



JOINT MAF/ETG BRIEFING OUTLINING IMPLICATIONS OF OPTIONS FOR FORESTRY POLICY IN THE NZ ETS

Date:	18 June 2009	MfE Priority:	High
Security Level:		Number of Attachments:	1
		MfE Ref No:	09-B-01534
		MAF Reference No:	B08-676

Action Sought

	Action Sought	Deadline
Minister for Climate Change Issues Hon Dr Nick Smith	Indicate which forestry options officials should undertake further work on	None
Minister for Forestry Hon David Carter	Note for information	None
Associate Minister for Climate Change Issues (International Negotiations) Hon Tim Groser	Note for information	None
Minister of Finance Hon Bill English	Note for information	None

Ministry for the Environment Contacts

Name	Position	Telephone		1st Contact
		(cell)	(work)	
[withheld]	Senior Policy Analyst, MAF		[withheld]	
Julie R Collins	Manager, Climate Change, MAF	[withheld]	[withheld]	✓
Mike Jebson	Director, Natural Resources Group, MAF	[withheld]	[withheld]	
Stuart Calman	Acting General Manager, Emissions Trading Group	[withheld]	439 7571	

Executive Summary

The Minister for Climate Change Issues has requested an analysis of a proposed package of policy options for pre-1990 and post-1989 forests in the New Zealand Emissions Trading Scheme (ETS). The proposed policy package comprises of:

- **[withheld]**.
- For post-1989 forest land: giving foresters an added option of earning credits for the 'average' level of carbon in their forests, and avoiding the need to pay for future harvesting liabilities; the Crown applying a 'risk margin' to this average credit option to fully recover the cost of its harvest liabilities; and requiring owners of post-1989 forest land to offset when they deforest. New forests planted since 1 January 2008 would receive carbon credits up to the average carbon stock level of the forest over the first 10 years of its first rotation.

Officials were directed to review the package in terms of practicality, cost to forest land owners, and fiscal cost.

Pre 1990 Forest Land Proposals

Under an offsetting regime owners of pre-1990 forest would be able to deforest their land without charge under the ETS so long as they established an equivalent area of offsetting forest land elsewhere. For the 2008-2012 period, the Government would meet the deforestation cost and retain the credits earned from the offset forest over time.

[withheld].

In terms of cost, offsetting would considerably reduce the deforestation costs facing those landowners who are ineligible for existing exemptions (for example, the less than 50 ha exemption): to a cost of **[withheld]** per ha compared to approximately \$22,000 per ha under the current ETS design. This would make offsetting considerably more attractive than the current regime to landowners who are in a position to deforest significant areas. Offsetting would also lead to modestly higher compliance costs for pre-1990 owners wishing to deforest, but these costs should be low relative to the benefits offsetting provides.

[withheld].

In practice it may therefore not be possible to introduce offsetting without at least some additional fiscal cost in CP1. **[withheld]**.

The table below shows the 'gross' fiscal costs of offsetting, and the net fiscal impact of introducing offsetting and removing the allocation plan in its entirety or retaining the existing exemptions for deforestation.

	CP1	2013-2020
Fiscal <u>cost</u> with offsetting allowed internationally post-2012		[withheld]
Fiscal <u>cost</u> where international rules do not allow offsetting post-2012	[withheld]	[withheld]
<u>Net</u> fiscal impact where all allocation and exemptions are removed	[withheld]	[withheld]
<u>Net</u> fiscal impact where allocation is removed but all current exemptions retained	[withheld]	[withheld]

It should also be noted that a shift from the current free allocation policy to an offsetting approach would lead to a complex set of winners and losers. The proportion of foresters in a position to take advantage of offsetting during CP1 is relatively small. Many landowners, and in particular Maori, will derive little or no benefit from CP1 offsetting as the young age of their

trees, or the existence of forestry rental agreements, mean they cannot convert their forest land until after 2012. This has the potential to raise significant equity issues should offsetting not be continued for CP2 and beyond, and may lead some in the industry to argue in favour of retaining the status quo, where offsetting must be provided after 2012 if it can be secured internationally. For owners of small forest holdings (less than 50 ha) the introduction of offsetting that also resulted in the removal of existing exemptions would result in them facing a cost of deforestation that they can currently avoid by applying for an exemption.

