Submission on the New Zealand Emissions Trading Scheme Review 2015/16

Priority issues

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Introduction

This submission has been prepared by the NZ Forest Owners Association (FOA), on behalf of our members.

The FOA is a voluntary organisation representing the interests of commercial forest growers, facilitating co-operation and co-ordination within the forest industry. FOA member companies collectively manage around 1.2 million ha of rural land and approximately 80% of the plantation forest harvest. The total New Zealand plantation forest area is 1.7 million hectares.

Government has sought feedback on the review of the Emissions Trading Scheme in two phases. The first phase relates to priority issues.

Priority issues are restricted in the discussion document to:

a. Moving to full surrender obligations

b. Managing the cost of full surrender obligations

The FOA has the following responses to the questions raised in the document.

Issues

Should the ETS move to a full surrender obligation for the liquid fossil fuels, industrial processes and energy and waste sectors?

The ETS currently provides a transitional one-for-two subsidy whereby emitters are required to submit only one NZU for every two tonnes of CO_2 emitted. The timetable for the phase out of this subsidy was originally the end of 2012. But, like other key transitional measures or intended developments, that didn't happen. The one-for-two subsidy works in tandem with the current cap on price of $NZ25, meaning that effectively the maximum price that an emitter currently faces is NZ$12.50 per unit, but only where their intensity of emissions has increased

The FOA position is that the one-for-two subsidy should be removed immediately and no transition period for that removal is necessary. We further argue that it should not be replaced by a compensatory level of assistance through some other mechanism as is proposed in the discussion document (page 13).

We base this position on the following arguments:

1. The rationale for the subsidy no longer exists.

   As the discussion document acknowledges, the one-for-two subsidy was introduced as protection for emitters to mitigate the impact of the global financial crisis. The argument was that the global financial crash of 2008 and the subsequent 2008-2012 economic depression, was sufficiently severe that the already subsidised price faced by liquid fossil fuels, industrial processes, stationary energy and waste emitters needed to be further reduced.

   The 2008 event and consequent fallout was extreme and the worst since the great depression. It created a liquidity crisis that threatened the collapse of large financial institutions, the housing market and wiped out trillions of dollars (US) of consumer wealth. While there will always be a level of international economic uncertainty, those conditions do not prevail today.

   Even during the financial crisis, the period after the introduction of the one-for-two subsidy was characterised by a collapse in the price of carbon – a consequence of the fall in economic activity. In New Zealand this was further compounded by the open door policy on cheap international units. We contend that if it had been clear that the price of carbon was going to fall by 90% the one-for-two measure would never have been introduced. In addition to the improved economic outlook, the price of carbon is still less than half the level it was when the subsidy was brought in.

2. There is on-going distortion to the ETS and the economy, and a lack of incentive for change while the 50% subsidy remains.

   When New Zealand submitted its second biennial report last December the increase in net greenhouse gas emissions to 2013 over 1990 levels was 16,134.82 kt CO or 42.4%. This is despite the first biennial report saying that by 2020 our net emissions would only be 12% above 1990 levels. Gross emissions were 11% higher.

   Looking ahead the picture does not get any better. By 2020 net emissions are projected to increase to 54% above 1990 levels, and gross emissions to 24% above 1990. However you measure it, the gap between our goal and where we are heading is increasing.

   Meanwhile, we are expecting to take on more ambitious reduction targets. This is not a path we can remain on. Existing forest plantations cannot provide the relief they did during the first commitment period and the mass importation of offshore units is equally unsustainable, especially post-Paris. The ETS must be allowed to do its job.

Until we have a price and a cost to emissions in the economy that sends a sufficient signal for change we will not make the reductions we need to get to where we say we want to get to.

As the document notes, decisions about long-lived assets will factor in expectations about the associated cost of emissions. Where this signal is removed or masked there will be a sub-optimal allocation of resources in the New Zealand economy. The last few years have not provided the appropriate signal. Instead of a gradual transition away from subsidisation, the history of assistance has been the reverse. Initially (2007) allocation subsidies for large emitters were intended to remain until 2025, then (2008) until 2030, then (2009) they were increased, and then (2012) they were made indefinite.

As the Parliamentary Commissioner for the Environment notes: "*The ETS is the right framework but I still have serious concerns about the subsidies to big emitters, which will not only impose significant costs on the taxpayer but also distort the carbon market and limit the incentives to reduce emissions*." She hoped that these distortions would be addressed in the 2011 review.

The 2011 Independent Review Panel established by the government concluded:

- Existing allocation thresholds of 90% allocation for highly intensive and 60% for moderately intensive activities should be maintained but the one for two subsidy should be phased out gradually so that by 2015 it was one-for-one.

