



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

November 2015 Discussion Document - Other issues

New Zealand Forest Owners Association Inc

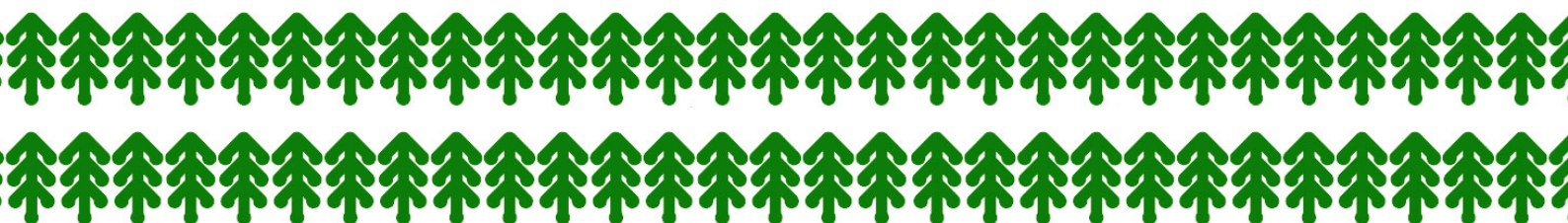
Level 9, 93 The Terrace

Wellington 6143

Tel 04 473 4769 Fax 04 499 8893

www.nzfoa.org.nz

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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, 80% of which is in plantation trees. The total New Zealand plantation forest area is 1.7 million hectares.

In the discussion documents released in November 2015 government sought feedback on the review of the Emissions Trading Scheme (ETS) in two phases. The FOA has already submitted on the first phase - priority issues. The second phase relates to other issues and includes free allocation, international units, use of auctioning and technical matters including those related to forestry. The comments in this submission are provided in response to these issues and key questions raised in the second part of the November discussion document

The FOA is also submitting on the Forestry Technical Note and the Operational Matters Technical Note which were both released in March 2016. As a number of the issues are inter-related these submissions should be read collectively.

Other issues

1. Drivers for the review

The FOA supports the reasons given for the review but not the statements made about the ETS.

With respect to "other factors" pertinent to the review we refute the assertion that "the NZ ETS has met the objective of assisting New Zealand to meet its international obligations". Forestry sequestration is the reason that New Zealand has met its obligations despite our emissions rising largely unchecked. Kyoto forests sequestered 85 Mt during the first commitment period. This was a legacy of historical plantings and had nothing to do with the ETS. To imply that the ETS is responsible "*and has put us on track to meet our current emission reduction target*" is disingenuous. Making such statements in a public discussion document undermines the Ministry's credibility as the key agency responsible for managing this issue and calls in to question its objectivity especially when another independent body – the Parliamentary Commissioner for the Environment - concludes exactly the opposite.

Indeed, the inability of the ETS to drive adequate change in the NZ economy is the prime reason for conducting this review. If the ETS was doing the job as claimed there would be little need to review the settings.

2. What other factors should the government be considering in this NZ ETS review?

The most obvious answer here is – Agriculture.

It is very concerning that the government has determined that there will be no discussion on whether agriculture faces any emissions costs as part of this review. This should be one of the factors being considered because of the wide ramifications for the ETS. Omitting such a huge contributor from the “all sectors all gases” ETS is neither credible nor sustainable. All our efforts are now going to be targeted at half our emissions. In other words the rest of the economy, businesses, and the taxpayer, will have to do twice as much to reduce emissions in order that agriculture is allowed to do nothing.

Treasury advised as far back as 2005 that forestry and agriculture should be brought in to the ETS. During the last review the Parliamentary Commissioner for the Environment concluded that there is insufficient evidence to justify leaving agriculture out of the NZ ETS until 2015.

We do not accept the argument that nothing can be done by farmers to reduce agricultural emissions and, even if it were true, why should agriculture not bear some of the cost of the emissions it creates. The taxpayer is unable to do anything about reducing agricultural emissions and yet they are expected to pay for all of them.

