Coversheet: NZ ETS tranche two: Improving compliance and penalties

Advising agencies	Ministry for the Environment
Decision sought	Final policy decision to be taken by Cabinet
Proposing Ministers	Hon James Shaw

Section A: Summary: Problem and Proposed Approach

Problem Definition

What problem or opportunity does this proposal seek to address? Why is Government intervention required?

The compliance and penalties regime (penalty regime) in the New Zealand Emissions Trading Scheme (NZ ETS) is not fit for purpose and requires amendment. An Impact Statement finalised in December 2018 outlined the proposal to introduce an infringement offence regime for low-level offending against the rules of the NZ ETS. This Impact Statement focuses on improving the compliance regime to address:

1) problems with the $30 per unit excess emissions penalty that is currently applied where participants incorrectly report their emissions resulting in a liability or fail to surrender or repay units
2) an opportunity to further strengthen the transparency of the NZ ETS through greater disclosure of non-compliance.

Problems with the existing excess emissions penalty

The problems are that:

3) the $30 value is not suitable to deter non-compliance given that the New Zealand carbon price has fluctuated, and is currently higher than the price at the establishment of the NZ ETS in 2008, and is expected to rise further
4) the design of the penalty is imposing a high administrative and cost burden on the regulator as regulators often use their discretion to substantially reduce penalties through the penalty assessment process
5) the process for applying penalties is challenging to apply consistently and transparently resulting in unpredictable outcomes, uncertainty for NZ ETS participants, and a potential lack of sufficient confidence in the compliance regime
6) The excess emissions penalty is applied the same to errors in reporting and failure to pay units, despite a difference in the severity of these non-compliant behaviours.
7) it is unclear, and untested, whether inaccurate reporting may be currently captured by criminal sanctions available under the CCRA. If it is, this creates a duplication in the penalties which may apply to inaccurate reporting resulting in a liability, creating uncertainty for the regulators and regulated parties
8) the penalty value for non-surrender or repayment of units, is not sufficiently rigorous to enable the NZ ETS to explore linking opportunities with overseas emissions trading schemes which have more stringent penalties and greater publication of non-compliance.

Opportunity to increase transparency of NZ ETS through disclosure of non-compliance

Publication of individual non-compliance information provides an opportunity to:

1) incentivise compliance by identifying particularly non-compliant actors and behaviours
2) contribute to the integrity of the NZ ETS by building an expectation that compliance is the norm
3) ensure penalties, and their application, are easy to understand, predictable, and transparent for participants and the public
4) reduce barriers to linking with other emissions trading schemes in the future by ensuring the penalties and compliance regime is sufficiently robust.

Proposed Approach

How will Government intervention work to bring about the desired change? How is this the best option?

It is proposed to restructure the existing excess emissions penalty into two new penalties, referred to as the reporting penalty and the surrender/repayment penalty. This extends the coverage of the current excess emissions penalty. There will still be a requirement to 'make good' on any units owed (either to or by the Crown). It is also proposed to publish more information on individual non-compliance as outlined in Table 1.

Table 1: Overview of Penalties and Publication

Enforcement tool	Penalty	Publishing level
Surrender/repayment penalty	3 times market price for missing units	Individual's name and offence
Reporting Penalty due to 'not taking reasonable care'	20% x Market Price x Lesser of (a) size of error or (b) corrected total emissions/removals/allocations	Aggregate level
Reporting Penalty due to 'gross carelessness'	40% x Market Price x Lesser of (a) size of error or (b) corrected total	Individual's name and offence
Reporting Penalty due to error 'knowingly made'	100% x Market Price x Lesser of (a) size of error or (b) corrected total	Individual's name and offence
Reporting Penalty resulting in Crown owing units or no liability	$1000	Aggregate level

Surrender/Repayment Penalty

It is proposed that the current excess emissions penalty be replaced by a three-for-one penalty for failures to surrender or repay units. This administrative penalty would be in addition to the participant or recipient meeting their underlying obligation. The penalty level would be based on the same fixed market price as is proposed for the reporting penalty, set by the Ministry for the Environment and updated annually in regulations.

Reporting Penalty, with extended coverage from existing emissions penalty

It is proposed that the current excess emissions penalty be replaced by administrative penalties that would cover inaccurate reporting, regardless of the outcome of the inaccuracy, and have bands of penalty levels aligned to the type of non-compliant behaviour (e.g. a 40% penalty for gross carelessness). Inaccurate reporting that results in an under claim of an

allocation or entitlement as the result of not taking reasonable care would receive a penalty of $1000.

The penalty level would be based on a fixed market price, set by the Ministry for the Environment and updated annually in regulations.

For clarity, this would bring all inaccuracies in reporting into the same reporting penalty in the CCRA. Duplicative penalties for reporting errors would be removed, except to the extent covered by s 133 of the CCRA, which applies where the offence has been committed with intent to deceive and for the purpose of either obtaining any material benefit or avoiding any material detriment. In other words, the reporting penalty will now apply not only to errors that result in a liability, but to all reporting errors, including when an assessment is made by the enforcement agency because a participant fails to provide a return.

Transparency

We propose to publish, at least annually and as soon as practicable beginning in 2021, more serious cases of individual non-compliance. This includes cases where the participant receives a reporting penalty at the level of gross carelessness or knowingly made, and all cases where a participant receives the surrender/repayment penalty.

Published individual cases of non-compliance would include relevant detail relating to the offence including account holder's name, penalty type, amount, date it was due and date it was paid.

The proposed approach is the best option for several reasons:

1) The proposed administrative penalties would be sufficiently stringent to effectively deter non-compliance while being easier to understand, predictable and transparent for participants and the public.
2) The three-for-one penalty multiplier for a failure to surrender or repay units and increased scheme transparency would ensure the penalties and compliance regime is sufficiently robust to allow for international linking.
3) The penalty bands, based on the categories of behaviour and percentage amounts used by the New Zealand Customs Service, and a simplified version of those used by the Inland Revenue Department, would reduce the administrative and cost burden to regulators and provide clarity to participants about the expected consequences of non-compliance.
4) Publication of individual non-compliance can be used to incentivise compliance by identifying particularly non-compliant actors and behaviours.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
Participants Participants will benefit from a clearer and more predictably applied penalty regime.

Regulators

The regulators will benefit from administrative efficiency and will be able to complete more compliance activity. The current penalty regime is resource intensive. They will be able to redirect resource currently required to conduct administrative tasks towards detecting a wider range of non-compliance. There may also be enhanced accuracy in emissions returns, which will give rise to less non-compliance to penalise.

Crown and taxpayers

Increased accuracy in the reporting of emissions covered by the NZ ETS will minimise the Crown's potential liability for distributing units into the market unnecessarily, and will assist the Crown to accurately report on progress towards domestic and international climate change targets.

New Zealand public

New Zealand will benefit in that compliance with the rules of the NZ ETS will be enhanced, improving emissions accounting, and upholding the scheme's integrity. A more robust compliance regime will assist New Zealand to develop linking opportunities with international carbon markets, if and when the Government decides to reopen the NZ ETS to international units. Increased publication of NZ ETS non-compliance provides the public with a greater transparency over the scheme and an ability to make informed decisions about which businesses to support and invest in, as well as New Zealand's progress towards meeting its domestic and international climate change targets.

Where do the costs fall?

Participants

The cost of penalties will be borne by non-compliant NZ ETS participants. Non-compliant participants may experience indirect costs through a reduced social licence to operate as a result of specific publication for some offences.

Regulators

Regulators will continue to bear the cost of administering the NZ ETS penalty regime, using funding from the Crown appropriations. In the short term, regulators will be required to update policies and existing systems to implement the proposed administrative penalties alongside other NZ ETS changes. Any associated funding will be sought through the budget bid process to enable this work.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?

Risk of undermining the voluntary aspects of the NZ ETS

An overly punitive penalty regime could undermine the voluntary aspects of the NZ ETS. For example, this could reduce voluntary participation by post-1989 forest owners, resulting in less new forest establishment than anticipated. Regulators currently manage this risk by substantially reducing penalties through the penalty assessment process. The proposed penalty regime will reduce the discretion available to enforcement organisations, as well as increasing the starting value of penalties where the participant has not surrendered or repaid units by the due date. However, the risk of rigidity in application will be mitigated by the use of a tiered approach, whereby bands of penalties are specified, according to the type of non-compliant behaviour in question.

Risk of increasing the administrative burden
There is also a risk that, rather than reducing enforcement organisations' administrative burden, introducing administrative penalties could increase this burden, as organisations would be required to retrain staff and update their processes for assessing penalties. This is a short lived risk and is integral to any process change. After a short implementation burden, the proposals will be less resource intensive than the status quo.

As penalty values increase, there is a risk that challenges to penalties will also increase. This will be mitigated by publishing the compliance operational guidelines to illustrate the type of behaviour that constitutes non-compliance.