Post 1989 Forests

Under an 'averaging' regime owners of post 89 forest that opted to join the ETS would have two options available to them: the status quo approach of fully accounting for all increases and decreases in carbon stocks; or a new option of earning units up to a pre-agreed 'average' level of carbon, and then retaining that level of units indefinitely so long as the land remained under forestry.

While the introduction of a voluntary averaging regime, and compulsory offsetting regime for deforestation of post 1989 forests, would again require several technical issues to be resolved officials can see no insurmountable practical barriers to their introduction.

From an administrative perspective, costs to the forest owner of participating under an 'averaging' approach are expected to be similar to those under the existing post-1989 provisions. (It should also be noted that forest owners can create their own 'averaging' schemes by creating a pool of forest blocks with different age classes under the existing legislation). The overall net benefit to forest owners of participating in an averaging scheme will therefore depend on the extent to which the Crown designs any averaging scheme in a way that provides an additional afforestation incentive to participants.

A design parameter that will be a key determinant of the overall fiscal cost of averaging is the size of the 'harvesting risk margin' (or proportion of units withheld by the Crown) built into the scheme. Applying a harvesting risk margin buffer of around 21% would make the scheme fiscally neutral from the Crown's perspective, but may mean that the option was no longer attractive to some participants. A lower margin would make the scheme more attractive to participants, as it would see the Crown providing a greater afforestation incentive to participants than a straight implementation of the Kyoto Protocol rules would imply. There may be more cost-effective ways for the government to provide this sort of afforestation incentive. One obvious option would be to expand the size and generosity of the existing afforestation grant scheme.

The cost to the Crown, per hectare, for a range of different risk margins is shown in the table below. We have not attempted to convert these figures into a total fiscal cost at this stage as it is not possible to credibly forecast participation levels. However, MAF is currently developing a number of illustrative participation scenarios that should provide a broad sense of the possible cost range. These figures will be provided next week as part of the material MfE is preparing for your next discussion at Strategy Committee.

Size of harvest risk margin (below the average carbon)	0%	7%	15%	21%
Share of credits (%)	50 forester 50 Crown	43 forester 57 Crown	35 forester 65 Crown	29 forester 71 Crown
Crown harvest liability (\$/ha and units/ha)	\$4,356/ha 174 units/ha	\$2,902/ha 116 units/ha	\$1,240/ha 50 units/ha	\$00.00/ha 0 units/ha

Note that the size of the Crown harvest liability shown above is also effectively a measure of the level of the afforestation incentive that the averaging approach would provide under different possible risk margins. **[withheld]**.

Other Considerations

A key issue for both sets of policy options is timeliness. The likely lead-in time required to implement offsetting and averaging will have a direct bearing on the extent of the benefit that can be derived during CP1. This is particularly important for offsetting, as the current legislation requires the government to introduce offsetting arrangements after 2012 if similar provisions are able to be negotiated internationally. Once the policy positions on offsetting and averaging are confirmed, additional time will be required to develop regulations and measurement methodologies and produce guidance material to support the new policy. These processes are likely to take an additional 6-12 months from the point that amending legislation is enacted. It may be possible to allow participants to begin to deforest before the rules and systems have been finalised, but this would come with risks. In turn, if deforestation is not allowed until those rules and systems have been finalised, the scheme could not be introduced until mid to late 2010.

Even if the government mitigates the fiscal cost by removing some or all of the allocation there is still an overall economic cost to NZ from introducing offsetting. Under offsetting, the cost burden of deforestation is shifted from the landowner to the Crown. The cost of the deforestation liabilities would not be paid by the landowner, and therefore higher rates of deforestation would likely occur. The cost of the emission liabilities (carried by the Crown) from this deforestation is greater than the extra economic activity generated from the new agricultural land. This outcome is inefficient and ultimately results in an overall loss in welfare for NZ.

[withheld].

