

Te Uru Rākau



New Zealand Forest Service

# Changing the surrender/repayment penalty for small forestry participants in the New Zealand Emissions Trading Scheme

## Regulatory Impact Statement

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November 2022



**Te Kāwanatanga  
o Aotearoa**  
New Zealand Government



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# Coversheet

Purpose of Document	
Decision sought:	<p>Cabinet agreement on amendments to the Climate Change Response Act 2002 to change the penalty which applies when small forestry participants in the New Zealand Emissions Trading Scheme fail to surrender or repay units on time. These obligations usually arise when forests are harvested, deforested, or deregistered from the scheme, and the resulting unit liabilities are not paid back on time.</p> <p>An <a href="#">Interim RIS</a> was prepared in July 2022 when approval was sought to consult on options for a revised penalty for small forestry participants and to extend the current transitional arrangement in place for those participants.</p>
Advising agencies:	Ministry for Primary Industries
Proposing Ministers:	Minister of Forestry and Minister of Climate Change
Date finalised:	14 November 2022
Problem Definition	
1.	A review of the New Zealand Emissions Trading Scheme (NZ ETS) resulted in a strengthened penalty (the <b>'three to one' penalty</b> ) <sup>1</sup> that applies when participants fail to surrender or repay ( <b>pay</b> ) units <sup>2</sup> on time.
2.	Influenced by New Zealand's interest in being able to link with international emissions trading schemes in the future, the 'three to one' penalty is set at three times the price of carbon (set in regulations) for each unpaid unit with no provision to be waived or reduced.
3.	Unlike other NZ ETS participants, <sup>3</sup> the introduction of the 'three to one' penalty was deferred for forestry participants with liabilities of less than 25,000 units on average per year ( <b>'small forestry participants'</b> ). This was due to concerns that it could lead to serious financial hardship if they were to incur the 'three to one' penalty and be unable to pay it.
4.	Three key risks associated with applying the 'three to one' penalty to small forestry participants are: <ul style="list-style-type: none"><li>• the potential significant financial impacts, which could lead to serious financial hardship in some cases;</li><li>• the size of the penalty being disproportionate to the level of the offence; and</li><li>• the penalty not being fit for purpose and small forestry participants' context, particularly for owners of small areas of pre-1990 forest land who face mandatory deforestation liabilities.</li></ul>

<sup>1</sup> The 'three to one' penalty has also been referred to as the surrender/repayment penalty. For the purpose of this document, the term 'three to one' penalty is used.

<sup>2</sup> Units are 'surrendered' to the Crown for carbon stock decreases, and 'repaid' to the Crown if they need to be paid back (e.g., if they are over-claimed).

<sup>3</sup> The 'three to one' penalty took effect for all other NZ ETS participants from 1 January 2021.



## Executive Summary

5. The Climate Change Response (Emissions Trading Reform) Amendment Act 2020 (**the Amendment Act**) introduced changes to the Climate Change Response Act 2002 (**the Act**) to improve the NZ ETS compliance system.
6. This included strengthening the penalty that applies to participants and other eligible persons who fail to pay units on time (the 'three to one' penalty).
7. The 'three to one' penalty is set at three times the price of carbon (set in regulations) for each unpaid unit. This penalty is an absolute liability penalty, meaning there is no provision for the regulator to waive or reduce the final penalty in any circumstances. Like all NZ ETS penalties, the 'three to one' penalty applies in addition to the original unit obligation.
8. While the 'three to one' penalty came into effect for most NZ ETS participants on 1 January 2021, Cabinet agreed to defer its application for small forestry participants until the end of 2022.<sup>4</sup> This was in recognition that the impacts of applying the 'three to one' penalty to these participants could be disproportionate to their context and the level of non-compliance, possibly leading to serious financial hardship in some cases.
9. Small forestry participants are defined in the Act<sup>5</sup> as participants or other eligible persons, in relation to forestry activities, who have average annual unit liabilities of less than 25,000 units per emissions return.
10. To put this into perspective, a unit obligation of 25,000 units<sup>6</sup> is valued at around \$1.9 million.<sup>7</sup> If a small forestry participant failed to pay these units on time, they would incur a penalty of \$5.6 million<sup>8</sup> (in addition to the original unit obligation) if the 'three to one' penalty applied to them.
11. At the same time, Cabinet agreed that the previous 'excess emissions penalty'<sup>9</sup> would continue to apply to small forestry participants who fail to pay units on time (the '**transitional arrangement**') and directed officials<sup>10</sup> to investigate the full-scale impacts of applying the 'three to one' penalty to these participants.<sup>11</sup>
12. In July 2022, officials reported back to Cabinet that the risks of applying the 'three to one' penalty to small forestry participants persists and is expected to increase as the price of carbon continues to rise. This is because the price of carbon is factored into the 'three to one' penalty calculation, which is updated annually in regulations based on the market price of carbon from the previous year. In 2022, the price of carbon was set at \$36.20 (a 46 percent increase from 2021) and it has been set at \$67.63 for 2023 (an 87 percent increase from 2022).

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<sup>4</sup> ENV-20-MIN-0017 refers.

<sup>5</sup> Clause 17, Schedule 1AA of the Act.

<sup>6</sup> 25,000 units roughly relates to a forest of up to 36 hectares (based on an average Pinus radiata forest at age 28 (~700 tonnes per hectare) using the stock change accounting methodology).

<sup>7</sup> Based on a market price of \$75 per unit.

<sup>8</sup> Based on a prescribed price of \$75 per unit.

<sup>9</sup> Set at \$30 per unpaid unit, with provisions for the regulator to exercise discretion to reduce or waive it by up to 100 percent in certain circumstances. Additional penalties may apply where a person fails to pay the units again following a penalty notice, and/or if they are convicted of a knowing/evasion offence in relation to their unpaid units.

<sup>10</sup> Ministry for Primary Industries and Ministry for the Environment.

<sup>11</sup> ENV-20-MIN-0017 refers.

13. Subsequently, Cabinet agreed to extend the transitional arrangement for small forestry participants with unit liabilities from forestry activities occurring up until the end of 2024,<sup>12</sup> and for officials to consult on options for a revised penalty to apply to small forestry participants from 1 January 2025.<sup>13</sup>
14. In August 2022, officials consulted on two options for a revised penalty. These were a strict liability penalty (officials' recommended option) and a discretionary penalty. Objectives consulted on included ensuring the revised penalty effectively deters non-compliance while remaining fair and proportionate.
15. In response to feedback received during consultation, officials refined the strict liability penalty that was consulted on and advice was provided to a delegated sub-group of ministers for final policy decisions.<sup>14</sup> The sub-group supported a strict liability option as the revised penalty for small forestry participants (the 'revised penalty').
16. The revised penalty uses a fixed rate multiplier for the purpose of calculating the final penalty, set at:
  - 0.5 x the price of carbon (as set in regulations) for post-1989 forestry participants
  - 0.25 x the price of carbon (as set in regulations) for pre-1990 forestry participants
17. The reduced rate (of 0.25) for pre-1990 forestry participants addresses feedback received during consultation by recognising the unique circumstances of pre-1990 forest owners, who do not receive units for carbon sequestration in their forests but become liable for unit surrenders if they deforest the land.<sup>15</sup>
18. It is intended that the revised penalty will apply for unit liabilities arising from forestry activities occurring from 1 January 2025, immediately after the transitional arrangement ends. The revised penalty will continue to apply in addition to the unit obligation.
19. A commencement date of 1 January 2025 provides time for legislation to be put in place (legislative changes to the Act are required) and for an education package to be developed and rolled out before the revised penalty takes effect. The education package will aim to improve understanding among small forestry participants about NZ ETS obligations and the consequences of failing to meet them, including what the revised penalty for small forestry participants will mean in practice.

### Limitations and Constraints on Analysis

Several limitations and constraints have affected our analysis as follows:

#### Timing and resource to complete analysis

20. When proposals were being made to strengthen the NZ ETS penalties and compliance regime in 2020 via the Amendment Act, Cabinet directed officials to explore potential options for a more flexible approach to applying the 'three to one'

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<sup>12</sup> To be implemented by the Climate Change Response (Extension of Penalty Transition for Forestry Activities with Low Volume Emissions Liabilities) Amendment Bill, introduced 4 October 2022.

<sup>13</sup> CAB-22-MIN-0293 refers.

<sup>14</sup> B22-0523 refers.

<sup>15</sup> Pre-1990 forest owners (or in some cases, relevant third parties) can become mandatory participants in the NZ ETS if they deforest (i.e., clear and do not re-establish or convert the land to non-forest) and therefore be liable for unit surrenders.



penalty to small forestry participants, and to test whether this would still maintain international linking potential.<sup>16</sup>

21. When reporting back in May 2020, officials noted that a long-term solution could not be resolved in the timeframe of Amendment Act and reiterated that the ‘three to one’ penalty could cause serious financial hardship to small forestry participants if they were to incur it.
22. Subsequently, Cabinet agreed to defer the introduction of the ‘three to one’ penalty for small forestry participants for unit liabilities from forestry activities occurring up until 31 December 2022, and in summary, directed officials to:
  - investigate compliance issues and impacts of applying the ‘three to one’ penalty to small forestry participants, and consider NZ ETS participants from other sectors who may be similarly affected by the new penalty;
  - carefully consider our ability to link the NZ ETS to overseas markets in the future in developing policy options; and
  - report back to Cabinet in mid-2021 with any potential amendments to the penalty provisions in the Act, to be included in any later Bill (if necessary).<sup>17</sup>
23. Due to resource and time limitations, officials did not report back to Cabinet until July 2022.<sup>18</sup> In doing so, officials highlighted that they had prioritised addressing small forestry participants as their penalty regime was out of date and required immediate action before 1 January 2023 to ensure the risk of serious financial hardship continued to be mitigated.
24. Therefore, officials have not considered the appropriateness of the ‘three to one’ penalty for NZ ETS participants from other (non-forestry) sectors who may be similarly affected. The Ministry for the Environment (MfE) will monitor the effectiveness and appropriateness of the ‘three to one’ penalty for other sectors to determine if changes may be required in future.
25. Officials also noted that amendments beyond the design of the penalty provision itself (e.g., extending the deadline for paying the original unit liability or enabling the original unit liability to be paid off in instalments) were out of scope and have not been considered.

#### **Availability of compliance data**

26. Our ability to understand of the scale of the problem and whether other NZ ETS participants may also be affected by the ‘three to one’ penalty has also been impacted by not having a complete and detailed set of historic compliance data.
27. This has meant that officials have had to rely on a small sample set of compliance data, and aggregated data that is publicly available. This data did not include detailed information on the types of participants that were non-compliant (e.g., the information did not go into details of individual participant information) and the reasons why penalties were applied or not applied in each case.

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<sup>16</sup> CAB-20-MIN-0062 refers.

<sup>17</sup> ENV-20-MIN-0017 refers.

<sup>18</sup> ENV-22-MIN-0029 refers.

## Non-regulatory options

28. Officials have not considered non-regulatory options (such as education and guidance) as a stand-alone solution to the policy issue.
29. This is because non-regulatory options were outside the scope set by the direction from Cabinet. Non-regulatory tools have generally been effective for deterring low-level non-compliance in the NZ ETS (such as inadequate record-keeping), as opposed to being used as a way to reduce the likelihood of participants incurring significant penalties for more serious conduct (such as failing to pay units on time).
30. While the recommended option set out in this regulatory impact statement is intended to be supported by education and guidance, this is for supplementary purposes only, to facilitate the implementation of the proposed regulatory changes.