Risk of increasing incentive to do an incorrect return to avoid larger surrender/repay penalty
It is possible that splitting the existing excess emissions penalty into two parts may have the unintended consequence of creating an incentive to submit an incorrect return rather than fail to surrender/repay units. This is because a participant would then only face the reporting penalty and avoid the much larger surrender/repayment penalty. However, this would still cost the participant more than being compliant in the first instance, and it is similar to overseas regimes in which penalties for failure to surrender/repay are at a different and often harsher level than penalties for inaccuracies in audit and verification.

This risk is considered to be low due to the fact that failure to surrender/repay units is uncommon behaviour. Only four participants have faced the excess emissions penalty for failure to surrender since 2010.

Risk of impacting public image of ETS
Publication of non-compliant behaviour could reduce the trust and confidence that the public has in the ETS and the non-compliant participants if it appears that non-compliance is the norm. However, this also serves as a deterrent for participants, which may experience a reduced level of public trust and confidence for a non-compliant account holder. Publication of non-compliance could also increase trust and support in the NZ ETS because it is clear that obligations that are not being met are being enforced by the regulators.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.
The proposals addressed by this full impact statement are consistent with the Government's 'Expectations for the design of regulatory systems' and are reflected in the specific objectives and criteria adopted to assess the options for improving the excess emissions penalty.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
How confident are you of the evidence base?
The proposals contained in this regulatory impact statement have been formulated based on evidence gathered by the regulators (EPA and MPI) over the previous ten years of operation. This evidence and data relating to the application of the existing penalties has been peer reviewed and has a high level of confidence associated with it.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
The Ministry for the Environment and the Treasury Regulatory Quality Team
Quality Assurance Assessment:
*The Panel considers that the RIA **meets** the Quality Assurance criteria*
Reviewer Comments and Recommendations:

Impact Statement: New Zealand Emissions Trading Scheme tranche two-Improving Compliance and Penalties

Section 1: General information

Purpose
The Ministry for the Environment is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing: • final decisions to proceed with a policy change to be taken by or on behalf of Cabinet

Key Limitations or Constraints on Analysis
We are confident with our scoping of the problem, the reliable evidence base, the broad range of options considered, the criteria used to assess the options, and the underlying assumptions and quality of data. *Submitters to NZ ETS consultation provided with limited new penalty options* The Ministry consulted on the proposal to improve the excess emissions penalty and publish cases of non-compliance as part of the broader consultation on improvements to the NZ ETS in 2018. However we did not provide submitters with a suite of options for comparison. The consultation sought feedback on two broad approaches to improve the penalty, rather than a comprehensive list of options, or the specific levels of non-compliance to be published. Had we provided other options for consideration, we may have received more diverse responses. Section 2.5 will provide further details on what was specified in the consultation to show that the final option chosen was in line with these broad approaches.

Responsible Manager (signature and date):

MCoie 27/3/19.

Matthew Cowie

Manager, NZ ETS Policy

Date:

Climate Directorate

Manatū Mō Te Taiao: Ministry for the Environment

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

The New Zealand Emissions Trading Scheme

1. The NZ ETS is the Government's key tool to assist New Zealand in meeting domestic and international emission reduction targets. It was established under the CCRA and is a market-based approach to reducing emissions of greenhouse gases, with just over half of New Zealand's emissions covered by the scheme.
2. The NZ ETS has been designed to reflect New Zealand's unique emissions and economic profile. It was one of the earliest, and most comprehensive, attempts at pricing emissions in the world. The NZ ETS covers all economic sectors and major greenhouse gases, assessing emissions at an 'upstream' point of obligation, and providing free allocation to eligible emissions-intensive, trade-exposed activities, even where those participants do not necessarily face surrender obligations.
3. The NZ ETS differs from other international emissions trading schemes along four key dimensions:
   - The NZ ETS is the only emissions trading scheme that includes compliance obligations for the forestry sector. Forestry changes proposed as part of the Bill to amend the CCRA will, if enacted, incentivise even more small forests to join the scheme.
   - The NZ ETS includes reporting requirements for the agriculture sector.
   - There are a significant number of participants with small emissions profiles, unit entitlements, and surrender obligations.
   - There are both mandatory and voluntary participants.

The changing context of climate change

4. The wider climate change context has changed since the NZ ETS was introduced. Domestically and globally, there is a strengthened response to combatting climate change and reducing greenhouse gas emissions. As a result, the importance of meeting NZ ETS obligations in a timely and accurate manner has increased.

The changing context of the NZ ETS penalty regime

5. Globally, the price of carbon is anticipated to rise, with current forecasting suggesting that carbon prices could rise to $150 per tonne by 2030.
6. Rising prices may be compounded domestically by NZ ETS design changes. The Bill to amend the CCRA will place a cap on emissions and, once implemented, this is likely to increase unit prices.
7. Increasing costs of compliance are anticipated to lead to the following changes in participant behaviour:
   - some participants may decide it is more cost effective to not comply
   - participants may be reluctant to disclose errors for fear of the outcome
   - more participants may challenge penalty decisions taken by enforcement organisations.
8. Without sufficient penalties to deter non-compliant behaviour, or the power to force actions to be taken, participants may engage in non-compliance if they think they will either not be caught, or that a penalty will be less than the cost of complying.
9. The NZ ETS has now been in operation for ten years. The scheme has been through a period of 'bedding in', where enforcement organisations have sought to provide

education and assistance to participants. This is resource-intensive and has kept compliance rates steady.

10. Now, after ten years of operation, behaviour and mistakes that may have been reasonable in a new scheme are increasingly unacceptable. Enforcement organisations should be equipped to deploy more interventionist compliance strategies to target risks to the integrity of the scheme.

Review of the NZ ETS and implications for the penalty regime

11. The 2015/2016 review of the NZ ETS, undertaken in anticipation of the Paris Agreement, found that the current form of the NZ ETS will not be fit-for-purpose for 2020 and beyond. Stage two of the review found that current settings and management of the NZ ETS create significant regulatory uncertainty, and operational and technical issues cause administrative inefficiencies.

12. It is critical to the integrity of the NZ ETS that participants comply with their obligations in the scheme. Proposed operational improvements to the NZ ETS will make it easier for participants to comply with their obligations, whereas proposals related to the penalty regime target when things go wrong.

13. The customer journey diagram below represents the interactions that a participant has with the NZ ETS, from entering through to exiting the scheme. The proposed improvements to the NZ ETS are designed to intervene at different points along the journey. This is in line with the OECD's 'Right from the Start' approach of investing early in the process to achieve better compliance outcomes.

Figure one: The Customer Journey

2.2 What regulatory system, or systems, are already in place?

The current NZ ETS penalty regime

14. The compliance system in the NZ ETS is based on a "self-assessment" methodology, similar to that used in the New Zealand tax system. A tough penalty regime was initially adopted to incentivise compliance. The focus on severe non-compliance balances with a non-interventionist approach to monitoring and verification. This allows participants to decide whether, for example, the costs associated with auditing and review of emissions returns are worthwhile, given the potential severe penalties if they do not meet their obligations. This is in contrast to the compliance regimes of some overseas emissions trading schemes, like the

European Union ETS, where emissions returns must be audited before they are submitted.

15. Responsibilities for monitoring and enforcing compliance with the rules of the NZ ETS sit with the Environmental Protection Authority (EPA). Forestry related matters are delegated to the Ministry for Primary Industries (MPI).

Objectives for the proposal

16. The objectives of the NZ ETS penalty regime fit within the objectives of the overall improvement to the NZ ETS. The primary purpose of the penalty regime is to maintain the integrity of the NZ ETS. Specifically, the objective of this proposal is to improve the NZ ETS penalty regime by:

- increasing incentives for people to take due caution when undertaking their obligations
- deterring non-compliant actions and behaviours
- contributing to the integrity of the ETS, and New Zealand's climate change response, by ensuring the penalty and compliance regime requires people to meet their obligations under the NZ ETS
- ensuring that penalties are applied using a process based on the principles of natural justice that provides for equitable treatment of participants for non-compliant behaviour
- ensuring penalties, and their application, are easy to understand, predictable, and transparent for participants and the public
- ensuring the penalties and compliance regime is sufficiently robust to allow for international linking.

The excess emissions penalty

17. To encourage participants to meet their emissions reporting, surrender, and repayment obligations in the NZ ETS, a civil penalty of $30 per unit was set in the CCRA. This is known as the excess emissions penalty, and exists in addition to the requirement that the participant 'make good' on their underlying obligations. Enforcement organisations have the discretion to reduce the penalty amount by up to 100 percent in certain circumstances.

18. The penalty only applies when participants fail to surrender or repay units by the due date or make a reporting error that results in an increase in the participant's liability.

19. The $30 per unit penalty rate was selected because it was approximately double the expected cost of carbon over the first commitment period of the Kyoto Protocol (expected average emissions cost over this period was $15 per tonne of CO2 equivalent). It was noted at the time that the $30 penalty rate might need to increase if emissions prices rose.

Non-compliance publication

20. Compliance with ETS obligations is currently published in the annual Emissions Trading Scheme Report at an aggregated level within the following categories:

- failed to submit emissions returns
- failed to surrender units
- failed to repay units.

