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Office of the Minister for Climate Change Issues

Chair

Cabinet Economic Growth and Infrastructure Committee

Amendments for a Moderated NZ ETS and Second Order Amendments to the Climate Change Response Act

Proposal

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

Executive summary

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

   - The stationary energy, industrial processes and liquid fossil fuels sectors will enter[1] the NZ ETS on 1 July 2010. Monitoring and reporting requirements for these sectors will still commence on 1 January 2010.
   - A reduced price period will operate from July 2010 to December 2012. The reduced price period will be implemented through a progressive obligation requiring participants to surrender only one unit for every two tonnes CO_2-e emitted, combined with a $25 price cap.
   - Free allocation to emissions-intensive, trade-exposed industry will be provided on an intensity basis. Eligibility thresholds will be set to reduce trans-Tasman competitiveness risks. The number of units allocated to emissions-intensive, trade-exposed industry will be reduced by 50% during the reduced price period when the progressive obligation is in place.
   - The level of assistance will phase-out at a rate of 1.5% per annum beginning in 2013. The phase-out of allocation will also be considered through a five-yearly review of free allocation. The first review will be conducted in 2012. Any significant changes to the provision of free allocation will require a five year notice period.
   - The progressive obligation will not apply to the forestry sector, but the $25 price cap will apply to deforestation liabilities before 1 January 2013.
   - A reduced price period will operate from January 2013 to July 2015 for the agriculture sector, through a progressive obligation requiring participants to surrender only one unit for every two tonnes CO_2-e emitted. The number of units allocated to agriculture will be reduced by 50% during the reduced price period when the progressive obligation is in place.
   - Free allocation to the agriculture sector will be provided on an intensity basis on a similar basis to industry.

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

- An initial processor-level point of obligation will apply with flexibility to move to a farm-level point of obligation in the future.
- Free allocation to the fishing sector will be increased from the current level of 50% of 2005 emissions for three years, to 90% of 2005 emissions for two and a half years (July 2010 to December 2012).
- A domestic '50 by 50' emissions reduction target for New Zealand will be set.

3. A number of second order amendments are also proposed. These amendments are technical in nature and would be helpful to assist with the effective functioning of the Act.
4. The proposed amendments are estimated to give rise to fiscal costs of $400 - $500 million before 31 December 2012, with further costs from 2013 onwards. Economic costs are estimated to be minor in the short term, but moderate in the medium to long term.
5. In principle agreement, subject to the Emissions Trading Scheme Review Select Committee's report back to Parliament, is sought now to the proposals set out in this paper. It is further proposed that the Minister for Climate Change Issues, working with the Emissions Trading Scheme Ministerial Group (ETS Ministerial Group), continues to develop policy in a number of areas between now and September. Parliamentary Counsel Office should begin drafting amendments to the Climate Change Response Act based on in principle agreements reflected in this paper and policy development led by the Minister for Climate Change Issues.
6. Final policy agreement and agreement to introduce a bill will then be sought in September. It is desirable to pass an amendment bill in the week beginning 8 December at the latest. Therefore, it is likely that a truncated select committee process will be required.
7. Between now and September there will be further engagement with the Climate Change Iwi Leadership Group and the Māori Reference Group. The Ministry for the Environment will also need to begin informal engagement with industry stakeholders in relation to free allocation to emissions-intensive, trade-exposed firms.

Background

8. The National Party Manifesto includes a commitment to amend the NZ ETS, which as currently designed is inconsistent with principles set out in the Manifesto. The NZ ETS is also subject to an inquiry by the Emissions Trading Scheme Review Select Committee, which will report back to Parliament shortly.
9. There are a number of concerns with the NZ ETS as currently designed:
    - Firstly, there are concerns that the NZ ETS could have large initial impacts on businesses given the current economic climate.
    - Secondly, the NZ ETS does not adequately protect against the loss of key industries that are exposed to a carbon price ahead of international competitors. In particular, the proposed Australian Carbon Pollution Reduction Scheme (CPRS) will provide greater free allocation to

emissions-intensive, trade-exposed (EITE) industry than the NZ ETS. This could lead to trans-Tasman competitiveness risks.