Responsible Director	
Oliver Hendrickson (Director, Forestry and Land Management, Te Uru Rākau – New Zealand Forest Service)	
Quality Assurance	
Reviewing Agency:	Ministry for Primary Industries
Panel Assessment & Comment:	<p>“The MPI Regulatory Impact Analysis Panel has reviewed the <i>Regulatory Impact Statement: Changing the surrender/repayment penalty for small forestry participants in the New Zealand Emissions Trading Scheme</i> produced by MPI dated 14 November 2022. The review team considers that it <b>partially meets</b> the Quality Assurance criteria.</p> <p>The <i>Regulatory Impact Statement: Changing the surrender/repayment penalty for small forestry participants in the New Zealand Emissions Trading Scheme</i> produced by MPI is a clear and concise document, setting out the limitations of the assessment undertaken and providing clear recommendations within the scope of the consideration undertaken. The proposals have benefited from public engagement and options considered, developed and refined in response to this engagement. However, the RIA does not fully show how the status quo 3:1 penalty disproportionately affects smaller forestry participants as against larger participants. Given the limitations around this proposal, it is unlikely that the RIA could make this clear”.</p>



## Section 1: Diagnosing the policy problem

### 1. WHAT IS THE CONTEXT BEHIND THE POLICY PROBLEM AND HOW IS THE STATUS QUO EXPECTED TO DEVELOP?

#### Legislative Framework: Overview of the NZ ETS

31. The NZ ETS was established through the Act in 2008 and is the Government's primary tool for meeting domestic and international climate change targets.
32. The Government limits economy wide emissions by allocating emissions into the NZ ETS market in the form of New Zealand Units. One unit represents one tonne of carbon dioxide (or equivalent greenhouse gas).
33. It is mandatory for most emitters to participate in the NZ ETS market by reporting, acquiring, and surrendering units to cover their emissions. The NZ ETS also incentivises carbon storage by enabling some entities that store greenhouse gases, such as forest owners, to earn units from the Government.
34. The Government sets and reduces the number of units supplied into the scheme over time through the NZ ETS settings. The number of units available in the market is intended to decrease over time in line with the government's emissions reduction targets.
35. This is expected to cause the unit price of carbon to increase over time, driving the decarbonisation of New Zealand's economy by incentivising emitters to reduce their emissions. The unit price has recently doubled within a short timeframe, from around \$35 in late 2020 to \$75 in early 2022.

#### Administering the NZ ETS

36. MfE, the Environmental Protection Authority (EPA) (the regulator) and Te Uru Rākau – New Zealand Forest Service (a branch of the Ministry for Primary Industries (MPI)) all play a role in administering the NZ ETS:

MfE	Leads the development of environmental and climate change policy in New Zealand, including relating to the NZ ETS. MPI works alongside MfE on environmental and climate change policy, particularly in relation to the NZ ETS for forestry and other land use policies.
EPA (the regulator)	Responsible for administering the NZ ETS under the Act. This includes enforcing compliance (including applying the 'three to one' penalty), collating, and reporting market and compliance data, and operating the New Zealand Emissions Trading Register (the Register <sup>19</sup> ).
Te Uru Rākau – New Zealand Forest Service	Has delegated authority from the regulator to administer some functions of the NZ ETS for forestry (e.g., determining forestry participants' eligibility to register, processing emissions returns, etc.).

<sup>19</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.

## Forestry in the NZ ETS

37. The baseline date for greenhouse gas emissions in international climate change agreements New Zealand joined is 1 January 1990. This creates two categories of forestry participants in the NZ ETS: pre-1990 forestry participants and post-1989 forestry participants.

Pre-1990 forestry participants	Post-1989 forestry participants
<ul style="list-style-type: none"> <li>• Pre-1990 forests are considered part of New Zealand's baseline carbon storage.</li> <li>• Landowners cannot earn units for carbon stored by their forests.</li> <li>• Landowners could apply for a one-off allocation of units from the Government in 2011/2012).<sup>20</sup></li> <li>• Landowners become mandatory participants in the NZ ETS if they deforest their land (i.e., they clear and do not re-establish or they convert to another land use).<sup>21</sup></li> <li>• Participants are liable to surrender units to account for the emissions from deforestation.</li> </ul>	<ul style="list-style-type: none"> <li>• Post-1989 forests are considered new carbon sinks.</li> <li>• Landowners or rights holders can voluntarily register as participants in the NZ ETS to earn units for carbon stored by their forests.</li> <li>• Once registered, participants have obligations, which include reporting on carbon stock changes in their forest.</li> <li>• Participants are liable to surrender units to account for carbon stock loss (e.g., if the forest is harvested, deforested or deregistered).</li> <li>• Participants are also able to sell units earned on the secondary market.</li> </ul>

## International context

38. There are 25 emissions trading schemes operating around the world in jurisdictions representing 55 percent of global Gross Domestic Product (GDP). These systems cover 17 percent of global emissions.
39. Unlike the NZ ETS, international emissions trading schemes often exclude forestry and emitters of less than 25,000 tonnes of carbon dioxide equivalent per year.
40. Linking the NZ ETS with other international emission trading schemes may help support New Zealand's transitions towards a low carbon economy and enable emissions allowances to be used to meet surrender obligations across borders.
41. It is important that the NZ ETS remains sufficiently robust, retains integrity and aligns with international emissions trading schemes for New Zealand to retain the option to link with these schemes in future.

## Compliance in the New Zealand Emissions Trading Scheme

42. A strong NZ ETS compliance system is important for upholding the scheme's integrity and supporting New Zealand to meet its climate change targets.

<sup>20</sup> This one-off allocation was made available to pre-1990 forest landowners to offset some of the economic impacts of introducing the pre-1990 deforestation rules. However, this only reflected a small proportion of the full deforestation liability and not all pre-1990 landowners applied to receive this.

<sup>21</sup> In most circumstances, except where small areas are cleared, land is affected by a natural event, land has been granted an exemption or land has been offset by establishing an equivalent forest elsewhere.



43. In addition to strengthening the penalties for non-compliant reporting on emissions and removals, and the introduction of infringement offences for lower-level non-compliance,<sup>22</sup> the Amendment Act strengthened the penalty that applies to people who fail to pay units to the Crown in accordance with their NZ ETS obligations – otherwise referred to as the ‘three to one’ penalty. This was achieved by replacing the former ‘excess emissions penalty’ for most participants<sup>23</sup> from 1 January 2021.
44. The ‘excess emissions penalty’ (which currently still applies to small forestry participants until it expires) is \$30 per unpaid unit, which the regulator can reduce at its discretion by up to 100 percent in certain circumstances. Issues identified with this penalty include:
- The static \$30 per unit value was insufficient to deter non-compliance and was significantly lower than penalties imposed for similar non-compliance in international emissions trading schemes.
  - The significant discretion available to the regulator to reduce or waive the penalty created a high administrative burden and was challenging to apply consistently, leading to uncertainty for participants.
  - The penalty was applied to conduct involving errors in reporting as well as failure to pay units, despite the latter action amounting to more serious non-compliance.
  - It was unclear whether inaccurate reporting was captured by criminal sanctions in the Act.
45. The ‘three to one’ penalty is:
- A cash penalty set at three times the price of carbon (set in regulations) for each unpaid unit.
  - An absolute liability penalty that cannot be reduced or waived.
  - Applicable in addition to the obligation to pay units.
  - Due within 20 working days of being issued unless a deferred payment arrangement is entered into.<sup>24</sup>
46. The regulator is required to publish the details of participants issued the ‘three to one’ penalty.<sup>25</sup>
47. Participants have the right to request a review of a penalty decision, as well as seek to appeal decisions in court.<sup>26</sup>
48. The ‘three to one’ penalty was introduced to replace the excess emissions penalty for unpaid units to:
- Encourage participants to take due caution to meet their obligations under the NZ ETS.
  - Ensure the penalties effectively deter non-compliance, uphold the integrity of the NZ ETS and support New Zealand to achieve its climate change targets.
  - Be consistent with international practice and ensure that New Zealand has the option to link with international emissions trading schemes in the future.
  - Ensure the penalties are applied using a process based on the principles of natural justice that provide for equitable treatment of participants for non-compliant behaviour.

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<sup>22</sup> Provided for under part 2, subpart 3 (infringement offences) and part 4, subpart 4 (offences and penalties) of the Act.

<sup>23</sup> As noted in this document, the application of the ‘three to one’ penalty has been deferred for small forestry participants.

<sup>24</sup> Provided under section 135A of the Act. Deferred penalty arrangements are available for payment of the penalty only and not the original unit surrender or repayment obligation.

<sup>25</sup> Introduced as part of the revised penalties and compliance regime on 1 January 2021, this is required under section 89(1A) of the Act for each reporting year, as well as any outstanding penalties from previous reporting years. This also applies under the transitional arrangement.

<sup>26</sup> Provided for under sections 144 and 145 of the Act.

- Ensure the penalties are easy to understand and can be applied consistently in a transparent way to provide certainty for participants.

#### When could forestry participants be subject to the ‘three to one’ penalty?

Pre-1990 forestry participants	Post-1989 forestry participants
<ul style="list-style-type: none"> <li>• Required to submit emissions returns by 31 March each year following deforestation.</li> <li>• Emissions returns must set out the carbon stock in the forest that has been deforested and calculate the number of units that need to be surrendered.<sup>27</sup></li> <li>• May be subject to reporting penalties for incorrect or late returns.</li> <li>• Must surrender units before 31 May in the year the emissions return is submitted.</li> <li>• Subject to the ‘three to one’ penalty if they fail to meet their unit obligations on time (excluding small forestry participants).</li> <li>• Have 20 working days to pay the penalty, unless they enter a deferred payment arrangement. Interest accrues if not paid on time.</li> </ul>	<ul style="list-style-type: none"> <li>• Required to submit emissions returns once every mandatory emissions return period (usually five years). Also required when land is sold, partially removed or deregistered.</li> <li>• Can also choose to submit emissions returns annually.</li> <li>• Emissions returns must set out the changes in the forest's carbon stock and calculate the number of units the forest is entitled to earn (for carbon stock increases) or that need to be surrendered (for carbon stock decreases, e.g., from harvesting) or repaid (e.g., if over-claimed).<sup>28</sup></li> <li>• May be subject to reporting penalties for incorrect or late returns.</li> <li>• Must surrender or repay any units owing within 60 working days of receiving notice.</li> <li>• Subject to the ‘three to one’ penalty if they fail to meet their unit obligations on time (excluding small forestry participants).</li> <li>• Have 20 working days to pay the penalty, unless they enter a deferred payment arrangement. Interest accrues if not paid on time.</li> </ul>

#### **Transitional arrangement for small forestry participants**

49. It was intended that the ‘three to one penalty’ would apply to all NZ ETS participants from 1 January 2021. However, during public consultation<sup>29</sup> and the select committee process to introduce the ‘three to one’ penalty, submitters raised concerns that it could significantly impact small forestry participants, causing serious hardship in some cases. Submitters were concerned the impact of the penalty would be disproportionate to the offence.
50. In May 2020, officials reported to Cabinet that a long-term solution for small forestry participants could not be resolved in the timeframe of Amendment Act, ahead of the ‘three to one’ penalty taking effect.<sup>30</sup>

<sup>27</sup> Carbon stock in pre-1990 forests is calculated using ‘stock change accounting.’

<sup>28</sup> Carbon stock changes in post-1989 forests are calculated using ‘stock change accounting.’ From 1 January 2023, some forests will use ‘averaging accounting’ (where units do not have to be surrendered at harvest as long as the forest is re-established), which will decrease the frequency of unit surrenders.

<sup>29</sup> Led by MfE and MPI in 2018 on a series of proposed amendments to improve the NZ ETS as part of the review of the NZ ETS taking place at that time.

<sup>30</sup> ENV-22-MIN-0029 refers.

51. In response to these concerns, Cabinet agreed to defer the introduction of the ‘three to one’ penalty for small forestry participants for unit liabilities from forestry activities occurring before 1 January 2023. Cabinet agreed to implement the transitional arrangement<sup>31</sup> as an interim measure (whereby the previous excess emissions penalty continues to apply when small forestry participants fail to pay units on time) and directed officials to:
- investigate compliance issues and impacts of applying the ‘three to one’ penalty to small forestry participants, and consider NZ ETS participants from other sectors who may be similarly affected by the new penalty;<sup>32</sup>
  - carefully consider our ability to link the NZ ETS to overseas markets in the future in developing policy options; and
  - report back to Cabinet in mid-2021 with any potential amendments to the penalty provisions in the Act, to be included in any later Bill (if necessary).<sup>33</sup>
52. While a key reason for the introduction of the ‘three to one’ penalty was to be consistent with international practice, most international emissions trading schemes often exclude forestry, and emitters of less than 25,000 tonnes of carbon dioxide equivalent per year. Therefore, the deferral, and future changes to, the ‘three to one’ penalty for small forestry participants is not expected to impact on New Zealand’s ability to link with international carbon markets in the future.

