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Ministry for the  
**Environment**  
Manatū Mō Te Taiao

Ministry for Primary Industries  
Manatū Ahu Matua



To: Hon Simon Bridges, Acting Minister for Climate Change Issues  
Hon Nathan Guy, Acting Minister for Primary Industries  
CC: Hon Tim Groser, Minister for Climate Change Issues  
Hon David Carter, Minister for Primary Industries

**Joint Briefing: ETS Review consultation analysis and advice for final policy decisions**

<b>MPI Tracking Number:</b>	B11-810	<b>MfE Tracking Number:</b>	12-B-00704
<b>Date Submitted:</b>	1 June 2012	<b>Priority:</b>	Urgent
<b>Security Level:</b>	SENSITIVE	<b>Number of Attachments:</b>	Nil

**Purpose**

This paper provides Ministers with analysis on the key issues raised in submissions to the ETS review consultation. It also seeks decisions for proposals to be included in the final ETS amendment Cabinet paper.

	Action sought	Response needed by
Acting Minister for Climate Change Issues	<b>Note and agree</b> recommendations and sign briefing, as appropriate	6 June 2012
Acting Minister for Primary Industries	<b>Note and agree</b> recommendations and sign briefing, as appropriate	6 June 2012

**Ministry for the Environment Contacts**

Name	Position	Telephone		1st Contact
		Work	Cell	
Peter Brunt	Responsible Manager	04 439 7575	027 498 2332	✓
Stuart Calman	Director, Climate and Risk	04 439 7571	021 662 162	

**Ministry for Primary Industries Contacts**

Name	Position	Telephone		1st Contact
		Work	Cell	
Kathy Perreau	Responsible Manager	04 894 0585	029 894 0585	✓
Mike Jebson	Director, Natural Resources	04 894 0696	029 894 0696	

## Executive Summary

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1. This briefing provides Ministers with analysis on the key issues raised in submissions to the ETS review consultation, which closed on 11 May. The briefing has been prepared by both agencies to tight time horizons by multiple authors. As a result it will not meet either Ministry's policy quality standards in terms of drafting or being free of errors. However, it is provided now to facilitate discussion and decision-making.
2. Your direction, on the basis of this analysis, is required by **6 June** to enable officials to draft a Cabinet paper seeking final policy agreement to a package of amendments to the ETS. It will also assist officials in preparing materials for a meeting of Ministers to take place on 11 June.
3. ~~A summary of officials' analysis is contained within the main briefing. Detailed analysis underpinning this summary is attached in the annexes. Officials' recommendations on the basis of an analysis of submissions are to:~~
  - Adopt the ETS Review Panel's recommended phase out of the '2 for 1' surrender obligation and to maintain the \$25 fixed price option until 2015.
  - Add fugitive coal seam methane to the list of emissions sources eligible for allocation for coal users.
  - Clarify the circumstances in which Ministers can exercise discretion to grant industrial allocation to new activities to include references to the purpose of the Act, to reduce risks of potential legal challenge.
  - Introduce an explicit power to allow auctioning within an overall cap and to seek Cabinet agreement that such a power will be exercised.
  - Specify that maintaining emissions at 1990 levels should form the basis of a default maximum cap.
  - Agree that no new power be introduced in the context of auctioning to provide for a restriction on the quantity of international units that may be surrendered.
  - Clarify that the intention of the cap is not to restrict the amount of NZUs allocated, and instead only limits the number of NZUs available for auction to be a maximum number less any NZUs allocated.
  - Clarify that the cap excludes NZUs provided for removal activities, NZUs purchased from the government under the \$25 fixed price option, and NZUs given under a negotiated greenhouse agreement.
  - Confirm decisions made in principle by Cabinet on the parameters for offsetting for pre-1990 forest, with the exception of the issue of allowing landowners who harvested in the first commitment period of the Kyoto Protocol to have the option to offset, which is subject to ongoing analysis.
  - Introduce a power to defer agriculture emissions subject to a review in 2014, but to consider whether this power should allow for deferral by up to 3 or up to 5 years.
  - Provide for a power to extend the fixed price option beyond 2015 and align it with any price ceiling in Australia, should linking with the Australian Carbon Pricing Mechanism occur, subject to a time restriction of up to 3 years on any extension.

- Remove the obligation to 'back' NZUs with international units, extend the export ban for non-forestry sectors whilst the fixed price option remains in place, and to align the ETS with the latest Global Warming Potentials agreed internationally.
4. With respect to the **second tranche of allocation** to pre-1990 forest landowners, the consultation has underlined both the policy case for adjusting the allocation **[Withheld under Sections 59(2)(g)(i) and 59(2)(h)]** However, fiscal savings for taxpayers from this option are very small.

5. A range of options for partial cancellation are set out in the briefing, including:

- A pro-rata cancellation (say, of 50% of the second tranche), which acknowledges that expectations/ business planning will have factored in the differing rates of the original compensation.
  - A flat rate (say, of 12 units per hectare) on the basis that the original categories are no longer relevant as offsetting is available to everyone equally (and the categories were not based on actual land value impacts in any case).
6. No partial cancellation option is without risks, however. Ministers are asked to indicate their broad preference, weighing up **[Withheld under Section 59(2)(h)]** on the one hand against the policy case and fiscal benefits on the other.
7. Following an indication of your broad preference, officials will provide further advice on your preferred position (including further legal advice and analysis of impacts on eligible individual landowners).
8. Based on consultation responses, officials recommend allowing eligible landowners to re-apply for the less than 50 hectares exemption if a significant reduction in the second tranche is agreed.
9. Based on the recommendations above, and decisions already made by Cabinet on the treatment of Synthetic Gases and other more minor and technical amendments in the ETS, an indicative estimate of overall fiscal cost of the ETS amendment package would be around \$117m over the forecast period to 2015/16, at a carbon price of \$6.35.
10. An indicative estimate of the fiscal savings of the package of amendments would be around \$20m to \$216m over the forecast period at a carbon price of \$6.35 depending on decisions made on the second tranche.
11. \$6.35 is not the carbon price used in the current Crown accounts, but is likely to be closer to the valuation used in the accounts in future. If the valuation used in the current accounts (\$10.47) were used, the costs would rise to around \$193m and the savings would rise to around \$33m to around \$356m.
12. These fiscal estimates are indicative only, and are subject to further checking and clarification prior to completion of the Cabinet paper.

## Situation Analysis

13. In February, Cabinet agreed in principle, subject to consultation, to a number of changes to the New Zealand Emissions Trading Scheme (ETS):
- more gently phasing out the current '2 for 1' surrender obligation in three equal steps between 2013 and 2015 (as recommended by the ETS review panel);