2.3 What is the policy problem or opportunity?

Overarching problems that this proposal seeks to address

There are several interconnected problems with the current compliance regime related to the excess emissions penalty. There is also an opportunity to improve the transparency of the scheme by publishing some non-compliance information. Problems are:

1. the set $30/unit penalty will become less of a deterrence to non-compliance in the future as the carbon price is expected to rise while the penalty remains static.
2. the discretion available for enforcement organisations to reduce the penalty is time-consuming and challenging to apply consistently, imposing an administrative burden on enforcement organisations and creating uncertainty for NZ ETS participants.
3. it is unclear and untested whether inaccurate reporting may be currently captured by criminal sanctions available under the CCRA, potentially creating duplication in application and uncertainty for regulators and interested parties.
4. the current penalties for non-surrender and requirements to disclose non-compliance may not be sufficiently rigorous to explore linking opportunities with international emissions trading schemes in future.

Opportunities exist to:

5. incentivise compliance by building an expectation that compliance is the norm
6. improve public trust in the NZ ETS and participating businesses, through providing an ability to make informed decisions about which participant businesses to support.

Problem 1: the $30 level is not effectively deterring non-compliance

21. The $30 per unit level of the excess emissions penalty is set in legislation. Since it is static it does not align with the current market price for carbon. This means that it may become less of a deterrence to non-compliance when the carbon price rises above current levels.
22. This may become more of an issue with the introduction of auctioning and the replacement of the $25 fixed price option with the cost containment reserve. It could also be overly punitive in the unlikely event that the carbon price drops.

Problem 2: existing discretion to reduce $30 per unit penalty is time consuming and creates uncertainty

23. What follows is a description of what occurs at present when an enforcement organisation becomes aware that a participant has not complied with s 134 of the CCRA and the excess emissions penalty applies.
24. The enforcement organisation undertakes a penalty assessment process to determine whether the $30 excess emissions penalty can be reduced, and what reduction should be applied.
25. The enforcement organisation currently has the discretion to reduce the penalty amount by up to 100 per cent. This broad discretion for reduction means that each decision requires careful justification; a process which takes much longer to exercise than if the discretion were limited.

26. This power to reduce the penalty can be applied when:

- the participant voluntarily discloses their failure to comply, or
- the enforcement organisation is satisfied that the participant formed a view that, while incorrect, was reasonable having regard to the information available at the time.

27. This level of discretion creates uncertainty for participants because it may be unclear to the participant whether the enforcement organisation will consider these grounds met and if it does, to what extent discretion will be applied.

28. Depending on the complexity of the assessment process and enforcement agency capacity, it may take months to advise non-compliant participants of their revised penalty amount. Each assessment must be peer and legally reviewed before approval.

29. In practice, ensuring consistency in reducing penalties has proved challenging for enforcement organisations. For example, the EPA has tended to rely on voluntary disclosure in conducting penalty assessments, whereas MPI has relied on reasonableness grounds. Over 80% of MPI penalty assessments are done on the basis of reasonable error. Most forestry participants do not voluntarily disclose their errors because they are not aware they have made an error in their return.

30. Enforcement organisations have tended to reduce penalties in order to try to create parity between participants and errors. This may create an expectation of leniency over time, whic h could undermine the incentives for compliance that the penalty regime seeks to create.

31. Moreover, the penalty assessment process is administratively burdensome. The number of penalty assessments fluctuates annually, depending on the frequency of non-compliance and the capacity of enforcement organisations.[1] Each penalty assessment may take the enforcement organisation from five to twenty hours to complete, costing enforcement organisations between $34,000 and $170,000 to administer annually.[2]

32. The high administrative burden of these penalty assessments reduces the capacity for the enforcement organisations to undertake more strategic compliance tasks, and undertake a wider amount of compliance enforcement with current resources.

Problem 3: unclear application of penalties and sanctions to inaccurate reporting

33. It is untested whether other provisions of the CCRA relating to a failure to comply with various reporting requirements could also cover inaccuracies in reporting. The penalty for those offences currently is prosecution, with the introduction of an infringement regime proposed (NZ ETS tranche one decisions). In any event, dealing with reporting inaccuracies across numerous provisions with different penalties adds to complexity and fragmentation within the CCRA.

34. Part of the complication is that the existing excess emissions penalty applies in the same way to errors in reporting and failure to pay units despite a difference in the severity of these non-compliant behaviours. A participant should know if they have failed to surrender or repay units because they will receive notification and the due date will be clear. A participant may be less likely to know that there is an error in their return.

[1] The number of penalty assessments averages about 35 per year, though peaks can be caused by the five year reporting cycle for forestry.

[2] As an example, MPI estimate that the number of assessments done annually is increasing and the average is likely to now approach $150,000

Problem 4: not sufficiently robust to enable potential international linking

35. In the future, the NZ ETS may seek to link to international emisions trading schemes. If international linking open up new markets for the trade of units, and would enable New Zealand to purchase units to meet its climate change targets.

36. In order to have the option of linking to other schemes, the NZ ETS need not be identical to those schemes, but the compliance regime must be robust enough for potential international linking partners to have confidence in the integrity of the NZ ETS. This may require a certain degree of 'equivalency' for some aspects of compliance.

37. Having a high level of scheme transparency is also important for potential linking to international schemes. Other major international schemes, such as the EU, include publication of the names of operators who are in breach of surrender requirements. The China Shenzen Pilot scheme, the Regional Greenhouse Gas Initiative (RGGI) and the Tokyo ETS also all include account holder level publication of certain levels of non-compliance.

38. The existing excess emissions penalty does not meet a level of 'equivalency' with the more established overseas schemes that we are most likely to consider linking with. [3]

Opportunity 5: incentivise compliance as compliance is seen to be the norm

39. With the publication of non-compliance information at the participant level for certain offences, participants have the opportunity to see that for the more serious offences proposed for publication non-compliance is relatively uncommon. This may encourage those businesses to continue to comply.

40. Some larger businesses may be able to easily absorb fines and have no greater economic penalty from further business impacts, however they may be more likely to comply in order to avoid the risk to their reputation arising from publication of their non-compliance.

Opportunity 6: improve public trust and transparency

41. When the public can see non-compliance of participants then they can choose to support the businesses of those participants who do comply and this may help to build confidence in those businesses.

Examples and Evidence

Example – non-forestry

42. Since 2010, the EPA has amended 150 NZ ETS emissions returns containing incorrect information.[4] 103 of the 150 incorrect emissions returns fell outside the scope of the excess emissions penalty provisions because:

- the participant did not have a surrender obligation, meaning that no penalty could be applied despite the amended return reporting an increase in obligation (4)[5]
- the participant had overreported their obligation (95)
- there was no change to the total emissions (4).

43. Due to problem 3 above (unclear application of sanctions and penalties), and the costs of prosecution, none of the 103 cases above that fell outside the scope of the excess emissions penalty were sanctioned for these reporting errors.

[3] Examples here – EU 100 Euros per unit, WCI three times unit penalty, Republic of Korea three times market price.

[4] As at 23 August 2018.

[5] Participants in this situation are those who are required to report but do not currently face surrender obligations, e.g. agriculture participants

44. The remaining 47 of the 150 emissions returns fell within the scope of the excess emissions penalty and could incur penalties. The penalty assessment process reduced 38 of these penalties by 100 per cent because the participant made reasonable errors. The other nine were reduced by a smaller margin as the participant had made non-deliberate but unreasonable errors.

45. Since 2010, four participants have received penalties for failing to surrender units. All four have subsequently met their obligations by surrendering the outstanding units. Under the proposed changes, these four participants would have been the only participants to incur the surrender/repayment penalty. All others would be within the scope of the proposed reporting penalty.

Example – Forestry

46. Since 2009, for all forestry activities, MPI has:

- Amended over 600 submitted returns (5.3 percent of returns). This includes over 430 amended returns for post-1989 forestry in the first half of 2018 (20 percent of returns processed for this period). A large number of returns were amended before being formally processed in order to assist participants to meet their obligations rather than receive a penalty through the penalty reduction process.
- Assessed over 300 returns (3.4 percent of returns) because the participant did not file the return as required.
- Cancelled or declined over 600 returns (5.8 percent of returns) for reasons including being incomplete or submitted by an unauthorised person.

47. Some of these amendments required repayments or increased unit surrender obligations and were subject to penalties. Of these, the average penalty reduction was more than 95 percent.

48. While it is not possible to give exact figures for forestry, MPI believes that reporting errors are fairly evenly split between over-reporting and under-reporting.

2.4 Are there any constraints on the scope for decision making?

Three matters were considered to be outside the scope of this proposal. These are:

1. the allocation of liability for non-compliance. This means that the ultimate liability for meeting obligations under the CCRA rests with the participant, regardless of whether the participant used an agent to meet its obligations. This approach may be altered through future decisions made to address market governance concerns in response to the 2015/16 NZ ETS review
2. review of the limitation periods contained in the CCRA for commencement of proceedings, in terms of when enforcement may no longer be pursued
3. introducing an ability for participants to request to 'pay-over-time' to meet surrender obligations, as a way to help participants to spread the cost of compliance over the year
4. releasing other individual-level information that could incentivise compliance but is not specifically about non-compliance, such as information about emissions and removals and the transfers and trade of NZUs.

