



Updating the New Zealand Emissions Trading Scheme: A consultation document

New Zealand Government



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Foreword



The New Zealand Emissions Trading Scheme (ETS) is the most cost-effective and efficient way New Zealand can do its fair share on the global issue of climate change.

As a signatory to the Kyoto Protocol, New Zealand has an obligation to reduce its emissions to 1990 levels for the period 2008 to 2012 or pay the difference. Following the introduction of the ETS, New Zealand is well on its way to meeting this obligation.

The Government remains committed to being part of an international solution on climate change. It is also conscious of the challenging economic conditions New Zealanders, households and businesses face. The key is striking a balance between these two imperatives.

To ensure the ETS remains fit for purpose, the Government has committed to five-yearly statutory reviews to refine the ETS over time. The first review was completed last year. An independent panel of experts reviewed the scheme, consulted widely and made a number of detailed recommendations. This includes proposals to continue to moderate the scheme's implementation in the short term.

The ETS also needs to be updated to reflect developments on the international front. This includes the negotiation of better rules for the forestry sector at the 2011 UN climate change summit in Durban as well as the fact there will be a period of uncertainty while a new comprehensive agreement on climate change is developed.

This document explains the key changes the Government is proposing to make to the scheme, taking into account the Panel's recommendations, developments on the international front and commitments the Government has previously made.

The Government believes the proposed amendments strike a fine balance of doing our fair share while ensuring the ETS doesn't impact unreasonably on New Zealand's businesses and households.

It is in all our interests that the scheme is fit for purpose and delivering in New Zealand's long-term benefit.

Hon Tim Groser
Minister for Climate Change Issues



The New Zealand Emissions Trading Scheme

The New Zealand Emissions Trading Scheme

The ETS is New Zealand's primary tool to reduce its greenhouse gas emissions. The scheme puts a price on emissions from sectors like industry, transport and electricity, and provides New Zealand Units (NZUs) for eligible forests that absorb emissions. In this way, the ETS creates a price on emissions and a market for reducing them.

In 2009, the Government amended the ETS in order to moderate its impact during the global economic downturn. The principal amendment was the inclusion of a transition phase for the first few years of the scheme. This included allowing participants, other than those in the forestry sector, to surrender one NZU for two tonnes of CO₂-equivalent greenhouse gases (carbon), and allowing all participants the option of meeting their obligations at a fixed price of \$25 per NZU. The Government is proposing to continue with a moderated approach.

Impact of the ETS to date

In July 2011, the Government published the first annual report on the operation of the ETS. It showed that, whilst it is still early days, there is already evidence the scheme is having positive impacts on investment decisions, including in forestry.

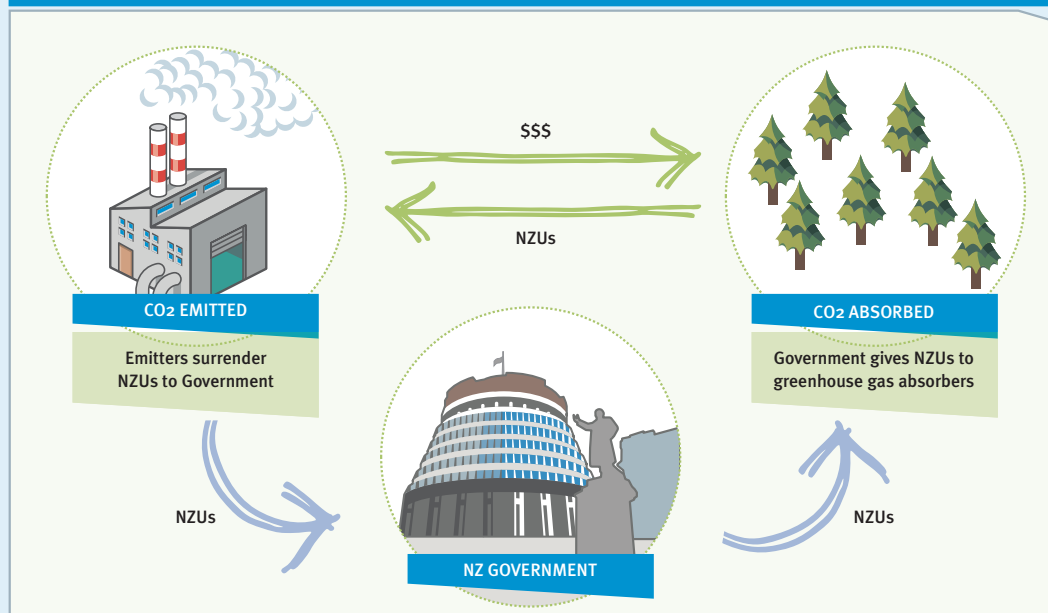
In the forestry sector, the ETS has created a disincentive to deforest, resulting in a change in the deforestation trends in New Zealand. Since 2008, new forest plantings (afforestation) have increased each year, with 12,000 hectares estimated for 2011.

