



Reviewing the Emissions Trading Scheme

Date:	21 January 2009	MfE Priority:	URGENT
Security Level:		Number of Attachments:	One
		MfE Ref No:	09-B-00182

Action Sought

	Action Sought	Deadline
Minister of Finance Minister for Infrastructure Hon Bill English	Note.	None.
Minister of Energy and Resources Hon Gerry Brownlee	Note.	None.
Minister for Climate Change Issues Hon Dr Nick Smith	Note the series of briefing papers that officials are preparing on possible amendments to the emissions trading scheme; and Indicate any other areas on which you wish to receive a briefing note.	27 January 2009
Minister of Agriculture Minister of Forestry Hon David Carter	Note.	None.
Associate Minister for Climate Change Issues (International Negotiations) Minister of Trade Hon Tim Groser	Note.	None.
Minister of Transport Hon Steven Joyce	Note.	None.

Ministry for the Environment Contacts [if required]

Name	Position	Telephone		1st Contact
		(cell)	(work)	
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Executive Summary

The government has signalled that it wishes to amend the Climate Change Response Act 2002 (CCRA), which establishes the New Zealand Emissions Trading Scheme (NZ ETS), by the end of September 2009 (the “legislative review”).

A special select committee review of the NZ ETS and related matters (the “special select committee review”) is also underway. In order for an amendment to the CCRA to be passed by the end of September 2009 the policy development for this amendment will need to take place at the same time as the special select committee review is underway. A briefing note on the special select committee review will be provided shortly.

This note focuses on the aspects of emissions trading that officials understand the government wishes to review as part of the legislative review. It does not cover implementation of the NZ ETS as required by the CCRA. From time to time other issues, not mentioned in this paper, might arise and officials will provide briefings accordingly.

In order to amend the CCRA by the end of September 2009, the following process and timeframe is proposed:

- A series of briefing notes are provided to ETS Ministers on possible amendments to the CCRA in February;
- Cabinet considers proposed changes in March;
- Changes to legislation drafted in March/April;
- Amendment Bill introduced end of April;
- Amendment Bill reported back by the end of August and passed in September.

This timeframe is very tight and does not allow for any slippage if an amendment bill is to be passed by September 2009. A key determinate of whether this timeframe can be achieved will be the policy development and Ministerial decision-making process. The NZ ETS is a complex financial instrument and it will be important that Ministers are completely comfortable with the decisions they make with respect to it. This includes both decisions not to change certain aspects of the NZ ETS and to change other aspects of it. There is a lot of interest and expectations around the NZ ETS and once an amendment bill is introduced it will be subject to intense scrutiny and criticism. More time may be required over the policy development process to ensure that Ministers are comfortable with the proposed package of changes.

Officials propose that the series of briefing papers would cover:

- Ability to link with Australia;
- Allocation (including allocation to fishers, phase out, and provision of allocation for growth);
- Forestry offsets;
- Agriculture;
- Innovation fund;

- Consumer assistance;
- Setting of a national emissions target;
- Fiscal neutrality;
- Second tier policy issues; and
- Other minor and technical amendments to the CCRA.

More than one paper might be required on each of these areas. Ministerial direction is sought as to whether further topics should be explored.

Officials propose that these briefing notes be provided to the group of ETS Ministers. This group of Ministers would then make initial decisions on proposed amendments to the NZ ETS. The proposed amendments would then be outlined in a Cabinet paper (or a series of Cabinet papers) seeking Cabinet sign-off.

The same group of officials providing advice to Ministers on possible amendments to the CCRA will also be providing advice to the special select committee. This will ensure that these two processes are aligned at an officials' level. It could however create resourcing pressures which will need to be managed.