#### **Further extension of the transitional arrangement until end of 2024**

53. In July 2022,<sup>34</sup> officials reported back to Cabinet that the risk of serious financial hardship identified in 2020 (which led to the transitional arrangement) persisted. In doing so, officials advised that the characteristics of small forestry participants mean that the impacts of applying the ‘three to one’ penalty to them is likely to be disproportionate to the offence.
54. It can be difficult for some participants to understand their obligations under the NZ ETS. Small forestry participants are often small farm foresters or Māori trusts, rather than well-established and sophisticated corporations. The characteristics of small forestry participants mean they may find it difficult to understand their obligations, as they have relatively fewer resources and engage less frequently with the NZ ETS compared to other participants.
55. Small forestry participants may find it difficult to meet unexpected unit obligations, especially at high carbon prices, which increases their likelihood of incurring the ‘three to one’ penalty.
56. Applying the ‘three to one’ penalty to small forestry participants could result in serious financial hardship in some cases, potentially putting their personal assets such as their home or farm at risk. The impact of the penalty in these situations would be disproportionate to the offence.

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<sup>31</sup> Clause 17, Schedule 1AA of the Act gives effect to the transitional arrangement and applies to small forestry participants only.

<sup>32</sup> The direction to investigate the potential impacts of the ‘three to one’ penalty on other non-forestry participants was included for equity reasons, to be fair to all NZ ETS participants.

<sup>33</sup> ENV-20-MIN-0017 refers.

<sup>34</sup> The delay in reporting back to Cabinet was due to resource and time limitations, which is also why officials did not have time to consider the potential impacts of the ‘three to one’ penalty on other participants from other sectors which may be similarly affected. MfE will continue to monitor the effectiveness and appropriateness of the ‘three to one’ penalty for other NZ ETS participants to determine if changes may be needed in future.



57. In July 2022, Cabinet agreed to officials publicly consulting on options to introduce a revised penalty to apply when small forestry participants fail to pay units on time from 1 January 2025.<sup>35</sup> Cabinet also recognised that it would not be possible to introduce a revised penalty for small forestry participants before the transitional arrangement was due to expire (on 31 December 2022) and agreed to extend the transitional arrangement for unit liabilities from forestry activities occurring up until 31 December 2024. This extension ensures that:

- the excess emissions penalty<sup>36</sup> will continue to apply to small forestry participants while a revised penalty is finalised; and
- there is enough time to implement an education package to improve understanding amongst small forestry participants of their obligations under the NZ ETS, the consequences of failing to pay units on time and how a revised penalty will work in practice.

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<sup>35</sup> Public consultation took place between 2 August and 30 August 2022.

<sup>36</sup> Set at \$30 per unpaid unit, with provisions for the regulator to exercise discretion to reduce or waive it by up to 100 percent in certain circumstances. Additional penalties may apply where a person fails to pay the units again following a penalty notice, and/or if they are convicted of a knowing/evasion offence in relation to their unpaid units.

## 2. WHAT IS THE POLICY PROBLEM OR OPPORTUNITY?

### Summary of the status quo: what would happen without government intervention?

58. If legislative change is not made to introduce a revised penalty for small forestry participants before the end of 2024, the 'three to one' penalty will apply to small forestry participants with unit liabilities from forestry activities occurring from 1 January 2025 that are not met on time.

### Why is this a problem?

#### Nature of the problem

59. There are three key risks associated with applying the 'three to one' penalty to small forestry participants. These are the risks that the penalty:
- Could significantly impact small forestry participants, leading to serious financial hardship in some cases.
  - Could be disproportionate in size compared to the level of the offence committed by small forestry participants.  
Will not be fit for purpose and small forestry participants' context, particularly for owners of small areas of pre-1990 forest land who face mandatory deforestation liabilities.
60. In general, small forestry participants may find it more difficult to understand and/or meet their obligations than larger-scale participants as they:
- Engage with the NZ ETS less frequently than other participants (post-1989 participants are usually only required to report once every five years, and pre-1990 forest owners are only required to report if they deforest), who engage with the NZ ETS annually (larger forestry participants tend to choose to report annually, and non-forestry participants are required to report annually). This may contribute towards unfamiliarity and misunderstanding of NZ ETS obligations.
  - May have fewer resources at their disposal to understand and meet their obligations (e.g., for reporting) as they are more likely to be individual persons such as small farm foresters, rather than well-established and sophisticated corporations.
  - May have limited cash flow and therefore have difficulty accessing units, especially at high carbon prices, to meet unexpected obligations on time (particularly for pre-1990 forest owners who do not receive units for the carbon stored in their forests).
  - In the case of pre-1990 forest owners, may be less aware of their obligations due to a general lack of awareness and difficulties in determining whether their land is pre-1990 forest land.
61. The absolute liability nature of the 'three to one' penalty means the penalty applies even when circumstances beyond a participants' control prevent them from paying units on time. This could have a disproportionate effect on small forestry participants, particularly given the size of the penalty and the potential impact it could have on them compared to other forestry participants in the NZ ETS.

#### Size and potential impact of the 'three to one' penalty on small forestry participants

62. Small forestry participants are those with annual unit obligations of less than 25,000 units, which roughly relates to a forest of up to 36 hectares.<sup>37</sup>
63. A unit obligation of 25,000 units is valued at around \$1.9 million.<sup>38</sup> If these units were not paid on time and the 'three to one' penalty applied, the participant would be required to pay an additional \$5.6 million.<sup>39</sup>
64. The cost of purchasing units will increase if the carbon price continues to increase, as will the associated penalties, as the price of carbon is factored into the penalty calculation. This is updated annually in regulations, based on the market price of carbon from the previous year. To show how this price has increased, it has been set at:
- \$25.60 for 2021;
  - \$36.20 for 2022 (a 46 percent increase from 2021); and
  - \$67.63 for 2023 (an 87 percent increase from 2022).
65. The carbon price is expected to continue to increase over time to drive the decarbonisation of New Zealand's economy.
66. In addition to carbon revenue (which only post-1989 forestry participants can receive), forest owners can earn revenue through harvesting, if they have viable production forests. This can be estimated to be around \$30,000 on average per hectare,<sup>40</sup> which would be equal to approximately \$1 million for 36 hectares.
67. Therefore, the significant size of the 'three to one' penalty, relative to the potential revenue for many small forestry participants, means that applying this penalty to these participants could result in serious financial hardship in some cases. Applying the 'three to one' penalty could put a small forestry participant's personal assets, such as their home or farm, at risk, the impact of which would be disproportionate to the offence.

### Scale of the problem

#### *Proportion of small forestry participants*

68. The majority (around 70 percent) of post-1989 forestry participants registered in the NZ ETS could be considered small forestry participants. This is despite the large majority of post-1989 forest land registered in the NZ ETS being owned by a few large-scale participants.
69. Pre-1990 participation is on the other hand, difficult to quantify. There are approximately 1.35 million hectares of pre-1990 forest land in New Zealand, however, participant size (in relation to the 25,000-unit threshold) depends on how much land is deforested each year by a participant. Based on historic deforestation data, it is estimated that the majority of pre-1990 forestry participants could also be considered small forestry participants.

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<sup>37</sup> Based on an average *Pinus radiata* forest at age 28 (~700 tonnes per hectare) using the stock change accounting methodology.

<sup>38</sup> Based on a market price of \$75 per unit.

<sup>39</sup> Based on a prescribed price of carbon of \$75, which is set in regulations annually for the purpose of calculating penalties.

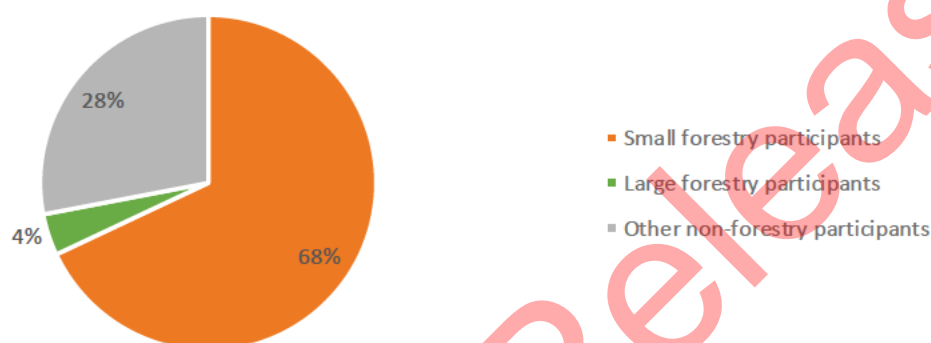
<sup>40</sup> Based on a 2019 report by NZ Farm Forestry Association (<https://www.nzffa.org.nz/farm-forestry-model/the-essentials/roads-earthworks-and-harvesting/reports/report-small-scale-grower-harvest-costs-and-returns/>).



### Historical non-compliance

70. Between 2014 and 2022, approximately 50 NZ ETS participants failed to pay units on time. The majority (36, or 72 percent) of which were forestry participants. Most of the forestry participants (34 participants, or 94 percent) were small forestry participants with unit obligations of less than 25,000 units. This data suggests that small forestry participants are more likely to fail to meet their unit payment obligations compared to other NZ ETS participants.

Number of participants who failed to surrender or repay units between 2014-2022



71. On average, around four to eight forestry participants fail to pay units on time each year. This increases to around 20 participants in a mandatory reporting year.
72. Historically, reasons forestry participants failed to pay units on time have included:
- Participants failing to check their emails and being unaware of their unit obligations.
  - Participants being unaware of their obligation to pay units due to misunderstandings following land sales and transfers of participation, and pre-1990 forestry participants being unaware they are required to surrender units if they deforest.
  - Various technical system failures occurring during the unit payment process which prevented participants from meeting their obligations on time.

### Impacts on Māori and iwi

73. Māori have significant interests in forestry. Forests and forest products support the cultural, social, environmental, and economic aspirations of Māori whānau, hapū and iwi.
74. Māori own a large proportion of pre-1990 forest land. The 'three to one' penalty is less likely to affect small pre-1990 Māori forest owners who did not receive an allocation of units, as they are more likely to be eligible for an exemption from deforestation liabilities.<sup>41</sup>
75. The 'three to one' penalty could significantly impact small Māori foresters who own pre-1990 forest land that is not eligible for an exemption, or registered post-1989 forest land.

<sup>41</sup> This exemption applies to an area of pre-1990 land that is less than 50 hectares and meets certain other criteria under section 183B(1) of the Act.

76. Changing the penalty which applies when small forestry participants fail to pay units on time will be important to help support Māori rights and interests and their ability to manage their land in line with their land-use aspirations.

## Stakeholder views

### Feedback received on 'three to one' penalty

77. During the public consultation (2018/2019) and the select committee process (2019/2020) for the Amendment Act, which included introducing the 'three to one' penalty half of the submitters that commented on the penalty raised concerns about it.
78. Key concerns raised by submitters include:
- That the size of the penalty, set at three times the price of carbon for each overdue unit, is excessive relative to the offence.
  - The absolute liability nature of the penalty means the penalty will apply in situations when it may be inappropriate and unjustified to apply a penalty. For example, when extenuating circumstances prevent a participant from surrendering or repaying units on time.
  - The penalty would significantly impact small forestry participants, causing serious hardship in some cases, which would be disproportionate to their offence.
79. Submissions by Māori landowners and organisations raised concerns that the 'three to one' penalty fails to consider the complexities of Māori land ownership. Māori submitters also raised concerns the complexity of the NZ ETS means it is difficult for small participants to understand their obligations, and the 'three to one' penalty could significantly impact small forestry participants, including small Māori forestry participants.
80. Submitters suggested the 'three to one' penalty could be improved by:
- Reducing the size of the penalty.
  - Enabling participants to pay money instead of surrendering or repaying units to meet their obligations under the NZ ETS.
  - Setting the penalty at a fixed price of \$30 for each overdue unit.
  - Enabling the regulator to apply discretion and reduce the penalty in certain circumstances based on a participant's culpability.
81. No changes were made to the 'three to one' penalty at that time, as it was considered that the size and design of the penalty would effectively achieve the Governments objectives for the penalty to:
- Be consistent with international practice and ensure that New Zealand has the option to link with international carbon markets in the future.
  - Effectively deter non-compliance and reflect the potential fiscal risk to the Crown when participants fail to surrender or repay units.
  - Improve transparency and fairness, providing certainty for participants.
  - Improve efficiency by avoiding the administration burden for the regulator associated with applying discretion to set the appropriate penalty rate.
82. However, the Government deferred the introduction of the 'three to one' penalty for small forestry participants and agreed to investigate the potential impact of the penalty on small forestry participants in response to these concerns.