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

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

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

Comment

Entry dates and reduced price period

11. The Act provides for the SEIP sectors and liquid fossil fuels (LFF) sectors to enter the NZ ETS on 1 January 2010 and 1 January 2011 respectively. I propose that the SEIP and LFF sectors will enter the NZ ETS on 1 July 2010 for unit surrender purposes (i.e. participants will be required to surrender units for emissions from 1 July 2010). Participants will still be required to monitor and report emissions from 1 January 2010, as currently provided for under the Act. This will enable them to prepare for surrender obligations accruing from 1 July 2010. To reduce compliance costs for industry, it is likely that surrender obligations for emissions from 1 July to 31 December 2010 will be based on a pro rata approach using total emissions reported for 2010.

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

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

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

14. In order to prevent arbitrage[2] occurring while the price cap is in place a ban on the export of New Zealand units converted to assigned amount units[3] may be needed. A ban on exports would also be needed if the NZ ETS linked with the Australian CPRS before 2016 (given a price cap is proposed until 2016 under the CPRS).

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

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

17. It is estimated that the reduced price period would give rise to fiscal costs of approximately $600 million before 31 December 2012, with a risk of increased costs if the international price of carbon rises above $25 per unit.

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

Intensity-based allocation to industry

19. The Act provides for free allocation to 'trade-exposed' industry from a capped pool of units equivalent to 90% of 2005 emissions from eligible industry. Under the Act, free allocation is to be phased out from 2018-2030. As currently designed, free allocation under the NZ ETS provides less protection for firms most at risk of suffering a substantial loss of competitiveness, compared to the proposed intensity-based allocation approach under the CPRS. This could lead to trans-Tasman competitiveness risks.

[2] Arbitrage refers to the acquisition of emission units in one market and sale in another in order to profit from a price difference between markets.
[3] The CCRA provides for NZUs to be converted to assigned amount units and exported.

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

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

- Activities will only be eligible for free allocation if they meet trade exposure and emissions intensity tests (with thresholds set to reduce trans-Tasman competitiveness risks).
- Consideration will be given to the possibility of providing allocation for very large emitters whose emissions-intensity falls below the applicable thresholds.
- More emissions-intensive activities will receive a higher level of assistance than less emissions-intensive ones. Initial levels of assistance under the CPRS have been increased to 94.5% and 66% respectively through the Global Recession Buffer mechanism. However, given the reduced price period until December 2012 and absence of any initial phase-out of free allocation, initial levels of assistance of 90% and 60% respectively are appropriate under the NZ ETS.
- During the reduced price period (see above) the number of units allocated will be reduced by 50%.
- The number of units each firm is eligible to receive will be calculated on the basis of the average emissions-intensity for each industry, not each firm's actual intensity. This will reward firms with lower than average emissions per unit of output, and ensure firms with higher than average emissions per unit of output are not rewarded for being less efficient.
- New entrants, or firms that are expanding, will automatically see their allocation increased, while shrinking firms will see their allocation decreased.
- The level of assistance will phase-out at a rate of 1.5% per annum beginning in 2013.
- Phase-out of allocation will also be considered through a five-yearly review of free allocation, which will consider progress in other countries (particularly Australia). It is intended the first review will be conducted in 2012. Any significant changes to the provision of free allocation will require a five year notice period.