2.5 What do stakeholders think?

49. Consultation on Improvements to the NZ ETS and NZ ETS for forestry was undertaken between 13 August and 21 September 2018. Submissions were received from 253 submitters, including forestry and non-forestry participants, iwi and Māori representatives, industry, city councils and non-governmental organisations.

Changes to the excess emissions penalty

50. There were two proposals outlined in the consultation document to address the issues with the excess emissions penalty. The first option was to set the penalty at a fixed dollar value and remove the ability to reduce the penalty (i.e. remove discretion). The second proposal was to use a proportional approach where the penalty applied is a percentage of the value of the outstanding surrender obligation, one option mentioned was to model this approach on existing regimes, for example Inland Revenue.

51. Submitters were then asked the following three questions related to changes to the excess emissions penalty[6]:

    24. Has the excess emissions penalty for failing to surrender or repay units by the due date caused issues for you? If so, please explain.

    25. Should the excess emissions penalty for failing to surrender or repay units by the due date be changed? If so, please explain.

    26. What option do you see as most appropriate for the excess emissions penalty?

        - set the penalty at a fixed dollar value and remove the ability to reduce the penalty
        - use a proportional approach where the penalty is a percentage of the outstanding surrender obligation
        - other (please explain).

52. When asked whether they had been impacted by the excess emissions penalty six submitters gave feedback. Issues included miscalculating the lead time on buying units, non-aligned timing of surrender notices and misinterpreting CCRA obligations.

53. Submitters were asked whether the excess emissions penalty should be changed. 56 submitters responded and answers were fairly evenly split: in favour of change (34%), no change (27%) and unsure (39%). Reasons for change included that the current penalty did not sufficiently motivate participants to comply, and that it should rise in line with expected higher carbon prices.

54. Of those opposing change, many felt it was high enough to deter non-compliance, possibly even too high. Some felt that stricter penalties would require justification, and that the regime should include an element of discretion.

55. Of those who were unsure, the most prevalent comment was that the penalty must match the offence. Some wished to see penalties applied only after a certain period (six months or one year).

Setting penalties

56. Only a small group (39) responded on whether a proportional approach or a fixed-dollar value is more appropriate, however nearly all (37) supported a proportional approach. It was noted that 'one size does not fit all' in the NZ ETS, and that a proportional approach was fair and provided consistency with other compliance requirements including Inland Revenue processes.

57. Many submissions expressed a preference for discretion to be exercised based on clear, published guidelines. Publishing guidelines was seen to contribute to

[6] Question numbers set to match the original consultation document that may be found here:

consistency and predictability in how decisions will be made. Some submissions suggested inclusion of minimum and maximum level penalties.

58. Māori and iwi have not been considered to be specifically or disproportionately impacted by this proposal. Submissions from relevant parties noted that the compliance and penalties proposals are not relevant under the Treaty of Waitangi, or expressed broader conceptual issues with the NZ ETS as it relates to Māori land and resources.

Publishing cases of non-compliance

59. The consultation document on improvements to the NZ Emissions Trading scheme stated that the Government is interested in whether there may be benefits from publication of non-compliance cases. Public information about non-compliance may act as a deterrent. However, care would be needed as, for example, some non-compliance is because of reasons outside the participant's control.

60. The consultation document then went on to ask the following questions related to the publishing of non-compliance information:

    20. Do you think cases of non-compliance should be published? (Please explain.)

    21. How would publishing these types of information impact you?

61. 82 submitters responsed to the question asking if they thought cases of non-compliance should be published (q 20 above). 47 submissions supported publication, with 21 preferred they not be published and 14 not sure.

62. Submitters supporting publication indicated that consumers require transparency in order to make informed decisions about which businesses to support and invest in. The public's trust in, and engagement with the scheme may also increase as a result of data being more readily available.

63. Several submitters noted that the release of information could incentivise compliance and put pressure on those participants who did not comply.

64. A number of submitters supported the publication of cases of non-compliance only when certain criteria were met. Several submitters specified that publication be restricted to instances of intentional non-compliance while others believed that case details could be published but with identifying information about participants removed.

65. Key reasons given in opposition to the publication of cases of non-compliance were that discretion is necessary, and that low-level non-compliance should not be treated in the same way as a criminal offence. A few submitters commented on perceived fairness, observing that the damage caused through publication of cases of non-compliance could be disproportionate to the offending that had occurred. 13 reported that publication of information about non-compliance would cause them to feel unfairly targeted and misrepresented, due to the risk of the information being taken out of context.

Consultation with the Ministry of Justice

66. The Ministry of Justice (MoJ) was consulted when considering options for addressing problems with the excess emissions penalty. MoJ considers that regimes in which determinations of guilt are made by non-judicial bodies are highly irregular and should be strongly discouraged. Judicial oversight provides protection against possible abuses, or the appearance of abuses, of regulators' powers. MoJ considers the taxation model as an exception, justified only due to the hugely technical nature of the regime and the overwhelming public interest in universal compliance.

67. The existing excess emissions penalty is imposed by the enforcement organisations rather than the Courts. The design of the NZ ETS penalty regime was based on the tax regime that existed at the time. The complexity, volume, and incentives for accuracy that exist in the tax context also exist in the NZ ETS. The proposed approach

continues the design intent to align the NZ ETS penalty regime with tax administration. This is further outlined in the description of the preferred option in section 3 below.

68. MoJ also consider that it is hugely important that the regulator, enforcer, and adjudicator are distinct from one another. This is because proper thought must be given at each stage (e.g. enforcement, prosecution, adjudication) as to whether and how to proceed. When these decisions are taken by the same body, there is a substantial risk that these decisions can be 'collapsed' into one choice to (or not to) proceed. In addition, judicial oversight provides protection against possible abuses, or the appearance of abuses, of regulators' powers. It protects against the regulator determining and handing down penalties unchecked without adequate appeal or review processes.

69. MoJ feedback has been considered, and design elements of the administrative penalties approach have been introduced to address a number of concerns. In particular, the intention to publish operational guidelines has been included to increase the transparency and predictability of penalties for participants. Also, consequential amendments to existing sections of the CCRA will ensure that existing review and appeal provisions apply to these penalties.

Impact of international emissions trading schemes

70. The penalty regimes operating in all other emissions trading schemes were considered in the design and assessment of options. This included the regimes operating in the European Union, United Kingdom, Poland, Switzerland, California, Ontario and Quebec, US states falling under the Regional Greenhouse Gas Initiative, US states included in the Western Climate Initiative, Australia (proposed but not implemented), The Republic of Korea, Kazakhstan, Tokyo, and the seven pilot schemes operating in the People's Republic of China.

71. A wide variety of tools are used across international emissions trading schemes to penalise non-compliant behaviour. Most schemes make use of some form of civil penalty. This may occur through fixed fee fines, fines based on a per-unit or per-day calculation, or submission of additional units. Many schemes have further penalties for non-compliance, such as prison sentences for individuals, including company directors. The publication of information about non-compliant entities is used in a number of international schemes as a further means to deter non-compliance.

72. International penalty regimes generally focus on large penalties for failures to surrender or repay units that the participant knew they must surrender. Errors in audit and verification are considered separate from matters of non-compliance. International approaches to the excess emissions penalty fall into three categories, all of which are in addition to meeting the underlying obligation. These are; paying penalty units as a multiplier of the shortfall, paying a fixed dollar penalty per unit of shortfall, or paying a monetary penalty calculated using a multiplier of the market price.

73. Ultimately, given that the NZ ETS is unique in some key aspects (as explained in section 2.1 above), it was determined that the experience of other jurisdictions should guide but not overly influence decisions made about the NZ ETS.

Section 3: Options identification

3.1 What options are available to address the problem?

Preferred option for penalties: restructure the compliance mechanism

74. In order to address all the problems identified with the current excess emissions penalty, the preferred option is to restructure the relevant offences and penalties into two separate penalties.

75. A 'surrender/repayment penalty' – that applies where participants have failed to surrender or repay units by the due date.

76. A 'reporting penalty' – which applies where participants have incorrectly reported their emissions.

77. Reporting and claiming errors often arise from complex matters of interpretation and, once amended, present a relatively low risk to the Crown. In contrast, failures to surrender or repay units are clear failures to meet known obligations and present a material risk to New Zealand's ability to meet its domestic and international climate change targets.

78. Restructuring the current mechanisms into separate penalties is consistent with international approaches. International penalty regimes generally focus on large penalties for failures to surrender or repay units where the participant knew they must surrender. Errors in audit and verification (such as reporting errors) are considered a different type of non-compliance.

79. Both new penalties use a proportional approach to setting the penalty amount and are therefore consistent with one of the broad approaches outlined in the consultation document.

Preferred option – market based, surrender/repayment penalty

What constitutes a failure to surrender or repay units

80. Once a participant or allocation recipient knows that they must surrender or repay units, they are given a clear deadline for this action to take place.

81. Failure to surrender or repay units occurs when a participant or allocation recipient fails to meet some or all of their surrender or repayment obligation by the due date. This is because the participant has emitted more than they have provided abatement to cover, or have received an excess of units to cover the abatement they have provided.

