woodco
WOOD COUNCIL OF NZ INC

Harvested Wood Products:

Managing Deferred Liability

Submission from the Wood Council of New Zealand

21 April 2016

Introduction

1. The Wood Council of New Zealand (Woodco) was incorporated under the Incorporated Societies Act 1908 on 2 March 2006 and is a pan-industry body representing the common interests of the forestry and wood processing sectors.

2. The Wood Council members are the following associations:

    a. Forest Owners
    b. Wood Processors & Manufacturers
    c. Farm Forestry
    d. Forest Industry Contractors

3. Commencing in 2015 in the lead up to Paris, the Wood Council of New Zealand led industry discussions on how the deferred liability benefit associated with the prolonged storage of carbon in wood products should be dealt with under the ETS. Officials have participated in some of this debate.

4. The government has sought feedback on a range of issues by 30 April as part of the 2015 review of the Emissions Trading Scheme. Included in a Forestry Technical Note released in March 2016 is the question of how to treat Harvested Wood Products in the NZ ETS.

5. The NZ forest industry has had a long involvement with the development of the international rules relating to Harvested Wood Products, recognising that the previous instant oxidisation rule was inaccurate and undervalued the contribution of the sector. As such the inclusion of this topic in the Technical Note is welcomed and this Wood Council submission focusses only on this issue.

6. This submission presents some potential policy approaches for devolving the deferred liability associated with the carbon in both forests and wood products,

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and capturing associated economic and environmental benefits. It should be noted that while good progress has been made, further work is expected to be required in evaluating and implementing any final approach and consequently engagement between the industry and government will continue past the 30 April deadline for submissions on this topic.

Summary

7. The industry considers that sufficient credits and liabilities associated with the extended life of carbon in wood products should be assigned to the sector, without direct application of international HWP accounting rules, to ensure government and industry objectives are aligned, and carbon mitigation is maximised in the most practical and cost-effective way for New Zealand. The Wood Council considers this is best achieved through a dual approach that provides a positive stimulus to both forest and processing investment.

8. It is proposed that deferred credits together with their associated liabilities should be devolved to the post-1989 forest growing sector via the ETS as suggested in the Forestry Technical Note.

9. It is also proposed that financial support based on unutilised carbon credits outside of the ETS should be targeted directly at wood processing without creating significant compliance costs. This paper considers options by which this assistance could be provided.

10. Under all options it is expected that a residual portion of credits and liabilities will remain with the Crown.

Outcome of industry evaluation

11. The Wood Council has identified a number of criteria that would ideally be satisfied by any option put forward as a proposed means of addressing the issue. These include that any approach should:

    - Provide recognition of the contribution made by harvested wood products versus competing materials;
    - Provide a benefit across the entire value chain from growing through processing;
    - Be simple and cost-effective to administer and manage;
    - Reduce the risk of deforestation to other land uses;
    - Reduce the risk of catastrophic forest loss from climate change;
    - Improve the likelihood of both afforestation and reforestation and, thereby, wood supply and regional employment.

12. As a result of the Wood Council discussions referred to in the Introduction there is agreement on the following:

1. **Providing benefit to any point in the forestry value chain will inevitably deliver benefit to all parts of the value chain, even if the distribution of the benefits is difficult to quantify.**

2. **Only the average decay curve for harvested wood products should be applied in the ETS.**

   The intent of the international agreement is to explicitly recognise that different products store carbon for different lengths of time. It is also recognised that, to move beyond the default position of instant oxidisation, the NZ government is obliged to make an assessment of the proportion of domestic product in each of the international half-life values of the three products streams, viz: sawn wood 35 years; panels 25 years; and paper 2 years. The same assessment will be needed to monitor changes in the product mix for international reporting requirements.

   It is the industry view that the complexity and cost involved in measuring and monitoring three product streams as described above, as well as the potential distortion they might cause within the value chain, are of sufficient concern to preclude this level of detail being introduced to the Emissions Trading Scheme.

