

Office of the Minister for Climate Change Issues

Chair

Cabinet

Emissions Trading Scheme Review 2012 – final decisions on amendments to the Climate Change Response Act 2002

Proposal

1. This paper seeks Cabinet's final decisions on 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, public consultation and further analysis.

Executive summary

2. Our domestic policy reflects international action and as such it is important to be clear on our position with respect to international commitments. **[Withheld under s9(2)(j)]**
3. **[Withheld under s9(2)(j)]** In the interim, our 2020 conditional target range of 10 to 20% below our 1990 gross emission levels will remain.
4. With respect to our domestic policy, I am proposing a range of amendments to the Act to:
 - implement key recommendations of the 2011 ETS Review Panel (the Panel);
 - implement key commitments in the National Party's Manifesto;
 - ensure the ETS helps to deliver New Zealand's 'fair share' of international action to reduce emissions post-2012; and
 - improve the technical operation of a number of parts of the Act.
5. Key strategic drivers for the proposed amendments 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.
6. In this context, the previous Minister for Climate Change Issues proposed a number of significant amendments to the Act to implement key recommendations of the Panel and key commitments in the National Party's

Manifesto [CAB Min (12) (8/7) refers]. These proposals were subject to a consultation which closed on 11 May 2012. I am now reporting back to Cabinet on this consultation and seeking Cabinet's agreement to final policy decisions.

7. I have also proposed a number of changes to improve the current treatment of the synthetic greenhouse gas (SGG) sector in the ETS [CAB Min (12) 16/6 refers], and to address more minor technical and operational matters [CAB Min (12) 19/7 refers]. These proposals were not subject to a formal public consultation but were agreed in principle subject to final decisions on the overall package of amendments.
8. The proposals I am now seeking Cabinet's final agreement to comprise of proposals previously agreed in principle subject to consultation in the first ETS Cabinet paper in February 2012 [CAB Min (12) (8/7) refers], adjusted where appropriate to reflect the outcomes of public consultation; previous in-principle decisions that were not subject to public consultation and new proposals following public consultation and further analysis. These are set out below:
 - Maintain the one-for-two surrender obligation after 2012, without specifying an end date in legislation.
 - Maintain the \$25 fixed price option after 2012, without specifying an end date in legislation.
 - Introduce an explicit power to allow auctioning within an overall cap on the supply of New Zealand Units (NZUs) and agree that such a power will be exercised, subject to consultation and further Cabinet agreement on the regulations establishing detailed design settings, including the level of the cap.
 - Remove the obligation under current ETS settings to 'back' all NZUs with an international unit.
 - Extend the ban on the export of NZUs from non-forestry sectors, whilst the fixed-price option remains in place.
 - Remove the entry date for surrender obligations for agricultural emissions.
 - Introduce offsetting within the ETS as an option for pre-1990 forests, with settings to reflect those agreed internationally.
 - Proceed with the second tranche of allocation to pre-1990 forest landowners, but claw back the second tranche from those who ultimately take up offsetting.
 - Align the ETS with international greenhouse gas accounting standards by adopting the latest, internationally accepted global warming potentials.
 - Change the current treatment of the SGG sector in the ETS [CAB Min (12) 16/6 refers] by:
 - i. removing the ETS obligation on the importation of SGG in motor vehicles, and replacing it with a motor vehicle levy;

- ii. removing the ETS obligation on the importation of SGG in goods, and replacing it with a goods levy;
 - iii. moving the ETS obligation on sulphur hexafluoride (SF6) importers and manufacturers to the user;
 - iv. prohibiting wilful release of SGG;
 - v. creating criteria for gaining units for the export and destruction of SGG to prevent stockpiling; and
 - vi. progressing the status quo for bulk importation of SGG.
- Adopt technical and operational changes stemming from experience gained in the practical application of the ETS [CAB Min (12) 19/7 refers], subject to the minor clarifications specified below:
 - i. In respect of the proposal to add the own-use of crude oil and other liquid hydrocarbons to the list of activities facing emissions obligations – not narrowing this to own-use by a miner – to avoid loopholes which might allow firms to avoid obligations, but narrowing it to crude oil only, to avoid capturing users of petrol or diesel; and
 - ii.* ensuring, when removing the obligation for the Crown to purchase and surrender units on behalf of insolvent participants, that the Crown can still pursue the cost of units not surrendered through a court.
- Adjust allocation:
 - i. Add fugitive coal seam methane to the list of emissions sources eligible for allocation for coal users
 - ii. Add liquid fossil fuels used in stationary energy to the list of emissions sources eligible for allocation.
 - iii. Clarify the circumstances in which Ministers can exercise discretion to grant industrial allocation to new activities to include references to the purpose of the Act, to reduce risks of potential legal challenge.
 - iv. Adopt the Australian approach to industrial allocation for the activity manufacture of carbon steel from cold ferrous feed.
 - v. Suspend the 1.3% phase out of industrial allocation until participants face full obligations
- Change how and when the ETS is reviewed:
 - i. Amend the sections of the Act relating to the formal review of the operation of ETS, to allow for more flexibility in the timing of future reviews.
 - ii. Agree that the next review of the ETS take place in 2015 and that it will specifically cover agricultures entry to the ETS and the extension of the one-for-two and fixed price option

- Adopt further technical and operational changes:
 - i. Clarify that the Environmental Protection Authority (EPA) can issue guidelines or standards for the collection of forestry data and information.
 - ii. Specify that the reporting period for the EPA's annual reporting under Section 89 should be 1 July to 30 June of each year, and the publishing date should be as soon as practicable thereafter.
- Provide flexibility to adjust to a new international framework:
 - i. Introduce a level of flexibility to some provisions in the Act that cross reference the Kyoto Protocol and other elements of the international framework **[Withheld under s9(2)(j)]**.

9. I recommend that we do not pursue Cabinet's agreement in principle to introduce a new power to restrict the number of international units that may be surrendered. This will ensure the ETS price of carbon continues to reflect the international price.

The fiscal cost of my proposed package of measures is \$328.447 million over the forecast period to 2015/16, as set out in Table 1 below. Fiscal costs will need to be met from the between-budget contingency, aside from the ETS Review contingency established through Budget 2012 (\$15.233 million). My proposed suite of recommendations will require \$313.214 million to be funded as a pre-commitment against Budget 2013.

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

\$ million	Increase/(decrease) in operating balance					Total across the forecast period
	2011/12	2012/13	2013/14	2014/15	2015/16 & Outyears	
Second tranche of pre-1990 forest land allocation — cancel for all owners who take up offsetting (they return NZUs they were allocated when they deforest)	-	1.443	1.443	1.443	1.443	5.772
Updating emissions projections with new Global Warming Potentials	-	0.541	0.961	1.264	0.704	3.470
Surrender obligation for own-use of oil	-	0.032	0.063	0.063	0.063	0.222
Removal of entry date of agriculture [sentence deleted to remove drafting error]	-	-	-	(12.156)	(23.640)	(35.796)
Transition phase—2:1 surrender obligation for LFF, SEIP, SGG and waste sectors	-	(28.053)	(79.995)	(79.779)	(77.853)	(265.679)
Extending the Pre-1990 tree weed exemption to 2015/16	-	(0.600)	(1.200)	(1.200)	(1.200)	(4.200)
Increasing allocation to coal users by amending the coal factor used in industrial allocation to cover costs associated with fugitive coal seam methane emissions	-	(0.692)	(0.692)	(0.692)	(0.692)	(2.767)
Increasing industrial allocation for "manufacture of carbon steel from cold ferrous feed" by reclassifying it as a highly emissions-intensive, trade-exposed activity	-	(0.107)	(0.109)	(0.112)	(0.114)	(0.442)
Application of SGG levy	-	(1.254)	0.300	0.300	0.300	(0.353)
Changing point of ETS obligation for SF6 activities	-	(0.395)	(0.791)	(0.793)	(0.794)	(2.773)
Emissions Trading Scheme Review implementation contingency	-	(8.745)	(2.095)	(2.213)	(2.180)	(15.233)
Add stationary energy use of liquid fossil fuels as an emission source eligible for industrial allocation	-	(2.017)	(2.017)	(2.017)	(2.017)	(8.069)
Suspending the phase-out of industrial allocation until ETS participants assume full	-	(0.236)	(0.501)	(0.780)	(1.081)	(2.599)

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

surrender obligation						
Total Operating	-	(40.084)	(84.632)	(96.671)	(107.060)	(328.447)

11. 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 by the end of the year. **[Withheld under s9(2)(f)(iv)].**
12. Legislative drafting of this package of amendments has already commenced. Parliamentary Counsel Office will complete their drafting of the amending legislation on the basis of decisions made by Cabinet on this paper. Given the complexity of the issues involved it is likely that, in the context of drafting, minor policy questions will arise which require clarification. I am therefore 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.
13. Finally, in light of the predicted on-going low carbon price and in line with the recommendations of the Advisory Group on Green Growth Initiatives and our agreement with the Māori Party I propose that officials be instructed to explore other measures in addition to the ETS that would promote investment by households and businesses in measures that will assist New Zealand to transition to a low carbon economy. I intend to report back to Cabinet on the result of this work later in the year.

Background

Key proposals for ETS changes

14. In December 2010, the Minister for Climate Change Issues appointed an independent panel (the Panel) to undertake a statutory review of the ETS, as required by the Act. The Panel delivered its final report to the Minister for Climate Change Issues on 30 June 2011.²
15. Following this review, Cabinet agreed in principle to a number of legislative amendments to the Act to improve the operation of the ETS, subject to public consultation [CAB Min (12) (8/7) refers]. These proposals were:
 - more gently phasing out the current one-for-two surrender obligation in three equal steps between 2013 and 2015 (as recommended by the Panel);
 - maintaining the \$25 fixed price option until 2015;

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

- providing for a more explicit power to auction NZUs to an overall cap on the supply of NZUs;
 - providing for a more explicit power to place a quantitative restriction on the surrender of international units;
 - the introduction of offsetting within the ETS as an option for pre-1990 forests;
 - a review of the second tranche of free allocation to pre-1990 forest landowners, with the option to reduce or remove the second tranche in recognition of the benefits offered by offsetting;
 - providing for a power to defer the start of surrender obligations for agricultural greenhouse gases by up to 3 years, subject to a review in 2014;
 - providing for a power to extend the fixed price option beyond 2015 and align it with any price ceiling in Australia should linking with the Australian Carbon Pricing Mechanism occur;
 - removing the obligation under current ETS settings to 'back' all NZUs with an international unit;
 - extending the ban on the export of NZUs from non-forestry sectors, whilst the fixed price option remains in place; and
 - aligning the ETS with international greenhouse gas accounting standards, by adopting the latest, internationally accepted global warming potentials.
16. In that discussion, Cabinet confirmed 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.
17. The Minister for Climate Change Issues also set out his key objectives for the package of amendments, which were to:
- ensure that the ETS more effectively supports the government's economic growth priorities;
 - ensure that the ETS is flexible enough to cater for a range of international outcomes in the period 2013 to 2020; and
 - improve the operation and administration of the ETS.

Public Consultation

18. A public consultation on the key proposed changes set out above closed on 11 May 2012. This consultation consisted of a written consultation document and a series of regional meetings and hui with Ministry for Primary Industries and

Ministry for the Environment officials. Several other meetings were also held with stakeholders during the consultation, including a meeting with industrial stakeholders organised by Business New Zealand.

19. 359 submissions were received in response to the written consultation. Overall, in both submissions and at meetings, stakeholder views on the overall package of amendments proposed by the Government were mixed. Many agreed or agreed in principle with some or all of the proposals put forward. However the majority of submitters had significant concerns around particular proposals.
20. A summary of submissions in response to the written consultation is attached at **Appendix 1**. My revised amendment proposals draw both on these written responses and on the points made in the stakeholder meetings.

Other changes agreed by Cabinet

21. In addition to the most significant proposals subject to the public consultation above, Cabinet has also agreed in principle to:
 - A number of changes to improve the current treatment of the SGG sector in the ETS [CAB Min (12) 16/6 refers].
 - A set of significant changes to the technical and operation settings of the ETS [CAB Min (12) 19/7 refers]. A total of 27 specific technical and operational changes were proposed and agreed in principle by Cabinet, subject to a final decision on the ETS package of amendments.

Comment

Context: New Zealand's post-2012 mitigation commitments

22. Pending further clarity internationally, New Zealand has not yet taken formal decisions on either its level of commitment or 'where' to take this commitment for the 2013-2020 transition period i.e. under the second commitment period (CP2) of the Kyoto Protocol or via alternative arrangements under United Nations Framework Convention on Climate Change (UNFCCC). **[Withheld under s9(2)(j)]**.
23. **[Withheld under s9(2)(j)]**
24. **[Withheld under s9(2)(j)]**
25. **[Withheld under s9(2)(j)]**

Amendments to the ETS

26. I have considered the outcome of the public consultations and other issues arising in the context of the agreed ETS objectives and wider international developments.
27. I now ask that Ministers make final decisions on a package of amendments to the Act, which have been grouped as follows:
 - Significant proposals previously agreed in principle subject to consultation, adjusted where appropriate to reflect the outcomes of public consultation.

- Confirmation of Cabinet's previous in-principle decisions that were not subject to public consultation.
- New proposals following public consultation and further analysis.