Recommended Action

We recommend that you:

- | | |
|--|-----------------|
| (a) Note that in order to amend the Climate Change Response Act 2002 by the end of September 2009 decisions will need to be made by Cabinet on the amendments in March and April. | Yes / No |
| (b) Note that officials are preparing a series of briefing papers reviewing and providing options for amendment in the following areas: | |
| i. Ability to link with Australia | Yes / No |
| ii. Allocation | Yes / No |
| iii. Forestry offsets | Yes / No |
| iv. Agriculture | Yes / No |
| v. Innovation fund | Yes / No |
| vi. Consumer assistance | Yes / No |
| vii. Setting of a national emissions target | Yes / No |
| viii. Fiscal neutrality | Yes / No |
| ix. Second tier policy issues | Yes / No |
| x. Other minor and technical amendments to the CCRA. | Yes / No |

(c) **Indicate** any other areas on which you wish to receive a briefing note:

(d) **Note** that the Emissions Trading Scheme Review Select Committee process is also underway and officials will provide a separate briefing on this. **Yes / No**

(e) **Forward** a copy of this briefing to the Minister of Maori Affairs. **Yes / No**

(f) **Convene** a meeting with ETS Ministers (Ministers of Finance, Infrastructure, Energy and Resources, Climate Change Issues, Agriculture, Forestry, Trade, Transport, and Maori Affairs, and the Associate Minister for Climate Change Issues (International Negotiations)) to discuss this paper and the special select committee review. **Yes / No**

John Scott, Acting General Manager
Emissions Trading Group

Date

Hon Dr Nick Smith
Minister for Climate Change Issues

Date

Purpose of Report

1. This report proposes a process for undertaking a legislative review of the New Zealand Emissions Trading Scheme (NZ ETS) with an objective of amending the Climate Change Response Act 2002 (CCRA), which establishes the NZ ETS, by the end of September 2009. This report also outlines the relationship between this legislative review and the special select committee review of the NZ ETS and related matters.

Background

2. The government has signalled that it wishes to amend the CCRA by the end of September 2009. It has identified a number of areas where it wishes to change how the NZ ETS operates. We refer to this as the “legislative review” throughout the rest of this briefing note.
3. A special select committee review of the NZ ETS and related matters (the “special select committee review”) is also underway. This select committee is anticipated to report back by mid April 2009. However, as no reporting timeframe was included in the motion establishing the review it will be up to the select committee to determine when it reports back.
4. The timeframe for amending the CCRA by the end of September requires decisions to be made on the content of an amendment bill while the special select committee review is underway and introduction of the bill soon after the anticipated select committee report back. Officials are preparing for both the legislative review and the special select committee review. The interrelationship between the reviews is discussed below.
5. This note focuses on the aspects of emissions trading that officials understand the government wishes to review. It does not cover implementation of the NZ ETS as required by the CCRA. As a result other issues, not mentioned in this paper, might arise from time to time and officials will provide briefings accordingly. For example, the Agriculture Technical Advisory Group (AgTag) is due to report shortly to the Director-General of the Ministry of Agriculture and Forestry. Officials will provide a briefing on this report and the government might wish to consider amendment to some of the agriculture provisions in the CCRA.

Timeframe for amending the Climate Change Response Act

6. In order to amend the CCRA by the end of September 2009, a number of steps are required. These are outlined below along with likely timeframes for each step and a possible completion date.

<i>Process step</i>	<i>Timeframe</i>	<i>Comment</i>	<i>Possible completion date</i>
Policy development	One – two months	Officials propose to provide Ministers with a staggered series of briefing notes on the areas where possible amendments to the ETS have been identified.	End of February

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Cabinet process to agree policy	One month	Normal Cabinet processes take approximately a month from the submission of the paper to the Minister to Cabinet consideration of the paper.	End of March
Drafting of amendment legislation	At least one month following Cabinet sign-off of policy	The complexity of the changes to legislation will drive the time required to draft the amendment bill.	End of April
Select Committee process	Four months	Cabinet Office guidelines suggest that four months is the minimum time that should be allowed for Select Committee consideration of a bill (usually six months is allowed)	End of August
Parliamentary debate	One month	At least 5 sitting days following report-back from Select Committee are required. There are 9 sitting days scheduled for September (between 8 th -24 th)	End of September