It is evident from engagement to date that some land/forest owners are struggling to evaluate the range of options that are currently available, without adding further complexity to the landscape. With this in mind, further consideration needs to be given to the level of consultation the government wishes to undertake, especially with Maori. We note that not engaging¹ adequately could present a risk to relationships between the Crown and Maori. Should this result in policy options which Maori oppose (such as removal or reduction of the free allocation), aggrieved parties could seek redress via the Waitangi Tribunal

Officials advise that further detailed design and analysis is required to more accurately assess and quantify the extent of the impacts of these policy preferences as outlined in this paper.

Recommended Action

We recommend that you:

- (a) **Note** the contents of this report

- (b) **Discuss** the contents of this report with your colleagues

¹ Particularly as it relates to policy changes and the process of engagement followed by the Crown.

(c) **Indicate** which of the following options officials should undertake further work on:

- | | | |
|----|---|-----------------|
| a. | Offsetting for pre-1990 forest owners (combined with removal of the 9-year rule and a significant reduction in free allocation and current scheme exemptions) | Yes / No |
| b. | A voluntary averaging scheme for post 1989 forest owners | Yes / No |
| c. | Compulsory offsetting for participating post 1989 forest owners wishing to deforest | Yes / No |

Mike Jebson
Director, Natural Resources Group
MAF POLICY

Date

Stuart Calman
Acting General Manager, Emissions Trading Group
Ministry for the Environment

Date

Referred to Ministry Communications Staff:

Yes/No

Hon Dr Nick Smith
Minister for Climate Change Issues

Date

Hon David Carter
Minister of Agriculture and Forestry

Date

Hon Tim Groser
Associate Minister for Climate Change Issues (International Negotiations)

Date

Hon Bill English
Minister of Finance

Date

Purpose of Report

1. To provide a review of the practicality, fiscal impact, and cost to the forest owner of a package of forestry options proposed by the Office of the Minister for Climate Change Issues.

Background

2. The Minister for Climate Change Issues (the Minister) has requested an analysis of a package of policy options for pre-1990 and post-1989 forests in the NZ ETS. These policy options include the following design features:
 - i. for pre-1990 forest land: allowing offsetting; **[withheld]**.
 - ii. for all post-1989 forest land: giving foresters an added option of earning 'average' carbon credits' (with the Crown paying for future harvesting liabilities); Crown applying a 'risk margin' to fully recover its harvest liabilities and requiring owners of post-1989 forest land to offset when they deforest. New forests planted since 1 January 2008 would receive carbon credits up to the average carbon stock level of the forest over the first 10 years of its first rotation.
3. The objectives of the revised package are to promote new forest plantings, maintain land use flexibility, manage Crown fiscal costs and create (where practicable) greater consistency between the treatment of pre-1990 and post-1989 forests.
4. Impacts of the proposed policies have been reviewed in terms of:
 - fiscal impact on the Crown;
 - cost to forest owners; and
 - practicality.
5. This paper summarises the outcome of the review and the high level issues Ministers need to be aware of prior to committing to changes to the existing ETS forestry provisions as they relate to 'offsetting' for pre-1990 forest land and 'averaging' for post-1989 forest land.
6. A more detailed assessment of the package will be made available to the Minister for Climate Change Issues and the Minister for Agriculture and Forestry's advisors.

Analysis

Assessment Fiscal Cost, Cost to Forest Owner and Practicality

A. Offsetting

7. There is no provision in the Kyoto Protocol (KP) or current international rules for offsetting; that is, deforesting an area of pre-1990 forest and 'replacing' it with a new area of forest elsewhere. Under offsetting, the Crown would pay the deforestation liabilities, provided landowners establish an equivalent (in area and/or carbon sequestered) offset forest. The Crown would keep the units earned from sequestered carbon from the offset forest as it grows. New Zealand (NZ) is seeking to have offsetting provided for under the international rules for post-2012.

i. Fiscal Cost

8. [withheld].

9. The fiscal cost of offsetting is difficult to predict with any certainty because the impact is dependent on the area of land deforested which is outside the control of the government, and will be affected by a range of factors. This is why estimates show a wide range of possible costs to the Crown.

10. Table 1 below shows the fiscal costs for CP1 and CP2 under two different scenarios; where the post-2012 international rules allow offsetting; and where they do not. The fiscal costs of offsetting are calculated using the expected area of deforestation and the carbon price, and the deforestation liability for the area deforested less the sequestration benefit from the offset forest².