- b. maintaining the \$25 fixed price option until 2015;
  - c. providing for a more explicit power to auction NZUs to an overall cap on the supply of NZUs;
  - d. providing for a more explicit power to place a quantitative restriction on the surrender of international units;
  - e. the introduction of offsetting within the ETS as an option for pre-1990 forests;
  - f. a review of the second tranche of free allocation to pre-1990 forest landowners, with the option to reduce or remove the second tranche in recognition of the benefits offered by offsetting;
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- g. providing for a power to defer the start of surrender obligations for agricultural greenhouse gases by up to 3 years, subject to a review in 2014;
  - h. providing for a power to extend the fixed price option beyond 2015 and align it with any price ceiling in Australia should linking with the Australian Carbon Pricing Mechanism occur;
  - i. removing the obligation under current ETS settings to 'back' all NZUs with an international unit;
  - j. extending the ban on the export of NZUs from non-forestry sectors, whilst the fixed price option remains in place;
  - k. aligning the ETS with international greenhouse gas accounting standards, by adopting the latest, internationally accepted global warming potentials.
14. A public consultation on these proposed changes closed on 11 May 2012. This consultation consisted of a written consultation document and a series of regional meetings and hui attended by Ministry for Primary Industries and Ministry for Environment officials. Several other meetings were also held with stakeholders during the consultation, including a meeting with industrial stakeholders organised by Business New Zealand.
15. A draft summary of submissions in response to the written consultation has already been sent to Ministers Bridges and Groser [Briefing 12-B-00690] refers. An updated summary is attached at **Appendix 1**. Officials' analysis of the issues raised draws both on these written responses and on the points made in the stakeholder meetings.
16. 359 submissions were received in response to the written consultation. Overall, in both submissions and at meetings, stakeholder views on the overall package of amendments proposed by the Government were mixed. Many agreed or agreed in principle with some or all of the proposals put forward. However the majority of submitters had significant concerns around particular proposals.
17. Cabinet will need to make final decisions on these proposals by early July [Briefing 12-B-00618 on the timetable for ETS amendments refers], in order to maximise the chance that a Climate Change Response Act amendment bill can be introduced and passed by the end of this year. A small group of Ministers are also meeting on 11 June, which will provide an opportunity to discuss the package of final recommendations to be put to Cabinet.
18. In order to ensure that officials can prepare the Cabinet paper seeking final decisions, and prepare material for the meeting of Ministers on 11, officials require a response to this briefing note by **6 June**. Officials will prepare a draft Cabinet Paper on the basis of this

response and the other proposed amendments that Cabinet have agreed (treatment of Synthetic Gases and more minor and technical amendments).

19. This briefing focuses on the package of proposals that were presented in the consultation document. You should note, however, that a number of other matters which may impact ETS amendments are still subject to ongoing consideration by officials. These are also referenced in the advice below.

## **Advice**

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20. Below is a summary of officials' analysis of the issues raised in consultation and recommendations for inclusion in the Cabinet paper seeking final decisions on ETS amendments. Working papers containing the detailed analysis underpinning this summary have been prepared by officials and are available should you or your office wish to consider them.

## **Transition measures**

21. The ETS current provides for two transition measures designed to mitigate the impact of the scheme during the first years of its operation and during the period of economic recovery:
  - A '2 for 1' surrender obligation currently, which allows ETS participants from non-forestry sectors to surrender one unit for every two tonnes of emissions, effectively reducing the obligation by 50 percent for all participants.
  - A '\$25 fixed price option', which allows all participants in the scheme to meet their obligation by giving the government \$25 per tonne of emissions, rather than surrendering units. This effectively 'caps' the carbon price at \$25.
22. Under current ETS settings, these two measures are due to end at the end of 2012.
23. The ETS also provides ongoing protection for firms undertaking the most emissions intensive, trade exposed activities in the economy through intensity based allocation. This allocation effectively reduces the ETS costs associated with undertaking these activities by 60% or 90%, depending on their emissions intensity, through a free allocation of units.
24. Together, with the carbon price, the transition measures and industrial allocation determine the level and nature of the economic impost and emissions reduction incentive created by the ETS in the short term.
25. In line with Cabinet's 'in principle' decisions, the consultation document proposed to:
  - Accept the recommendation of the ETS Review Panel to phase out the '2 for 1' surrender obligation more gently in three steps from 2013 – 2015.
  - Extend the '\$25 fixed price option' to 2015, in light of uncertainty around the international carbon price.
26. In addition, the ETS review panel recommended that officials explore whether certain emissions costs that were currently excluded from calculations of eligibility for allocation should be included. Notably these emissions sources were liquid fossil fuels and fugitive coal seam methane.

## *Issues raised in consultation*

27. A majority of submitters (around 66%) commenting on the issue in the written consultation supported the proposal to phase out the '2 for 1' surrender obligation. Some of these

submitters (around 20%) preferred to extend the '2 for 1' further. Around 34% opposed the proposal on the basis that the '2 for 1' ought to end earlier.

28. By contrast, a majority of written submissions opposed continuation of the fixed price option, calling for the fixed price to end or be increased incrementally over time. Of those commenting, around 23% supported.
29. Submitters' arguments for extending the '2 for 1' and fixed price option included the need to moderate the cost impact of the ETS given limited progress internationally. Arguments against included the risk of weakening incentives for emissions reductions and the impact on afforestation incentives from the reduced demand for units.
30. ~~In addition, a number of submitters raised in consultation proposals to increase the level of allocation to emissions intensive, trade exposed industries (including the additional emissions sources specified above) or increase access to industrial allocation (by changing eligibility thresholds).~~
31. A number of submitters also raised the risk of new, highly emissions intensive activities not currently being undertaken in New Zealand being incentivised by the availability of allocation – increasing emissions and making it more difficult to meet future international obligations. Some submitters suggested that allocation should only be awarded to a completely new activity where it could be demonstrated that it was reducing emissions vs the status quo.

#### Summary of analysis

32. A decision on the optimal approach to the transition measures and industrial allocation, is likely to balance up the costs and competitiveness impacts for emitters; the impact on afforestation incentives in terms of net demand for forestry NZUs; the impact on long term incentives to invest in abatement; and the fiscal costs.
33. Addressing these issues in turn, officials note that:
  - **Carbon prices are likely to remain low in the short term**, and well below the \$25 fixed price option. For most businesses and households, the impact of the carbon price in the short term is likely to be small as a proportion of overall costs. Estimates of the impacts of the ETS at current carbon price on costs for businesses and households have been set out in previous briefings [for example, MfE briefing 12-B-00624 refers].
  - **Costs will remain most significant for the companies undertaking the most emissions-intensive, trade-exposed activities.** There is a principled argument for including all emissions for which companies face ETS costs in allocation; although doing so may not be material for most allocation recipients, and will raise some administrative complexities. Including liquid fossil fuels in stationary energy in particular will raise significant administrative complexities and will likely take some time to implement, as identifying where the use of the fuel is part of the eligible activity or not is particularly complex.
  - Phasing out the '2 for 1' in line with the Panel's recommendations would **reduce potential domestic demand for forestry units** by around 25% in the period 2013-15. Extending the '2 for one' would reduce demand for forestry units from emitters by around 60% in the same period; and by 90% in the period 2016-20. Combined with continuing uncertainty on international carbon markets (including the ability for foresters to be able to export units after 2012) and the current low carbon price, extending the '2 for 1' may impact significantly on afforestation incentives after 2012.

- **The Panel's proposed '2 for 1' phase out is designed to maintain clear long term incentives to invest in abatement** by showing clearly how the '2 for 1' will be withdrawn over a number of years. Extending the '2 for 1' until 2020 would reduce certainty for emitters about when the transition to full obligations will be, and may reduce incentives for such investments.
  - Given low carbon prices, maintaining the fixed price option until 2015 is unlikely to affect short or long term abatement incentives.
  - **The fiscal costs for extending the '2 for 1' are relatively high** (around \$298m over the forecast period at a carbon price of \$6.35) compared with the panel's recommended phase out (around \$90m over the forecast period at a carbon price of \$6.35). Changes to industrial allocation to include additional emissions sources are relatively low fiscal cost (\$5.9m over the forecast period for Fugitive Coal Seam Methane and \$17.1m for liquid fossil fuels used in stationary energy). As the carbon price is likely to remain low, continuing the fixed price option is unlikely to raise fiscal costs.
34. With respect to the concern that the availability of allocation may incentivise new emissions intensive activities; officials note that, even with allocation, the carbon price should be an increasing a factor in investment decisions in new economic activity over time. New activities will have economic benefits as well as impacting on emissions. Officials do not recommend that Ministers seek to take a view in advance on whether awarding allocation to particular new activities is desirable.
35. Officials note that Ministers already have discretion on whether to make regulations prescribing a new activity eligible for allocation. However, this discretion is potentially open to legal challenge. In order to reduce legal risks and increase flexibility, officials propose that the circumstances in which the Minister's discretion can be used be clarified by allowing the Minister to consider the purposes of the Act in making his decision.

