyse the level of the risk and the potential for other approaches to manage the risks of liabilities arising. However, in case there is a significant risk, I propose that a power be included in the CCRA for the Minister for Climate Change Issues, in consultation with the Minister for Primary Industries and Minister of Finance as appropriate, to place a limit on offsetting. Such a power should enable a restriction to apply either on the age of the trees to be deforested or on the requirement to maintain the offset forest for a full rotation. The imposition of any such limit should be subject to consultation with interested parties.

Operation of offsetting

108. In addition to the high-level policy design issues discussed above, officials have begun to consider the technical detail of how offsetting could be implemented in

⁸ Estimates based on Global Warming Potential values from the Fourth Assessment Report to be used in CP2 accounting.

⁹ Estimated using IPCC AR2 global warming potentials.

the ETS. I recommend that offsetting is implemented by building on existing ETS operational processes and systems to minimise administrative costs for the Crown and participants and to enable implementation as early as practicable. Specifically, that:

- The decision to deforest and take-up offsetting will rest with the landowner.
- Use of pre-1990 forest land look-up tables to estimate deforestation emissions of the cleared forest.
- Use of post-1989 forest land look-up tables to estimate carbon sequestration of the offset forest (this is to keep consistency in the methodologies used to estimate emissions and sequestration).
- The landowner will be responsible for self-assessing and declaring any non-compliance of his or her offsetting obligations, with MAF conducting risk-based audits as necessary to monitor and enforce compliance.
- If a landowner does not establish an offset forest of sufficient area or carbon equivalence, 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.
- Any subsequent deforestation of the offset planting will be subject to the normal ETS deforestation liability.
- The ability to set reporting and other thresholds through regulation.

Proposal to change the second tranche of pre-1990 forestry allocation in light of offsetting, following consultation

109. The possible reduction or cancellation of the second tranche if offsetting is introduced, if deforestation liabilities are removed or if international rules change has been signalled in a number of ways. Appendix 3 sets out a range of published statements on this matter, which include

- Section 30F of the Act, which provides for the cancellation of the second tranche if deforestation of pre-1990 forest land is removed as an activity from the ETS.
- The 2009 Forestry Allocation Plan Consultation Draft, which stated that *“If the rules change, for example if restrictions on the deforestation of pre-1990 forests are removed, or offset planting is permitted under the international rules in Commitment Period 2, the Government may cancel some, or all, of the allocation relating to this period”*.
- A letters to foresters on pre-1990 Allocation determinations in 2011, which states that *“If a change to the Act is made, for example the removal of deforestation of pre-1990 forest land as an activity, NZUs transferred or to be transferred after 31st December 2012 may be recovered from any holding account or the transfer cancelled”*.

- The Panel's report, which recommended introducing a claw back provision for the second tranche of pre-1990 forestry allocation if offsetting is introduced and taken up by a forest owner.

Current distribution of allocation

110. The purpose of the pre-1990 forestry allocation was to partially compensate owners of pre-1990 forest land for the lost land value that they would face because of ETS deforestation liabilities and the resulting loss of land use flexibility.
111. The allocation was intended to partially compensate the estimated ETS liability for future deforestation based on the historic deforestation rate before 2007 of around 5% of harvested pre-1990 forests.
112. The value of pre-1990 allocation was 50.9 million units, to be paid out in two tranches. The first tranche of the allocation (*about 38%*) is to be transferred by 31 December 2012, and the second tranche (62%), estimated at 30.9 million NZUs¹⁰ is due to be transferred from 1 January 2013.
113. In the absence of any information on forest owners land-use intentions, the allocation was distributed on a *pro rata* per hectare basis to eligible forest owners. A targeted approach would have distributed the allocation based on the land suitability for other land uses. However this implementation would have been complex and time consuming and potentially not accurate. A *pro rata* approach was decided to distribute the allocation acknowledging the ETS impact on landowners according to when they acquired their land. The allocation categories (with the distribution of units across the two tranches in brackets) are as follows:
- 60 (23 and 37) NZUs per hectare for eligible pre-1990 forest land acquired prior to 1 November 2002;
 - 39 (15 and 24) NZUs per hectare for eligible pre-1990 forest land acquired on or after 1 November 2002;¹¹ or
 - 18 (7 and 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 settlement after that date.^{12,13}

¹⁰ The final estimate of the value of the second tranche depends on the final determinations made to all applications. These are still in process.

¹¹ This allocation category also applies to land acquired before this date where beneficial ownership has changed in the way set out in the allocation plan (s 72(2)(b)(ii)(B) CCRA),

¹² These units are in compensation to iwi for the restrictions on future land use of pre-1990 forests transferred under Treaty of Waitangi settlements since 1 January 2008. Crown forest licensed land transferred to Ngati Awa and Te Uri o Hau under Treaty of Waitangi Settlements receives 60 NZUs per hectare, as this settlement was agreed prior 1 November 2002.

¹³ Section 72(2)(b)(i)(A) of the CCRA also includes Crown forest licence land that will not have been transferred to iwi as part of a settlement by the date of the allocation plan (i.e. regular CFL, or CFL that may be part of a settlement but has not been transferred at the date of the allocation).

114. The allocation to pre-1990 foresters was distributed pro rata to eligible forest owners irrespective of whether they intend to deforest, and therefore irrespective of whether they would face ETS liabilities. Arguably, therefore, many landowners who were not intending to deforest have been over-compensated.

Benefits of offsetting, and implications for allocation

115. In contrast to allocation, the benefits of offsetting are directed towards those forest owners who would convert their land to a higher land use.
116. Offsetting reduces the cost of pre-1990 forest land conversion by waiving the forest owner's deforestation liability under the ETS, provided that they establish a new forest on post-1989 forest-eligible land elsewhere. Offsetting is not cost free, but nonetheless makes the conversion of pre-1990 forest more viable for owners with land better suited to a higher value uses.
117. The benefits offered by offsetting depend strongly on the carbon price. At a \$25 carbon price, officials estimate that offsetting could reduce conversion costs for land owners on average by \$15,000 per hectare of 28-year old *radiata* pine, effectively reducing the \$20,000 deforestation liability by 75%. At the current low carbon price of \$10.41, the net benefit of offsetting compared to current ETS settings is less: \$4,000 -\$6,000, effectively halving a deforestation liability of around \$8,000.
118. Large landowners in the central North Island, Canterbury, Otago and Southland are most likely to take up offsetting and obtain the benefit of converting land to higher value use. Smaller 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 obtain benefit from offsetting. Maori-owned pre-1990 forest land is likely to fall into this category.
119. All pre-1990 forest owners could be considered to benefit from the introduction of offsetting, however, regardless of whether they take it up, via reductions in future opportunity costs that might arise from being unable to respond to changes in the relative economics of different land uses.
120. Given the significant benefits offered by offsetting to those who are likely to wish to deforest and convert land into a higher value use, and who will therefore face ETS liabilities, I consider there is a strong in principle case for reducing or cancelling the second tranche.
121. Given the range of potential reductions in conversion costs (50%-75% depending on the carbon price assumed), a reduction of the second tranche by around 55% may be most reasonable. It should be noted that the first tranche of compensation was provided in full. With a reduction of the second tranche by around 55%, total allocation to pre-1990 forest owners would be around 67% of that originally proposed (i.e. a reduction of around 33% in total allocation received).

