

In Confidence

Office of the Minister for Climate Change

Chair, Cabinet Environment, Energy and Climate Committee

New Zealand Emissions Trading Scheme tranche two: cancellation and replacement of Kyoto units in private accounts

Proposal

1. This paper seeks in-principle decisions to amend the Climate Change Response Act 2002 (CCRA). It is part of tranche two of a package of amendments designed to improve the New Zealand Emissions Trading Scheme (NZ ETS).
2. I am proposing to address an operational issue concerning privately-held emissions units from the first commitment period to the Kyoto Protocol (CP1) through the upcoming CCRA amendment bill. Decisions on this were agreed by the previous Cabinet in 2013, but not implemented. I am seeking in-principle agreement to implement these proposals subject to targeted stakeholder engagement.

Executive summary

3. The Government is reforming the NZ ETS to ensure the scheme is effective in assisting to meet emission reduction targets and in supporting the transition to a low-emission and climate-resilient New Zealand. This requires amending the CCRA to provide:
 - 3.1. certainty to the market of the long-term credibility and effectiveness of the NZ ETS by signalling the trajectory of our transition to a low-emissions economy
 - 3.2. flexibility for the government to manage the NZ ETS in changing circumstances.
4. I am in the process of bringing the tranche two amendments to Cabinet via a series of separate papers [CAB-19-MIN-0089 refers]. These decisions will combine with tranche one to form a single bill amending the CCRA, to be introduced to the House in mid-2019 and to enter into force in 2020.
5. This paper is part of tranche two and seeks in-principle agreement to implement two decisions made by the previous Government in 2013 on privately-held emission units from CP1 by:
 - 5.1. cancelling all Kyoto units from the now-ended first commitment period of the Kyoto Protocol (CP1) held in private accounts.
 - 5.2. providing a New Zealand Unit (NZU) to replace each privately-held New Zealand-issued assigned amount unit (NZ AAU).
6. These decisions were made to resolve an operational issue. The rationale behind the original decisions remains sound and implementing them can support regulatory predictability.

7. I consider it important to follow through with the decisions that have been communicated to NZ ETS participants. Due to the length of time since the original Cabinet decision on this matter, I consider it appropriate to re-engage with stakeholders before seeking agreement to a final proposal. As a result, I am seeking in-principle agreement in this paper, subject to targeted stakeholder engagement, and to direct officials to undertake targeted engagement with group of affected CP1 Kyoto unit holders.
8. Following the outcomes of this engagement, I will report back to Cabinet and seek final agreement ahead of introducing the CCRA amendment bill to the House.

Context

Reform of the NZ ETS is underway

9. As part of the Government's programme of action on climate change, the NZ ETS is being reformed to ensure it is an effective tool to assist New Zealand in meeting emissions reduction targets, increasing removals, and transitioning to a low-emission future.
10. The 2015/2016 review of the NZ ETS, in anticipation of the Paris Agreement, found that, in its current form, the NZ ETS will not be fit-for-purpose for 2020 and beyond. In response, work has commenced to amend the CCRA which is the establishing legislation for the NZ ETS, manages New Zealand's progress under the Kyoto Protocol, and supports our current 2020 target under the UNFCCC.
11. Decisions about the design and operation should be considered in light of their potential impact on New Zealand's ability to access international carbon markets with environmental integrity in the future. Cabinet has agreed to retain the option to use international carbon markets after 2020 [CAB-18-MIN-0248 refers]. The proposed changes to the CCRA, will reduce barriers to creating such links.
12. Proposals to amend the CCRA are being progressed in two tranches, which will form a single CCRA amendment bill, to be introduced to the House in mid-2019 and to enter into force in 2020:
 - 12.1. Tranche one was agreed by Cabinet in December 2018 [CAB-18-MIN-0606.01 refers] and the Parliamentary Counsel Office (PCO) has commenced drafting.
 - 12.2. I am currently seeking tranche two decisions through a series of papers I am bringing to Cabinet in March to May 2019 (forestry papers are being co-led with Hon Shane Jones, Minister of Forestry).
13. This paper comprises part of tranche two. It contains in-principle proposals to correct a Kyoto Protocol legacy issue concerning privately-held emissions units from the first commitment period of the Kyoto Protocol (CP1). These are to amend the CCRA to implement two decisions made by the previous Cabinet in 2013 to:
 - 13.1. cancel all Kyoto units from CP1 held in private accounts
 - 13.2. provide an New Zealand Unit to replace each privately-held New Zealand Assigned Amount Unit (NZ AAU).
14. I consider it important to act consistently with undertakings previously given to NZ ETS participants and unit holders. Although the context has changed since 2013,

