FOREST OWNERS ASSOCIATION

Submission

- to the –

Finance & Expenditure Select Committee

- on -

The Climate Change Response (Moderated Emissions Trading) Amendment Bill

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1. Executive Summary

1.1. In the near term the net effect of the Bill for forestry is not significantly different from what prevailed in the previous legislation.

1.2. Beyond the short-term, however, the Bill hints at changes that would significantly worsen the situation for forestry and ultimately cost the country in terms of opportunities lost. Even suggesting such changes creates further uncertainty for forestry despite the intent of the Bill to reduce uncertainty. This additional uncertainty will immediately have a negative impact on forest investment.

1.3. It is also disappointing that some earlier recommendations by FOA to make changes to enhance the participation of forestry in the ETS by lowering risk at minimal cost to the Crown have not been implemented.

The key concerns for the forest sector are:

- The suggestion that export of forest credits may be banned;
- Government not specifying its position on CP2 deforestation units;
- Inclusion of wood biofuel emissions in the ETS;
- The intention to align with Australia despite uncertainty over the CPRS and the reservations expressed by Treasury in its Regulatory Impact Statement of doing so;
- The continued arbitrary use of 2002 as a basis for differing levels of compensation for owners of pre-1990 forests;
- Government not making a decision about what carbon credits it may import or even whether it will do so;
- The possibility of extending the transition period and/or the price cap for emitters.

2. Introduction

2.1 The NZ Forest Owners Association (FOA) welcomes the opportunity to comment on the Climate Change Response (Moderated Emissions Trading) Amendment Bill.

2.2 The FOA is an NGO that represents the majority of plantation forest owners in New Zealand. Its members' forests comprise around 80 per cent of the country's 1.8 million hectares of plantation forests. The FOA has also caucused widely with other forestry groups and the views represented here are widely supported.

2.3 The forest sector has been included by law in the ETS since 1 January 2008 but has effectively been stalled in terms of investor decision making because of the continued lack of certainty around the rules. The decision by government to move ahead with an Emissions Trading Scheme is considered to be consistent with international obligations and consistent with the intended or announced approaches of other key Annex One countries. Its introduction has long been awaited by the sector as a means of providing certainty to the forest sector and to allow new planting to resume.

2.4 Amongst the stated objectives of the Bill it is intended to:

- reduce competitiveness impacts of the NZ ETS and provide greater certainty for economic growth;
- improve the administrative effectiveness of the NZ ETS.

2.5 The Bill proposes some minor amendments for forestry that will achieve the latter but also introduces some significant levels of uncertainty for forestry that work against the former.

2.6 The sector is pleased to see that logic has prevailed for the immediate future but is very concerned with the message that this logic may be dispensed with in the next few years.

2.7 Increased uncertainty beyond the relatively short transition period has been created by the failure to confirm that pre-1990 forest units due for allocation after 2012 will be delivered, and to suggest that the market for post-1989 forest credits may be severely constrained.

2.8 This lack of commitment to a framework upon which forest investors can plan is very unhelpful. The Bill accurately records the impact of such a lack of commitment by government on new planting and states that:

> "*Reduction of expected returns to forestry or high levels of uncertainty among investors could reduce investment in new planning and participation of existing post-1989 foresters in the ETS – both outcomes come at a high economic cost. It is difficult to quantify this impact. However, it should be noted that even relatively small changes to the new planting rate can create a significant economic impact. If the new planting rate under the modified scheme is 10,000 ha per year lower than the new planting rate under a scheme that allows exports, an economic benefit to New Zealand (potentially in the order of $125-$200 million) would be delayed*".

2.9 Much is made in the Bill of the need to align with Australia. Until it becomes clear what Australia will be progressing with this seems to be a premature decision. It is important that New Zealand develops ETS legislation that suits its own unique circumstances. While we must pay heed to trade competition matters, it must also be recognised that the two economies are fundamentally different, particularly in terms of their emissions profiles.

2.10 At this stage the New Zealand system is further advanced than that of Australia and it is suggested that the government should be seeking assurance from Australia that it will align with what has been developed here rather than being prepared to introduce changes that undermine the efficiency of emissions trading to the New Zealand system.

