

# Regulatory Impact Statement: Consultation on options to amend the surrender/repayment penalty for small forestry participants in the New Zealand Emissions Trading Scheme

## Coversheet

Purpose of Document	
Decision sought:	Interim Regulatory Impact Statement (RIS) to support the release of a discussion document and public consultation
Advising agencies:	Ministry for Primary Industries
Proposing Ministers:	Minister of Forestry and Minister of Climate Change
Date finalised:	19 July 2022
Problem Definition	
<p>The New Zealand Emissions Trading Scheme (NZ ETS) for forestry is complex, a number of small forestry participants become non-compliant with requirements due to a lack of understanding of the system or from poor advice. This can lead to unexpected surrender or repayment obligations. When these small forestry participants fail to surrender or repay units on time, they are subject to a penalty regime that is disproportionate to their context. Cabinet has instructed officials to report back with options for potential amendments to the penalty regime.</p>	
Executive Summary	
<p>A revised penalty regime came into force for NZ ETS participants on 1 January 2021. This new regime strengthened the penalty that applies when a person fails to surrender or repay units to the Crown by the due date (the surrender/repayment penalty). The regulator’s discretion to reduce the penalty was removed and the size of the penalty was increased to three times the price of carbon as set in regulations (three for one).</p> <p>The application of the new ‘three to one’ surrender/repayment penalty was deferred until 1 January 2023 for forestry participants with net liabilities of less than 25,000 units per year (low volume liabilities). This deferral was due to the risk of serious hardship to small forestry participants resulting from the significant size of the penalty and the personal nature of the assets they hold.</p> <p>Legislative change is required to ensure that small forestry participants are not subject to the three to one penalty (and the impacts on them are avoided).</p> <p>This paper considers options for a surrender/repayment penalty for small forestry participants. These include:</p>	

- a) the status quo (no legislative change) – subject to three for one penalty
- b) a strict liability penalty with reduced penalty amounts based on the number of units owed
- c) a modified excess emissions penalty – modifying the previous penalty regime that existed for all participants before 2021, and that is used for forestry participants with low volume liabilities until 2023.
- d) a penalty based on culpability bands
- e) a civil pecuniary penalty imposed by a Court

At this stage we consider the strict liability penalty option most likely to balance reducing the risk of serious hardship, with an administratively straightforward and robust regime for international linking.

We anticipate that stakeholders are likely to prefer greater use of discretion to reduce or waive the penalty, which the modified excess emissions penalty (c) affords. This is based on previous feedback on changes to the penalty in 2020 gathered through the select committee process.

### Limitations and Constraints on Analysis

There are several limitations and constraints that have affected our analysis.

#### Timing to complete analysis

Requiring a legislative solution by the end of 2022 has restricted the number of options we have been able to consider. We have focused our attention on the risk of serious hardship to smaller forestry participants given the known risk, unique factors that impact this group and that their transitional arrangement is due to expire at the end of the year. We have been unable to consider the impacts of the surrender/repayment penalty on other small NZ ETS participants in non-forestry sectors and this work may need to be considered at a later date.

The broader design of the NZ ETS compliance regime, and the appropriateness of the ETS surrender/repayment penalty for all participants has not been considered as this was not in scope of Cabinet's directive. We have considered different penalty approaches in our analysis for small forestry participants (for example the differences between a court-imposed penalty or an administrative penalty) but these are not described in detail due to time constraints.

We have not considered factors that may reduce the risk of serious hardship unrelated to the design of the penalty, e.g. the amount of time to pay units, or the ability to pay unit obligations in instalments. These were not considered due the inability to consider broader changes to obligations in the NZ ETS by the end of 2022.

#### Availability of compliance data

Our understanding of the scale of the problem and whether other participants may be affected has been impacted by not having complete and detailed set of historic compliance data. We have had to rely on a small sample of specific compliance data, and aggregated data that is publicly available. This did not include detailed information on type of persons who were non-complaint and the reasons that penalties were not applied in each case.

#### Difficulties in defining 'small forestry participants'

We have considered different ways to differentiate small forestry participants from other forestry participants. Defining small forestry participants by the size of their landholding

was not preferred due to relatively easy way for larger participants to split up their landholdings to be treated as small. Other ways to differentiate size of businesses, based on number of employees and cash-flow were too difficult to define in the time available. This meant that we continue to rely on low volume liabilities as a proxy for small forestry participants. This means that it may capture some larger forestry participants (who have small payment obligations e.g. due to the timing and scale of their harvesting).

#### Responsible Manager(s) (completed by relevant manager)

Anne Manley (Te Uru Rākau – New Zealand Forest Service, Operational Policy – Forestry Incentives)

#### Quality Assurance (completed by QA panel)

Reviewing Agency:	Ministry for Primary Industries
Panel Assessment & Comment:	The MPI Regulatory Impact Analysis Panel has reviewed the Interim Regulatory Impact Assessment “Consultation on options to amend the surrender/repayment penalty for small forestry participants in the New Zealand Emissions Trading Scheme” produced by MPI, and dated July 2022. The review team considers that it meets the Quality Assurance criteria. The Interim RIA is clear and concise and complete. The Interim RIA clearly outlines the limitations placed on the analysis, and is convincing within those limits. Adequate targeted stakeholder consultation has been undertaken, given that this Interim RIA is supporting a public consultation document.

## Section 1: Diagnosing the policy problem

### What is the context behind the policy problem and how is the status quo expected to develop?

#### A potential problem with the new penalties regime in the NZ ETS was identified but unresolved through a legislative process in 2020

1. The New Zealand Emissions Trading Scheme (NZ ETS) was reformed in 2020 through a package of amendments to the Climate Change Response Act 2002 (the Act). This included improvements to the compliance regime, most of which came into force on 1 January 2021<sup>1</sup>. An exception was the application, in certain circumstances, of the penalty that applies when forestry participants fail to surrender or repay emission units below a certain threshold, by the due date (surrender/repayment penalty). The surrender/repayment penalty was deferred until 1 January 2023 for forestry participants with small volume liabilities (less than 25,000 units per year) because of the potential disproportionate negative impacts of the penalty on this group. This gave officials a window of time to consider the impact of the penalty on participants with small volume liabilities, including whether further amendments to the penalty provisions may be required.

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<sup>1</sup> Infringement offences for low-level non-compliance came into force on 1 January 2022; a year later than planned largely due to COVID reprioritisation in 2020.

2. The section below provides more detail on this context, covering:
  - a brief introduction to the NZ ETS
  - compliance in the NZ ETS and why it matters
  - improvements to the compliance regime in 2020
  - deferred application of the surrender/repayment penalty to certain participants
  - diversity of participants in the NZ ETS and comparisons to other schemes
  - what has changed since 2020.