### Feedback received in 2022 on a revised penalty

83. Of the 25 submissions received during public consultation on options to introduce a revised penalty for small forestry participants who fail to pay units on time held in August 2022:

- most submitters (84 percent) agreed with our description of the problem, either in full (60 percent) or partially (24 percent).
- 84 percent of submitters considered applying the 'three to one' when small forestry participants fail to pay units on time would significantly impact small forestry participants, creating serious hardship in some cases.
- 88 percent of submitters considered the impact of the 'three to one' penalty on small forestry participants would be disproportionate to the offence.
- 80 percent of submitters considered it would be inappropriate to apply the 'three to one' penalty to small forestry participants, particularly to owners of small areas of pre-1990 forest with limited ability to be aware of their obligations under the NZ ETS.



### 3. WHAT OBJECTIVES ARE SOUGHT IN RELATION TO THE POLICY PROBLEM?

84. We seek to introduce a revised penalty for small forestry participants which:
- Effectively deters non-compliance and upholds the integrity of the NZ ETS.
  - Treats participants fairly and equitably, recognising the differences between participants and safeguarding the rights and interests of all participants.
  - Is straightforward and easy to apply consistently in a transparent way. This will help participants understand their obligations and minimise administration costs for the regulator.
  - Supports Māori rights and interests and their ability to manage their land in line with their land-use aspirations.
  - Is consistent with international practice to ensure that New Zealand will have the option to link with international emissions trading schemes in the future.
85. There may be trade-offs needed to balance different and competing objectives. For example, the objective to treat participants fairly and equitably could necessitate a more complex penalty which is potentially less straightforward and more expensive penalty to administer.

#### Feedback from submitters

86. During the public consultation on penalty options most submitters (76 percent) agreed with our objectives, either in full (36 percent) or partially (40 percent).
87. Submitters considered our objectives for the revised penalty to be straightforward and easy to apply consistently in a transparent way, and for the revised penalty to treat participants fairly and equitably to be particularly important.

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

### 4. WHAT CRITERIA WILL BE USED TO COMPARE OPTIONS TO THE STATUS QUO?

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

Criteria	Explanation
Deters non-compliance and upholds the integrity of the NZ ETS	<ul style="list-style-type: none"> <li>Effectively deters non-compliance, reducing the risk the Crown will need to cover the economic costs of participants emissions. This is also necessary to uphold the integrity of the NZ ETS and to support New Zealand to achieve our climate change targets.</li> <li>Encourages participants to take due caution to ensure they meet their surrender and repayment obligations under the NZ ETS.</li> </ul>
Treats participants fairly and equitably	<ul style="list-style-type: none"> <li>Treats participants equitably, applying consistently to different participants while recognising the differences between participants where this is justified.</li> <li>Upholds the principles of natural justice, safeguarding the rights and interests of all participants.</li> <li>Ensures the penalty is proportionate to the offence and that the penalty does not apply when it is unjustified.</li> </ul>
Is straightforward and easy to apply consistently in a transparent way	<ul style="list-style-type: none"> <li>Straightforward and easy to apply consistently in a transparent way.</li> <li>Helps participants understand the consequences of non-compliance.</li> <li>Minimises administration costs for the regulator and the Crown.</li> <li>Consistent and coherent with the broader NZ ETS compliance system.</li> </ul>
Supports Māori rights and interests	<ul style="list-style-type: none"> <li>Supports Māori rights and interests and their ability to manage their land in line with their land use aspirations.</li> </ul>
Consistent with international practice	<ul style="list-style-type: none"> <li>Maintains New Zealand's ability to link with international carbon markets in the future.</li> </ul>

## 5. WHAT SCOPE WILL OPTIONS BE CONSIDERED WITHIN?

### Penalty options for small forestry participants

89. This analysis considers different penalty options which could apply when small forestry participants fail to pay units on time. The penalty options are intended to reduce the risks associated with applying the 'three to one' penalty to small forestry participants.
90. Considering whether the 'three to one' penalty is operating effectively and is appropriate for other NZ ETS participants, including small participants from non-forestry sectors, is outside the scope of this analysis. MfE will continue to monitor the effectiveness and appropriateness of the 'three to one' penalty for other sectors to determine if changes may be needed in future.
91. Broader changes to the NZ ETS which could mitigate or avoid the problems associated with applying the 'three to one' penalty to small forestry participants that are unrelated to the design of the penalty itself are also outside the scope of this analysis. For example, making other changes such as increasing the time provided for participants to pay their original unit liability or enabling participants to pay those units in instalments.
92. Options on how to further increase awareness and understanding of NZ ETS obligations amongst small forestry participants, such as through more targeted outreach, is also outside the scope of this analysis. However, as the likelihood of incurring the 'three to one' penalty is increased for small forestry participants due to less awareness and understanding of NZ ETS obligations, the introduction of the revised penalty will be accompanied by an education package. The education package will help small forestry participants understand their obligations under the NZ ETS and how the revised penalty will work in practice.
93. The design and delivery of the education package will be led by Te Uru Rākau – New Zealand Forest Service (more details about implementation are included in Section 3, Delivering an option).
94. This scope reflects Cabinet's direction and is necessary to ensure the revised penalty takes effect before the extended transitional arrangement for small forestry participants ends on 31 December 2024.

### Defining 'small forestry participants'

95. All options proposed in this document use the same definition of 'small forestry participants' as that used for the existing transitional arrangement, defined under Clause 17, Schedule 1AA of the Act.<sup>42</sup>
96. We have considered different ways to define 'small forestry participants' from other forestry participants, including defining them based on the amount of pre-1990 or post-1989 forest land a person or participant owns or has registered in the NZ ETS.
97. 9(2)(g)(i)

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<sup>42</sup> Small forestry participants are defined in the transitional arrangement provisions as participants or other eligible persons, in relation to forestry activities, who have average annual unit liabilities of less than 25,000 units per emissions return.



98. In addition, defining 'small forestry participants' on the basis of land size, would be less directly comparable to the 25,000-unit threshold that most international emissions trading schemes require for participation, (a key reason the 'three to one' penalty was set for NZ ETS participants above this threshold, was to maintain international linking potential). In addition, this approach differs from the transitional arrangement and would create additional complexity for the regulator when determining what penalty applies to different participants.<sup>43</sup>
99. Although defining 'small forestry participants' based on the size of their unit obligation could also influence participant behaviour to qualify for the revised penalty (e.g., 9(2)(g)(i))
100. We recognise that defining small forestry participants based on the size of their unit obligation may mean the revised penalty could apply to relatively large forestry participants whose annual unit obligations are less than 25,000 units. However, these participants would still be subject to a penalty for non-compliance. While the penalty would be lower, it would still encourage compliance.
101. We consider defining small forestry participants based on the size of their unit obligation the best approach as it allows us to make a clear comparison with international practice, maintains consistency with the transitional arrangement, and is less likely to create distortions.
102. It is also well supported by stakeholders. During the public consultation on options to introduce a revised penalty for small forestry participants, 76 percent of submitters either fully (52 percent) or partially (24 percent) supported our proposed definition of small forestry participants.
103. We will continue to monitor the appropriateness of the definition of (and thresholds for) 'small forestry participants' for any potential gaming opportunities or unintended capture or exclusion of participants. We currently assess this as low risk.

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<sup>43</sup> Note, penalties can be applied retrospectively as they are based on when the activity was carried out. Different penalty regimes will continue to be administered at the same time to support this.

## 6. WHAT OPTIONS ARE BEING CONSIDERED?

### Improving transparency

104. A key purpose of the changes to the NZ ETS introduced through the Amendment Act in 2020 was to improve the transparency of the NZ ETS penalty and compliance system. This included requiring the EPA to publish the name and details of participants' non-compliance in certain circumstances, such as when participants fail pay on time.<sup>44</sup>
105. All penalty options considered in this analysis also seek to improve the transparency of the NZ ETS penalty and compliance system and therefore maintain the requirement for the details of small forestry participants who fail pay units on time to be published.
106. Under each option outlined below:
- penalties would be calculated using the price of carbon set in regulations (updated annually based on the average market price of the previous year), so that the penalty remains proportionate to the cost of the unit obligation and fiscal risk to the Crown;
  - penalties would be applied in addition to the participant's obligation to pay units; and
  - details of cases of non-compliance would still be required to be published by the EPA.<sup>45</sup>

#### Option 1: 'Three to one' penalty (status quo)

107. If a revised penalty for small forestry participants who fail to pay units on time isn't introduced, the 'three to one' penalty will apply to all NZ ETS participants, including small forestry participants, after the transitional arrangement expires on 1 January 2025.
108. The potential impacts and risks associated with applying the 'three to one' penalty to small forestry participants have been discussed in detail throughout this analysis.

#### Option 2: Discretionary penalty (as consulted on)

109. A discretionary penalty could be introduced to apply when small forestry participants fail to pay units on time for liabilities from forestry activities occurring from 1 January 2025.
110. A discretionary penalty could apply in a similar way to the previous 'excess emissions' penalty, with improvements to address some of the concerns identified in 2020 (including that it was too low to deter non-compliance and that too much discretion was available to the regulator). This was one of the options consulted on.
111. This penalty would be:
- A cash penalty set at the price of carbon (set in regulations) for each unpaid unit.
  - Able to be reduced or waived by the regulator based on a participant's level of culpability, determined in a similar way to the approach used for the previous 'excess emissions' penalty or the current reporting penalties. This could involve considering whether participants are likely to have been aware of their unit obligations, any extraordinary circumstances or case-specific considerations, a participant's compliance history, the complexity of meeting the obligation, and a

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<sup>44</sup> This is required under section 89 "EPA to publish certain information" of the Act.

<sup>45</sup> Currently in place for the 'three to one', as well as the excess emissions penalty under the transitional arrangement, as required by section 89 and clause 17 of Schedule 1AA of the Act.

- participant's sophistication and experience in the scheme; or whether they took reasonable care, were grossly careless or knowingly failed.
- Accompanied by clear published guidelines outlining how a participant's level of culpability would be determined.

Table 1: Option 2: Discretionary penalty (as consulted on)

Total average annual unit liability	Applicable penalty
< 25,000 units	1x (the price of carbon x number of unpaid units), can be reduced up to 100% based on the participant's culpability.

*Analysis of the expected impacts of Option 2 for small forestry participants*

112. A discretionary penalty could provide flexibility to ensure a penalty does not apply when a participant's individual or case specific circumstances deem this to be justified. This could help reduce the risk of serious hardship for small forestry participants and ensure the penalty is proportionate to the offence.
113. However, retaining the ability for the regulator to reduce the penalty by up to 100 percent (updated to be based on a participant's culpability) is likely to result in similar problems associated with the previous 'excess emissions' penalty. This includes the penalty being challenging for the regulator to apply consistently due to difficulties determining the appropriate penalty rate to apply in different circumstances. This could create uncertainty for participants, as it would be more difficult for them to determine specifically how the penalty would be applied.
114. It's unlikely to be feasible or most effective to reduce the penalty based on a participant's culpability as in most cases, unless they are negligent, participants will be aware of their requirement to pay units. This is because they will have already gone through the process of calculating and submitting an emissions return (or having the regulator calculate it on their behalf), which determines the applicable unit obligation or entitlement. Following this, they will always receive a notice from the regulator outlining their unit obligation and the relevant due date. The process for then paying the units is straightforward, and technical challenges are unlikely to prevent participants from paying units on time. Therefore, it is likely that participants will always be culpable for the offence if units are not paid.
115. This differs from the reporting penalties where it is appropriate for the regulator to reduce the penalty based on a participant's culpability, as this prevents participants who take reasonable care but make unintentional reporting errors (e.g., in carbon stock change calculations) from being subject to significant penalties.
116. A discretionary penalty that considers individual circumstances is likely to create uncertainty for participants as it would be difficult for them to determine how the regulator will apply the penalty to their specific circumstances. This is likely to make it more difficult for participants to understand what the outcome of the final penalty would be if they were to incur it.
117. In addition, the discretionary nature of this penalty option is also expected to carry a high administrative burden and cost for the regulator.
118. Feedback received during public consultation indicated that submitters slightly favoured this option (36 percent).<sup>46</sup> However, submitters also raised concerns that a

<sup>46</sup> 25 submissions were received in total during public consultation. Of those, 36 percent favoured a discretionary penalty, 24 percent preferred a strict liability penalty, 16 percent preferred an alternative option, and the remaining 24 percent did not answer the question.



discretionary penalty could be difficult to administer and could create uncertainty for participants if it is not applied consistently. Several submitters suggested a discretionary penalty would be less effective at achieving our objectives for the penalty to be straightforward and easy to apply consistently in a transparent way.

