

In Confidence

Office of the Minister for Climate Change

Chair, Cabinet Environment, Energy and Climate Committee

Approval of policy changes to the Climate Change Response (Emissions Trading Reform) Amendment Bill

Proposal

- 1 I propose to amend the Climate Change Response (Emissions Trading Reform) Amendment Bill (**the Bill**) to make further policy changes to the New Zealand Emissions Trading Scheme (**NZ ETS**).
- 2 These policy changes can be drafted as a supplementary order paper (**SOP**) to the Bill. If you approve these changes, I also seek Power to Act for the Cabinet Legislation Committee to approve the final SOP.

Executive summary

- 3 I propose policy changes to the Bill to help make the reformed NZ ETS more effective in driving emission reductions to support Aotearoa New Zealand reaching its domestic and international climate change targets. These changes improve treatment of forestry, streamline compliance and penalty arrangements, and provide better cost certainty for participants in the transition to auctioning of emission units.
- 4 Further, I propose additional contingency measures to ensure the NZ ETS reforms can be delivered effectively, given widespread disruptions stemming from the COVID-19 pandemic. I propose amending the Bill to delay implementing the major forestry policies, and to allow the Minister for Climate Change to extend the Climate Change Commission's statutory deadlines.
- 5 I have jointly developed these proposals where relevant with Hon Shane Jones, the Minister of Forestry, and Hon Grant Robertson, the Minister of Finance.
- 6 If approved, these proposed amendments to the Bill will be introduced through a supplementary order paper (**SOP**) for consideration by the Committee of the whole House.

Background

- 7 The Bill was introduced on 24 October 2019. It amends the Climate Change Response Act 2002 (**the Act**), redesigning the NZ ETS based on Cabinet decisions from December 2018 to September 2019. The Bill has been considered by the Environment Select Committee which, due to the disruptions caused by COVID-19, delayed its report to the House until 4 May 2020.

- 8 The Bill significantly reforms the architecture of the NZ ETS. It introduces a coordinated decision-making framework to cap the number of emission units entering the scheme (except for units earned from removals, such as through forestry). Capping the supply of units enables the Government to reduce total allowable emissions over time. These limits on supply will be set each year in regulations on a rolling five-year basis, announced annually. In this way the reformed NZ ETS will play a key role in delivering our climate change targets, including the 2050 targets set by the Zero Carbon Act in November 2019. The Bill also implements the phase-down of free industrial allocation, improves the scheme's transparency, and provides a robust compliance and penalties regime.
- 9 Other amendments make substantial reforms for forestry. The Bill introduces averaging accounting for post-1989 forests and provides supporting policies increasing flexibility around land-use and further incentives for forestry participation. It replaces the Permanent Forest Sink Initiative with a new permanent forestry activity, and improves operational efficiency for forestry in the scheme.
- 10 The Bill will also price methane and nitrous oxide emissions from livestock and fertilisers on farms from 2025. Farm-level reporting of livestock emissions will begin in 2024, while fertiliser manufacturers and importers already report on their emissions. In 2022, the Minister of Agriculture and I must report on a farm-level emissions pricing system as an alternative to the NZ ETS. The details of this pricing system will be informed through a Joint Action Plan on Primary Sector Emissions (He Waka Eke Noa). The Climate Change Commission will review He Waka Eke Noa's progress toward other milestones in the Bill in 2022. If progress is insufficient, processor-level pricing of both livestock and fertiliser emissions can come into effect at an earlier date.
- 11 Cabinet earlier delegated authority for in-principle decisions on two of the policy changes I propose in this paper to myself and:
 - 11.1 the Minister of Forestry to consider extending temporary adverse event provisions to existing stock change forests [CAB-20-MIN-0063 refers];
 - 11.2 the Minister of Forestry and the Minister of Finance to consider extending the fixed-price option to emissions from the start of 2020 at \$35 [CAB-20-MIN-0062 refers].

Analysis

- 12 I propose amendments to the Bill as set out below.
- 13 The first two policy changes are driven by the disruptions stemming from COVID-19: *A new power to extend the Climate Change Commission's statutory deadlines*, and *Delaying implementation of major forestry policies*.

A new power to extend the Climate Change Commission's statutory deadlines

The Commission may not be able to meet its statutory deadlines under the Act

- 14 The Act requires the Climate Change Commission (**the Commission**) to provide the Minister for Climate Change with its recommendations for the first three emissions budgets and advice on the first emissions reduction plan by 1 February 2021.
- 15 The Commission has consistently told me that these statutory deadlines are challenging, and it is clear they have been exacerbated by COVID-19. On 8 April, the Commission wrote to me asking to extend its deadlines by six months, from 1 February 2021 to 30 July 2021. It believes this is necessary to provide robust, high quality advice incorporating the impacts of COVID-19; and to meet its statutory responsibilities (eg, consultation and iwi/Māori engagement).

I propose introducing a new power to allow the Minister for Climate Change to extend these deadlines under limited circumstances

- 16 It is difficult to quantify the impact COVID-19 will have on the Commission's ability to meet its deadlines. There are also risks in extending those deadlines, such as adversely affecting the Government's ability to fulfil its own statutory requirements under the Act.¹ On balance, I consider it prudent to introduce a new power allowing the Minister for Climate Change to extend the Commission's deadlines under the Act. This provides the flexibility to better understand the impacts of COVID-19 and monitor the Commission's progress. If necessary, the statutory deadlines can be amended when there is greater clarity around the need for an extension and its necessary duration.
- 17 I propose amending the Bill to introduce this power, but constrain its use so that any extension should:
 - 17.1 only be granted upon a written request from the Commission submitted after the enactment of this amendment, which clearly explains why an extension is necessary and details the length of the extension required;
 - 17.2 not exceed six months;
 - 17.3 be notified in the *Gazette*, to provide transparency and greater certainty.

Delaying implementation of major forestry policies

The COVID-19 pandemic has created a delivery risk for the current January 2022 implementation date for the forestry regulations required by the Bill

- 18 Significant amendments to the Climate Change (Forestry Sector) Regulations 2008 (**the forestry regulations**) are required to implement major forestry policy changes proposed in the Bill. These policies are listed in **Appendix 1**, and include:

¹ This includes notifying the first three emissions budgets and publishing the first emissions reduction plan by 31 December 2021.

- 18.1 introducing averaging accounting for post-1989 forests;
 - 18.2 creating a new permanent forestry activity in the NZ ETS;
 - 18.3 preventing eligible forests from being required to surrender units to cover emissions from temporary adverse events;
 - 18.4 allowing some types of post-1989 forestry participants to offset their deforestation liability by planting a forest elsewhere;
 - 18.5 improving the pre-1990 forest land offsetting.
- 19 In March 2020, Cabinet approved extending the implementation date of major forestry policies in the Bill, and consequently the associated forestry regulations, from 1 January 2021 to 1 January 2022 [CAB-20-MIN-0063 refers].
- 20 However, disruptions from COVID-19 have created a substantial risk the regulations cannot be delivered to this timeframe. Policy decisions by Cabinet would be needed no later than June 2020 to allow enough time for drafting by the PCO, and for operational testing of the forestry regulations in late 2020 and early 2021 for Gazettal by 1 October 2021. Given their complex and technical nature, the forestry regulations will require rigorous drafting, testing, and reviewing following policy decisions.