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

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

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

25. The costs of adopting intensity-based free allocation for EITE industry depend on the details of allocation design (including eligibility thresholds, levels of assistance and phase-out) and the future emissions pathways of the sectors. Assuming that eligibility for free allocation is consistent with the CPRS, it is estimated it will provide fiscal savings of $100 - $200 million before 31 December 2012. It is also estimated that there will be savings of $90 - $160 million in 2013 and $40 - $100 million in 2020.[4]

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

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

28. It is important to start developing details of free allocation policy as soon as possible. This will ensure we are in a position to provide the greatest possible certainty over individual firms' entitlements to free allocation by the time the SEIP sectors enter the NZ ETS in July 2010. It will be difficult to undertake large scale engagement on intensity-based allocation prior to an amendment bill being passed. However, I propose that the Ministry for the Environment commences informal engagement with selected industry stakeholders shortly to begin developing details of the free allocation process.

Forestry

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

[4] These estimates assume a 1.5% per annum growth rate.

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

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

31. As noted above, a ban on the export of New Zealand units converted to assigned amount units may apply while the proposed price cap is in place. In contrast to other participants, owners of post 1989 forests benefit from a higher price of carbon. There may be some resistance from owners of post 1989 forests to banning exports, as it may close off a higher priced market for selling units. However, I expect any resistance to be mitigated by the ability for participants to continue to bank units and export them once an export ban ends.

32. I would expect, for this reason, to continue to allow exports of assigned amount units derived from the Permanent Forest Sink Initiative.

33. New Zealand is actively seeking changes to the international climate change rules to allow for more flexible land use. Providing for pre 1990 forestry offsetting prior to New Zealand securing a rule change internationally would give rise to significant fiscal and economic costs. Furthermore, forest owners have the option of delaying deforestation at little cost and potentially taking advantage of offsetting arrangements if they are introduced after 2012. Therefore, it is not appropriate to amend the existing Act provisions for offsetting.

34. The Act provides for free allocation to the pre 1990 forestry sector: 21 million units from 2008 – 2012 and 34 million units from 2013 – 2021. A draft allocation plan has been prepared, providing for the allocation of all 55 million units.[5] 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.

35. To retain flexibility over the second tranche of allocation, it may be necessary to either amend the draft allocation plan or the Act provisions for forestry allocation. Further analysis will be undertaken on this issue.

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

Agriculture

36. I propose that the agriculture sector is treated as follows:

    - The agriculture sector will enter the NZ ETS on 1 January 2013, as provided for in the Act.[6]
    - A progressive obligation will apply to emission liabilities from the agriculture sector from January 2013 to July 2015, with participants required to surrender only one unit for every two tonnes CO_2-e emitted (effectively providing a 50% discount).
    - Free allocation will be provided on an intensity basis, on a similar basis as EITE industry.
    - From January 2013 to July 2015 (while the progressive obligation applies) the number of units allocated will be reduced by 50%.
    - The level of assistance will phase-out at a rate of 1.5% per annum beginning in 2013.
    - Phase-out of allocation will also be considered through a five-yearly review of free allocation. Any significant changes to the provision of free allocation will require a five year notice period. This is consistent with free allocation for EITE industry.
    - An initial processor-level point of obligation will apply. The Act will be amended to keep open the option of a farm-level point of obligation, subject to stakeholder views and a number of key administrative challenges being successfully addressed. I also propose that the option of a hybrid point of obligation for the agriculture sector be removed from the Act, because it would be complex and potentially unworkable.

37. The proposed progressive obligation will lessen the impact of the NZ ETS on the agriculture sector until the end of June 2015, providing a smoother transition for the sector. Until more effective emission abatement technologies have been developed, or the weaknesses in the current international regime's treatment of agricultural emissions are addressed, a relatively generous level of assistance is justified for the agriculture sector.

38. The total fiscal costs of the proposed progressive obligation are estimated at approximately $190 million. The costs of adopting intensity-based free allocation for the agriculture sector depend on the level of assistance and phase-out. Assuming a 90% rate of assistance, fiscal costs are estimated at $20 - $30 million per annum in 2013, rising to $100 - $150 million in 2020.[7]

39. Economic costs from the proposed progressive obligation are expected to be minor. Moderate economic costs are expected in the medium to long term from adopting intensity-based allocation. The review mechanism will allow for future changes to free allocation.