2.11 The FOA submitted a number of suggestions to the previous Select Committee process that we consider will improve the uptake of forestry in the ETS without materially

affecting the position of the Crown. This included the option of providing averaging carbon credits and including force majeure provisions. Both of these provisions have the potential to significantly improve the interest in the ETS by farmers and others who own or wish to develop small woodlots or forests.

2.12 It is acknowledged that a number of administrative changes and clarifications of definitions are being progressed with the intent of simplifying and streamlining the process for pre-1990 allocation as well as avoiding potential litigation. These improvements are supported.

3. Key issues

- Government has not made a decision about what quality of carbon credits it may purchase offshore or even whether it will purchase credits.

- The clear intent to align with the Australian CPRS despite the uncertainty over the status of the CPRS and the strong reservations expressed by Treasury in its Regulatory Impact Statement including that "there is no clear analytical basis for the proposal to align some key design elements of the New Zealand ETS with those in the currently proposed Australian Carbon Pollution Reduction Scheme (CPRS)"

- The Treasury conclusion that "*the level and quality of analysis presented is not commensurate with the significance of the proposals*".

Export of units

3.1 The Bill states that the forestry sector will be permitted to bank and export units during the transition phase. It also points out that "restrictions on banking and exports would reduce the economic incentives for this sector adding costs to the economy as a whole".

3.2 This illustrates government recognition that if the export of forest credits were prohibited and the price of carbon capped, it would send a very negative signal to potential investors and result in minimal emissions trading. In effect this would be

asking forestry to cross-subsidise emitters. Given this understanding it is illogical, and very frustrating, to then also see the Bill suggest that these principles could be abandoned to align with Australia as follows:

"*It may be necessary to ban exports from the forestry sector in the future in the event that the NZ ETS and the CPRS are linked. In this case, foresters would be able to sell units to the Australasian market*."

3.3 The FOA is strongly opposed to any domestic measures to artificially constrain the price that the world market is prepared to pay for NZ forest carbon credits. Not only is this economically inefficient it is a cross-subsidisation of carbon polluting industries at the expense of the forest sector.

3.4 If government chooses to provide such protection in the interest of the nation then it is free to do so at the nation's expense but not as the cost of the forest sector, particularly when it is not, at the same time, proposing to similarly constrain the obligations that forest owners will face at harvest.

3.5 It should also be noted that such distortions are not consistent with the international position being advocated by New Zealand that seeks support for an international carbon market. If there is to be a link with Australia then it should be founded on principles that are consistent with the objectives of the Kyoto Protocol and not whatever suits the Australian political system. The strong rationale for permitting exports of forestry units remains regardless of whether NZ aligns with the Australian CPRS. In this case it would be more appropriate for Australia to align with NZ.

Relief sought:

Confirm that owners of NZ forestry units will not be prevented from accessing the international market, and will not be subject to an artificial price cap without appropriate compensatory measures.

Pre-1990 CP2 Forestry Allocation

3.6 It is proposed in the Bill that in order to retain "flexibility" over the second tranche of pre-1990 forestry compensation units the Act should be amended to allow for this.

3.7 It is proposed that the Act deliberately separates the compensation provided to pre-1990 forest owners into two components and to make the second payment subject to the outcome of the international negotiations on off-setting. The Bill raises the possibility that the second part of the compensation package may be cancelled or reduced.

3.8 The FOA is opposed to this imposition on the allocation of compensation.

- All pre-1990 forest owners have had their land devalued regardless of its potential for alternate use. The price paid for land with a permanent encumbrance on it will obviously be less than without that encumbrance.

3.9 In a number of areas forestry is the highest and best use for land and an alternative is not currently considered practical. However, it cannot be stated with any confidence that this will always be the case. Land previously thought unsuitable for dairying, wine-growing etc has proven to be a much more productive alternative in these land uses. Similarly, lifestyle or residential conversion is always a possibility depending on other development patterns.