The Government's transitional measures and the low carbon price in recent months have meant the impacts of the ETS for the majority of businesses and households have been low.

The ETS has also contributed to a 12-year high in renewable generation as generators choose to maximise the use of generous rainfall. In 2010/11, we experienced a fivefold increase in the new renewable energy capacity consented, as compared to the decade pre-ETS when most growth was fossil-fuelled.

We now need to refine the ETS to ensure it operates as efficiently as possible and helps New Zealand do its fair share globally on climate change at the least cost to our businesses and households.

→ The basic concept of the ETS





The 2011 Review, international situation and proposed changes

The 2011 Review of the ETS

In 2011, an independent panel (the Panel) chaired by Hon David Caygill, reviewed the ETS to consider how the scheme should evolve over the next five years. The Panel consulted widely, receiving more than 150 submissions from the public, businesses and NGOs.

The Panel recommended that the Government provide for a gradual transition to full obligations in the short term, but give businesses certainty about when they will face the full cost of their emissions. It also advised the Government to change aspects of how forestry is treated in the scheme, especially in regard to pre-1990 forests.

The scheme also needs to reflect developments on the international front. This includes the actions others are taking on climate change, the negotiation of better rules for forests at the recent Durban summit and the fact we are now entering a period of uncertainty while a new comprehensive agreement on climate change is negotiated to take effect in 2020.

This document explains the key changes the Government is proposing to make to the scheme, taking into account the Panel's recommendations, developments on the international front and commitments the Government has previously made.

The Government's objectives for the ETS

The Government has reconfirmed the objectives of the ETS:

- help New Zealand to deliver its “fair share” of international action to reduce emissions, including meeting any international obligations
- deliver emission reductions in the most cost-effective manner
- support efforts to maximise the long-term resilience of the New Zealand economy at least cost.

These objectives will continue to guide the implementation of any changes to the ETS, including those outlined in this document.

The Government's proposed changes

The following are the key changes as set out in this document.

- Phase out the ‘transition measures’ more gradually from 2013 to 2015 by accepting the Panel's recommendation to phase out the ‘one for two’ measure in three equal steps.
- Maintain the \$25 fixed price option until at least 2015 rather than accepting the Panel's recommendation to increase the fixed price by \$5 each year.
- Introduce more explicit powers to enable auctioning of NZUs within an overall cap subject to further consultation on the detailed settings.
- Provide a power for appropriate quantitative restrictions on the use of international units subject to further consultation on details.
- Provide more flexibility to convert land to its highest value use by allowing for the ‘offsetting’ of deforestation on pre-1990 forest land, and consistent with the international flexible land-use rules agreed in Durban.
- In light of the introduction of pre-1990 forest ‘offsetting’, which will significantly reduce deforestation liabilities under the ETS, review the number of compensatory NZUs provided to pre-1990 forest landowners.
- Provide for a power to delay the entry of emissions from animal livestock and fertiliser use for up to three years if certain criteria are not met, following a review in 2014.
- Provide for a power to extend, if necessary, the fixed price option beyond 2015 and align it with any price ceiling in Australia if we link with the Australian scheme.



Transition phase

The Government agrees with the Panel's view that there is a strong case to phase out the 'transition measures' more gradually. Currently, these measures are due to expire on 31 December 2012. The economy is still in the process of recovery and the details of a new comprehensive global climate change agreement are still uncertain.

The Government acknowledges that businesses need certainty about when they will face full obligations so they have clear incentives to invest in measures that will ensure emissions reductions in the long term.

However, while many of our major trading partners are in the early stages of developing their climate change policies, the Government wants to provide a clear signal to businesses to inform their investment decisions.

The Government therefore proposes to gradually phase out the transition measures it put in place in 2009.

The Government also intends these proposed changes to the transition measures should cover any new sectors facing a surrender obligation from 1 January 2013.