### Options 3a, 3b and 3c: Variations of a strict liability penalty

119. Another option that could be introduced to apply when small forestry participants fail to pay units on time for liabilities from forestry activities occurring from 1 January 2025, is a strict liability penalty.
120. Under a strict liability penalty option, participants who fail to pay units on time would automatically be subject to a cash penalty, unless (like all strict liability regimes) they could prove total absence of fault.

#### Option 3a: Strict liability penalty (as consulted on)

121. The strict liability option consulted on was:
- A cash penalty based on the price of carbon (set in regulations) and the size of the participant's unpaid unit obligation.
  - Applicable at a lower penalty rate than the existing 'three to one' penalty, lowered further for smaller forestry participants with average annual unit liabilities of less than 10,000 units, thereby further improving the proportionality of the penalty compared to the level of non-compliance and recognising the higher risk of hardship to very small participants.
  - Applicable unless participants could prove total absence of fault.

Table 2: Option 3a: Strict liability penalty (as consulted on):

NZ ETS small forestry participants	Total average annual unit liability	
	< 10,000	≥ 10,000 to < 25,000
Multiplier based on size of total liability	0.5x unpaid units x price of carbon	1.0x unpaid units x price of carbon
Total absence of fault	None	None

#### Option 3b: Strict liability penalty (improved) – 'sliding scale' multiplier

122. This option is another variation of a strict liability penalty, which was revised as a result of feedback from consultation. This option takes the concept of applying different penalty multipliers to achieve more proportionate penalties. It applies a multiplier relevant to the size of the unpaid unit obligation, whereby the final penalty increases as the number of unpaid units increases. This penalty option also applies a lower penalty rate to small pre-1990 forestry participants, compared to small post-1989 forestry participants.
123. This penalty would be:
- A cash penalty based on the price of carbon (set in regulations) and the size of the participant's unpaid unit obligation.
  - Applicable at a lower penalty rate than the existing 'three to one' penalty, which is halved for pre-1990 forestry participants.
  - Applicable unless participants could prove total absence of fault.



Table 3: Option 3b: Strict liability penalty (improved) – ‘sliding scale’ multiplier

Calculation	
[multiplier] x [number of unpaid units] x [price of carbon]	Halved for pre-1990 participants
Applicable multiplier	
Unpaid unit obligation	Multiplier
0 to <5,000	0.1
≥5,000 to <10,000	0.2
≥10,000 to <15,000	0.3
≥15,000 to <20,000	0.4
≥20,000 to <25,000	0.5

Option 3c: Strict liability penalty (improved) – ‘fixed’ multiplier (recommended)

124. This option is another variation of a strict liability penalty, also revised as a result of feedback from consultation. This is the recommended option to apply when small forestry participants fail to pay units on time for liabilities from forestry activities occurring from 1 January 2025.

125. This penalty would be:

- A cash penalty based on the price of carbon (set in regulations) and the size of the participant’s unpaid unit obligation.
- Applicable at a lower penalty rate than the existing ‘three to one’ penalty, halved for pre-1990 forestry participants.
- Applicable unless participants could prove total absence of fault.

Table 4: Option 3c: Strict liability penalty (improved 2) – ‘fixed’ multiplier (recommended)

[0.5] x [number of unpaid units] x [price of carbon]	Halved for pre-1990 participants
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Comparison of the strict liability penalty options (Option 3a, Option 3b and Option 3c)

126. Both multiplier options (Options 3b and 3c) are an improvement to the strict liability penalty consulted on (Option 3a) because they:

- deliver all the benefits associated with a strict liability penalty option (detailed further below);
- apply a maximum multiplier of 0.5x (compared to 1x) for all small forestry participants, resulting in lower overall penalties, to reduce the risk of causing serious financial hardship (particularly if the price of carbon continues to increase); and
- take pre-1990 participants’ unique circumstances into consideration by halving the final penalty (strongly supported by consultation and further analysis). Officials consider that a maximum penalty multiplier of 0.5x is appropriate for small forestry participants. This multiplier generates penalties that are high enough to effectively deter non-compliance, but not so high as to result in an increased risk of serious financial hardship. On further analysis, officials consider a penalty multiplier of 1x for participants with total liabilities of between 10,000 and 25,000 (Option 3a, as consulted on) generates penalties that are still considerably high. This may result in an increased risk of serious financial hardship to small forestry participants.

### *Benefits of a strict liability penalty*

127. Having completed consultation on both a strict liability and discretionary penalty, officials consider a strict liability to be the most suitable for small forestry participants. This is because:
- It provides certainty to participants and makes it easier for them to understand their obligations. Submitters who indicated a preference for a strict liability penalty (24 percent) noted that it would be simpler and easier to apply consistently and transparently, making it easier for participants to understand.
  - It is straightforward and less administratively burdensome for the regulator to apply efficiently, in a certain and transparent way; and
  - The 'total absence of fault' provision under a strict liability penalty provides a clear threshold for waiving the penalty where circumstances mean the participant is not culpable for the offence (e.g., due to major technical failures; natural disasters, etc.)<sup>47</sup>

### *Applicable penalty rates*

128. Feedback received during public consultation indicated that most submitters (60 percent) supported our strict liability penalty in *Option 3a*, to apply a lower penalty rate to smaller small forestry participants with average annual unit liabilities of less than 10,000 units. Submitters who supported this proposal suggested it could help reduce the risk of serious hardship amongst particularly small forestry participants who have limited financial resources.
129. *Option 3b* (with a 'sliding scale' multiplier) was developed in response to this feedback, applying five different penalty rates to small forestry participants based on the size of the participants unpaid unit obligation.
130. However, after further analysis and having consulted with other agencies, we consider that applying a 'fixed' rate (under *Option 3c*) instead is more suitable. This is because:
- a 'fixed' multiplier is more certain for the participant, particularly if they are on the 'cusp' of one of the five categories (from the 'sliding scale').
  - a fixed multiplier set at 0.5x (halved for pre-1990 participants) already effectively recognises the size of the participant by considering the number of unpaid units in the calculation and, in addition, the size of the unpaid unit obligation is not necessarily a direct result of participant size, so a fixed rate is fairer.
  - a 'fixed' multiplier is easier for the regulator to apply, compared to introducing more complexity in applying five different thresholds in the 'sliding scale' approach. This option avoids creating additional complexity; and
  - officials consider that the size of the penalty is significant enough to effectively deter non-compliance and reduce fiscal risk to the Crown, while minimising the risk of causing serious financial hardship to small forestry participants.

### *Applying a lower rate for pre-1990 small forestry participants*

131. *Options 3b* and *3c* apply a lower penalty rate to small pre-1990 forestry participants compared to small post-1989 forestry participants. This change has been made in response to feedback received during public consultation on penalty options. Submitters suggested the penalty should treat pre-1990 forestry participants more leniently to reflect that:

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<sup>47</sup> The 'total absence of fault' provision would align with the standard 'total absence of fault' defence defined by the New Zealand courts. Following receipt of a penalty, the participant would have to satisfy the regulator that this provision was met for the penalty to be waived. Where the penalty was waived, interest for late payment would not accrue (provided it is waived before the penalty due date, or the due date is paused). Any unpaid debt (including unpaid units) would still be recoverable under s 159 of the Climate Change Response Act 2002.

- Pre-1990 forestry participants did not directly choose to participate in the NZ ETS, therefore, are more likely to be unaware of their NZ ETS obligations and incur unexpected deforestation costs.
  - Pre-1990 forestry participants cannot earn units for carbon sequestration,<sup>48</sup> so are less likely to have units available to surrender when required and will need to source these from the market.
132. We consider it would be appropriate for the revised penalty for small forestry participants to apply a lower rate to pre-1990 forestry participants, as this would help ensure the penalty effectively achieves our objectives, particularly the objectives for the penalty to:
- **Treat participants fairly and equitably:** Applying a lower penalty rate to pre-1990 forestry participants recognises the fundamental differences between these and post-1989 participants, to safeguard the rights and interests of all participants. Pre-1990 forestry participants do not directly choose to participate in the NZ ETS and do not benefit from it in the same way as post-1989 forestry participants, who can choose to voluntarily register to earn units for the carbon stored by their forests. It can be difficult for pre-1990 forestry participants to be aware of their obligations under the NZ ETS, as they are only required to engage with the scheme if they deforest. This means small pre-1990 forestry participants are more likely to face unexpected surrender obligations, which could be difficult to meet at high carbon prices, making it more likely that they receive penalties. Generally, once deforestation has occurred, pre-1990 forestry participants cannot avoid NZ ETS obligations.
  - **Support Māori rights and interests:** A high proportion of Māori freehold land is pre-1990 forest land, meaning Māori landowners may be particularly impacted by the penalty should they fail to pay units on time. Applying a lower penalty to small pre-1990 forestry participants would help support Māori and iwi landowners to manage their land in line with their land use aspirations.<sup>49</sup>
133. The wider NZ ETS penalty regime has some recognition of pre-1990 participants, e.g., in applying the reporting penalties (for filing incorrect or late emissions returns), the EPA must exercise some discretion to determine a participant's level of culpability. As part of this, participant size and sophistication, including whether they are a pre-1990 or post-1989 participant, is considered.
134. While the 'three to one' penalty does not specifically recognise pre-1990 participants, most of those participants are small forestry participants who would be subject to the revised penalty discussed here.<sup>50</sup> Therefore, we consider this is to be an appropriate place within the NZ ETS penalty regime for this factor to be recognised.
135. The proposed penalty rate for pre-1990 participants is half what is applicable for post-1989 participants. We consider this level of reduction strikes a good balance between recognising the difference in participant type to ensure equitable treatment while effectively deterring non-compliance. This is also considered to be easy and straightforward for the regulator to apply and for participants to understand.

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<sup>48</sup> With the exception of a one-off allocation of units from the Government, which was made available to pre-1990 forest landowners in 2011/2012 to offset some of the economic impacts of introducing the pre-1990 deforestation rules. However, this only reflected a small proportion of the full deforestation liability and not all pre-1990 landowners received this.

<sup>49</sup> While there is an exemption from deforestation liabilities available for some Māori land, this must be approved before deforestation occurs and is subject to certain conditions, e.g., it is not available for any land that received a one-off allocation of units from the Government in 2011/2012.

<sup>50</sup> The majority of pre-1990 deforestation emissions returns received by Te Uru Rākau – New Zealand Forest Service contain total annual liabilities of less than 25,000 units.

### *Recommended option*

136. As a result of our analysis, *Option 3c* (strict liability with a 'fixed' multiplier) is our recommended option as it best achieves the five objectives that underpin this work.
137. We consider this option takes into account feedback received during consultation. It reduces the penalty rate for all small forestry participants (compared to the 'three to one' penalty), further reducing it for small pre-1990 forestry participants. It also supports the objectives for the revised penalty to be straightforward and easy for the regulator to apply transparently, to treat participants fairly and equitably while encouraging compliance and maintaining the integrity of the NZ ETS, which submitters also noted as important.