### **A brief introduction to the NZ ETS**

*The NZ ETS is one of New Zealand's main tools for responding to climate change*

3. The NZ ETS puts a price on greenhouse gas emissions, encouraging producers, consumers, and investors to reduce emissions. It was established in 2008 through amendments to the Act. The scheme has a legislated purpose of helping New Zealand to meet its international climate obligations<sup>2</sup> and assisting New Zealand to meet its domestic 2050 emissions reduction target and emissions budgets.
4. Emissions trading schemes (ETSs) operate in about 24 jurisdictions around the world<sup>3</sup>. In general terms, an ETS places obligations on certain entities to surrender to the government a volume of tradeable emissions units equivalent to the emissions they are responsible for. Entities can purchase these units on a secondary trading market where supply and demand establishes a market price. A government can manage the supply of emission units, for example, by auctioning units into the market, to align market supply (and therefore allowances to emit) with strategic goals for emissions reductions.
5. The NZ ETS largely operates as described above. The tradeable unit in the NZ ETS is currently limited to a New Zealand Unit (NZU)<sup>4</sup>. As of May 2022, an NZU held a spot price on the secondary market of about \$75. The Government supplies NZUs directly into the market through four auctions each year. The auction volume is determined by setting a rolling annual limit or cap on emissions which is linked to emissions budgets set in legislation.

*Who is covered by the NZ ETS?*

6. The NZ ETS puts surrender obligations on entities responsible for emissions from certain forestry activities, industrial processes, the import and use of synthetic greenhouse gases (excluding in goods), waste disposal, supply of liquid fossil fuels and the supply or use of stationary energy sources such as coal and natural gas. Entities responsible for agricultural emissions have reporting, but not surrender obligations,

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<sup>2</sup> Under the United Nations Framework Convention on Climate Change, the Kyoto Protocol, and the Paris Agreement

<sup>3</sup> As of January 2021. Schemes in other jurisdictions are also under development.

<sup>4</sup> Though the Act allows for other unit types to be used, should regulations be made to that effect.

under the scheme. Owners of land in exotic forest before 1990 (pre-1990 forest) have surrender obligations if they deforest that land<sup>5</sup>.

7. Alongside mandatory participants, the scheme allows for voluntary participation for some activities. The main voluntary participation is for forestry removal activities. The NZ ETS encourages new forest planting by allowing owners of eligible forests established after 31 December 1989 (post-1989 forests) to voluntarily register and earn NZUs as their trees grow and absorb carbon dioxide. Post-1989 forest participants must account for the carbon stock in their registered forests and may, depending on a range of factors, be required to surrender units if emissions are greater than removals (for example, after harvest).

#### *Who is responsible for the NZ ETS?*

8. The Ministry for the Environment (MfE) is responsible for leading whole-of-government climate change policy, including policy development for the NZ ETS. The Ministry for Primary Industries (MPI) also contributes to policy on the scheme, particularly in relation to forestry and land use.
9. The Environmental Protection Authority (EPA) manages the administration of the NZ ETS. This includes compliance, reporting and market information and operation of the New Zealand Emissions Trading Register (the Register<sup>6</sup>). Te Uru Rākau – New Zealand Forest Service, a branch of MPI, has delegated authority from the EPA to administer some functions of the NZ ETS for forestry.

#### **Compliance in the NZ ETS**

##### *What requirements do participants in the NZ ETS have to comply with?*

10. Mandatory participants<sup>7</sup> in the NZ ETS must:
  - apply to open a holding account in the Register
  - register as a participant
  - file an emissions return (reporting obligation) – this requires participants to collect and record information on their emissions
  - surrender or receive units (surrender obligation).
11. Generally, non-forestry participants and pre-1990 forest owners who deforest more than two hectares must file emissions returns annually by 31 March, reporting on the

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<sup>5</sup> Pre-1990 forest land in the NZ ETS is land that was forest land on 31 December 1989; remained forest land on 31 December 2007 and contained mostly exotic forest species on 31 December 2007. Up to November 2011, owners of pre-1990 forest land were given the option to apply for a one-off allocation of New Zealand Units (NZUs), in recognition of the impact of the ETS deforestation rules. They do not receive further NZUs if their forest's carbon stock increases.

<sup>6</sup> The Register is New Zealand's national registry for emission units, including those owned by the Crown. The Register acts like a bank, but it holds emission units instead of money. Businesses must have an account in the Register to be able to own or trade emission units in New Zealand. Anyone wanting to own or trade emissions units in New Zealand must have an account in the Register.

<sup>7</sup> Mandatory participants are those entities that carry out activities set out in Parts 1-4 and Part 6 of Schedule 323 of the Act. This includes for deforestation of pre-1990 forest.

last calendar year of emissions. They have until 31 May each year to surrender units in respect of the emissions they have reported on.

12. Voluntary post-1989 forestry participants have similar obligations but with timeframes that reflect the long-term nature of forest growth. Generally, these obligations are to:
  - submit a mandatory emissions return at the end of every mandatory emissions return period; usually every five years<sup>8</sup>
  - measure the forest's carbon stock in accordance with certain rules if they have 100 hectares or more of registered forest land, or use Carbon Look-Up Tables for smaller land areas<sup>9</sup>
  - report any changes to their registration details, including changes of ownership
  - surrender units if the forest's carbon stock decreases (e.g. after harvesting), after deforesting (shifting land to a different land use), or when removing land from the NZ ETS (de-registering).
13. Entities can also register for other (non-forestry) removal activities<sup>10</sup>. They have similar obligations to mandatory non-forestry participants (e.g. are required to report their removals annually). While the details are not salient for the purpose of this document, this points to a range of circumstances and activities that the NZ ETS's compliance regime must cater for.

### **Strengthening the compliance regime in 2020 reforms**

14. The compliance regime in the NZ ETS was strengthened as part of a package of wider reforms through the Climate Change Response (Emissions Trading Reform) Amendment Act 2020 (Amendment Act). Most of the new compliance provisions came into place on 1 January 2021.
15. The Amendment Act addressed a range of problems relating to both low-level and more serious non-compliance. Low-level offending in the NZ ETS might involve, for example, inadequate collecting or providing of information or inadequate record-keeping<sup>11</sup>. More serious conduct involves failing to submit an emissions return, submitting an inaccurate return, or failing to surrender or repay units when required.

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<sup>8</sup> The current mandatory emissions return period is 2018-2022. The next period is a shorter three year period (2023-2025) to better align the returns with emission budgets.

<sup>9</sup> The rules sit within what is referred to as a "Field Measurement Approach".

<sup>10</sup> Other removal activities include, for example, embedding global warming gases in a product, storing carbon dioxide after capture, or exporting Liquefied Petroleum Gas (LPG).

<sup>11</sup> For low-level offending, before 2020:

- Attempts to deter low-level offences through non-regulatory tools such as warning notices and education were not successfully reversing trends of non-compliance, including significant levels of repeat offending
- The only available penalties for some offences were criminal penalties brought by enforcement agencies for consideration by the Court, which were rarely used due to the significant costs in pursuing prosecution.