[6] Unit surrender obligations will commence from this date. Monitoring and reporting obligations will commence from 1 January 2011.

[7] These estimates assume a 0.7% per annum growth rate.

Other changes

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

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

42. It is proposed that a domestic '50 by 50' emissions reduction target for New Zealand is introduced. This target may be incorporated as a purpose provision in the Act or set via the *Gazette* under the existing target mechanism provided for in the Act. Introducing the target will also include further clarification around its status and details for monitoring and reporting on progress toward meeting the target.

Second order amendments

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

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

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

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

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

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

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

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

49. The final reason for making amendments is to clarify certain provisions where the current wording could be considered to be ambiguous. These amendments are primarily recommended to reduce the risk of legal challenge to the exercise of administrative powers. Although in some cases the risk of challenge is considered to be low, the consequences of a successful challenge would be serious. Clarifying the meaning of these provisions will create greater certainty which will be beneficial for both participants and administrators.

Next steps

50. Following agreement in principle to the proposed modifications, further policy detail in a number of areas will be developed by the ETS Ministerial Group. Parliamentary Counsel Office should begin drafting amendments to the Climate Change Response Act as soon as possible based on in principle agreements reflected in this paper and policy development led by the Minister for Climate Change Issues. It is intended that final policy clearance and approval to introduce an amendment bill will be sought in September.

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

Risks

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

53. It is intended that an amendment bill will be passed in December and the SEIP sectors will enter the NZ ETS on 1 July 2010. Therefore, there is a limited timeframe during which a large volume of detailed policy on intensity-based

allocation is to be determined. This gives rise to a risk that on 1 July 2010 there will be a degree of uncertainty over the number of units individual firms will be allocated. However, I hope to give most industries a strong degree of certainty by then.

Consultation

Amendments for a moderated NZ ETS

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

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

56. The Treasury and the Ministry of Economic Development have made significant comments on the proposed amendments, which are outlined below. MAF are considering the implications of an export on Forestry units.

Treasury – reduced price period and phase-out comments

57. Treasury notes that the fiscal impacts of these proposals are very significant, particularly within the current fiscal environment. In particular, the sustainability of the fiscal costs and risks from intensity-based allocation to industry and agriculture is unknown. If proposed phase out rates remain unchanged, the long term fiscal costs are large and ongoing (in the order of $900m p.a. by 2030). Within the context of this paper it would be possible to reduce the short term fiscal impacts by shortening the time frame under which the progressive obligation applies or by increasing the progressive obligation over the phase out period (e.g. moving from 50% to 75% for the 2012 year). These options would reduce the fiscal costs.

Ministry of Economic Development – entry dates and reduced price period

58. The Ministry of Economic Development supports the objective of modifying the Emissions Trading Scheme to reduce its economic impact, especially given current economic conditions. The Ministry's view is that given the emission cost is likely to be very small cost for most businesses, the progressive obligation is not the most effective (targeted) way to manage economic risks. In addition it will be necessary for ETS ministers to receive advice on eligibility thresholds to ensure that they are appropriate to New Zealand circumstances. In addition, the Ministry supports a delay to the commencement of SEIP until January 2011 in order to develop appropriate allocation plans. The Ministry considers that this will give SEIP participants sufficient lead time to more fully understand their compliance obligations and to implement their support systems and processes.

Second order amendments

59. The Ministry for Agriculture and Forestry and the Ministry of Economic Development have important roles in implementing the NZ ETS and a large number of the proposed second order amendments to the governing legislation are recommended changes initiated by these agencies. The Ministry for the Environment has worked with these agencies to develop the proposed second order amendments which are agreed on by all agencies involved. The following further government departments have been consulted on the second order amendments and have not raised any concerns: the Treasury, the Ministry of Foreign Affairs and Trade, the Ministry of Transport and Te Puni Kokiri.