Amending the Bill and transitional provisions for forestry will mitigate the risk of non-delivery of the forestry regulations

- 21 To mitigate the above risk, I recommend Cabinet agree to amend the Bill to defer implementation of the major forestry policies, and consequently the forestry regulations, by one year to 1 January 2023. Policy decisions on the forestry regulations will be brought to Cabinet in early 2021.
- 22 I do not expect deferring the implementation of major forestry policies to 2023 will impact projected afforestation rates. Recent afforestation data suggests landowners are already planting in anticipation of averaging accounting and not waiting for final forestry regulations on the detail. The COVID-19 response and its potential impact on planting in 2020 is more likely to influence afforestation rates in the short term.
- 23 Changing the implementation date to January 2023 will make the new forestry policies commence in the next (rather than the current) mandatory reporting period, which starts on 1 January 2023.
- 24 To ensure those who registered under the currently announced settings are not disadvantaged, I recommend Cabinet agree to amend the relevant transitional provisions in the Bill. This would see post-1989 forests registered in 2022 extended the same option of choosing to remain on stock change or make a switch to averaging as those forests registered in 2019, 2020, and 2021.

- 25 The remaining transitional provisions are technical in nature.² Minor amendments to these provisions in the Bill are needed in order to line up with the later implementation date of the major forestry policies.

Deferring the implementation date to the start of a new reporting period means a previous decision to allow leeway for late registrations no longer works operationally

- 26 Cabinet previously agreed to link the option of using averaging to the registration application date, rather than the date the registration is approved (following assessment by the regulator), so long as approval was granted by 30 June 2022 [CAB-20-MIN-0063 refers]. This change was made to give leeway for the expected rush of registrations at the end of 2021 following winter planting, to be processed in time to be considered as registered in 2021.
- 27 However, extending the implementation date of the major forestry policies means the approach above will no longer work operationally as the application and approval dates would be across different reporting periods. For example, a participant must submit their mandatory emissions return for the current period (2018 – 2022) by 30 June 2023; however, in that return they must include all of the forest land they had registered on 31 December 2022. If the leeway was retained there would be much less time in practice as both the application and the emissions return would need to be completed by the 30 June 2023 deadline for the participant to be considered registered in 2022. This is likely to create confusion for participants and a large spike in resourcing requirements for processing in the first half of 2023.
- 28 To address these issues I recommend amending the Bill so that forests must have their registration approved before 31 December 2022 to have the option of using stock change or averaging accounting, rather than have just submitted an application to register. Given the additional year available to register their forests, this is unlikely to disadvantage participants and can be effectively managed through clear communications.

Cover for surrender liabilities arising from a temporary adverse event will not be available until forestry regulations are in force

- 29 Foresters planting in 2020 are likely to be planning to use averaging, and may be expecting adverse event cover to be available for adverse events occurring before averaging becomes available (but following registration).³ If the forestry policies aren't implemented until 1 January 2023, existing participants will still need to surrender New Zealand Units (**NZUs**) for any carbon lost in an adverse event until that time.
- 30 However, I consider it unlikely participants will be significantly affected by liabilities from adverse events before 2023, as adverse events resulting in significant forest

² For example, transitioning forests in the Permanent Forest Sink Initiative to permanent forestry.

³ Temporary adverse events such as fire or wind throw damage forests, resulting in carbon being lost to the atmosphere. Foresters can have their surrender liabilities suspended in these circumstances; see the discussion from paragraph 46.

clearing (more than 5 hectares) are rare.⁴ Rather than bring the temporary adverse event provisions forward, the exemptions scheme under new section 60A in the Bill could assist any participant significantly disadvantaged by an adverse event before the regulations are in place. I therefore consider changing the Bill is unnecessary and the provisions should commence from 1 January 2023 alongside the other forestry policies.

Delaying the new surrender/repayment penalty regime for small foresters

- 31 I propose delaying the introduction of the new surrender/repayment penalty for small forest participants, with the existing penalty applying to those participants in the meantime. This will give officials time to ensure that the proposals for a long-term solution work domestically, s9(2)(j) . Any solution that needs to eventually replace the surrender/repayment penalty will require further legislative change after the passage of the Bill.

The financial penalty could cause serious hardship for small-scale forest owners

- 32 The surrender/repayment penalty imposes a financial penalty equivalent to three times the current market price of carbon (as specified in regulations) for each outstanding unit. The participant must also make good on their original obligation. The penalty was set as this level for two main reasons:
- 32.1 to reflect the potential fiscal risk to the Crown created when a participant fails to pay units for their emissions; and
- 32.2 to be consistent with international practice. This is particularly important to keep our options open should the Government decide to link to international carbon markets in the future.
- 33 Having a large number of smaller participants (particularly in the forestry sector) makes the NZ ETS unique among emission trading schemes internationally. In Select Committee, submitters highlighted a potential issue whereby applying the penalty to smaller forestry participants may result in a substantial and disproportionate impact on individuals who unintentionally make errors leading to non-compliance.⁵ Stakeholders also raised similar concerns directly with officials.
- 34 In response, in March 2020 Cabinet directed officials to explore potential options for a more flexible approach to applying the surrender/repayment penalty to small foresters, and to test with potential linking partners [CAB-20-MIN-0062 refers]. Cabinet also directed officials to report back to the Minister for Climate Change and

⁴ Liabilities are also commonly 'netted out' during the final mandatory return in a reporting period and, as such, result in a reduction in units earned for the participant, rather than a direct and immediate cost.

⁵ For example, a farmer who deforests two hectares of pre-1990 forest will incur a surrender obligation of approximately 1600 units (about \$42,000 at a unit price of \$26). If they fail to pay within the timeframe they will also incur a penalty of up to \$126,000. The total value of \$168,000 will then be due within 20 working days. This compares to the average annual profit of a North Island hill country farm of approximately \$90,000 (Beef + Lamb NZ).

the Minister of Forestry with any potential amendments to the surrender/repayment penalty in the Bill.

35 Officials have since advised the Minister of Forestry and myself that a long-term solution cannot be resolved in the Bill's intended timeframe. Officials have confirmed the surrender/repayment penalty does have the potential to cause serious hardship in some instances for some small-scale forest owners.

36 However, any proposals to amend the Bill's penalties regime need to consider the impact that would have on our ability to link the NZ ETS to overseas markets in the future. s9(2)(j)

I propose an interim measure for small foresters while officials develop a long-term solution

37 I propose an interim measure to address these risks. I propose delaying introduction of the surrender/repayment penalty for participants that meet both of the following criteria:

37.1 the failure to surrender or repay units applies to forestry activities that occurred before 1 January 2023; and

37.2 where an emissions return or notice results in a net liability less than 25,000 units per year covered in the return or notice.

38 Delaying the introduction of the penalty for participants that meet the above criteria mitigates the risk of hardship for these participants until a long-term solution is found. In the interim, these participants will be subject to the relevant sections of the existing Act, if they fail to surrender or repay units (sections 134 to 136).

39 I also recommend that Cabinet direct officials to report back to Cabinet by mid-2021 on options for a long-term solution to compliance and penalties for small foresters, and any other sectors that may be similarly affected.⁶ s9(2)(j) Following that analysis, if a different type of penalty is preferred for this group, a further amendment Bill will be needed before 2023.

Amending penalties to align with amended emissions returns

The Bill creates a new surrender/repayment penalty scheme, with limited ability to amend penalties in line with amendments to returns

40 The Bill introduces a new penalty that applies when NZ ETS participants fail to surrender or repay units by the due date (amended section 134 of the Act).⁷ The Environmental Protection Authority (**EPA**) calculates the penalty amount using a

⁶ For example small synthetic greenhouse gas importers.

⁷ 'Pay' here refers to either surrendering units to meet an obligation, or repaying units that may have been transferred in excess of what the person was eligible to receive.

formula based on the number of units a participant failed to surrender or repay in relation to the obligation/entitlement reported on their emissions return.