*The strengthened compliance regime uses a mix of compliance tools depending on the seriousness of the conduct*

16. The changes to the NZ ETS compliance regime introduced by the Amendment Act were intended to:
- incentivise participants to exercise due caution to meet their NZ ETS obligations
  - deter non-compliance
  - ensure penalties are applied based on principles of natural justice and equitable treatment of participants
  - ensure penalties, and their application, are easy to understand, predictable and transparent for participants and the public
  - ensure the regime is sufficiently robust to allow the NZ ETS to link with emissions trading schemes in other jurisdictions in future
17. The current compliance regime for the NZ ETS is summarised in Table One below

**Table One: Summary of the NZ ETS penalties regime (see Appendix One for more detail)**

<b>Non-compliant conduct</b>	<b>Compliance tool</b>
For low-level offending	Infringement offences (fees and fines) <ul style="list-style-type: none"> <li>– encourage compliance for low level offences while reducing the costs on the regulator of compliance action</li> </ul>
For more serious non-compliance	Reporting penalty <ul style="list-style-type: none"> <li>– for inaccuracies or failure to report</li> <li>– based on culpability bands</li> </ul> Surrender/repayment penalty <ul style="list-style-type: none"> <li>– for failure to surrender or repay units by the due date</li> <li>– strict liability – no discretion</li> </ul> Excess emissions penalty until 31 December 2022 <ul style="list-style-type: none"> <li>– for failure to surrender or replay units by the due date for forestry participants with small volume liabilities. The surrender/repayment penalty will apply from 1 January 2023</li> <li>– discretion up to 100% waiver.</li> </ul>
For intentional non-compliance	Criminal offences can be applied for situations of intentional misconduct.

*The new surrender/repayment penalty came into force on 1 January 2021 for most participants. This date was deferred for some forestry participants.*

18. The penalty for failure to surrender or repay units (surrender/repayment penalty) is the focus of this analysis. The penalty requires a person to pay a financial penalty (in cash) equivalent to three times the market price of carbon for each outstanding unit (three for one). The participant is also required to meet their original surrender or repayment obligation. The 'price of carbon' used for calculating penalties and setting synthetic greenhouse gas levies is prescribed in regulations and updated annually<sup>12</sup> using a prescribed methodology based on secondary market prices.
19. The surrender/repayment penalty replaced the excess emissions penalty and associated penalties, except in certain circumstances. The excess emissions penalty is a civil penalty of \$30 per unit. The penalty also applied in addition to participants or eligible persons meeting their original surrender or repayment obligation. It applied where a person failed to repay or surrender units by the due date, where an enforcement agency was required to amend or assess a person's emissions, resulting in a surrender or repayment liability, or where a person was required to repay units transferred in error.
20. The excess emissions penalty had four main problems:
  - The static \$30 per unit value was insufficient to deter non-compliance and was significantly lower than penalties imposed for similar non-compliance in other jurisdictions.
  - The significant discretion available to enforcement agencies to reduce the penalty created a high administrative burden and was challenging to apply consistently, leading to uncertainty for participants.
  - The penalty applied to conduct involving errors in reporting and failure to pay units, despite the latter amounting to more serious non-compliance.
  - A lack of clarity in the law whether inaccurate reporting was (also) captured by criminal sanctions in the Act.
21. The surrender/repayment penalty was intended to address some of these problems. The reasons for this design of the new penalty as submitted to Cabinet<sup>13</sup> were:
  - Removing the ability for enforcement agencies to apply discretion is administratively simpler to enforce and provides certainty for participants.
  - A cash penalty based on the market price ensures the penalty reflects changes in the carbon price but avoids participants facing different costs due to their ability to access units in the market<sup>14</sup>.
  - The severity of the penalty reflects the risk to the integrity of the scheme and the "fiscal risk created when a person fails to pay units to the Crown". Failure to pay

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<sup>12</sup> Climate Change (Synthetic Greenhouse Gas Levies) Regulations 2013, r 10.

<sup>13</sup> Hon James Shaw, Minister of Climate Change, *NZ ETS Tranche Two: Improving compliance and penalties* [ENV-19-SUB-0010]

<sup>14</sup> The cash penalty also avoids units being used to meet a penalty, and therefore being unavailable to other participants who are compliant



units is foregone revenue to the Crown and maintains a liability in the Crown accounts that would otherwise be reduced<sup>15</sup>.

22. The surrender/repayment penalty came into force on 1 January 2021, except for NZ ETS forestry participants with low volume liabilities. The next section of this document describes the reasons for that deferral in more detail.

#### *The design of the penalty aligns with overseas compliance regimes*

23. The stringency and size of the new penalty was influenced by New Zealand's interest in being able to link to other emissions trading schemes in the future. This linking is an important backstop measure to meeting our international climate obligations.

#### **Deferral of the surrender/repayment penalty until 1 January 2023 for forestry participants with low volume liabilities**

24. The deferral of the new surrender/repayment penalty for forestry participants with liabilities under a specified amount is provided through clause 17 of Schedule 1AA of the Act. These participants will be subject to the surrender/repayment penalty for surrender and repayment liabilities arising from forestry activities undertaken after 31 December 2022. Liabilities below the threshold for forestry activities prior to that point remain subject to the excess emissions penalty carried over from the old compliance regime.

#### *Who is covered by the deferral and still subject to the excess emissions penalty?*

25. The deferral applies to participants with a liability to surrender or repay units, below a threshold, that resulted from a forestry activity carried out before 1 January 2023. Generally, the deferral applies to liabilities of less than 25,000 units<sup>16</sup>. This covers both mandatory pre-1990 and voluntary post-1989 forestry participants.
26. The threshold of 25,000 units reflects the mandatory participation threshold in other international emissions trading schemes. For forestry this equates to emissions from deforesting approximately 36 hectares of pre-1990 forest, or 60 hectares of post-1989 forest<sup>17</sup>.

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<sup>15</sup> While not part of the original submission to Cabinet, at scale, unmet surrender obligations would make the business of managing unit supply to align with emission budgets more difficult and would require the unmet cost of the emissions to be passed on to others.

<sup>16</sup> The liability must result from one or more of the following, as set out in clause 17(1)(b)(ii): an emissions return with an emissions return period and under which the average liability per year of that period is less than 25,000 units; an emissions return without an emissions return period and under which the liability is less than 25,000 units; any other requirement in this Act (for example, the requirement to repay units under section 125 or any requirement to surrender units equal to a unit balance) and under which the liability is less than 25,000 units. The reference to "average liability per year" reflects the multi-year nature of the reporting requirements of post-1989 forestry participants.

<sup>17</sup> Based on *Pinus radiata* deforested at age 28. For post-1989 forests, the 60 ha figure is based on average of *Pinus radiata* forests under stock change accounting, which equates to 36 ha, and those that will be registered under averaging accounting, 81 ha. More deforestation is required to meet the threshold for a typical pine forest under averaging accounting as they only earn units up to age 16.

27. For context around 70% of post-1989 forestry participants own less than 60 hectares of post-1989 forest land. This equates to around 10% of the post-1989 forest land registered in the NZ ETS<sup>18</sup>.