### Analysis of the expected impacts of the recommended penalty option

138. The recommended strict liability penalty option (*Option 3c*) is expected to improve fairness for small forestry participants (in comparison to applying the 'three to one' penalty) by:
- reducing the overall penalty rate (and applying a lower rate for small pre-1990 forestry participants); and
  - allowing the penalty to be waived where this is justified, when the participant can demonstrate total absence of fault.
139. This will reduce the risk of serious financial hardship for small forestry participants and help ensure the impact of the penalty is more proportionate to their context and the offence.
140. Where small forestry participants incur the revised penalty due to circumstances beyond their control that prevent them from meeting their unit obligations, the 'total absence of fault' provision will allow the regulator to waive the penalty. This is intended to be a clear threshold that will apply to specific circumstances, as it is well defined by the New Zealand courts and there are many examples in New Zealand case law.
141. Where small forestry participants incur the revised penalty and are not in a financial position to pay it on time, participants would still have the option of requesting to enter a deferred payment arrangement so that it can be paid in instalments (available for all NZ ETS penalties). As well as the reduced penalty rate, this option further reduces the risk of the penalty causing serious financial hardship to small forestry participants.
142. While reduced, we consider that the recommended penalty will still effectively deter non-compliance, incentivising participants to ensure they understand and can meet their unit liabilities when they arise to reduce the fiscal risk to the Crown.
143. The recommended penalty is expected to be straightforward and easy for the regulator to apply consistently in a transparent way, due to its strict liability nature. This will provide certainty for participants and help them understand their obligations as well as the consequences of failing to meet them. It is also expected to maintain efficiency by minimising the administrative costs for the regulator to apply the penalty.
144. The recommended penalty aligns with the broader NZ ETS compliance system. The strict liability nature of it is relatively consistent with the existing 'three to one' penalty that applies to all other NZ ETS participants who fail to pay units on time (which is similar but a stricter, absolute liability penalty). It is also consistent with the strict liability infringement offences applied for low level non-compliance. Applying a lower penalty rate to small pre-1990 forestry participants also aligns with the reporting penalties, in which the regulator can consider a range of factors when determining a participant's culpability, including a participant's size, sophistication and type (i.e., whether they are pre-1990 or post-1989 forestry participants).



145. The recommended penalty is not expected to affect New Zealand’s ability to link with international emissions trading schemes in future. Most emissions trading schemes in other jurisdictions do not include forestry or only include emitters who emit more than 25,000 tonnes of carbon dioxide each year. Therefore, the recommended penalty is not expected be of concern to potential linking partners.

### Expected impacts of the penalty options on small forestry participants

146. To put these options into context, Table 5 compares the size of the applicable penalties for small forestry participants under the different penalty options.<sup>51</sup>

**Table 5: Size of the penalties for small forestry participants under the different penalty options**

Total unit obligation	Number of unpaid units	Monetary value of units	Relative hectares <sup>52</sup>	Option 1: ‘three to one’ penalty (status quo)	Option 2: Discretionary penalty (as consulted on)	Option 3a: Strict liability penalty (as consulted on)	Option 3b: Strict liability penalty (improved) – ‘sliding scale’	Option 3c: Strict liability penalty (improved) – ‘fixed’
2,000 units	2,000 units	\$150,000	3 ha	\$450,000	Up to \$150,000	\$75,000	\$15,000 (\$7,500 for pre-1990)	\$75,000 (\$37,500 for pre-1990)
9,000 units	9,000 units	\$675,000	13 ha	\$2,025,000	Up to \$675,000	\$337,500	\$135,000 (\$67,500 for pre-1990)	\$337,500 (\$168,750 for pre-1990)
24,999 units	24,999 units	\$1,1874,925	35 ha	\$5,624,775	Up to \$1,1874,925	\$1,1874,925	\$937,462 (\$468,731 for pre-1990)	\$937,462 (\$468,731 for pre-1990)

<sup>51</sup> A carbon price of \$75 has been used to calculate the size of the penalty and the monetary value of units in the Table. \$75 was the carbon spot price in early 2022.

<sup>52</sup> Calculated under stock change accounting. In addition to carbon revenue (available for eligible post-1989 forests only), forest harvesting profits are estimated to be around \$30,000 on average per hectare, based on a 2019 report by NZ Farm Forestry Association (<https://www.nzffa.org.nz/farm-forestry-model/the-essentials/roads-earthworks-and-harvesting/reports/report-small-scale-grower-harvest-costs-and-returns/>).

## 7. WHAT OPTIONS WERE CONSIDERED BUT DISCOUNTED?

### Pecuniary penalty option

147. We considered whether a pecuniary penalty should be introduced to apply when small forestry participants fail to pay units on time for liabilities from forestry activities occurring from 1 January 2025.
148. A pecuniary penalty would involve:
- The regulator initiating court proceedings against participants who fail to pay units on time. The regulator would be required to provide evidence to prove the physical and/ or mental<sup>53</sup> elements of the offence through a statement of claim.
  - Participants would be required to prove the existence of defence if appropriate.
  - The court would subsequently determine whether the penalty should apply and the size of the penalty.<sup>54</sup>
149. During consultation to introduce the ‘three to one’ penalty in 2020, the New Zealand Law Society and the Ministry of Justice recommended the penalty should be a pecuniary penalty as judicial oversight would ensure the penalty is applied fairly and consistently and aligns with the Legislative Design and Advisory Committee Guidelines 2021.
150. However, the ‘three to one’ penalty was not changed to a pecuniary penalty at the time. Officials determined that the scale, complexity, self-reporting nature of the NZ ETS, and the public interest in universal compliance meant it was more appropriate for surrender/repayment penalty to remain an administrative penalty which is applied by the regulator.
151. Operational guidelines outlining how the ‘three to one’ penalty applies have been developed and published to ensure the penalty is applied consistently and participants understand how the penalty applies. Participants can also request for the regulator to review a decision made by the regulator under the Act, including relating to the application of penalties<sup>55</sup>, or appeal a decision in court.
152. The reasons why it would be inappropriate for the ‘three to one’ penalty to be a pecuniary penalty, also apply to the recommended penalty for small forestry participants.
153. Further, a pecuniary penalty is likely to be particularly inappropriate for small forestry participants as it would be expensive for participants to defend themselves in court. It is intended that operational guidelines outlining how the revised penalty applies will be developed and published similarly to the ‘three to one’ penalty and an education package will be rolled out before the revised penalty comes into effect. This will ensure that participants understand the penalty.
154. A pecuniary penalty would be inconsistent with the existing ‘three to one’ penalty applicable to all other NZ ETS participants as well as the broader NZ ETS penalty compliance system. The reporting penalties and infringement offences are administrative penalties which are applied by the regulator.

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<sup>53</sup> If a discretionary pecuniary penalty is introduced the regulator would be required to prove both the mental and physical elements of the offence. If a strict liability pecuniary penalty is introduced the regulator would only be required to prove the physical elements of the offence.

<sup>54</sup> The maximum size of the penalty would usually be set in legislation.

<sup>55</sup> Provided under section 144 “request for review of decisions.”

## 8. HOW DO THE OPTIONS COMPARE TO THE STATUS QUO/COUNTERFACTUAL?

155. **Table 6** assesses the impact of each option against the evaluation criteria. The status quo/no action would mean the 'three to one' penalty applies to all NZ ETS participants, including small forestry participants, after the transitional arrangement expires on 1 January 2025.
156. The objective 'consistent with international practice' has not been assessed in Table 6 below, as we consider all options score equally (0 – about the same) on this objective. This is because most international emissions trading schemes often exclude forestry, and emitters who emit less than 25,000 tonnes of carbon dioxide equivalent per year. This means the penalty options assessed are not expected to impact on New Zealand's ability to link with international carbon markets in the future (as advised by MfE and MFAT).
157. The key for the table below is as follows:

<u>Key:</u> Variations from status quo/no action	
+++	Significantly better
++	Much better
+	Better
0	About the same
-	Worse
--	Much worse
---	Significantly worse

9. TABLE 6: IMPACT ASSESSMENT OF EACH OPTION

Criteria	Option 1: Status quo: 'three to one' penalty	Option 2: Discretionary penalty (as consulted on)	Option 3a: Strict liability penalty (as consulted on)	Option 3b: Strict liability (improved) – 'sliding scale' multiplier	Option 3c: Strict liability (improved) – 'fixed' multiplier
<b>Deters non-compliance and upholds the integrity of the NZ ETS</b>	<p>0</p> <p>Like all NZ ETS penalties, this penalty would apply in addition to the participant's obligation to pay units. This means it would effectively deter non-compliance, which in turn, helps to uphold the integrity of the NZ ETS.</p> <p>However, it could be disproportionate (too large) to the size of the participant and the level of non-compliance, creating a high risk of serious financial hardship for small forestry participants.</p>	<p>-</p> <p>Like all NZ ETS penalties, this penalty would apply in addition to the participant's obligation to pay units. This means it would effectively deter non-compliance, which in turn, helps to uphold the integrity of the NZ ETS.</p> <p>However, a discretionary penalty has the potential to create ambiguity for the participant and the regulator, which could potentially have a negative impact on the integrity of the NZ ETS.</p> <p>This is because a discretionary penalty involves assessing individual circumstances in relation to how the non-compliance occurred, meaning it would be more difficult for the participant and regulator to have clarity around what the final penalty will be. This would also likely affect the time in which the final penalty is determined.</p>	<p>0</p> <p>Like all NZ ETS penalties, this penalty would apply in addition to the participant's obligation to pay units. This means it would effectively deter non-compliance, which in turn, helps to uphold the integrity of the NZ ETS.</p> <p>The strict liability nature of the penalty makes it clear to participants what penalty will apply for the non-compliance, and under what circumstances it will not apply (if the participant is at total absence of fault).</p> <p>This is likely to incentivise participants to take reasonable care to ensure they understand and can meet their obligations under the NZ ETS.</p>	<p>0</p> <p>Like all NZ ETS penalties, this penalty would apply in addition to the participant's obligation to pay units. This means it would effectively deter non-compliance, which in turn, helps to uphold the integrity of the NZ ETS.</p> <p>The strict liability nature of the penalty makes it clear to participants what penalty will apply for the non-compliance, and under what circumstances it will not apply (if the participant is at total absence of fault).</p> <p>This is likely to incentivise participants to take reasonable care to ensure they understand and can meet their obligations under the NZ ETS.</p>	<p>0</p> <p>Like all NZ ETS penalties, this penalty would apply in addition to the participant's obligation to pay units. This means it would effectively deter non-compliance, which in turn, helps to uphold the integrity of the NZ ETS.</p> <p>The strict liability nature of the penalty makes it clear to participants what penalty will apply for the non-compliance, and under what circumstances it will not apply (if the participant is at total absence of fault).</p> <p>This is likely to incentivise participants to take reasonable care to ensure they understand and can meet their obligations under the NZ ETS.</p>
<b>Treats participants fairly and equitably</b>	<p>0</p> <p>The absolute liability nature of this penalty does not recognise the</p>	<p>+</p> <p>The discretionary nature of this penalty could improve fairness and equity by enabling the</p>	<p>++</p> <p>This penalty would improve fairness and equitable</p>	<p>++</p> <p>This penalty would improve fairness and equitable treatment for small forestry participants.</p>	<p>+++</p> <p>This penalty would improve fairness and equitable treatment for small forestry participants.</p>



Criteria	Option 1: Status quo: 'three to one' penalty	Option 2: Discretionary penalty (as consulted on)	Option 3a: Strict liability penalty (as consulted on)	Option 3b: Strict liability (improved) – 'sliding scale' multiplier	Option 3c: Strict liability (improved) – 'fixed' multiplier
<p>difference between small forestry participants and all other ETS participants.</p> <p>Nor does it differentiate between pre-1990 and post-1989 participants (as options 3b and 3c do) and their different circumstances.</p> <p>Because of this, we do not consider this option treats small forestry participants fairly and equitably and does not safeguard their rights and interests.</p> <p>The absence of any provision for the regulator to reduce the penalty where appropriate creates a risk of serious financial hardship for small forestry participants if they fail to pay units on time, as their personal assets (such as their home and farm) could be put at</p>	<p>regulator to reduce or waive the penalty where this is justified. It could allow the regulator to issue a penalty that is proportionate to the offence, based on a participant's individual circumstances (which could include recognising the difference between pre-1990 and post-1989 participants).</p> <p>The lower maximum penalty rate also improves fairness and equity for small forestry participants by reducing the impact of the penalty and the risk it will be disproportionate to the offence.</p> <p>However, the discretionary nature of this penalty could result in it being applied inconsistently over time, reducing fairness and equity between different small forestry participants.</p>	<p>treatment for small forestry participants.</p> <p>This penalty recognises the differences between different sized participants (those with total liabilities of &gt;/&lt; 10,000 units) to safeguard the rights and interests of small forestry participants.</p> <p>The penalty would reduce the risk of serious hardship for small forestry participants as it applies lower penalty rates, particularly for small forestry participants with average annual unit obligations of less than 10,000 units. This would reduce the impact on small forestry participants, and the risk it will be disproportionate to the offence.</p> <p>However, because this option does not recognise the differences between pre-1990 and post 1989 forestry participants, this option could result in disproportionate and unfair treatment of pre-1990 participants.</p> <p>The strict liability nature of the penalty (with the total absence of fault provision) would</p>	<p>Like option 3a, this penalty seeks to distinguish between different sized small forestry participants. It does this differently, by creating five categories based on the size of the unpaid unit obligation (rather than the total liability under option 3a).</p> <p>This would further help to ensure that the size of the penalty is proportionate to the non-compliance (i.e., the number of unpaid units) and support equitable treatment of small forestry participants.</p> <p>Applying a lower penalty rate to small pre-1990 forestry participants recognises the differences between post-1989 and pre-1990 forestry participants.</p> <p>The penalty would reduce the risk of serious hardship for small forestry participants as it applies lower penalty rates, particularly for small pre-1990 forestry participants and for small forestry participants with smaller unit obligations. This will reduce the risk the penalty will significantly impact small forestry participants, which could result in an impact</p>	<p>This penalty applies a fixed penalty multiplier, based on the number of unpaid units, which already takes into account the size of the participant's unpaid unit obligation which helps to ensure the size of the penalty is fair and proportionate to the offence.</p> <p>It applies a lower penalty rate to small pre-1990 forestry participants, to recognise the differences between post-1989 and pre-1990 forestry participants.</p> <p>The penalty would reduce the risk of serious hardship for small forestry participants as it applies lower penalty rates, particularly for small pre-1990 forestry participants. This will reduce the risk the penalty will significantly impact small forestry participants, resulting in an impact which is disproportionate to the offence.</p> <p>The strict liability nature of the penalty (with the total absence of fault provision) improves fairness by ensuring the penalty does not apply in extenuating</p>	