'One for two' surrender obligation

Currently, ETS participants, other than those in the forestry sector, do not face a full obligation under the scheme and are required to surrender one NZU for every two tonnes of carbon emitted. The Government proposes to accept the Panel's recommendation to phase out the 'one for two' surrender obligation in three steps to reduce the impact of the scheme on businesses and households.

This means the level of obligation will rise in three equal steps from 2013, reaching a 'one-for-one' obligation in 2015 and businesses will have certainty they will face a full obligation in 2015.

Fixed price option

In 2009, the Government put in place a fixed price option for business of \$25 per tonne of carbon emitted to protect against price volatility. The Panel recommended this should increase by \$5 per annum from 2013.

However, in an uncertain international situation, the Government considers it is appropriate to maintain the fixed price at a constant rate of \$25 until at least 2015.



*Sparks fly during steelmaking at Glenbrook Steel Mill.
Photo NZ*



Traffic on Auckland motorway



Supply of NZUs after 2012

The situation

New Zealand's ETS is linked to international carbon markets. ETS participants can buy eligible international units to meet their obligations and post-1989 forest owners or pre-1990 forest landowners can sell their units on the international market.

However, the current design of the ETS provides participants with limited access to NZUs and they are required to purchase international units in order to meet their surrender obligations under the ETS. This presents a real risk that New Zealand will end up holding more international units than it requires to meet its international obligations.

With the uncertainty regarding future international agreements, these surplus units may have no market value. This would result in an unnecessary flow of funds offshore which may have an adverse impact on the economy.

Other trading schemes, such as that in Europe from 2013 and the planned Australian Carbon Pricing Mechanism from 2015, plan to manage their level of purchasing of international units by selling additional domestic units through an auction. These schemes set a cap on the total number of domestic units supplied through auction and free allocation. This cap reflects their national targets, thus ensuring that overseas purchasing is no more than the level needed to meet their international commitments.

Cap and auction

The Government intends to introduce a mechanism through legislation that will allow the Minister for Climate Change Issues to auction NZUs. The number of NZUs auctioned, combined with the NZUs allocated to trade-exposed, emissions-intensive businesses, would not exceed the agreed target level of emissions in any one year.

Auctioning NZUs would not raise revenue for the Government as each additional NZU sold would mean one less international unit of equal value would be surrendered to the Government to meet participants' obligations. However, auctioning would ensure the supply of NZUs to participants is consistent with New Zealand's targets, avoiding excessive purchasing of international units and unnecessary offshore cash flows.

The use of this auctioning power, including the level of the cap and detailed auction settings, would be subject

to a further consultation before implementation.

The Government proposes to amend the legislation to allow these matters to be set out in regulations. The legislation would state clearly the matters the Minister for Climate Change Issues must have regard to when setting the cap, such as the level of any domestic or international target to reduce emissions. It would also set a process for amending the regulations.

Any auction would likely be introduced in 2014 or 2015, with a pilot auction held in advance.

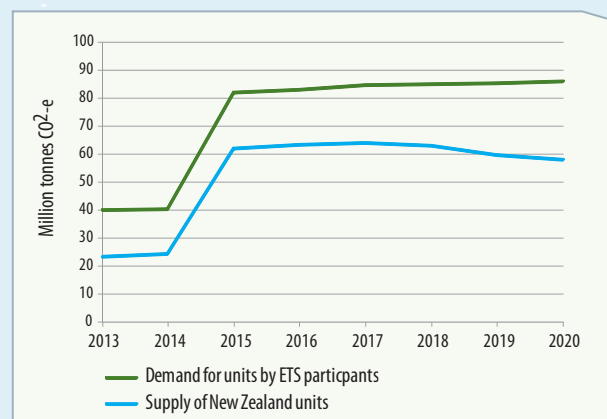
Restriction on international units

Consistent with plans in the European and Australian schemes mentioned above, the Government also intends to introduce a mechanism that would allow the Minister for Climate Change Issues to place a restriction on the proportion of international units an ETS participant can surrender to meet its ETS obligations. Such a restriction would encourage participants to buy NZUs at the auction rather than international units, helping to ensure that there was no excessive overseas purchasing.

As with auctioning, the proposed use of this mechanism, including the level of any restriction, would be subject to further consultation.

The figure below shows the expected level of demand for units by ETS participants based on their surrender obligations and the expected level of supply of NZUs by the Government. The difference is the amount of overseas units ETS participants would need to buy in order to meet their surrender obligations.