*Why was a deferral considered necessary?*

28. The deferral was developed in response to submissions to Select Committee and parallel engagement between officials and forestry stakeholders. Submitters raised concerns that the proposed surrender/repayment penalty:
- Lacked discretion for regulators to reduce the surrender/repayment penalty in certain circumstances.
  - Was excessively large and, with no discretion to reduce the penalty, posed a risk to participants who may face unexpected obligations due to unintentional errors.
29. Further information also became available at about this time on the number of relevant non-compliant cases. When preparing policy decisions on the new regime, officials had understood that there had been four cases of failure to surrender since the NZ ETS began in 2008. However, new data indicated that there had been over 100 cases (most being forestry participants).
30. As a result, Cabinet considered there was a risk some forestry participants could be significantly affected by the new surrender/ repayment penalty. This conclusion was underpinned by the following factors:
- The NZ ETS has a low emissions threshold for participation compared to other schemes. In pre-1990 forestry this is deforestation of more than 2 hectares within a 5 year period.
  - The complexity of the NZ ETS for forestry means small forestry participants are more likely to make unintentional errors that result in unexpected unit surrender obligations. Small forestry participants may find it difficult to meet unexpected unit surrender or repayment obligations, particularly at high carbon prices. Meeting these obligations could create serious hardship for these participants, potentially putting key assets such as their home or farm at risk.
  - About two-thirds of post-1989 forestry participants have less than 50 hectares of registered forest in the scheme. Participants are usually natural persons, or small businesses including farmers with small forestry blocks, Māori landowners, forestry syndicates and conservation groups.
  - Landowners with pre-1990 exotic forest may be unaware their land is subject to deforestation liabilities. It can be difficult for landowners to determine whether their land is pre-1990 forest as it is not recorded on the land title. Their mandatory participation is therefore not a regular, familiar obligation but only arises in circumstances where they have mistakenly or intentionally deforested.
31. Cabinet concluded that there was a risk of serious hardship for small NZ ETS forestry participants if they were subject to the new surrender/repayment penalty. There was

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<sup>18</sup> At the end of May 2022, 1723 forestry participants had less than 60 hectares registered in the ETS out of a total of 2,482 post-1989 forestry participants. These 1,723 participants hold approximately 38,732 hectares of post-1989 forest land, out of a total of 380,671 hectare of post-1989 forest land registered in the ETS.

insufficient time to adjust the proposed surrender/ repayment penalty to address these issues prior to the passing of the Bill and the new surrender/ repayment penalty taking effect in 2021.

*What did Cabinet direct officials to do?*

32. In May 2020, Cabinet agreed to delay the implementation of the surrender/ repayment penalty for forestry participants with small liabilities per emissions return and directed the Ministry for the Environment, Ministry for Primary Industries and Ministry of Foreign Affairs and Trade to:
- Investigate compliance issues and the potential impact of the surrender/repayment penalty on small foresters and to consider as well as other sectors that may be similarly affected by the new penalty
  - Carefully consider our ability to link the NZ ETS to overseas markets in the future when developing policy options; and
  - Report back to Cabinet in mid-2021 on potential amendments to the penalty provisions in the Act to be included in any later Bill (if necessary) [ENV 20-MIN-0017 refers].
33. The requirement to consider other sectors similarly affected by the penalty was for equity reasons. There are other small businesses in the NZ ETS who are not engaged in forestry activities, and as a matter of fairness, the impact of the new surrender/ repayment penalty on their businesses also needs to be considered.

### **Who is subject to surrender or repayment obligations in the NZ ETS?**

34. Based on reported emissions in 2021, the makeup of participants in the NZ ETS were as follows:
- forestry participants make up the largest proportion of participants in the scheme:
    - 2,205 voluntary post-1989 forest participants.
    - 42 mandatory pre-1990 forest participants who deforested more than two hectares (this does not reflect the potential number of pre-1990 forest owners who could become participants if they deforest more than two hectares)
  - 141 mandatory non-forestry participants with surrender obligations.
    - 45 out of 141 mandatory non-forestry participants with surrender obligations (32%) reported emissions of less than 10,000 tonnes
    - 65 out of 141 mandatory non-forestry participants with surrender obligations (46%) reported emissions of less than 25,000 tonnes.
  - there are 211 mandatory non-forestry participants including those in agriculture sector who do not currently have surrender or repayment obligations, only an obligation to report emissions.

*Eligible persons who receive a free allocation of units and may also be subject to the surrender/repayment penalty in certain circumstances*

35. In addition to participants who must surrender units for their emissions, eligible persons<sup>19</sup> who receive a free allocation of units and may be required to repay some units to the Crown in certain circumstances<sup>20</sup>. Allocations can be made in advance based on a business' provisional production figures. In some cases, businesses may cease production, or dramatically reduce production compared to provisional figures. In these cases, they must repay units to the Crown. If these are not repaid on time, they also would be subject to the surrender/repayment penalty.

*Differentiating between pre-1990 forestry participants and other forestry participants*

36. Owners of pre-1990 forest land become mandatory participants if they deforest. Before deforesting, pre-1990 forest owners have no obligations in the NZ ETS. This differs from other mandatory participants in non-forestry sectors who are required to regularly account for and report on emissions while undertaking normal business activities.
37. Pre-1990 forest owners also differ from voluntary post-1989 forestry participants as they are unable to register to earn units for the carbon stored by their forests. It can also be more difficult for pre-1990 forest owners to be aware of deforestation obligations as the NZ ETS status of the forest land and any obligations are not recorded on land titles as is the case with post-1989 forests<sup>21</sup>.
38. This means pre-1990 forest owners may be more likely to fail to meet their surrender or repayment obligations due to being unaware of their obligations under the NZ ETS.

**What, if anything, has changed since 2020?**

*Forestry cases of failure to surrender or repay units from liabilities in 2020*

39. In 2020 there were nine cases of forestry participants with low volume liabilities subject to the excess emissions penalty system for forestry activities<sup>22</sup>. In all cases, the EPA used discretion to reduce the penalty, and the average surrender liability was 15,000 units. This suggests some participants will be affected by the more stringent surrender/repayment penalty when it comes into effect in 2023.
40. Publicly available data on non-compliance in the 2021 calendar year will not be available from EPA until mid-2022 at the earliest.

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<sup>19</sup> Eligible persons belong to industries considered to be emissions-intensive and trade exposed. Their free allocation of units was designed to mitigate the risk of emissions leakage, by offsetting the increase in production costs these businesses face from the price of carbon.

<sup>20</sup> In 2020 there were 78 recipients of a free allocation of units.

<sup>21</sup> Of the approximately 1.4 million hectares of pre-1990 forest in New Zealand, there is approximately 150,000 hectares where the pre-1990 status is not recorded on the land title.

<sup>22</sup> <https://www.epa.govt.nz/industry-areas/emissions-trading-scheme/ets-reports/non-compliance/>

### *Rising market price of carbon*

41. There has been a sharp increase in the carbon price since the introduction of the Amendment Act. The carbon price impacts both the cost of the initial obligation (units purchased at auction or on the secondary market) and the cash price of the penalty.
42. The carbon price used to calculate the penalty is set out in regulations that are updated annually<sup>23</sup>. The carbon price for 2022 is set at \$36.50, an increase of 46 percent from the price applicable in 2021 (\$25.60). The carbon price used to calculate the penalty is expected to continue increasing in future years if the carbon price continues to increase.
43. The carbon spot price in the secondary market was about \$75 in May 2022. Increases in the carbon price may make it more difficult for some participants to meet unexpected surrender or repayment obligations. For example, a unit obligation of 5,000 units would amount to \$375,000 based on a carbon price of \$75, compared to \$125,000 based on a carbon price of \$25.
44. Unexpected obligations for forestry participants may arise when errors in harvesting calculations are corrected, these are more likely to arise through the mandatory emissions return process. The next mandatory returns are due in 2023, and then again in 2026.