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

Iwi engagement

61. A process for engagement on modifications to the NZ ETS has been agreed between Minister Smith, the Climate Change Iwi Leadership Group (ILG) and the Māori Reference Group Executive (MRGE). This will involve engagement between the ETS Ministerial Group and the ILG, supported by officials and the MRGE. Engagement will involve a small number of regional hui, as well as a national hui in September.

Financial implications

62. The proposals in this paper give rise to significant fiscal costs, which are detailed below. For intensity-based allocation, though there are savings in the short term, the proposed policy settings potentially lead to large and growing fiscal costs in the long term, as shown in the table below. The extent of these costs will depend on the policy settings chosen, particularly on phase out rates for assistance. The fiscal costs will impact on the government's operating balance.

63. Treasury has modelled these costs and, while the model has limitations, they estimate that, if a 1.5% phase out rate is maintained into the long term, the proposed policy settings for intensity based allocation indicate a cumulative increase in Government debt of around 6-8% of GDP by 2050.

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

65. Fiscal costs of major amendments for a moderated NZ ETS are as follows:[8]

Proposed changes	Fiscal cost before 31 December 2012 ($m)	Fiscal cost from 1 January 2013 ($m)
Reduced price until 31 December 2012 (combined with a 1 July 2010 start date for the LFF and SEIP sectors)	Cost of $600m (with risk of increased cost if price goes above $25)	N/A
Intensity-based approach to allocation for EITE industry[9]	Likely saving of $100 - $200m	Saving of $90 - $160m in 2013 Saving of $40 - $100m in 2020
Reduced price for agriculture until July 2015	N/A	$190m (with risk of increased costs if price goes above $25)
Intensity-based approach to allocation for agriculture (assuming a 90% rate of assistance)	N/A	Cost of $20 - $30m in 2013 $100 - $150m in 2020
Increased fisheries allocation[10]	Cost of $3 - $4m	Saving of $7 - $8m
Total Fiscal Cost	$400 - $500m	Cost of $50 - $110m in 2020. Costs thereafter depend on phase-out rate for free allocation.

66. Fiscal costs of second order amendments are as follows:

	Fiscal cost/benefit before 31 December 2012 ($m)	Fiscal cost/benefit from 1 January 2013 ($m)
Inclusion of emissions from biofuel combustion	Eliminates risk of lost revenue of approx $0.75m p.a.	Eliminates risk of lost revenue of approx $0.75m p.a
Inclusion of egg producers	n/a	Eliminates risk of lost revenue of $0.5m p.a.
Ability to charge fees for emissions rulings[11]	Eliminates risk of administrative costs in the region of $0.5m - $1m p.a.	Eliminates risk of administrative costs in the region of $0.5m - $1m p.a.
Total Risk of Fiscal Cost eliminated	$1.25m – $1.75m p.a.	$1.75m - $2.15m p.a.

Human rights

67. 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.

[8] All fiscal estimates are comparisons against current appropriations.

[9] All fiscal estimates for intensity-based allocation are subject to assumptions on growth rates, and decisions on thresholds, assistance rates and phase-out rates. Fiscal estimates from 1 January 2013 are based on the adoption of phase-out rates similar to those proposed under the CPRS. As such, costs are indicative.

[10] Fiscal costs for increased fisheries allocation reflect the fact that allocation is increased to 90%, but the number of units is reduced by 50% during the reduced price period.

[11] It is very difficult to estimate the annual cost of administering the emissions rulings regime because rulings applications are demand driven so that it is difficult to estimate the volume, scope, and complexity of the rulings applications that would be received. Accordingly the figures provided are an indicative range only.

Legislative implications

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

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

Regulatory impact analysis

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

71. Treasury's Regulatory Impact Analysis Team (RIAT) was provided with

- limited regulatory impact analysis (RIA),
- only a draft Cabinet paper, and
- very limited time in which to review the RIA and the RIS.