Significant proposals previously agreed in principle subject to consultation, adjusted where appropriate to reflect the outcomes of public consultation

Transition Phase

One-for-two surrender obligation

28. The consultation document proposed to phase out the one-for-two surrender obligation in three equal steps from 2013 to 2015 and that these changes cover the new sectors facing surrender obligations from 1 January 2013 (i.e. waste and synthetic greenhouse gases). This was proposed in order to reduce the impact of the ETS on businesses and households in the short term and provide for a smoother transition to a full obligation. These changes were recommended by the Panel.
29. A majority of those who commented on the proposal supported it. Some submitters (mainly emitters) preferred extending the one-for-two surrender obligation further than proposed because of the desire to moderate the costs of the ETS given what they saw as limited progress towards an international agreement and limited effort by other countries to implement emissions trading schemes. Those who opposed the proposal were concerned about weakened incentives to reduce emissions, the cost to taxpayers and reduced demand for emission units.
30. Given the current level of uncertainty around international action on climate change and the continuing economic recovery, I propose to amend the Act to extend the one-for-two surrender obligation after 2012. I do not propose to legislate a specific end date instead I propose that its continuation be reviewed in 2015. I also intend to apply the one-for-two surrender obligations to the waste and synthetic greenhouse gas sectors.
31. Under the current one-for-two obligation, entitlements to receive NZUs for non-forestry removal activities and industrial allocation are halved so that they are proportionate to the surrender obligations. To ensure that these entitlements remain proportionate to the new surrender obligations, I further propose that they are adjusted to reflect the continuation of the one-for-two surrender obligation (i.e. that they remain at 50% of the normal entitlement).
32. I consider that the proposed extension to the one-for-two surrender obligations remains a transitional measure (despite the open end date) and therefore and should remain a distinct legislative provision.
33. The fiscal impacts associated with these changes are shown in the table below.

Table 3: Net fiscal impact of transition phase measures (\$ million)

	increase/(decrease) in operating balance					
	2011/12	2012/13	2013/14	2014/15	2015/16 & Outyears	Total across the forecast period
\$ million						
Extension and phase-out of one-for-two surrender obligation to non-forestry sectors	-	(28.053)	(79.995)	(79.779)	(77.853)	(265.679)

Fixed price option

34. The consultation document proposed to extend and maintain the \$25 fixed price option until 2015. This was proposed given uncertainty about the future of international carbon markets, which creates uncertainty about international carbon prices.
35. The majority of submitters, mainly foresters and NGOs, disagreed with the Government's proposal. Some of these submitters preferred the Panel's recommendation to extend and increase the fixed price option by \$5 per annum from 2013. Others preferred to end the fixed price option as currently legislated on the basis that it is unnecessary given the low current carbon price and it would unfairly cap the profits of foresters at \$25 given that there is no cap on their future liabilities. Some of those that supported the proposal, mainly emitters, said they would prefer extending the \$25 fixed price option beyond 2015 in order to provide greater certainty.
36. In the light of the consultation responses, and considering the uncertain international position, I propose to extend and maintain the \$25 fixed price option. I note uncertainty about international carbon markets and carbon prices is greater after 2015. I therefore do not, at this stage, propose to legislate an end date for the fixed price option, so that it remains an option for the period after 2015. This will protect ETS participants from the risk of future carbon price spikes. I note that the Government would need to provide for any difference between the fixed price option and the international carbon price, if it was required in future to buy international units to meet an emissions target. However, the continuation of the fixed price option would of course be subject to the next ETS review, which will be better placed to assess the post-2015 situation.
37. A consequence of this decision is that the previous in principle decision by Cabinet to provide for a power to extend the fixed price option beyond 2015 and align it with any price ceiling in Australia, should linking with the Australian Carbon Pricing Mechanism occur, is no longer required. I therefore propose to withdraw this proposal. This means that any adjustment to the fixed price option to facilitate linking would require a change to primary legislation. Given the significance of this adjustment I consider this appropriate.

Ban on exports of NZUs from non-forestry sectors

38. The consultation document proposed to extend the ban on exports of NZUs from the non-forestry sectors given that it also proposed to extend the fixed price option. This was proposed in order to reduce arbitrage risks.
39. Only four submitters commented on this proposal, with three supporting it. . The submitter disagreeing with the proposal said that holders of NZUs should be able to exploit arbitrage opportunities.
40. In the light of the consultation responses, I propose to amend the Act in line with Cabinet's previous in principle decision to extend the ban on exports of NZUs from non-forestry sectors while the fixed price option remains in place.

Supply of NZUs after 2012 – auctioning within a cap

41. The consultation document proposed to introduce a mechanism through legislation that will allow the Minister for Climate Change Issues, following further consultation and decisions on detailed auction design settings, to:
 - auction NZUs within an overall cap on the amount of NZUs allocated and auctioned; and
 - place a restriction on the proportion of international units an ETS participant can surrender.
42. These proposals are designed to ensure an adequate supply of NZUs in the ETS, so that ETS participants did not have to purchase and surrender more international units than was necessary for New Zealand to meet its international or domestic target to reduce emissions.
43. The proposals were not designed to increase the price of NZUs within the ETS. My strong view is that this price should continue to reflect the international price. This view is reflected in my proposals below.

Restriction on international units

44. Substantially more submitters agreed or agreed in principle with the proposal to restrict the proportion of international units an ETS participant can surrender than disagreed. Business submitters predominantly disagreed and foresters agreed.
45. Those in favour of the proposal argued it would increase NZU prices above international prices. However, this was not the purpose of this proposal, which was to ensure ETS participants buy NZUs at the auction rather than international units. In addition, a number of submitters pointed out that a well-designed and efficient auction will in itself encourage ETS participants to buy NZUs at the auction, without the need for a restriction on international units.
46. On balance, I propose that a new power to place a restriction on the proportion of international units an ETS participant can surrender is not introduced in the context of auctioning. This will mean that:
 - the ETS remains open to international markets;

- the new power to introduce auctioning within an overall cap in the number of NZUs auctioned or allocation cannot by itself be used to influence ETS prices; and
 - the NZU price will continue to reflect the international price.
47. This is consistent with Cabinet's agreed objective for the ETS to 'deliver emission reductions in the most cost effective manner'.
48. I note that the Act already allows for restrictions on international units through regulations, and these powers could be used if such a restriction is needed to support auctioning in future, subject to consultation.

Auctioning within an overall cap

49. Slightly more submitters disagreed with the proposal to auction NZUs within an overall cap than agreed or agreed in principle. The most common reasons given by those who disagreed were concerns over the impact on NZU prices, reduced ability for foresters to sell their NZUs and that the international market will continue to work effectively without the need for Government intervention.
50. In terms of these concerns:
- Auctioning within an overall cap will not in itself increase NZU prices above international prices. If NZU prices rose above international prices at the auction, then ETS participants would simply buy and surrender international units instead.
 - Whilst auctioning will increase the supply of NZUs, there will continue to be demand for foresters' NZUs. This is because the supply of NZUs at the auction is not expected to meet demand for units. This means ETS participants will need to source NZUs (or international units) from elsewhere, such as foresters.
 - I am convinced that there is sufficient international market uncertainty to justify action. Many submitters agreed with the proposal because of concerns about international market uncertainty.
51. Some submitters proposed alternative ways for the Government to increase the supply of NZUs instead of auctioning, such as allocating free NZUs to projects which reduce emissions. These alternatives would increase the supply of NZUs but either:
- do not guarantee that they would increase supply by the required amount, unlike auctioning; and/or
 - raise additional fiscal costs, unlike auctioning; and/or
 - require Government, rather than the market, to set the price, effectively transforming the ETS into a carbon tax and losing the associated efficiencies of a trading scheme (e.g. closing the scheme to international units and relying on the fixed price option).
52. On this basis, I believe that there remains a need to introduce auctioning within an overall cap in order to address the problems of excessive purchasing of international units and international market uncertainty [CAB Min (12) (8/7)]

refers]. Accordingly, I propose that Cabinet agrees to its previous in principle decision to amend the Act to allow for an express regulation making power to introduce auctioning within an overall cap [Cab minute (12) 8/7 refers].

53. Furthermore, I propose that this power is exercised, subject to consultation. If Cabinet agrees to this proposal then further consultation on the introduction of auctioning and detailed auction design settings, including the level of the cap, will commence during 2012, consistent with Cabinet's previous decision. I propose to present Cabinet with the proposals for consultation later in 2012, prior to this consultation being launched.

Providing more certainty

54. A common concern, raised by both those who agreed and disagreed with the proposals, was that if they were implemented this would increase regulatory and market uncertainty. This is because the Government would be able to make changes through regulations and would only need to give 12 months notice of a change.
55. There is a need to balance calls for more certainty with the need for flexibility to respond to changing international (e.g. the international obligations New Zealand might face after 2012) and domestic circumstances, such as changes to ETS design settings (e.g. the possible delay in covering agriculture emissions). Similarly, it is likely that any auction mechanism will need to be refined in the early years of its operation, as the Government and participants get to grip with its operation.
56. I note that the Act already theoretically allows NZUs to be sold, which could include by auction. It also allows for restrictions on international units through regulations. The proposed changes were designed to provide more clarity and specificity in relation to how powers would be used.
57. Cabinet has previously agreed in principle that the regulations related to auctioning should specify the number of NZUs to be allocated and auctioned under the cap in each year over a five year period. This already provides a significant degree of certainty. Certainty could be increased by annually extending the regulations related to auctioning by one year. This will mean ETS participants will have information in any one year about the supply of NZUs under the cap for the next five years. This would not however reduce Government flexibility as we would retain the ability to change regulations with one year's notice.
58. The annual extension would be subject to the same regulation making procedures that apply to them being made initially, but will not be subject to the additional restrictions that apply to amending these regulations. I propose that the Act is amended accordingly.

NZUs excluded from the cap

59. The purpose of the cap is to provide ETS participants with a degree of certainty about the supply of NZUs to be released onto the market by the government. As proposed, the cap would be based on the number of NZUs to be auctioned and

allocated. This would include allocations to emissions-intensive, trade-exposed industrial activities and agriculture. **[Withheld under s9(2)(b)(ii) & s9(2)(ba)]**

60. However, the cap would exclude all NZUs issued for administrative reasons but not allocated or auctioned to participants, or transferred for any other reason, such as:
- NZUs transferred for removal activities (e.g. post-1989 forestry).
 - NZUs purchased from the Government under the \$25 fixed price option.
61. Removal activity NZUs should be excluded as they relate to emission reductions rather than actual emissions. The fixed price option is intended to protect businesses from excessive carbon prices. Capping NZUs sold under this option would undermine this purpose and should also be excluded.
62. I also propose to exclude NZUs provided to correct for an error in an initial allocation (under s86C(5) of the Act). Administratively, it will be very problematic to include such corrections within the cap. A breach of the cap could easily arise if NZUs have been auctioned up to the cap, but it is subsequently found that too few NZUs were allocated to a particular firm due to an error, requiring additional NZUs have to be allocated to make up the shortfall.

Clarifying and finalising Cabinet's previous in principle decisions

63. I propose that Cabinet agrees to amend the Act in line with its previous in principle decisions related to auctioning, subject to the technical clarifications below, identified in discussion with the Parliamentary Counsel Office (PCO):
- I propose to amend the Act to specify that the cap does not restrict the amount of NZUs allocated, but only limits the number of NZUs available for auction. The number of NZUs available for auction would be the level of the cap, minus the number of NZUs allocated. If allocation is in excess of the cap, then no NZUs should be auctioned. Whilst it is unlikely that allocation would, on its own, breach the cap, this clarification would ensure that allocation continues to be provided on an uncapped, intensity-basis.
 - Cabinet had agreed in principle to a list of matters the Minister must have regard to when determining 'the amount of NZUs to be auctioned and the overall cap'. However, the regulations will only specify the level of the overall cap, not the amount of NZUs to be auctioned. The list of matters therefore only relates to setting the overall cap.
 - This list of matters should include the sector coverage of the ETS, such as whether agriculture emissions are included, and other ETS design settings, such as the level of the surrender obligation.
 - Cabinet agreed in principle to the process for amending the regulations related to auctioning. However, Cabinet has not made any decisions in relation to the process for introducing and extending the regulations related to auctioning. I propose that the general procedure for making regulations in s30H of the Act is used for introducing and extending the regulations related to auctioning.

- I propose that the specific requirements that Cabinet has agreed in principle to when amending the regulations apply in addition to the general procedure for making regulations in s30H of the Act and that the consultation provisions in s30H to consult 'substantially affected parties' should apply.

Removal of obligation to 'back' NZUs

64. The consultation document proposed to remove the obligation to 'back' all NZUs issued with an equivalent amount of approved international units. This was proposed because the proposal to auction NZUs within an overall cap would remove the need for this requirement.
65. A majority of those who commented on this proposal disagreed with it. The main reasons given by those who disagreed were the perception that ETS forestry participants would no longer be able to sell units overseas and that removing backing would damage the environmental integrity of the ETS.
66. I note that removing the backing requirement would not remove the facility, elsewhere in the Act, for the Government to allow NZUs to be swapped for AAUs for export. A decision on whether this facility can be maintained after 2012 (for example, if New Zealand is not part of a second commitment period of the Kyoto Protocol) can be taken separately under existing legislation. This will need to be subject to a further discussion between Ministers.
67. In terms of environmental integrity, I note that New Zealand is expected to exceed its commitments under the first commitment period of the Kyoto Protocol. If auctioning within a cap is introduced then this will provide similar assurances around the environmental integrity of the ETS as the 'backing' policy.
68. On balance, based on the issues raised in consultation and analysis, I recommend that Cabinet confirm its previous in principle decision to remove the obligation under current ETS settings to 'back' all NZUs with an international unit, subject to agreement to introduce auctioning of NZUs within an overall cap.
69. This will avoid the currently unbudgeted fiscal costs of \$140 million at a \$6 carbon price in the period 2012/13 to 2015/16, covering the NZUs allocated in excess of the AAUs and RMUs received in CP1, should the requirement to 'back' NZUs for the first commitment period be maintained.