### *Removal of the fixed price option*

45. Prior to 2021, participants were able to pay a fixed dollar amount for their emissions rather than surrender units. This was known as the Fixed Price Option. The fixed price before 2020 was \$25 a unit (and for emissions that occurred in 2020 was \$35). This option meant that participants did not need to source units from the secondary market to pay for their emissions. This alternative method for paying for emissions was removed in 2021, with the introduction of unit auctions. With this option now removed, it may be much more costly and difficult to source units to meet any unexpected unit liabilities, especially relatively small obligations as many brokers trade in parcels of 5,000 or 10,000 NZU.

### *Pandemic – a reminder that events can happen beyond our control*

46. The Covid-19 pandemic has demonstrated that usual business processes can be interrupted by events outside any one organisation's control. The Christchurch Earthquake is another similar example.
47. Any unforeseen impacts on business as usual as a result of such events could prevent NZ ETS participants from repaying or surrendering units by a due date.

### *Interdependency with high priority international linking work*

48. Any changes to the penalty regime require testing with potential linking partners to ensure New Zealand does not foreclose the option to join with other emissions trading schemes to source offshore mitigation.

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<sup>23</sup> This is calculated using the weekly average market prices in the year from 1 July to 30 June, to apply for the following calendar year. Assuming a rising carbon price, the price in regulations may lag behind the market prices.

## What is the policy problem or opportunity?

### *Summary of status quo*

49. Most NZ ETS participants and eligible persons who fail to surrender or repay units by the due date are subject to an absolute liability penalty of three times the price of carbon as set in regulations for each outstanding unit. They must also meet their original obligation. Regulators have no discretion to adjust the penalty.
50. The size and inability for regulators to apply discretion when enforcing the penalty provides a strong deterrent for non-compliance. This is similar to the surrender/repayment penalty equivalents used in other international emissions trading schemes. This consistency allows New Zealand to keep our options open should the Government seek to link to other carbon markets in the future.
51. Most NZ ETS participants have been subject to the surrender/repayment penalty since 1 January 2021. However, application of the surrender/repayment penalty for forestry participants with small volume liabilities has been deferred until 1 January 2023 to reduce the risk of the penalty resulting in serious hardship for small forestry participants. This deferral enables officials to assess the risk to these participants, and adjust the surrender/repayment penalty if necessary.

### *Forestry participants with low volume liabilities are used as a proxy for “small forestry participants”*

52. Small forestry participants are defined by the differential application of the surrender/repayment penalty to certain participants, as set out in clause 17, schedule 1AA of the Act. As a summary, these are participants engaged in forestry activities with surrender obligations of less than an average of 25,000 units per annum. This definition also captures some larger forestry participants with surrender obligations less than 25,000 units. This approach was used on the basis that participants wouldn't be able to restructure their commercial affairs quickly enough to exploit the penalty regime before 1 January 2023. Even though this was intended as an interim measure we still consider this is the most effective way to capture small forestry participants as other measures could be gamed easily or were too difficult to define.<sup>24</sup>

### **Problem definition**

53. The NZ ETS for forestry is complex, a number of small forestry participants become non-compliant with requirements due to a lack of understanding of the system or from poor advice. This can lead to unexpected surrender or repayment obligations. When these small forestry participants fail to surrender or repay units on time, they are subject to a penalty regime that is disproportionate to their context. Cabinet has instructed officials to report back with options for potential amendments to the penalty regime.
54. There is a risk that small forestry participants in the NZ ETS who fail to surrender or repay units by the due date may face serious hardship if subject to the new surrender/repayment penalty intended to apply to their activities from 1 January 2023.

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<sup>24</sup> This included defining participants based on the size of their land holding, or size and sophistication of their business operations.

55. At a penalty carbon value of \$75 per unit a participant who fails to surrender or repay 5,000 units would be subject to a \$1,125,000 penalty under the new 3x surrender/ repayment penalty. The potential impact of the penalty to small forestry participants is likely to be disproportionate to the offence or the effect on the integrity of the NZ ETS (based on 2020/2021 the equivalent of 39,000,000 units were surrendered to the Crown)<sup>25</sup>.
56. The penalty particularly impacts small forestry participants due to:
- their surrender obligations often being unexpected due the complex nature of NZ ETS forestry reporting requirements.
  - them being less likely to be prepared to meet that penalty payment due to the scale of the obligation compared to their cash flow
  - should they incur a penalty and be unable to pay it, their personal assets including their house or farm could be at risk from debt collection by the Crown.
57. This creates a risk of regulatory failure as the penalties' impact could be considered greater than the harm of non-compliance and particularly unfair on small forestry participants.

*The application of the penalty to non-forestry participants and participants with larger volume liabilities has not been included in the scope of this analysis*

58. Non-forestry participants with small volume liabilities are already subject to the surrender/ repayment penalty. Non-forestry participants have not historically been the main source of non-compliance for failure to surrender or repay units. Nonetheless, Cabinet directed officials to consider the impact of the surrender/ repayment penalty on non-forestry sectors with small volume liabilities, based on the principle of equity.
59. This analysis does not seek to resolve any identified risk of regulatory failure for participants with small volume liabilities outside the forestry sector or eligible persons who face a repayment obligation. It will, however, seek to better understand that risk. The outcome of that consideration may be to undertake further work on the penalty in a later timeframe.
60. The disproportionate impact on NZ ETS participants with larger volume liabilities across all sectors including forestry has not been considered. This may also need to be reconsidered given the increases in the carbon price expected over time which could make it more difficult for emitters to meet their surrender or repayment obligations. This is outside the scope of this analysis.

## **Scale of the problem**

### *Forestry activity*

61. Based on previous compliance data for returns, between 4-8 forestry participants with low volume liabilities fail to meet their surrender or repayment obligations each calendar year. Up to 20 participants may miss their obligations in a mandatory

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<sup>25</sup> This includes NZUs surrendered and use of the Fixed Price Option (which enabled participants to pay a fixed cash price for a unit)

emissions reporting year, which usually occurs once every five years<sup>26</sup>. The reasons for missing obligations have historically included:

- lack of understanding of ETS rules leading to an unplanned or unexpected surrender obligation,
  - reliance on poor advice.
62. The average size of the initial surrender or repayment obligation faced by some small forestry participants is approximately 5,000 units. At a carbon price, and penalty value, of \$75 this equates to a value of \$375,000. If the participant failed to surrender or repay the units within 60 working days, the participant would also be subject to an additional surrender/ repayment penalty of \$1,125,000.
63. The initial obligation of 5,000 units and \$1,125,000 would be due within 20 working days. A participant may request to enter an arrangement to pay the penalty in instalments but not the underlying obligation. The total would be \$1.5m within 80 working days.
64. In comparison, the average annual profit before tax of a central North Island hill country sheep and beef farm for the 2020/2021 financial year was approximately \$64,000<sup>27</sup>.

#### *Non-forestry activity*

65. Cases of failure to surrender or repay are much less common for non-forestry participants (Since 2014 there have been 14 documented cases).
66. Based on emissions in the 2020 calendar year, there were two cases of failure to surrender or repay emissions for non-forestry activities. These were unexpected failures related to the Covid-19 pandemic.