Limitations of current legislative provisions

122. Under the current legislation, only two compensation scenarios for pre-1990 forest are provided for:

- payment in full of the compensation specified in the Pre-1990 Forest Allocation Plan; or
 - cancellation of the second tranche of allocation to pre-1990 forest owners if ETS deforestation liabilities no longer apply after 2012.
123. The introduction of offsetting presents a scenario whereby deforestation liabilities still apply, but the liability costs have been reduced significantly from 2013.
124. The current distribution of allocation under the Act acknowledges that not all pre-1990 forest landowners were impacted equally by the ETS. The basis used for distributing allocation was therefore the land acquisition date, with higher allocation to landowners who acquired their land before 2002 when the Government first signalled deforestation controls. The current distribution also considers that some landowners who purchase forests or received forests through earlier Treaty settlements would not have had the opportunity to factor potential deforestation liabilities into their purchase.
125. The use of the land acquisition date as a proxy indicator for determining the relative impact of the ETS deforestation liabilities, and therefore how much compensation should be paid, was a reasonable approach at the time. However, I consider that it was arbitrary and untargeted in nature.
126. Offsetting, in contrast, provides significant benefits which are available to any forest owner who seek to convert their land to other uses, irrespective of the date of the land's purchase.
127. It may be appropriate therefore that the second tranche be modified to provide a more appropriate level of compensation, which is distributed equally across all categories of pre-1990 forest land. This recognises that all landowners have the potential to benefit from offsetting, should they seek to deforest and convert to a higher value land use.
128. Specifically, the second tranche could be reduced so that all land owners received a common rate of 11 NZUs per hectare. This level is the level of allocation currently proposed to be provided in the second tranche to the CFL land category (due to receive 18 NZUs in total). It would be commensurate with cancelling around 55% of the second tranche and therefore with the scale of the reduction in conversion costs faced by land owners. This would provide a fiscal saving of \$175.929 million at a carbon price of \$10.41.
129. By comparison, cancelling all of the second tranche would provide a fiscal saving of \$321.669 million. Implementing the ETS Panel's recommendation to cancel only for those who uptake offsetting would provide a fiscal saving of only \$1.7m - \$27m.

Requirement for further consultation and engagement

130. Landowners who are less likely to take up offsetting are more likely to oppose any cancellation of the second tranche. These landowners are likely to advance a range of arguments against any proposal to cancel the second tranche. Whilst the case for cancellation of the second tranche is clearly linked to the benefits provided by offsetting, the sector may characterise the cancellation as a wealth

transfer from forestry to other sectors, given that any fiscal savings will offset the fiscal costs of an extension of the transition phase measures.

131. As noted above, those who are likely to oppose any cancellation include Maori. Around 50% of the second tranche (around 14-16m NZUs) are likely to go to iwi under current settings. Of these units:

- [Withheld under s9(2)(a) and 9(2)(b)(ii)].
- [Withheld under ss9(2)(a) and 9(2)(b)(ii)].
- [Withheld under s9(2)(j)].
- Around 3-5m NZUs are expected to go to Maori freehold land.

132. I am aware that [Withheld under s9(2)(b)(ii)] is interested in offsetting and conversion of their forest land to dairy. However, interest in offsetting and potential for conversion are unknown for many other iwi.

133. [Withheld under s 9(2)(h)]:

- [Withheld under s 9(2)(h)].
- [Withheld under ss 6(a) and 9(2)(h)].
- [Withheld under s 9(2)(h)].
- [Withheld under s 9(2)(h)].

134. Acknowledging the need for wider engagement, [Withheld under s 9(2)(h)] I propose to consult on the proposed modification of the second tranche, prior to asking Cabinet to make final decisions on a package of ETS amendments in May 2012.

135. Specifically, I propose to consult on three options:

- Cancellation of the second tranche only for those who take up offsetting.
- Reduction of the second tranche so that all landowners received 11 NZUs per ha.
- Cancellation of the second tranche in full.

136. Iwi will be a particularly important stakeholder in this consultation. [Withheld under s 9(2)(g)(i)]. Accordingly, I propose to launch the consultation at a hui to be organised by CCILG on 14th March.

Pre-1990 Forests less than 50 Hectares

137. Some landowners with less than 50 hectares of pre-1990 forests were eligible for a exemption from deforestation liabilities available under the Act but chose to receive the allocation instead. Under current ETS rules, those receiving allocation are no longer eligible for this exemption. These landowners chose the allocation expecting to receive it in full. Any cancellation reduces the value of the allocation in relation to the exemption.

138. I propose to consult additionally on allowing these landowners to re-apply for the exemption in the case of a significant reduction in the second tranche. Landowners taking up this option would need to agree to full cancellation of the

second tranche, and to repay the value of the allocation they received in the first tranche.

139. Whilst this proposal might raise some administrative complexities, I consider it a potentially desirable option to reduce the impact of any decision on the second tranche on smaller land owners. I note that, depending on the level of take up, this option could generate fiscal savings of \$2.249 million across the forecast period.

Group 3: Overarching changes relating to the international framework

140. As noted earlier, New Zealand has not yet decided whether it will take a commitment under CP2 or outside the Kyoto Protocol. The Act contains multiple references to the Protocol which may need adjusting if New Zealand does not sign up to CP2. I have instructed my officials to undertake a systematic analysis of the linkages between the Act and the international framework, and will report back to Cabinet on any necessary amendments in March.
141. The update to Global Warming Potentials is one such issue which is presented in this paper because it has a fiscal impact in the forecast period and for the cost of the proposed amendments.

Updated emissions projections with new Global Warming Potentials

142. At the recent Durban conference, it was agreed that from 1 January 2013, the accounting of greenhouse gases will use the updated 100 year global warming potentials (GWPs) from the IPCC's 4th Assessment report (AR4). At present, under the Convention and during the first Kyoto Protocol Commitment Period, countries' emissions are calculated using the GWPs from the IPCC 2nd Assessment Report (SAR). Parties have agreed that the approach to GWPs should be consistent across the UNFCCC (both within Kyoto and outside).
143. GWPs are a common metric used to assess the relative impact of each gas, to enable non-CO₂ gases to be converted into CO₂-equivalent quantities for common accounting purposes. The new AR4 values have the effect of increasing the relative contribution of methane to New Zealand's greenhouse gas emissions profile by approximately 19%, and reducing the impact of nitrous oxide by about 4%, as well as lesser impacts on synthetic greenhouse gases. Overall adopting the AR4 values will increase New Zealand's net emissions by about 8% from 2013-2020.
144. New Zealand will be obliged to use the new AR4 values for its international reporting of historical, current and future projections of New Zealand's greenhouse gas emissions from the start of the second Kyoto Commitment Period (1 January 2013),¹⁴ irrespective of whether New Zealand signs up to CP2.