11. The figures reflect the two different methods used to calculate the area that could be deforested. These two methods generate very different estimates for the area of deforestation over 2012-2020 and range between [withheld]³ ha per year. This is a reflection of the difficulty in predicting the effect of offsetting on decision making. In comparison actual deforestation was 12,900 ha, 12,700 ha, and 20,000 ha in the years 2005, 2006 and 2007 respectively.

Table 1: Fiscal costs of offsetting vs fiscal savings of removing allocation plan and/or retaining exemptions for deforestation

	CP1	2013-2020
Fiscal <u>cost</u> with offsetting allowed internationally post-2012		[withheld]
Fiscal <u>cost</u> where international rules do not allow offsetting post-2012	[withheld]	[withheld]
<u>Net</u> fiscal impact where all allocation and exemptions are removed	[withheld]	[withheld]
<u>Net</u> fiscal impact where allocation is removed but all current exemptions retained	[withheld]	[withheld]

12. The fiscal impact could be mitigated by removing some or all of the allocation of NZUs under the Forestry Allocation Plan. The current fiscal cost in CP1 for the allocation (21 million units) is approximately \$525m⁴. However, some of these units are committed to exemptions (less than 50 ha, less than 2 ha, tree weeds) and are part of treaty settlements (CNI). To realise the full fiscal savings these exemptions need to be removed and the treaty settlement renegotiated.

13. Under a scenario where the entire forestry allocation (including exemptions noted above and CNI allocation) was removed, the fiscal costs of allowing offsetting under the current ETS approach would be similar for CP1. In contrast, fiscal costs for CP2 vary largely and could either be a net fiscal saving or impose much greater costs than the allocation package over this period and depends on the international rules negotiated. The table above also shows the fiscal savings that could be realised if the forestry allocation plan was removed in its entirety or where current exemptions under the ETS were retained.

14. Ministers should expect pressure to maintain some level of free allocation⁵ especially from those landowners who will not benefit from offsetting and/or some exemptions.

² This means netting off a single large deforestation liability with an initially small but increasing and ongoing sequestration benefit. The large deforestation liability dominates in CP1, hence the cost.

³ [withheld]

⁴ 21 million NZUs allocated to pre-1990 forest landowners, able to be surrendered in CP1, at \$25/tonne CO₂e (\$25/NZ U).

⁵ Forest owners have stated in submissions to the special select committee on the ETS that both an allocation and offsetting should be provided as offsetting still imposes some cost. Several Iwi have also signed 'Deed of

The possibility of allowing both offsetting AND paying out some level of allocation would significantly increase the fiscal cost to the Crown. Landowners most likely to be in favour of maintaining a free allocation or exemptions include those:

- not in a position to offset during CP1;
- where no alternative land use exists for their land;
- who can currently deforest at no cost due to current exemptions; or
- who consider offsetting too costly and/or onerous (once carbon equivalency/purchasing land and ongoing management costs are factored in).

15. Some landowners say they are relying on the allocation of NZUs to help fund the replanting of their pre-1990 forest estate ([withheld]⁶ is a case in point). Removing the allocation of NZUs in favour of offsetting may be seen by a number of pre-1990 forest owners as raising inequities greater than currently exists under the allocation plan.
16. In the event the allocation of NZUs is replaced with offsetting, it may be reasonable to maintain some level of exemption from having to offset. This is justified to an extent to minimise the cost of compliance and to ensure offsetting requirements are not too onerous for owners who have deforested small areas of land. The previous exemption threshold was set at <50 hectares and estimated to cost \$235 million (over CP1-CP3). If an exemption is retained then the potential fiscal savings from removing the allocation in favour of offsetting would be reduced by this amount. Any change in this threshold limit would lead to a corresponding change in government funding required.