#### **Stakeholder views**

##### *Summary of analysis of submissions from 2020 Bill process:*

67. Changes to the surrender/repayment penalties is one of the significant policy changes that was requested by submitters through the Climate Change Response (Emissions Trading Reform) Amendment Bill. Of the 38 submitters who commented on the new regime, 19 were concerned about the form and potential impact of the new surrender/repayment penalty. Their submissions expressed two major concerns:
- that they consider the size of the penalty to be excessive and pose a risk to participants who may be having trouble meeting their surrender obligation due to no fault of their own.
  - they view the absolute liability approach to the regime allows no flexibility to regulators to mitigate the penalty in certain limited circumstances, for example, when a force majeure event means participants cannot meet their surrender obligations on the due date.

Submitter suggested for improvements which include:

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<sup>26</sup> With the exception of a so-called mini-mandatory emissions reporting period (MERP) in 2023-2025 that has been adjusted to align the reporting periods with emission budgets and the introduction of averaging.

<sup>27</sup> Ag First Financial Survey 2020 Central North Island Hill Country Sheep and Beef



- setting the penalty at a fixed price of \$30 per unit or carbon price at the time
- to reduce the penalty down from 3x the number of units not surrendered/ repaid
- provide participants with an option to pay money for surrendering units in certain situations
- calculate penalties in relation to a materiality threshold
- use the culpability factors similar to the reporting penalty (see below)
- provide discretion for voluntary disclosure, or cases of where a one-off error was made

68. No substantive changes to the penalties and compliance provisions were recommended at the time, as the penalties reflected both the fiscal risk to the crown and provided opportunities for potential linking by aligning closely with international carbon markets. However, consideration was given to the potential impact of the surrender/repayment penalty on small forestry participants.

#### *Views of Māori landowners and organisations*

69. Submissions by Māori landowners and organisations noted that the penalty regime is not equitable and would affect both Māori and other small forestry participants disproportionately. Submitters mentioned that:
- The penalty regime did not take into consideration the complexities of Māori land ownership, in particular lease arrangements and transfer to family members
  - Small forestry participants lack the resources to ensure that they meet all the obligations upon entry into the ETS
  - Many participants will find it difficult to cope with the complexity of the ETS
  - The penalty for minor error is concerning and will deter entry into the ETS
  - Consideration was not given for the lack of access to legal advice on ETS issues by small forestry participants

### **What objectives are sought in relation to the policy problem?**

70. Develop a failure to surrender/ repay units for small forestry participants that:
- effectively responds to non-compliance and upholds the integrity of the NZ ETS
  - appropriately safeguards the rights and interests of participants (fairness), providing equitable treatment or a clear rationale for differential treatment based on unique circumstances
  - is part of an overall penalty and compliance regime that is compatible with other tools in the compliance regime
  - is easy to understand, predictable and transparent for both participants and enforcement agencies
  - protects Māori rights and interests and their ability to manage their land in line with their land-use aspirations.
  - is sufficiently robust to allow for international linking
71. There may be trade-offs between the different objectives. The objective to develop a robust penalty which allows for international linking could mean a more stringent penalty is required which may compete with the objective of fairness and equitable treatment of all participants.

## Section 2: Deciding upon an option to address the policy problem

### What criteria will be used to compare options to the status quo?

72. The following criteria will be used to evaluate options against the status quo:

Criteria	Explanation
Deters non-compliance and upholds the integrity of the ETS	Effectively deters non-compliance – avoiding the risk of the Crown meeting the costs of participants' emissions  Incentivises participants to use due caution and put in place the necessary steps to meet surrender and repayment obligations  Is proportionate to the serious nature of the harm caused  Contributes to an overall coherent and appropriate compliance regime.
Treats participants fairly and equitably	Safeguards the rights and interests of participants (provides for natural justice)  Sanctions are not excessive or unwarranted.  Is easy for participants to understand.  Provides equitable treatment of participants – or a defensible rationale for differentiating between participants based on their unique circumstances.
Is straightforward to apply and transparent	Straightforward and easy for participants to understand what is expected of them, and how the penalty will be applied.
Supports Māori rights and interests	Protect Māori rights and interests and their ability to manage their land in line with their land use aspirations.
Is operationally efficient to administer	Reduces or minimises administration costs to the Crown and the Regulator
Able to be passed into legislation by the end of 2022	Meet expectations that it can be passed in legislation by the end of 2022.

73. There are a range of tensions and potential trade-offs between the criteria. For example:

- a penalty that provides greater discretion to consider the different circumstances of each case may create apparent inconsistent treatment between participants, and/or be more complex and costly to implement.
- a penalty that provides procedures for natural justice may be more costly to implement than one that enforces an absolute liability<sup>28</sup>.

74. Evaluating different options requires understanding the expectations of potential international linking partners and when these partners consider differences are

<sup>28</sup> Note that sections 144-146 of the Act provide a right of review, and right of appeal to the District and High Court for a decision made by the EPA.

justified. We also need to understand the attributes and requirements of different participants to ensure participants are treated equitably.

### What scope will options be considered within?

75. Options which address the potential adverse impacts of the surrender / repayment penalty on small forestry participants will be considered. Options that address potential adverse impacts of the surrender/ repayment penalty on participants in other sectors with small volume liabilities, or for all participants with liabilities over 25,000 units annually will not be considered.
76. This limited scope is necessary to meet Ministers' expectations to develop a legislative resolution before 1 January 2023. Nonetheless, it will be important not to entrench any identified problems with the existing penalty, into an amended penalty for a differentiated group. To that extent, officials have remained open to the possibility that further work may be needed in parallel, or through a later process, that re-considers the penalty more widely.
77. Improving transparency – the 2020 reforms introduced greater transparency to the compliance regime. This included a requirement on the EPA to publish, at least annually, individual cases of non-compliance in certain circumstances, including as a result of failure to surrender or repay units by a due date. The expectation is that all options considered in this process will uphold the principle of transparency through similar requirements.

### What options are being considered?

#### **A non-regulatory approach will be considered alongside all options to mitigate the risks associated with a penalty**

78. There is a need to increase the level of understanding around the obligations of NZ ETS forestry participants. Te Uru Rākau – New Zealand Forest Service has several workstreams underway to educate NZ ETS forestry participants of their obligations. These efforts would be increased to reduce non-compliance with the surrender repayment penalty. Educating NZ ETS forestry participants on changes to the penalty and ensuring that robust operational policies are in place so participants understand how the penalty will be applied will therefore be a key part of all the options being considered.

#### **Option One – *Status Quo Status Quo – subject to the 'three for one' surrender/repayment penalty***

79. Under the Act, forestry participants with low volume liabilities will be subject to the surrender/repayment penalty from 1 January 2023. The excess emissions penalty that currently applies to these participants will then be removed.
80. After 1 January 2023 all participants in the NZ ETS will then be subject to the three for one surrender/repayment penalty for activities that take place from that date.

#### **Option Two – Modified excess emissions penalty**

81. This option would extend the application of the excess emissions penalty to forestry participants with low volume liabilities indefinitely. The size of the penalty would be

amended to align with the current market price<sup>29</sup>. This would ensure that the excess emissions penalty is more effective at deterring non-compliance. The EPA could use discretion to reduce the penalty by up to 100% based on existing operational guidelines.