the rationale behind the previous Cabinet's original decision remains sound. I am proposing in-principle agreement to implement these decisions, subject to targeted engagement with affected stakeholders. This approach will support the overall effectiveness of the NZ ETS through increasing regulatory predictability and certainty.

New Zealand's international targets to reduce emissions

15. New Zealand took a binding emissions reduction commitment under CP1 (from 2008 to 2012), which it met in 2015. The Kyoto Protocol established a framework for accounting as well as a system of internationally tradeable emission units.
16. In 2013, the previous Government announced a voluntary unconditional target to reduce emissions to 5 per cent below our 1990 greenhouse gas emissions levels by 2020. Although New Zealand chose to take its 2020 target under the UNFCCC rather than the Kyoto Protocol, we are applying the Kyoto Protocol rules in our emissions accounting to ensure transparency.

Types of units traded in the NZ ETS

17. Under the Kyoto Protocol, a number of different types of emission units were generated and the NZ ETS was open to these until mid-2015. The primary emission unit of trade in the NZ ETS is the NZU.
18. Due to New Zealand's participation in the Kyoto Protocol, there were also several other types of units that New Zealand account holders were previously able to purchase and, in many cases, use to meet NZ ETS obligations, including (Appendix One contains more detail on these units):
 - 18.1. Assigned Amount Units (AAUs)
 - 18.2. Certified Emission Reduction Units (CERs)
 - 18.3. Emissions Reduction Units (ERUs) and
 - 18.4. Removal Units (RMUs).
19. Some NZ AAUs were transferred to private account holders from 2008-2013. NZ AAUs that remain in private accounts are currently still eligible for use in the NZ ETS. During the period from 2008 to 2013, the Government allocated NZ AAUs as part of policies to support emissions reductions, including the Projects to Reduce Emissions (PRE) programme, the Permanent Forest Sink Initiative (PFSI), and Negotiated Greenhouse Agreements (NGAs).
20. The policies were set up before the introduction of the NZ ETS. Emission units are no longer being allocated under the PRE programme. The Government has moved to allocating NZUs, rather than NZ AAUs, to PFSI participants and to the only firm that still has an active NGA (Refining New Zealand).
21. The ongoing integrity of these programmes depends on the provision of long-lasting incentives. The owners of units provided under the PFSI, and the smaller numbers issued in other initiatives, have a legitimate expectation that their units will continue to be tradable and eligible for surrender in the NZ ETS.

2013 decisions

22. In 2013, Cabinet agreed the following [CAB Min (13) 41/11 refers]:

- i. That if New Zealand is not able to carry over AAUs, the Government will replace privately-owned NZ AAUs by allocating an equivalent number of NZUs to their owners.
- ii. To amend regulations to reflect that CERs, ERUs and RMUs from CP1 cannot be surrendered after 1 June 2015.

23. These decisions have only been partially implemented:

23.1. On 1 December 2014, regulations were passed to prohibit surrender of CP1 CERs, ERUs and RMUs from 1 June 2015, with the expectation that they would be mandatorily cancelled as part of our obligations at the end of CP1.

23.2. In 2015 the cost of replacing NZ AAUs with an equivalent number of NZUs was expensed.

23.3. However, the cancellation of CP1 Kyoto units and the 'swap out' for NZ AAUs has not occurred.

24. Currently, the CCRA provides the Minister of Finance power to direct the cancellation of units in private accounts, but only with account-holder consent, if it is necessary to do so to meet Kyoto Protocol or UNFCCC obligations, or in response to a breach of certain regulations.