ii. Cost to the Forest Owner

17. Offsetting has a considerably lower cost per hectare to the forest land owner than paying deforestation liabilities under the existing scheme. In broad terms offsetting costs about a tenth of deforestation liabilities under the ETS (around [withheld]⁷ compared to approximately \$22,000 per ha⁸ under the current NZ ETS) at a 1:1 offsetting ratio. If a higher ratio was required this would increase the cost to the landowner. This would make it attractive to landowners, especially those with well developed plans to undertake conversions from forests to agriculture. In comparison if the government were to fix the price of carbon during CP1 at \$12, the maximum cost of deforesting would be about \$9,800.
18. However forest owners may face additional costs associated with demonstrating the offset forest was 'equivalent' (in terms of the carbon it sequesters over time) to that of the deforested land and other ongoing forest management and reporting costs.

iii. Practicality

19. Offsetting is certainly 'doable' and will provide greater flexibility for land use. It will make the existing scheme more complex for both administrators and participants. Increased complexity will also increase costs for the Ministry of Agriculture and Forestry (MAF) as more land (the offset land) will require periodic reporting and ongoing compliance checking. However these are issues the Government may have to address anyway as the Act requires the Minister to introduce offsetting in CP2 if the international rules allow it.
20. A key limiting factor from a practicality perspective is that of 'timeliness'. The likely lead-in time required to implement offsetting will have a direct bearing on the extent of the benefit that can be derived for having offsetting during CP1. Before offsetting can

Agreements' or 'Agreements in Principle', enshrining 18 units/hectare. The CNI collective Deed of Settlement becomes operative as of 1 July 2009.

⁶ [withheld].

⁷ Cost relates to buying offset land only, not cost to purchase seedling stock.

⁸ Emissions liabilities based on 815.6 tonnes CO₂ per hectare at a carbon price of \$25 per tonne CO₂.

become a reality on the ground, there is still much to be resolved in terms of the development of higher level policy processes including:

- Cabinet approval and development of the detailed design aspects
- Undertaking an adequate level of consultation/hui with stakeholders and Maori;
- Development of supporting departmental administrative processes; and
- Enacting amendments to the legislation (which is in turn impacted by timing issues around harmonising with the Australian CPRS). The earliest new legislation is likely to be in place is December 2009.

21. Once the policy position is confirmed, additional time is required to develop regulations and measurement methodologies and produce guidance material to support the new policy. These processes are likely to take an additional 6-12 months from the point that amending legislation is enacted.
22. It may prove possible to allow pre-1990 participants to begin the process of deforestation after the legislation has been enacted, but before the new operational rules and administrative systems have been finalised. However, this approach would pose a degree of risk. If participants are not allowed to begin to deforest until the rules and systems have been established⁹, the introduction of offsetting could not occur until mid to late 2010.
23. The last timing constraint relates to the time it takes to physically establish the offset forest. Although there are forest owners with deforestation plans well advanced, to maintain the integrity of the scheme forest owners should be required to demonstrate carbon equivalence in the new forest **prior** to deforestation (or deforestation liabilities being extinguished). It will take time for forest owners to source land and tree stocks. It is estimated that it will be mid 2011 before forest owners would be able to demonstrate the establishment of an offset forest and 'get approval' to be relieved of their deforestation liability.

B. The 'Averaging' Carbon Accounting Option for Post-1989 Forests

24. The draft Australian Carbon Pollution Reduction Scheme (CPRS) legislation proposes an 'averaging' (50:50 split of credits) approach for carbon accounting for post-1989 forests. Under averaging, units are issued up to the long term average forest carbon stock level for carbon earned from 1 January 2008, and none have to be paid back when harvesting occurs provided the forest owner does not change their management (especially their harvesting intentions).
25. Although the Crown retains half of the units, there are two trade-offs:
 - the Crown takes responsibility for potentially large fiscal costs associated with harvesting in the future; and
 - there may be significant economic inefficiencies/wealth losses created because the forest owner has no incentive to manage the forest to respond to future carbon prices.
26. The version of averaging considered in this policy package is an amended version of the CPRS 50:50 averaging scheme with the addition of a 'harvesting risk margin'¹⁰ to offset the Crown liability when the trees are harvested.

i. Fiscal Costs

⁹ To ensure participants met 'carbon equivalency' requirements, it is likely this timeframe would be more realistic.

¹⁰ A harvesting risk margin is a reduction in credits the forest owner earns below the average carbon earned by their forest at harvest – typically age 28 for *Pinus radiata*. The Crown keeps these, along with units earned above the average carbon stock level. Note also that a 'risk of reversal' buffer to cover deforestation from natural events is in addition to the harvest risk margin specified above.