7. This timeframe is very tight and does not allow for any slippage if an amendment bill is to be passed by September 2009. Failure to meet any of the proposed completion dates would either push out the whole timeframe or require the time allowed for select committee consideration of the amendment bill to be shortened.
8. A key determinate of whether this timeframe can be achieved will be the policy development and Ministerial decision-making process. The NZ ETS is a complex financial instrument and it will be important that Ministers are completely comfortable with the decisions they make with respect to it. This includes both decisions not to change certain aspects of the NZ ETS and to change other aspects of it. There is a lot of interest and expectations around the NZ ETS and once an amendment bill is introduced it will be subject to intense scrutiny and criticism. More time may be required over the policy development process to ensure that Ministers are comfortable with the proposed package of changes.
9. There are a number of changes that the government could make without needing to amend the CCRA. This paper identifies those areas where officials understand the government wishes to review the implementation and operation of the NZ ETS. The Annex briefly outlines these and discusses the extent to which changes can be made without amending the legislation. This paper also notes that there are a few other policy areas where the government might wish to consider changes and some areas where officials would recommend largely technical amendments to the legislation if the CCRA is to be amended.

Decision-making process

10. A group of Ministers with an interest in the NZ ETS (ETS Ministers) has been established. This group includes the Ministers of Finance, Infrastructure, Energy and Resources, Climate Change Issues, Agriculture, Forestry, Trade, Transport, and Maori Affairs, and the Associate Minister for Climate Change Issues (International Negotiations) [CBC Min (08) 32/10 refers].

11. This group has been given power to act on management issues and the information requirements of the special select committee reviewing the NZ ETS. It is proposed that this same group of Ministers would receive the series of briefing papers outlined below and make initial decisions on proposed amendments to the NZ ETS. The proposed amendments would then be outlined in a Cabinet paper (or a series of Cabinet papers) seeking Cabinet sign-off to these amendments.

Areas for review

Areas identified by the government

12. Officials understand that the government wishes to review the following aspects related to the NZ ETS:
- a. Ability to link with Australia;
 - b. Allocation;
 - c. Forestry offsets;
 - d. Agriculture;
 - e. Innovation fund;
 - f. Consumer assistance;
 - g. Setting of a national emissions target;
 - h. Fiscal neutrality.
13. Each one of these is briefly discussed in the Annex and will be the subject of a subsequent briefing paper. Each briefing paper will outline the existing policy, any implementation challenges, policy options and implications, fiscal implications and whether legislative amendment is required in relation to the policy options. Analysis of possible amendments to the CCRA will also need to take into account, where relevant, trade policy and legal issues. More than one paper might be required on each of these areas.

Other policy issues

14. While reviewing the aspects of the NZ ETS outlined above it is possible that other policy issues might come to light. Officials will provide briefing notes on these as necessary.
15. Officials are also aware of a number of other second tier policy issues that the government might wish to consider. These include whether to remove HFCs and fugitive coal seam gas from having an obligation under the NZ ETS. Officials propose to outline these in a combined briefing paper(s) following the briefing papers on the government's identified areas for review.

Possible amendments identified by officials

16. If the CCRA were to be amended, there are a number of minor technical amendments that officials would recommend to better reflect the intent of existing policy. These include amending the legislation to:
- insert definitions of “economic regrets” and “perverse behavioural incentives” into the Act, and clarify certain other terms under the Act, or remove these terms from the CCRA;
 - clarify that a forestry allocation plan can specify a land transfer date in allocation plans;
 - clarify that forestry participants do not have to be registered until all fees and charges are paid.

Relationship with the Special Select Committee Review

17. The timeframe for amending the CCRA by the end of September requires decisions to be made on the content of an amendment bill while the special select committee review is underway and introduction of the bill soon after the select committee is due to report back.
18. The Emissions Trading Group in the Ministry for the Environment has been appointed as advisers to this select committee. As climate change and emissions trading policy is cross-government in nature, the Emissions Trading Group will act as a co-ordinator and involve the Treasury, Ministry for Agriculture and Forestry, Ministry of Economic Development, Ministry of Foreign Affairs and Trade, Ministry of Transport, and IRD as necessary.
19. The same officials who will be advising the special select committee will be involved in drafting the briefing papers outlined above and providing advice to Ministers on amending the CCRA. This will ensure that any relevant findings from the special select committee review can be taken into account when providing advice on amending the CCRA. It could however create resourcing pressures which will need to be managed.
20. The next meeting of the select committee is scheduled for Thursday 12th February. Officials will be providing you with a briefing note shortly on the special select committee review. The briefing note will outline a proposed set of background papers, a list of the officials who will be advising the committee and the initial presentation to be made by officials at this meeting. The briefing note will also cover communication issues and a proposal for Australian officials to make a presentation to the committee.