→ The projected supply & demand for units in the ETS, 2013–2020



Notes: These projections are based on the following key assumptions: emissions projections based on a \$25 carbon price, the ETS as currently legislated and the global warming potentials from the IPCC's Fourth Assessment Report, and that all NZUs supplied are surrendered in the same year.

Source: Ministry for the Environment



Forestry

Pre-1990 forestry offsetting

Foresters play an integral part in the ETS and that is why the Government has fought hard to influence the international Kyoto rules to ensure they reflect the environmental benefits the forestry sector provides. Pre-1990 forest landowners have liabilities for the emissions if the trees are permanently cleared from their land. This means, in some cases, it may be uneconomic for this land to be put to better uses, for example farming.

At the 2011 UN climate change summit in Durban, the Government agreed to a forestry rule change under the Kyoto Protocol introducing what is known as 'offsetting' as an option for pre-1990 plantation forest landowners.

The Government intends to introduce this rule in a way that is consistent with the international flexible land-use (FLU) accounting rules agreed for the Kyoto Protocol second commitment period in Durban.

This means that from 1 January 2013, forestry offsetting will be an option for pre-1990 plantation forest landowners. It will remove the deforestation liability under the ETS and therefore the requirement for a forest landowner to surrender units when they deforest, provided they establish an equivalent new forest on eligible land elsewhere.

The new forest must be established by direct planting (not natural regeneration) on land that would be eligible as post-1989 land, and will need to be of at least the same area and achieve the same carbon stock as the original cleared forest, within the usual rotation length of the cleared forest.

Review of compensation to pre-1990 forest landowners

Currently, the Government is providing some compensation to pre-1990 forest landowners through an allocation of NZUs that recognises the loss in land value arising from deforestation liabilities originally imposed under the ETS. This level of compensation was decided at a time when full deforestation liabilities were expected to apply.

A total of either 60, 39 or 18 NZUs per hectare were allocated in two tranches to eligible landowners, depending on when the pre-1990 forest land was acquired. The first tranche of allocation represented



Young radiata pine forest, North Island

about 38 per cent of the total allocation and is due to be transferred to eligible landowners before the end of 2012.

The second tranche of the allocation which is either 37, 24 or 11 NZUs per hectare, was due to be transferred to eligible landowners in 2013. Ministers have previously signalled the second tranche would be subject to a review if deforestation liabilities changed.

Offsetting significantly reduces the cost of pre-1990 forest land deforestation and therefore the impacts on land value that arise, as landowners are no longer required to surrender units to cover emissions when their land is deforested. For example, the costs of converting a hectare of 28-year-old radiata pine with offsetting could be reduced by 50–75 per cent compared to the ETS deforestation charge, at a carbon price of \$10 to \$25 respectively and assuming the land on which the equivalent forest was planted had to be purchased.

The Government acknowledges the proposed changes may raise particular concerns for iwi/Māori, particularly given their involvement in the forestry and primary sectors. The Government is holding a number of hui after Easter to engage and gather feedback on the proposed changes. Details of the hui and opportunities for iwi/Māori engagement are available on www.climatechange.govt.nz/ets

Given the significantly reduced deforestation liabilities and resulting impacts on land value by offsetting for those who wish to convert land use, the Government is consulting on the extent to which the level of compensation should be adjusted to take account of the reduced deforestation costs.



Options for changing the second tranche of pre-1990 forest allocation

1. A full removal of the second tranche of pre-1990 forestry compensation for all eligible landowners.

Pre-1990 forestry offsetting significantly reduces deforestation costs by 50–75 per cent (depending on the carbon price assumed) for those who wish to convert to another land use. Cancellation of the second tranche in full would reduce the overall level of compensation to forest landowners by 62 per cent.

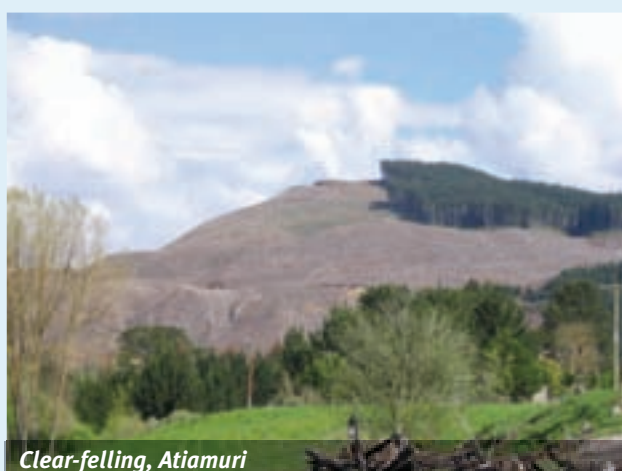
2. A reduction of the second tranche of pre-1990 forestry compensation for all eligible landowners.