27. The fiscal cost for averaging ranges between zero to \$4,356¹¹ per hectare for new forest. The size of the fiscal cost can be varied by changing the size of the risk margin applied which depends on the cost the Crown is willing to bear for future harvesting liabilities. Table 2 illustrates the impact changing the size of the risk margin has on Crown liabilities and the share of carbon credits between the forester and Crown.

Table 2: Showing range of fiscal costs (per hectare) when applying different 'risk margin' scenarios

Size of harvest risk margin (below the average carbon)	0%	7%	15%	21%
Share of credits (%)	50 forester 50 Crown	43 forester 57 Crown	35 forester 65 Crown	29 forester 71 Crown
Crown harvest liability (\$/ha and units/ha)	\$4,356/ha 174 units/ha	\$2,902/ha 116 units/ha	\$1,240/ha 50 units/ha	\$00.00/ha 0 units/ha

28. Note that the size of the Crown harvest liability shown above is also effectively a measure of the level of additional afforestation incentive that the averaging approach would provide under different possible risk margins **[withheld]**.

29. While the Crown can manage the fiscal cost by changing the percentage of risk margin applied, determining the aggregate cost to the Crown is unpredictable. This is because the overall harvesting liability is determined by the area of post-1989 forest brought into the ETS and opt-in rates under an averaging approach – both of which is unknown. Future carbon prices at the time of harvest will also have an impact on the overall size of future Crown harvest liability. We have therefore not attempted to provide a total fiscal cost estimate at this stage. However, MAF is currently developing a number of illustrative participation scenarios that should provide a broad sense of the possible cost range. These figures will be provided next week as part of the material MfE is preparing for your next discussion at Strategy Committee.

30. Applying a risk margin buffer of ~21% essentially eliminates future Crown harvest liabilities. However it reduces the number of units that forest owners receive to such an extent that averaging may no longer be an attractive option. In order to achieve the objectives of encouraging more planting and covering Crown harvest liabilities Ministers will need to decide:

- a. Whether to provide a fiscal incentive for new planting over and above those already offered under the existing ETS;
- b. If so, whether it is best to do that by providing greater incentives under the ETS to forest owners through averaging, or through some other mechanism (such as the existing Afforestation Grant Scheme); and
- c. How much money the government willing to spend to do this.

ii. Cost to the Forest Owner

31. Costs to the forest owner of participating under an 'averaging' approach are expected to be similar to those under the existing post-1989 provisions. Averaging (closer to a 50:50 carbon credit share) will be attractive to some as all harvesting liabilities would reside with the Crown. However if the Government took an approach where some or all Crown harvesting liabilities are covered, the benefit to the forest owner of participating in such a scheme is reduced (as they receive fewer carbon credits). As

¹¹ Assuming a price of carbon \$25 tonnes CO₂-e per hectare and carbon growth over 28 year harvest rotation of *Pinus radiata*.

a result, participation rates are likely to decrease under an averaging option as the risk margin increases.

32. Under the existing ETS, Participants can already elect to manage their post-1989 forest as if it were under an averaging regime. That is, participants have the flexibility to manage carbon growth and harvesting strategies (i.e., liabilities) to their own personal risk profile – one of which could be investing the credits earned from the permanent carbon sequestration from land use change and banking the units earned above this level to surrender against future harvesting liabilities.
33. In relation to requiring owners of post-1989 forest to offset upon deforestation (under both averaging or the existing rules) while it is possible to do, it is difficult to justify why compulsory offsetting should be required for a regime whose participation is voluntary.
34. Under the Kyoto Protocol NZ has received credits for post-1989 forest land and therefore there is a small (to nil) net liability for deforestation of these. This is not the case for pre-1990 forest land. Therefore requiring post-1989 forest owners to offset where there is no or low net cost to the taxpayer is likely to be seen as imposing an unnecessary and additional cost on forest landowners. This is likely to act as a disincentive to participation and new planting.
35. Under the current ETS rules, those post-1989 forest owners that do enter can exit (which could be for the purpose of deforesting) the scheme at any time as long as they have surrendered the equivalent credits earned. Furthermore, the existing scheme already allows for offsetting in the sense that if deforestation liabilities cannot be met by paying back the carbon credits earned, they can be met with sequestration credits from other forest blocks.
36. Providing a dual system would provide a choice between averaging and the net carbon stock approaches and give maximum flexibility to forest owners.

iii. Practicality

37. Introducing an additional option of an averaging or 'modified averaging' scheme is no more complex than the existing scheme (except that there are more options for landowners to have to understand and choose between).