82. Failing to surrender or repay units is a more straight-forward failure to comply than errors in reporting emissions or claiming allocations. It also carries with it a higher risk to the Crown as ultimately the Crown is responsible for New Zealand meeting its domestic and international emissions targets. A failure to surrender or repay units risks undermining the emissions cap.

Proposal for treatment of failure to surrender or repay units

83. The 'surrender/repayment penalty' will be an administrative penalty equivalent to three times the current market price of carbon for each outstanding unit. This replaces the existing static $30 per unit calculation and is designed to ensure that the penalty reflects the realities of the market and will increase or decrease alongside changes in the market price of carbon.

84. As is presently the case, a participant or recipient who fails to surrender or repay units by the due date will also still be liable to meet the underlying obligation.

85. In order to implement an effective and fair administrative penalty regime, penalty levels need to be clear to participants. Therefore it is proposed that the current

market price of carbon be set using the average carbon price over the previous 12 months and laid out in regulations to be updated annually.

86. A similar mechanism already exists for setting the Synthetic Greenhouse Gas levy. Adopting this formula would not be novel, and would increase transparency and certainty for participants. Price signals would be clear over the preceding twelve months, as the actual price is set out in regulations. Although the penalty price could be seen to 'lag' for twelve months, this would usually reflect the cost of compliance for the period where the non-compliance happened.

87. Setting a penalty which is three times the price of carbon will more closely align the NZ ETS compliance regime with several international carbon markets; particularly California, Québec and the Republic of Korea. The European Union Emissions Trading Scheme (EU ETS) has a fixed penalty of 100 Euros per unit, which is currently over four times its current market price for carbon.

88. s 9(2)(j) [redacted]

89. This proposal will remove enforcement agencies' discretion to reduce the surrender/repayment penalty, so it will be administratively simple and will increase certainty.

90. If this penalty is not paid, interest will accrue as is currently provided for in the CCRA. Further non-performance could be pursued through the Courts using the existing provisions, except to the extent that the time bar on bringing action contained in s 159 will be reduced (refer to section 6.1).

How this would work in practice

91. When the due date passes, the enforcement agency notifies the participant, setting out the number of units to be transferred or surrendered, the amount of the surrender/repayment penalty to pay and a due date for compliance. This penalty would act in addition to any other penalties, and would constitute a debt to the Crown to which existing provisions would apply.

92. At present, once a participant submits an emissions return, they must meet their surrender obligation by 31 May in the same year. The obligation to surrender units is not suspended if an amendment or assessment is being undertaken, even if that could result in a change to the participant's liability. In practice, this could mean the participant was liable to surrender units to meet an obligation which is subsequently reduced. We therefore propose that the requirement to surrender units is paused while an assessment or amendment is undertaken. The participant will then be provided a new future surrender deadline to give them the opportunity to comply and avoid the significant surrender/repayment penalty.

93. The power to set regulations prescribing the methodology to specify the price of carbon would be set in the CCRA.

Preferred option – reporting penalty with enhanced coverage

94. The reporting penalty would cover inaccurate reporting, regardless of the outcome of the inaccuracy (i.e. there would be a penalty irrespective of whether the Crown or the person owes units). This extends the coverage of the reporting penalty from the existing excess emissions penalty that only applies when the reporting error results in a liability.

95. The reporting penalty will also apply when a participant fails to provide a return and then receives a default assessment. When a participant fails to provide a return they are initially sanctioned with an infringement notice for missing the due date and given

a new deadline to provide a return. Once that deadline passes, the enforcement agency then completes a default assessment. The reporting penalty will apply to this default assessment.

96. Penalties will attach to the lesser of the size of the error (in units), or the total emissions that should have been reported or removals/allocation applied for, measured in tonnes of emissions. This determination is required so that when a participant significantly misreports their emissions, they do not receive a penalty significantly larger than their undertaking. This might happen, for example, where a participant uses kilograms rather than tonnes to calculate their emissions and reports 1000 times more emissions than they should have. The resulting quantity will then be multiplied by the current market price of carbon[7] to determine the base reporting penalty to which behaviour-based bands will then apply.

97. The level of reporting penalty will be set in the following behaviour-based bands that mirror those set in the Customs and Excise Act 2018:

- not taking reasonable care (20% of the calculated base penalty)
- gross carelessness, (40%)
- errors made knowingly (100%).

98. These behaviours would not be defined in legislation, but would be supported by operational guidelines which would be made publicly available to demonstrate to affected parties the expectations on scheme participants.

99. The reporting penalty will be further reduced by 50 percent when a participant voluntarily discloses their non-compliance, apart from where an error was knowingly made. Voluntary disclosure of non-compliance remains beneficial to the scheme as it reduces the administrative burden on enforcement organisations, and encourages participants who are best placed to amend their errors to do so in a timely manner. Despite this, voluntary disclosure should not prevent a penalty from being applied, to avoid creating a perverse incentive where a participant who fails to comply in a timely manner can simply report non-compliance to avoid a penalty. A reduction would not be available for errors that are made knowingly because of the seriousness of this kind of misconduct.

100. Participants who have been found to have taken reasonable care would not receive a penalty. This would also be consistent with the tax and Customs regimes.

101. The motivations for over- and underclaiming units, and the resulting risk and cost profile (with the participant facing the costs of underclaiming and the Crown the costs of overclaiming), justify different treatment. For this reason, it is proposed that underclaiming an allocation or entitlement, or over-reporting a surrender obligation, will receive a penalty of $1000. The Customs regime also takes a minimum penalty approach in these types of situations. A minimum level penalty is believed to limit the potential chilling effect on voluntary NZ ETS participation while still encouraging due care to be taken. If the NZ ETS rules are too difficult to comply with, small-scale, risk-averse, voluntary participants may decide to leave the scheme.

102. Proposed penalty bands are set out in the following table:

[7] The market price of carbon will be calculated using the same methodology adopted for the surrender/repayment penalty to provide consistency within the penalty regime.

Table 2: Proposed penalty bands

Behaviour category	Percentage of error in reporting	Penalty percentage with voluntary disclosure
Not taking reasonable care	20%	10%
Gross carelessness	40%	20%
Knowingly made	100%	100%
Underclaiming an allocation or entitlement, or over surrendering/repaying units	$1000	$1000

103. The reporting penalty is a type of administrative penalty. Administrative penalties are behaviour-based penalties imposed by enforcement organisations, rather than by the Courts. This approach reflects the administrative penalties available under the Tax Administration Act 1994 and the Customs and Excise Act 2018. The Customs approach in particular has been used as a model for designing these proposed penalties, as it has recently been reviewed and modernised. In particular the customs approach has informed the bands used and the approach taken to reduce penalties for voluntary disclosure.

104. The NZ ETS penalty regime was initially based on the tax administration regime that existed at the time the NZ ETS was established. The design of the NZ ETS was considered to be similar to tax administration because of the scale, complexity, and self-reporting nature of the scheme, and the high public interest in accuracy.

How this would work in practice

105. The above three tiers of behaviour would be set in the CCRA, with explanation set out in the public operational guidelines. The penalty price would apply to tonnes of emissions misreported, or to units overclaimed. The penalty of $1000 would apply to errors in applications resulting in an underclaim of an allocation or entitlement where reasonable care has not been taken. The power to set regulations prescribing the methodology to specify the price of carbon would be set in the CCRA.

106. For clarity, this would bring all inaccuracies in reporting into the same reporting penalty in the CCRA. Duplicative penalties for reporting errors would be removed, except to the extent covered by s 133 of the CCRA, which applies where the offence has been commited with intent to deceive and for the purpose of either obtaining any material benefit or avoiding any material detriment. In the latter, more serious case the enforcement agency would have to choose whether to prosecute or penalise the person, and could not choose to do both.

Preferred option – publication of non-compliance

107. It is proposed to publish, at least annually and as soon as practicable beginning in 2021, individual cases of non-compliance where participants have been penalised with serious individual non-compliance (i.e. gross carelessness, knowingly made or failure to surrender/repay units by the due date).

108. This proposal does not include publication of any individual level information regarding infringement offences, as these will be reported on at an aggregate level by the EPA.

109. When a participant fails to submit or surrender units, this risks the integrity of the scheme, is a cost to the Crown, and impacts on New Zealand's domestic and

international emissions targets. Therefore it is appropriate that the NZ ETS is transparent about non-compliance.

Other options – publication of non-compliance

110. The other option considered for publication of non-compliance was to continue to publish only aggregated information rather than publishing non-compliance information at the account holder or NZ ETS participant level, in other words, the status-quo.

111. However, the status quo does not provide a credible disincentive to individual non-compliance. Only publication of the responsible non-compliant actor's name is likely to incentivise compliance through a reduced level of trust and confidence the public places in the non-compliant account holder.

112. To help build an expectation that compliance is the norm and non-compliance is irregular, individual account holders who commit certain types of non-compliance are identified by name. This approach complements a concurrent proposal to publishing individual level emissions and removals data.