- 41 At times, the EPA may need to amend an emissions return under section 120 of the Act.⁸ This can occur both before and after a surrender due date passes and, in some cases, after a penalty has been paid. The current Bill requires the EPA to reverse the penalty (amended section 134(4)) if the EPA proposes to amend an emissions return. In practice, this means the EPA would need to pay back the original penalty in full. The current drafting is also unclear about how to reissue a revised penalty, and doesn't allow the EPA to correctly apply the new penalty in some situations.⁹
- 42 A simpler process would be providing the EPA a restricted power to recalculate the penalty based on the amended return, and reconcile any difference with the participant. This recalculation may result in a further penalty, or a reimbursement. The EPA may also need to provide new due dates for a penalty to be paid.

When amending an emissions return, the EPA should be able to amend an associated penalty, applying a further penalty or providing a reimbursement, as appropriate

- 43 I seek approval to amend the Bill to adopt this simpler process, requiring the EPA to recalculate the surrender/repayment penalty after amending an emissions return. They will either apply a further penalty or reimburse any overpaid amount, as appropriate, taking into account any penalty already paid.
- 44 Any further penalty would need a revised due date, aligning with the way due dates are currently treated in the Bill.¹⁰ Any accumulation of interest associated with a penalty should also be paused, so a participant is not disadvantaged over the period the EPA is amending the return.

Extending temporary adverse event provisions to existing stock change forests

- 45 I propose extending the suspension of unit surrender requirements during temporary adverse events to existing post-1989 forests using stock change accounting.¹¹ The Minister of Forestry and I made an in-principle decision to adopt this proposal under delegated authority from Cabinet [CAB-20-MIN-0063 refers].

⁸ Section 120 of the Act allows the EPA to amend an emissions return if it is satisfied the return is incorrect. The Bill amends s 120 to include an example where a return used an incorrect unique emissions factor.

⁹ For example, if the underlying emissions return increases the number of units due, the Bill only allows the EPA to apply a new penalty for the difference between the new and the old return, rather than the full outstanding obligation (if that has not yet been met).

¹⁰ If a return is amended to create a new surrender/repayment obligation then the due date for that obligation is set to 60 days from the date of notice of the amendment (per amended s 123(3)). New penalties would apply from that date if the obligation was not met. Once notice is given of a failure to surrender/repay units, participants have 20 working days to pay the relevant penalties (per amended s 134–134D).

¹¹ All post-1989 forests in the NZ ETS currently measure the carbon in their forests using stock change carbon accounting, designed to reflect short term fluctuations in carbon storage. Participants must surrender NZUs to account for any loss of carbon, even if that loss is temporary (such as when forests are harvested and replanted). Following harvest, foresters must surrender to the Crown a significant amount of the NZUs they earned from the forest's growth.

The Bill provides for a suspension of liabilities for forests using averaging accounting after a temporary adverse event

- 46 At present, participants with post-1989 forests in the NZ ETS are required to surrender units to the Crown for the carbon lost when their forest is damaged in an adverse event (eg, fire or wind throw). The Bill provides for a suspension of unit surrender requirements after an adverse event ('the suspension'), provided the forest is re-established.
- 47 Under this suspension, participants would no longer earn or be required to surrender units for an affected area of forest until the forest regained the level of carbon storage it had before the adverse event.
- 48 Cabinet previously agreed to introduce this provision for post-1989 forests using averaging accounting. This was intended, in part, to encourage afforestation and to incentivise participants to shift to averaging from the existing stock change accounting method.¹² This suspension was also provided to the new permanent forestry activity due to the high cost of insuring against carbon loss from an adverse event relative to the annual revenue from carbon sequestration for a permanent forest.
- 49 Subsequent to agreeing this policy, Cabinet decided in June 2019 [CAB-19-MIN-0337 refers] that existing stock change forests registered in the NZ ETS prior to 2019 would not be able to transition to averaging accounting. This decision was in part due to the fiscal cost of this transition on the Crown [ENV-19-SUB-0035 refers, confirmed by CAB-19-MIN-0337]. As a result, existing forests using stock change can't access the liability suspension for temporary adverse events by transitioning to averaging accounting — they must continue to repay NZUs for carbon lost from an adverse event. Cabinet invited the Minister of Forestry and myself to revisit this decision and report back in late 2021.

Foresters have expressed a strong preference for all forests in the NZ ETS to access the temporary adverse events suspension

- 50 A number of submissions on the Bill and the forestry regulations¹³ expressed a strong preference for existing stock change forests to be able to access the suspension of temporary adverse event liabilities. The justification for this included:
- 50.1 It was inequitable to provide the suspension to only certain forest types.
- 50.2 The high cost of maintaining insurance to cover liabilities from temporary adverse events could disadvantage some forest owners.

¹² The Bill introduces a new carbon accounting approach called averaging. Under the current Bill, averaging accounting will be optional for post-1989 forests registered between 1 January 2019 and 31 December 2021, and mandatory from 1 January 2022 onwards. Under averaging accounting, participants with newly registered forests will receive NZUs that reflect the amount of carbon stored in their forest over the long term, and would no longer face harvest liabilities. The NZUs will be paid to the participant as their new forest grows. NZU payments would cease once the forest reaches the age at which it stores its long-term average for carbon. As long as the forest is replanted following harvest, no NZUs would be owed to the Crown.

¹³ Te Uru Rākau consulted on these regulations between November 2019 and January 2020.

- 50.3 The inability of smaller participants to insure for such events created a risk of financial hardship if an event occurred. For example, if fire destroyed one hectare of 18-year-old radiata pine in the Waikato, the liability for carbon lost would be 430 NZUs. At a carbon price of \$25/unit, this equates to \$10,750.¹⁴
- 50.4 As the surrender liability is linked to the price of carbon, it will become more difficult to meet the liability over time as carbon prices are expected to rise.
- 50.5 Not extending the suspension would increase the complexity of the NZ ETS, and pose additional compliance burdens and costs for participants who manage multiple forest types.

51 I agree with these concerns. I seek to address them by extending the suspension of surrender liabilities after an adverse event to existing forests in the NZ ETS. In this way, all post-1989 forests in the NZ ETS and their owners can gain the benefits of this new provision.

Not extending the suspension could impact the attractiveness of the NZ ETS

- 52 I do not anticipate that extending the suspension will have a significant impact on the incentive for stock change forests to switch to averaging if this becomes available in the future, as averaging provides a range of other benefits.
- 53 Further, inconsistently applying beneficial rules across different forest types, such as the temporary adverse event suspension, may negatively affect the attractiveness of the NZ ETS for potential participants. This may have flow-on effects on the NZ ETS' ability to drive afforestation.
- 54 Not providing the suspension could also pose a potential perverse incentive. Some participants with production forests in the NZ ETS may be incentivised to move their forests into the permanent forest category to access the temporary adverse event suspension. This may result in sub-optimal land-use decisions and add to existing log supply shortages.
- 55 Providing the suspension to forests already established and registered in the NZ ETS will not directly increase afforestation. However, it may indirectly result in additional afforestation by freeing up participants' working capital — they will no longer be required to purchase insurance for carbon loss from adverse events and this will help build confidence in the NZ ETS.

I also seek an exemption from consultation requirements on the relevant regulations

- 56 The Bill requires that regulations for temporary adverse event suspensions are consulted on. In parallel to the Select Committee process on the Bill, Te Uru Rākau consulted on the regulations required to implement the temporary adverse event suspension for forests using averaging accounting and permanent forests. These regulations define an adverse event, and the scale needed to use the suspension.

¹⁴ In most cases at present, this liability would be 'netted out' in the first return after the event, and therefore result in decreased revenue for the participant rather than a direct cost.