#### *Summary of recommendations*

36. On balance, based on the issues raised in consultation and analysis, officials recommend that the Cabinet paper seek agreement to:
- The panel's recommended '2 for 1' phase out, as proposed in the consultation. This provides a smoother transition for the economy as a whole to full obligations in the short term; but mitigates the high fiscal costs and other significant downsides for abatement incentives associated with simply extending the '2 for 1'.
  - Continuing the fixed price option to 2015, as proposed in the consultation, as this is unlikely to raise fiscal costs or reduce incentives (given low carbon prices).
  - Increasing industrial allocation to coal users by amending the coal factor used in industrial allocation to cover costs associated with fugitive coal seam methane emissions.
  - Clarifying the circumstances in which the Minister's discretion to grant industrial allocation to new activities can be used by adding the purposes of the Act to the list of issues the Minister can consider.
37. On balance, officials recommend against including liquid fossil fuel use in stationary energy to the list of eligible emission sources eligible for allocation, given the administrative

complexities involved and low materiality for most allocation recipients. However, officials note that the 'in principle' arguments for inclusion are likely to remain strong.

38. If Ministers wished to provide further assistance to mitigate the cost impacts of the ETS in the short term, officials recommend that these be targeted at emissions-intensive, trade-exposed industries (those at or near the threshold for free allocation). MfE officials have previously outlined some possible options for this [Briefing 12-B-00624 refers].

### Supply of NZUs after 2012

39. The consultation document proposed to introduce a mechanism through legislation that will allow the Minister for Climate Change Issues to:
- auction NZUs within an overall cap on the amount of NZUs allocated and auctioned, and
  - place a restriction on the proportion of international units an ETS participant can surrender.
40. These proposals were designed to ensure that Ministers had more flexibility over the supply of NZUs within the ETS, so that ETS participants did not have to purchase and surrender more international units than was necessary for New Zealand to meet its international targets or equivalent level of domestic effort.

### Issues raised in consultation

41. Slightly more submitters disagreed with the proposal to auction NZUs within an overall cap than agreed or agreed in principle. Substantially more submitters agreed or agreed in principle with the proposal to restrict the proportion of international units an ETS participant can surrender than disagreed.
42. A common concern, raised by both those who agreed and disagreed with the proposed amendments, was that if they were implemented this would increase regulatory and market uncertainty. This is because the Government would be able to make changes through regulations and would only need to give 12 months notice of a change. Another common concern was that the consultation did not provide sufficient information for some submitters to make an informed assessment of the proposals.
43. Some submitters also proposed alternative ways for the Government to increase the supply of NZUs instead of auctioning, including allocating units for free to projects which reduce emissions or otherwise increasing free allocation.

### Summary of analysis

44. Officials consider that the problem definition set out in the March Cabinet paper [12-C-00035] remains a valid one. The submissions do not raise significant challenges to that problem definition, although they propose alternative solutions and seek more certainty over how powers will be used, particularly in respect of the volume of units to be auctioned and the level of the restriction on international units.
45. Ministers will need to balance calls for more certainty with the need for flexibility given uncertainty in the international environment. In particular, after 2015, it is unclear what international obligations, if any, New Zealand might face after 2015 or what level of domestic effort New Zealand might want to commit to. Similarly, it is likely that any auction mechanism



will need to be refined and tuned in the early years of its operation, as the Government and participants get to grip with its operation.

46. Officials note that the Act already allows NZUs to be sold. It also allows for restrictions on international units through regulations. These powers are therefore already available. The proposals agreed to in principle by Cabinet are designed to reduce uncertainty over their application, by specifying more clearly how and why they will be used.
47. With respect to auctioning, it is difficult to see how more certainty could be provided now around volumes of units to be auctioned, as this decision will require more analysis and consultation. However, certainty could be increased in two ways:
  - Specifying a backstop basis for a cap in the primary legislation, based on maintaining 1990 emissions, reflecting the maximum possible number of NZUs supplied to the market. This would maintain Government flexibility to set a cap in the regulations below this level.
  - Increasing the notice period for amending the regulations specifying the supply cap; for example, from one year to at least three years. But this would reduce the Government's flexibility to respond to changes in international or domestic circumstances.
48. Officials recommend that a backstop basis for a cap is specified in the legislation. Officials still believe that the current proposal for regulations to set out the level of the cap in each year for a five year period, but with the option for Government to amend these regulations with one year's notice, provides the right balance of certainty and flexibility.
49. With respect to the restriction on international units, officials note that a strong part of the argument raised by submitters in favour of such a restriction relates to a desire to increase NZU prices above international prices, rather than the problem definition of greater flexibility over volumes of international purchasing. A number of submitters pointed out that a well designed and efficient auction process will in itself encourage ETS participants to buy NZUs at the auction, allowing auctioning to address the purchasing problem.
50. On balance, considering the consultation responses, officials do not believe that a restriction on international units is necessary in the context of auctioning, assuming that Ministers wish to ensure that the domestic price continues to reflect the international price. Government retains the option of using existing regulatory powers if experience indicates that such a restriction is needed to support an auction in future - noting that Ministers would need to approach such a decision carefully and with due consultation. Further consideration might be given to whether constraints need to be put around the use of this power in future.
51. A number of alternatives to auctioning were proposed by submitters to address the problem definition. Officials note that these alternatives would increase the supply of NZUs but either:
  - do not offer the flexibility that auctioning to a cap would offer (and therefore offers no guarantee that they would increase supply by the required amount, e.g. increasing existing free allocation rates), and/or
  - raise additional fiscal costs, in a context where auctioning is fiscally neutral (e.g. free allocation to projects that reduce emissions), and/or
  - require government, rather than the market, to set the price – effectively transforming the ETS into a carbon tax and losing the associated efficiencies of a trading scheme (e.g. closing the scheme to international markets and relying on the fixed price option).

52. On balance, therefore, officials consider that auctioning remains the most efficient and flexible means of addressing the problem described to Cabinet.

### ***Other issues identified by officials***

53. Outside of consultation, work on drafting instructions with Parliamentary Counsel Office has identified two issues:

- ***What to do to address risks that any cap on the total number of NZUs is breached, if levels of allocation are unexpectedly in excess of the cap.*** In most instances, the chances of this occurring are relatively low. However, some instances (such as errors and corrections in levels of allocation) are more likely than others. On balance, officials recommend that the proposed intention of the cap should be clarified such that the cap does not restrict the amount of NZUs allocated but does limit the number of NZUs available for auction less NZUs allocation. This option is consistent with the current purpose and approach to allocation (i.e. uncapped, intensity-based). In addition the cap will ensure the Government does not auction an unlimited amount of NZUs in the case where allocation is below the cap. If allocation were in excess of the cap, then there would be no auctioning of NZUs.
- ***Which NZUs should be excluded from the cap.*** Officials propose to clarify that the cap excludes NZUs issued and transferred for any other purpose, such as for removal activities (e.g. post-1989 forestry), purchased from the Government under the \$25 fixed price option and NZUs given under a negotiated greenhouse gas agreement (NGA). Removal activity NZUs should be excluded as they relate to emission reductions rather than actual emissions. For the other two purposes, given these involve relatively small amounts of NZUs, and the uncertainty and administrative complexity created by including these NZUs in a cap officials believe these should be excluded from the cap. Officials will ensure that the Cabinet paper clearly distinguishes between NZUs issued and NZUs subject to the cap, and the link with any emissions reduction target.