The Government could instead allocate a part of the second tranche of compensation to forest landowners. This could be done in a number of ways, for example:

- allocate all landowners 11 NZUs per hectare under the second tranche
- reduce all allocations in the second tranche on a pro rata basis by an appropriate percentage, whilst retaining the current differentiation between categories of landowner.

3. Only remove the second tranche of pre-1990 forestry compensation for those landowners who take up offsetting.

This option would mean landowners, except those taking up offsetting, would receive the second tranche of compensation and does not recognise the original reason for the compensation.



Clear-felling, Atiamuri

Treatment of owners of pre-1990 forests of less than 50 hectares

If the Government decides to adopt one of the options, to either reduce or remove the second tranche, then it intends to allow landowners who are eligible for the less than 50-hectares exemption but who have registered in the ETS and received an allocation, to have the option to revisit their choice. This change from an allocation to an exemption will be accepted in exchange for forfeiting the second tranche of allocation and returning the units issued in the first tranche.

Other forestry sector considerations

The Government is also considering a number of operational changes to the forestry settings of the ETS to ensure its ongoing efficiency and effectiveness for participants. Details of these proposed changes will be announced later in the year.



Replanting, Mangakino



Agriculture

The Panel recommended that emissions from animal livestock and fertiliser use should enter the ETS as currently planned in 2015. The Panel further recommended a transitional period, similar to that provided for other participants, be provided to the agriculture sector.

However, as previously indicated, the Government supports the entry of agricultural emissions into the scheme only under two conditions:

- there are technologies available to reduce these emissions
- international competitors are taking sufficient action on their emissions in general.

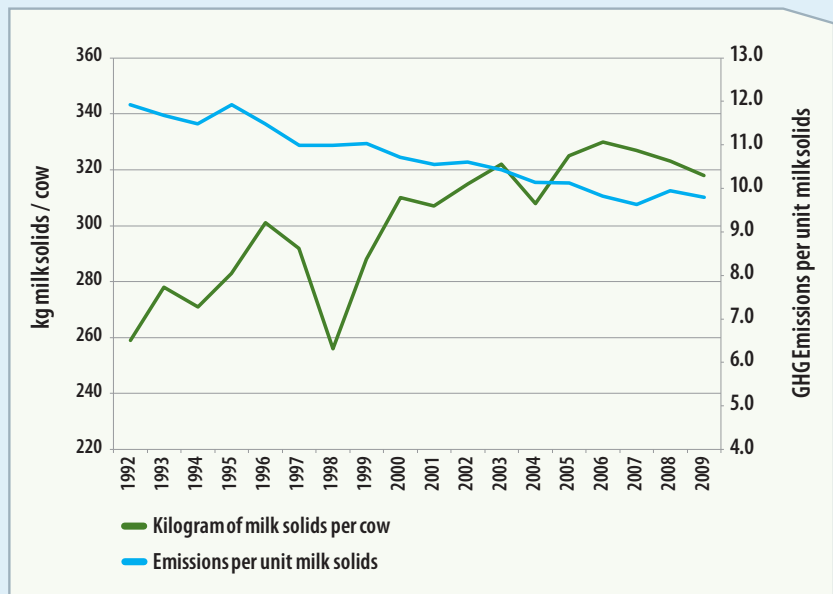
Consistent with this position, the Government proposes to undertake a review, to report in 2014, on whether these conditions have been met.

To enable the results of this review to be implemented, the Government proposes to include the power to defer the entry of these agricultural gases by up to three years. As it is possible that different gases or agricultural activities could have varying levels of opportunities to reduce emissions, it will set up this power to enable the Government to defer obligations for some or all activities.



A herd of mixed breeding cows grazing on a coastal Northland farm

→ Emissions per unit of milk solids production



Overall, milk production per cow has increased on average 16 per cent in New Zealand since 1992. This has resulted in a 10 per cent decrease in greenhouse gas emissions per kilogram of milk solids.



Other amendments

There are several other amendments the Government is seeking to make.