- 57 Permanent forestry uses the stock change accounting approach. Officials are therefore confident the same methodologies can be developed for post-1989 stock change forests.
- 58 I am satisfied that the Select Committee process for the Bill, and the regulations consultation, has provided an opportunity for stakeholders to comment on the initial set of regulations, which will apply to existing post-1989 forests. As a result, I propose a one-off exemption from the requirements to consult on the regulations which apply to stock change forests. The information required to develop these regulations has already been acquired from stakeholders. An exemption will enable the suspension to be made operational for stock change forests sooner.

Extending access to the fixed-price option for emissions from the start of 2020 at \$35

- 59 I propose extending access to the fixed-price option (**FPO**) for emissions from the start of 2020 and to raise the price from \$25 to \$35. This proposal limits the maximum compliance costs for participants in the transition to auctioning. Access to the FPO would remain in place for emissions in 2021 and future years as a contingency measure, until auctioning begins.
- 60 The Minister of Forestry, the Minister of Finance, and I made an in-principle decision to adopt this proposal under delegated authority from Cabinet [CAB-20-MIN-0062 refers]. Our proposal combines two decisions under this authority: extending access to the FPO for 2020 emissions, and doing so using a 'backstop' approach (the contingency measure).

The current FPO has played a central role in the NZ ETS to date

- 61 Under existing arrangements, NZ ETS participants with surrender obligations can choose to purchase NZUs from the Government at a fixed price of \$25 each, as an alternative to using other sources of supply. Those NZUs purchased from the Government are immediately surrendered to meet surrender obligations. This FPO therefore improves certainty for participants about their compliance costs in meeting their obligations — they know they don't have to pay more than \$25 to cover their emission activities. As a result, the FPO tends to act as a de facto price ceiling for the secondary NZU market.
- 62 The FPO remains available today under the Act to cover emission activities in 2019. It is also available to cover emissions in 2020 (the current emission year) for any participant ceasing activities, such as by going out of business.

The Bill removes the FPO entirely when auctioning begins

- 63 The Bill as currently proposed requires the FPO be repealed on the same day auctioning begins under the reformed NZ ETS architecture. If auctioning begins in early 2021 as planned, the FPO will no longer be available as of that first auction.
- 64 Under the reformed NZ ETS architecture, the cost-limiting effect of the FPO is replaced by the new price control mechanisms supporting auctioning (the auction price floor and the cost-containment reserve). The cost-containment reserve

releases additional units when a specific trigger price is reached. By increasing NZU supply, the reserve reduces the risk of auction prices reaching unacceptably high levels.

- 65 Along with settings for unit supply into the NZ ETS, these price controls are set in regulations under the Bill. I have proposed unit supply and price control settings for a provisional emissions budget over 2021–2025 in a separate Cabinet paper: *New Zealand Emissions Trading Scheme settings regulations*.

Removing the FPO immediately poses unintended risks to participants

- 66 Removing the FPO immediately, as proposed in the Bill, poses risks to participants in the transition to auctioning:

66.1 If auctioning begins in 2021 as planned, participants could no longer use the FPO to cover their 2020 emission activities from the date of the first auction.¹⁵ Participants therefore have significant uncertainty over the maximum compliance costs they face in 2021 for their 2020 emissions, and difficulty in passing accurate emissions costs through to consumers.

66.2 Holders of existing NZUs (in the NZU stockpile) will therefore have substantial market power over 2020 and into 2021, as the secondary market would be the major source of supply for NZ ETS participants. Prices are likely to be volatile and could be inefficiently and temporarily high through the transitional period as a result.

Extending the FPO to emissions from the start of 2020 in the transition to auctioning provides participants reasonable certainty about their compliance costs

- 67 To address these risks, the Government consulted on a proposal to instead extend the FPO to cover 2020 activities as a transitional measure, and raising the price from \$25 to \$35.¹⁶ Extending the FPO to overlap with the start of auctioning gives participants certainty about the maximum compliance costs they face for their emissions in 2020. That certainty supports participants during the transition while they build confidence in the reformed NZ ETS and develop expectations about future prices.

- 68 The \$35 price was chosen as a reasonable mid-point between the proposed auction price floor of \$20 and the price trigger for the cost containment reserve at \$50. Raising the FPO price sends an important signal that emission prices are expected to rise over time as the NZ ETS drives emission reductions across the economy. At \$35, the extended FPO smooths the transition to auctioning, avoiding sudden or significant price impacts on businesses and households.

¹⁵ Although the \$25 FPO would still be available in 2021 for 2020 emission returns, from 1 January until the earlier of the first auction date or the surrender deadline of 31 May.

¹⁶ The \$35 FPO was included in the Government's consultation on proposed settings for NZ ETS unit supply and price controls during December 2019 to February 2020.

Submissions on the NZ ETS settings consultation generally supported extending the FPO

- 69 Submissions on the proposed extended FPO revealed a wide range of views. The majority considered it to be sound, agreeing with the Government's objective.
- 70 Many submitters, including the Climate Change Commission, considered the FPO should be set above \$35 to avoid its use and better signal increased ambition from the Government. Some business submitters were concerned about increased emission units prices in general, and the application of the change 'retrospectively' in particular.
- 71 I am satisfied that officials have appropriately considered these views in developing the proposed extended \$35 FPO. I consider the price of \$35 appropriately balances our emission reduction goals with economic concerns, as an interim step toward full auctioning. While the FPO price limits compliance costs, prices for NZUs are primarily determined by the interaction of unit supply and demand.
- 72 Full details of this analysis is provided in the regulatory impact statement (RIS) submitted with this paper.

We recommend the FPO be extended as proposed, with the price raised to \$35 as consulted on

- 73 The Minister of Forestry, the Minister of Finance, and I recommend extending the FPO to cover 2020 emissions to address the risks to participants set out above. We recommend the price be set at \$35 as proposed in the NZ ETS settings consultation.
- 74 We also recommend this extended \$35 FPO remain in place until auctioning begins. I currently intend to begin auctioning under the reformed NZ ETS in early 2021. However, given the Government's focus on the COVID-19 pandemic and the uncertainty of its economic impacts in early 2021, it is possible auctioning could be delayed, though officials advise the risk of a delay remains low at this stage. Retaining the \$35 FPO to cover emissions in years after 2020 until auctioning begins is an important 'backstop' contingency measure.
- 75 Under this backstop approach:
- 75.1 The \$35 FPO automatically 'rolls over' to each calendar year after 2020 until auctioning starts. This means the \$35 FPO will also be available in 2021 for any participant ceasing activities that year, until the date auctioning begins.
- 75.2 Once auctioning starts, the \$35 FPO automatically becomes only available to cover activities in 2020 and any *full* calendar year before the date of that auction.¹⁷

¹⁷ This would use the same mechanism to repeal the FPO in the current Bill: the Minister for Climate Change would be obliged to make an Order in Council to enact the further amendments provided in the Bill (as amended by the SOP) giving effect to these changes from the date of the first auction.

- 76 Finally, I consider it important not to reduce the price level below \$35 as a way to address any concerns about NZ ETS costs to the economy over 2020. There are several key reasons:
- 76.1 The FPO is available to NZ ETS participants only as a fallback measure, not a required payment. The secondary market currently has ample liquidity — participants can buy units for significantly less than \$35 today.
 - 76.2 A lower price encourages greater use, further contributing to the significant oversupply of units in the existing NZU stockpile. This was one of the main concerns expressed by the Commission in its submission on the NZ ETS settings consultation.
 - 76.3 The \$35 price maintains the structural signal to the market of Government's continued commitment to reduce emissions and to steadily increasing emission prices.
 - 76.4 Changing from the proposed \$35 now introduces regulatory uncertainty into the operation of the NZ ETS — and improving regulatory certainty is a major objective of the NZ ETS reforms.
 - 76.5 Some participants may have already included \$35 in their contractual and supply arrangements for the year, based on the Government's NZ ETS settings consultation. Reducing the FPO mid-way through the year may therefore give only partial economic benefit to downstream consumers.
- 77 Amending the FPO as proposed also requires consequential changes for forestry emission returns and the synthetic greenhouse gas levy.¹⁸ These policy changes are detailed in **Appendix 2**. I propose these consequential changes set out in Appendix 2 are also agreed.

