



**Joint Briefing:** Outstanding agriculture issues for the Moderated ETS

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<b>Date:</b>	24 August 2009	<b>MfE Ref No:</b>	09-B-02518
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**Action Sought**

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	<b>Action Sought</b>	<b>Deadline</b>
Minister for Climate Change Issues Hon Dr Nick Smith	Confirm your preferences on options set out in this briefing.	26 August
Minister of Agriculture and Forestry Hon David Carter	Confirm your preferences on options set out in this briefing.	26 August
Associate Minister of Climate Change Hon Tim Groser	Note	None

**Contact for Telephone Discussion (if required)**

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<b>Name</b>	<b>Position</b>	<b>Telephone</b>	<b>1st Contact</b>
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## Executive Summary

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### Purpose

1. Ministers have agreed a broad package for agriculture that includes:
  - A processor level point of obligation initially with the ability to transition to farm level once administrative challenges have been satisfactorily resolved;
  - An intensity-based allocation beginning at a 90 percent assistance level and phasing out at -1.5 per cent per annum subject to 5 yearly review; and
  - Consideration of a delayed entry into the scheme beyond 1 January 2013.
2. This briefing outlines advice on a number of second order policy issues that now require decisions, and advice on the content of the legislation.

### Entry and reporting dates

3. Ministers are considering delaying agriculture's entry date for obligations from the current date of 1 January 2013. If this approach is confirmed, then you will also need to decide whether or not to also move the reporting dates. Voluntary reporting is currently scheduled to commence on 1 January 2011 followed by mandatory reporting in 2012.
4. A longer reporting period is not strictly necessary, so there is an option to push out the reporting dates to line up with the delay in obligations. However, officials consider that it may be useful to maintain the reporting dates as they are, with voluntary beginning in 2011 and mandatory reporting beginning in 2012.
5. Lengthening the reporting period is not administratively costly and will provide a valuable signal to participants about the need to begin managing emissions. Processors are likely to begin to communicate to suppliers and shareholders about annual emissions and their notional cost, and thus begin to shape behaviour. The period will also provide an opportunity for processors to apply for Unique Emission Factors and/or develop systems to provide a more accurate price signal to farmers.

### Point of Obligation

6. Ministers have agreed that the initial point of obligation will be at processor level and the Government will have the ability to change to a farm level obligation subject to stakeholder views and successful resolution of administrative challenges. The option for a hybrid point of obligation will be also removed from the legislation.
7. From a practical perspective this means that the legislation would specify a processor level obligation from the outset. At any time after that the Government could pass an Order in Council (OIC) to begin reporting at farm level. There would be a minimum twelve month lead-in from the passing of the OIC to the time that reporting obligations began. Processors would continue to report emissions and surrender units during the farm level reporting years meaning there would be no loss of revenue for the Crown during the transition.

### *Criteria for moving the point of obligation*

8. The legislation would specify certain criteria that the Minister must have regard to before making an OIC for the point of obligation. Officials recommend that the criteria should include:
  - The ability to enforce compliance;
  - The costs including administrative and compliance costs;
  - The benefits in terms of additional mitigation.
9. These criteria would help ensure a robust decision, although it also increases legal risk of judicial review if the Minister has incorrectly applied the criteria. On balance, we think including these criteria in the Act would assist in demonstrating the government's commitment to working towards the implementation of a farm level point of obligation.
10. Officials also consider that if the sector is committed to a farm level point of obligation, the criteria should motivate the sector to help resolve verification issues that exist with a farm level obligation.

### *Reporting at Farm Level*

11. Moving to a farm level point of obligation will create significant administrative challenges because of the sheer number of participants that must be registered. These challenges will exist regardless of the lead-in time.
12. The voluntary and mandatory reporting years were designed partly to help spread the registration load, but experience with the Forestry ETS registration process has highlighted that the registration process can be administratively time consuming. Officials therefore recommend a subtle change to the voluntary reporting year so that it would become a mandatory-registration / voluntary reporting year. In this way, farmers would have a full 12 months to become registered in the scheme and could choose to report in that year.

### *Ability stage the transition to Farm Level*

13. Another useful addition would be to provide the Government with the ability to stage the transition to the farm level. A staged approach might involve, for example, beginning reporting and surrender obligations for one sector at a time. Officials would not currently recommend a staged approach to the transition for a number of reasons<sup>1</sup> but it is possible that these will be resolved in the future.

### **Intensity Based Allocation**

14. With respect to allocation the Government has agreed that free allocation will be provided on an intensity basis, on a similar basis as Energy Intensive and Trade Exposed industry. Officials understand the level of assistance will begin at 90 percent and phase-out at a rate of -1.5% per annum from the date of entry and be subject to five-year review. Any significant changes to the provision of free allocation will require a five year notice period.
15. Further detailed decisions relating to allocation to agriculture include the content of the legislation in relation to the following design features:
  - Eligibility;
  - The methodology for calculating a participant's allocation;

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<sup>1</sup> The OVERSEER model is a farm-based (land-based) model and it at present cannot pick up "off-farm" activities meaning that participating farmers will be incentivised to push emissions onto another non-participating farm. This would reduce their emissions on paper only. Examples include the use of dairy run-off blocks and imported feed supplements. There are also equity issues around charging one group of farmers and while excluding others.

- The allocation baseline; and
- The level of assistance.

### *Eligibility*

16. The current framework assumes that the whole of the agriculture sector is trade exposed with the costs of the ETS largely being borne by farmers as opposed to processors who will pass the costs back through lower product prices. Therefore there are no trade exposure tests or eligibility requirements.
17. Officials consider this approach remains appropriate and recommend no trade exposure tests or thresholds be specified in the legislation. However, the current legislation allows allocation to be provided to non-participants. This provision was to allow flexibility while more work was done on the appropriate point of obligation and is therefore no longer necessary. We recommend clarifying that only participants are eligible for free allocation.