25. In 2013, it was expected that New Zealand would receive specific direction requiring either cancellation or carry-over of units from CP1 under the Kyoto Protocol. However, New Zealand has never received an explicit direction from the UNFCCC on this matter, which has frustrated the ability to implement the 2013 decisions under the current legislative framework. With the CCRA now open for amendment, there is an opportunity to resolve this issue.

Units currently held in the New Zealand Emissions Trading Register

26. As at 28 February 2019, 1,960,057 NZ AAUs remain in private accounts in the New Zealand Emissions Trading Register (the Register). These units are held across 73 accounts.

27. There are also Kyoto units held in private accounts that are not eligible for use in the NZ ETS. As at 28 February 2019, this includes 145,592 CERs, 13,423,879 ERUs and 1,911 RMUs. There are also 2,566,343 AAUs from overseas registries being held in private accounts. The use of these imported AAUs for surrender was prohibited by the CCRA in 2008, so these units have almost never had any value in the NZ ETS.

Analysis

In-principle proposals

28. I seek in-principle approval to amend the CCRA to cancel CP1 Kyoto units in private accounts and replace privately-held NZ AAUs with an equivalent number of NZUs. This will allow for the implementation of the 2013 decisions. Although the context has changed since 2013, the rationale behind the original decision remains sound.

29. I consider this proposal to be a relatively straightforward decision as Cabinet decisions on this issue were made by the previous Government and

communicated to the market. It is important that NZ ETS decisions be followed through to support its effectiveness through increasing regulatory predictability.

30. The rationale behind the decisions made by the previous Government was to resolve an operational issue that arose from New Zealand's decision not to take a binding second commitment period under the Kyoto Protocol. NZ ETS participants and registry account holders were informed of this decision at the time.
31. Those holding New Zealand issued CP1 units (NZ AAUs) in 2013 were specifically informed that they would be compensated for this cancellation by replacing their NZ AAU with an NZU. Since NZ AAUs are fungible with NZUs, this will not impact the overall supply of units in the scheme. Note that private participants who hold CP1 units other than NZ AAUs¹ will not be compensated.
32. I recommend clarifying that imported AAUs held in private accounts will be cancelled without compensation alongside CP1 CERs, ERUs and RMUs as part of this in-principle proposal. There are now 2,566,343 imported AAUs held in private accounts. These units are not, and have never been, eligible for NZ ETS use. Cancelling imported AAUs is in line with the policy intent of the 2013 decisions, which was to capture all Kyoto units from CP1 other than New Zealand-issued AAUs.
33. To implement the 2013 decisions, I propose, in-principle, amending the CCRA to require the following:
 - 33.1. That NZ AAUs in private accounts be transferred to the general cancellation account.
 - 33.2. That an equivalent number of NZUs be transferred from the Crown to the private accounts that the NZ AAUs were cancelled from (this will compensate the owners of the NZ AAUs).
 - 33.3. The transfer of CP1 CERs, RMUs and ERUs in private accounts into the general cancellation account without compensation.
 - 33.4. The transfer of privately-owned AAUs originating from overseas registries into the general cancellation account without compensation.
34. At this stage, I am seeking in-principle agreement subject to the outcomes of targeted stakeholder engagement. As it has been five years since the original Cabinet decision on this matter, I consider it appropriate to re-engage with stakeholders before seeking agreement to a final proposal.
35. I propose Cabinet directs officials from the Ministry for the Environment and the Environmental Protection Authority to undertake targeted stakeholder engagement with affected parties (that is, New Zealand Emission Unit Register account holders currently holding CP1 Kyoto units). Engagement with stakeholders will focus on the in-principle proposals outlined in this paper and the alternative option to do nothing and let the relevant units remain in private accounts, pending any international requirement to cancel. Either way, Kyoto units other than NZ AAUs will remain ineligible for use in the NZ ETS.

¹ CP1 Kyoto units (excluding NZ AAUs) have negligible value, as they cannot be used in the NZ ETS and cannot be transferred offshore. Internationally these units are worth very little. For example, in Europe, CERs eligible for compliance within the EU ETS currently trade for less than NZD \$0.50.