### ***Summary of recommendations***

54. On balance officials believe that, in the light of the consultation responses, auctioning NZUs within an overall cap remains the most appropriate mechanism for avoiding the unnecessary purchase of international units and the loss of economic welfare this entails. Officials recommend that Cabinet be asked to agree that:

- An explicit power is introduced to allow auctioning within an overall cap
- This power is exercised, subject to further work and consultation with effective parties in 2012
- The forward certainty implied by Cabinet's previous in principle decisions be maintained – i.e. regulations setting out caps for each year over a five year period but subject to amendment with 1 year's notice
- The Act is amended to specify a backstop basis for a cap, based on maintaining emissions at 1990 levels setting out the maximum possible amount NZUs supplied to market
- There should be no restriction on the quantity of international units that may be surrendered

- The cap does not restrict the amount of NZUs allocated but does limit the number of NZUs available for auction less NZUs allocation
- The cap excludes NZUs provided for removal activities, purchased from the Government under the \$25 fixed price option and NZUs given under a negotiated greenhouse gas agreement.

### Pre-1990 forest offsetting

55. The consultation document outlined a proposal to introduce offsetting as an option for pre-1990 forest landowners with a design that mirrored the settings of the Flexible Land Use rule agreed at Durban. Specifically, the consultation proposed that:

- pre-1990 forest land could be converted to other land use without deforestation liabilities as long as a new forest was established elsewhere;
- the new forest would need to be at least the same area and achieve the same carbon stock as the forest harvested within the usual rotation length;
- the option would only apply to pre-1990 forest harvested from 2013; and
- only direct planting was permitted for the establishment of the new forest.

### Issues raised in consultation

56. Some forest land owners have indicated interest in pre-1990 forest offsetting, if it became available as they have potential conversion projects. Many of these owners have commented on the design of offsetting and requested the following requirements to be changed:

- Including land that was harvested in CP1 to be offset.
- Using regeneration of native species for offsetting.
- Allowing existing post-1989 forest to be used as offset forest.
- Allowing deforested pre-1990 forest land to be used to establish an offset forest.
- Applying the 9-year rule<sup>1</sup> only to estimate carbon equivalence for offsetting (and not to prevent offsetting for 9 years).

### Summary of Analysis

57. The pre-1990 forestry offsetting policy proposal put to Cabinet excluded pre-1990 forest land that was harvested in CP1 and currently unstocked (i.e. not yet been converted). This criterion was developed based on:

- A conservative interpretation of the Flexible Land Use rule in the Durban text;
- Uncertainty on the requirements of future international accounting guideline for flexible land use in CP2 (guidelines currently in development); and
- Implications for CP1 accounting if such land was excluded from offsetting in the guidelines in CP2.

58. However, we are aware of the desire to offer pre-1990 forestry offsetting as an option to forest landowners who harvested in CP1. Officials agree that this is, in principle, desirable,

<sup>1</sup> The 9 year rule in section 186 in the CCRA requires the estimation of deforestation emissions when trees cleared are 8 years or younger as if the trees cleared were of the age and species of the oldest trees of the predominant species during the previous 9 years.

as it would maximise access to the benefits offered by offsetting. Based on discussions to date, it seems likely that the interpretation of the Flexible Land Use rule in the Durban text and its application in this context is likely to be most critical. Officials are in conversation with MFAT legal advisors on this issue and further advice will be provided prior to Cabinet consideration.

59. Other requests raised by submitters are likely to be more problematic, as it would involve significantly departures from the Durban rule which would involve fiscal costs should New Zealand sign to CP2 or take an emissions reduction target:

- Allowing existing post-1989 forest as an offset forest contravenes the requirement for this land to be a newly established forest. Existing post-1989 forest is accounted under article 3.3. of the Kyoto Protocol, for which New Zealand currently is and will continue to be earning credits (whether the land is in the ETS or not). Land that is already accounted under article 3.3. is required to remain in this accounting and cannot be changed to article 3.4 for offsetting.
- Allowing natural regeneration of indigenous species for the establishment of an offset forest would not be considered as a direct human induced planting and/or seeding which is required under the forestry rules for pre-1990 forest land in CP2. Landowners could however use direct planting of native species which would require a greater area to achieve the carbon equivalency in the time period permitted.

60. The application of the 9-year rule in offsetting was not included in the consultation document or part of the March Cabinet paper (CAB Min (12) 8/7). The 9-year rule will be applied to estimate the carbon equivalency that the new offset forest will need to achieve.<sup>2</sup>

61. Some submitters indicated concern that pre-1990 forestry offsetting will cause land use intensification and environmental impacts to water quality. These concerns have been raised by submitters and in consultation meetings, and by local authorities.

62. Officials draw your attention to the Waikato Regional Council, who has indicated reliance of the CCRA legislation until land and water management rules in the regional plans are in place. Officials consider that while these concerns are valid, the CCRA should not apply specific local requirements aimed at achieving RMA outcomes. If Ministers agree that this is a special case, further work from Government may be required outside the ETS to address the issues.

63. There was also commentary on the availability of the pre-1990 forestry offsetting policy in the ETS as many land owners have practical constraints that will prevent them to take up offsetting in the short term. Officials consider these concerns could be addressed by indicating the intention to keep offsetting as long as the Flexible Land Use rule is allowed internationally.

#### *Summary of Recommendations*

64. Further work is being undertaken on the impact of allowing forest landowners who harvested in CP1 to take up the option of pre-1990 forestry offsetting and advice will be provided prior to the meeting with your colleagues on the 11 June.

65. Officials recommend that Cabinet be asked to confirm all other parameters for the offsetting policy that they agreed in last March 2012. Officials also recommend that the pre-1990

<sup>2</sup> The 9 year rule in section 186 in the CCRA requires the estimation of deforestation emissions when trees cleared are 8 years or younger as if the trees cleared were of the age and species of the oldest trees of the predominant species during the previous 9 years.

offsetting policy is designed to remain in the CCRA while the Flexible Land Use rule is allowed internationally.

66. Officials request Ministers consider if further work is required to address the issues raised by the Waikato Regional Council.

### Second Tranche of Pre-1990 Forest Land Allocation

67. The consultation document sought feedback on whether Government should adjust the level of compensation to pre-1990 forest land owners in light of the introduction of offsetting, and if it did adjust the level of compensation, which of the following three options was preferred and why:

- A full-removal of the second tranche of pre-1990 forestry compensation for all eligible landowners.
- A reduction of the second tranche of pre-1990 forestry compensation for all eligible landowners. Examples were provided of how this could be done, including allocating all landowners 11 NZUs per hectare, or reducing all second tranche allocations on a pro rata basis by an appropriate percentage.
- Only removing the second tranche of pre-1990 forestry compensation for those landowners who take up offsetting.

68. If a partial reduction was preferred, comments were sought on the most desirable way to do it. Further, if the Government decided to either reduce or remove the second tranche, then feedback was sought on allowing landowners who were eligible for the less than 50-hectares exemption, but who had chosen to take allocation, to revisit their choice. They would be required to forfeit the second tranche of the allocation, and return the units issued in the first tranche.

#### *Issues raised in consultation*

69. Of those who responded to the question of whether to adjust the level of compensation in light of the introduction of offsetting, nearly all submitters did not support it. A number of reasons were cited:
- Introducing offsetting was not considered a rationale for adjusting the second tranche; as it did not change the original basis for the allocation
  - The original compensation was too little or negligible in the first place
  - Government is reneging on its promise, agreement or contractual obligations with landowners
  - Adjusting the compensation was unfair and unacceptable
  - Inter-sector equity- agriculture does not face emissions liabilities and other sectors have the '2 for 1'; while pre-1990 forestry faces full obligations
  - Inability to benefit from offsetting because their land has long-term forestry leases, they lack capital or for other reasons.
70. If Government were to adjust the allocation, then cancelling the second tranche only for those who take up offsetting was strongly preferred overall, on the basis of fairness. It was noted that this was recommended by the ETS Review Panel.