Annex: Areas for review identified by the government

1. This Annex provides some initial thoughts on each of the areas identified by the government for review.

Ability to link with Australia

2. The Australian government released the detailed design of its proposed Carbon Pollution Reduction Scheme in December [see 08-B-1140 for a discussion on the Australian scheme]. It plans to introduce and pass legislation this year to implement the scheme. The scheme would then commence on 1 July 2010 for most sectors (a decision on agriculture is scheduled for 2013, with the earliest entry date being 2015).
3. Development of the two emissions trading schemes to date has been guided by the principle, confirmed at Prime Ministerial level, that to the extent possible the two schemes should be 'compatible'. Australian officials have signalled that the Australian government would look favourably on linking the two schemes in the future.
4. There is broad alignment between the Australian's proposed scheme and the NZ ETS as currently outlined in legislation. However, there are a few areas where changes would be required in order for linking to occur. These relate to the Australian decision to include a price cap in their scheme from 2010/11 to 2014/15 and the related restrictions on banking and the international sale and importation of units.
5. Ultimately, climate change policies in both Australia and New Zealand should take account of each country's interests, the extent to which the two economies are integrating and the large number of trans-Tasman companies which operate in both countries, and reflect our respective economic structures and emissions profiles.

Allocation

6. The provision of free allocation is the most complex area of NZ ETS design, and it is also the most controversial. Rules on free allocation have significant effects on both the equity (who pays and how much) and also the efficiency (how strong are the incentives to reduce emissions) of the NZ ETS.
7. In recognition of the increased costs firms will face as the NZ ETS commences, the system is currently designed to:
 - reduce the risk of economic regrets (the loss of economic capacity that we may regret if there is a fuller international climate change agreement in the medium term) while retaining an incentive to reduce emissions (most important in the industrial sector); and
 - recognise the potential loss in asset value that some affected parties will suffer as a result of implementation of the NZ ETS (particularly relevant in the forestry and fishing sectors).
8. The CCRA establishes the quantum of allocation to be provided, the sectors which will be eligible to receive allocation, the phase out of this allocation and the process for determining which firms will receive an allocation and how much they will receive. There is significant scope for the government to make decisions on the

methodology and criteria for the provision of free allocation without needing to amend the CCRA.

9. Officials understand that the government is particularly interested in reviewing the following aspects of allocation policy:
 - The amount of allocation provided to the fishing industry;
 - The phase out of free allocation;
 - Allocation to the forestry sector (as this relates to any decisions of forestry offsetting); and
 - Provision of allocation for growth (in particular for the industrial sector).
10. Decisions on the amount of assistance provided to the fishing industry represent an equity decision. Depending on the objective of any assistance the government has choices on what is the appropriate amount of assistance and how best to provide it. Any changes to the amount of allocation provided to the fishing industry through the allocation mechanism established in the CCRA would require a change to the legislation. Alternatively, the government could consider other ways of providing assistance to this industry.
11. Any changes to the phase out of free allocation would require changes to the CCRA. However, the initial levels of free allocation do not start to decrease until 2018. The CCRA requires that the operation and effectiveness of the NZ ETS be reviewed by the end of 2011. Such a review would be able to take into account the state of international negotiations and agreements which would affect the need for free allocation and influence the most appropriate phase out path.
12. It is possible to implement an allocation methodology that provides an allocation for growth within the existing legislative framework (although this provision would be within a fixed allocation level).