72. In the time available, RIAT formed the view that the level of analysis presented is not commensurate with the significance of the proposals, which represent major design changes to the Emissions Trading Scheme, and that the RIS does not provide an adequate basis for decision-making. Major information gaps include:

- The rationale and analytical basis for the proposal to align key design elements of the New Zealand ETS with those in the currently proposed Australian Carbon Pollution Reduction Scheme, including assessment of the implications of adopting allocation formulas designed specifically for the Australian economy;
- Analysis of the potential equity effects on firms which will fall below the qualifying threshold for assistance under the proposed intensity-based allocation system;
- The basis for the proposed 50 per cent by 2050 emissions reduction target; and
- The likely effectiveness of the proposals in delivering on the stated policy objectives.

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

Publicity

74. It will be necessary to manage public announcements on policy decisions for amendments to the NZ ETS through a coordinated strategy. Authorisation is sought for the Minister for Climate Change Issues to manage public announcements/engagement on the proposed package of amendments following the report back to Parliament of the Emissions Trading Scheme Review Select Committee's report.

Recommendations

75. The Minister for Climate Change Issues recommends that the Committee:

1. note that the Emissions Trading Scheme Review Select Committee is still deliberating and that Cabinet is being asked to agree in principle in this paper subject to the Select Committee reporting back to Parliament

Entry dates and reduced price period

2. agree in principle that the stationary energy, industrial processes and liquid fossil fuels sectors shall commence to accrue surrender obligations in the New Zealand Emissions Trading Scheme from 1 July 2010
3. note that the Climate Change Response Act requires participants in the stationary energy, industrial processes and liquid fossil fuels sectors to monitor and report on emissions from 1 January 2010
4. agree in principle that stationary energy, industrial processes and liquid fossil fuels participants shall be required to surrender one emission unit for every two tonnes carbon dioxide equivalent emitted from 1 July 2010 to 31 December 2012
5. agree in principle to adopt a price cap of NZ$25 per unit from 1 July 2010 to 31 December 2012
6. agree in principle to provide for the ability to set a price cap in the period after 2012
7. direct the Ministry for the Environment to undertake further analysis in relation to a ban on the export of New Zealand units converted to assigned amount units to prevent arbitrage

Intensity-based allocation to industry

8. agree in principle to adopt an intensity-based approach to free allocation to emissions-intensive, trade-exposed industry with the following design features:
    - 8.1. eligible activities will be required to meet trade exposure and emissions intensity tests
    - 8.2. more emissions-intensive activities will receive a higher level of assistance than less emissions-intensive activities (with initial rates set at 90% and 60% respectively)
    - 8.3. subject to approval of recommendation 4, from 1 July 2010 to 31 December 2012 the level of assistance will be reduced by 50%

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

8.5. the level of assistance will phase-out at a rate of 1.5 per cent per annum beginning in 2013 subject to a five-yearly review of free allocation, with the first review conducted in 2012 (any significant changes to the provision of free allocation will require a five year notice period)

9. agree in principle to remove the requirement for an Innovation Fund provided for in the Climate Change Response Act

Forestry

10. agree in principle that emission liabilities from the pre 1990 forestry and post 1989 forestry sectors will be covered by a price cap of NZ$25 per unit from 1 July 2010 to 31 December 2012

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

12. agree in principle that the Permanent Forest Sink Initiative should not be covered by any ban on the export of units

13. direct the Ministry of Agriculture and Forestry to undertake further analysis on how to ensure flexibility to cancel some or all of the second tranche of allocation to the pre 1990 forestry sector (34 million units from 2013 – 2021) should offsetting be allowed as a result of international rule changes

Agriculture

14. agree in principle that agriculture participants shall be required to surrender one emission unit for every two tonnes carbon dioxide equivalent emitted from 1 January 2013 to 30 June 2015

15. agree in principle to adopt an intensity-based approach to free allocation to the agriculture sector with the following design features:

15.1. subject to approval of recommendation 14 from 1 January 2013 to 30 June 2015 the level of assistance will be reduced by 50%