Technical changes to transferring entitlement units

- 78 The Bill introduces new provisions regarding transfer of entitlement units to NZ ETS participants. These changes ensure overdue or outstanding surrender or repayment obligations will be met before recipients receive their entitlement to units. Or in the case of agriculture participants, the current surrender obligation will be satisfied before a recipient receives an entitlement to units.
- 79 The process in the Bill requires the EPA to deduct outstanding surrender or repayment units (the specified units) before transferring entitlement units (the potential transfer units) to the recipient. This process avoids removing units from a person's holding account.
- 80 However, the EPA have since advised deducting units prior to transfer raises a number of technical issues, including the need for a significant rebuild of the Register

¹⁸ Synthetic greenhouse gases in the NZ ETS are sulphur hexafluoride (SF₆), and the hydrofluorocarbon (HFC) and perfluorocarbon (PFC) gas species. All are highly potent greenhouse gas that do not exist naturally. They are used in a wide range of equipment and products such as refrigeration and air conditioning, electrical switchgear, or fire protection.

system. These changes required by the wording in the current Bill would introduce risks to the security of the Register and may undermine the integrity of the scheme.

- 81 I consider those issues outweigh the property rights impacts in deducting units from recipient accounts.
- 82 An alternative process avoiding these problems would be for the EPA to first pay the entitlement units (the potential transfer units) to the recipient holding account, then deduct the surrender or repayment obligation (the specified units) immediately after. This process still meets the original policy intent — and the end result for the recipient is the same — while preserving the security and integrity of the Register.
- 83 I propose amending the Bill to adopt this alternative process.

Financial implications

- 84 The proposals to extend the Commission's statutory deadlines, and technical changes transferring entitlement units have no fiscal impacts.

Delaying implementation of major forestry policies

- 85 There are likely to be minimal fiscal impacts to the Crown of extending the option to use stock change accounting until 31 December 2022. This is because the vast majority of ETS participants who afforest between 1 January 2019 and 31 December 2022 are expected to take up averaging accounting, as it is likely to improve their economic return.
- 86 Afforestation data also indicates afforestation is occurring in anticipation of being able to use averaging accounting and is unaffected by the detailed forestry regulations being unavailable.

Changes to the surrender/repayment penalty regime

- 87 I am not seeking any additional funding to implement the penalty regime changes proposed in this paper. Additional funding may be required to operationalise the proposals once they are implemented from 2021 onwards. Any additional funding will be sought through further implementation decisions or through Budget.

Extending temporary adverse events provisions to forests already registered

- 88 There is no projected fiscal revenue from forests affected by temporary adverse events in the NZ ETS due to the unpredictable nature of adverse events.
- 89 Extending the suspension would result in participants surrendering fewer units to the Crown after an adverse event. However, at present the Crown typically re-issues these units to the participant over time as they re-plant the affected forest area. Therefore, extending the suspension for stock change participants will be fiscally neutral in the long term as it stops this circular flow of units between participants and the Crown following an adverse event.

- 90 Any short-term changes to units surrendered are accounted for as part of regular baseline updates to the NZ ETS. Adverse events are common across New Zealand's forest estate. Smaller events of less than 5 hectares occur fairly frequently, often as a result of slips and wind throw; while larger events that clear more than 5 hectares are relatively rare (often from fire and storm events).¹⁹

Extending access to the FPO for emissions from the start of 2020 at \$35

- 91 The fiscal impacts of extending the FPO depend on the level of its use.
- 92 To date, use of the FPO has increased the cash available to the Government by around \$500 to \$600 million per annum. The amount the Government needs to borrow falls as a result, reducing net core Crown debt track by around 0.6% of GDP by 2023/24. Although the FPO has a positive impact on net core Crown debt, it does not reduce the Government's obligation under the NZ ETS which will need to be settled in the future.

Current market prices are trading below the existing \$25 FPO

- 93 In 2019 approximately half of emissions surrender obligations were met by using the \$25 FPO. The present COVID-19 circumstances have had substantial effects on the secondary market — at time of writing NZUs are trading below that \$25 level. It is difficult to project use of the \$25 FPO in 2020 in these conditions, given the NZU stockpile is sufficient to fully supply participant requirements.
- 94 Potential use of the extended \$35 FPO in 2021 is even more uncertain. With current market prices it is highly unlikely any participant would use it. If so, the fiscal impact to the Crown would be zero.

Effects of deferring auctioning

- 95 If auctioning is deferred in 2021, the backstop approach would partly compensate for cash not being received through auctioning; ie, any use of the continuing \$35 FPO for activities after 2020 is revenue the Government would otherwise not receive, because NZU auctioning has not begun.
- 96 However, use of the FPO after 2020 also means the NZU stockpile and hence the Crown's liability is not reduced where it otherwise would have been. Without the FPO (and no auctioning), NZ ETS participants would have to obtain NZUs from the secondary market. Surrendering those NZUs (ie, sourced from the stockpile) is recorded as an increase in revenue for the Crown and a corresponding reduction in liability. Conversely, while use of the FPO also increases revenue, it is accounted as an increase in cash rather than a decrease in liability.

¹⁹ Consultation on the forestry regulations asked submitters how often they have experienced adverse events that cleared less than 5 hectares and more than 5 hectares over the last 10 years. Submitter responses suggested that smaller events less than 5 hectares happen approximately every 1-3 years in larger (ie, over 1000 ha) estates, and larger events over 5 hectares happen about half as often.

Legislative implications

- 97 All policy changes proposed in this paper will be enacted through amendments to the Bill by way of a SOP to be considered at the Committee of the whole House stage.
- 98 I seek your approval to delegate Power to Act to the Cabinet Legislation Committee to approve the final SOP at its 26 May 2020 meeting. This will allow me to introduce the SOP to the House as soon as appropriate after the second reading.

Impact analysis

Regulatory Impact Statement

- 99 The Ministry for the Environment determined impact statements were not required for the proposals to extend the Commission's statutory deadlines, revise the process for the EPA to amend penalties when amending emission returns, and for technical changes to transferring entitlement units.
- 100 Treasury's Regulatory Quality team has determined that the proposal to defer implementation of specified forestry policy provisions and associated regulations from 1 January 2022 to 1 January 2023 is exempt from the regulatory impact analysis on the grounds of minor impacts.
- 101 Treasury's Regulatory Quality Team has determined that the proposal to delay application of the new surrender/repayment penalty for small foresters is exempt from the regulatory impact analysis requirements on the grounds that it is expected to have minor impacts on businesses, individuals and not-for-profit entities. While the new surrender/repayment penalty is delayed for small foresters the existing penalty regime in the Act will apply.
- 102 A cross agency review panel led by the Treasury's Regulatory Quality Team has reviewed the *Addendum to the Regulatory Impact Assessment: Forestry ETS proposals* produced by the Ministry for Primary Industries and dated 5 May 2020. The review team considers that it partially meets the quality assurance criteria.
- 103 In response to submissions on the Bill, a case has been made for extending temporary adverse event liabilities exemptions to all forests in the NZ ETS. However, the Addendum acknowledges that it has some limitations in the supporting evidence.
- 104 The Addendum indicates that the cost of insurance for foresters could potentially be high, although a monetised estimate has not been provided. Submissions on the Bill highlighted that it can be challenging, particularly for small foresters, to access insurance for temporary adverse events. This is because relevant insurance products are not always available and may not be affordable for some foresters, which is exacerbated when insurance costs rise over time as the carbon price increases.
- 105 It is also acknowledged in the Addendum, that a full assessment of the financial impact to the Crown could not be completed in the time available. However, the cost to the Crown is expected to be relatively low and the amount of land likely to be

impacted by temporary adverse events is low, at 350,000 ha out of the total of 1.7 million ha of forestry land.