¹⁴ The CP1 net position report will continue use AR2 GWPs, as it only covers the first commitment period of the Kyoto Protocol. The net position of a CP2 Kyoto commitment or other binding commitments after 2013 would use the newer AR4 GWPs.

145. This will have implications for the way in which we account for obligations under the ETS. New Zealand's accounting of greenhouse gases under the ETS needs to remain consistent and comparable with its international reporting and with internationally agreed rules and scientific methodology.
146. Under current legislation, emissions accounting under the ETS would continue to be based on the GWPs used during CP1 after 2012 unless it signs up to CP2. I therefore propose to amend the CCRA to bring the ETS in line with the new prescribed GWPs for international reporting and accounting after 2012. These amendments should provide for internationally recognised GWPs to be specified through regulations, regardless of whether New Zealand signs up to a CP2 or chooses to take commitments outside Kyoto.
147. These changes to GWPs will have fiscal implications in that they will affect both allocation and surrender obligations within the ETS. The changes would affect mainly participants in the agriculture, waste and SGG sectors. Over and above other changes specified in this paper, the revised GWPs will result in increased costs for some ETS participants by \$18.823 million over the forecast period up to 2015/16, resulting in a corresponding increase in the net ETS fiscal position.

Next steps

148. **[Withheld under s 9(2)(h)].**
149. A number of the major policy proposals presented above will also likely require further, supporting technical and operational policy decisions and clarifications. I propose that Cabinet delegate the Minister for Climate Change Issues, in consultation with the Minister for Primary Industries as appropriate, responsibility for further decisions on the technical detail of drafting these decisions.
150. A further series of Cabinet papers on proposed changes for the synthetic gas sector, and technical and operational amendments to the Act will also be provided to Cabinet for its approval over the next few months.
151. I propose that Cabinet confirm I am able to share this Cabinet paper, any drafts and final versions of the next Cabinet papers, drafting instructions to PCO, subsequent drafts of the amendments (and any sufficiently related documents) with the Environmental Protection Agency for consultation, where necessary.

Consultation on the proposed changes

152. The Panel's consultation included a public call for written submissions and a series of stakeholder meetings. It received submissions from 162 organisations and individuals. There have been a number of recent consultation opportunities in relation to the ETS. Therefore I recommend any detailed consultation on the proposed package of amendments be focused and targeted.
153. I have outlined above the need to consult on cancellation of the second tranche of pre-1990 forest allocation prior to final policy decisions on a package of ETS amendments.
154. In addition, due to the tight timeframes, consultation is likely to be required in parallel to legislative drafting on a number of issues for associated regulations. In this context, I propose that Cabinet agree to delegate power to the Minister for

Climate Change Issues to undertake formal consultation on some regulatory and implementation matters in parallel to the legislative process, including in relation to the detailed design of auctioning, and the operation of offsetting.

155. Alongside this more targeted, detailed consultation, I consider that it will be desirable to undertake a wider programme of engagement following these initial Cabinet decisions, to set out and explain the government's key proposals. I propose to undertake this programme of engagement through meetings that I and my officials will have with key stakeholders over the coming months. In addition, I intend to set up an informal stakeholder reference group in order to test current proposals and modifications as they arise. This will enable us to test reactions prior to Select Committee consideration of the Bill.
156. I propose that Cabinet delegate responsibility to the Minister for Climate Change Issues, working in conjunction with the Minister for Primary Industries, for ongoing communications and engagement regarding the proposed amendments and response to Panel recommendations.

Formal response to the Review Panel

157. The Act requires that the Minister for Climate Change Issues prepare a response (and present a copy of this report to the House of Representatives) if the Panel recommends any legislative change in relation to allocation. Only one of the Panel's recommendations relates to legislative change to allocation and they are relatively minor in nature (the recommendations to change the 1.3 per cent phase out rate). However, it is likely to be desirable for the government to respond to the Panel more fully.
158. I propose that the government's response to the Panel's recommendations be combined with a government's statement on its proposed amendments; following Cabinet decisions and prior to introduction of legislation. To support this, I will publish a short, high level summary of how the government is addressing each recommendation.

Consultation

159. The following agencies were consulted in the preparation of this paper: the Ministry of Agriculture and Forestry, the Treasury, the Ministry of Foreign Affairs and Trade, the Ministry of Economic Development, the Department of Conservation, and Te Puni Kōkiri. The Department of Prime Minister and Cabinet was informed.

MAF Comment

160. **[Withheld under s 9(2)(h)]**. MAF recommends that Ministers cancel the second tranche only for landowners who take up offsetting (i.e. the recommendation of the 2011 ETS Review Panel).

Treasury Comment

161. The Treasury supports the proposal to extend the current one-for-two surrender obligation as recommended by the ETS Review Panel. Given uncertainty over future carbon prices, extending the transition settings as proposed will reduce the potential for business and household cost increases.

162. The introduction of offsetting into the ETS provides an in-principle argument for cancelling the second tranche in full. Introducing offsetting into the ETS both reduces the cost of conversion by eliminating the deforestation liability for pre-1990 forest and increases the flexibility of land use. Offsetting option provides an economical alternative to forest owners who were most impacted by the ETS, while the cancellation of the second tranche reduces compensation to forest owners whose land values were not significantly affected by the ETS.
163. Cabinet has agreed that the ETS package will be fiscally neutral [CAB Min (11)37/16 refers]. There is uncertainty over the final costs of the ETS package, as Cabinet will be considering further ETS policy decisions over coming months that are not quantified in this paper. The option of reducing the second tranche allocation to 11 units or a pro-rated equivalent provides very limited flexibility for the Crown to change its second tranche decision or meet additional costs in the ETS package. The option of only cancelling compensation for foresters that take-up offsetting would not result in a fiscally neutral package, if implemented alongside the other recommendations proposed in this paper.
164. Consulting only on a full cancellation option at this stage allows the Government flexibility to consider feedback raised through the consultation process, including Treaty of Waitangi concerns that may be raised.

Financial implications

Summary fiscal implications

165. The operating balance impacts of the proposed decisions in this paper are summarised in the table below. Further details on the fiscal impacts of these decisions are included in Appendix 2.

Table 3: Summary fiscal impacts (\$ million)

\$ 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

166. Given that some decisions are subject to consultation, I am not seeking changes to appropriations at this stage. I will seek Cabinet approval for appropriation changes along with final policy decisions and drafting instructions in May 2012.
167. I will be proposing further ETS technical and other decisions for Cabinet's consideration in March, which will also have additional fiscal implications. These proposals are expected to have a net negative impact of \$10 – 20 million across

the forecast period, but this estimate will depend on policy decisions and is still to be reviewed.

168. In addition to the operating balance impacts outlined above, the proposal to introduce auctioning would have a positive impact on the Government's net debt position. Auctioning provides the Government with a financial asset, cash, at the point of auction rather than carbon units which are an intangible asset. This would have an impact on net debt, but not on revenue. The extent of this impact will depend on the detailed design and level of auctioning, and will be detailed when taking decisions on the level of auctioning.