15.2. the level of assistance will phase-out at a rate of 1.5 per cent per annum beginning in 2013 subject to a five-yearly review of free allocation (any significant changes to the provision of free allocation will require a five year notice period)

16. note that the Climate Change Response Act provides as a default position for the agriculture sector to enter the New Zealand Emissions Trading Scheme on 1 January 2013

17. note that the Climate Change Response Act provides for a processor-level point of obligation for the agriculture sector

18. agree in principle to keep open the option of a farm-level point of obligation for the agriculture sector in the future and remove the potential for a hybrid point of obligation

Other changes

19. agree in principle to increase the total pool of free allocation to the fishing sector from 50% of 2005 emissions for three years, to 90% of 2005 emissions for two and a half years (July 2010 to December 2012)
20. agree in principle that the number of units allocated to the fishing sector will be reduced by 50% reflecting the reduced price phase
21. agree in principle that legislation shall specify a total number of units for free allocation to the fishing sector equivalent to 90% of 2005 emissions for the two and a half years of allocation, having been adjusted for recommendation 20, as opposed to including the formula in legislation
22. agree in principle to introduce a New Zealand target of a 50% reduction of net greenhouse gases from 1990 levels by 2050
23. agree in principle that, if necessary, the bill amending the Climate Change Response Act should include a provision stating that the Act will bind the Crown

Fiscal impacts

24. note that the fiscal costs and negative impacts on the operating balance of the proposed changes are forecast as follows (based on a carbon price of $25):

Proposed change	**2010 ($m)**	**2011 ($m)**	**2012 ($m)**	**Fiscal cost from 1 January 2013 ($m)**
Reduced price until 31 December 2012 (combined with a 1 July 2010 start date for the LFF and SEIP sectors)	120	240	240	0
Intensity-based approach to allocation for EITE industry	*Likely saving of* (25-40)	*Likely saving of* (50-80)	*Likely saving of* (50-80)	*Saving of* ($90 – 160m) *in 2013* *Increasing annually to cost of* $40 – 100m *in 2020*
Reduced price for agriculture until June 2015	0	0	0	Cost of $190m *(with risk of increased costs if price goes above $25)*
Intensity-based approach to allocation for agriculture (assuming a 90% rate of assistance)	0	0	0	*Cost of* $20 – 30m *in 2013* *Increasing annually to cost of* $100 – 150m *in 2020*
Increased fisheries allocation	3-4	0	0	*Saving of* $7 - 8
Total Fiscal Cost	80-95	160-190	140-180	Cost of $50 – 110m in 2020. Costs thereafter depend on phase-out rate for free allocation.

25. note that all fiscal estimates for intensity-based allocation are subject to assumptions on growth rates, and decisions on thresholds, assistance rates and phase-out rates; fiscal estimates from 1 January 2013 are based on the adoption of phase-out rates similar to those proposed under the CPRS (as such, costs are indicative)

26. note that the costs in the forecast period will reduce the between Budget contingency

Second order amendments

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

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

    <u>High priority amendments</u>

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

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

    28.3. Enabling the delegation of the Registrar's Powers

    28.4. Creating the ability to waive fees and charges

    28.5. Creating the ability to charge fees for emissions rulings

    28.6. Removing potential time lag for other removal activity participants to earn emission units

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

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

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

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

    28.11. Defining farming in relation to land ownership

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

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

    28.14. Clarifying cost benefit analysis requirements in exemption provision

    <u>Medium priority amendments</u>

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

    28.16. Clarifying that section 64 directions will not be published

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

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

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

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

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

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

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

28.24. Amendment to the definition of forest land

<u>Lower priority amendments</u>

28.25. Requiring the Registrar to give effect to directions

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

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

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

28.29. Providing for authorised representatives in respect of joint activities

28.30. Clarifying obligation to retain records

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

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

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

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

Next steps

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

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

31. agree that the Minister for Climate Change Issues, working with the Emissions Trading Scheme Ministerial Group, shall further develop policy to be implemented through an amendment bill, including (but not limited to):