82. The parameters for discretion are set out in section 135 of the CCRA before it was amended in 2020. In summary, the excess emissions penalty can be reduced up to 100% if the participant:
- voluntarily discloses the failure to surrender or repay units before receiving a penalty notice, or
  - if the unit obligation arose from an amendment or assessment - the EPA is satisfied that the person formed an incorrect view that was reasonable having regard to the information available to that person at that time.

### Option Three - Strict liability penalty differentiated by size of liability

83. This option proposes a strict liability penalty based on the size of the surrender or repayment liability. With strict liability penalties, if the defendant can prove total absence of fault a penalty will not apply. Strict liability does not involve proving the intention of the defendant. This means the participant would likely have a full defence if an unprecedented event prevented the participant from paying their units on time.
84. Table Two below demonstrates how the penalties that would apply depending on the size of the net surrender/repayment obligation averaged across a year. For example, under this option, for average obligations under 10,000 units a year, the penalty would be calculated by multiplying half the size of the overdue obligation by the price of carbon, while for net liabilities between 10,000 and 25,000 units the penalty would be calculated by multiplying the full size of the overdue obligation by the price of carbon.

**Table Two: Example by size of obligation**

NZ ETS forestry participants	Average annual unit surrender obligation in the return	
	< 10,000	≥ 10,000 to < 25,000
Total absence of fault	None	None
Multiplier based on size of penalty	0.5x overdue unit surrender x obligation penalty price	1.0x overdue unit surrender obligation x obligation penalty price

### Option Four - Reduced 1 x penalty by Culpability Factors

85. This option would allow for discretion to reduce or waive the penalty based on a participant's culpability and differs depending on the size of the initial obligation. Where a person took reasonable care the penalty would not be applied. The size of the penalty would be calculated by multiplying:

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<sup>29</sup> The price of carbon would be based on the price set out annually in regulations, as is used for the surrender / repayment penalty

- a. The number of units that person has failed to surrender or repay by the due date
- b. price, in dollars, of carbon set out in the regulations made under section 30W
- c. culpability factor

Culpability Category	Culpability factor	
	Liabilities <10,000	Liabilities 10,000 ≥ <25,000
Person did not take reasonable care	0.1	0.2
Person was grossly careless	0.3	0.4
Person knowingly failed	1.0	1.0

86. The culpability categories could be interpreted as:

- Did not take reasonable care: Failed to take actions that any person might reasonably expect to have taken to meet the surrender or repayment obligation by the due date.
- Gross carelessness: Conduct that created a high risk of non-compliance, where the risk would have been foreseen by a reasonable person in the circumstances. The carelessness must have been flagrant.
- Knowing failure: The person knew or appreciated the risk that the surrender or repayment obligation would not be made by the due date.

#### Option Five – A court-imposed penalty

87. This option involves a court imposing a pecuniary penalty rather than the Regulator. The Regulator (EPA) would initiate court proceedings through a statement of claim. The facts of the offence must be proven using the civil standard of proof (“balance of the probabilities”). Subject to the protection of privilege and the discretion of the Court, the defendant is required to provide answers to the accusations and state their own case (via a statement of defence).

88. The Court takes into account subjective elements when determining the size of the penalty. The maximum size of the penalty would usually set in legislation (with different levels for individuals and companies). Parties can agree the size of the penalty prior to it being approved by the Court.

89. Legislative Design and Advisory Committee Guidelines note that, generally, pecuniary penalties should be imposed by the Court. Judicial oversight provides open and transparent consideration of liability and any aggravating and mitigating circumstances. It prevents the regulator determining and applying penalties without adequate appeal or review processes. Furthermore, it suggests that determinations of fault or intention are subjective and more appropriately left to a judge.

## How do the options compare to the status quo/counterfactual?

	<b>Option One Status quo: 3X penalty</b>	<b>Option Two – Modified excess emissions penalty</b> Liability X market price with discretion to reduce by 100%	<b>Option Three– Strict liability penalty</b>  Penalties are lower for lower volume liabilities and differentiated by activity	<b>Option Four – 1 X liability penalty with culpability factor</b>  Parameters for discretion and reduced penalty set out in legislation based on culpability	<b>Option Five– Court based penalty (with discretion and/or with strict liability)</b>
Deters non-compliance and upholds the integrity of the ETS	0	0 size of penalty still effective at deterring non-compliance but somewhat less so than status quo; more proportionate penalty to harm and behaviour, discretion to reduce by 100% may not lead participants to be as cautious as a more stringent penalty.  This penalty does not align with the stricter compliance regime envisioned for the ETS which is now reaching a more “mature” stage. – the reason this penalty was changed initially.	0 size of penalty still effective; about the same as status quo; more proportionate to harm but not adjusted for behaviour beyond no fault.  Penalty fits the scheme, most similar to the status quo, with some discretion to reflect the unique nature of forestry in the NZ ETS.	0 size of penalty still effective but somewhat less so than status quo; more proportionate to harm and behaviour.  Culpability factors are used for reporting penalties, so this aligns well with the reporting penalty.	0 size of penalty still likely to be effective; depends on other design features applied to the penalty  Court option is quite different to other compliance measures. While it is an appropriate option, it is not compatible with the overall regime unless the court option is available to all participants.

Fair and equitable to participants	0	++ provides for participants interests but may involve uncertain or inconsistent outcomes at times	+ provides for participants interests when no fault; but may not cover all scenarios. This could be mitigated through an education programme.	+ provides for participants interests through different treatment based on their culpability. However, difficult to apply clearly.	+ provides for participants interests when absolute no fault; more certainty and transparency in decision making than administrative discretion.  Small foresters may not be able to afford to defend selves in Court.
Is straightforward to apply and transparent	0	- More complex to administer than status quo, but EPA has had 14 years' experience in administering this penalty. Consistency and transparency could be improved through refreshing operational guidelines.	0 Should be straightforward to apply provided no fault defence is clearly explained and published through operational guidance.	-- Much less likely than status quo, applying culpability bands to failures to pay not sufficiently clear. Would be difficult to administer.	0 Straightforwardness would depend on final design of penalty. Court process would ensure a transparent process.
Efficient for administrators	0	- already in place so well tested already original identified issue with penalty was discretion was costly to administer	- Note discretion is limited to cases of total absence of fault.	-- Lack of clarity and ability to enforce different culpability factors as they relate to failures to pay would make it difficult for the Regulator to administer.	-- Changes role for EPA but will still have administrative burden to bring cases to Court.
Supports Māori rights and interests	0	+ Discretion enables the Regulator to consider unique circumstances of Māori landownership in determining whether a penalty is appropriate.	+ Better than status quo, but still limited discretion to consider unique circumstances. Could be mitigated through an education programme	+ Not applying the penalty for reasonable mistakes allows Regulator to consider unique circumstances of Māori rights and interests.	+ Judicial process will enable Māori rights and interests to be considered. Noting that cost of court process may be a negative factor.