The entry of Agriculture to the ETS

70. Agriculture accounts for a significant proportion of New Zealand's greenhouse gas emissions (47.1% or 33.7 million tonnes CO₂-e in 2010). Agriculture processors, mainly milk and meat processors, are currently the participants for agriculture in the ETS and must report agricultural emissions from 1 January 2012. Under current settings participants will face costs for their emissions from 2015 with net liabilities equating to approximately 10% of agricultural emissions.
71. The consultation document proposed a power to defer the entry of agricultural gases into the ETS by up to three years, subject to a review in 2014, if certain conditions have not been met. These conditions were that:

- there are technologies available to reduce these emissions; and
 - international competitors are taking sufficient action on their emissions in general.
72. Seventy-one submissions were made on the deferral power during the recent consultation process. Agricultural organisations, agribusiness companies and farmers were generally in favour of the proposed power. The majority (mainly foresters, industry and environmental groups) were opposed for equity, economic and environmental reasons.
73. I consider that it is important to have flexibility to determine when agriculture enters the scheme; I am concerned that tying this decision to a special review in 2014 does not provide enough flexibility for the Government to make this decision at an optimal time and risks “review fatigue”. I therefore propose to remove the 2015 entry date for surrender obligations for agricultural emissions.
74. The proposed removal of the 2015 entry date for agriculture is intended to be a transitional measure designed to give Ministers more flexibility over the optimal timing for the imposition of surrender obligations for the agricultural sector.
75. Reducing agricultural emissions in the long-term remains a priority. As practical technologies to reduce emissions become available a more effective point of obligation for agriculture in the ETS could be at farm level.
76. As such, I recommend that officials explore options for moving to a farm level for the reporting of agricultural emissions in the ETS as soon as possible. The Agriculture ETS Advisory Committee is currently working on options for moving to a farm-level point of obligation for emission liabilities and will report on those options in December 2012.
77. The fiscal impact of this proposal is shown in the table below

Table 4: Net fiscal impact of removal of entry date of agriculture (\$ million)

	increase/(decrease) in operating balance					
	2011/12	2012/13	2013/14	2014/15	2015/16 & Outyears	Total across the forecast period
\$ million						
Removal of entry date of agriculture [sentence deleted to remove drafting error]	-	-	-	(12.156)	(23.640)	(35.796)

Introduction of offsetting for pre-1990 forestry policy

78. In March 2012, Cabinet agreed in principle, subject to consultation, to introduce offsetting for pre-1990 forestry in the ETS consistent with the international Flexible Land Use (FLU) rule agreed at Durban. This policy would allow flexibility to pre-1990 forest landowners to change to a more profitable land use without any deforestation liabilities, as long as a new forest is established elsewhere.

79. Cabinet agreed in principle, subject to consultation, to amend the Act in order to:
- enable a domestic pre-1990 forest offsetting policy consistent with the flexible land use FLU rule agreed at Durban (Cab. Min (12) 8/7, paragraph 38);
 - build on existing ETS operational processes and systems when implementing offsetting (Cab. Min (12) 8/7 paragraph 39); and
 - include a power for the Minister of Climate Change Issues to place a limit on the age of trees to be deforested or requirement to maintain the offset forest for a full rotation if this is necessary to mitigate any fiscal risks (Cab. Min (12) 8/7, paragraph 43). I now propose that this power is not taken forward, as set out below.
80. Cabinet agreed that the domestic policy should be based on the requirements of the FLU rule. This would significantly lessen the potential fiscal costs of pre-1990 offsetting in the ETS should New Zealand sign up to a CP2 and best manage any risks and acceptability from trading partners if New Zealand takes a commitment outside the Kyoto Protocol.

Proposed Changes to Offsetting Rules

81. The consultation process in April focused on the key requirements to enable offsetting in the ETS. The majority of submitters agreed with offsetting in the ETS and considered it will optimise land use, and consequently support economic growth. Despite the acceptance of the policy, submitters noted that offsetting represents a benefit only to a few pre-1990 forest landowners. The main reasons were the practical and economic barriers for adopting offsetting. These included a lack of alternative land uses for the forest land, the need to wait for harvesting to take up offsetting, and landowners wanting to exit forestry after harvest.
82. Submitters sought the following changes to the proposed pre-1990 forestry offsetting policy, which reflect potential impediments for some landowners to take up the policy:
- a. Using existing post-1989 forest not in the ETS as offset forest;
 - b. Using deforested pre-1990 forest land (converted to other land use) to establish an offset forest;
 - c. Using natural regeneration for offset forest establishment.
83. All of these changes would involve significant departures from the international FLU rules, and (in some instances) from the general international rules that govern accounting for emissions from forestry. In instances where these proposed changes were applied, New Zealand would likely continue to face deforestation liabilities under any future international obligation, and would not be able to apply the FLU rules to avoid these liabilities.
84. This would create a significant fiscal risk for the government under any future international agreement. I do not consider that these fiscal risks are outweighed by the additional flexibilities these proposed changes to the offsetting rules might provide to forest land owners. I therefore do not propose that Cabinet agrees to these changes.

Land Harvested in CP1

85. Submitters have argued that land harvested in CP1 (before 2013) and currently unstocked and not classified as deforestation, in compliance with the Act, should be to be eligible for offsetting. Officials have analysed the implications of this in the light of the interpretation of the Durban rule, existing international accounting and reporting guidelines and future processes to update these.
86. **[Withheld under s9(2)(j)]**
87. **[Withheld under s9(2)(j)]**
88. **[Withheld under s9(2)(j)]**

Regulations for pre-1990 forestry offsetting

89. Regulations are needed to implement pre-1990 forestry offsetting, consistent with previous decisions made in principle. I propose that Cabinet agree that the various matters below be addressed through the development of the regulations, including through consultation:
 - pre-1990 forestry offsetting application process (including but not limited to requirements for applications and information required);
 - prescribing conditions for offsetting;
 - requirements for calculating carbon equivalency;
 - land status notifications for lands in respect of which a person has registered participation;
 - penalties for breaches of the regulation not already specified in the Act;
 - any other matters the Minister for Climate Change Issues considers necessary to ensure the effective operation of the pre-1990 offsetting policy.
90. I propose Cabinet agrees to consultation on pre-1990 forestry offsetting regulations, including detailed operational processes. Due to the tight timeframes this consultation will need to take place in parallel to the drafting of the legislation.
91. Previously Cabinet agreed in principle, subject consultation, to introduce a power to limit the uptake of offsetting either on the age of trees to be deforested or the requirement to maintain the offset forest for a full rotation, should it prove necessary to mitigate any fiscal risks of exceeding New Zealand's reference level under a future international agreement. This proposed power was not specifically consulted on. However, based on information received in public consultation on the introduction of offsetting, it appears likely that the demand for offsetting will be low, and I no longer consider this risk to be significant. I therefore now consider it unnecessary to introduce this power and accordingly withdraw this proposal.

Pre-1990 forestry – review of second tranche of forestry allocation

92. The pre-1990 forestry allocation was partial compensation for the loss of land value land owners were expected to face because of ETS deforestation liabilities. The compensation is to be transferred in two tranches. The first tranche is due to be transferred by 31 December 2012, and the second tranche (estimated to be 30.9 million NZUs³) is due to be transferred from 1 January 2013.
93. The proposed introduction of offsetting changes the rules for pre-1990 forest land, and can be expected to reduce the cost of deforestation and therefore the impact of the ETS on land values. The government has previously signalled a possible reduction or cancellation of the second tranche of the allocation if offsetting is introduced to the ETS.
94. Therefore, because of the proposal to introduce offsetting, Cabinet agreed to consult on three options to adjust the second tranche [Cab Min (12) 8/7 refers]. The three options were:
- cancellation of the second tranche in full;
 - reduction of the second tranche (for example, allocating all landowners 11 NZUs per hectare, or a *pro rata* cancellation in proportion to their existing entitlements);
 - cancellation of the second tranche only for those who take up offsetting (recommended by the Panel).
95. Consultation included an option to allow eligible landowners to take up the less than 50 hectares exemption, in exchange for forfeiting the second tranche of allocation, and returning the first tranche.

Issues raised in consultation

96. Of those who responded to the question of whether to adjust the level of compensation in light of the introduction of offsetting, nearly all submitters did not support it. A number of reasons were cited, including:
- Their inability to benefit from offsetting because forestry is the best use for their land, the land has long-term forestry leases, or they lack capital or ability to offset.
 - The original compensation was too little or negligible in the first place.
 - The Government is reneging on its promise, agreement or contractual obligations with landowners.
 - It creates inequity across sectors because agriculture does not face emissions liabilities and other sectors have the '1 for 2' surrender obligation; while pre-1990 forestry faces full obligations.

³ The final estimate of the value of the second tranche depends on the final determinations made to all applications. These are still in process.

97. If Government were to adjust the allocation, then cancelling the second tranche only for those who take up offsetting was strongly preferred overall.
98. A few submitters supported full cancellation of the second tranche. One reason provided was that with current carbon prices it is considerably cheaper than originally envisaged to change land use, and another was that the compensation provided the incentive to not replant.
99. Many submitters argued that adjusting the second tranche could result in reduced willingness to invest or reinvest in forestry, despite the allocation being one-off historical compensation. Submitters also stated that adjustment or cancellation would negatively impact on the Māori/Crown relationship, and be a breach of good faith and previous commitments.
100. There was a high level of misunderstanding from submitters regarding the original reasons for allocation. Many consider the allocation as an entitlement. While the link between the pre-1990 deforestation rules and the allocation was made in a number of government publications and presentations, this may not have been consistently understood by participants.

Analysis and consideration of the options

101. The original allocation was based on average impacts and did not take into account individual circumstance. Some pre-1990 forest landowners would have faced significantly higher land value impacts than others; particularly where land was suitable for conversion to another, higher value, use. Offsetting helps to redress this balance as it will enable flexible land use for landowners whose land value has been most impacted.
102. The consultation results and comments indicate much of the pre-1990 forest may already be in the best land use and have limited conversion potential.
103. It remains the case, therefore, that a principled policy argument can be made to cancel the compensation in full or in part because the introduction of offsetting reduces the cost of deforestation under the ETS and can be expected to have a positive impact on property values (because it lowers the cost of putting land to best use). Where land is already in best use the impact on land values would not have been great.
104. However, if the Government were to proceed with cancellation, in whole or in part, **[Withheld under s9(2)(h)]**. In addition, there are likely to be relationship risks with the forestry sector and iwi.
105. Following the consultation I considered a number of additional options for partial compensation **[Withheld under s9(2)(g)(i) & s9(2)(h)]**. These are summarised below:
 - a. A pro-rata cancellation (say, of 50% of the second tranche), which acknowledges that expectations/business planning will have factored in the differing rates of the original compensation.
 - b. A flat rate (of say, up to 11 units per hectare) on the basis that offsetting is available to everyone equally and the 11 units are provided equally to support the costs of offsetting in response to the submitters concerns.

- c. A targeted fund to support offsetting (based on 50% of the value of the second tranche), which would target those whose land value has been most impacted and who wish to convert.

[Withheld under s9(2)(h)]

106. **[Withheld under s9(2)(h)]**
107. **[Withheld under s9(2)(h)]**
108. **[Withheld under s9(2)(h)]**
109. **[Withheld under s9(2)(h)]**
110. **[Withheld under s9(2)(h)]**
111. **[Withheld under s9(2)(h)]**
112. **[Withheld under s9(2)(h)]**
113. **[Withheld under s9(2)(h)]**
114. **[Withheld under s9(2)(h)]**
115. **[Withheld under s9(2)(h)]**

Preferred option

116. I expect the proposed introduction of offsetting from 2013 to reduce the impact of the ETS on pre-1990 forest land values. In this light there is a clear policy case for cancelling the second tranche of pre-1990 allocation. However, few stakeholders appear to accept this case and it would create significant relationship risks, **[Withheld under s9(2)(h)]**.
117. On balance, I therefore propose that Cabinet agree to claw back the second tranche from landowners who take up offsetting. **[Withheld under s9(2)(h) & s9(2)(g)(i)]**.
118. **[Withheld under s9(2)(h)]**.
119. I note that the fiscal savings for taxpayers from this option will be small.

Table 5: Net fiscal savings of second tranche option (\$ million)

	increase/(decrease) in operating balance					
	2011/12	2012/13	2013/14	2014/15	2015/16 & Outyears	Total across the forecast period
\$ million						
Cancellation of the second tranche for those who take up offsetting	-	1.443	1.443	1.443	1.443	5.772

120. It was proposed to allow landowners with less than 50 hectares of pre-1990 forests to revisit their choice to receive an allocation instead an exemption if there was a reduction or cancellation of the second tranche. As this is not recommended, I do not consider it necessary to make this option available.