3. The cost to non-emitters is high, inequitable and unsustainable.

The Ministry for the Environment previously estimated the cost to the taxpayer of maintaining the subsidy over the 4 years through to 2015 at $330 million based on a price of $6/tonne. On current projections the price of C is likely to average more than $10 over the next commitment period. Using the same estimates and based on an average price of $14.50, the cost to the taxpayer over 5 years through to 2020 would be in the order of $1 billion dollars. Moreover, this is not the total cost to the taxpayer who faces also the cost of providing the energy intensive and trade-exposed assistance, as well as the subsidisation of agriculture.

Without a signal to reduce emissions these costs can be expected to continue to rise because there is minimal incentive for behavioural change. Meanwhile, New Zealand has agreed internationally to increasingly stringent emissions reductions targets going forward.

4. There is other assistance protecting industrial emitters.

   There might be a case for transitioning the one-for-two subsidy if it was the only level of assistance being provided to emitters, but it isn't. On 24 September 2009 the government introduced the Climate Change Response (Moderated Emissions Trading) Amendment Bill to Parliament, proposing a number of changes to the New Zealand Emissions Trading Scheme (NZ ETS). Included in changes was free allocation to emissions-intensive and trade-exposed (EITE) industry based on intensity of emissions per NZ$1 million revenue.

   The list of eligible industries and free allocations is extensive (https://www.climatechange.govt.nz/emissions-trading-scheme/participating/industry/allocation/eligible-activities/) and it is not clear why this information has not been made clearer in the discussion document as it is very relevant to the topic of moving to full surrender. Two thresholds exist:

   i. Moderately intensive (60% assistance)- 800 tonnes of CO_2-e/NZ$1m compared with weighted average NZ emissions intensity from those conducting the activity

   ii. Highly intensive (90% assistance)- 1600 tonnes of CO_2-e/NZ$1m compared with weighted average NZ emissions intensity from those conducting the activity

   This free allocation was supposed to be phased out from 2013 at a rate of 1.3% per annum over 80 years but the transitioning has not commenced. The discussion document, in the only reference to this assistance, notes (page 4) that the ETS was moderated in 2011 to "*indefinitely delay reductions in the level of free allocation of NZU's to protect the competitiveness of businesses involved in emissions-intensive and trade expose activities*".

   The FOA has previously submitted that "*the free allocation based on intensity, and the one-for-two subsidy on only those units above the free allocation, are providing the same type of relief. It would be more transparent and administratively efficient to have just the one measure of free allocation".*

   Why only the one-for-two subsidy is considered a priority issue for review and not this other substantial assistance, is unclear given that this would seem to fall under the description of "moving to full surrender obligations".

We note also that the document states that "*if the one-for-two surrender obligation is removed, the amount of free allocation provided to emissions-intensive and trade-exposed activities will automatically be increased to correspond with the increased surrender obligation*".

This is effectively providing the subsidy through another channel and the FOA does not support this book balancing proposal. Removing the one-for-two subsidy will increase the net demand for units and this can be expected to have a positive upward pressure on the price that has probably already been built in. However, because the energy-intensive and trade exposed emitters will be provided with free units to compensate for this then they will not be the one with increased demand nor the related cost. The cost will, again, fall on the taxpayer. This is also another reason why there is no justification for transitioning the removal of the one-for-two extraordinary assistance.

We support the Prime Minister's international call for the removal of fossil fuel subsidies. As he states - "*It makes no sense to be calling for emissions reductions on one hand, while subsidising emissions on the other*." We note that this has been endorsed by a number of New Zealand business groups.

5. The government is carrying a significant future financial risk.

   Because the government bears the cost of New Zealand's international obligations, when businesses buy or surrender NZUs the value of these transactions are reflected in the government's budget.

   The current settings have contributed to "banking" or stockpiling of a large number of units as the discussion document records (page 10). While these stockpiled units can be surrendered under the ETS after 2020, they won't count towards New Zealand meeting its 2030 emission reduction target. Unless the stockpile is significantly reduced before 2020 the government faces the financial cost and this will not happen unless there is an appropriate price signal to encourage it.

If full surrender obligations are applied, when should this be implemented?

For all the above reasons the one-for-two subsidy should be removed as soon as possible. Even if the change was implemented in late 2016 - early 2017 the surrender obligations will not impact until some 12 to 18 months later so it will hardly be an overnight change.

It was well signalled that it was an extra-ordinary transitionary measure and the sooner it is removed the lower the number of carry over units will be taken forward for surrender and thus the lower the cost to the crown.