31.1. the detailed design of intensity-based allocation to emissions-intensive, trade-exposed industry

31.2. the detailed design of intensity-based allocation to the agriculture sector

31.3. a ban on the export of New Zealand units to prevent arbitrage

31.4. the details of a mechanism to provide the ability for a price cap for the period after 2012

31.5. the timing and implementation of free allocation to the fishing sector

31.6. the precise mechanism for introducing a 50% reduction of net greenhouse gases from 1990 levels by 2050

32. invite the Minister for Climate Change Issues to issue drafting instructions to the Parliamentary Counsel Office to give effect to the recommendations in this paper and further policy proposals from the Minister for Climate Change Issues

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

34. agree that the Minister for Climate Change Issues should return to Cabinet for final policy approval and agreement to introduce a bill in late September following the Emissions Trading Scheme Review Select Committee's report back to Parliament

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

36. authorise the Minister for Climate Change Issues to manage public announcements on amendments to the New Zealand Emissions Trading Scheme following the Emissions Trading Scheme Review Select Committee's report back to Parliament

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

Appendix 1

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

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

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

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

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

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

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

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

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

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

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

3. Enabling the delegation of the Registrar's Powers

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

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

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

4. Creating the ability to waive fees and charges

It is proposed to introduce regulation making powers that provide a power to exempt, waive and refund fees and charges to correct administrative errors (e.g. inadvertent double payments by an ETS participant). Similar powers exist under many enactments including the Biosecurity Regulations. MAF's internal legal advice has been that without an explicit power, MAF is unable to make refunds to correct administrative mistakes. This has already raised issues of equity and fairness in one case. While this is a minor technical amendment it is important to avoid any risk of bringing the ETS into disrepute through perceptions of inequity or unfairness in the administration of the ETS.

5. Creating the ability to charge fees for emissions rulings

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

6. Removing potential time lag for other removal activity participants to earn emission units

Under the Act as currently drafted, other removal activity participants cannot apply to register as participants until 1 January 2010. Registration will take effect once the application has been processed. Accordingly, it will not be possible for registration to be effective as at 1 January 2010.

This creates a timing issue because participants will face a cost increase from 1 January 2010, but not be able to become eligible to receive emission units until a time after 1 January 2010.

Accordingly, it is proposed to amend the Act so that registration can have effect from1 January 2010. This would mean that other removal activity participants would be entitled to receive emission units from the date that cost increases are experienced.

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

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

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

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

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

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

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

It is proposed that the Act be amended to clarify that emissions from biofuels combusted for electricity generation or industrial heat are covered by the Act.

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

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

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

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

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

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

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

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

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

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

11. Defining farming in relation to land ownership

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

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

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

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

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

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

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

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

The transfer date is important because it affects the amount of allocation that pre-1990 land receives. The rationale behind the decreased allocation for land that was transferred after 31 October 2002 was that once the previous government first

announced its intention to introduce policies to control rates of deforestation, a willing buyer could have factored that into the purchase price they were willing to pay for the land. However, this rationale does not apply to land that was transferred after 31 October 2002 by operation of law, for example by order of the Court, or by transmission on the death of a joint owner.

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

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

14. Clarifying cost benefit analysis requirements in exemption provision

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

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

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

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

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

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

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

2. Clarifying that section 64 directions will not be published

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

10. Amendment to the definition of forest land

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

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

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

1. Requiring the Registrar to give effect to directions

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

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

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

Administrative Accounts are held by the Crown for:

(a) Kyoto compliance; and

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

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

3. Clarifying relevance of subsequent commitment periods to NZU issuance

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

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

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

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

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

5. Providing for authorised representatives in respect of joint activities

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

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

6. Clarifying obligation to retain records

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

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

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

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

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

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

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

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

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