Forestry offsets

13. At present, offset planting for pre-1990 deforestation is not provided for under current international rules and consequently it is not provided for under the CCRA. The CCRA does, however, provide for offsetting in the NZ ETS should the future international rules allow for it.
14. [withheld].
15. [withheld].

Agriculture

16. Under the CCRA the agriculture sector faces obligations relating to methane from livestock emissions and manure management, and nitrous oxide from animal urine and dung and synthetic fertiliser. Participants can voluntarily report their emissions in 2011 and are required to report their emissions in 2012, but they are not required to pay for their emissions in these years. Agriculture fully enters the scheme in 2013 under the present CCRA.
17. The government has indicated that it wishes to ensure that the NZ ETS does not compromise the international competitiveness of the agriculture sector. It has also signalled that it wishes to establish an international centre for research into greenhouse gas emissions from livestock. Officials can provide information on policy options regarding the agriculture sector in the ETS.

Innovation fund

18. The CCRA requires the Minister to establish an innovation fund for the purpose of facilitating deployment of innovative technologies that significantly reduce or avoid, or have the potential to significantly reduce or avoid, greenhouse gas emissions from the industrial sector, or part of the industrial sector. This fund will be made up of 150,000 New Zealand units taken from the pool of units provided for allocation to the industrial sector each year from 2010 to 2012. This fund is only intended for industrial firms otherwise not receiving free allocation.
19. The Minister has discretion under the Act to determine how the fund will operate. However, any changes to the amount of units to be provided to the fund and the relationship of these to the industrial allocation pool would require a change in legislation. Removal of the fund altogether would also require legislative amendment.
20. It is worth noting that the CCRA only requires the innovation fund to be established for three years (2010-2012). From 2013 the Minister has discretion on whether or not to continue the fund and the amount of units available for allocation through the fund.

Consumer assistance

21. Officials understand that Ministers wish to consider the impacts of the NZ ETS on consumers and the options for providing assistance in relation to these impacts. Officials also understand that the government wishes to disestablish the Household Fund provided for in the CCRA. The CCRA requires a total of \$1 billion be paid into the Household Fund before the end of 1 July 2024. The Act does not specify what amount is to be appropriated in which year and the previous government made no decisions on this apart from approving expenditure of \$7 million.
22. The previous government agreed and announced that financial assistance would be provided to households in the form of a one-off cash payment to families who receive benefits, superannuation and Working for Families tax credits and that there would also be a one-off electricity rebate to all households. Officials from Treasury, MSD, IRD and MED were directed to report back to Cabinet by 18 March 2009 with all necessary design and implementation details. No changes to appropriations were agreed with respect to this assistance.

Setting of a national emissions target

23. The CCRA requires the Minister responsible for the administration of the Act to set a target. This target must be publicly notified in the *Gazette*. A set of targets was gazetted on the 16th October 2008.
24. Officials note that National Party policy is to set and legislate for an achievable emission reduction target for New Zealand – a 50% reduction in New Zealand's carbon-equivalent net emissions, as compared to 1990 levels, by 2050 (known as "50 by 50"). Options to achieve this include amending the existing targets that have been gazetted or amending the CCRA to include this target.
25. Officials note that the key issue for the current UN negotiations are medium term targets (up to 2020 or thereabouts). Officials suggest that consideration of the setting of a long term national emissions target include what medium and long term targets have been announced by other key countries and international groupings and the international negotiations.

Fiscal neutrality

26. An emissions trading scheme will result in the government receiving revenue from the surrender of emission units. This revenue can be used in a number of different ways from purchasing Kyoto units to cover New Zealand's Kyoto liability, to providing free allocation to affected firms, to providing support for households/consumers, to reducing taxes.
27. Officials note that the National Party has stated that the NZ ETS should be fiscally neutral. The definition of this has yet to be defined. One interpretation is that all revenue raised from the NZ ETS would be spent on covering New Zealand's Kyoto liability, providing assistance to those affected by the scheme and on programmes to encourage emissions reduction. Officials suggest that consideration of how to achieve fiscal neutrality also include the use of the revenue to reduce overall taxes.