Linking with Australia

Linking the ETS to international carbon markets helps ensure the scheme can deliver emissions reductions at the lowest cost. The New Zealand and Australian Governments have stated their desire that both countries' respective schemes are able to be linked.

The Government therefore wants to make changes now to ensure our ETS can connect with the Australian scheme when that scheme moves from fixed price to full trading in 2015. This may mean extending our fixed price option beyond 2015 if needed to align with any price ceiling in Australia. The use of this power would be subject to a number of conditions.

Removal of obligation to “back” NZUs

Under existing ETS settings, the Government is required to ‘back’ all NZUs it issues with an equivalent amount of approved international units. This requirement was put in place to ensure the Government did not over-allocate units during the first Kyoto commitment period. With the proposed introduction of auctioning within an overall cap on NZUs issued, this provision is no longer needed. Therefore, the Government intends to remove this requirement.

Extending the ban on the export of NZUs from non-forestry sectors

Given that the Government intends to extend the transition phase measures, including a \$25/tonne fixed price option, it also intends to extend the ban on the export of NZUs from non-forestry sectors whilst the fixed price option remains in place and the ETS is not directly linked to another emissions trading scheme.

Aligning the ETS with international greenhouse gas accounting standards

At the recent Durban conference it was agreed that countries should use an updated method for measuring greenhouse gas emissions, based on the global warming potentials (GWPs) from the Intergovernmental Panel on Climate Change's Fourth Assessment Report. This means that from 2013, the value of methane relative to carbon dioxide will increase from 21 to 25, while the relative value of nitrous oxide will decrease from 310 to 298. The GWPs for synthetic greenhouse gases will also be updated.

This has implications for the ETS as without updating the legislation, the scheme will have to continue using the outdated methodology. Therefore, the Government proposes to replace the old methodology with the updated international rules.

Future considerations

This consultation document outlines the first set of proposed amendments the Government intends to make to the ETS. Subsequent Cabinet decisions will deal with further Panel recommendations concerning synthetic greenhouse gases (which will be subject to further consultation), the waste sector and other forestry changes. Decisions will also be taken on the Electricity Allocation Factor and a number of technical amendments.



Consultation

Consultation questions

The Government wishes to focus its consultation on the following four questions.

General

1. What do you think of the overall package of amendments the Government is proposing to make to the ETS as outlined in this document?

Second tranche of compensation

2. Should the Government adjust the level of compensation to pre-1990 forest landowners in light of the introduction of offsetting?
3. If the Government was to adjust the level of compensation, which of the three options for adjusting the second tranche of allocation, as outlined in this document, do you prefer and why?
 - a. a full removal of the second tranche of pre-1990 compensation for all eligible landowners
 - b. a reduction of the second tranche of pre-1990 compensation for all eligible landowners
 - c. a removal of the second tranche of pre-1990 compensation only for those landowners who take up offsetting.
4. If a reduction of the second tranche is your preferred option (option 3b) what do you consider is the most desirable way to do this and why?

Find out more

The Ministry for the Environment and the Ministry of Agriculture and Forestry will be holding a series of nationwide hui and meetings for foresters, forest landowners, iwi, businesses and other interested parties where you can hear more on the proposed changes. Details of these meetings are available at www.climatechange.govt.nz/ets.

Phone: 0800 CLIMATE (254 628)

Have your say

Please send your submission by email to:
etsconsultation@climatechange.govt.nz

If you are unable to email your submission then please post it to:

ETS Review Consultation
Ministry for the Environment
PO Box 10362
Wellington 6143

The closing date for submissions is 5pm Friday 11 May 2012.

About submissions

The Ministry for the Environment may publish all or part of any written submission on the Government's climate change website. We will consider you to have consented to such publishing by making a submission, unless you clearly specify otherwise in your submission.

The content of submissions is subject to the Official Information Act 1982. Copies of submissions sent to us will normally be released in response to an Official Information Act request from a member of the public. If you object to the release of any information contained in your submission, please clearly state this in your submission, including which part(s) you consider should be withheld, together with the reason(s) for withholding the information. We will take into account all such objections when responding to requests for copies of, and information on, submissions to this document.

If you do not wish your name and any identifying details in your submission to be released in response to a request, please clearly state this in your submission. At your request, we will make your submission anonymous before it is published on the climate change website. However, please note that the Ministry for the Environment will not be able to withhold any information if doing so would contravene the requirements of the Official Information Act.