36. Following officials' targeted engagement and before the CCRA amendment bill is introduced to the House, I will report back to Cabinet on summary feedback received and seek a final policy decision on this matter.
37. This approach will allow the Parliamentary Counsel Office to begin drafting amendments based on the in-principle proposals in this paper, and will also ensure stakeholders' views are properly considered before Cabinet makes a final policy decision.
38. The other option available is to do nothing, letting the relevant units remain in private accounts, ensuring owners know that Kyoto units other than NZ AAs are ineligible for any use.
39. In developing the in-principle proposal in this paper, I considered providing for regulation-making powers to implement the cancellation and replacement via regulations at a later date. I consider primary legislation to be preferable as it provides a greater degree of regulatory predictability and s 9(2)(h)

Timing

40. I propose that the cancellation and transfer take place on 30 November 2020, near the end of the second commitment period. This will allow time for the Environmental Protection Authority to determine the appropriate implementation method for cancelling and transferring units and will provide sufficient lead in time for officials to communicate this decision to holders of these units.

Consultation

Public consultation

41. Consultation with NZ ETS participants took place from 4 to 29 March 2013 on the previous Government's intention to cancel NZ AAs and replace them with NZUs if they could not be carried over, and to cancel other Kyoto units without compensation.
42. Given that it has been a long time since stakeholders were consulted about this issue, I consider it prudent to undertake targeted consultation with the owners of the units to be cancelled.
43. When the amendment bill is referred to Select Committee there will be a further opportunity for NZ ETS participants and the general public to share their views on these proposals.

Agency consultation

44. This paper was prepared by the Ministry for the Environment. The Treasury, the Environmental Protection Authority, the Ministry of Foreign Affairs and Trade, the Ministry for Primary Industries, the Department of Conservation, the Ministry of Transport, the Ministry of Business, Innovation and Employment and the Ministry of Justice were consulted in the preparation of this paper. Where feedback was received it is reflected in this paper. The Department of Prime Minister and Cabinet and Te Puni Kōkiri were informed.

Financial implications

45. I am not seeking any additional funding in this paper. Additional funding may be required to operationalise the proposals in this paper once they are implemented, which will be from 2020 onwards. Additional funding, if required, will be sought through further implementation decisions or through Budget.
46. Implementing the package of proposals to improve the NZ ETS (tranches one and two) will have costs for the EPA. I expect the EPA will seek additional funding in Budget 2020 to operationalise the full package of proposals. The EPA considers that without funding, changes to the New Zealand Emissions Trading Register and the required operational support cannot be operationalised, including any changes required in 2019/20.
47. In 2015, the cost of swapping NZ AAUs for NZUs was expensed. Since 2015, the Ministry for the Environment has continued to revalue these units annually based on the market price at the end of each financial year, a process which will continue until the swap-out occurs. The revaluation expenses are recognised as a remeasurement cost in the Crown accounts. This cost will be balanced by revenue over time as the NZUs are surrendered back to the Crown.

Legislative implications

48. The policy decisions from this paper will require legislative amendments to the Climate Change Response Act 2002.
49. The amendments were given a category 2 priority on the 2019 Legislation Programme (meaning the bill must be passed by the end of 2019). The Parliamentary Counsel Office has already commenced drafting tranche one amendments.

Regulatory impact analysis

50. The Regulatory Quality Team has determined that a Regulatory Impact Assessment is not required because the relevant issues have already been addressed by existing impact analysis. The original regulatory impact analysis is attached.

Human rights

51. The proposals in this paper are consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Crown-Māori Partnership

52. Māori have a significant stake in climate change action, and a significant interest in the NZ ETS. Māori have a large economy and asset base sitting largely in the primary industries, as well as Treaty-based rights and interests in natural resource use and management. It will be critical when implementing the proposals to continue to adhere to Treaty of Waitangi principles as provided by section 3A of the CCRA.
53. A Māori Leaders' Forum was held in Wellington on 17 September 2018 as part of consultation on improvements to the NZ ETS. The Ministry for the Environment

plans to further engage with iwi/Māori on a range of environmental issues through a series of hui in April. This will include discussions on the NZ ETS and seek views on how we can best support iwi/Māori ahead of consultation on regulations anticipated for the second half of this year.