- 106 The Ministry for the Environment prepared a full impact statement for the decision to extend the FPO to cover emissions from the start of 2020 at a higher price of \$35. The quality assurance panel at the Ministry for the Environment has reviewed the Regulatory Impact Assessment (RIA) and considers it meets the quality assurance criteria.
- 107 The panel considers the RIA provides a clear description of the proposed change (extension of the FPO) and the problem it is intended to address. Consultation has taken place and been taken into account in the assessment of options.
- 108 Monetised values have been estimated only for operational costs. Other expected costs and benefits have been indicated qualitatively. However, the panel is satisfied that the assessment includes the available information.
- 109 The options considered are limited to technical legislative changes that would extend the FPO for 2020 activities. This scope is made clear and the panel considers it appropriate given the purpose of the assessment, which is to inform decisions about providing transitional measures in a Bill in progress.

Climate Implications of Policy Assessment

- 110 A CIPA assessment for extending the FPO to cover emissions from the start of 2020 at a higher price of \$35 is given below.
- 111 The Ministry for the Environment has been consulted and confirms that the CIPA requirements do not apply to all other proposals as the impacts are indirect. The Ministry notes these proposals are part of the package of NZ ETS proposals and necessary in achieving the emission reductions objectives of the reformed NZ ETS as a whole.

Extending access to the FPO for emissions from the start of 2020 at \$35

- 112 Extending the FPO to emissions from 2020 has the potential to increase the NZU stockpile. The stockpile would increase every time an NZ ETS participant uses the extended FPO to meet their surrender obligations, rather than buying equivalent NZUs at auction.
- 113 However, the extent of FPO use depends largely on prices at auction and in the secondary market. Participants are highly unlikely to use the FPO if they can buy NZUs at prices below \$35. Estimated increases in the NZU stockpile are shown in the table below, based on indicative rates of FPO use.
- 114 As discussed in paragraphs 93 and 94, NZUs are currently trading in the secondary market substantially below \$35.

Percentage use of FPO	Increase to the NZU stockpile	Increase as percentage of current stockpile
0%	0	0%
10%	4 million	3%
50%	21 million	14%
100%	41 million	27%

- 115 A key component of the proposed NZ ETS settings is adjusting the supply of units through auction to reduce the stockpile [Cabinet paper *New Zealand Emissions Trading Scheme settings regulations* refers]. This adjustment can easily ensure any increase in the stockpile does not lead to greater emissions, reducing auction volumes in future years to negate any stockpile increase. Under this approach, the use of the FPO will not result in greater greenhouse gas emissions.

Te Tiriti o Waitangi

- 116 I acknowledge the significant interest iwi/Māori, including Māori entities, have in the NZ ETS, particularly through substantial investments in forestry.
- 117 Māori/iwi are not directly impacted by the proposal to introduce a new power for the Minister for Climate Change to extend the Commission's statutory deadlines.
- 118 As NZ ETS participants, Māori/iwi would benefit from the proposed improvements to calculating amended emission returns. As for any other NZ ETS participant, Māori/iwi would not be directly affected by the proposed technical changes to transferring entitlement units.
- 119 Māori/iwi forestry owners would benefit from the proposals to extend the suspension of surrender requirements during temporary adverse to post-1989 stock change forests, and to delay implementing the penalty regime for small foresters. As for any other NZ ETS forestry participant, Māori/iwi forestry owners would be affected — but not disadvantaged — by delaying the major forestry policies.
- 120 A series of 14 regional hui were held throughout New Zealand by the Ministry of Environment in February 2020 to discuss a range of the Ministry's work programmes with Māori/iwi groups. The proposed \$35 FPO (as part of the NZ ETS setting consultation) was included on the agenda at these hui and was discussed with attendees. Māori/iwi were invited to participate in consultation on the proposed NZ ETS settings — including the \$35 FPO — alongside other stakeholders and notice of the consultation was included in a regular Ministry iwi newsletter.
- 121 Māori/iwi NZ ETS participants would benefit from the proposed \$35 FPO providing improved certainty about maximum compliance costs for emission activities in 2020. Māori/iwi forestry participants would benefit from access to the \$35 FPO for net emission returns spanning multiple years (see Appendix 2), if they chose to do so.

Human rights

- 122 The proposals in this paper are consistent with the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993.

Gender implications

123 There are no immediate gender implications arising from this paper.

Disability perspective

124 There are no immediate disability implications of the proposals in this paper.

Consultation

125 This paper was prepared by the Ministry for the Environment in concert with the Ministry of Primary Industries. The Treasury, the Environmental Protection Authority, Ministry of Business, Innovation and Employment, Ministry of Foreign Affairs and Trade, Ministry of Justice, Ministry of Transport, and the Department of Conservation were consulted in preparing the paper and all comments are reflected in the paper. The Department of Prime Minister and Cabinet and Te Puni Kōkiri were informed.

Communications

126 Announcements about the NZ ETS need to be managed carefully to avoid any inconsistencies and market risks, including sudden changes of NZU prices. In addition, information should not be disseminated in a way that advantages some market participants over others and compromises NZ ETS participants' ability to make decisions.

127 I recommend that the decisions in this paper are announced alongside the decisions taken in *New Zealand Emissions Trading Scheme: Regulatory Decisions on the Rules for Auctioning* and *New Zealand Emissions Trading Scheme settings regulations* Cabinet papers. These decisions should be announced at the same time as together they form a package that establishes the reformed NZ ETS.

Proactive release

128 I intend to proactively release this paper on the Ministry for the Environment's website subject to withholdings as appropriate under the Official Information Act 1982 once all final relevant policy decisions have been announced.

Recommendations

The Minister for Climate Change recommends that the Committee:

- 1 note the Climate Change Response (Emissions Trading Reform) Amendment Bill (the Bill) to amend the Climate Change Response Act 2002 (the Act) was recently considered by the Environment Select Committee;
- 2 note that, following input from officials, the Minister for Climate Change has developed further policy changes to ensure the objectives of the Bill and the Government's wider climate change goals are achieved, and that the reforms to the New Zealand Emissions Trading Scheme (NZ ETS) can be implemented effectively;
- 3 note the policy changes in this paper will require amendments to the Bill via a supplementary order paper (SOP);

A new power to extend the Climate Change Commission's statutory deadlines

- 4 note the Climate Change Commission faces significant difficulties in meeting its statutory deadlines to provide initial advice to the Minister for Climate Change in the present circumstances;
- 5 agree to give the Minister for Climate Change powers to extend the deadline for the Climate Change Commission's advice on:
 - 5.1 the first three emissions budgets in section 5ZA(4)(a) of the Act; and
 - 5.2 the first emissions reduction plan in section 5ZH(2) of the Act.
- 6 agree that these powers to extend the deadlines in sections 5ZA(4)(a) and 5ZH(2) of the Act:
 - 6.1 are limited to a maximum extension period of six months from 1 February 2021; and
 - 6.2 can only be exercised upon the written request of the Climate Change Commission submitted after the enactment of this amendment; and
 - 6.3 can only be exercised by way of notice in the *New Zealand Gazette*;

Delaying implementation of major forestry policies

- 7 note that delivering amendments to the Climate Change (Forestry Sector) Regulations 2008 in time to implement the major forestry policies listed in Appendix 1 by 1 October 2021, so they can come into force on 1 January 2022, is at considerable risk due to the Government-wide COVID-19 response;
- 8 agree to delay implementation of those major forestry policies by one year, by:
 - 8.1 extending the implementation date for forestry policies listed in Appendix 1 to 1 January 2023;

- 8.2 updating the transitional provisions to reflect the change in commencement date;
- 8.3 requiring forests registered from 1 January 2023 to use averaging accounting, and allowing forests registered between 1 January 2019 and 31 December 2022 the option of using stock change accounting or averaging accounting;
- 8.4 commencing temporary adverse event liability suspensions from 1 January 2023.