Aligning the ETS with international greenhouse gas accounting standards

121. Global warming potentials (GWPs) are the metric used to assess the relative impact of each greenhouse gas, to enable non-CO₂ gases to be converted into CO₂-equivalent quantities for common accounting purposes. From 1 January 2013, international rules for reporting and accounting of greenhouse gases will require use of updated GWPs from the Intergovernmental Panel on Climate Change (IPCC) 4th Assessment report (AR4). Overall, adopting the AR4 values will increase New Zealand’s net emissions by about 8% from 2013-2020.
122. Cabinet agreed in principle, subject to consultation, to amend the Act to bring the ETS in line with the new prescribed GWPs after 2012. Arguments from submitters who supported the proposal included the need to adopt consistent international rules and common standards (e.g. to facilitate linking with other trading schemes). Other submitters were concerned about the underlying science of GWPs, or the additional ETS cost the new GWPs would impose on certain activities.
123. The updated GWPs represent the latest scientific consensus internationally and will continue to ensure the ETS remains aligned with our international reporting (and any future international obligations). Not aligning the ETS with the latest GWPs would create significant fiscal risks for the Government should New Zealand face new international obligations in future. If Cabinet agrees to the Panel’s proposed one-for-two surrender obligation phase out, the initial impact of the updated GWPs will be mitigated.
124. On balance, based on the issues raised in consultation and analysis, I recommend that Cabinet confirm its previous in principle decision to align the ETS with international greenhouse gas accounting standards, by adopting the latest, internationally accepted global warming potentials.

125. These changes to GWPs will have fiscal implications in that they will affect both allocation and surrender obligations within the ETS. The changes would result in increased costs for some ETS participants by \$3.470 million over the forecast period up to 2015/16, and affect mainly participants in the agriculture, waste and SGG sectors.

126. The fiscal impact of the is proposal is given below.

Table 6: Net fiscal impact of GWP update (\$ million)

\$ million	increase/(decrease) in operating balance					
	2011/12	2012/13	2013/14	2014/15	2015/16 & Outyears	Total across the forecast period
Adopting the IPCC AR4 GWPs	-	0.541	0.961	1.264	0.704	3.470

Confirmation of Cabinet’s previous in-principle decisions that were not subject to public consultation

Synthetic greenhouse gases

127. On 14 May 2012, Cabinet agreed in principle to a number of proposed amendments relating to the treatment of Synthetic Greenhouse Gases (SGG) [CAB Min (12) 16/6]. I seek re-confirmation of these in-principle decisions. A summary of the proposals is as follows:

- Removing the ETS obligation on the importation of SGG in motor vehicles, and replacing it with a levy on motor vehicles fitted with air-conditioning units (motor vehicle levy).
- Removing the ETS obligation on the importation of SGG in goods, and replacing it with a levy on goods imported containing HFC/PFC (goods levy).⁴
- Moving the ETS obligation on sulphur hexafluoride (SF₆) importers and manufacturers to the user and removing the ability to gain units from destroying and exporting SF₆.
- Prohibiting wilful release of SGG.
- Creating criteria for gaining units for the export and destruction of SGG to prevent stockpiling.

⁴ Hydrofluorocarbons (HFCs) and Perfluorocarbons (PFCs)

- Progressing the status quo for bulk importation of SGG, therefore bulk importers will continue to have an obligation for emissions under the ETS.

SGG sector engagement – May 2012

128. Cabinet noted that I would engage with the SGG sector to explain the proposed amendments [CAB Min (12) 16/6]. The engagement included meetings in Wellington and Auckland between officials, motor vehicle and refrigerant associations and their members. The proposals were welcomed by the SGG sector. However, some refrigerant association members, who import bulk SGG, were concerned about the significant price increases that would result out of being part of the ETS. Officials note that this is not an issue with the proposals but instead with having an emission price attached to the import of bulk SGG. I agree with the Panel that the ETS is the best mechanism to apply a carbon price to the import of bulk SGGs.
129. The SGG engagement also included a meeting in Wellington with the major power line companies, including Transpower and Vector, regarding the proposal to move the SF₆ obligation from the importer to the large user. This proposal was also welcomed by the industry. However, some raised concerns with the proposal to base the surrender liability on an assumption of 2 percent annual leakage, as some companies claim to leak less than this. They argued that by using a default emission factor (DEF) of 2 percent, there would be little incentive to reduce emissions. To mitigate this problem, and to align with other parts of the NZ ETS, I propose to create an option for the companies to apply for a unique emissions factor (UEF) through regulations.

Operational and legislative clarifications

130. Following engagement with industry and the Parliamentary Council Office the following points need clarification:
- To align with other levies, I would like to clarify that the Goods and Services Tax (GST) will apply to the goods and motor vehicle levies.
 - Exemptions under the Act have already been applied to some goods containing SGG such as household goods and other effects of a passenger of a ship or aircraft (accompanied or unaccompanied) that is not intended for gift, sale, or exchange. I would like to clarify that these exemptions will continue under the goods levy.⁵
 - The New Zealand Customs Service (Customs) will collect the goods levy as if the levy were a duty using relevant powers in the Customs and Excise Act.
131. The motor vehicle and goods levy will require a high level of operational detail, which will largely be set out in regulations. Memoranda of Understanding will be

⁵ The motor vehicle levy is not applied at the point of importation, so the exemption is not necessary.

agreed between the Ministry for the Environment, Customs, New Zealand Transport Agency (NZTA) and the Environmental Protection Authority. This will include a process for annually updating the goods levy rates, which will allow at least 3 months between Cabinet decisions on the new rate or any changes in the coverage of the levy and implementation of the change. This will allow Customs to update their electronic systems.

132. As agreed by Cabinet on 14 May 2012, regulations are being drafted and consulted on in parallel to the legislative process [CAB Min (12) 16/6]. In order for the goods levy to commence on 1 July 2013, decisions on the levied categories, which will be prescribed in regulations, will need to be made by the end of 2012. This will allow Customs and NZTA the required 6 months to update their electronic systems.

Other amendments already agreed in principle by Cabinet

133. Cabinet agreed to in principle to a number of technical and operational amendments [CAB Min (12) 19/7 refers].
134. These amendments will improve the operation of the ETS. The proposals are based on experience with the practical implementation of the ETS and arise from issues identified by the Panel, officials and stakeholders.
135. Officials have had some targeted discussions with those affected by the proposed changes. They have not identified any need to make changes.
136. I now ask that Cabinet confirm its previous decisions from the third Cabinet paper entitled *Forestry, agriculture and other technical and operational changes to facilitate the efficient administration of the Emissions Trading Scheme* [CAB Min (12) 19/7 refers], subject to some minor clarifications identified in discussions with PCA.
137. Cabinet is asked to confirm the operational and technical in principle decisions relating to forestry and agriculture, which:
- clarify where deforestation liabilities do not apply – by allowing existing forest management practices to be undertaken along forest land boundaries, so long as the cleared land is not put to any other use; ensuring where forest land cannot be replanted due to natural disturbance, that participants do not face a deforestation liability; and better allowing for natural regeneration and re-establishment of poplar and willow forests for erosion control;
 - continue to ensure that the ETS supports efforts to control tree weeds – by extending application rounds for pre-1990 tree weed exemptions; and by preventing tree weeds on post-1989 forest land from further participating in the ETS;
 - allow trustees appointed under the Te Ture Whenua Māori Act 1993, the Māori Trustee, and other sole trustees to apply for less than 50 hectare exemptions – by ensuring that the unrelated landholdings of such trustees are not counted towards the 50 hectare threshold; and
 - clarify settings for agricultural emissions under the ETS - by removing egg producers from having to participate in the ETS, to avoid a costly

administrative burden for an activity with very small emissions; and by clarifying the meat processors definition.

138. Cabinet is asked to confirm the operational and technical in principle decisions relating to the energy sector, which:

- clarify a number of matters relating to the inclusion of energy emissions in the scheme – adding the own-use of crude oil or other liquid hydrocarbons to the list of activities facing emissions obligations, to avoid a loophole in reporting and surrender obligations;
- clarify the ‘user’ of geothermal fluid for the purposes of obligations; and
- allow purchasers of obligation fuels including petrol and diesel to opt into the scheme as voluntary participants, subject to an appropriate threshold.

139. In respect of the inclusion of ‘own-use of crude oil and other liquid hydrocarbons’ in the list of activities facing emissions obligations, Cabinet agreed in principle that this should apply to oil miners. However, the drafting process has identified that this could create a loophole, whereby miners restructure their companies to avoid liabilities. I therefore propose that this new activity not be limited to miners, but that it be limited to crude oil (to avoid capturing wider use of petrol and diesel by firms and individuals).

140. Cabinet is asked to confirm the operational and technical in principle decisions relation to the allocation, which:

- change the way in which industrial and agricultural allocations phase out at 1.3%, so they continue to reduce each year, which was the original policy intent, rather than levelling off in the 2060s – as recommended by the Panel;
- clarify compliance powers – by providing more explicitly in legislation for monitoring and enforcement activities by the EPA relating to allocations, to allow government to tackle improper or erroneous allocations; and by clarifying that a financial penalty for failure to surrender or repay units can be applied where the EPA has granted an extension to the surrender or repayment date;
- clarify timescales for allocation applications, to simplify administration of the scheme – by extending the period under which post-1989 forest participants can submit voluntary emission returns to 30 June, to smooth the volume of returns being processed; by requiring applications for industrial and agricultural allocations to be submitted between 1 January and 30 April each year; and by placing a time limit for acceptance of allocations, to address instances where an applicant declines to open a Registry account.

141. Cabinet is also asked to confirm the following operational and technical in principle decisions, which:

- provide more flexibility for participants – by not requiring participants who undertake covered activities intermittently to deregister from the scheme; and by allowing use of a consolidated group account for allocations;

- allow the Crown more flexibility to dispose of international units surrendered by ETS participants - by allowing government to sell Kyoto units in an ETS surrender account, if they are surplus to what is required to meet any international obligation or domestic target;
 - reduce fiscal risks associated with insolvent or non-paying participants – by removing the requirement for the Crown to purchase units on behalf of these participants, while ensuring the Crown can still pursue the cost of these units through a court; and
 - make a number of other minor and technical amendments relating to rounding rules for the calculation of emissions; regulation-making powers for removal activities; cross-referencing errors; and other matters.
142. In respect of the proposal to remove the obligation for the Crown to purchase and surrender units on behalf of insolvent participants; I propose to clarify that the Crown can still pursue, through a court, the cost of those units not surrendered.
143. These technical and operational amendments will have modest fiscal cost of \$3.990 million over the forecast period.

Group 3: New proposals following public consultation and further analysis

144. A number of new policy problems have been identified which require amendment to the Act. These new policy proposals arise from comments made by submitters in the consultation, and further analysis by officials.

New allocation proposals

145. Under the ETS, 26 emissions-intensive, trade-exposed (EITE) activities are eligible for industrial allocation in New Zealand. The level of assistance for moderately EITE activities starts at 60 percent, while the level of assistance for highly EITE activities starts at 90 percent. Under the current ETS settings, the level of assistance will be phased out at a rate of 1.3 percent per annum from 2013.
146. The list of eligible emissions sources for determining eligibility for industrial allocation and the level of allocation is restricted to the direct use of coal, natural gas, used/waste oil and geothermal fluid and industrial process emissions.

Add fugitive coal seam methane to the list of emissions sources eligible for allocation for coal users

147. Fugitive Coal Seam Methane (FCSM) emissions are not currently of eligible emissions sources for determining eligibility for industrial allocation and the level of industrial allocation, even though coal miners are required under the ETS to surrender units in respect of any coal seam gas associated with mining.
148. During the consultation on the Government's proposed changes, no proposal was put forward to change the industrial allocation settings. However, some submitters commented that FCSM emissions should be included as an eligible emission source for industrial allocation purposes because their businesses face

ETS costs as a result of FCSM emissions, and there are few practical abatement options to reduce FCSM emissions. According to these submitters, excluding FCSM emissions either causes their activities to be ineligible for industrial allocation, or results in a lower level of allocation for their activities. On this basis, I consider that industrial allocation in its current form might not adequately mitigate the impact of the ETS on the international competitiveness of businesses facing ETS costs associated with FCSM emissions.

149. If we included FCSM as an eligible emissions source, we would need to decide who was eligible to receive allocation for costs associated with these emissions — the coal miner or the coal user. Otherwise, we could risk “double counting” these emissions.
150. On balance, I propose to include FCSM emissions from underground mining as an eligible emission source for coal users. This will entail lower administrative and fiscal costs, and is most consistent with the way in which emission costs associated with coal are treated. It will mitigate international competitiveness risks and make the industrial allocation rules more equitable to coal users.
151. The estimated fiscal costs of this proposal over the forecast period are shown in the table below. However, I note that there are uncertainties in these estimates, as some new activities might unexpectedly become eligible for allocation (which would increase the fiscal cost of this proposal).