Administrative cost implications

169. The Ministry for the Environment and the Ministry of Agriculture and Forestry have advised that the ETS package of amendments will give rise to operating costs that cannot be met through current baselines. The indicative total of these costs is \$15.233 million across the forecast period.
170. I propose that Cabinet agree to establish a contingency fund so that Ministers can further consider these operating costs, and that this contingency be funded through Budget 2012. I propose that the Minister of Finance, the Minister for Climate Change Issues and the Minister for Primary Industries have delegated authority to jointly approve any business case for operating costs made against this fund, as policies are implemented. The amount eventually released to fund implementation costs may be significantly less than this contingency. Agencies will need to provide a clear and convincing case before any funds are released. However, this contingency will be incorporated into cost calculations of the final package.

Fiscal risks and other impacts

171. The following proposals in this paper also raise fiscal risks:
- The proposal to consult on changing the second-tranche of forestry compensation creates a risk that some or all of the second-tranche will not be cancelled, reducing the fiscal savings available. This risk will be reflected in the 2012 Budget Economic and Fiscal Update.
 - Extending the \$25 fixed price option until 2015. The magnitude of this fiscal risk depends on whether the Crown is subject to an emissions reductions target requiring international units and the price of carbon units. Current price forecasts indicate relevant carbon unit prices will remain below \$25 through to 2015, but if the carbon price exceeds \$25, the Crown will face a relative loss of revenue through the ETS.
 - Offsetting for pre-1990 forests. New Zealand could become liable for an associated increase in agriculture emissions under an international target and, without use of and a power to limit offsetting. New Zealand could breach its emissions allowance. To manage this risk, a cap on offsetting is proposed to be provided for in legislation but not enacted at this stage.
 - Allowing landowners to take up the under 50 hectare exemption for deforestation liabilities, in exchange for forfeiting the second tranche of

allocation and paying back the value of the first tranche. Fiscal risk would arise as a result because landowners with exemptions can deforest without incurring any ETS liability, which would create emissions for which New Zealand may be liable under an international target.

Human rights

172. 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

173. A bill will be required to implement a range of modifications to the ETS.

174. The Act binds the Crown. The bill for the proposed amendments to the Act will also bind the Crown. New regulations will be required to specify details of proposed amendments. Consequential amendments to a number of regulations under the Act will also be required within 12 months of enactment of the bill to give effect to certain provisions in the bill.

Regulatory impact analysis

175. In respect of the proposed major amendments for a revised ETS, the Ministry for the Environment confirms that the principles of the code of Good Regulatory Practice and the regulatory impact analysis (RIA) requirements, including the consultation requirements, have been complied with. The final Regulatory Impact Statement (RIS) was circulated with the Cabinet paper for departmental consultation.

Regulatory Impact Analysis requirements

176. The RIA requirements apply to the proposals in this paper and a Regulatory Impact Statement (RIS) has been prepared and is attached.

Quality of the Impact Analysis

177. Treasury's Regulatory Impact Analysis Team has reviewed the RIS prepared by the Ministry for the Environment and associated supporting material, and considers that the information and analysis summarised in the RIS meets the quality assurance criteria.

Consistency with Government Statement on Regulation

178. I have considered the analysis and advice of my officials, as summarised in the attached Regulatory Impact Statement and I am satisfied that, aside from the risks, uncertainties and caveats already noted in this Cabinet paper, the regulatory proposals recommended in this paper:

- are required in the public interest
- will deliver the highest net benefits of the practical options available, and

- are consistent with our commitments in the Government statement “Better Regulation, Less Regulation”.

Publicity

179. It will be necessary to manage public announcements on policy decisions for amendments to the ETS through a coordinated strategy. I am seeking authorisation to manage public announcements/ engagement on the proposed package of amendments prior to the finalisation of Cabinet’s deliberations on amendments to the ETS.

Recommendations

The Minister for Climate Change Issues recommends that the Committee:

Background

1. **note** that a statutory review of the ETS was completed in 2011 and that the ETS Review Panel (the Panel) made 61 recommendations, largely focused on improving the operation of the ETS and slowing the transition to full obligations under the scheme;
2. **note** that on 18 July 2011 Cabinet invited the Minister for Climate Change Issues to report to Cabinet through the relevant Cabinet committee by February 2012 with proposed changes to the ETS based on the Panel’s recommendations, developments in and discussions with Australia and further analysis [Cab min (11) 27/15 refers];
3. **note** that, in this and subsequent Cabinet papers, I intend to seek agreement to number of changes to 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; and
 - 3.5. improve the technical operation of a number of parts of the Act;
4. **note** that to enable an amendment act to be passed by the end of 2012, it is necessary for Cabinet to make decisions on the legislative proposals contained in this paper in March, in order that legislative drafting may take place over March-April 2012;
5. **note** that this paper is the first in a series and seeks Cabinet’s agreement to the most significant policy changes;
6. **note** 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 in May 2012;

7. **note** that the Minister for Climate Change Issues will report back to the Cabinet Committee in late March 2012 on a further set of proposed technical and operational amendments to the Act, including supporting technical detail for the major proposals presented here, where needed;

CP2/Durban outcome implications

8. **note** the decisions reached at the recent UN Conference of the Parties in Durban provides more certainty about the potential international framework after 2012;
9. **note** 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. **note** 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. **note** that changes to international rules agreed at Durban will have implications for ETS settings, in particular for the forestry sector;

ETS design amendments

12. **confirm** that the Government's objectives for the ETS are to:
 - help New Zealand to deliver its 'fair share' of international action to reduce emissions, including meeting any international obligations
 - deliver emission reductions in the most cost effective manner, and
 - 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. **note** 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. **agree** to amend the Act to allow for an express regulation making power to introduce auctioning of 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. **agree** 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. **agree** 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:

- the year in which full auctioning will commence
- to allow for one or more pilot auctions to be held before a full auction commences
- the overall cap on the number of NZUs issued each year over a five year period (excluding forestry allocation)
- the limit, if any, on the amount of eligible overseas units an ETS participant can surrender in each year
- the persons eligible to participate in the auction
- any other auction design features that the Minister considers relevant to ensure the effective operation of the auction
- any penalties for breaches of the regulation not already specified in the Act.

17. **[Withheld under s 9(2)(f)(iv)];**

18. **agree** that officials conduct further work and consult with affected parties during 2012 on the detailed auction design to be introduced by regulations, including:

- the level of any limit on the amount of eligible overseas units an ETS participant can surrender
- the frequency of the auction
- the type of auction process used
- the permitted participants in the auction
- any other aspects of auction design identified by the Minister for Climate Change Issues where consultation would be useful

19. **agree** 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:

- New Zealand's projected emission trends
- any domestic target and/or obligation under an international agreement to reduce emissions
- the expected amount of NZUs allocated
- the limit, if any, on the amount of eligible overseas units an ETS participant can surrender
- the objectives of the ETS
- any other matters the Minister considers relevant

20. **agree** to amend the Act to specify the process for amending the regulations related to auctioning, namely:

- notice of one year must be given before the regulations can be amended
- 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
- consultation is required with interested parties before any amendment can be made.