			focusing on Māori landowners.		
Meets expectations of a resolution in place by end of 2022	0	0 Yes, this option was originally in place prior to the 3X penalty, the guidelines are there and will not require major changes to implement.	0 A strict liability penalty would be relatively simple to draft and implement	-- Requires more detail on how discretion can be applied by the EPA, this may take extra time. Would be more complex to draft than other options.	-- Requires much more detail on how the court option would work, would need to be consulted in depth. This will take extra time. Would need to justify why we are not changing the design of the penalty for other larger participants.
<b>Overall Assessment</b>	0	+ Fairer to some participants, but process lacks repeatability, certainty.	+ Better than status quo, equally effective, fair, can provide more certainty than other options, in line with legislative guidelines. No fault defence may not cover all cases of non-compliance however if implemented in tandem with education programme those risks could be mitigated.	- Better than status quo in areas on fairness, considers the unique circumstances. It will be difficult to administer as culpability is not easily applied to failures to pay (compared to reporting errors for example). It will be difficult to be certain of what culpability band applies. Therefore, not recommend.	- Aligns better with Legislative Guidelines, and well suited for an option that includes culpability / discretion. Better than status quo, equally effective, fair, can be designed to consider unique nature of participants. Would result in less coherent and inequitable overall penalty regime if other participants continue to face an absolute liability imposed by EPA.



## What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

90. Option Three (Strict Liability penalty) is the preferred option at this stage. On balance this option best meets the policy objectives, addresses the problem, and delivers the highest net benefits. A strict liability penalty with a reduced starting point (one to one, rather than three to one) mitigates some of the risk of the disproportionate impact to small forestry participants from the size of the penalty. Having a further 50% reduction for liabilities less than 10,000 would also reduce that risk further. Additionally, enabling the penalty to be avoided in situations where the participant is not at fault provides an equitable approach which takes into consideration the participants rights and interests.
91. There is some risk that there may be cases of non-compliance which do not meet the threshold for total absence of fault but may still involve taking reasonable care. We will be interested in hearing from submitters about this risk, and may need to consider other justifications for reductions available. Provided this option is implemented with an extensive education package, with particular focus on pre-1990 forest owners and Māori foresters we consider that any risks of inadvertent non-compliance could be adequately mitigated. There are also other improvements to the NZ ETS that mean that unexpected payment obligations will reduce for post-1989 forestry participants. Improvements to the NZ ETS for forestry that come in to effect in January 2023 mean that new post-1989 forestry owners are less likely to face unexpected surrender obligations (for example under the new averaging accounting approach they will not need to surrender units after harvest if they replant).
92. A strict liability approach would provide a much more transparent and easier to understand use of discretion than other options (such as a modified excess emissions penalty or using culpability bands).
93. Option Two (a modified excess emissions penalty) is the next best option that meets the policy objectives, and addresses the problem and so we consider this should also be consulted on. The biggest benefit of this penalty is the much broader discretion that could ensure that all cases of serious hardship are accounted for when the regulator administers the penalty. (As the Regulator has discretion to reduce the penalty up to 100%). We consider that this option could be more transparent and easier for the Regulator to apply consistently if the way the discretion is applied is modified. For example, the use of voluntary disclosure as a ground for waiving a penalty could be removed, and the discretion could be focused on the reasonableness of the failure.
94. Option Four (culpability bands) was not preferred due to the lack of certainty in how to define and apply different culpability bands in the context of failures to surrender or repay units. This would have led to significant uncertainty for participants on how the penalty would apply and much greater administrative burden for the Regulator that would outweigh any benefit a culpability assessment would bring in providing a more equitable outcome.
95. Option Five (a court-imposed penalty) was not preferred as the high financial burden on smaller forestry participants to defend themselves in court, high costs to the regulator, and may not meet the public interest test which would outweigh the benefits of a court process determining the final penalty. This would also create an inconsistency where larger penalties are decided by the Regulator and smaller penalties are decided by the Court. Additionally, this option would have required much

more resource and time to test and develop which was not achievable to meet a legislative deadline by the end of the year. Such a change would be better considered in a broader review of the compliance and penalty regime.

## What are the marginal costs and benefits of the option?

<b>Affected groups</b> <i>(identify)</i>	<b>Comment</b> <i>nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks.</i>	<b>Impact</b> <i>\$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts.</i>	<b>Evidence Certainty</b> <i>High, medium, or low, and explain reasoning in comment column.</i>
<b>Additional costs of the preferred option compared to taking no action</b>			
Regulated groups	Cost to prove not at fault, but this is balanced by avoiding a large penalty if successful.	Low	High
Regulators	Higher cost to consider whether total absence of fault applies than an absolute liability approach, but not likely to be significantly larger.	Low	Medium  Costs of applying penalty will depend on final design of penalty, and how constrained discretion is, for example if no fault is the only defence or if more discretion is appropriate.
Others (eg, wider govt, consumers, etc.)	None	None	
<b>Total monetised costs</b>		Low	Medium
<b>Non-monetised costs</b>		Low	Medium
<b>Additional benefits of the preferred option compared to taking no action</b>			
Regulated groups	Forestry participants are protected from serious hardship in cases of no fault.	Moderate to high	Low-Medium  Based on available data there is a risk of serious hardship, which this option

			will help protect for certain cases. More analysis will be required to understand if this will be sufficient or if more discretion is required.
Regulators	Integrity of the scheme is maintained and enhanced	Moderate	Medium
Others (eg, wider govt, consumers, etc.)	Reduces risk of people avoiding entering the ETS due to large penalty risk.	Low to moderate	Low  We will have a better idea of impact on others once consultation has occurred.
<b>Total monetised benefits</b>		Moderate to high	Medium Will ensure that participants avoid serious financial hardship in cases where it wasn't their fault.
<b>Non-monetised benefits</b>		Moderate to high	Medium Will remove a deterrent for ETS participation for small foresters who might be concerned with size of penalty.

## Section 3: Delivering an option

### How will the new arrangements be implemented?

96. Implementation of these proposals require amendments to the Act. An amendment bill to the Act will be required in 2022 to ensure forestry participants are not subject to the three to one surrender/repayment penalty from 1 January 2023.
97. A two-step legislative and policy process will be necessary to ensure passage amendments to the Act before 1 January 2023. This two-step process will involve extending the transitional penalty until 31 December 2024 through reducing the scope of the Forestry Bill legislative bid to be passed this year. A new penalty will be prescribed through the Climate Change Response Amendment Bill, to be passed mid-2023, for a new penalty to come into force on 1 January 2025.
98. An additional year for implementation will allow the Environmental Protection Authority and the Ministry for Primary Industries to educate forestry participants on changes to the penalty and ensure that robust operational policies are in place so participants understand how the penalty will be applied.
99. The education package will give participants time and resources to understand their obligations and will aim to increase compliance, which is particularly important if a stricter penalty is implemented. Participants will be aware of the steps required to surrender or repay units on time and understand the magnitude of the penalty they will face if they fail to meet their obligations.

### How will the new arrangements be monitored, evaluated, and reviewed?

100. The Government will monitor and evaluate compliance rates on an ongoing basis to ensure that the new penalty regime is meeting the policy objectives. Penalty non-compliance rates are published on an annual basis. In addition, in the interests of transparency we consider that serious non-compliance should be published on an individual basis in line with other NZ ETS penalties to ensure decision making is transparent, and failures are deterred.