Other options - penalties

113. Three other options were considered to address the problems with the excess emissions penalty. Two of the three options adopted a strict liability approach were considered less effective in meeting the objectives of the penalties regime than proportional approaches and were therefore also not favoured by the majority of submitters. The third approach was a proportional approach, but it diverged from the original design intent of aligning with the tax and Customs penalties regimes in New Zealand.

114. The other, non-preferred options are set out below.

Other penalty option: fixed fines

115. The first alternative option to be considered was to apply fixed fines with no discretion on the part of the enforcement organisations to modify the penalty value. Once an offence takes place, the fine must be issued. Strict liability offences would be imposed by the enforcement agency as an infringement penalty, or by the Court. To challenge a penalty, the defendant must prove, on the balance of probabilities, an absence of fault to avoid the fine.

116. This approach would remove the discretion of the enforcement agency, leading to greater certainty, predictability, and administrative efficiency. Fixed fines also are not calculated based on a per unit amount, so they are consistent across different types of non-compliance.

117. However, the corollary of the fine being fixed is that this approach does not scale to the size of the participant in terms of their emissions profile, meaning that the fine could be overly punitive for small participants, and insignificant for large participants. This option does not perform well against the proportionality and equitability criteria. This type of approach is suitable only for simple acts of non-compliance.

Second non-preferred option: additional unit-based penalties

118. This option would replace the $30 per unit penalty with a penalty based on the surrender or repayment of additional units instead of a monetary penalty. This approach is used in some overseas emissions trading schemes; for instance, it has been used in Ontario to penalise a failure to surrender sufficient allowances. Often the penalty level is set at a three for one level, that is, the participant will be required to surrender an additional three units for every unit missing from their initial surrender or repayment.

119. Additional unit-based penalties would peg the cost of non-compliance to the market price of carbon, since the participant would be required to procure additional units to

surrender. However, this would not address offences that do not have a corresponding unit value, such as reporting errors for participants without a surrender obligation. This approach would be open to provide different penalties for reporting and allocation errors, and for failures to surrender or repay units, with an additional unit-based penalty applying to the latter.

120. As participants would have to procure additional units this means that non-compliant participants would no longer face the same penalty price. Instead the price they pay for non-compliance will depend on the price the pay to access additional units.

121. An aspect of the wider NZ ETS improvements package is to cap emissions. Thus, adding an additional unit-based penalty could lead to some market distortion. Additional units required to pay for non-compliance could artificially increase demand, and reduce the units available to meet emissions targets. It is also possible spikes in demand may occur, for example, around the time of a surrender obligation due date. If excess units are required to pay penalties following this date, this could contribute to temporary illiquidity in the market. However, it is likely, based on existing compliance history that this effect would be small.

122. Smaller participants have previously raised concerns about being unable to access small packets of units. A unit-based penalty could exacerbate these concerns.

Third non-preferred option: fixed dollars per unit/tonne of emissions

123. The third option considered was to set a fixed dollar per unit penalty, banded by behaviour (similar to the reporting penalty approach), with no discretion to reduce. This approach would require bands to be set, with relevant dollar penalty levels attributed in legislation or regulations. This approach is a modified status quo in that the behaviour would determine the penalty level, however the penalty level would be a fixed dollar amount per unit (as is the existing $30 per unit penalty).

124. This approach is a modified version of the European Union (EU) ETS penalty regime, which applies a set €100 per unit penalty for failure to surrender or repay units, then would be modified to include different fixed amounts per unit for different behaviours.

125. In this option, the behaviour would determine the penalty band, and the band value could be determined as a percentage of the carbon price. For example, a participant who fails to take reasonable care may face a $10 per unit or tonne of emissions penalty (equal to 40 percent of the current carbon price), whereas another who shows gross carelessness could receive $15 per unit or tonne of emissions (60 percent of the current market price), and so forth.

126. The fixed dollar approach gives certainty to participants, but it would need to change on a regular basis to ensure that the penalty would continue to reflect market realities. This approach has many of the same benefits as the preferred administrative penalty mechanism, but would require frequent review and updating to ensure the fixed dollar penalty levels remained relevant therefore would not be administratively less burdensome.

3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

127. Five operational criteria have been adopted for assessing proposals to improve the NZ ETS. The criteria and their application to the compliance and penalties proposals are set out in the below table.

Table 2: Criteria to Assess Options

	Description
Integrity	Consistent with the overall NZ ETS objectives of helping New Zealand meet emissions reduction targets and reduce net emissions below business as usual levels. In practical terms, this means encouraging compliance and enabling enforcement of the NZ ETS's rules. It also includes avoiding perverse incentives and unintended consequences.
Minimal complexity and administrative cost	This relates to ensuring implementation of the NZ ETS is as straightforward as possible, so administration and transaction costs for both participants and the Government are minimised. Therefore, compliance and penalties should be straightforward to apply and administer as well as transparent and easy to understand.
Consistency and proportionality	Implementation of the penalty regime should treat participants consistently and avoid advantaging some participants over others. Proportionality means interventions are appropriately scaled to address the problem or achieve the outcome sought.
Clarity and transparency	The penalty regime should be easy to understand and unambiguous. Transparency includes ensuring that appropriate information is made publicly available to all stakeholders equally in a timely manner.
Market efficiency	An emissions trading scheme is efficient when it achieves allocative efficiency and delivers efficient price discovery. The penalty regime should encourage participants to meet their reporting requirements accurately and in a timely manner to inform unit supply decisions and accurately account for abatement. In addition, implementation of the penalty regime should not distort the market, or risk undermining the emissions cap, relative to if the obligation had been met in a timely manner.

3.3 What other options have been ruled out of scope, or not considered, and why?

List the options and briefly explain why they were ruled out of scope or not given further consideration

Per-day penalties

128. Penalties could be applied on a per-day basis to cover the period of time a participant is non-compliant. These could be charged in units or dollars and would not require an initial quantum of units on which to base the penalty.

129. This approach would require a high level of administration given that every instance of non-compliance would be administratively unique, would require clear decisions around when non-compliance begins and ends and could pressure enforcement organisations to respond in haste. The per-day penalty would need to accumulate to a level significant enough to have an economic impact on the participant before becoming a deterrent.

130. Overall, this approach was considered to be administratively burdensome and would not meet criteria for minimal complexity and administrative cost or consistency and proportionality.

Civil pecuniary penalties

131. Civil pecuniary penalties are monetary penalties imposed by the Court. Enforcement organisations lay charging documents, and the Court imposes a penalty after considering factors such as the level of harm caused by the offending, and the offender's ability to pay. The standard of proof required is on the balance of probabilities.

132. Agencies would require additional resourcing to undertake this approach. This could include an increase in forensic advice to collect evidence to build each case. It could also increase the workload of the judiciary. This approach would allow for judicial discretion to be exercised in applying penalties. However, it is considered that the use of civil pecuniary penalties would not meet the criteria for minimal complexity and administrative cost and was not considered further for that reason.

Pecuniary and use of money interest

133. Sanctions based on the use of money interest and compensatory interest exist in the tax administration and Customs regimes. Pecuniary interest and use of money interest work well where they can attach to a particular dollar value, and where the non-compliance can be characterised as lateness, or failing to meet a deadline.

134. This approach was not pursued because of the complexities in ensuring all relevant types of non-compliance are covered by the interest regime and the fact that only a small proportion of non-compliance can be characterised as lateness.

Disaggregation based on overseas schemes

135. An option to disaggregate New Zealand participants was considered. In this scenario, participants that meet the thresholds for participation in overseas schemes would be liable for larger penalties than participants who did not meet the threshold. This could include a preceding requirement for participants above the threshold to submit audited and verified reports.

136. This approach does not meet the criteria for minimal complexity, clarity and consistency. It could be unclear for participants as they may have different compliance obligations each year, depending on whether or not they met the given threshold. It would place a higher burden on some participants and suggests that smaller participants are not important enough to be subject to the same compliance requirements. It could be administratively complex for enforcement agencies to apply the threshold and to apply different compliance obligations accordingly.

Section 4: Impact Analysis- New penalty approach[8]

Impact Analysis: Surrender/ Repayment Penalty	No action: status quo	Preferred Option: Surrender/Repayment Penalty	Option: Strict liability fixed fines when failure to surrender/repay units on time	Option: strict liability unit-based
Integrity	0	++ This approach is considered sufficiently robust for international linking while reflecting the unique NZ ETS.	-- Although this approach is clear, fixed fines will be difficult to set at a level that deters non-compliance across the spectrum of participants. It also would not be sufficiently robust for international linking.	0 While this approach would also be sufficiently robust for international linking, it could create unintended consequences in the way participants access the market.
Minimal complexity and admin cost	0	+ This approach reduces the complexity and administration required by the current penalty assessment process	+ Potential fines would be clear and easy to understand.	++ The penalty would be clear and easy to administer because there would be no calculation of cost, simply a multiplication of number of units.
Consistency and proportionality	0	+ This approach calculates the penalty amount proportional to the size of the error, therefore meeting the proportionality criteria. The removal of discretion means that all non-compliance will be treated consistently.	-- Although fixed fines would be consistent, they would not scale to be proportionate to the errors made.	0 This is still a proportional approach in that penalties are proportional to the size of the error. However the relative cost of the units may not be consistent between participants depending on how they are accessed.
Clarity and transparency	0	+ Clarity will be improved as there is no longer discretion to reduce the penalty. Although the market price will be published in regulations, it could be said that clarity may be slightly less because the legislation no longer specifies the fixed penalty amount ($30 per unit)	++ Fixed fines that are published are very clear and transparent.	+ The removal of discretion would aid clarity in the penalty that may apply.
Markey efficiency	0	+ The focus on large penalties for non-compliance directly related to actions that impact the market cap is designed to emphasize the importance of surrender obligations.	- Fixed fines would not respond to the market price of compliance, and may have more or less of an impact dependent on the cost of compliance.	- Small volumes of units (below 5,000 – 10,000) are already difficult to access and this may prove problematic for smaller market participants.