### *Methodology for determining a participant's allocation*

18. The legislation will specify the formula for determining a processor's allocation as:

[Output] x [Allocation Baseline] x [Assistance Level (adjusted for the phase-out)].

### *Level of assistance*

19. The initial level of assistance and phase-out rate will be explicitly specified in the legislation. Officials understand that the initial level of assistance will be 90 per cent and the allocation will phase-out at - 1.5 per cent from the date of entry.

### *Output*

20. In the case of agricultural processors, output refers to production throughput. For example, for dairy processors it will be volume of milksolids processed; for meat processors their output (production throughput) of meat in kilograms from various livestock classes (ie. bulls, cows, steers etc); and fertiliser importers/manufacturers their imports or manufacture of synthetic fertilisers containing nitrogen in tonnes.
21. Officials recommend that the legislation specify that allocation be based on the participant's output from the current compliance year<sup>2</sup>, rather than historic output levels which is likely to be adopted for EITE industry in line with the Australian approach. A different approach for agriculture is necessary because basing allocation on historic production levels could potentially limit processors' expansion of market share and constrain competition. This issue is of greater concern for agriculture (particularly dairy) than for EITE industry. Using current emissions also eliminates the complexity involved in dealing with new processing entrants because new entrants are implicitly provided for.
22. Due to the size of the emission liability and to manage the risk that certain agriculture processors may occasionally be in a weak financial position,, it will be important to ensure that the legislation allows processors to apply for and receive their allocation in advance of surrendering units<sup>3</sup>. Officials therefore recommend that the surrender date for obligations be extended from the end of April to the end of May. This would likely apply to all sectors for consistency of treatment.

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<sup>2</sup> For clarity, this means that processors' obligations and allocation are calculated using output from the same year.

<sup>3</sup> [withheld].

## Allocation baselines

23. The allocation baseline is the estimated emissions per unit of output for the purposes of determining the allocation. Officials recommend that the allocation baselines for agriculture be based on sector average emissions per unit of output, similar to the approach for EITE industry. This would mean that dairy processors would be eligible for a set number of NZUs based on their volume of output of milksolids; meat processors for their output of meat (in Kgs) from various livestock classes (ie. bulls, cows, steers etc); and fertiliser importers/manufacturers for their imports or manufacture of synthetic fertilisers containing nitrogen.
24. Using sector average emissions per unit of output as the allocation baseline means that processors who can reduce their emissions per unit of output will receive more allocation per unit of output; thus rewarding efficient production. This is more challenging in agriculture because processors do not directly influence the emissions intensity of production (this happens on farm), but there is an ability for processors to apply for Unique Emission Factors. In principle, a processor could apply to the government to have their emission factor adjusted downwards by providing evidence their suppliers were undertaking particular mitigation practices or using particular mitigation technologies. This is one way that the price signal could be improved over time.
25. Similar to the emission factors for the obligation, the allocation baselines will be specified in regulation.

## Minor/technical

26. Officials have discovered an issue with a description of the activity for nitrogen fertilisers and recommend a minor amendment. Currently, the activity description attributes a nitrous oxide emission to all imported and manufactured nitrogen fertilisers. However, fertiliser imported or manufactured for industrial purposes would not have an agricultural nitrous oxide emission and should not be included. Clarifying that the activity is importing or manufacturing nitrogen fertiliser for application to soils would resolve this.

## Implications for Other Sectors

27. This paper recommends that surrender obligations be extended from the end of April to the end of May. It would be logical to extend the surrender obligations in a similar way for other sectors; officials see no issue with this. The paper also recommends that for agriculture, allocation be based on output in the current compliance year rather than historic output levels. Officials do not recommend that this be extended to other sectors, the case for basing allocation on current output is stronger in the agricultural sector than in other sectors.<sup>4</sup>

## Recommendations:

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28. We recommend that you include in the Climate Change Response (Emissions Trading Sector Entry) Amendment Bill (officials' preference shown in bold):

<b>Option</b>	<b>Ministers' preference</b>
a) The reporting dates for agriculture remain unchanged with voluntary reporting beginning on 1 January 2011;	<b>Yes / No</b>

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<sup>4</sup> Although this will be covered in an upcoming SEIP allocation paper, it is likely that officials will recommend that the phase-out of free allocation does not commence until both the agricultural and SEIP sectors are participating in the ETS.

b) The Bill specify certain criteria that the Minister must have regard to before making an Order in Council for the point of obligation; **Yes / No**

c) Assuming your preference is to include criteria in the Bill as outlined above, for the following criteria to be used:

The Minister must have regard to:

i. The ability to enforce compliance; **Yes / No**

ii. The costs including administrative and compliance costs; **Yes / No**

iii. The benefits in terms of additional mitigation. **Yes / No**

d) The ability to stage the transition to the farm level; **Yes / No**

e) There would be a minimum twelve month lead-in period from the passing of the OIC regarding reporting obligations to the time that reporting obligations begin **Yes / No**

f) There be no trade exposure tests or eligibility requirements for agriculture allocation; **Yes / No**

g) Only participants will be eligible for an allocation of units; **Yes / No**

h) The allocation be based on output in the current compliance year rather than historic output levels; **Yes / No**

i) The surrender date for obligations be extended from the end of April to the end of May; and **Yes / No**

j) The description of the activity for nitrogen fertilisers be amended to clarify that the activity is importing or manufacturing nitrogen fertiliser for application to soils. **Yes / No**

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