71. A few submitters supported option 1 or full cancellation of the second tranche. One reason provided was that with current carbon prices it is considerably cheaper than originally envisaged to change land use, and another was that compensation provided the incentive to not replant.
72. A few submitters supported option 2 or partial cancellation of the second tranche. Several suggested partial cancellation should be based on the potential land use change (to allow for it), or the value of the offset land (reduced compensation for lower value offset land).
73. Many submitters commented that adjusting the second tranche would result in reduced willingness to invest or reinvest in forestry.
- ~~74. Submitters also stated that adjustment or cancellation would negatively impact on the Māori/Crown relationship, and be a breach of good faith and previous commitments. Iwi/Māori cited specific barriers they face through the lack of available land for offsetting, and the difficulties presented by the Te Ture Whenua Māori Act 1993 (TTWMA).~~
75. Two submissions directly addressed the issue of the treatment of landowners with less than 50 hectares of pre-1990 forest land. Both agreed that if the level of allocation is reduced, then eligible landowners should be able to revisit their choice.

#### *Summary of Analysis*

76. The introduction of offsetting does change the rules for pre-1990 forest land, and can be expected to reduce the impact of the ETS on land values, albeit that offsetting is not without cost. Therefore, it is appropriate that the government now review previous decisions on the second tranche of the forestry allocation.
77. The basis for the current allocation is the possible impact the pre-1990 forestry ETS rules may have on the value of pre-1990 forest land. The loss in land value originates from the encumbrances placed on the land that limit the opportunity to convert to a higher value land use. The consultation results and comments indicate much of the pre-1990 forest may already be in the best land use and have limited conversion potential; therefore that few parties are in a position to benefit from offsetting.
78. For land that has no higher-value alternative use, the impact of the ETS can be expected to be the impact of the general encumbrance the ETS rules creates, and possible perception and preference impacts. The impact of encumbrances are in the order of 5-15%, and for the ETS, the mid-range of 10% is expected to be appropriate. On that basis, the average encumbrance impact could be \$166 per hectare (assuming an average pre-1990 forest land value of \$1,660 per hectare<sup>3</sup>).
79. However, submissions indicated some misunderstanding and a level of confusion regarding the allocation. For example, submitters have assumed that the allocation was intended to cover deforestation liabilities in full (which would have negated the point of the pre-1990 forestry rules to limit deforestation). While the link between the pre-1990 deforestation rules and the allocation was made in publications and presentations, and was in legislation, this may not have been consistently understood. Many consider the allocation as an entitlement.

80.

Withheld under section 59(2)(h)

<sup>3</sup> Recent Overseas Investment Office transactions for pre-1990 forest land, 2010 and 2011.

[ Withheld under section 59(2)(h) ]

81. Māori / iwi submitters raised a number of specific issues, including:

- **Treaty Settlement.** The CCILG submitted that Minister Groser acknowledged sensitivities around some issues such as Treaty settlements. The Ngāti Apa submission states that it negotiated its settlement in part on the basis that it was to receive NZU's to their full value. [

Withheld under Section 59(2)(h)

- ] [
- **Disproportionate impacts on Māori.** Because pre-1990 land is disproportionately Māori owned, iwi submitters have argued any changes to the allocation may have a disproportionate effect on Māori. [ Withheld under

Section 59(2)(h) ]

- **Ability to take up offsetting.** Offsetting is unlikely to be used through Māori forestry as it is unlikely Trustees will have any land available to offset deforestation. It was also stated that it is contrary to tikanga to purchase or rent other lands to which there is no whakapapa or manawhenua associations with, which further prevents offsetting. Many pre-1990 forests on Māori land are currently or will soon be coming out of lease arrangements. Even reforestation of such lands is likely to require external financing or renewed leasing, particularly if there is any decrease in the second tranche allocation.

82. More broadly, for land that does have a higher-value use, submissions have indicated that offsetting is not a feasible option for land use change for many landowners due to practical constraints and financial limitations to take up this option, including not having sufficient capital available up-front.

#### Summary of Recommendations

83. The consultation has highlighted that the three broad options available to Ministers remain valid. Officials have presented a range of options for partial adjustment of the second tranche and outlined the risks and benefits of each. Ministers will need to weight up the wider fiscal/economic considerations against the legal and relationship risks presented in these options. Given the range of issues to address there is no clear cut case either for or against cancelation.

84. [

Withheld under sections 59(2)(h) and 59(2)(g)(i)

[Withheld under Sections 59(2)(h) and 59(2)(g)(i)]

85. It remains the case that an argument could be made to cancel the compensation in full because the introduction of offsetting has a direct impact on property values (because land can now be put to best use). The majority of submitters believe that their land is currently in best use, therefore the impact on land values would not have been high. [

Withheld under Section 59(2)(h)

86. Whilst acknowledging the policy case for full cancellation, Ministers could offer a proportion of the second tranche in recognition of the relationship it wishes to maintain with the sector and to respond to submitters concerns that offsetting is not without costs. This could be done in 3 broad ways:

- A pro-rata cancellation (say, of 50% of the second tranche), which acknowledges that expectations/business planning will have factored in the differing rates of the original compensation.
- A flat rate (of say, up to 12 units per hectare) on the basis that the original categories are no longer relevant as offsetting is available to everyone equally (and the categories were not based on actual land value impacts in any case).
- A targeted fund to support offsetting (based on 50% of the value of the second tranche), which would target to those whose land value has been most impacted and who wish to convert.

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Summary of options to modify the pre 1990 allocation – second tranche

Option	Risks / Impacts (the contents of this column derive from legal advice and are subject to legal privilege)	Fiscal impact (\$ Million) <sup>4</sup>
A. Cancel all of the 2nd Tranche	<ul style="list-style-type: none"> <li>• [ Withheld under Section 59(2)(h) ]</li> <li>• Relationship risks (forestry sector and iwi)</li> </ul>	\$196.2
B1. Partial cancelation: pro-rata 50% of the second tranche to all forest owners	<ul style="list-style-type: none"> <li>• Equitable on the basis of the initial compensation</li> <li>• [ Withheld under Section 59(2)(h) ]</li> </ul>	\$98.1
B.2. Partial compensation: flat amount of compensation e.g. up to 12 units to all	<ul style="list-style-type: none"> <li>• Inequitable (on basis of initial compensation)</li> <li>• Could be considered equitable on the basis of offsetting offered to all pre-1990 participants</li> <li>• [ Withheld under Section 59(2)(h) ]</li> </ul>	12 units = \$98.1
B.3. Cancel all of the 2nd Tranche but establish a offsetting support fund with % of the units (eg, 50%)	<ul style="list-style-type: none"> <li>• Could be considered better targeting of compensation – if land value is considered key argument</li> <li>• Addresses the concerns made by a number of submitters</li> <li>• Could address national as well as individual interests</li> <li>• [ Withheld under Section 59(2)(h) ]</li> </ul>	\$98.1
B.4. Cancel all of the 2nd Tranche and create a case-by-case compensation fund	<ul style="list-style-type: none"> <li>• Could reactive fund and would account of specific issues as they arise</li> <li>• Possible equity issues – depending on focus</li> <li>• Parameters and quantum would be difficult to</li> </ul>	Would depend on fund parameters

<sup>4</sup> At a carbon price of \$6.35. Note that all savings will be in the 12/13 financial year, except option c where there fiscal savings may be spread across a number of years depending on when/if offsetting is taken up by participants

	define and forecast <ul style="list-style-type: none"> <li>• Reactive rather than pro-active response to consultation</li> </ul>	
<b>C. Cancel for all owners who take up offsetting (they return NZUs they were allocated when they deforest).</b>	<ul style="list-style-type: none"> <li>• Lowest risk option</li> </ul>	\$1.0 – \$16.5

87.