Criteria	Option 1: Status quo: 'three to one' penalty	Option 2: Discretionary penalty (as consulted on)	Option 3a: Strict liability penalty (as consulted on)	Option 3b: Strict liability (improved) – 'sliding scale' multiplier	Option 3c: Strict liability (improved) – 'fixed' multiplier
	risk in the event of default.		improve fairness by ensuring the penalty does not apply in extenuating circumstances when participants are not at fault.	<p>which is disproportionate to the offence.</p> <p>However, there is limited justification to support applying lower penalty rates relative to the size of unpaid unit obligations, as this is not necessarily a good indicator of participant size (i.e., participants who have very small unpaid unit obligations are not necessarily the smallest participants).</p> <p>As the size of the penalty already takes into account the size of a participant's unit obligation (as the rate is multiplied by the number of unpaid units), applying a lower penalty rate to relatively smaller small forestry participants could inadvertently reduce fairness by treating participants differently without strong rationale.</p> <p>The strict liability nature of the penalty (with the total absence of fault provision) improves fairness by ensuring the penalty does not apply in extenuating circumstances when participants are not at fault.</p>	circumstances when participants are not at fault.
<b>Is straightforward and easy to apply</b>	<b>0</b> This penalty clearly prescribes the penalty rate that will apply	<b>-</b> As the penalty rate would be based on the participant's level of culpability (determined	<b>0</b> This penalty clearly prescribes the penalty rate that will apply when different types of small	<b>-</b> This penalty prescribes five different penalty rates that will apply when small forestry	<b>0</b> This penalty clearly prescribes the penalty rate that will apply when small forestry participants



Criteria	Option 1: Status quo: 'three to one' penalty	Option 2: Discretionary penalty (as consulted on)	Option 3a: Strict liability penalty (as consulted on)	Option 3b: Strict liability (improved) – 'sliding scale' multiplier	Option 3c: Strict liability (improved) – 'fixed' multiplier
<p><b>consistently in a transparent way</b></p>	<p>when forestry participants fail to pay units on time. A fixed penalty rate will help participants understand their obligations and minimise administrative costs for the regulator involved with applying discretion to set the appropriate penalty in individual cases.</p>	<p>by the regulator by applying a certain level of discretion), the applicable rate for small forestry participants could be considered ambiguous.</p> <p>The discretionary nature of the penalty and the nature of the offence means it's likely to be more difficult for the regulator to apply consistently in a transparent way than an absolute or strict liability penalty. This is likely to create uncertainty for participants and make it more difficult for them to understand and predict how the penalty will apply in different situations.</p> <p>Difficulties applying the penalty due to its discretionary nature means the penalty is also more likely to increase administrative costs for the regulator.</p> <p>The penalty is less consistent with the 'three to one' penalty, which is an absolute liability penalty, due to its discretionary nature.</p>	<p>forestry participants fail to pay units on time. A fixed penalty rate (based on the total liability per year) will help participants understand their obligations and minimise administrative costs for the regulator involved with applying discretion to set the appropriate penalty in individual cases.</p> <p>Strict liability penalties with a total absence of fault defence are well defined and commonly applied in New Zealand common law.</p> <p>The penalty is expected to provide certainty for participants, helping them to understand their obligations under the NZ ETS and the consequences of failing to pay units on time.</p> <p>The strict liability nature of the penalty is expected to enhance administration efficiencies; therefore, minimising the regulators administration costs.</p> <p>The strict liability nature of the penalty is relatively consistent with the existing 'three to one' penalty.</p>	<p>participants fail to pay units on time. Administrative costs for the regulator involved with applying discretion to set the appropriate penalty in individual cases would be minimised. However, there is a risk that the 'sliding scale' multiplier (which results in a higher penalty as the unpaid unit obligation increases) could create uncertainty for participants who may find it difficult to understand its application, especially if they are on the 'cusp' of a different multiplier/category.</p> <p>A fixed penalty rate based on the number of unpaid units (halved for pre-1990 participants), would help participants understand their obligations. However, the added complexity of the 'sliding scale' would offset some of this benefit.</p> <p>Although the strict liability nature of the penalty and the clear prescription of the penalties that will apply when different types and sizes of small forestry participants fail to pay units on time, having five different penalty rates for different size participants in addition to applying lower penalty rates for pre-1990 forestry</p>	<p>fail to pay units on time. A fixed penalty rate (based on whether the participant is a small pre-1990 or post-1989 participant) will help participants understand their obligations and minimise administrative costs for the regulator involved with applying discretion to set the appropriate penalty in individual cases.</p> <p>A consistent fixed multiplier of 0.5x (halved for pre-1990 participants), leverages off the proposal put forward and consulted on in option 3a, but applies it to all small forestry participants, ensuring consistent and transparent application.</p> <p>The penalty is expected to be straightforward and easy to apply. Strict liability penalties with a total absence of fault defence are well defined and commonly applied in New Zealand common law.</p> <p>This penalty also clearly prescribes the penalty that will apply when different types of small forestry participants fail to pay units on time. In doing so, the penalty would provide certainty for participants, helping them to understand their</p>

Criteria	Option 1: Status quo: 'three to one' penalty	Option 2: Discretionary penalty (as consulted on)	Option 3a: Strict liability penalty (as consulted on)	Option 3b: Strict liability (improved) – 'sliding scale' multiplier	Option 3c: Strict liability (improved) – 'fixed' multiplier
				<p>participants increases the complexity of the penalty.</p> <p>This is likely to create more uncertainty for participants, making it more difficult for them to understand their obligations under the NZ ETS and the consequences of failing to meet them. The additional complexity is also likely to make it more expensive for the regulator to administer the penalty.</p> <p>The strict liability nature of the penalty is relatively consistent with the existing 'three to one' penalty.</p>	<p>obligations under the NZ ETS and the consequences of failing to meet them.</p> <p>The strict liability nature of the penalty and the fixed rate(s) for the purpose of calculating the final penalty are expected to ensure it can be administered efficiently, minimising administration costs for the regulator.</p> <p>The strict liability nature of the penalty is relatively consistent with the existing 'three to one' penalty.</p>
<b>Supports Māori rights and interests</b>	<p>0</p> <p>Many Māori landowners are likely to be small forestry participants. In addition, a large proportion of Māori freehold land is pre-1990 forest land that is not eligible to be included in the NZ ETS to earn units, meaning this penalty could significantly impact small pre-1990 Māori forest owners.</p>	<p>+</p> <p>Discretion means that Māori rights and interests (e.g., noting the impacts as a result of a large proportion of Māori freehold land being pre-1990) can be taken into account by the regulator when determining the penalty based on the individual circumstances.</p> <p>However, as noted above, there is a broad risk that if the discretion is not applied in a clear, consistent, and transparent way, equitable and</p>	<p>+</p> <p>While this penalty does result in lower overall penalties for small forestry participants compared to the 'three to one' penalty, it does not differentiate between pre-1990 and post-1989 participants and the fundamental differences which put pre-1990 participants more at risk of being significantly impacted by a penalty.</p>	<p>++</p> <p>This penalty results in lower overall penalties for small forestry participants compared to the 'three to one' penalty.</p> <p>In addition, it differentiates between pre-1990 and post-1989 participants (halving the penalty rate which applies to pre-1990 participants). With a high proportion of Māori freehold land containing pre-1990 forest, this ensures the status of their land is taken into consideration.</p>	<p>++</p> <p>This penalty results in lower overall penalties for small forestry participants compared to the 'three to one' penalty.</p> <p>In addition, it differentiates between pre-1990 and post-1989 participants (halving the penalty rate which applies to pre-1990 participants). With a high proportion of Māori freehold land containing pre-1990 forest, this ensures the status of their land is taken into consideration.</p>



Criteria	Option 1: Status quo: 'three to one' penalty	Option 2: Discretionary penalty (as consulted on)	Option 3a: Strict liability penalty (as consulted on)	Option 3b: Strict liability (improved) – 'sliding scale' multiplier	Option 3c: Strict liability (improved) – 'fixed' multiplier
	Therefore, this penalty does not achieve this objective because it does not distinguish between small and large forestry participants, or pre-1990 and post-1989 forestry participants.	fair treatment would not be well achieved.			
<b>Overall Assessment</b>	0	+	++	++	+++ (preferred option)
		<p>The penalty may be less effective at incentivising compliance if participants expect the penalty to be waived.</p> <p>The penalty could improve fairness where the regulator applies discretion to reduce the penalty rate to consider individual circumstances. This may better ensure the impact of the penalty is proportionate to the offence.</p> <p>Discretion means that Māori rights and interests (e.g., the impacts of a large proportion of Māori freehold land being pre-1990 forest) can be considered by the regulator in determining the penalty based on the individual circumstances.</p>	<p>The strict liability nature of the penalty is expected to incentivise compliance by making it clear that the penalty will apply unless participants are not at fault.</p> <p>Strict liability also means it will be straightforward for the regulator to apply the penalty consistently and transparently in a timely manner. This will make it easier for participants to understand and help provide certainty.</p> <p>While this penalty does result in lower overall penalties for small forestry participants compared to the 'three to one' penalty, it does not differentiate between pre-1990 and post-1989 participants and the fundamental differences which put pre-1990 participants more at risk of</p>	<p>The strict liability nature of the penalty is expected to incentivise compliance by making it clear that the penalty will apply unless participants are not at fault.</p> <p>Strict liability also means it will be straightforward for the regulator to apply the penalty consistently and transparently in a timely manner. This will make it easier for participants to understand and help provide certainty, however, due to the number of different penalty rates relating to the number of unpaid units, this increases complexity, which reduces the benefits of a strict liability penalty by making it more difficult for participants to understand and the regulator to apply.</p> <p>This penalty is expected to improve fairness by applying lower penalty rates to small</p>	<p>The strict liability nature of the penalty is expected to incentivise compliance by making it clear that the penalty will apply unless participants are not at fault.</p> <p>Strict liability also means it will be straightforward for the regulator to apply the penalty consistently and transparently in a timely manner. This will make it easier for participants to understand and help provide certainty.</p> <p>This penalty is expected to improve fairness by applying a lower penalty rate to small forestry participants, as well as recognising the differences between pre-1990 and post-1989 small forestry participants.</p> <p>This penalty helps support Māori rights and interests by</p>

Criteria	Option 1: Status quo: 'three to one' penalty	Option 2: Discretionary penalty (as consulted on)	Option 3a: Strict liability penalty (as consulted on)	Option 3b: Strict liability (improved) – 'sliding scale' multiplier	Option 3c: Strict liability (improved) – 'fixed' multiplier
		<p>However, the discretionary nature of this penalty means it could be difficult for the regulator to consistently apply it in a transparent way. This is likely to create a higher administrative cost for the regulator and create uncertainty for participants. Inconsistent application of discretion could reduce fairness amongst small forestry participants.</p>	<p>being significantly impacted by a penalty. This does not contribute to supporting Māori rights and interests.</p>	<p>forestry participants, as well as recognising the differences between pre-1990 and post-1989 small forestry participants.</p> <p>This penalty helps support Māori rights and interests by reducing the penalty rates for small forestry participants, particularly for those with pre-1990 forest land.</p>	<p>reducing the penalty rates for small forestry participants, particularly for those with pre-1990 forest land.</p>

## 10. WHAT OPTION IS LIKELY TO BEST ADDRESS THE PROBLEM, MEET THE POLICY OBJECTIVES, AND DELIVER THE HIGHEST NET BENEFITS?