21. **agree** 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. **note** 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. **note** that New Zealand is expected to exceed its commitments under the first commitment period of the Kyoto Protocol and therefore the need to back during this period is not required;

24. **note** that the need for backing from 2013 is significantly reduced if a cap on the amount of NZUs issued is introduced;

25. **agree** 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. **agree**, in principle subject to final decisions in May, to extend the current one-for-two surrender obligation over two years from the end of 2012, whilst 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. **agree**, in principle subject to final decisions in May, 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. **agree** 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. **agree** to amend the Act to extend the ban on exports of NZUs from non-forest sectors whilst a fixed price option remains in place, to reduce risks of arbitrage;

30. **agree** 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:

- The power can only be exercised if linking with the Australian Carbon Pricing Mechanism has occurred.

- Any extended fixed price option must be set at the same level as any price ceiling in Australia.
- Use of the power is subject to consultation with affected parties.

ETS sectoral changes

Agriculture

31. **note** that the Agricultural sector already has reporting obligations under the ETS and incurs emissions liabilities from 2015;
32. **agree** to review in 2014 the date from which the agriculture sector will face liabilities;
33. **note** 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. **agree** to amend the Act to include a discretionary power for the Minister for Climate Change Issues to defer the date from which the Agriculture sector will incur emissions liabilities; and that this power will:
- Allow deferral of all liabilities, or for liabilities for particular agricultural greenhouse gases or particular activities.
 - 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.
 - Require a prior independent review, which will assess the conditions above.
 - Require prior consultation to be undertaken with interested parties.
 - Allow a maximum deferral of 3 years.
 - 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)].**

Forestry

Introduction of offsetting for pre-1990 forestry

36. **note** that at Durban in December 2011, Parties to the United Nations Framework Convention on Climate Change agreed to introduce the Flexible Land Use (FLU) 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;
37. **note** 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:
- waiving the cost of deforestation under the ETS provided that a forest is established elsewhere on post-1989 eligible land; and

- transferring the ETS deforestation liability from existing pre-1990 forest land with higher economic uses to land more suited to forestry.
38. **agree** to enable offsetting for pre-1990 forest land consistent with the Flexible Land Use rules agreed for the Kyoto Protocol CP2 at Durban;
39. **agree** 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:
- The decision to deforest and take up offsetting will rest with the landowner.
 - Use of pre-1990 forest land look up tables to estimate the deforestation emissions of the cleared land.
 - Use of post-1989 forest land look up tables to estimate the carbon sequestration of the offset forest.
 - The landowner will be responsible for self-assessing and declaring non-compliance of his or her offsetting obligation, with MAF conducting risk-based audit as necessary to monitor and enforce compliance.
 - 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].
 - Any subsequent deforestation of the offset planting will be subject to the normal ETS deforestation liability.
 - The ability to set reporting and other thresholds through regulations.
40. **note** 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;
41. **note** that it is not possible to predict forest owners' demand for offsetting, as the economics for land conversion may change in the future. 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. **note** 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 offsetting¹⁵ ;

¹⁵ The estimated fiscal costs associated with offsetting presented here 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.

43. **agree** 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. 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. **note** 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. **note** that offsetting reduces the costs of the deforestation liabilities (potentially by 50% to 75%, 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. **note** 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;

47. **note** that cancelling the second tranche only for those who take up offsetting would produce fiscal savings of \$1.7million to \$27million in 2011/12;

48. **note** 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. **note** 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. **note** 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. **note** 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. **note** that the cancellation of the second tranche would produce fiscal savings of \$321.669 million in 2011/12;

53. **note** that the second tranche of allocation to pre-1990 forest land is to be provided in three categories:

- 37 NZUs per hectare for eligible pre-1990 forest land acquired prior to 1 November 2002;
- 24 NZUs per hectare for eligible pre-1990 forest land acquired on or after 1 November 2002;

- 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 settlement after that date.

54. **note** 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. **note** this approach would reduce the second tranche by around 55%, or in total by around 33% if you include tranche one, which is commensurate with the reduction in conversion costs provided by offsetting, and would 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. **EITHER** [supported by the Ministry for the Environment]

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

- Cancellation of the second tranche only for those who take up offsetting.
- 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 ha or an equivalent pro rata cancellation that reduces landowners' second tranche in proportion to their existing entitlements
- Cancellation of the second tranche in full.

OR [supported by the Treasury]

59.2. **agree** in principle to cancel the second tranche of pre-1990 forestry allocation in light of the introduction of offsetting, subject to consultation on this one option

OR [supported by the Ministry of Agriculture and Forestry]

59.3. **agree** to cancel the second tranche of pre-1990 forestry allocation only for landowners who take up offsetting

60. **agree** 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 paying back the value of the first tranche;

61. **note** that this would potentially general fiscal savings of \$2.249million over 2012/13 to 2014/15;

62. **agree** to delegate the responsibility to approve any consultation process and materials to the Minister for Climate Change Issues and the Minister of Primary Industries;

63. **agree** that the Minister for Climate Change Issues should launch this consultation at a hui to be organised by the Climate Change Iwi Leadership Group (CCILG) on 14 March;

64. **agree** that the Minister for Climate Change Issues should report back to Cabinet in May 2012 on the results of this consultation and that Cabinet should make a final decision on the second tranche at this time;

Global Warming Potentials (GWPs)

65. **note** that it was agreed at Durban that from 1 January 2013, the accounting of greenhouse gases will use the updated global warming potentials from the IPCC's 4th Assessment report;

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

67. **agree** 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

68. **note** the following indicative fiscal implications of recommendations 13 – 21, 26–27, 38–39, 58 and 68, as follows, with further details on these changes included in Appendix 2

\$ 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

69. **note** that final decisions on appropriations will therefore not be possible until after consultation on proposals to cancel the second tranche;
70. **note** that further technical and other decisions will be considered by Cabinet in March 2012 which will have fiscal implications and also be incorporated into the final package of decisions;
71. **note** that I will propose changes to appropriations when Cabinet makes decisions on the final package of ETS changes by June 2012, following public consultation on some decisions;
72. **note** that the Ministry for the Environment and 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;
73. **agree** 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;
74. **authorise** 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;
75. **agree** that decisions in this paper are subject to funding being available through the Budget 2012 process;

Process and timeline

76. **agree** that PCO should draft the final and ‘in principle’ decisions by Cabinet on the policy proposals presented in this paper;
77. **agree** to delegate power to the Minister for Climate Change Issues, in consultation with the Minister for Primary Industries as appropriate, to work with Parliamentary Counsel Office to further clarify and develop policy matters relating to the amendments set out in this paper, in a way that is consistent with Cabinet decisions;
78. **agree** that the Minister for Climate Change Issues may share this Cabinet paper, 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

79. **agree** to delegate responsibility to the Minister for Climate Change Issues for communication and engagement regarding the proposed amendments and response to Panel recommendations;
80. **note** that this engagement is likely to include contact with key stakeholders to test reactions to decisions made by Cabinet on ETS amendments, prior to introduction of legislation;

81. **agree** to delegate power to the Minister for Climate Change Issues to consult on parallel regulatory provisions in relation to:

- Detailed auction design (in consultation with the Minister of Finance).
- The operation of offsetting (in conjunction with the Minister for Primary Industries).