Table 7: Net fiscal impact of fugitive coal seam methane allocation proposal (\$ million)

\$ million	increase/(decrease) in operating balance					Total across the forecast period
	2011/12	2012/13	2013/14	2014/15	2015/16 & Outyears	
Adding fugitive coal seam methane to the list of emissions sources eligible for allocation for coal users	-	(0.692)	(0.692)	(0.692)	(0.692)	(2.767)

Add liquid fossil fuels used in stationary energy to the list of emissions sources eligible for allocation

152. The list of eligible emissions sources for determining eligibility and allocative baselines for industrial allocation also does not currently include emissions from liquid fossil fuels (LFF). However where a business uses fuels other than LFF they are included as an emission sources for determining their eligibility and allocative baselines.
153. Some submitters commented that emissions from stationary energy use of LFF (such as emissions from LFF used for the provision of industrial heat) should be included as an emission source eligible for industrial allocation because LFF used in the production process generate a significant proportion of their emissions, and eligibility assessments and allocative baseline should reflect all major emission sources.

154. I agree in principle that stationary energy use of LFF should be included as an emission source eligible for industrial allocation, since businesses face ETS costs as a result of these emissions. I also note that there may be relatively limited opportunities for some businesses to switch from LFF to other less-intensive energy sources, or to become more efficient in using LFF in the short term. For example, natural gas is not available in the South Island and some parts of the North Island, while biofuel is not yet readily available at affordable commercial prices. Small users of LFF may also find it more difficult to achieve efficiency improvements than large users.
155. This change would require consultation on the existing industrial activity definitions and any new industrial activities that might become eligible in light of this change. In addition, a new data collection and verification process would be required for the new or amended industrial activity definitions.
156. On balance, I propose that stationary energy use of LFF be included in the list of eligible emissions sources for the purpose of industrial allocation.
157. The estimated fiscal costs of including LFF for stationary energy use as an emission source are shown in the table below. These estimates do not include the administrative costs associated with implementing this proposal. Also, there are uncertainties in these estimates, as data available to officials on the LFF-related emissions from activities that are already eligible for allocation, or who might become eligible if LFF emissions are included, is limited.

Table 8: Net fiscal impact of liquid fossil fuels allocation proposal (\$ million)

Vote Environment Minister Responsible for Climate Change Issues	\$m — increase/(decrease) in operating balance					
	2011/12	2012/13	2013/14	2014/15	2015/16 & Outyears	Total across forecast period to 2015/16
Adding stationary energy use of liquid fossil fuels as an emission source eligible for industrial allocation	-	(2.017)	(2.017)	(2.017)	(2.017)	(8.069)

Clarify discretion to grant industrial allocation to new activities

158. During the consultation, the Parliamentary Commissioner for the Environment raised the concern that the availability of allocation may incentivise new emissions-intensive activities, such as activities that use lignite on a large scale.
159. I note that, even with allocation, the carbon price should be an increasingly important driver in investment decisions for new economic activity over time. New activities will have economic benefits as well as impacting on emissions, and I certainly do not recommend that Ministers seek to take a view in advance on whether awarding allocation to particular new activities is desirable.

160. However, I note that the Act currently implies rather than states expressly that the Minister for Climate Change Issues has discretion on whether to make regulations prescribing a new activity eligible for allocation. I consider there is a need to clarify the existence of this discretion to ensure more flexibility in making decisions on eligibility for industrial allocation. **[Withheld under s9(2)(h)]**. I therefore propose an amendment to section 161A(3) of the Act that more clearly establishes the Minister's discretion on whether to make regulations prescribing a new activity eligible for allocation.

161. **[Withheld under s9(2)(h)]**.

Increasing industrial allocation for "manufacture of carbon steel from cold ferrous feed" by reclassifying it as a highly emissions-intensive, trade-exposed activity

162. "Manufacture of steel from cold ferrous feed" is classed as a moderately emissions-intensive, trade-exposed (EITE) activity under the ETS. This means that it is currently eligible for 60 percent free allocation. In Australia, all steelmaking activities are classed as highly EITE activities, and will be eligible for 94.5 percent free allocation in the 2012/13 financial year.

163. During the consultation, one submission proposed that, to mitigate competitiveness risks versus steelmakers in Australia, "manufacture of steel from cold ferrous feed" should be classed as a highly EITE activity and be given 90 percent free allocation.

164. Under section 161B of the Act (which is commonly known as the Australian track), if an activity is eligible for industrial allocation in Australia, it may become eligible for industrial allocation in New Zealand and may be give similar level of industrial allocation. However, this section was not applied when officials assessed the eligibility of "manufacture of steel from cold ferrous feed" for industrial allocations and developed the industrial allocation regulations, as the Australian Carbon Pricing Mechanism was not passed at the time.

165. At present, amongst the activities that are eligible for industrial allocation in both New Zealand and Australia, "manufacture of carbon steel from cold ferrous feed" is the only activity that is given a lower equivalent rate of allocation in New Zealand than in Australia.

166. On balance, I agree that the level of industrial allocation to "manufacture of steel from cold ferrous feed" should be increased to mitigate competitiveness risks. I consider that increasing the level of industrial allocation to this activity is justified, given that the "Australian track" is intended to align the industrial allocation regime in New Zealand with that in Australia.

167. I propose to class "manufacture of steel from cold ferrous feed" as a highly EITE activity, which would allow increase its level of assistance from 60 percent to 90 percent in 2013 (assuming that industrial allocation will not start to phase out until ETS participants face full surrender obligations). This will require change to the industrial allocation regulations for this activity, but no change to the Act.

168. The fiscal impact of this proposal is expected to be relatively small over the forecast period to the financial year 2015/16 (as shown in the table below).

Table 9: Net fiscal impact of adopting Australian approach to industrial allocation for the activity manufacture of carbon steel from cold ferrous feed (\$ million)

\$ million	increase/(decrease) in operating balance					
	2011/12	2012/13	2013/14	2014/15	2015/16 & Outyears	Total across forecast period to 2015/16
Increasing industrial allocation for "manufacture of carbon steel from cold ferrous feed" by reclassifying it as a highly emissions-intensive, trade-exposed activity	-	(0.107)	(0.109)	(0.112)	(0.114)	(0.442)

Suspend the 1.3% phase out of industrial and agricultural allocation

169. At present, allocation will decline by 1.3 percent per annum from 2013 for eligible industrial activities. During the consultation on the Government's proposals, some submitters suggested that the phase-out of industrial allocation should be delayed until certain conditions are met, e.g. similar cost of carbon is imposed in other major trading countries.
170. On the other hand, the Parliamentary Commissioner for the Environment suggested the phase-out rate of allocation should be accelerated because she considers that the current industrial allocation settings are too generous.
171. I am not inclined to either view, however, suspending the phase out until ETS obligations reach 100% could provide administrative benefits and reduce complexities involved in calculating allocation levels.
172. I therefore propose that the phase out of industrial allocation be suspended until ETS participants face full surrender obligations.
173. I also note that the 1.3% phase-out applies to agricultural allocation. Given the uncertainties about when agriculture will enter the scheme I propose that the phase-out of agricultural allocation also be suspended until agricultural sector participants face full surrender obligations.
174. The fiscal cost of suspending the phase-out would be relatively small in the forecast period to 2015/16, but would become more significant over time if the suspension were to remain beyond 2015/16.

Table 10: Net fiscal impact of suspending phase-out of allocation until 2015 (\$ million)

\$ million	increase/(decrease) in operating balance					Total across forecast period to 2015/16
	2011/12	2012/13	2013/14	2014/15	2015/16	
Suspending the phase-out of industrial allocation until ETS participants face full surrender obligations ⁶	-	(0.236)	(0.501)	(0.780)	(1.081)	(2.599)

Amending the ETS independent review provisions

175. Sections 160 and 161 of the Act set out a review process that I believe is unnecessarily restrictive. It does not allow the flexibility for the Government to review the ETS or parts of the ETS at the most appropriate time, without creating the needless burden of numerous reviews and associated “review fatigue”.
176. I therefore propose that these sections be removed and replaced with a discretionary power for the Minister of Climate Changes Issues to initiate a review of the operation and effectiveness of the ETS at any time by any method.
177. There are risks that this proposal will be seen by stakeholders as removing their rights to participate in regular reviews of the ETS and this concern will be heightened by the fact this proposal has not been consulted on. In addition, removing the requirement for a regular mandatory review removes an legislated opportunity for Maori to be involved in the review, and have a representative on the panel (s3A(d)). **[Withheld under s9(2)(h)].**
178. Because of the risks I have noted above I recommend that this discretionary power also specifies that when the Minister initiates any review of the ETS that they must consult with stakeholders and the representatives of iwi and Māori.
179. As noted above this discretionary power would allow the review to be undertaken by any method, and I consider that this may include the appointment of an independent panel to conduct a review. I propose that the Act makes it clear that if a panel review is initiated then the current requirements of iwi involvement (s3A(d)) would stand.
180. I am also seeking agreement to announce that the first discretionary review will occur in 2015 and that the focus of this review will be on the entry of agriculture

⁶ Note that the costs of suspending the phase-out of agricultural allocation are not included because these costs have been included in the fiscal costs of removing the entry date of agriculture to the ETS.

and the continuation of transition arrangements (one-for-two obligation and the fixed price option).

New technical and operational amendment proposals

181. I further propose a number of additional technical amendments, which have arisen from subsequent analysis following the third Cabinet paper.

Regulation-making abilities for forestry methods

182. Determining the area of forest land is a necessary precursor to determining both emissions and removals from that land. The format and method for delineating forest boundaries is described in the *Geospatial Mapping Information Standard* made under section 90 of the Act. Section 90 enables the EPA to prescribe the form and electronic format of various documents, and the manner in which such documents must be submitted or notified.

183. I consider that the method and format for determining the spatial extent of an area of forest land would be more appropriately issued by the EPA in guidelines or standards by notice in the *Gazette*, made under regulations. To do this, the current regulation-making powers for the EPA should be amended. I also consider it necessary to clarify that the EPA can issue guidelines or standards relating to both the method and the mechanisms by which data and information should be determined and collected for the purposes of calculating emissions or removals.

184. The changes I propose are administrative and for the avoidance of doubt, and have no effect on ETS participants.

Environmental Protection Authority reporting period

185. Under section 89 of the Act the EPA is required to publish information relation to emissions, removals and allocations under the Emissions Trading Scheme.

186. Section 89 is very prescriptive as to the information to be published and the information must be published by 30 June of each year. This requirement is an important component of the operation of the ETS to ensure transparency and that activity under the ETS can be assess year-by-year. So far 3 reports have been published, covering ETS activity from its inception in 2008.

187. To enhance the ability to compare ETS activity from year to year and assist in reconciling reported figures with other publishing requirements under the Act (for example, of allocation recipients), I recommend that this requirement be amended to specify the reporting period and adjust when the information must be published by.

188. Currently the period that is covered by the Section 89 reports varies as the EPA attempts to take the snapshot of activity as close to the required publishing date as possible (which varies from year to year depending on the day that 30 June falls on and the extent of consultation, analysis and checking required on the data). This means that Section 89 reports aren't precisely comparable from year to year. Additionally the Act is unclear as to when the reporting period should start. To ensure consistency, I recommend that the reporting period for Section

89 report be information reported to the EPA between 1 July to 30 June (inclusive) of each year.

189. Currently the Act requires the report to be published by a specific date (30 June of each year). This is inconsistent with other publication requirements in the Act, which generally refer to “as soon as practicable” (for example, S86B(5) and S77(8)). To assist the public in comparing various publications relating to the ETS, and allow for the recommendation above, I recommend that the publishing date be amended to refer to “as soon as practicable”.

International framework

Cross references in the Act to the international framework

190. The Act is drafted to include a large number of cross references to the Kyoto Protocol, and elements of the international framework it establishes (such as the International Transaction Log which tracks transfers of emissions units between countries). At this stage, New Zealand has not yet made a decision on whether it will take its post-2012 commitments under the second commitment period of the Kyoto Protocol, or under the United Nations Framework Convention on Climate Change, in the transition to the new international agreement beyond 2020 (the Durban Platform). Internationally, the amendments to the Kyoto Protocol to give effect to a second commitment period have not yet been finalised, but are expected to be agreed in December. It is not clear when (or whether) the amendments will come into force.
191. Until decisions have been taken on changes to the Kyoto Protocol and the international framework it establishes, and New Zealand’s relationship to them, it would be premature to attempt to make substantive amendments to the Act to align with a revised international framework. However, it is possible, and useful, at this stage to amend the Act to introduce a level of flexibility in some provisions, with the aim of enabling these provisions to accommodate the range of possible outcomes of the Kyoto Protocol negotiations. The current legislative amendment process offers an opportunity to make these amendments.
192. In a number of places, the Act makes reference to obligations both under the Kyoto Protocol and the United Nations Framework Convention on Climate Change. In other places, the references are to the Protocol alone. Some of these references appear in provisions that provide potentially useful powers or protections – such as the ability to make regulations requiring persons to provide information to the inventory agency about greenhouse gas emissions.
193. Given uncertainty regarding the sources of New Zealand’s international obligations in the future, I recommend that where appropriate, references to the Protocol alone be supplemented with references to the Convention. There is no guarantee that this amendment will ensure the effective functioning of the provisions in question. However, the additional flexibility might prove to be helpful in enabling some parts of the Act to be able to accommodate the possible outcomes of the Kyoto Protocol negotiations without further amendment.
194. Within the further provisions in the Act which reference the international framework established by the Kyoto Protocol, there are a small number which

could be usefully amended at this stage with a view to accommodating the possible outcomes of the Kyoto Protocol negotiations. These include references to the International Transaction Log regarding transfers of units, as well as references to subsequent commitment periods under the Kyoto Protocol. The changes proposed would be largely technical, and aimed at achieving a level of flexibility. Accordingly, I am seeking Cabinet approval to delegate, to the Minister for Climate Change Issues, power to approve further amendments to the Act to enable provisions of the Act to reflect changes to the international framework established by the Kyoto Protocol.