During the last review the Independent Panel provided an information paper that discussed some of the actions being undertaken by other countries. Forest offsetting is one obvious option that is available to many livestock farmers without adversely affecting productivity and, in fact, it may well increase production. Some farmers have been quick to take advantage of the benefits of the ETS for marginal hill country - a lot more could be planted. Nitrogen inhibitors, manure and effluent management, stock management, biofuel use and nutrient monitoring also offer potential, but are being insufficiently applied at present. New Zealand scientists have proven in field trials that emissions of nitrous oxide (15% of New Zealand's total GHG emissions) from animal urine can be cut drastically (up to 70%) by adding biochar to many soils .

It is acknowledged that there is a limit to what can be achieved with current technology and New Zealand's leadership on research to improve this is rightly highlighted by government as a contribution that New Zealand is making. The FOA is not arguing for agriculture to face the full costs of the pollution it creates. This would be in no-one's best interest and has never been part of the way the ETS was supposed to develop. But it is very important for agriculture, forestry and the rest of the economy that the sector does face a price signal, with a clear direction of travel indicated that land use investors can take note of. Excluding agriculture will send the wrong signal and is material to forestry as it influences what an investor will take in to account when determining what to do with rural land.

What was proposed by the independent review panel in 2011 was

- Agriculture should be brought into the scheme with surrender obligations to take effect (essentially on an intensity basis) from 2015 as planned;

- The free allocation of NZUs for agriculture should be 90% of a baseline initially phased out at 1.3% per annum on a straight line basis but that a 1 for 2 subsidy apply for the first two years i.e. 2015 and 2011, and then this be phased out over the following three years.

Is it unreasonable to ask them to face this cost when, in many cases there are options to reduce emissions and when the alternative is to insist that the taxpayer, who has no control over the emissions, has to face 100% instead of 95%?

4.1 Business responses to the NZ ETS

The forest growing sector was the first section of the economy to be brought in to the Emissions Trading Scheme. For pre-1990 forest owners and ETS-participating post-1989 forest owners, there are significant consequences that flow from the future cost of emissions and thus, inevitably it influences business planning and investment. Even for those not currently participating in the ETS though, it is something that typically must be monitored and will affect business planning. The single biggest reason why more post-1989 forest owners are not registered in the ETS is because of the uncertainty related to the future price of carbon.

There are a number of factors that would improve the ability to take future emissions into account. Greater certainty about the involvement, or non-involvement, by government in the carbon market is a key factor. The recent history of the ETS is one of conflicting signals and high levels of uncertainty. Key questions going forward for forest growers will be related to how and when auctioning will be undertaken and how international units will be managed (both covered in this paper) and what liabilities forest growers will face at harvest. With respect to the latter, there are options currently under consideration in the Forestry Technical Note (notably Averaging and the deferral of liability associated with Harvested Wood Products) that could significantly reduce uncertainty around future emissions costs for forest growers. These have been elaborated on in the FOA submission on the Forestry Technical Note.

4.2 Protecting competitiveness through free allocation

The FOA provided feedback on moving to full surrender obligations in its submission on Priority Issues and this includes comment on the issue of free allocation.

Free allocation to emissions-intensive, trade-exposed (EITE) industry are provided on an intensity basis and the list of eligible industries and free allocations is extensive (<https://www.climatechange.govt.nz/emissions-trading-scheme/participating/industry/allocation/eligible-activities/>).

When the ETS was introduced, the number of units allocated to EITE industry was intended to be reduced by 50 per cent during the transition phase.

<https://www.mfe.govt.nz/sites/default/files/Emissions-trading-bulletin-11.pdf>

At the end of the transition phase firms were expected to face the international carbon price. The timeline for phasing out free allocation has been extended twice.

The November 2015 Discussion Document notes that the ETS was moderated in 2011 to “indefinitely delay reductions in the level of free allocation of NZUs to protect the competitiveness of businesses involved in emissions-intensive and trade exposed activities”. The Technical Note now states that the government favours keeping the free allocation in place until at least 2020.

The continued subsidy places higher costs on taxpayers and creates a cost differential between emitters from forestry and those in other sectors. A full surrender obligation has always applied to the forestry sector and no protection exists for managing the emissions liability faced by growers at harvest some 30 years after planting.