[8]No further impact analysis is provided for the preferred approach to transparency as the only alternative considered to the preferred option was the status quo.

Overall assessment	**0**	**++**	**-**	**0**

Key:

++ much better than doing nothing/the status quo

+ better than doing nothing/the status quo

0 about the same as doing nothing/the status quo

- worse than doing nothing/the status quo

- - much worse than doing nothing/the status quo

Impact Analysis: Reporting Penalty	No action: status quo	Preferred Option: Reporting Penalty	Option: Strict liability fixed fines for reporting penalties	Option: proportional fixed dollars per unit with behavioural bands for reporting penalties
Integrity	0	++ This approach is considered the most sufficiently robust for international linking while reflecting the unique NZ ETS. Also it is likely to retain similar levels of deterrence with a rise in carbon prices because the penalty will also increase.	- Although this approach is clear and straight forward, fixed fines will be difficult to set at a level that deters non-compliance across the spectrum of participants.	0 This approach could be sufficiently robust for international linking with a suitably high fixed value (i.e. significantly higher than the existing $30 per unit). However it has the same problem as the existing penalty in that rises in carbon price may reduce the relative impact of this penalty over time.
Minimal complexity and administrative cost	0	+ This approach reduces complexity and administration costs by reducing the level of discretion available and clarifying the application of the penalty.	+ Potential fines would be clear and simple to administer.	+ This approach would also be less complex than status-quo due to the removal of discretion and introduction of bands.
Consistency and proportionality	0	+ This approach calculates both types of penalty amounts proportional to the size of the error, therefore meeting the proportionality criteria. Consistency should be enhanced by the enforcement agencies publishing and following guidelines to set these penalties rather than relying on discretion.	-- Although fixed fines would be consistent, they would not scale to be proportionate to the errors made.	+ This is still a proportional approach in that penalties are proportional to the size of the error, and they would be consistent across participant types.
Clarity and transparency	0	+ Clarity will be improved as there is no longer discretion to reduce the penalty. Although the market price will be published in regulations, it could be said that clarity may be slightly less because the legislation no longer specifies the fixed penalty amount ($30 per unit)	++ Fixed fines that are published are very clear and transparent.	++ Removal of discretion does increase the clarity of this penalty and if the amount of the per unit penalty is a fixed dollar amount set in legislation then this is also very clear.
Markey efficiency	0	+ This approach encourages compliance generally, and the split approach ensures that abatement is accurately accounted for and met.	- Fixed fines would not respond to the market price of compliance, and may have more or less of an impact dependent on the cost of compliance.	+ This approach would still encourage compliance generally, and help to ensure that abatement is accurately accounted for, however it does not address all the problems with the existing penalty.
Overall assessment	0	++	-	+

Key:

++	much better than doing nothing/the status quo
+	better than doing nothing/the status quo
0	about the same as doing nothing/the status quo
-	worse than doing nothing/the status quo
- -	much worse than doing nothing/the status quo

Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

137. The preferred option is replacing the excess emissions penalty with administrative penalties for errors in reporting or claiming an allocation or entitlement (reporting penalty), and a market price based excess emissions penalty for failure to surrender or repay units (surrender/repayment penalty). This is combined with the publication of non-compliance at the participant level for reporting penalties (at the level of gross carelessness and knowingly made errors), and a failure to surrender or repay units.

138. This combined approach to penalties performs best against the operational criteria and offers a durable and scalable approach to non-compliance across the relevant offences in the NZ ETS.

139. The administrative nature of the reporting penalty continues the intended design alignment between the NZ ETS and New Zealand's tax administration regime.

140. Reporting penalties will be extended to apply to cases of inaccuracy that the excess emissions penalty does not currently cover. This includes misreporting emissions, whether or not there is a corresponding surrender obligation, and over- and underclaiming allocations and under claiming entitlements. Coverage of all inaccuracies is required to encourage participants to take due care in meeting their obligations in a timely manner.

141. Failures to surrender or repay units will receive a penalty calculated with reference to the market price. A participant who fails to meet their surrender or repayment obligations is clearly failing to comply with their obligations. The market-based penalty will thus act as a stronger penalty to encourage participants to take due care in meeting their obligations. This will maintain the integrity of the NZ ETS and any future emissions cap while also not creating a barrier to future linking to international ETS markets.

142. Alongside pecuniary penalties, publication of non-compliance will be used to further disincentivise non-compliance. Although there is no direct pecuniary loss caused by publication, there may be indirect loss through reduced customers, loss of certifications, and reduced social license to operate.

Impact of consultation on development of this policy

143. Submitters supported taking a proportionate approach to the types of conduct currently covered by the excess emissions penalty, and retaining discretion for enforcement organisations in applying these penalties. The majority of submitters (57 percent) supported publication of cases of non-compliance, with 26 percent preferring non publication.

144. The two new penalties proposed will provide a proportionate approach. The publication of operational guidelines to making determinations on setting penalties will ensure that discretion is applied in a fair and transparent manner.

145. The Ministry of Justice provided the view that regimes where determinations of guilt are made by non-judicial bodies are highly irregular and should be strongly discouraged. The Ministry of Justice views the tax regime as exceptional in terms of legislative design because of the highly technical nature of the regime and the overwhelming public interest in universal compliance.

146. The NZ ETS penalty regime was designed to mimic the tax regime at the time of its inception, and a good reason to depart from this design has not been identified. The NZ ETS is highly complex, and there is growing public interest in universal compliance as illustrated by the significant profile that New Zealand's climate change response

has gained. Universal compliance is critical to meeting New Zealand's domestic and international climate change targets, and not meeting these targets presents a risk to the Crown.

147. Informal feedback has been taken on board from international emissions trading schemes, s 9(2)(j) [redacted]. A stronger response to failures to surrender or repay units has been proposed in response to this feedback.

148. Minimum and maximum penalties were also suggested by submitters, however after further consideration it was decided not to pursue maximum and minimum values for the two new penalties as that would not allow the penalties to be fully proportionate to the scale of the offence. A fixed value of $1000 has however been set to apply in instances where the Crown owes units or there is no liability associated with the reporting error.

149. The proposed penalties demonstrates the seriousness with which New Zealand is undertaking to meet its domestic and international climate change ambitions, and they provide a significant tool to ensure the effectiveness of the emissions cap.

5.2 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach, compared to taking no action			
Compliant regulated parties	Regulated parties will continue to bear the cost of compliance.	Low, as there will be no direct increased costs on compliant regulated parties as the result of the penalty regime. Participants may incur expenditure, for example hiring consultants, which is a business decision for the participant which sits outside the penalty regime.	High, as the underlying obligations for participant are not being changed by this proposal.
Non-compliant regulated parties	Regulated parties will continue to bear the cost of compliance. A more efficient and fit for purpose penalty regime could lead to a greater use of penalties for non-compliant behaviour.	Medium, as non-compliant participants may be more likely to experience indirect loss through a reduced level of trust and confidence the public places in the non-compliant account holder.	High
Regulators	The enforcement organisations are currently resourced to apply	Medium, In the short term, enforcement	Medium enforcement

	the excess emissions penalty through operational expenditure. This resource would be reallocated to implementing the proposed penalties and focussing on a wider range of non-compliance due to the more efficient operation of the proposed penalties. Enforcement organisations may need to allocate more resource to compliance as the scope of the penalty is being extended.	organisations will be required to update policies and existing systems to implement the proposed changes to the compliance regime alongside other NZ ETS changes. Publication of non-compliance, including at the individual level will require additional resource to implement.	organisations prioritise compliance resources to meet need. Higher risk compliance activity is likely to take priority.
Wider Government	Penalties will continue to be payable to the Crown.	Low, as extending the scope of penalties may increase the quantum of penalties being received.	High, this continues the current treatment of penalty revenue.
Other parties	Iwi and Māori will not be disproportionally impacted by the proposed improvements to compliance and penalties as the penalty regime is not the source of obligations, rather it enforces the obligations established through the NZ ETS.	Nil	High
Courts	There may be an increase in NZ ETS cases being brought to Court in the short-term, due to the reduction in the one year time ban for action. However, it is positive that cases would be brought before the Courts in a timelier manner, and the overall number of cases is not expected to increase.	Low	High
Total Monetised Cost	*Changes to the existing regime can be met through reallocation of existing compliance resources.*	Low	High
Non-monetised costs	*Non-monetised costs may be experienced by enforcement organisations allocating compliance resources on a risk-based approach, which may increase the requirement for compliance resources.*	*Low*	High