Hon Dr Nick Smith
Minister for Climate Change Issues
____ / ____ / ____

Appendix 1

2011 ETS Review Panel Recommendations

1. The 61 recommendations made by the ETS Review Panel in its final report are set out below.

The Panel recommends:

- 1.1 The government considers those issues raised during the Panel's consultation which it has not been able to reach a recommendation on using the *Summary of Submissions* as a starting point.
- 2.1 The government continues to accord priority in international negotiations, as well as in wider bilateral and regional engagements, to the development of international carbon markets generally, and specifically to ensure New Zealand has the ability to sell NZUs and buy international emission units.
- 2.2 The government continues to monitor the development of the carbon pricing mechanism in Australia and that, whilst it is desirable for the New Zealand and Australian schemes to work broadly in harmony, we should not be bound by the features of any particular overseas scheme.
- 3.1 The price cap should be retained after 2012, but should increase by \$5 per annum from 2013 to 2017, starting at \$30 per NZU in 2013 and reaching \$50 per NZU in 2017.
- 3.2 The next review of the ETS should consider whether a price cap is needed after 2017.
- 3.3 For the liquid fossil fuels, stationary energy and industrial processes sectors, the one-for-two surrender obligation should scale up to a full surrender obligation progressively from 2013 to 2015, increasing at equal intervals per annum, that is to 67 per cent in 2013, 83 per cent in 2014, and 100 per cent in 2015 (rounded to the nearest percentage).
- 3.4 The price cap should be available to all the new sectors entering the scheme after 2012, including the agriculture, synthetic greenhouse gases and waste sectors.
- 3.5 Participants in the synthetic greenhouse gases and waste sectors should have access to a 67 per cent obligation in 2013 and an 83 per cent obligation in 2014, and should assume full surrender obligation from 2015.
- 3.6 Participants in the agriculture sector should have a one-for-two surrender obligation in 2015 and 2016, a 67 per cent obligation in 2017, and an 83 per cent obligation in 2018, and should assume full surrender obligation from 2019.
- 3.7 The ban on NZU exports from non-forestry sectors should be removed when the price cap is removed, or sooner if the price cap is significantly above the international carbon price (and hence the risk of arbitrage is minimal).
- 3.8 An ETS price floor should not be introduced.

- 3.9 The existing allocation thresholds of 90 per cent allocation for highly emissions-intensive activities and 60 per cent allocation for moderately emissions-intensive activities should be maintained.
- 3.10 A value-added test for determining eligibility for industrial allocation should not be introduced.
- 3.11 The government examine further the potential inclusion of additional eligible emission sources for determining eligibility and allocative baselines under the Act.
- 3.12 The government examine further the potential inclusion of fossil fuel proxies for biofuels and new material proxies for recycled materials as eligible emission sources for determining eligibility under the Act.
- 3.13 The current phase-out rate of 1.3 per cent per annum of the previous year's allocation should be revised to an annual reduction of 1.3 percentage points, to clarify the exact phase-out rate and the year in which the free allocation of NZUs will cease.
- 3.14 The government gives consideration to the risks associated with the potential for new, emissions-intensive activities to significantly expand the volume of allocation, and options to mitigate these risks, in the context of the Minister's discretion to consider new emissions-intensive activities for eligibility.
- 3.15 The potential introduction of an allocation cap should be further considered in the next ETS review.
- 4.1 Agriculture remains within the ETS on the timetable that is currently legislated, with mandatory reporting beginning in 2012 and surrender obligations beginning in 2015.
- 4.2 The point of obligation for agriculture should be at the farmer level rather than the processor level.
- 4.3 The free allocation of NZUs for agriculture should be 90 per cent of a baseline initially, phased out at 1.3 per cent per annum on a straight line basis from 2016.
- 4.4 To support farmers within the ETS, the government and industry should continue to focus on technology transfer for existing mitigation options and the development of future options and tools to reduce emissions.
- 5.1 The government should make a hard-headed assessment of the Panel's recommended changes to the domestic ETS forestry rules after 2012 taking account of the international position, the potential fiscal impact/risk and financial impact/benefit to foresters and other stakeholders with a view to changing the ETS forestry rules along the lines recommended, if necessary unilaterally.
- 5.2 The forest ownership associated persons' test rules should be reviewed to determine whether the associated persons' percentage thresholds should be increased or varied to recognise the situation of related family farming operation.
- 5.3 The government should undertake further study on the amalgamation of smaller forestry blocks and the application of section CB25 of the Income Tax Act 2007.
- 5.4 Subject to recommendation 5.1, pre-1990 forestry offset planting should be introduced within the rules for pre-1990 forestry from 2012.
- 5.5 The government should introduce a claw-back provision for the second tranche of the pre-1990 forestry allocation, if offset planting is introduced into the ETS (as recommended by the Panel – see recommendation 5.4) and taken up by a participant.

- 5.6 There should be no changes to the two hectare pre-1990 deforestation threshold.
- 5.7 The government reviews applications for pre-1990 allocations and exemptions in November 2011 and considers whether there is a need to extend the current application timeframes.
- 5.8 The government continues to promote understanding within the forestry and land-use sectors about post-1989 harvesting liabilities and options for managing these.
- 5.9 The government should ask the International Accounting Standards Board and the soon-to-be-established New Zealand External Reporting Board to look into the treatment of post-1989 forest actual and contingent liabilities (of future harvesting) in financial accounts.
- 5.10 Subject to recommendation 5.1, the ETS rules in relation to post-1989 harvested wood products should be modified to reflect an 'emissions to atmosphere' approach if agreement on this has been reached internationally.
- 5.11 Averaging should be available as an option from 2012 for post-1989 forests. The government should consider whether a ceiling on the maximum size of forest that could participate in this option would be required.
- 5.12 The government gives consideration to, and consults on the establishment of, a self-insurance pool of units for post-1989 forests, along the lines of that proposed in Australia (5% retention). Such a scheme would have no recourse to the government and should not result in any further liabilities to the government.
- 5.13 The Panel recommends that owners of less than 100 hectares of forest have the option, at their cost, of undertaking actual measurement.
- 5.14 The Panel recommends that the government consider whether the 100 hectare threshold should be increased.
- 5.15 The pre-1990 tree weed exemption should be available beyond 2012.
- 5.16 The government should consider the appropriateness and means of introducing a voluntary ETS equivalent for pre-1990 indigenous forests.
- 6.1 The continuation of complementary measures such as the home insulation programme in order to mitigate the impacts on vulnerable households, including Māori.
- 6.2 The government continues, and considers strengthening, the existing afforestation schemes to encourage greater Māori participation in respect of post-1989 forests and takes into account the particular issues faced by Māori.
- 6.3 The government develops amendments to the Act that address the application requirements that affect Māori land, including:
 - reducing the application requirements for Māori freehold land in multiple ownership or owned by trustees of Māori trusts
 - ensuring that the Māori Trustee can apply for the 50 hectare exemption on the basis of individual Māori trusts' ownership rather than on the basis of its total landholding.
- 6.4 The government should explore whether temporary extensions to the exemption and allocation deadlines for Māori owners are necessary, whilst these issues are being addressed.