3. **Direct application of the deferred harvest liability for post-1989 forests in the ETS to the processing sector, or a point of obligation further down the value chain, is not supported.**

   While officials suggest there is merit in providing a behaviour signal at the point of most influence over the HWP, in the NZ context the industry considers it is inappropriate because:

   i. It would be expensive to create a monitoring framework for processors, noting that nothing currently exists under the ETS. Allowing voluntary participation in such a framework, and differentiating between wood obtained from ETS forests and non-ETS forests would be complex and costly, and likely act as a deterrent to participation.

   ii. The length of time harvested wood products remain in the processing sector is relatively short compared to their in-service lives indicating that a later point in the value chain would be more appropriate. However, this would significantly complicate how the associated HWP liability would be devolved.

iii. Policies which favour a particular product mix will undoubtedly have a distorting influence on the supply chain. The wood supply chain in New Zealand is complex and yields a wide range of products. The long run economic viability of the supply chain depends upon the interdependence of products and residues. Polices which upset the balance risk undermining the sustainability of the supply chain. Such polices will also deter biotechnological innovation at the end of the supply chain deemed to produce "short half-life" products. The relative importance of distinguishing between wood products is minor in comparison with distinguishing between wood versus non-wood products. The approach proposed retains a wood versus non-wood market signal.

iv. It would do little to encourage afforestation or avoidance of deforestation and therefore not achieve the intent of the ETS.

4. **Direct application of the deferred HWP liability to the forest growing sector would be positive for investment, could be done relatively easily and would satisfy most, if not all, of the criteria. How this benefit might be distributed across the rest of the value chain is not easily quantified.**

   Because forestry already participates in the ETS, extending the liability already carried by foresters who choose to participate is relatively easily accommodated within the existing framework.

   The impact on the IRR of first rotation ETS-participating forests has been considered and would be significantly positive. All things being equal this can be expected to increase interest in afforestation and reforestation, and decrease interest in deforestation.

Rationale for domestic devolvement of HWP credit and liability

13. Since 2015 the NZ government has been accounting for, as well as reporting on, harvested wood products as part of its national report under the UNFCCC framework.[1] The NZ government's international obligations benefit from the inclusion of harvested wood products though it is noted that at the international level the government also retains, and must manage, the liability for any significant reduction in the harvested wood products pool or change in the products mix.

[1] New Zealand's Greenhouse Gas Inventory 1990-2013, Submitted to the United Nations Framework Convention on Climate Change 10th April 2015, p276

14. The Government adopted HWP accounting under UNFCCC guidelines to help manage New Zealand's international carbon liabilities. It does not have to devolve any benefits of this practice to the sector, but has invited feedback via a Forestry Technical Note released in March 2016 on whether, and how, this might be accomplished. As acknowledged in the Technical Note, there are a different ways this may be achieved and the government is not bound to apply the international rules domestically.

15. The industry considers that, as long as the criteria referred to in paragraph 11 are satisfied it is preferable to develop an approach that defers the harvest liability to the sector. This ensures that the sector that is responsible for generating, and managing, forestry carbon credits and liabilities, has drivers that are aligned with the national interest. It would also be consistent with how other forest-generated carbon credits are dealt with under the Emissions Trading Scheme.

16. The default position of instant oxidisation does not adequately recognise the contribution of forests and wood products to climate change mitigation, and the sector and government have worked closely as members of the NZ delegation to the international negotiations to champion change that more accurately reflects reality. The current ETS settings are still based on the default assumption but should equally reflect reality as the atmosphere sees it.

17. The New Zealand greenhouse gas accounts are heavily influenced by forestry and the government has recognised the importance of increased afforestation and the retention of existing forestry. The approach proposed in this paper could incentivise this, stimulate increased wood processing, and provide increased liquidity for the Emissions Trading Scheme.