Delaying the new surrender/repayment penalty regime for small foresters

- 9 agree to delay the introduction of the new surrender/repayment penalty for forestry activities that occurred before 1 January 2023, and where an emissions return or notice results in a net liability less than 25,000 units per year covered in the return or notice;
- 10 agree the existing penalties contained in sections 134 –136 of the Act will apply for the failure to surrender or repay units by the due date for obligations arising from forestry activities that meet the threshold;
- 11 direct the Ministry for the Environment, the Ministry for Primary Industries, and the Ministry of Foreign Affairs and Trade to:
 - 11.1 investigate compliance issues and impacts of the non-surrender/ repayment penalty on small foresters and to consider other sectors that may be similarly affected by the non-surrender/ repayment penalty;
 - 11.2 carefully consider our ability to link the NZ ETS to overseas markets in the future in developing policy options; and
 - 11.3 report back to Cabinet in mid-2021 with any potential amendments to penalty provisions in the Act to be included in any later Bill (if necessary).

Amending penalties to align with amended emissions returns

- 12 agree to require the Environmental Protection Authority (EPA) to recalculate the surrender/ repayment penalty after amending an emissions return;
- 13 agree to require the EPA to either apply further penalties with appropriately amended due dates, or reimburse any penalties that had been overpaid, as appropriate, based on the difference between the original and the revised obligations;
- 14 agree the surrender/repayment penalty will not accumulate interest for the period while the EPA amends the emissions return;

Extending temporary adverse event provisions to existing stock change forests

- 15 note the Bill provides a suspension of the surrender liabilities arising from temporary adverse events to permanent forestry and post-1989 forestry using averaging

accounting, but the Bill does not currently extend this suspension to existing registered forests using stock change accounting;

- 16 note submissions on the Bill, and the supporting regulations, strongly support access to the temporary adverse event suspension for stock change forests, primarily due to the ongoing financial costs associated with liabilities from temporary adverse events;
- 17 note Cabinet delegated authority to the Minister for Climate Change and the Minister of Forestry to make in-principle policy decisions related to these matters [CAB-20-MIN-0063 refers];
- 18 note the Minister for Climate Change and the Minister of Forestry recommend the policy changes below;
- 19 agree all post-1989 forests in the NZ ETS will not be required to surrender units arising from carbon lost in a temporary adverse event so long as they comply with the current Bill requirements for temporary adverse events, including re-establishing the forest;
- 20 agree this policy commences alongside the temporary adverse events suspension for averaging and permanent forests on 1 January 2023;
- 21 note the Bill requires regulations on temporary adverse events be consulted on, including this proposed extension of the suspension to stock change forests;
- 22 note that parallel to the Select Committee process on the Bill, Te Uru Rākau consulted on the policy to inform regulations required to implement the suspension for averaging and permanent forests;
- 23 agree to a one-off exemption from the requirements to consult on the regulations for the first set of regulations that apply to stock change forests, as recent consultation on the same methodology for permanent forests has allowed stakeholders the opportunity to comment and to provide the relevant information needed to develop the regulations;

Extending access to the fixed-price option for emissions from the start of 2020 at \$35

- 24 note an increase and extension of the fixed-price option (FPO) was proposed in the Government's consultation on NZ ETS settings in December 2019, to resolve a market risk of limited supply sources in the transition to auctioning emission units;
- 25 note the proposal was generally supported by submitters;
- 26 note Cabinet delegated authority to the Minister for Climate Change, the Minister of Forestry, and the Minister of Finance to make in-principle policy decisions related to the FPO [CAB-20-MIN-0062 refers];
- 27 note the Minister for Climate Change, the Minister of Forestry, and the Minister of Finance recommend the FPO policy changes below;

- 28 agree to extend the FPO as follows:
- 28.1 from the date the amended Act takes effect, the price of the FPO is raised from \$25 per New Zealand unit (NZU) to \$35 per NZU for emission activities in calendar year 2020 and in emission years indefinitely thereafter;
 - 28.2 on the date of the first NZU auction the \$35 FPO is restricted to be available only for activities in 2020, and for any full calendar years up to that auction date;
 - 28.3 the \$35 FPO can be used to meet emission unit surrender obligations arising from non-forestry activities and pre-1990 forestry activities in any year included in recommendation 28.1 and as amended by recommendation 28.2 above;
 - 28.4 the \$35 FPO is available to post-1989 foresters on a pro-rata basis that considers the time period covered by an emissions return for activities in any year included in recommendation 28.2 above;
 - 28.5 post-1989 foresters can only access the FPO when submitting net emission returns;
 - 28.6 the \$35 FPO will remain in the Act, with no expiry, as a way for participants to meet surrender obligations arising from activities in any year included in recommendation 28.2 above and for access by post-1989 foresters using the pro-rata approach;
 - 28.7 the \$25 FPO will also remain in the Act, with no expiry, as a way for participants to meet surrender obligations arising from activities before the start of calendar year 2020 and for access by post-1989 foresters for that period using the pro-rata approach;
 - 28.8 until the date of the first NZU auction the maximum price of carbon used to calculate synthetic greenhouse gas levy rates is \$35.

Technical changes to transferring entitlement units

- 29 note the Bill currently requires the EPA to deduct outstanding surrender or repayment units (the specified units) before transferring entitlement units (the potential transfer units) to the recipient account in the NZ ETS Register;
- 30 note implementing this process raises technical issues, including the need for a significant rebuild of the Register system;
- 31 note an alternative process is for the EPA to first pay the entitlement units (the potential transfer units) to the recipient holding account, then deduct the surrender or repayment obligation (the specified units) immediately after;
- 32 note the alternative process would meet the original policy intent to ensure overdue or outstanding surrender or repayment obligations will be met before recipients receive their entitlement to units;

- 33 agree the implementation issues outweigh the property rights impacts in deducting units from recipient accounts through this alternative process;
- 34 agree to adopt the alternative process for transferring entitlement units in the Register;

Authorising these policy changes and proactive release

- 35 authorise Power to Act to the Cabinet Legislation Committee to approve the final SOP;
- 36 authorise introducing the final SOP to the House to be considered at the Committee of the whole House stage;
- 37 approve the release of this paper proactively on the Ministry for the Environment's website, subject to any redactions as are appropriate under the Official Information Act 1982.