International forestry rules

195. The United Nations Framework Convention on Climate Change and the Kyoto Protocol set the wider context for domestic action in New Zealand. International rules on Land Use, Land Use Change and Forestry (LULUCF) are particularly influential on ETS forestry settings. In December 2011, the following rules were agreed for a second commitment period of the Kyoto Protocol:

- flexible land use (ie, pre-1990 forestry offsetting discussed above);
- reference level accounting for pre-1990 forest management;
- natural disturbance;
- harvested wood products;
- the Afforestation-Reforestation Debit-Credit (ARDC) rule is not available.

196. **[Withheld under s9(2)(j)]** . The value and impact of the forestry rule package will be better understood in the second half of 2013, once research gaps have been filled and the UN accounting guidelines finalised. Forest participants are keen to know whether the ETS will be amended in light of the agreed international rules – particularly the harvested wood products rule. **[Withheld under s9(2)(j)]**.

197. Therefore, with the exception of Flexible Land Use, I propose no changes to the ETS now in relation to the international rules agreed in Durban. Future changes could be considered when there is more certainty in the international guidelines, **[Withheld under s6(a)]**.

Other measures to promote long term emissions reductions and productivity

198. New Zealand's primary measure to reduce emissions is the ETS. Despite having been in place for only two years, it has already had an impact in some areas, such as deforestation. **[Withheld under s9(2)(g)(i)]**.

199. Even with the ETS in place, New Zealand's emissions are projected to continue to increase significantly over the longer term. This creates longer term risks for New Zealand's competitiveness – on the assumption that, over time, countries and consumers will take and expect action; and that New Zealand may face new international obligations in future.

200. Therefore we may need to consider other measures that could help to reduce New Zealand's emissions over the long term, whilst also increasing productivity.

201. The Green Growth Advisory Group, which reported to Ministers in December 2011, highlighted a number of areas that could be explored. These included the establishment of an agency, based on a refocused Energy Efficiency and Conservation Authority (EECA), committed to helping businesses (particularly SMEs) and households reduce their emissions.
202. I note that, in National's agreement with the Māori Party to support passage of the 2009 ETS Amendment Bill, we agreed to 'consult with the Māori Party on the wider programme of complementary climate change measures that, alongside the ETS, will contribute to New Zealand moving to a lower carbon economy'. We have yet to make significant progress on this agreement.
203. I therefore propose that Cabinet should direct officials to explore options for the other measures to reduce greenhouse gas emissions. I further propose that the scope for such measures should then be the focus of a further Cabinet discussion to take place before the end of the year.

Next steps

204. As noted in previous papers, timing will be tight for the introduction of legislation as it is highly desirable to pass an amendment bill by the end of the year.
[Withheld under s9(2)(f)(iv)].
205. Parliamentary Counsel Office have already begun drafting, and will complete the amending legislation on the basis of decisions made by Cabinet on this paper, with the view to introduction of a Bill in **[Withheld under s9(2)(f)(iv)]**.
206. Given the complexity of the issues involved it is likely that, in the context of drafting, minor policy questions will arise which require clarification. I am therefore 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 decisions set out in this paper.
207. A number of the existing regulations that support the operation of the ETS will need to be amended if the proposals in this paper are agreed. Therefore, I am also seeking Cabinet approval that PCO may make amendments to regulations that are consequential to any of the decisions made on the amendments to the Act set out in this paper.
208. I also 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 Authority for consultation, where necessary.

Consultation

209. The following agencies were consulted in the preparation of this paper: the Ministry of Primary Industries, the Treasury, the Inland Revenue Department, the Ministry of Foreign Affairs and Trade, the Ministry of Economic Development, the Department of Conservation, New Zealand Customs Service, Te Puni Kōkiri, the Ministry of Transport and the New Zealand Transport Agency. The Department of Prime Minister and Cabinet was informed.

Treasury comment

Second-tranche cancellation

1. The option to cancel compensation for foresters that take up offsetting would result in an ETS package with net fiscal costs of \$328.447 million over the forecast period, if implemented alongside the other recommendations proposed in this paper. Unfunded costs would need to be funded as a pre-commitment against Budget 2013, reducing the funding available for other initiatives funded through Budget 2013. Cabinet has previously agreed that policy decisions arising from the ETS review would be fiscally neutral [CAB Min (11) 37/16 refers].
2. We consider there is a strong argument for the cancellation of the second tranche of compensation to pre-1990 forest owners in full: first, the original Allocation Plan in some cases compensated unnecessarily; and second, offsetting ameliorates the negative impact on land values for those most adversely affected by the introduction of the ETS, by reducing the cost of deforestation for those that offset. The Crown has previously stated that it may reduce or cancel the second-tranche if offsetting is introduced.
3. Consultation feedback from iwi and foresters signalled that there would be opposition to any reduction in the second tranche, which could present relationship risks for the Crown.
4. In light of the relationship risks cited above, the Treasury recommends that Cabinet agree a pro-rata 50 percent reduction of the second-tranche. This strikes a balance between the principled policy argument for cancellation, the need to manage relationship and other risks with foresters. This approach will result in a pre-commitment of \$223.400 million from Budget 2013.

Introducing offsetting for the 2008-12 period

5. **[Withheld under s9(2)(j)].**
6. This fiscal risk should be weighed up against the potential private economic benefit for those landowners who would no longer face a deforestation liability under the ETS and could therefore convert their land to a higher value use.
[Withheld under s9(2)(j)].

Ministry for Primary Industries comment

7. **[Withheld under s9(2)(g)(i)].**

Financial implications

Summary fiscal implications

8. These proposed decisions will reduce the net revenue the Crown receives through the ETS over the forecast period, and therefore will have a negative

impact on the Crown's operating balance. The fiscal cost of the proposed package is \$328.447 million over the forecast period to 2015/16 at a carbon price of \$6⁷.

9. The operating balance impacts of the proposed decisions in this paper are summarised in the table below.

⁷ As at Budget 2012, the Government's financial statements included a carbon price of \$10.60. However, officials are in the process of agreeing a methodology change for valuing NZUs in the Crown Accounts so that the valuation more accurately reflects market prices. This revised methodology is proposed to be used for the Crown's year-end 2011/12 financial statements, and is therefore the more appropriate price for recognising policy decision.

Table 11: Summary fiscal impacts (\$ million)

\$ million	Increase/(decrease) in operating balance					Total across the forecast period
	2011/12	2012/13	2013/14	2014/15	2015/16 & Outyears	
Second tranche of pre-1990 forest land allocation — cancel for all owners who take up offsetting (they return NZUs they were allocated when they deforest)	-	1.443	1.443	1.443	1.443	5.772
Updating emissions projections with new Global Warming Potentials	-	0.541	0.961	1.264	0.704	3.470
Surrender obligation for own-use of oil	-	0.032	0.063	0.063	0.063	0.222
Removal of entry date of agriculture [sentence deleted to remove drafting error]	-	-	-	(12.156)	(23.640)	(35.796)
Transition phase—out of 2:1 surrender obligation for LFF, SEIP, SGG and waste sectors	-	(28.053)	(79.995)	(79.779)	(77.853)	(265.679)
Extending the Pre-1990 tree weed exemption to 2015/16	-	(0.600)	(1.200)	(1.200)	(1.200)	(4.200)
Increasing allocation to coal users by amending the coal factor used in industrial allocation to cover costs associated with fugitive coal seam methane emissions	-	(0.692)	(0.692)	(0.692)	(0.692)	(2.767)
Increasing industrial allocation for "manufacture of carbon steel from cold ferrous feed" by reclassifying it as a highly emissions-intensive, trade-exposed activity	-	(0.107)	(0.109)	(0.112)	(0.114)	(0.442)
Application of SGG levy	-	(1.254)	0.300	0.300	0.300	(0.353)
Changing point of ETS obligation for SF6 activities	-	(0.395)	(0.791)	(0.793)	(0.794)	(2.773)
Emissions Trading Scheme Review implementation contingency	-	(8.745)	(2.095)	(2.213)	(2.180)	(15.233)
Add stationary energy use of liquid fossil fuels as an emission source eligible for industrial allocation	-	(2.017)	(2.017)	(2.017)	(2.017)	(8.069)
Suspending the phase-out of industrial allocation until ETS participants assume full surrender obligation	-	(0.236)	(0.501)	(0.780)	(1.081)	(2.599)
Total Operating	-	(40.084)	(84.632)	(96.671)	(107.060)	(328.447)

10. The unfunded portion of this negative impact on the operating balance, totalling \$313.214 million, is proposed to be funded as a pre-commitment against Budget

2013 The remaining \$15.233 million has been funded through Budget 2012, to establish an ETS implementation contingency for agency operating costs arising from the review. Slowing the implementation of the ETS will also reduce the New Zealand Units to be allocated to ETS participants. Changes to the NZU appropriation are currently calculated at a \$25 carbon price to allow for variations in the carbon price. I am seeking authorisation for myself and the Minister of Finance to update appropriations as necessary to give effect to Cabinet's decisions.

11. Only one of the operating balance impacts outlined above will have an impact on net debt. This is because ETS carbon unit flows do not impact on the Government's net debt position. Introducing a levy for the synthetic greenhouse gas sector provides the Government with a financial asset, cash, rather than carbon units which are an intangible asset. This has a positive impact on net debt, as follows:

Table 12 : Net fiscal impact of SGG levy (\$ million)

\$ million	(Increase)/decrease in debt					
	2011/12	2012/13	2013/14	2014/15	2015/16 & Outyears	Total
SGG Levy	0	0	1.404	1.404	1.404	4.212

12. The introduction of auctioning will also impact on the net debt position, by providing the Government with a cash rather than carbon unit asset. The extent of this impact will depend on the detailed design and level of auctioning, and will be detailed when Cabinet takes decisions on the level of auctioning.

Administrative cost implications

13. The Ministry for the Environment, the Ministry for Primary Industries, the Environmental Protection Authority, the Ministry of Transport, New Zealand Customs Service and the New Zealand Transport Agency 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.
14. Cabinet has already agreed to establish a contingency fund so that Ministers can further consider these operating costs, and that this contingency be funded through Budget 2012 [CAB Min (12) 8/7, paragraph 70 refers]. Cabinet has further agreed that the Minister and 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.

Fiscal risks and other impacts

15. The following proposals in this paper also raise fiscal risks:

- Extending the \$25 fixed price option. 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.
- **[Withheld under s9(2)(j)].**
- **[Withheld under s9(2)(j)].**

Human rights

16. 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

17. A bill will be required to implement a range of modifications to the ETS. The proposed amendment bill has been given Category 2 priority.
18. 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

19. 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

20. The Regulatory Impact Analysis (RIA) requirements apply to the proposal in this paper and a Regulatory Impact Statement (RIS) has been prepared and is attached.
21. Note that not all of the proposals in this Cabinet paper were included in the RIS, such as the proposal to remove the entry date of agriculture from legislation. This is because changes were made to this paper subsequent to Economic Growth and Infrastructure Committee consideration.

Quality of the Impact Analysis

22. The Regulatory Impact Analysis Team (RIAT) has reviewed the RIS prepared by the Ministry for the Environment and associated supporting material, and considers that, given this RIS updates an earlier RIS following consultation on

policy proposals, the information and analysis summarised in the RIS meets the quality assurance criteria.

23. With specific reference to the 'clear and concise' criterion, RIAT notes that the RIS is very long, but considers that this is as a result of the number of distinct policy issues addressed in the RIS. Much of the analysis is usefully summarised in summary tables throughout the RIS and at Annex 2.

Consistency with Government Statement on Regulation

24. 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

25. Cabinet previously agreed that the Minister for Climate Change issues would manage public announcements and engagement on the proposed package of amendments to the ETS, prior to the introduction of legislation [CAB Min (12) 8/7, paragraphs 76, 78 refers].
26. The Act also 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.
27. As noted in a previous paper, 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's final decisions on the package of amendments presented here, 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. I propose that Cabinet delegate to the Minister for Climate Change Issues responsibility for preparing a response to the Panel's recommendations and tabling it in the House.