Referring to a transition arrangement without having any guidance on when, and how, that will take place creates considerable investment uncertainty for all ETS participants. During the post global financial crisis era it is understandable that a cautionary approach would be taken with a transition to market pricing. Deferring the transition to 2020 cannot be justified on the same grounds.

As part of the review that government should be providing a signal now on what will take place with free allocation both pre, and post 2020.

The FOA remains supportive of any change being introduced gradually and in a well signalled pathway. The free allocation was initially intended to be phased out at a rate of 1.3 per cent per annum beginning in 2013, and reviewed on a five yearly basis. We consider that this 77 year time frame, or similar, provided security as well as certainty and could be introduced before 2020.

Leading in to 2020 the international response to the tabled Nationally Determined Commitments (NDCs) will also be much clearer and can be taken in to account as part of any review.

The forest growing and processing sector operates on long term investment horizons. Providing a clear pathway would help both parts of the sector to plan accordingly.

It is also noted, in this section, that “ allocation rates are tied to the one-for-two surrender obligation, so the number of units recipients receive would increase proportionately if this was removed or phased out”. This is effectively providing the one-for-two subsidy through another channel and the FOA does not support this proposal or the logic used to justify it. 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 ones with increased demand nor the related cost. The cost will, again, fall on the taxpayer.

In essence, 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."

4.3 Managing Unit Supply

Forestry

The Discussion Document summarises the role of forestry accurately. It notes that “carbon removals from forestry are one of New Zealand’s largest and most cost-effective domestic abatement options” and that “the NZ ETS is intended to encourage carbon removal through forestry...” With the right incentives, the FOA is confident that the government’s desire to “increase the rate of forest planting” can be achieved.

The Paris Agreement also reinforced the important role of forestry and its articles include some specific references which are relevant. Notably that parties should:

- take action to conserve and enhance sinks;
- encourage, including through result based payments, policy approaches for sustainable management of forests while recognising the importance of the non-carbon benefits.

The price of carbon has a potentially important influence on forest investment decision-making. There is evidence for this from when the price was around \$20/t two years ago and also when it was at \$2/t.

Not all forest owners will be interested in participating in the carbon market, but with a reasonable price, policy stability and a means to manage harvest liabilities, carbon will be an important consideration for most.

This illustrates that, in addition to the NZU price, there are other important ETS considerations.

We note, and support, the announcements by Associate Minister for Primary Industries Jo Goodhew released late last year that outlined an intended review of:

- accounting methodologies for post-1989 foresters, including averaging, harvested wood products, and emissions from adverse events;
- the exemption provisions for tree weeds for pre-1990 forests;
- the transfer of participation for post-1989 forestry; and
- the penalty and prosecution regime.

More important drivers for forestry investment would be the introduction of averaging and/or devolution for deferred liability at harvest for wood products. These additions could have a significant impact on the attractiveness of carbon forestry by reducing the amount of carbon liability to be repaid upon harvest and reducing perceived risk. They are submitted on in more detail in the FOA submission on the Forestry Technical Note.

International units

There are significant supply side impacts on the ETS from international units and therefore for forest owners supplying the ETS. Controls must remain in place to limit their entry into NZ if the ETS is to remain functional.

The Environmental Protection Authority (EPA) release of the latest ETS Facts and Figures highlighted that last year New Zealand had a 97% dependency on Kyoto (international) emissions units – way more than any other country. The vast majority of these were ERUs - mainly from the Ukraine and Russia – and such “hot air” units have been widely discredited including:

- a study by the Stockholm Environment Institute that found as many as three-quarters of carbon credits generated under the JI mechanism (i.e. ERUs) are unlikely to have generated any actual emissions reductions. In fact it is estimated their use has potentially increased global emissions by some 600 million tonnes compared to if countries had met the targets domestically;
- The Morgan Institute “Carbon Cheats” report released this month.

The unfettered access of international units was the reason why the price of carbon fell to a meaningless level in New Zealand and emitters, far from modifying behaviour, were able to profit from transactions conducted in that environment. It also helped drive forest owners out of the ETS and significantly damage the forest sector’s confidence in the ETS.

Even now, a significant backlog of these units hangs over the ETS - several times the total number of units surrendered under current settings.