3.10 The Bill recognises, rightly, that the deforestation units provided to pre-1990 forestry owners is "*compensation for the loss in the value of their assets*".

3.11 Offsetting by comparison is not compensation. If achieved it will effectively allow a forest landowner to relocate their liabilities but it in no way discharges them. It is also very important to realise that relocation entails re-establishment expenses. It is not a costless exercise.

3.12 The so called "*free*" allocation supposedly represents "*compensation for the long-term reduction in land values faced by the sector*" according to the Bill. It should be remembered that the pre-1990 forest owners are expected to receive a one-off total of either 60 or 39 units/ha of these "*free*" units. This contrasts with the average

permanent liability that has been imposed on them of 800 units/ha if they ever change land-use. The Bill now proposes that even this level may be reduced to 23 or 15 if those due in the second commitment period are not honoured.

3.13 It is also worth remembering that the level of compensation available has already been reduced. An allocation of 39 units, or in a smaller number of cases 60 units, has been made in recognition that land values have been affected. This represents what is left after exemptions have been removed. Of the 55 million units available to 2020, 9.4 million units are expected to be used to cover the "*applied for*" exemptions (those between 2 and 50 hectares) and a further 1.3 million will be used for the automatic exemptions for those under 2 ha. Thus only a total of 44.3 million are actually available for all other forest growers. The exclusion of owners of small forest areas is at the expense of those who own larger forests.

3.14 The FOA supports the NZ negotiating position of seeking to have offsetting permitted under the CP2 Kyoto rules. It is widely accepted that the inability under the international rules to relocate a forest without penalty is nonsensical from both an atmospheric and an economic efficiency perspective.

3.15 The FOA has committed considerable time and resources to pressing the case for the rules for the second commitment to be changed to allow forest offsetting. We have worked with industry counterparts overseas and achieved significant recognition and support, including endorsement by the International Council of Forest and Paper Associations for such change. Our position is also aligned with New Zealand government negotiators with whom there has been close co-ordination of effort. We remain optimistic that, as long as the offsetting can be confined to plantation forestry and not adversely impact on biodiversity, the position is achievable.

3.16 The FOA supports offsetting being provided in a way that ensures it is carbon neutral and does not have an adverse impact on biodiversity. It does not support offsetting at the cost of the removal of compensation.

3.17 If forest-offsetting was approved then those most affected would have a means of avoiding most of the cost involved in a carbon neutral relocation exercise. While there

is still a significant cost in developing the land and recreating the associated infrastructure, this is more manageable and would be mitigated by the existing compensation units. Even with offsetting and the compensation units, however, there is still expected to be a net cost and the permanent restriction over land has not been removed.

3.18 It should be remembered that the reason the cost of land use change away from forestry is so high (800 tonnes/ha times the price of carbon) is not because of the requirements of the Kyoto Protocol but because the previous government introduced an additional rule into the ETS to prevent landowners replanting and then deforesting young trees to reduce their financial liability.

3.19 The ETS requires an owner to either:

- pay the full liability for the mature trees that were recently harvested; or
- allow the newly planted trees to grow for nine years before deforesting.

This is not a Kyoto Protocol requirement. In contrast the Kyoto Protocol requires the landowner to be liable for release of carbon where, and when, the decision to change land use is taken. If the government chooses to retain these additional non-Kyoto restrictions then the government, rather than private individuals, should bear the extra unnecessary cost.

3.20 Failure by government to confirm that CP2 compensation units will be honoured regardless of the international outcome is unsatisfactory. It will have an undesirable negative impact on confidence in the sector and is not justified.

Relief sought:

Amend the Bill to confirm that the CP2 allocation of deforestation compensation units will proceed regardless of the international negotiations on offsetting.

Deadline for applications for pre-1990 forestry deforestation units

3.21 The Climate Change Response (Emissions Trading Forestry Sector) Amendment Bill amends the Climate Change Response Act 2002 to delay a number of requirements, including reporting requirements for foresters. The date by when applications for deforestation units related to pre-1990 forestry must have been submitted is unspecified, although clearly this would need to be sufficiently before the end of the first commitment period to allow for the units to be processed and accounted for. Allowing sufficient time for pre-1900 forest owners to adequately assess and apply for such units is supported and any deadline should be at least 2011.