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 Cabinet has previously agreed in principle to:
 - 2.1. significant amendments to the Act to implement key recommendations of the Panel and key commitments in the National Party's Manifesto [CAB Min (12) (8/7) refers];
 - 2.2. changes to improve the current treatment of the synthetic greenhouse gas sector in the ETS [CAB Min (12) 16/6 refers]; and
 - 2.3. to address technical and operational amendments [CAB Min (12) 19/7 refers];
3. **Note** that the following proposed amendments, agreed in principle by Cabinet [CAB Min (12) (8/7) refers], have recently been subject to a public consultation:
 - 3.1. more gently phasing out the current one-for-two surrender obligation in three equal steps between 2013 and 2015 (as recommended by the Panel);
 - 3.2. maintaining the \$25 fixed price option until 2015;
 - 3.3. providing for a more explicit power to auction NZUs to an overall cap on the supply of NZUs;
 - 3.4. providing for a more explicit power to place a quantitative restriction on the surrender of international units;
 - 3.5. the introduction of offsetting within the ETS as an option for pre-1990 forests;
 - 3.6. a review of the second tranche of free allocation to pre-1990 forest landowners, with the option to reduce or remove the second tranche in recognition of the benefits offered by offsetting;
 - 3.7. providing for a power to defer the start of surrender obligations for agricultural greenhouse gases by up to 3 years, subject to a review in 2014;
 - 3.8. providing for a power to extend the fixed price option beyond 2015 and align it with any price ceiling in Australia should linking with the Australian Carbon Pricing Mechanism occur;
 - 3.9. removing the obligation under current ETS settings to 'back' all NZUs with an international unit;
 - 3.10. extending the ban on the export of NZUs from non-forestry sectors, whilst the fixed price option remains in place; and
 - 3.11. aligning the ETS with international greenhouse gas accounting standards, by adopting the latest, internationally accepted global warming potentials.
4. **Note** that this paper seeks Cabinet's final agreement to a final package of policy changes, based on the outcome of this public consultation;
5. **Note** that, subject to Cabinet's final decisions on the proposals set out in this paper, the Minister for Climate Change Issues will submit a draft Bill to Cabinet in August 2012 for approval to introduce into Parliament;

New Zealand's post-2012 mitigation commitment

6. [Withheld under s9(2)(j)];
7. [Withheld under s9(2)(j)];

Proposals for amendment to the Act in 2012

Significant proposals previously agreed in principle subject to consultation, adjusted where appropriate to reflect the outcomes of public consultation

Transition phase

8. **Note** that a majority of those who commented on the proposed more gentle phase out of the one-for-two surrender obligation supported the proposal to phase out the one-for-two surrender obligation in three equal steps between 2013 and 2015;
9. **Agree**, given the current level of uncertainty around the international action on climate change and the continuing economic recovery, to extend the one-for-two surrender obligation after 2012;
10. **Agree** that there be no specified end date for the one-for-two obligation;
11. **Agree** that the one-for-two surrender obligations also be applied to the waste and synthetic greenhouse gas sectors (including to the SGG levy) when their obligations begin in 2013;
12. **Agree** that the proposed extension to the one-for-two surrender obligations remains a transitional measure (despite the open end date) and therefore should remain a distinct legislative provision;
13. **Note** that entitlements to receive NZUs for industrial allocation and non-forestry removal activities should be consistent with the proposed surrender obligations;
14. **Agree** to amend the Act to adjust the entitlement to receive NZUs for industrial and agriculture allocation and non-forestry removal activities to reflect the extension of the one-for-two obligation (i.e. 50% of normal entitlement);
15. **Agree** to review the one-for-two surrender obligation in 2015;
16. **Note** that a majority of submitters who commented on the fixed price option did not support the proposal to extend the fixed price option until 2015;
17. **Note** that the future international carbon price remains uncertain, particularly after 2015, and that this creates a risk of future carbon price spikes;
18. **Agree** to amend the Act to extend the \$25 fixed option after 2012, without specifying a particular end date;
19. **Note** that future reviews of the ETS will provide an opportunity to examine the need to maintain the fixed price option, in light of developments in international carbon markets;
20. **Agree** not to provide for a power to extend the fixed price option in order to align it with any price ceiling in Australia, should linking with the Australian Carbon Pricing Mechanism occur;

21. **Note** that the majority of submitters supported the proposal to extend the ban on exports of NZUs from the non-forestry sector;
22. **Confirm** Cabinet's previous in principle decision to amend the Act to extend the ban on exports of NZUs from non-forestry sectors while the fixed price option remains in place [CAB Min (12) (8/7) refers];

Supply of NZUs after 2012

23. **Note** that substantially more submitters agreed or agreed in principle to the proposal to restrict the proportion of international units an ETS participant can surrender than disagreed;
24. **Note** that those submitters that agreed with the proposal did so because they saw it as a mechanism to increase the price of NZUs rather than its intended purpose of encouraging participation at the auction;
25. **Note** that a well designed and efficient auction will encourage ETS participants to buy NZUs at the auction, without the need for a restriction on international units;
26. **Agree** that a restriction on the proportion of international units an ETS participant can surrender is not introduced in the context of auctioning and this will not form part of the consultation on the detailed auction design settings;
27. **Note** that, as the ETS will remain open to international markets this means that the introduction of an auction of NZUs within an overall cap on the number of NZUs auctioned and allocated would not impact on the price of units within the scheme, which will continue to reflect the international price;
28. **Note** that slightly more submitters disagreed with the proposal to auction NZUs within an overall cap than agreed or agreed in principle;
29. **Note** that the proposed approach for introducing auctioning within an overall cap set out below addresses the most substantive concerns raised by submitters;
30. **Confirm** Cabinet's previous in principle decision [CAB Min (12) 8/7 refers] to amend the Act to allow for an express regulation making power to auction NZUs within an overall cap on the number of NZUs auctioned and allocated;
31. **Agree** that the regulation making power to auction NZUs within an overall cap be exercised, subject to consultation;
32. **Note** that further consultation will take place during 2012 on the detailed auction design settings, consistent with Cabinet's previous decision [Cab Minute (12) 8/7 refers], including the level of the cap;
33. **Invite** the Minister for Climate Change Issues to return to Cabinet with proposals for consultation on auction design settings in 2012, prior to consultation;
34. **Note** that a common concern, raised by both those who agreed and disagreed with the proposals, was a desire for more certainty about how these powers will be used;
35. **Agree** to amend the Act so that the regulations related to auctioning are updated and extended annually so that ETS participants always have forward notice of cap levels over the following five years;

36. **Agree** that the annual extension would be subject to the same regulation making procedures that apply to the initial making of those regulations, but will not be subject to the additional restrictions that apply to amending these regulations;
37. **Note** that the cap should exclude NZUs transferred for removal activities and NZUs purchased under the Government's fixed price option;
38. **Agree** to amend the Act such that NZUs provided under s86C(5) of the Act to correct for an error in an initial allocation are excluded from the cap;
39. **[Withheld under s9(2)(b)(ii) & s9(2)(ba)]**;
40. **Agree** to amend the Act in line with Cabinet's other previous in principle decisions [CAB Min (12) 8/7 refers] in relation to auctioning, subject to the following clarifications:
 - 40.1. specify that the cap does not restrict the amount of NZUs allocated, but does limit the number of NZUs available for auction to be the level of the cap less NZUs allocated, so that if allocation is in excess of the cap, then no NZUs should be auctioned;
 - 40.2. the list of matters the Minister must have regard to when determining 'the amount of NZUs to be auctioned and the overall cap' should only relate to 'the overall cap';
 - 40.3. the list of matters the Minister must have regard to when determining the overall cap should include the emissions covered by the ETS and other ETS design settings;
 - 40.4. the general procedure for making regulations set out in s30H of the Act should be used for introducing and extending the regulations related to auctioning;
 - 40.5. the specific requirements that Cabinet has agreed in principle to when amending the regulations related to auctioning apply in addition to the general procedure for making regulations set out in s30H of the Act, but that the specific requirement to consult with 'interested parties' is not required, as s30H requires consultation with 'substantially affected' parties;

Removal of obligation to 'back' NZUs

41. **Note** that a majority of those who commented on the proposed removal of the NZU backing obligation disagreed with the proposal;
42. **Note** that the main reason cited by those who disagreed was the incorrect understanding that ETS forestry participants would no longer be able to sell units overseas;
43. **Note** that New Zealand is expected to meet its commitments under the first commitment period of the Kyoto Protocol;
44. **Note** that the need for backing is significantly reduced if auctioning within an overall cap is introduced, and that maintaining the backing requirement would result in significant fiscal costs of up to \$140 million in the period 2012/13 to 2015/16;

45. **Confirm** Cabinet's previous in-principle decision [CAB Min (12) 8/7 refers] to amend the Act to remove the requirement to back NZUs during CP1, subject to agreement to introduce auctioning an overall cap;

Deferral of agricultural liabilities

46. **Note** that the majority of submitters who commented on the proposed power to allow deferral of surrender obligations for agricultural emissions, subject to a review in 2014, disagreed with the proposal for equity, economic and environmental reasons;
47. **Note** that there will be 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);
48. **Agree** to remove the 2015 entry date for surrender obligations for agricultural emissions;
49. **Note** that this approach would have the effect of delaying the entry of agriculture indefinitely or until legislation is amended;
50. **Agree** to review the entry date for surrender obligations for agriculture obligations in 2015;
51. **Agree** that despite the proposed removal of the 2015 entry date for agriculture, provisions related to the surrender obligations for agriculture should remain in the Act;

Pre-1990 forestry – Introduction of offsetting

52. **Note** submitters have requested changes to the offsetting for pre-1990 forestry policy proposed through the consultation;
53. **Confirm** Cabinet's previous in principle [CAB Min (12) 8/7 refers] decisions to amend the Act to enable offsetting for pre-1990 forest land consistent with the Flexible Land Use rule agreed for the Kyoto Protocol CP2 at Durban;
54. **Note** that Cabinet previously agreed in principle to introduce a power to place a limit on offsetting, should this be required to manage any fiscal risks [CAB Min (12) (8/7) refers], but that this power is no longer considered necessary;
55. **Agree** not to introduce a power to place a limit on offsetting;
56. **Agree** that offsetting for pre-1990 forest land shall not include the use of :
- 56.1. existing post-1989 forest not in the ETS as offset forest;
 - 56.2. deforested pre-1990 forest land (converted to other land use) to establish an offset forest;
 - 56.3. natural regeneration for offset forest establishment;
57. **Note** that submitters requested allowing land harvested in the first commitment period and currently unstocked and not classified as deforestation to be eligible for offsetting;
58. **[Withheld under s9(2)(j)]**;
59. **[Withheld under s9(2)(j)]**;

60. **Agree** to amend the Act to allow land harvested in the first commitment period that is currently unstocked and not classified as deforestation to be eligible for offsetting;
61. **Agree** that regulations be developed for the effective operation and implementation of the pre-1990 forestry offsetting policy;
62. **Agree** that officials consult on the pre-1990 forestry offsetting regulations with interested parties in 2012;

Pre-1990 forestry – Second tranche of Pre-1990 Forest Land Allocation

63. **Note** that the 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;
64. **Note** that the introduction of offsetting changes the ETS rules for pre-1990 forest land, reducing the costs of the deforestation liabilities;
65. **Note** that the possible adjustment or cancellation of the second tranche was signalled to landowners; including through the Act, consultations and letters to landowners;
66. **Note** that I consulted on the following options for adjusting the second tranche:
 - 66.1. cancelling all of the second tranche;
 - 66.2. partial cancellation (for example a pro-rata of 50% to all forest owners, or a flat amount of compensation to all e.g. 11 units);
 - 66.3. cancel for all landowners who take up offsetting (recommended by the Panel);
67. **Note** that a majority of submitters did not support an adjustment to the level of compensation in light of the introduction of offsetting; and that if Government were to adjust the allocation, submitters strongly preferred cancelling the second tranche only for those who take up offsetting;
68. **Note** that concerns were raised that offsetting has limited value either because land is already in the best use or because participants will not be able to offset because of the financial or other constraints;
69. **Note** that the points raised in consultation that much pre-1990 forest land is in best use underlines the policy case for reviewing the level of compensation to pre-1990 forest landowners;
70. **Note** that iwi/Māori raised a number of concerns around partial or full cancellation including:
 - 70.1. the potential impacts on Treaty of Waitangi deeds of settlement;
 - 70.2. the disproportionate impacts on iwi/Māori and therefore on the Government's relationship with iwi;
 - 70.3. limited ability to take up offsetting;
71. **[Withheld under s9(2)(h) & s9(2)(g)(i)];**
72. **[Withheld under s9(2)(h) & s9(2)(g)(i)];**

73. **[Withheld under s9(2)(g)(i)];**

- 73.1. **Agree** to cancel the second tranche of pre-1990 forest land allocation only for those that take up offsetting;
- 73.2. **Note** that if there is not a significant reduction or cancellation of the second tranche, the option to allowing landowners to re-apply for the less than 50 hectares exemption, in exchange for forfeiting the second tranche of their allocation and paying back the value of the first tranche, is not required;
- 73.3. **Note** that this option will create fiscal savings of \$5.772 million over 2012/13 to 2015/16;

74. **[Withheld under s9(2)(g)(i)];**

Aligning the ETS with international greenhouse gas accounting standards

- 75. **Note** that it was agreed at Durban that from 1 January 2013, the reporting and accounting of greenhouse gases will use the updated Global Warming Potentials (GWPs) from the IPCC's 4th Assessment report;
- 76. **Note** that the updated GWPs will increase costs for some ETS participants and result in fiscal savings of about \$3.470 million over to the forecast period up to 2015/16;
- 77. **Confirm** Cabinet's previous in principle decision to amend the Act 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 [CAB Min (12) (8/7) refers];

Confirmation of Cabinet's previous in-principle decisions that were not subject to consultation