- 6.5 The government should establish a working group to work with the Māori Trustee to address the application requirement issues, as suggested by the Māori Trustee.
- 6.6 The government should monitor the level of engagement and capacity of Māori land trusts in relation to the ETS and consider ways to provide support where appropriate.
- 7.1 The point of obligation under the ETS should be on users of SF6 in electrical switchgear rather than importers of SF6.
- 7.2 The ETS obligation of users of SF6 in electrical switchgear should be based on estimates of actual emissions.
- 7.3 The government should consider the treatment of SF6 contained within equipment and still remaining upon disposal.
- 7.4 No changes should be made to the current ETS framework for bulk imports of non-SF6 synthetic greenhouse gases.
- 7.5 A levy, equivalent to the market price of emission units and reflecting the transition phase arrangements, should be placed on goods imported containing synthetic greenhouse gases that are not for personal use and the current exemption for small importers of motor vehicles should be removed.
- 7.6 The government should ensure such a levy is administratively simple for importers while minimising competitive distortions with New Zealand manufacturers.
- 7.7 The government should recycle a proportion of the levy revenue into industry-led initiatives that will reduce synthetic greenhouse gases emissions.
- 7.8 The government should prohibit knowingly releasing synthetic greenhouse gases into the atmosphere.
- 8.1 The government should introduce a discretionary power to exempt landfills from obligations under the ETS that are (i) geographically isolated, (ii) have a low volume of waste disposed of, and (iii) do not have alternative disposal options.
- 8.2 The government works with Local Government New Zealand to define criteria relating to landfill size.
- 9.1 No changes should be made at this stage in relation to the administration of the ETS across government.
- 9.2 No changes should be made at this stage to the penalties in the Act.
- 9.3 The security of the ETS register should be subject to periodic assessment/review.
- 9.4 The government should consider what further education resources could be provided to enhance current levels of understanding of the ETS.
- 9.5 The government should urgently consider whether HFC CERs pose a significant risk and whether a time limit should be imposed on their eligibility.

Appendix 2

Fiscal implications of proposals

1. The proposals in this paper give rise to significant fiscal impacts, which are detailed below.

Table A1: Summary fiscal impacts (\$ million)

\$ 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

2. Further fiscal impacts are likely to arise from proposals for technical and operational amendments to follow in the next Cabinet paper. These proposals are estimated to have a net negative impact of approximately \$10 million across the forecast period.

Proposals with fiscal costs and risks

3. The proposed change to phase out the one-for-two surrender obligation would raise estimated fiscal costs of 14.191 million units or \$147.731 million in total at a carbon price of \$10.41 per unit.
4. In addition, some of the proposals for amendments made in this Cabinet paper have implications for Agency operating costs, specifically:
 - *Implementation of auctioning (MfE)*. Initial estimates suggest that an auctioning system would require additional operating expenditures of up to \$2 million in one-off implementation costs and up to \$0.5 million per annum in on-going administration costs. These fiscal costs are estimated to be distributed as follows.
 - *Implementation of offsetting (MAF)*. Initial estimates suggest that implementation will take approximately 8-12 months from the time legislative amendments establishing offsetting are passed into law. Operating expenditure will be approximately \$4 million over a five year period including both operational and capital costs, with over 50% occurring in the first year (\$3.6 million in the period to 2014/15).
 - *Implementation of gradually phasing out the one-for-two surrender obligation (Environmental Protection Authority)*. Approximately \$0.1 million will be required to update the system for calculating surrender obligations and allocations, update guidance and provide education on the changed rules. This would be incurred in the 2012/13 financial year.
 - *Maintaining the \$25 price cap (MfE and Environmental Protection Authority)*. The operating expenditure will depend on how many ETS participants purchase NZUs directly from the Government through the price cap. It is estimated that the administrative cost associated with the price cap is \$200 – \$500 per transaction. The administrative cost associated with \$25 price cap will be minimal (about \$2,000 per annum) if international carbon prices are below the price cap. However, it could reach up to approximately \$0.3m if international carbon prices are above the price cap.
 - *Changing the second tranche of pre-1990 forest allocations (MAF)*. The operating expenditure for this proposal has yet to be confirmed, as it will depend on how the proposal is legislated.
5. The fiscal cost estimates in this Cabinet paper do not include the following fiscal risks already outlined:
 - The proposal to consult on changing the second-tranche of forestry compensation creates a risk that some or all of the second-tranche will not be cancelled, reducing the fiscal savings available. This risk will be reflected in the 2012 Budget Economic and Fiscal Update.

- Extending the \$25 fixed price option until 2015. The magnitude of this fiscal risk depends on whether the Crown is subject to an emissions reductions target requiring international units and the price of carbon units. Current price forecasts indicate relevant carbon unit prices will remain below \$25 through to 2015, but if the carbon price exceeds \$25, the Crown will face a relative loss of revenue through the ETS.
- Offsetting for pre-1990 forests. New Zealand could become liable for an associated increase in agriculture emissions under an international target and, without use of and a power to limit offsetting, New Zealand could breach its emissions allowance. To manage this risk, a cap on offsetting is proposed to be provided for in legislation but not enacted at this stage.
- Allowing landowners to take up the under 50 hectare exemption for deforestation liabilities, in exchange for forfeiting the second tranche of allocation and paying back the value of the first tranche. Fiscal risk would arise as a result because landowners with exemptions can deforest without incurring any ETS liability, which would create emissions for which New Zealand may be liable under an international target.

Proposals resulting in fiscal savings

6. Cancellation or reduction of the second tranche of pre-1990 forestry allocation would create fiscal savings of \$1.7 to \$321.669 million at a carbon price of \$10.41 per unit.
7. Adoption of the AR4 GWPs within the ETS will create additional fiscal savings of 1.808 million units or \$18.823 million, when applied in addition to the policy changes proposed in this Cabinet Paper.
8. Providing the option of re-apply for the under 50 ha exemption to pre-1990 foresters who have already received allocation could create fiscal savings of \$2.249 million at a carbon price of \$10.41. This is based on the assumption that these foresters would be required to forfeit their right to the second tranche of allocation and return the value of the first tranche.
9. The proposal to introduce auctioning would have a positive impact on the Government's net debt position. Auctioning provides the Government with a financial asset, cash, at the point of auction rather than carbon units which are an intangible asset. This would have an impact on net debt, but not on revenue. The extent of this impact will depend on the detailed design and level of auctioning, and will be detailed when taking decisions on the level auctioning.