What impact will moving to full surrender have on you or your business?

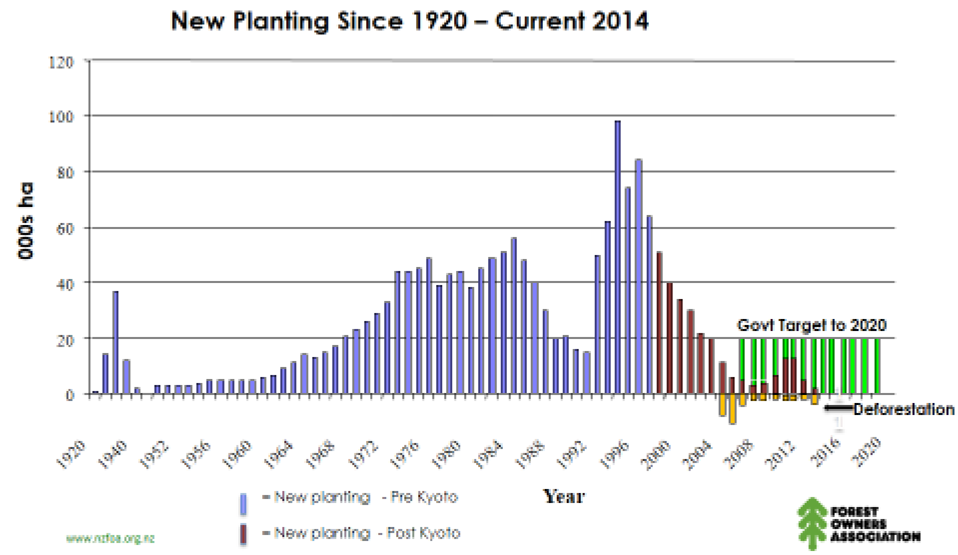
The full impact of the removal of the one-for-two subsidy is difficult to determine because of the uncertainty around other policy actions – such as the suggestion that the one-for-two subsidy will be offset by an increase in subsidy elsewhere, the number of banked units, the history of the forest sector's experience with the ETS and the varying levels of free allocation. Potentially it could increase forest planting and investor confidence, noting that there is a time lag involved while nurseries respond by planting more seed.

The discussion document acknowledges (page 10) that there could be a lack of confidence or clarity by people in the government's intentions. This is the case with forestry. The first sector to be introduced to the ETS, it is also one where there is now considerable wariness and lack of confidence in the ETS. The government's concern with ensuring the price does not rise too high has not been matched by a similar concern that the price does not fall too far. The price slump (which would fit the definition of a price shock) has had a serious impact on those who could potentially supply an ETS with units including the failure of a number of forest nurseries. This is important because, for the part of forestry that society is most interested in – new planting – participation in the ETS is optional. Some are now sufficiently disillusioned that no carbon price will entice them to enter the ETS. For most, economic rationale will likely prevail, but they can be expected to require more reassurance than previously especially given that they have to manage the liability that comes with the credit.

In general the move to reducing subsidies and allowing a price signal to influence investor behaviour will have a positive impact on new forest planting. It will have little to no influence on the pre-1990 established forest estate.

There is clear evidence of the influence of the price of carbon on new forestry investment as illustrated by the following graph.

New Planting Rates



Carbon prices reached their peak in 2011/12 and this is reflected above in a healthy increase in new planting. The plummet in new planting rates and the increase in deforestation that follow are evidence of the influence that the price has on whether marginal land is converted to forestry or whether forestry is converted to agriculture. This also explains why the treatment of agriculture is so relevant.

Market prices for wood products will also have an influence but this can be reflected in an increased level of interest in existing forest plantations rather than in new forest investment. Carbon uniquely provides a level of cash-flow in the early part of a forest investment cycle where the returns are typically 30 years hence. This is particularly important to those with limited capital and looking to invest in smaller blocks of trees. Analysis on the impact on forest investment returns has been undertaken previously by the School of Forestry in Canterbury. The following references provide further details on the impact of price and the one-for-two concession:

i. http://www.nzfoa.org.nz/resources/file-libraries-resources/environment/65-manley-b-maclaren-p-potential-impact-of-carbon-trading-on-forest-management-in-new-zealand/file
ii. Manley, B. 2016. *Afforestation responses to carbon price changes and market certainties.* NZ School of Forestry. University of Canterbury. January.

It should be noted that if there is no carbon price signal the biggest loser is not the forest industry but society. Without new planting there will still be a regular level of replanting associated with the existing estate, albeit with the possibility of some low level of deforestation. This will continue to supply the wood processing industry. What will be missing is the carbon sequestration that can help New Zealand with its future targets. What will also be missing are the environmental and economic benefits from stabilising erosion prone hill country farmland.