Any use of international units after 2020 must be restricted to those associated with verified reductions and even then the import should be constrained in the way that other countries have done. Most countries will be placing an emphasis on domestic action, as expected by the international agreements and for New Zealand too, reliance on units that reflect reductions in emissions outside New Zealand should be an option of last resort. This question will likely be linked with the topic of auctioning in the next section. Whatever the government intends to do in terms of non-domestic supply it is imperative that this is signalled clearly and early to investors and potential investors.

Auctioning

Use of international units, auctioning, a price cap and managing price stability are all inter-linked and go to the question of how, and when, the government could or should step in to the carbon market to control the price.

The FOA accepts that the government may wish to have mechanisms to ensure to avoid a price that would damage the economy, or wild fluctuations in the price. Auctioning is one possible tool.

The FOA sees no immediate need, however, for auctioning to be introduced. If the fixed price cap of \$25 is retained this gives certainty for emitters and auctioning would be unnecessary. If the government intends to stand in the market below this price then it is

important that this information is made transparent. Effectively it would be a new cap level.

The key message here is that before auctioning is introduced it is essential all ETS participants first know the parameters that will determine when the auctioneer will take action. Without this information potential forestry investors will be reticent to commit to the ETS.

4.4 Managing Price Stability

The impact of the volatility in the carbon price on forest investors over the last few years has been very negative. This impact is now well known and is acknowledged in the Technical Note. It is important that this experience is not repeated and, in that sense, the forest sector accepts that there is a role for government in providing a degree of stability with the carbon price but, aside from exceptional circumstances, that stability should be provided through consistent ETS settings rather than intervening in the market to control price.

The potential supply of forestry units to the ETS will remain uncertain until the government provides clarity about what government expectations for price and what level of domestic reduction the government wishes to achieve.

As previously submitted, the FOA considers it appropriate to manage price shocks to the economy but we do not consider recent changes in the market price qualify as shocks. The NZU price has simply adjusted over relatively short time frames to both the international price, and the signals that the NZ government has sent to the market.

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.

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 if overall emissions rise the price increase for those units not already covered by free allocation, can be avoided.

The fixed price cap is another means of constraining the price of carbon. 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. If a price cap is to be retained to give certainty, there would be merit in signalling a price floor. This would establish a price corridor in much the same way that the Reserve Bank operates within upper and lower limits for the same reasons. We concur with the Minister's comments that if we are "*going to seriously change behaviour, the price of carbon needs to be higher than it is now.*"

Work by Professor Bruce Manley of Canterbury University indicates that "*The \$25 fixed price surrender option has the potential to suppress carbon price in the future*" and he has provided estimates of the levels of new planting that can be expected with an increasing carbon price. This work suggests that a price cap of \$50/tonne is more in line

with the afforestation levels that are required and that limited afforestation will take place below \$15.

Consequently, the FOA considers these prices to be more in line with the upper and lower limits that should be set if price caps are to be retained. While the market trades within these bounds there is no rationale for government intervention.

The Canadian government is seeking to introduce such a minimum price in an arrangement with the provinces in order to prevent carbon leakage.

Another important element for providing stability is ensuring that emissions units are bankable with no risk of confiscation because this promotes stability through increased liquidity.

It will depend heavily on the effect of the decision on market expectations. Recent NZU price rises seem likely to reflect gradually shifting perceptions of the Government's ambition, and hence limits on future supply.

4.5 Operational and Technical Matters

As part of the consultation on the review of the ETS the government has produced an Operational Matters Technical Note. The FOA has submitted separately on this.

4.6 Addressing barriers to the uptake of low emissions technologies

New Planting is listed as a key initiative implemented by government to encourage innovation, and the Afforestation Grant Scheme and the Erosion Control Funding Programme in the Gisborne District are cited as examples of this.

While welcomed by the industry, these initiatives have had a relatively minimal impact on new forest planting. A much greater, positive, impact on new planting could be achieved by:

- ensuring that all land use options that are an alternative to new planting face the real cost of emissions;
- ensuring the ETS settings appropriately recognise the value of new planting;
- recognising the extended life of carbon in wood products by introducing this to the ETS, and actively supporting the development of wood technology in New Zealand. This is expanded on in further detail in the FOA submission on the Forestry Technical Note.

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



David Rhodes
Chief Executive