Withheld under Section 59(2)(g)(i)

88. Overall, there are no options of full or partial compensation that are without risk. Officials recommend that ministers indicate their preference and they direct officials to provide further advice on their preferred options (including further legal advice and some analysis on individual impacts) before making a final decision.
89. Based on the consultation responses, however, officials recommend allowing landowners to re-apply for the less than 50 hectares exemption in the case of a significant reduction in the second tranche. While this might have administrative complexities, it reduces the impact of any decision on the second tranche on smaller landowners.
90. Landowners taking up this option would need to agree to full cancellation of the second tranche, and to repay the value of the allocation they received in the first tranche.

### Agriculture

91. The consultation document noted that government wished to review, in 2014, the application of surrender obligations to agricultural emissions in 2015. This would be subject to two conditions:
- there are technologies available to reduce those emissions
  - international competitors are taking sufficient action on their emissions in general.
92. To allow the conclusions of the review to be implemented, the consultation document proposed a power that would enable government to defer the entry of agricultural emissions by up to three years. This power would be flexible, and allow for different treatments of different gases or agricultural activities.

### Summary of Analysis

93. Of the 71 submitters with a view on the agricultural deferral power, 42 were opposed to the deferral and 29 supported it.
94. The key issues raised by submitters are presented in the table below.

	Support (29)	Opposed (42)
Submitters	<ul style="list-style-type: none"> <li>• Farmers</li> <li>• Agricultural industry organisations</li> </ul>	<ul style="list-style-type: none"> <li>• Forest owners and associations</li> <li>• Forest managers and processors</li> <li>• Non-Government Organisations</li> </ul>
Key Issues	<ul style="list-style-type: none"> <li>• Impacts on international competitiveness</li> <li>• Lack of practical mitigation technologies</li> <li>• Defer entry until conditions are met</li> </ul>	<ul style="list-style-type: none"> <li>• Equity between sectors</li> <li>• Economic distortions</li> <li>• Environment reasons</li> <li>• Technologies do exist</li> <li>• Continued uncertainty about long term direction and investment</li> </ul>
Points of agreement	<ul style="list-style-type: none"> <li>• Appropriate to differentiate amongst gases and sectors</li> <li>• Criterion used for the decision to defer need further clarification and should be set in legislation</li> </ul>	

95. There was agreement among submitters that it is appropriate to differentiate among gases and sectors. This discretionary power enables the government to distinguish between where mitigation is practical, which will be in New Zealand's best interest, and where no action is practical.
96. Many supporters and those opposed said that the criteria were "vague" and open to interpretation. Broad criteria provide the government flexibility to respond to any unforeseen changes over the next two years. Officials agree that the criteria should be set in legislation in line with the Cabinet's in-principle decision.
97. A number of submitters who supported the deferral believe that a 3-year deferral is not long enough, and that agriculture should not enter the ETS until the conditions proposed in the consultation document are met, or not at all.
98. If the entry date of agriculture into the ETS was deferred for up to five years, there would be a fiscal cost during the forecast period arising from a reduction in units surrendered. The fiscal cost is estimated to be \$37.9m across 2014/15 and 2015/16 at a carbon price of \$6.35 [also noted in MfE Briefing 12-B-00624]. This rises to \$36.4m in the financial year ending 30 June 2020.

Financial Year	2014/2015	2015/2016	2016/2017	2017/2018	2018/2019	2019/2020
Total agricultural participants net liability (\$ millions)	12.86	25.02	27.84	30.7	33.51	36.36

99. Ministers may want to consider amending the original recommendation in principle, that was to provide for a maximum deferral of three years, to extend the time frame to allow a deferral for up to five years (i.e. to 2020).

100. The Minister for Climate Change Issues will be obliged to make a statutory decision to either use or not use the deferral power, having regard to the matters in the empowering provision. The consultation indicates a split in opinions among agriculture and other sectors, and highlights the risk of a legal challenge by way of application for judicial review.
101. Submitters raised others matters, outside of the consultation, including supporting a farm-level point of obligation and the need for incentives to reduce emissions similar to the Carbon Farming Initiative in Australia.

#### *Summary of Recommendations*

102. On balance, based on the issues raised in consultation and analysis, officials recommend introducing a power to allow deferral of surrender obligations for agricultural emission for a specified period, subject to a review in 2014.
103. Officials seek your view on whether you wish the length of deferral under the power to be:
- Up to 3 years (as per the previous in principle decision)
  - Up to 5 years.

#### **Other issues**

104. The other proposals in the consultation document were:
- Providing for a power to extend the fixed price option beyond 2015 and align it with any price ceiling in Australia should linking with the Australian Carbon Pricing Mechanism occur.
  - Removing the obligation under current ETS settings to 'back' all NZUs with an international unit.
  - Extending the ban on the export of NZUs from non-forestry sectors, whilst the fixed price option remains in place.
  - Aligning the ETS with international greenhouse gas accounting standards, by adopting the latest, internationally accepted global warming potentials.

#### *Overview of Submissions*

105. A majority of submitters who commented on the proposed extension of the fixed price option beyond 2015 agreed with the proposal to provide for an extension of this option to allow linking to occur, provided this would be of benefit to New Zealand. The central concerns related to the impact of the extension, and linking more generally, on carbon market liquidity and the ability for domestic unit holders to sell units overseas.
106. A majority of those who commented on the proposed removal of the NZU backing obligation disagreed with the proposal. The main reason for the opposition to the proposal was the perception that ETS forestry participants would no longer be able to sell units overseas and as a result no longer get the best price for their carbon sequestration. The other reason for opposition to the proposal was the opinion that removing backing would damage the environmental integrity of the scheme, with one submitter comparing removing backing to printing money.
107. A majority of submitters who commented on the proposal to extend the ban on exports from non-forest sectors supported it. Those who supported the proposal noted that it benefited the forestry sector and would protect emitters and government in the event that the international

carbon price exceeds the \$25 fixed price. The submitter disagreeing with the proposal said that holders of NZUs should be able to exploit market opportunities for their assets.

108. There was no strong majority either way on the proposal to adopt the most up to date Global Warming Potentials into the ETS. Arguments from those that supported the proposal included the need to adopt consistent international rules and common standards (e.g. to facilitate linking with other trading schemes). Other submitters were concerned about the additional ETS cost the new GWPs would impose on certain activities.

### *Summary of analysis*

109. A majority of submitters did not raise strong concerns with the proposal to provide for a power to extend the price cap to enable linking with Australia, or to extend the ban on exports from non-forest sectors. Officials consider that the policy justification for these proposals remains valid.
110. However, we concur with submitters that linking with Australia (and, therefore, the use of the power to extend the price cap) should be subject to a national interest analysis. One of the concerns raised was the concern that the power provided for an open-ended extension of the price cap. [ Withheld under section 5(2)(b) ]
111. Officials note that part of the concern around the removing the requirement to 'back' NZUs stems from a misunderstanding of the impact of such a decision. Removing this requirement would not remove the facility, elsewhere in the Act, for the government to allow NZUs to be swapped for AAUs for export. A decision on whether this facility can be maintained after 2012 (for example, if New Zealand is not part of a Second Kyoto Commitment Period) can be taken separately under existing legislation, subject to a separate decision.
112. With respect to the concerns raised around environmental integrity, officials note that the introduction of auctioning within a cap would bring us into line with the way in which other international trading schemes (the Australian Carbon Pricing Mechanism and EU Emissions Trading Scheme) ensure integrity. Maintaining the backing requirement would raise very significant fiscal costs without adding significantly to integrity, providing auctioning within a cap is introduced.
113. With respect to the updated Global Warming Potentials, officials note that these represent the latest scientific consensus internationally and will continue to ensure the ETS remains aligned with our international reporting and any future international obligations.
114. Concerns raised about the relatively late notice given to sectors just about to incur surrender obligations (notably waste) around increases in obligations arising from the new GWPs are more compelling. However, officials note that, if Ministers adopt the panel's proposed '2 for 1' phase out (see above), the initial impact of the increase GWPs will be mitigated.