158. The proposed strict liability penalty in Option 3c is expected to effectively incentivise small forestry participants to meet their unit payment obligations, while being proportionate for small forestry participants.
159. The proposed strict liability penalty is expected to effectively achieve our objectives for the penalty to:
- **Effectively deter non-compliance and uphold the integrity of the NZ ETS:** The strict liability nature of the penalty makes it clear to participants that a penalty will apply, unless extenuating circumstances prevent them from meeting their unit obligations. This will incentivise participants to take reasonable care to ensure they understand and can meet these obligations.
  - **Treat participants fairly and equitably:** The strict liability nature of the proposed penalty maintains consistency with the existing 'three to one' penalty. The total absence of fault clause improves fairness by ensuring the penalty does not apply in extenuating circumstances when participants are not at fault. The penalty is expected to reduce the risk of serious hardship for small forestry participants. This is because it applies penalty rates that are overall lower relative to the 'three to one' penalty, and the penalty options initially proposed during the public consultation. It takes into consideration small pre-1990 forestry participants by applying a further reduced penalty rate compared to post-1989 forestry participants.<sup>56</sup>
  - **Be straightforward and easy to apply consistently in a transparent way:** The proposed penalty clearly prescribes the penalty rate that will apply when different types of small forestry participants fail to pay units on time. Strict liability penalties with a total absence of fault defence are well defined and commonly applied in New Zealand common law. This will help participants understand their obligations and minimise administrative costs for the regulator when applying the penalty and will also be clearer for participants to understand how the penalty will be applied.
  - **Support Māori rights and interests:** Māori have significant interests in forestry and own a large amount of land which could be eligible to be registered in the NZ ETS as post-1989 forest land. A large proportion of Māori land is also pre-1990 forest land. Reducing the size of the penalty that applies when small forestry participants fail to pay units on time is expected to benefit Māori and iwi landowners, as well as supporting them to manage their land in line with their land use aspirations.
  - **Be consistent with international practice:** The proposed penalty is not expected to affect New Zealand's ability to link with international emissions trading schemes in future.

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<sup>56</sup> In addition, the ability for a participant to enter a deferred payment arrangement under section 135A of the Act remains, which can further reduce the risk of serious hardship when a participant is not in a financial position to pay the penalty on time.

## Stakeholder views

160. Consistent with feedback received from stakeholders, the proposed penalty is expected to effectively achieve the two objectives the submitters considered to be particularly important: for the penalty to be straightforward and easy to apply consistently in a transparent way, and for it to treat small forestry participants fairly and equitably.
161. The proposed penalty improves fairness and equity by recognising the differences between small pre-1990 forestry participants and small post-1989 forestry participants. The strict liability nature of the penalty also improves fairness by ensuring the penalty does not apply when participants are not at fault, while ensuring the penalty is straightforward and easy to apply consistently in a transparent way.



## 11. WHAT ARE THE MARGINAL COSTS AND BENEFITS OF THE PREFERRED OPTION?

162. Our assessment of the wider economic benefits and fiscal costs and benefits is outlined in the table below. We have used an indicative financial impact rating of low (less than \$2m), medium (up to \$10m), high (up to \$20m) and very high (greater than \$20m) to describe the impact of the revised penalty for small forestry participants on affected groups. For the purposes of our assessment, we are referring to individual participant costs and benefits within an affected group, rather than the total potential costs to the affected group as a whole.
163. While care has been put into developing a reasonable cost benefit analysis, as outlined in the table below, there are limitations on the availability of data. Further limitations identified in the development of the cost benefit analysis include:
- Historical data limitations
  - Number of participants likely to be affected by the revised penalty are difficult to quantify given:
    - a. the data limitations
    - b. that non-compliance is inherently difficult to forecast
    - c. the recent increase in the number of applications to register in the NZ ETS
    - d. that many registered post-1989 forests are approaching their typical harvest age, which is when surrender liabilities and penalties are most likely to be incurred.
  - The extent of non-compliance: participants could surrender the majority of the units owing by due date, or none. This will greatly impact the penalties applied.

Affected groups	Comment	Impact	Evidence certainty
<b>Additional costs of the preferred option compared to taking no action/status quo<sup>57</sup></b>			
Post-1989 small forestry participant/s	The proposed penalty seeks to reduce the cost to participants in this group from high to low, while still creating a proportionate penalty to encourage compliance.	Reduction in impact.  The maximum penalty possible for a post-1989 small forestry participant (who owes 24,999 units) reduces from \$5,624,775 (with no ability to be reduced or waived) to \$937,462.50 (which may be waived if the participant can prove total absence of fault).	Medium – given the data limitations outlined in the RIA, we have focused on the individual impacts to participants in this group.
Pre-1990 small forestry participant/s	The proposed penalty seeks to reduce the costs to participants in this group from high to low. Additional reduction in penalty is considered appropriate for this group because they cannot earn units for the carbon stored by their forests	Reduction in impact.  The maximum penalty possible for a pre-1990 small forestry participant (who owes 24,999 units) reduces from \$5,624,775 (with no ability to be reduced or	Medium – given the data limitations outlined in the RIA, we have focused on the individual impacts to participants in this group.

<sup>57</sup> A unit price of \$75 is used throughout.

	(notwithstanding some participants received a one-off allocation of units made available by the Government in 2011/2012 in recognition of the impacts of the NZ ETS rules on their land). <sup>58</sup>	waived) to \$468,731.250 (which may be waived if the participant can prove total absence of fault).	
Other participants in the NZ ETS	The proposed penalty does not change or impact the penalty for other participants (including forestry and non-forestry) in the NZ ETS.	N/A	High
Regulators	The EPA as the regulator, will be responsible for administering the revised penalty, which is a strict liability penalty (compared to the penalty that would otherwise apply in the absence of the proposed penalty, which is an absolute liability penalty). Strict liability will allow the regulator to waive the penalty where it is satisfied that the participant was at total absence of fault.	The EPA will continue to be responsible for resourcing the administration of the revised penalty.	Medium – Given the limitations on predicting the scope and scale of penalties, we have a medium level of confidence with this assessment, which was prepared in consultation with the regulator.
<b>Additional benefits of the preferred option compared to taking no action/status quo</b>			
Post-1989 small forestry participant/s	The benefits relating to small forestry participants are predominantly financial, as the proposed penalty relates exclusively to financial penalties. It is important to note the proposed penalty does not reduce the initial unit liabilities incurred by the participant, only the subsequent penalties for failing to pay units on time. In addition, the proposed penalty is a strict liability penalty, which maintains certainty to participants (as does the status quo) and makes it easier for them to understand their obligations (in comparison to other types of penalties, such as discretionary penalties).	Reduction in impact.  Reduced maximum penalty (with the ability to be waived where participants are at no fault) reduces the overall financial impact if the proposed penalty is incurred.	Medium
Pre-1990 small forestry participant/s	The benefits relating to small forestry participants are predominantly financial, as the proposed penalty relates	Reduction in impact.  Reduced maximum penalty (with the ability to be waived where participants are at no	Medium

<sup>58</sup> Which did not reflect the full deforestation liability.

	<p>exclusively to financial penalties.</p> <p>It is important to note that the Bill does not reduce the initial unit liabilities incurred by the participant, only the subsequent penalties for failing to pay units on time.</p> <p>In addition, the Bill is a strict liability penalty, which maintains certainty to participants (as does the status quo) and makes it easier for them to understand their obligations (in comparison to other types of penalties, such as discretionary penalties).</p>	<p>fault) reduces the overall financial impact if the proposed penalty is incurred.</p>	
Other participants in the NZ ETS	<p>The proposed penalty provides no benefit to other participants (including forestry and non-forestry) in the NZ ETS.</p>	N/A	High
Regulators	<p>The proposed penalty is strict liability in nature, which is straightforward and less administratively burdensome (in comparison to other types of penalties, such as discretionary penalties) for the regulator to apply efficiently, in a certain and transparent way.</p>	<p>The proposed penalty introduces a revised penalty for small forestry participants that should be easy to understand and administer from a regulator's perspective. This is because it is strict liability in nature, meaning (like the 'three to one' penalty), there is no discretion to be exercised, in comparison to the former (discretionary) excess emissions penalty.</p> <p>The delay in implementation provides an opportunity for the regulator to communicate these changes to participants, alongside Te Uru Rākau – New Zealand Forest Service.</p> <p>The limited scope of the proposed penalty and unique nature of small forestry participants in the NZ ETS means New Zealand's ability to link with other carbon markets in future is not expected to be affected.</p>	Medium

## Section 3: Delivering an option

### 12. HOW WILL THE REVISED PENALTY FOR SMALL FORESTRY PARTICIPANTS BE IMPLEMENTED?

164. Introducing a revised penalty for small forestry participants who fail to pay units on time requires legislative change to the Climate Change Response Act 2002.
165. The revised penalty is to take effect from 1 January 2025.
166. The revised penalty differs from the 'excess emissions' penalty that currently applies to small forestry participants (under the transitional arrangement) in terms of the level of the penalty and removal of discretion. The most significant risks to implementing the revised penalty are that small forestry participants do not fully understand their NZ ETS obligations and the consequences of failing to meet them. In particular, that they are not aware when the 'excess emissions' penalty will stop applying, and how the revised penalty will work in practice.
167. To ensure the revised penalty is well signalled to small forestry participants (and prospective participants), Te Uru Rākau – New Zealand Forest Service will roll out an education package to increase understanding of NZ ETS obligations and the revised penalty. This is expected to be developed and delivered well in advance of the new penalty coming into effect with plenty of lead-in time for participants.
168. The education package will be designed to complement and build on existing education initiatives already underway to increase understanding of NZ ETS obligations among different forestry participants (and prospective participants) such as:
- Regular digital updates through the 'Forestry ETS Alert' newsletter, which is periodically distributed to key stakeholders, including forestry consultants and NZ ETS participants.
  - Extensive guidance published on Te Uru Rākau – New Zealand Forest Service's website.
  - A series of webinars held by Te Uru Rākau – New Zealand Forest Service for different participants and user groups including question and answer sessions, 'NZ ETS for forestry 101' workshops, 'NZ ETS for forestry 2023 changes' webinars, and demonstrations of the emissions returns process.
169. The education programme will likely make use of all the communication channels above and include bespoke webinars on the penalty, targeted to small forestry participants. Te Uru Rākau – New Zealand Forest Service will also work to improve awareness of NZ ETS obligations and the penalties for failing to meet these obligations (including the revised penalty for small forestry participants) among pre-1990 forest landowners.
170. In addition, Te Uru Rākau – New Zealand Forest Service will work closely with the regulator (the EPA) as it implements this change, to ensure communications across the two agencies are aligned.



### 13. HOW WILL THE REVISED PENALTY BE MONITORED, EVALUATED, AND REVIEWED?

171. Monitoring and evaluation of the revised penalty will be ongoing.
172. The impact, appropriateness and effectiveness of the revised penalty will be monitored through current reporting lines and processes to ensure the penalty achieves its long-term objectives. This will include monitoring by the regulator of non-compliance rates by small forestry participants.
173. If there is a significant shift in non-compliance data gathered about pre-1990 forest landowners and/or post-1989 small forestry participants through business-as-usual processes, the reasons will be explored and MfE and MPI (Te Uru Rākau – New Zealand Forest Service) will work with the regulator (EPA) to determine if further work is needed.
174. As noted earlier in this document, the scope of this review did not include investigating compliance issues and impacts of applying the ‘three to one’ penalty to NZ ETS participants from other sectors who may be similarly affected to small forestry participants, by the new penalty. MfE will monitor the effectiveness and appropriateness of the ‘three to one’ penalty for those other sectors to determine if changes may be required in future.