Authorised for lodgement

Hon James Shaw
Minister for Climate Change

Appendix 1: Forestry policies which need to come into force with amendments to the Climate Change (Forestry Sector) Regulations 2008

<p>Provisions to take effect on 1 Jan 2023</p> <p><i>Rationale: Many of these provisions require regulations for implementation. They are also interconnected (e.g. Permanent forestry off-setting provisions are not workable without the averaging accounting provisions) and best implemented together.</i></p>
<p>New emissions returns process</p> <p>Simplifying and standardising the types of emissions returns participants need to submit for post-1989 forests. The new emissions returns process includes alignment to other policies being introduced (e.g. simplified reporting for averaging forests).</p>
<p>Permanent forest/end of Permanent Forest Sink Initiative</p> <p>Creating a new permanent forestry activity in the NZ ETS.</p>
<p>Averaging accounting</p> <p>Introducing and making mandatory the use of averaging accounting for all rotational post-1989 forests which apply for registration in the NZ ETS after 31 December 2022 and describing averaging accounting methodology.</p> <p>Includes the <i>option</i> to switch to averaging accounting for carbon accounting areas constituted between 1 January 2019 and 31 December 2022.</p>
<p>Temporary adverse events</p> <p>Specifying that participants with standard post-1989 forests subject to averaging and permanent forestry will not be required to surrender units for emissions liabilities from temporary adverse events, as long as they meet certain criteria including that forest is replanted.</p> <p>The Supplementary Order Paper will amend the Bill so that this provision is also available to standard post-1989 forests using stock change accounting.</p>
<p>Post-1989 offsetting</p> <p>Allowing participants using averaging accounting to offset their deforestation liability by planting an equivalent forest elsewhere.</p>
<p>Pre-1990 offsetting</p> <p>Improving pre-1990 forest land offsetting to allow greater flexibility of land use.</p>
<p>Tree weeds</p> <p>Simplifying the process to access exemptions for deforestation liabilities for areas of tree weeds (including wilding conifers). Excluding post-1989 land which predominantly contains tree weed species from being eligible to be registered in the NZ ETS and earn NZUs.</p>
<p>Persistent non-compliance</p> <p>Allowing persistent non-compliant post-1989 participants to be deregistered.</p>
<p>Transmissions of interest</p> <p>Improving and enabling enforcement of the transmission of interest process which is prescribed in the Act for transferring registered post-1989 forest land between parties, commonly when buying and selling land.</p>

Reconfiguring Carbon Accounting Areas

Allowing participants to reconfigure Carbon Accounting Areas without having to surrender their full unit balance at the time the reconfiguration occurs. The unit balances will carry over to the new carbon accounting areas, to be surrendered at harvest or deregistration.

Emissions returns for post-1989 forest land with mixed ages

Clarifying how emissions or removals from all forest land in a Carbon Accounting Area are to be included in an emissions return.

More flexibility in submitting mandatory emission returns

Clarifying that if a transmission of interest has occurred but the final transmission requirements are not completed before the mandatory emission return is due, the final transferee (i.e. the 'buyer') will be required to complete the Mandatory Emission Return.

Require all post-1989 forestry returns to be 'net returns'

Specifies that post-1989 forestry participants' unit entitlements are made net of any unit repayment/surrender obligations they may have for that activity (i.e. for the participants all standard post-1989 forest is one net return for each form of accounting, and all permanent post-1989 forest is a separate net return).

Boundary deforestation

Clarifying that post-1989 forest land around boundaries of a forest, which is cleared and not maintained as forest must be deregistered from the NZ ETS and that there will be no requirement to submit an emission return for this change in area.

Appendix 2: Extended FPO: Related changes for forestry emission returns and the synthetic greenhouse gas levy

- 1 Additional changes are required to align arrangements for forestry and the synthetic greenhouse gas levy to extend the FPO as proposed in paragraphs 59-77. This is because forestry participants may also opt to use the FPO, and because the levy is calculated using a maximum cost of carbon tied to the current \$25 FPO.

Arrangements for forestry activities

Accessing the FPO through emission returns covering multiple years

- 2 Deforestation activities for pre-1990 forests should be treated like non-forestry activities. Surrender obligations arising from these land use changes in 2020 could use the \$35 FPO.
- 3 The applicable FPO available for post-1989 forestry activities should be determined by the time period covered by the emissions return, using a pro-rata approach. For example, for an emission return filed in 2021 covering 2018–2020: the \$25 FPO would be available for 2018–2019 (or 2/3 of net emissions in that return, if the participant opted to use the FPO), and the \$35 FPO for 2020 (1/3 of net emissions). As under the current Act, the participant could choose not to use the FPO for some or all of their net emissions.

Limiting the FPO to ‘net emission returns’ for post-1989 forestry

- 4 There are a two types of post-1989 forestry emissions returns: Mandatory Emissions Return (MERs),¹ and Voluntary Emissions Return (VERs).²
- 5 A MER will cover the period from 2018 (or the most recent MER³) to a specific end date for that carbon accounting area⁴ (eg, then end of the Mandatory Emissions Return Period). All post-1989 forestry participants will need to file a MER in 2023, the majority of which cover the period from 2018-2022. In certain cases, some participants will need to file MERs before 2023, for example if their forest land is subject to a transmission of interest (eg, sale) or deregistration from the ETS.
- 6 A VER covers the period since the participant’s most recent emissions return. It can include some or all of a participant’s carbon accounting area (CAA), at their discretion. Any units surrendered or issued as a result of a VER are netted off against the participant’s entitlement in their next MER so that they receive only their true entitlement of units.

¹ These are renamed ‘Final Emissions Returns’ in the Bill, and the current range of MERs are being standardised.

² These are named ‘Provisional Emissions Returns’ in the Bill.

³ For example, if person A sells land to person B in 2019, person A files a MER starting in 2018. The first MER filed by person B would only go back to the date on which they became the participant for that land.

⁴ A carbon accounting area (CAA) is how the participant records their ETS registration. All post-1989 forest held by a participant must be in a CAA but there is no limit on the number of CAAs a participant can hold, provided each is at least 1 hectare in size.

- 7 A 'net emissions return' is one which calculates the participant's net entitlement or surrender obligations across all CAAs the return covers. Effectively, the participant does not receive units for forest growth only to need to surrender some of the units for emissions in another part of their forest. The netting off is done before their final entitlement is calculated.
- 8 Until 2022, participants have the option to file net emissions returns or to have each CAA's entitlement/surrender obligations determined individually. The Bill changes all forestry returns to require net emissions returns from 1 January 2022, as it reduces the risk of non-surrender of units.
- 9 If participants are able to access the pro-rated FPO option for non-netted returns submitted before 31 December 2021, there is an arbitrage opportunity if the market price of an NZU exceeds the FPO. That is, the FPO would be used for those CAAs with surrender obligations, while they would be entitled to receive more valuable NZUs for those CAAs with a positive stock change.
- 10 To reduce this risk the Minister of Forestry and I propose limiting use of the pro-rata FPO for forestry returns 'net emissions returns' only.

The pro-rata period should be the longest period covered in the emissions return

- 11 In any emissions return it is possible that the carbon stock change of the different CAAs will be calculated for different time periods. This is particularly likely for MERs at the end of the current Mandatory Emissions Return Period (2018-2022).⁵
- 12 For simplicity, we propose the pro-rata approach is based on the longest time period covered by the return. For example, if one CAA is reported from 2018 and a second starts in 2020 the pro-rating would begin in 2018.

Consequential changes to the synthetic greenhouse gas levy

- 13 As the FPO sets the maximum cost of compliance for NZ ETS participants, it is equitable to provide similar cost certainty for people subject to the synthetic greenhouse gas levy. The levy is calculated under a methodology set in regulations which determines the emissions price each year, by averaging NZU market prices over the preceding financial year. The Act currently states the maximum price of carbon underpinning levy rates is \$25. The current Bill will remove this.
- 14 The maximum price of carbon underlying the calculations for levy rates for 2021 should be set to \$35, commensurate with the \$35 FPO being available in 2021 for 2020 activities. This ensures importers of synthetic greenhouse gases in goods and subject to the levy continue to face reasonably equivalent emissions costs to importers of bulk synthetic greenhouse gases, who are mandatory participants in the NZ ETS.

⁵ For example, a CAA can only report from when the land became forest so forest planted in 2020 would report from 2020 to 2022.