### *Summary of recommendations*

115. On balance, based on the issues raised in consultation and analysis, officials recommend that the Cabinet paper confirm previous in principle decision to:
- a. Provide for a power to extend the fixed price option beyond 2015 and align it with any price ceiling in Australia should linking with the Australian Carbon Pricing Mechanism occur.

- b. Remove the obligation under current ETS settings to 'back' all NZUs with an international unit.
  - c. Extend the ban on the export of NZUs from non-forestry sectors, whilst the fixed price option remains in place.
  - d. Align the ETS with international greenhouse gas accounting standards, by adopting the latest, internationally accepted global warming potentials.
116. In the case of the power to extend the fixed price option, officials recommend that a time restriction of up to 3 years be placed on the extension. Any further extension beyond this time restriction would need to be subject to legislative change.

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## Risks and Mitigations

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117. This analysis has been undertaken to tight time horizons. Given the time constraints, officials have focussed on the proposals that were included in the consultation paper, or which have subsequently been raised by Minister Groser's office. We have not sought to address all the other issues raised by stakeholders. As a result, some legitimate issues raised by submitters may have been missed, given the volume of submissions received.
118. [ Withheld under Section 59(2)(h) ]
119. The timetable for completing the next Cabinet paper seeking final policy decisions on ETS amendments is also tight. If officials do not have a response from you on these recommendations next week, it is likely that Cabinet consideration will be delayed, leading to a similar deferral in the date of legislative introduction.

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## Financial, Regulatory and Legislative Implications

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120. Initial indicative estimates fiscal impact of the recommendations set out in this paper, plus those already agreed separately by Cabinet, are summarised in the table below. The overall fiscal impact of the amendments is likely to depend significantly on decisions made about the second tranche. Fiscal costs are presented at a carbon price of \$6.35. However, as noted elsewhere in this briefing, this is not the price currently used within the Crown accounts.
121. These estimates are indicative only. Further refinement and checking will be needed prior to their inclusion in the final Cabinet paper.

Indicative net fiscal impact of proposed policy changes (\$ million) - \$6.35 Carbon Price

	Increase/(decrease) in operating balance					
	2011/12	2012/13	2013/14	2014/15	2015/16	Total
<b>Fiscal Costs</b>						
Transition phase — gradual phase-out of 2:1 surrender obligation	-	(20.9)	(49.2)	(20)	-	(90.1)
Increasing allocation to coal users by amending the coal factor used in industrial allocation to cover costs associated with fugitive coal seam methane emissions	-	(1.5)	(1.5)	(1.5)	(1.5)	(5.9)
Adopting the Australian approach to industrial allocation for the activity "manufacture of carbon steel from cold ferrous feed"	-	(0.2)	(0.2)	(0.2)	(0.2)	(0.9)
Excluding layer hens from the ETS (not including admin. cost savings)	-	-	-	(0.008)	(0.017)	(0.025)
Extending the Pre-1990 tree weed exemption to 2015/16	-	(0.63)	(1.27)	(1.27)	(1.27)	(4.44)
Emissions Trading Scheme Review implementation contingency	-	(8.745)	(2.096)	(2.213)	(2.180)	(15.233)
<b>Total Fiscal Costs</b>	-	(31.975)	(54.265)	(25.191)	(5.167)	(116.598)
<b>Fiscal Savings</b>						
Updating emissions projections with new Global Warming Potentials		1.203	2.707	5.973	8.940	18.823
<b>Second Tranche Option:</b> savings from full cancellation of second tranche	196.2	-	-	-	-	196.2
<b>Second Tranche Option:</b> savings from a common rate of 11 NZUs per hectare for all land owners	107.3	-	-	-	-	107.3
<b>Second Tranche Option:</b> pro-rata 50% cancellation or offsetting fund based on 50% of second tranche.	98.1					98.1
<b>Second Tranche Option:</b> savings from cancellation of the second tranche only for those who take up offsetting.	1 – 16.5	-	-	-	-	1-16.5
Landowners with <50 ha swapping allocation for exemption (i.e. return of 1st tranche of pre-1990 forest allocation)	-	0.343	0.69	0.343	-	1.376
<b>Total Potential Fiscal Savings</b>	1 – 196.2	1.203 – 1.546	2.707 – 3.397	5.973 – 6.316	8.94	19.823 – 216.399

## Consultation

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122. Treasury, Office of Treaty Settlements and MED officials were informed in the process of developing this paper.

## Next steps

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123. Based on the policy preferences you set out in response to this briefing note, officials will begin drafting a Cabinet paper for decision in late June / early July.

124. Senior Ministers are meeting on 11 June to discuss preferred policy options for inclusion in the June Cabinet paper. It is likely that Ministers will wish to consider a range of options at this meeting. However, your steer on policy preferences following this briefing note will assist officials in preparing material for consideration at this meeting.

## Recommended Actions

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### We recommend that you:

1. **Note** the tight timescales involved in finalising policy agreement to the package of amendments to be made to the ETS if amendments are to be passed this year.
2. **Note** that officials need direction from you by 6 June if a Cabinet paper is to be finalised in time to allow Cabinet consideration in late June/early July.
3. **Note** that your response to this briefing will also assist officials in preparing materials for the meeting of senior Ministers on 11 June; but that Ministers are likely to wish to consider a range of policy options at this meeting.

### Transition Measures and Industrial Allocation

4. **Agree** that the Cabinet paper seeking final policy agreement to ETS amendments confirm the panel's recommended phase out of the '2 for 1', as proposed in the consultation (i.e. 67% obligation in 2013, 83% obligation in 2014).

Yes / No

5. **Note** that officials recommend against simply extending the '2 for 1' to 2020, given the high fiscal costs and significant downside in terms of abatement and afforestation incentives.

6. **Agree** that the Cabinet paper seeking final policy agreement to ETS amendments agree to increase industrial allocation to coal users by amending the coal factor used in industrial allocation to cover costs associated with fugitive coal seam methane emissions.

Yes / No

7. **Agree** that the Cabinet paper seeking final policy agreement to ETS amendments agree to clarify the circumstances in which the discretion to grant industrial allocation to new activities can be used, by adding the purposes of the Act to the list of issues the Minister can consider

Yes / No

8. **Agree** that the Cabinet paper seeking final policy agreement to ETS amendments confirm the continuation of the fixed price option to 2015.

Yes / No



*Supply of NZUS after 2012*

9. **Note** that a common concern, raised by both those who agreed and disagreed with the proposals for powers to introduce auctioning to a cap, and a place a quantitative restriction on international units, was a desire for more certainty about how these powers will be used.

10. **Agree** that the Cabinet paper seeking final policy agreement to ETS amendments seek explicit agreement to introduce a power for auctioning within an overall cap.

**Yes / No**

11. **Agree** that the Cabinet paper seeking final policy agreement to ETS amendments seek agreement that this power is exercised, subject to further work and consultation with effective parties in 2012.

**Yes / No**

12. **Agree** that the Cabinet paper seeking final policy agreement to ETS amendments confirm the mechanisms that will provide forward certainty about how this power will be used: regulations setting out caps in each year for a five year period but subject to amendment with 1 year's notice.

**Yes / No**

13. **Agree** that the Cabinet paper seeking final policy agreement to ETS amendments seek agreement to amend the Act to specify a basis for a maximum possible backstop cap based on maintaining 1990 emissions.