Continued use of 2002 as a basis for varying the level of compensation to pre-1990 forest owners

3.22 The rationale for using the year 2002 as yet another line in the sand within the forest growing industry does not stand up to any reasonable scrutiny.

3.23 Various comments and suggestions on policy were made at, or around that time, as increasing consideration was given to how domestic policy would be formed. Policy had not been confirmed, and development was still in the early stages. Changes were common and to be expected. It should be remembered that this was when government signalled its intention to proceed with a carbon tax, which the FOA gave its in-principle support to, but which was subsequently rejected. It could equally be argued that investors made their decisions based on a carbon tax being in place but this would also be a long bow to draw.

3.24 In addition, the government's policy announcement of a deforestation tax at that time was not accompanied by any detail on how such a tax was to be administered, how and when it would be measured, and how the government's contribution of deforestation units would be allocated across individual landowners. Indeed, the lack of detail around the deforestation tax suggestion was a major reason that forest growers felt unable to sign up to the FIFA Accord.

3.25 While a deforestation tax was certainly mooted it would be a gross misrepresentation to interpret this as clear government policy and to then draw the conclusion that all investors should immediately have operated on the basis that it would be implemented. Government also signalled at the same time, without giving specifics, that it would make available units to defray the impact of any liability and said that the impact would not be onerous. Indeed, the then Climate Change Minister Pete Hodgson indicated that government would have significant ability to absorb liability based on the anticipated level of credit that the country would be in. The subsequent trend in emissions in New Zealand may have increased the reliance of government on a deforestation tax, but the private sector cannot have been expected to predict these trends. Government certainly did not.

3.26 Even by 2006 the government was adamant that talk of a deforestation tax being up to $13,000/ha was gross exaggeration and would be nowhere near that level. On this basis, and considering that government had twice previously lifted the level of the cap when it appeared that it might be breached, forest growers had every reason to expect that a deforestation tax, if imposed at all, would be introduced at a modest level.

3.27 Other factors such as the fact that the steady state level of carbon in the average forest at harvest is below the 800 units, that there is not instant oxidisation at harvest, and that there is a considerable lag period while the roots rot during which time new stems are absorbing carbon, are also factors that forest growers could reasonably have expected would have been taken into account. They haven't been. One could also argue that if 2002 is the deadline then it is consistent to argue that these forest owners should only be liable for the carbon that has accumulated since 2002.

3.28 What growers could reasonably have expected was that if land use restrictions were introduced they would take effect from when any legislation was drafted and the rules were clear. There are parallels with the situation where land is required for public work. In such cases compensation is due from when the land has been designated for another use, not from when it was first indicated it might happen. Growers would also have expected that any measures that were implemented would be on an equitable basis at a relatively low level of impact. There was never any suggestion, in contrast to

the clear signals that government has provided to agriculture, that there would be differing levels of treatment between pre-1990 forest owners.

3.29 Rather than second guessing what land owners could have been expected to know, if a cutoff is to be used, a more appropriate date would be 2006/2007 when the policy affecting forestry within an ETS was put into the public arena for consultation. While the principle of this could be justified, the administrative costs associated with the very limited area involved would undoubtedly mean it is not justified on economic grounds.

Relief sought:

Remove reference to 2002 as a basis for providing different levels of compensation to owners of forests established pre-1990.

Government importation of credits

3.30 Not only has no decision been made on the quality of units that it would be acceptable for the government to purchase and import in to New Zealand, but no decision has even been made on whether government will undertake this activity.

3.31 The government is in a position to enter the market and potentially purchase units at a price that is cheaper than what either the New Zealand forest units may sell at, or is cheaper than the price that NZ emitters would be able to achieve if they sought to purchase credits on their own without the efficiencies of scale of government.

3.32 The FOA is not opposed to the import of credits by government even though this supply could potentially suppress the price that NZ forest growers could achieve for their units so long as growers retain the ability to sell in to the international market.