Synthetic greenhouse gases

- 78. **Confirm** Cabinet's in principle decisions to amend the Act to change the treatment of Synthetic Greenhouse Gases [CAB Min (12) 16/6 refers];
- 79. **Note** as a result of engagement with industry a unique emissions factor will be created for sulphur hexafluoride Participants;
- 80. **Agree** that the Parliamentary Counsel Office should draft regulations for a sulphur hexafluoride Unique Emissions Factor to be included in the Climate Change (Unique Emissions Factors) Regulations 2009;
- 81. **Note** consultation on SGG regulations will occur parallel to the legislative process, as agreed by Cabinet, and will take place throughout September;
- 82. **Note** as a result of engagement with industry and the Parliamentary Counsel Office some clarifications are needed;
- 83. **Agree** that in order to align with other levies, Goods and Services Tax (GST) will apply to the goods and motor vehicle levies;
- 84. **Agree** to carry over the exemption for goods that are household goods, other effects of a passenger of a ship or aircraft (accompanied or unaccompanied) that

are not intended for gift, sale, or exchange to the levy on the importation of goods (excluding motor vehicles) containing HFC/PFC;

85. **Agree** Customs will collect the levy on the importation of goods (excluding motor vehicles) containing HFC/PFC as if the levy were a duty using relevant powers in the Customs and Excise Act;
86. **Note** that Memoranda of Understanding will outline operational responsibilities of agencies implementing the goods and motor vehicle levies;
87. **Note** that in order for the levy on the importation of goods (excluding motor vehicles) containing HFC/PFC to commence on 1 July 2013, decisions on the specific coverage and specific structure of the regulations establishing the levy will need to be at least 6 months in advance;
88. **Note** that s.149 of the Act will apply to the sharing of information on individuals for the purposes of collecting and enforcing the levies, and that the relevant Memorandum of Understanding will ensure that processes match those otherwise applying to Customs, now and in the future;

Technical and operational amendments

89. **Note** that Cabinet has previously agreed in principle [CAB Min (12) 19/7 refers], subject to a decision on the overall ETS package, to 27 specific technical and operational changes to the ETS, that are more minor in nature and aimed at improving the operational effectiveness of the ETS;
90. **Note** that these minor and technical amendments will raise fiscal costs of \$3.990 million over to the forecast period up to 2015/16;
91. **Confirm** all of Cabinet's previous in-principle decisions to make these technical and operational amendments to the Act [CAB Min (12) 19/7 refers], subject to the following clarifications:
 - 91.1. in respect to Cabinet's agreement in principle to add the own-use of crude oil and other liquid hydrocarbons to the list of activities facing emissions obligations - that this is not narrowed to own- use by a miner and includes own-use of crude oil only;
 - 91.2. in respect of Cabinet's agreement in principle to remove the obligation for the Crown to purchase and surrender units on behalf of insolvent participants - that the Crown can still pursue the cost of units not surrendered through a court;

New proposals following public consultation and further analysis

Industrial Allocation

92. **Note** that the list of emissions sources to be counted towards the eligibility for and level of allocation to activities for the purposes of industrial allocation do not include Fugitive Coal Seam Methane emissions or Liquid Fossil Fuel emissions from stationary energy;

93. **Note** that these emissions sources are subject to ETS liabilities, meaning that allocation recipients may face costs for which they are not eligible for an allocation;
94. **Note** that the inclusion of Fugitive Coal Seam Methane as an eligible emission source for coal users will raise fiscal costs of approximately \$2.767 million over the forecast period up to 2015/16;
95. **Agree** that Fugitive Coals Seam Methane emissions be included in the list of emissions sources to be counted towards the eligibility for and level of allocation to activities for the purposes of industrial allocation to coal users;
96. **Note** that including liquid fossil fuel emissions from stationary energy use in the list of emissions sources to be counted towards the eligibility for and level of allocation to activities for the purposes of industrial allocation is logical considering the emissions from other fuel types are already counted;
97. **Note** the inclusion of emissions from stationary energy use of liquid fossil fuel as an eligible emission source for coal users will raise fiscal costs of approximately \$8.069 million over the forecast period to 2015/16;
98. **Agree** that stationary energy use of liquid fossil fuels be included as an eligible emissions source for the purpose of industrial allocation;
99. **Note** that “manufacture of steel from cold ferrous feed” is given a significantly lower level of industrial allocation in New Zealand than in Australia. It is currently classed as a moderately emissions-intensive, trade-exposed activity in New Zealand, but a highly emissions-intensive, trade-exposed activity in Australia;
100. **Note** that the fiscal cost of reclassifying ‘manufacture of steel from cold ferrous feed’ as a highly emissions-intensive, trade-exposed activity will be \$0.442 million over the forecast period to 2015/16;
101. **Agree** that the Climate Change (Eligible Industrial Activities) Regulations 2010 be amended so that “manufacture of steel from cold ferrous feed” will be classed as a highly emissions-intensive, trade-exposed activity;
102. **Note** that suspending the phase-out of industrial allocation until ETS participants face full surrender obligations will result in a fiscal cost of approximately \$2.599 million over the forecast period to 2015/16;
103. **Agree** that the phase-out of industrial allocation be suspended until ETS participants face full surrender obligations;
104. **Agree** that the phase-out of agricultural allocation be suspended until agricultural sector ETS participants face full surrender obligations;
105. **Note** that the Act currently implies rather than states expressly that the Minister for Climate Change Issues has discretion on whether to make regulations prescribing a new activity eligible for allocation;
106. **Agree** that section 161A(3) of the Act be amended to state expressly that the Minister’s decision to make regulations prescribing a new activity eligible for allocation is discretionary;

ETS review provisions

107. **Note** that Sections 160 and 161 of the Act set out a review process that is unnecessarily restrictive and does not allow flexibility for the Government to review the ETS at the most appropriate time, without creating the needless burden of numerous reviews;
108. **Agree** to amend the Act to remove sections 160 and 161 of the Act and replace them with a discretionary power for the Minister of Climate Changes Issues to initiate a review of the operation and effectiveness of the ETS at any time using any method;
109. **Agree** that this discretionary power also specifies that when the Minister initiates a review that they must consult with stakeholders and the representatives of iwi and Māori;
110. **Agree** that as this discretionary power would allow the review to be undertaken by any method, and that this may include the appointment of an independent panel to conduct the review;
111. **Agree** that the Act makes it clear that if a panel review is initiated then the current requirements for iwi involvement (s3A(d)) would stand;
112. **Agree** that the first discretionary review will occur in 2015 and that it will specifically include consideration of the entry of agriculture and the continuation of one-for-two and fixed price transition arrangements;

Clarification of regulation-making powers

113. **Agree** to amend the regulation-making powers to allow the EPA to issue guidelines or standards by notice in the Gazette relating to method and format for determining the spatial extent of an area of forest land;
114. **Agree** to amend the Act to clarify that the EPA can issue guidelines or standards by notice in the Gazette relating to the method and mechanisms by which the data and information must be collected for the purposes of calculating emissions or removals;

Environmental Protection Authority reporting period

115. **Note** that S89 of the Act requires the EPA to annually report on the activities of the ETS to promote transparency;
116. **Note** that the requirements regarding the period the S89 report is based on makes it difficult to compare activity year-to-year or reconcile the information with other information published in relation to the ETS;
117. **Agree** that the Act be amended so that the reporting period for the Section 89 report be information reported to the EPA between 1 July to 30 June (inclusive) of each year;
118. **Agree** that the Act be amended to require the S89 report to be published as soon as practicable each year;

Cross references in the Act to international framework

119. **Agree** to amendments to enable some parts of the Act to more easily accommodate the range of possible outcomes of the Kyoto Protocol negotiations by, where appropriate:
- 119.1. supplementing references to the Kyoto Protocol with references to the United Nations Framework Convention on Climate Change; and
 - 119.2. allowing the transfer of Kyoto units to be registered without approval of the international transaction log if this is no longer required under the international framework;
 - 119.3. enabling provisions that refer specifically to a commitment period to operate in the situation where there is no subsequent commitment period under the Kyoto Protocol or New Zealand has not accepted obligations in relation to a subsequent commitment period;
120. **Authorise** the Minister for Climate Change Issues to approve further changes of a similar character to the Act to enable further provisions of the Act, which reference the international framework established by the Kyoto Protocol, to be able to accommodate the range of possible outcomes of the Kyoto Protocol negotiations;

International forestry rules

121. **Note** that I am proposing no changes be made to the Act in response to international decisions agreed on Land Use and Land Use Change rules at this point in time, with the exception of the Flexible Land Use rule;
122. **Note** that, in response to the harvested wood products rule, officials will undertake further analysis before a decision is made;
123. **Agree** that given the high interest in the forestry sector, public statements on the government's response to the Durban rules be developed and issued following Ministers' decisions on the final ETS amendments;

Other measures to promote long term emissions reductions and productivity

124. **Agree** that officials should explore options for measures other than the ETS that will improve productivity and reduce New Zealand's greenhouse gas emissions over the long term;
125. **Invite** the Minister for Climate Change Issues to report back to Cabinet on the initial results of this exploration by the end of 2012;

Fiscals costs and implications

Summary of Initiatives

126. **Note** that Cabinet has agreed any changes to Emissions Trading Scheme (ETS) policy settings resulting from the ETS Review will be fiscally-neutral [CAB Min (11) 37/16 refers];
127. **Note** the following fiscal implications of proposed ETS decisions;

A: Summary of Proposed Package

\$ million	Increase/(decrease) in operating balance					Total across the forecast period
	2011/12	2012/13	2013/14	2014/15	2015/16 & Outyears	
Updating emissions projections with new Global Warming Potentials	-	0.541	0.961	1.264	0.704	3.470
Surrender obligation for own-use of oil	-	0.032	0.063	0.063	0.063	0.222
Removal of entry date of agriculture [sentence deleted to remove drafting error]	-	-	-	(12.156)	(23.640)	(35.796)
Transition phase—gradual phase-out of 2:1 surrender obligation for LFF, SEIP, SGG and waste sectors	-	(28.053)	(79.995)	(79.779)	(77.853)	(265.679)
Extending the Pre-1990 tree weed exemption to 2015/16	-	(0.600)	(1.200)	(1.200)	(1.200)	(4.200)
Increasing allocation to coal users by amending the coal factor used in industrial allocation to cover costs associated with fugitive coal seam methane emissions	-	(0.692)	(0.692)	(0.692)	(0.692)	(2.767)
Increasing industrial allocation for "manufacture of carbon steel from cold ferrous feed" by reclassifying it as a highly emissions-intensive, trade-exposed activity	-	(0.107)	(0.109)	(0.112)	(0.114)	(0.442)
Application of SGG levy	-	(1.254)	0.300	0.300	0.300	(0.353)
Changing point of ETS obligation for SF6 activities	-	(0.395)	(0.791)	(0.793)	(0.794)	(2.773)
Emissions Trading Scheme Review implementation contingency	-	(8.745)	(2.095)	(2.213)	(2.180)	(15.233)
Add stationary energy use of liquid fossil fuels as an emission source eligible for industrial allocation	-	(2.017)	(2.017)	(2.017)	(2.017)	(8.069)
Suspending the phase-out of industrial allocation until ETS participants assume full surrender obligation	-	(0.236)	(0.501)	(0.780)	(1.081)	(2.599)
Total Operating	-	(41.527)	(86.075)	(98.114)	(108.503)	(334.219)

Further policy options

128. **EITHER:**

B: Minister for Climate Change proposed option for the second-tranche

	increase/(decrease) in operating balance					
	2011/12	2012/13	2013/14	2014/15	2015/16 & Outyears	Total across the forecast period
\$ million						
Cancellation of the second tranche for those who take up offsetting	-	1.443	1.443	1.443	1.443	5.772

OR:

129. **C: Treasury proposed option for the second-tranche**

	increase/(decrease) in operating balance					
	2011/12	2012/13	2013/14	2014/15	2015/16 & Outyears	Total across the forecast period
\$ million						
Cancellation of 50% of the second tranche and for those who take up offsetting	92.700	0.722	0.722	0.722	0.722	95.586

130. **Note** that Cabinet has previously agreed that a “Emissions Trading Scheme Review implementation contingency” of \$15.233 million in 2012/13 be established from the Budget 2012 operating allowance, to fund implementation costs that cannot be met through existing agency baselines;

131. **Note** that the Minister for Climate Change Issues proposed package (A+B) will require a \$313.214 million pre-commitment against Budget 2013;

132. **Note** that the Treasury’s preferred option for the second-tranche (A+C) will require a \$223.400 million pre-commitment against Budget 2013;

133. **Delegate** authority to the Minister of Finance and the Minister for Climate Change Issues to make changes to appropriations as necessary to give effect to the decisions in this paper;

Process and timeline

134. **Agree** to delegate power to the Minister for Climate Change Issues, in consultation with the Minister for Primary Industries as appropriate, to further clarify and develop policy matters relating to the amendments set out in this paper, in a way not inconsistent with Cabinet decisions;

135. **Agree** that Parliamentary Counsel Office may make amendments to regulations that are consequential to any of the decisions made on the amendments set out in this paper which require the Act to be amended;
136. **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 Authority, as a key agency in the proposed amendments;

Communication and public consultation

137. **Note** that responsibility has been delegated to the Minister for Climate Change Issues for communication and engagement regarding the proposed amendments and response to Panel recommendations;
138. **Delegate** responsibility to the Minister for Climate Change Issues to prepare and table in the House a response to the Panel’s recommendations.

Hon Tim Groser
Minister for Climate Change Issues

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