Other Relevant Considerations

38. In addition to the three criteria officials were directed to use to review the policy package, there are several other aspects worth noting for Ministers to consider and relate to timeliness, economic costs, international reputation and consultation requirements.

A. Likely Winners and Losers (Equity Issues) - Offsetting

39. It is worth noting that while many forest owners are in favour of offsetting overall, the proportion of foresters in a position to take advantage of offsetting during CP1 is relatively small¹² compared to the total number of pre-1990 forest owners. Many other landowners (Maori in particular) will derive little or no benefit from CP1 offsetting as forestry rental agreements mean they cannot convert their forest land until after the forest has been harvested. This has the potential to raise significant equity issues should offsetting not be continued for CP2 and beyond.
40. Ministers should expect pressure to maintain both an allocation of NZUs and allowing offsetting. In addition, review of the current exemptions would raise deforesting costs for small foresters (for example holding of less than 50 ha) that they do not face under the existing ETS. Ministers should expect pressure to maintain these exemptions.

B. Economic Costs

i. Offsetting

41. The current ETS has been designed to reflect (as closely as possible) the Kyoto Protocol rules, in that it provides a tool for the world price of carbon to be introduced into emitters' decision making processes. Any move away from these design elements introduces greater complexity, higher fiscal and economic costs and transfers carbon price risk to the Crown. Introducing either offsetting or averaging shifts domestic policy away from international rules and causes a misalignment of timber and carbon management incentives for foresters. This ultimately results in poorer decisions by NZ emitters and an overall wealth loss.
42. Even if the government mitigates the fiscal cost by removing some or all of the allocation there is still an overall economic cost to NZ from introducing offsetting. Under offsetting, the cost burden of deforestation is shifted from the landowner to the Crown. The cost of the deforestation liabilities would not be paid by the landowner, and therefore higher rates of deforestation would likely occur. The cost of the emission liabilities (carried by the Crown) from this deforestation is greater than the extra economic activity generated from the new agricultural land. This outcome is inefficient and ultimately results in an overall loss in welfare for NZ. In CP1 this economic cost ranges from [withheld].
43. The benefit to NZ of introducing offsetting early will be limited because of the short time period over which offsetting can occur during CP1. Initial estimates suggest a maximum period of only 18-24 months will be available for forest owners to take advantage of offsetting prior to any international rule changes in this area. Conversely the cost of delaying offsetting into CP2 (when NZ can potentially do this cost free) will be relatively small because the landowner only faces two years of delayed benefit.

ii. Averaging

44. Under any averaging approach, participants face muted incentives to manage forests for carbon and timber optimally and to minimise associated harvest liabilities. For example, delaying harvesting when carbon prices are high could increase carbon sequestration - creating wealth benefits for both the participant and New Zealand that are not encouraged under averaging.

C. Reputational Issues and International Negotiating Position - Offsetting

¹² Although small in number those in favour of offsetting over CP1 tend to be the large multinationals with advanced conversion plans where they have already cleared forest land but not yet changed the land use.

45. [withheld].

46. [withheld].

47. [withheld]. Officials can provide further information and options for maintaining carbon equivalency if required.

D. Stakeholder Reaction to Compulsory Offsetting

48. Implementing a compulsory offsetting scheme upon deforestation for post-1989 forest owners is likely to be unpopular as there is a weak argument to justify imposing such a cost. This could result in lower participation and new planting rates.

E. Consultation – Offsetting and Averaging

49. An extensive engagement/communications plan with the forest sector and Maori will be required. Inadequate engagement may leave the Crown open to legal or Treaty challenge – especially as many forest owners may perceive themselves disadvantaged under offsetting compared to the current policy.