Intensity-based allocation approach for industry

3.33 The adoption of an intensity-based approach to allocation has pros and cons as noted in the Bill. It will provide protection for the subset of New Zealand firms that otherwise may be at risk of suffering a loss of competitiveness and it will align New Zealand with the approach being taken by Australia.

3.34 The change from a fixed allocation of emissions based on 2005 levels to a production based approach based on industry average per unit of production and not related to 2005 levels also entails some unquantified risks.

3.35 It fails to guarantee that New Zealand will achieve its required emissions reduction level because it allows an increase in the total level of emissions so long as the increase is more carbon efficient and the government may have to purchase a greater amount of emissions units from overseas in order to meet our commitments.

3.36 It also comes at a higher cost to the nation. As the Bill notes:

"*Protecting the competitiveness of more firms by providing a higher rate of assistance for a longer period will benefit eligible firms, but will come at a cost to the economy as a whole, by delaying the transition of the New Zealand economy to a carbon constrained world."*

3.37 Forest growers are also concerned at the implications for the sale of NZ forest credits in to the US market given the stated US aversion to intensity-based emissions trading schemes.

3.38 Another key concern is that the Bill discriminates against firms that have made progress in reducing emissions from 1990. This is the case with many firms within the forest processing sector. Just as New Zealand is judged on its performance, whatever the circumstances, against its 1990 levels, so too should firms that have reduced emissions since that time, rather than 2005.

Inclusion of Wood Biofuel Emissions

3.39 It is proposed that the Act be amended to clarify that emissions from biofuels combusted for electricity generation or industrial heat are covered by the Act.

3.40 Given that the emissions from wood biofuel are already accounted for under the instant oxidisation approach of the Kyoto protocol we cannot see the logic for including such emissions in the Act. Indeed the inclusion of emissions from wood

biofuels would seem to be perversely working against the very behavioural changes that the ETS is intended to encourage.

Relief sought:

Remove wood biofuels from the Act.

Inclusion of an Averaging Option for Post-1989 Forestry

3.41 At present post-1989 forest owners entering the ETS receive all the associated carbon credit less compliance costs and also face full liability for emissions at harvest.

3.42 Although the liability at harvest can be managed by retaining credits to cover this, it is likely that a significant number of the post-1989 credits available will not be taken up by forest owners. Typically these are owners of small forests or limited age class stands of forest who perceive there to be long-term risks associated with the price of carbon if they face a liability at harvest.

3.43 A relatively simple means of addressing this is to provide an additional option under the ETS regulations to allow credits to be earned only up to the long-term average carbon that the forest would sequester over its life. Credit for the carbon absorbed above this level would be held by the government. In return the forest owners who elected this method would not face any liability at harvest provided that they replanted.

3.44 Removal of the threat of an unknown cost at harvest is likely to encourage many owners of small forest blocks, including farm-foresters and farmers, to participate in the ETS and carry out new planting. The government is required to maintain a separate register in addition to those who are participating on a full credit, full liability, basis but it has the benefit of the credits prior to the harvest date. In addition, measurement reporting and compliance costs are likely to be less than the current option because it is a simpler system.

3.45 The FOA does not support all the credits being provided up-front at planting under an averaging option. This entails risk of permanence for the Crown and has the potential

to adversely impact on both land values and the carbon market. The credits should, instead, be provided sequentially.

3.46 The current option should be retained alongside the averaging option for those who are in a better position to manage the flow of credits over time. Thus, investors in new forest plantings post-1989 would have three options – no participation in the ETS, participation on an averaging basis, or full carbon sequestration and liability.

Force Majeure

3.47 Government does not typically expect private individuals to cater for catastrophic events that can be considered beyond reasonable risk management provisions, or Acts of God. The compensation provisions associated with a foot and mouth outbreak in New Zealand are an example. Requiring forest owners to assume liability for similar types of forestry events that could unpredictably decimate very large tracts of forests (as has happened with the mountain pine beetle in Western Canada) is not reasonable. Unless this is addressed it will deter many from participating in the ETS. Conversely coverage should not be provided where commercial arrangements can be made such as for fire.