Summary of Fiscal Impacts of Proposed Amendments

Table A2: Fiscal savings of proposed policy changes, excluding administrative costs

	increase/(decrease) in operating balance					
	2011/12	2012/13	2013/14	2014/15	2015/16	Total
Option subject to consultation: savings from full cancellation of second tranche (\$ million)	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) (\$ million)	-	0.562	1.124	0.562	-	2.249
Updating emissions projections with new Global Warming Potentials (million units)	-	0.116	0.260	0.574	0.859	1.808
Updating emissions projections with new Global Warming Potentials (\$ million)	-	1.203	2.707	5.973	8.940	18.823
Total (\$ million)	1.700 - 321.669	1.765	3.832	6.535	8.940	22.772 - 342.741

Table A3: Fiscal cost of proposed policy changes, excluding administrative costs

	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 (million units)	-	(3.292)	(7.743)	(3.156)	-	(14.191)
Transition phase— gradual phase-out of 2:1 surrender obligation (\$ million)	-	(34.268)	(80.609)	(32.854)	-	(147.731)
Total (million units)	-	(3.292)	(7.743)	(3.156)	-	(14.191)
Total (\$ million)	-	(34.268)	(80.609)	(32.854)	-	(147.731)

Table A4: Administrative costs of proposed policy changes (\$ million)

	increase/(decrease) in operating balance					
	2011/12	2012/13	2013/14	2014/15	2015/16	Total
Auctioning (\$million)	0.000	2.500	0.500	0.500	0.500	4.000
Transition phase — gradual phase-out of 2:1 surrender obligation (\$ million)	0.000	0.130	0.000	0.000	0.000	0.130
Transition phase — \$25 price cap (\$ million)	0.000	0.250	0.250	0.250	0.125	0.875
Forestry — offsetting (\$ million)	-	2.650	0.450	0.450	0.450	4.000

Notes:

- Fiscal impacts are shown as costs and savings relative to current legislation. Figures in brackets represent fiscal costs, while positive figures represent fiscal savings.
- The estimates for the fiscal impacts of policy proposals are based on a carbon price of \$10.41 per unit and AR2 Global Warming Potentials.
- Estimates for the fiscal impacts of the technical and operational amendments, which relates to the operational settings for the agriculture, waste and synthetic greenhouse gases sectors, are not included in the above tables. The total fiscal cost of these technical and operational amendments is in the range of \$10 – 20 million for the period up to the 2015/16 financial year, although this estimate depends on policy decisions and is still to be reviewed.
- It is assumed that the fiscal savings associated with cancelling the second tranche of pre-1990 forest allocation would be accounted for in the 2011/12 financial year. However, if the Government announces the cancellation of the second tranche after May 2012, the savings associated with the cancellation will be accounted for in the 2012/13 financial year.
- The proposal to allow landowners with less than 50 hectares to swap allocation for exemption will lead to fiscal savings, which are shown in table A2. The savings are due to the return of the first tranche of pre-1990 forest allocation. The estimated fiscal savings is based on the assumption that

20 percent of the landowners with less than 50 hectares will take up the option to swap allocation for exemption. However, this proposal also presents a fiscal risk because landowners with exemptions can deforest without incurring any ETS liability, which would create emissions for which New Zealand may be liable under an international target.

Appendix 3

Published Statements on Second Tranche of Pre-1990 Forest Allocation

Pre-1990 Draft Forest Allocation Plan – MAF, Oct 2008

2nd page, last paragraph:

Another reason for post-dating these NZUs is that negotiations are underway on the international framework that will apply post-2012, including the rule for the second commitment period of the Kyoto Protocol. If the rules change, for example if restrictions on the deforestation of pre-1990 forests are removed, the Government will wish to review its intention to allow the post-dated 34 million NZUs to be surrendered or converted. The Act allows post-dated NZUs to be cancelled if there are no longer any controls on deforestation under the NZ ETS.

Climate Change Response (Moderated Emissions Trading) Amendment Bill (Ministry for the Environment) RIS – MfE, Sep 2009 (Released)

Pages 16-17:

Only minor changes will be made to the treatment of forestry under the modified NZ ETS:

- *The forestry allocation plan process will be continued, with the option to cancel the second tranche of 34 million units relating to the 2013-2021 period if offsetting is introduced from 2013.*

To reduce litigation risk and to retain flexibility over the second tranche of allocation, it is necessary to amend the draft allocation plan. It is further recommended 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.

Cabinet Economic Growth and Infrastructure Committee - Amendments for a Moderated NZ ETS and Second Order Amendments to the Climate Change Response Act – MfE, Sep 2009 (Released)

Para 34:

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.

Appendix 2, Page 8, second paragraph:

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.

Departmental Report on the Climate Change Response (Moderated Emissions Trading) Amendment Bill – MfE, Oct 2009

Page 22:

While not stipulated in the Bill, the Government has indicated that if offsetting is introduced in the ETS from 2013 it may consider cancelling the second tranche of units that would otherwise be allocated to eligible owners of pre-1990 forest land.

Pre-1990 Forest land Allocation Plan (Consultation Draft) – MAF, Oct 2009

Page 2, last paragraph:

The NZUs relating to later commitment periods will be transferred after 2012. The reason for this change is that negotiations are under way on the international framework that will apply post-2012, including the rules for the second commitment period of the Kyoto Protocol. If the rules change, for example if restrictions on the deforestation of pre-1990 forests are removed, or offset planting is permitted under the international rules in Commitment Period 2, the Government may cancel some, or all, of the allocation relating to this period.

Climate Change Response Act 2002 – as at December 2009

Section 30G: Restrictions on certain New Zealand units allocated to landowners of pre-1990 forest land

(1) This section applies to any New Zealand units transferred or to be transferred after 31 December 2012 in accordance with the pre-1990 forest land allocation plan issued under section 70.

(2) [Repealed]

(3) If the activity listed in Part 1 of Schedule 3 is repealed, the Minister of Finance may issue a direction to the Registrar under section 7 to transfer from any holding account to a cancellation account any New Zealand units to which this section applies

A guide to the Pre-1990 Forestry Allocation and Exemptions – MAF, Dec 2010

Page 6:

The allocation will be transferred to landowners in two parts, but some or all of the second part may be cancelled if the law changes.

2011 ETS Review Panel Final Report – June 2011

Recommendation 5.5:

The Government should introduce a claw-back provision for the second tranche of the pre-1990 forestry allocation, if offset planting is introduced into the ETS (as recommended by the Panel – see recommendation 5.4) and taken up by a participant.

Letter to foresters on pre-1990 Allocation determinations – MAF, June 2011

If a change to the Act is made, for example the removal of deforestation of pre-1990 forest land as an activity, NZUs transferred or to be transferred after 31st December 2012 may be recovered from any holding account or the transfer cancelled.

Forestry Emission Unit Trust Factsheet final – MAF Oct 2011

Page 2:

Under the current international rules for reporting forest emissions and removals, New Zealand faces a cost for deforestation of pre-1990 land. It is possible these rules may change in the future. The Government has signalled it is possible part or all of the

second tranche may be cancelled. This will only happen if the deforestation liability is reduced or removed, probably following a change in the international rules.