International obligations

54. The proposed amendments are consistent with New Zealand's obligations under the Paris Agreement and other international commitments.

Gender implications

55. There are no gender implications arising from this paper.

Disability perspective

56. There are no disability implications arising from this paper.

Publicity

57. I intend to make public announcements on the proposed amendments to the CCRA and the amendment bill. It is expected that these announcements will form part of a wider climate change communications plan.

58. The Ministry for the Environment and the Environmental Protection Authority will also communicate with participants and account holders affected by the cancellation and replacement. This may occur before public announcements.

Proactive Release

59. I propose to proactively release this paper on the Ministry for the Environment's website in whole, subject to redactions as appropriate equivalent to those under the Official Information Act 1982, once public announcements have been made.

Recommendations

The Minister for Climate Change recommends that the Committee:

1. **note** the New Zealand Emissions Trading Scheme (NZ ETS) is the Government's key tool to assist New Zealand to meet its climate change targets, and that:
 - 1.1. the Government is reforming the NZ ETS to ensure it can support the transition to a low-emissions and climate resilient New Zealand
 - 1.2. this requires amendments to the Climate Change Response Act 2002 (CCRA)
2. **note** these amendments are being developed in tranches;
 - 2.1. in December 2018 Cabinet agreed to tranche one of amendments to the CCRA and drafting has commenced [CAB-18-MIN-0606.01]
 - 2.2. tranche two comprises of a series of papers with discrete proposals which will be considered by Cabinet over March to May 2019

- 2.3. tranche one and two will result in a single bill amending the CCRA to be introduced to the House in mid-2019, and to enter into force in 2020
3. **note** the previous Government made decisions in 2013 [CAB Min (13) 41/11 refers] to, upon receiving an expected direction from the UNFCCC about expired units, cancel:
 - 3.1. New Zealand-issued Assigned Amount Units in private accounts and replace them with an equivalent number of New Zealand Units, if they could not be carried over
 - 3.2. Certified Emissions Reduction Units, Emission Reduction Units and Removal Units from the first commitment period held in private accounts
 4. **note** that:
 - 4.1. participants in the NZ ETS were consulted on these decisions in 2013
 - 4.2. the context for the 2013 Cabinet decisions has now changed, and we have not received any direction from the UNFCCC to cancel or carry over units
 - 4.3. while imported Assigned Amount Units were not included in the 2013 decision, the policy intent was to encompass all units from the first commitment period of the Kyoto Protocol other than New Zealand-issued Assigned Amount Units
 - 4.4. Kyoto units other than New Zealand-issued Assigned Amount Units are of negligible value
 5. **agree in principle**, subject to targeted engagement with relevant stakeholders to amend the CCRA to:
 - 5.1. cancel New Zealand-issued Assigned Amount Units in private accounts
 - 5.2. replace New Zealand-issued Assigned Amount Units in private accounts with an equivalent number of New Zealand Units
 - 5.3. cancel, without compensation, Assigned Amount Units from overseas registries, Certified Emissions Reduction Units, Emission Reduction Units and Removal Units from the first Kyoto commitment period held in private accounts
 - 5.4. implement these decisions on 30 November 2020
 6. **direct** the Ministry for the Environment, to undertake targeted engagement with relevant stakeholders on the in-principle proposal described in recommendation 5
 7. **authorise** the Minister for Climate Change to further clarify policy decisions relating to the in-principle amendments proposed in this paper, in a way not inconsistent with Cabinet's decisions
 8. **invite** the Minister for Climate Change to issue drafting instructions to the Parliamentary Counsel Office based on the agreed decisions and "in principle" decisions in this paper

9. **note** that I will report back to Cabinet to detail the results of the engagement and confirm the relevant proposals prior to agreeing to introduce the CCRA amendment bill

Authorised for lodgement

Hon James Shaw
Minister for Climate Change