Consideration of the one-for-two subsidy should not be undertaken in isolation to a review of the overall levels of free allocation assistance. We acknowledge that such a review falls under “other issues” and we will submit on this in more detail. It is relevant, nonetheless, to point out in this submission that:

a. There should be a clear timetable for the gradual removal of free allocation units as proposed by the independent panel;

b. It should be noted that pre-1990 forestry emissions are treated no differently to any other emissions as far as the atmosphere is concerned. Each and every emission faces the full market cost and there is no free allocation protecting the sector. It is this important to indicate the path by which all emitters will be dealt with on an equal basis;

c. The 60% and 90% allocation categories should be reviewed and the free allocation provided to the wood sector increased to bring it in line with competing sectors.

Currently most wood products are only provided with 60% free allocation. The reason the trade-exposed and energy intensive wood products are not in the 90% allocation category along competing products, such as steel and concrete is because the wood products sector put considerable effort in to moving away from fossil fuel reliance and converting to biomass energy. Unfortunately, the lines drawn in the sand by the Kyoto rules mean that much of this effort has been dismissed. It is important that New Zealand policy sends the appropriate domestic signal to our economy. We are not bound to apply international agreements if they work counter to the signals that we want to send to domestic investors.

For energy efficiency and waste management reasons the wood products industry is now one of the highest bioenergy users and consequently has a relatively low carbon emissions footprint. The FOA considers that it is appropriate to take this in to consideration. The current 60% allocation does not do this. The higher level of protection (90%) provided to competitors who are more intensive polluters, is making the wood products sector relatively less competitive at a time when it should be benefitting.

If the NZ ETS moves to full surrender obligations, should potential price shocks be managed?

The FOA considers it appropriate to manage any price shock to the economy but the definition of shock needs clarification.

FOA does not support wild fluctuations in the price of carbon as this is unhelpful for all investors, and for both genuine buyers and sellers of carbon units (as opposed to speculators). What this means is that the magnitude of price fluctuation, and the time period over which the change takes place, need defining before we can understand what is meant by price shock.

The price of carbon can be expected to fluctuate but also to track upwards over the next few years. This is normal in a global economy that is increasingly recognising the importance of reducing emissions. In the three months to the start of 2016, for example, the price of carbon rose by 39%, but we do not consider that this constitutes a price shock but rather an anticipated market adjustment to supply and demand that has been going on since mid-2013. The price also recorded a similar magnitude fall in the 2nd quarter of 2015.

It should also be remembered the ETS is an uncapped intensity-based model based on tonnes of emissions per unit of output. Thus, if emissions per unit of output are decreased, then even if overall emissions rise, the price of those emissions not already covered by the free allocation, can be avoided.

The government has tools – the price cap and the signalled auctioning system – that provide it with the ability to manage any movement that is considered too severe or prolonged.

Those conditions do not exist at present. Under what was intended to be temporary relief the maximum price paid while the one-for-two subsidy is in place is $12.50 per unit, but even then it is only on those units that exceed the free allocation that is also provided. The current price of an NZU is well below $12.50 and thus there would be no price shock to anyone. The government has the option of lowering the price cap but we see no justification for this at the present point in time. Indeed the Independent Review Panel recommended that the price cap be increased by $5 per annum from 2013. We are also aware that a number of the energy suppliers have used the $25 cap as a benchmark to set the price that they have passed on to consumers.

The $25 fixed price cap has the potential to constrain the price of carbon and move it away from a realistic level. The FOA considers it would be appropriate to schedule a review of the price cap with a view to lifting or removing it.

We note that auctioning will be considered under "Other Issues" and we will submit further on this then. The impact of government "printing" NZUs and introducing this new volume to the market through auctioning cannot be understated. If it does not have high integrity and well-signalled intervention points, then the damage to the ETS could be terminal.

As we have noted previously, if consideration is being given to managing price shock on the upside, the same impact should be catered for on the downside.

Summary

The one-for-two price subsidy was introduced when it was expected that New Zealand businesses needed additional protection above and beyond the free allocation they were already receiving. History has shown that this additional layer of taxpayer protection was probably not warranted. There is no justification for maintaining the subsidy or for transitioning it, or for providing it through other avenues. The price impact of its removal on emitters will be negligible given other existing and proposed free allocations. Government also has measures to manage price shocks in the unlikely event that these will occur. The one-for-two subsidy should be removed as soon as possible.

FOA requests the opportunity to be heard in support of our submission.

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