Expected benefits of proposed approach, compared to taking no action

Compliant regulated parties	The potential penalties for non-compliance will be more predictable and certain for participants. An improved penalty regime will be fairer to compliant participants as non-compliance will be properly sanctioned. Penalties will be applied in a more transparent way and allow participants visibility over other participants' non-compliant behaviour.	Medium	High
Non-compliant regulated parties	The potential penalties for non-compliance will be more predictable and certain for participants. The proposed penalties will also be fairer to participants as they are more consistent and applied on a more transparent basis.	Medium	High
Regulators	The proposed new penalties will be more efficient to administer than the current excess emissions penalty due to operational changes and the reduction in discretion from status-quo. Over time, the extra coverage of non-compliance will promote further accuracy in the NZ ETS and if compliance rates increase the administrative burden on enforcement organisations would reduce.Tools to sanction all non-compliance are critical in this regard. A reduced level of discretion will be clearer to exercise, and will enable greater consistency in the application of penalties.	High	High
Wider Government	Encouraging increased compliance in the NZ ETS will help the Government to meet its domestic and international climate change goals. The increased scope of penalties may contribute initially to Crown revenue but will reduce over time as compliance increases.	High	High
Other parties	The public will benefit from a penalty regime that provides the tools to enforce the timely meeting of NZ ETS obligations to ensure a high integrity NZ ETS. The public will also benefit from the transparency of non-compliance publication, giving them an ability to build trust in the scheme and make more informed decisions about businesses to support.	High	High
Total Monetised Benefit	There may be an initial increase in penalty revenue to the Crown, which will decrease over time as compliance increases.	Medium	High
Non-monetised benefits	All parties will benefit from a penalty regime with increased transparency, consistency, and predictability.	*High*	High

5.3 What other impacts is this approach likely to have?

150. Elements of the NZ ETS operate on a voluntary basis. An overly punitive penalty regime could undermine voluntary participation. For example, some participants, particularly those with smaller emissions profiles, may choose to deregister from the NZ ETS due to the proposed penalty regime and the greater certainty of penalties tipping the risk-reward balance for them. These participants are likely to be smaller scale and/or those who are risk-adverse.

151. A clear penalty regime like the administrative penalty regime which has been proposed will assist potential participants and recipients to make informed decisions.

152. Publication of non-compliant behaviour may incentivise compliance as, although there is no direct pecuniary loss caused by publication, there may be indirect loss through a reduced level of trust and confidence the public places in the non-compliant account holder.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

153. The introduction of these new penalties into the NZ ETS and providing improved information on non-compliance is compatible with the Government's expectations for the design of regulatory systems.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

Consequential amendments for effective implementation

In order to aid effective implementation, a number of additional changes are proposed to provide greater certainty for participants. These include:

1. reducing the one year time bar on enforcement to allow the regulator to take enforcement action 90 days after a non-compliant party fails to meet their penalty obligations
2. introducing an explicit ability for the regulator to enter into payment plans for the payment of penalties
3. introducing an ability to set a new surrender deadline for after the assessment or amendment has occurred
4. allowing compliance deadlines to be provided for participants and recipients to have the opportunity to comply (for example, the ability to submit a return 10 working days after the deadline for annual emissions returns to avoid a default return being generated).

Impacts on legislation and regulations

154. Implementation of the proposed penalties would occur through amendments to the CCRA legislation, regulation, and published operational guidelines. Legislation will contain empowering provisions to create regulations that will contain: the formula for setting the penalty rate, the penalty percentage bands and the amount of the penalty to apply when the Crown owes units or there is no liability. Amendments to existing

sections will ensure the review and appeal provisions apply to these penalties, and that the underlying obligation can be enforced in a timely manner.

155. A detailed implementation plan was not developed in advance of public consultation. However, subject to Cabinet approval, it is intended that the CCRA will be amended in 2019, and that specific regulations will be developed in parallel over 2019 to take effect in 2020. This timeframe will allow sufficient time for regulated parties to consider changes to their behaviour.

156. Non-statutory operational guidelines will set out how discretion will be exercised for both the application of penalties and the publication of non-compliance information.

157. Impact on CCRA Section 99, Obligation to maintain confidentiality. Will require the addition of a provision under the Act specifying ability to disclose the relevant information related to non-compliance.

158. To remove duplicative penalties for reporting errors, the CCRA should be amended to ensure that situations covered by the new reporting penalty are no longer also an offence under s 129 of the CCRA.

159. There is currently a further excess emissions penalty applied following conviction for an offence in a limited set of circumstances, including knowing failures to comply (s 132(1)(c) to (f) and s 133 – note, not s 132(1)(g) to (i)). To avoid duplication under the new approach, s 132 will no longer apply to situations covered by the reporting or surrender/repayment penalty. S 133 requires updating to reflect the proposed new form of the excess emissions penalty. If the conviction relates to a reporting penalty, a penalty for knowing failure to comply would be applied, and if it relates to a failure to surrender or repay units the new surrender/repayment penalty would apply. This penalty applies to the underlying obligation rather than any previously applied penalties. Furthermore the legislation must be clear that the enforcement agency may either charge the participant under s 133 or apply the reporting penalty but not both for the same situation.

Administration and enforcement of the regime

160. The EPA will continue to enforce the penalty regime, delegating responsibility to MPI for aspects of the penalty regime related to forestry participants where appropriate. EPA publishes ETS related information and reports. MfE will maintain its regulatory stewardship role. Reliance on the current arrangement assumes that the present institutional structure will remain, however, this may change with the possible introduction of an independent Climate Commission.

161. Investigations and recommendations on penalties will be carried out internally by staff members in accordance with the CCRA. There will be no increased need for enforcement officers to conduct field work.

Use of revenue gathered from penalties

162. The revenue gathered from penalties will be returned to the Crown, reflecting existing arrangements. The proceeds of penalties will not be held by enforcement organisations, or hypothecated for their use, avoiding the unintended consequence of organisations having an incentive to issue more penalties than necessary.

6.2 What are the implementation risks?

General

163. Reliance on existing institutional structures assumes that the introduction of a Climate Commission will not substantially alter roles in the NZ ETS. If changes are significant, existing delegations and role allocations may need to be revisited in the medium to long-term.

164. In setting the penalty levels, an assumption relied on is that the carbon price will continue to rise. If the carbon price drops significantly, the penalty will also drop

potentially affecting the deterrence value. This risk is somewhat mitigated because the penalty is always applied in addition to the fulfilment of the underlying obligation.

165. Consultation raised concerns that disproportionate penalties could result if discretion is not maintained. This proposal does retain some level of discretion to help address this concern. Furthermore it is intended to publish operational guidelines to ensure participants are aware of how discretion will be applied.

Risks and mitigations for enforcement organisations

166. A large number of changes to the NZ ETS are intended to be implemented simultaneously, including the introduction of an infringement regime. Given that enforcement activity will increase in the short-term following the introduction of the infringement offences, there is a risk that initially, enforcement organisations may have issues with timeliness of compliance decision making. This is expected to decrease over time because the new regime Is easier to apply and should encourage participants to become more compliant.

167. Implementing the package of proposals to improve the NZ ETS will have financial implications for the EPA. Without funding, changes to the New Zealand Emissions Trading Register and the required operational support cannot be operationalised.

168. This risk can be mitigated by enforcement organisations signalling within the Budget processes the need for additional resourcing for enforcing the NZ ETS and implementing changes. This risk is considered manageable due to implementation timeframes being taken into account in the timeframe for changes to take effect.

169. Because only a comparatively small subset of individual non-compliance will be published, the risk of unintentional publication is low.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

170. The CCRA already contains monitoring and review mechanisms and we are not proposing to change these.

171. Enforcement organisations will continue to monitor compliance levels, with success measured by monitoring trends in non-compliance rates over time.

172. MfE will continue to monitor the effectiveness of the CCRA to ensure the legislation is fulfilling its desired purpose. This will include consideration of whether the purpose of the legislation is being fulfilled in an administratively efficient way.

173. The CCRA currently provides for review and appeal of decisions under Parts Four and Five of the CCRA. These Parts relate to the operation of the NZ ETS, including issuing and allocating units, emissions returns, offences and penalties, and sector specific provisions.

174. These sections allow for a person affected by a decision of the EPA to request the EPA to review the decisions, appeal to the District Court, and appeal to the High Court (on questions of law only).

7.2 When and how will the new arrangements be reviewed?

175. Regulatory stewardship over the NZ ETS remains the responsibility of MfE. Enforcement organisations will contribute data and evidence to support assessments of the NZ ETS legislation. The independent Climate Commission may also have a future role in providing oversight and recommendations for the NZ ETS.

176. It is anticipated that stakeholders will be able to raise concerns through the legislative process, through submissions to Select Committee, and through consultation on regulations.

177. A review is recommended five years after the proposed penalties come into force, or if appeals to the Court on penalties exceed 10 percent of penalties issued.[9]

[9] Based on the current average of 35 assessments per annum this would mean appeals on approximately 4 assessments per annum.