**Yes / No**

14. **Note** that some submitters proposed alternative ways to increase the supply of NZUs instead of auctioning; or ways of reducing demand for NZUs to reduce the scale of the problem.

15. **Agree** that these alternatives are not considered further as auctioning remains an appropriate mechanism to avoid unnecessary purchasing of international units.

**Yes / No**

16. **Note** that auctioning does not raise additional fiscal revenues.

17. **Note** that there is a risk that the cap could be breached if allocation increases substantially in any particular year or if an under-allocation occurs due to an error which is subsequently corrected (i.e. after the auction for that year have concluded).

18. **Agree** that the Cabinet paper seeking final policy agreement to ETS amendments seeks agreement that the intention of the cap is not to restrict the amount of NZUs allocated, and instead only limits the number of NZUs available for auction.

**Yes / No**

19. **Agree** that the Cabinet paper seeks final agreement to all of its previous in principle decisions in relation to auctioning with the following changes in order to clarify these previous decisions:

- the cap should relate to all NZUs auctioned and allocated, but would exclude NZUs issued in general, or transferred for any other reason (such as removal activities)
- the list of matters the Minister must have regard to when determining 'the amount of NZUs to be auctioned and the overall cap' should only relate to 'the overall cap'
- the list of matters the Minister must have regard to when determining the overall cap should include the emissions covered by the ETS and other ETS design settings

- the regulation making procedures (including consultation) set out in s30(H) should apply to regulations introducing auctioning and any regulations setting a cap.

Yes / No

20. **Agree** that the Cabinet paper seeking final policy agreement to ETS amendments notes that further consultation will commence on the detailed auction design settings (consistent with a previous decision made by Cabinet).

Yes / No

21. **Agree** that the Cabinet paper seeking final policy agreement to ETS amendments seeks agreement not to introduce a restriction on international units in the context of auctioning and this will not form part of the consultation on the detailed auction design settings.

Yes / No

#### *Offsetting*

22. **Note** that allowing existing post-1989 forests and natural regeneration of indigenous species to be offset is not consistent with international rules and is not recommended.

23. **Note** that further advice will be provided on the feasibility of allowing pre-1990 forest land harvested in CP1 to be eligible for offsetting prior to the meeting with your colleagues on the 11 June.

24. **Note** that officials are currently working on more detailed implementation issues of offsetting and that comments made through the consultation will be considered then.

25. **Agree** that offsetting policy will remain in the CCRA legislation while the international forestry rules allow the Flexible Land Use rule.

Yes / No

26. **Agree** that the application of the 9-year rule for offsetting will be to estimate the carbon equivalency requirements.

Yes / No

27. **Note** the issues raised by the Waikato Regional Council in relation to the impacts on the region that will be caused from land use intensification from the pre-1990 forestry offsetting policy.

28. **Discuss** with officials whether further analysis/work is required in the Waikato Regional Council case?

Yes / No

#### *Second Tranche of Pre-1990 Forest Allocation*

29. **Note** that a vast majority of submitters did not support an adjustment to the level of compensation in light of the introduction of offsetting.

30. **Note** that if Government were to adjust the allocation, then cancelling the second tranche only for those who take up offsetting was strongly preferred by submitters.

31. **Note** that concerns were raised about the link between offsetting and the second tranche and that these included the belief that offsetting does not address the impact on land values, and that offsetting has limited value either because land is already in the best use or because participants will not be able to offset because of the financial or other constraints.

32. **Note** a number of submitters raised the potential impacts if some or all of the second tranche is cancelled, including financial and property rights impacts.

33. **Note** that submitters were concerned that changing the allocation would disincentivise investment and re-investment in forestry, and damage the Government's relationship with the sector.

34. **Note** that Iwi have raised a number of concerns around partial or full cancellation these included:

- The potential impacts on treaty settlement deeds
- The disproportionate impacts on Māori and therefore on the Government's relationship with Iwi
- Limited ability to take up offsetting (noting similar to issues to the general response although Māori may have some unique issues re: land ownership).

35. Withheld under sections 59(2)(g)(i) and 59(2)(h)

36. **Note** that officials considered the following options for adjusting the second tranche.

Option	Fiscal impact (\$ Million) <sup>5</sup>
A. Cancel all of the 2nd Tranche	\$196.2
B1. Partial cancellation: pro-rata 50% of the second tranche to all forest owners	\$98.1
B.2. Partial compensation: flat amount of compensation e.g. 11 or 12 units to all	11 units = \$107.3 12 units = \$98.1
B.3. Cancel all of the 2 <sup>nd</sup> Tranche but establish a offsetting support fund with % of the units (eg 50%)	\$98.1
B.4. Cancel all of the 2nd Tranche and create a case-by-case compensation fund	TBC
C. Cancel for all owners who take up offsetting (they return NZUs they were allocated when they deforest).	\$1.0 – \$16.5

37. Withheld under sections 59(2)(g)(i) and 59(2)(h)

38. **Indicate** your preferred option/s (outlined above) to adjusting the second tranche

39. **Direct** officials to provide further advice on your preferred option/s (including further legal advice some analysis on individual impacts) by 11 June

Yes / No

<sup>5</sup> At a carbon price of \$6.35. Note that all savings will be in the 12/13 financial year, except option c where there fiscal savings may be spread across a number of years depending on when/if offsetting is taken up by participants

40. **Agree** that, if Cabinet agrees to a full or partial cancellation of the second tranche, to allow landowners to re-apply for the less than 50 hectares exemption, on the basis that, in taking up this option, they would need to agree to full cancellation of the second tranche, and to repay the value of the allocation they received in the first tranche.

Yes / No

*Agriculture*

41. **Agree** that the Cabinet paper confirm the previous in principle decision to introduce a power to allow deferral of surrender obligations for agricultural emissions; subject to a review in 2014.

Yes / No

42. **Indicate** whether you wish the length of deferral under the power to be:

a. Up to 3 years (as per the previous in principle decision).

Yes / No

b. Up to 5 years.

Yes / No

*Other Issues*

43. **Agree** that the Cabinet paper confirm the previous in principle decision to:

- Provide for a power to extend the fixed price option beyond 2015 and align it with any price ceiling in Australia should linking with the Australian Carbon Pricing Mechanism occur.
- Remove the obligation under current ETS settings to 'back' all NZUs with an international unit.
- Extend the ban on the export of NZUs from non-forestry sectors, whilst the fixed price option remains in place.
- Align the ETS with international greenhouse gas accounting standards, by adopting the latest, internationally accepted global warming potentials.

Yes / No

44. **Agree** that, in the case of the power to extend the fixed price option, Cabinet be asked to agree a time restriction of up to 3 years be placed on the extension.

Yes / No

45. **Note** that an initial indicative estimate of the total fiscal costs raised by the recommendations above and decisions already made by Cabinet is around \$117m over the forecast period to 2015/16, at a carbon price of \$6.35.

46. **Note** that an initial indicative estimate of the fiscal savings raised by the recommendations above and decisions already made by Cabinet is \$20m to \$216m over the forecast period to 2015/16, at a carbon price of \$6.35, depending on decisions made on the second tranche of pre-1990 forest allocation.

47. **Note** that \$6.35 is not the carbon price used in the current Crown accounts. If the valuation used in the current accounts (\$10.47) were used, the costs would rise to around \$193m and the savings would rise to around \$33m to around \$356m.

Stuart Calman  
Director, Climate and Risk  
**Ministry for the Environment**

Date

Mike Jebson  
Director, Resource Policy  
**Ministry for Primary Industries**

Date

Hon Simon Bridges  
**Acting Minister for Climate Change Issues**

Date

Hon Nathan Guy  
**Acting Minister of Agriculture and Forestry**

Date

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