3.48 It should be noted that Australia, along with Canada, is arguing in the international negotiations for unmanageable events to be able to be "factored out" of accountability, and Australia has proposed to deal with these at a government level under its Carbon Pollution Reduction Scheme. This recognises that private insurance provision will either be unavailable, or prohibitively expensive.

Relief sought:

Government should amend the ETS regulations to clarify that forest owners will not, individually, be expected to manage coverage of force majeure types of events, and should consider the Australian approach.

Timing of entry of sectors

3.49 It is acknowledged that given the time that has passed there is now little choice but to defer the entry of the stationary energy and industrial processes sectors by six months. The FOA supports the proposal to bring forward the Liquid Fossil Fuels by six months to July 2010. We do not support the extension of a further two years to 2015 of the entry of the agricultural sector.

3.50 Inclusion of other sectors is required to maintain equity. New Zealand faces the cost of emissions regardless of whether emitters reduce emissions or not. Any delay in reductions by emitters must be met by some other sector of society – typically the taxpayer.

3.51 An illustration of the cost of delaying sector entry is provided in the Bill. It is estimated, for example, that the cost of a further delay to 2013 for the Stationary Energy and Industrial Processes (SEIP) and Liquid Fossil Fuels (LFF) sectors is approximately $1.275 billion relative to the status quo. Any further delays should be avoided. As the Bill notes, economic modelling indicates that our economy will continue to grow even under a $100 carbon price and no action by the rest of the world.

Transition period and the price cap

3.52 The FOA is opposed to the current transition phase (from 1 July 2010 to 31 December 2012) and the associated price cap being extended. The cost of the transition phase is borne by the taxpayer and is significant. Economic analysts have already reported on the greater cost that will be borne by the economy if the transition phase is prolonged and the transition to lower carbon emitting processes prolonged.

3.53 As the Bill records, both the transition phase and the intensity-based allocation shift costs from emitters to the taxpayer and risk to the Crown particularly under an intensity-based allocation.

3.54 The transition period and fixed cap also postpone the efficient operation of a domestic market for forest credits.

3.55 We remain concerned that as part of the Regulatory Impact Statement the Treasury concludes that "*it is hard to assess whether the changes will, in fact, deliver a smoother transition path for the economy*" and summarising that "*the level and quality of analysis presented is not commensurate with the significance of the proposals*".

3.56 In the event of further delays then the government should give serious consideration, as suggested in the Bill, to setting up guaranteed purchasing arrangements for units generated from forestry.

3.57 The FOA concurs with, and supports, the requirement for mandatory reporting by the SEIP, LFF and agricultural sectors ahead of their actual entry on the basis that it will assist with management of emissions and preparation for entry.

Amendment to the definition of forest land

3.58 The FOA supports the rewording of the definition of forest land to make it consistent with the definition under Kyoto and to avoid the operational issues caused by the current definition being triggered too easily by a relatively small number of juvenile trees.

Compliance with a Pest Management Plan

3.59 Subclause (1) of Clause 46 specifies that an application must be accompanied by a declaration that the post-1989 land complies with a pest management strategy under the Biosecurity Act 1993.

3.60 It is noted that this proposal does not actually introduce anything that is not already required to be complied with and is merely reinforcing an existing compliance to highlight the obligations to control wilding trees. As such this would seem to be a redundant requirement. It is not a change of any importance to the FOA.

Carbon Accounting Areas

3.61 A Carbon Accounting Area (CAA) is the area of forest land for which a post-1989 participant is required to report the change in forest carbon stocks over time. Currently a participant can only define a CAA when they first register the forest land into the ETS. Early implementation experience is that some aspects of the provisions relating to CAAs are overly cumbersome, likely to lead to unnecessarily high transaction costs, and could create unintended liabilities for participants.

3.62 The change to CCA requirements to ensure that an existing participant is able to redefine the way in which their forest land is assigned to CAA's without incurring any additional obligation to surrender emissions units or having to pay any fee for reapplication is supported by the FOA.

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