Proposed actions

18. It is proposed that government provide ETS related encouragement of forest growing and harvested wood products via two avenues to achieve mutually beneficial aims.

    1. **Devolve all forward carbon liability at harvest of post-1989 forests that are voluntarily registered in the ETS to the owners of those forests.**

    2. **Use a portion of the national value created by post-1989 forests that are not registered in the ETS to provide direct assistance to New Zealand wood processing and manufacturing.**

Devolvement of liability for participating post-1989 forest owners

19. It is proposed that the emissions liability for carbon stored in harvested wood products should be devolved to post-1989 ETS–participating forest growers on harvest on a per hectare basis, rather than treated as an instantaneous emission, and then 'oxidised' from the growers' ETS accounts according to the average decay curve for HWP. This would not require the growers to adopt HWP accounting, as the liability could be debited from the ETS accounts automatically by MPI on an annual basis using a simple computer algorithm. The direct debit would be modified by the government from time to time as the national product mix changed. This would add no compliance costs to the growers and would be cheap to run once established.

20. The average decay curve would be determined from the product mix and half-lives used by the government for reporting its international obligations.

21. This approach would substantially reduce ETS-registered forest owners' anxieties about carbon liabilities at harvest time. It would facilitate the following desirable outcomes:

    - More forest planting on under-utilised and vulnerable land;
    - Improved returns and a greater volume of wood products that would displace less benign competing products;
    - A reduction in the risk of catastrophic forest loss from climate change through encouraging growers to harvest and replant, rather than holding forests past maturity
    - Remove the current perverse incentive not to harvest, thus generating more employment for both harvesting and silvicultural contractors

22. The proposed change is simple, inexpensive and has positive implications that would help deliver on the basic purposes of the ETS, notably:

    a. For a post-1989 forest grower in the ETS who had claimed all of the credits available as the forest grew, the surrender liability on harvest would be reduced to a fraction of what is currently required and the balance of the liability spread in a more manageable way ;

    b. Forest owners would have a wider 'price window' (of log prices vs carbon prices) in which it was profitable to harvest;

    c. The IRR (Internal Rate of Return) of a first rotation forest would increase; investors would be encouraged to plant new forests and retain existing post-1989 forests;

d. Wood processors would have a more assured log supply as forests were planted, cut and replanted and it would ensure wood processors were not confronted by oversize logs;

e. The risk of carbon loss through catastrophic storm events would be reduced as on average, forests would be harvested more frequently;

f. The allocation would be de-coupled from product mix and market destinations. Consequently there would be no effect on log prices since the proposed change would not involve HWP accounting;

g. There would be no market distortion affecting wood processors. Domestic production, export production and wood product imports would all be treated equally without the need to account for carbon storage;

h. Introduction of deferred liability would have some implications for the concept of averaging for which feedback is also sought in the Forestry Technical Note. The industry has previously argued for the optional inclusion of averaging carbon sequestration over time. For owners of smaller blocks of limited age classes of tree this was seen as particularly beneficial. If deferred liability were applied as proposed above, this would significantly reduce the need for forest averaging as it would remove most of the sudden and large liability associated with harvest.

23. The change would not:

a. Affect a post-1989 forest grower's liability on deforestation. At that time all carbon liabilities in the grower's ETS account would fall due as they do now.

b. Affect the Government's own HWP accounting practice or its reporting to the UNFCCC.

c. Lead to any additional compliance costs for the industry.

d. Appear to have any fiscal implications for the Government, other than through the lag effect of growers deferring the surrender of NZUs /ha at harvest.

Industry-good assistance to New Zealand wood processing and manufacturing.

24. The forest and wood processing sectors are co-dependent. While the deferral of liability at harvest will provide benefits for the entire forest industry value chain

the benefit for processing is indirect, and difficult to quantify. The Wood Council considers it is appropriate for government to provide some direct encouragement to processing and manufacturing that will complement the deferred liability at harvest for growers and equally stimulate forest investment and an expansion of the harvested wood products pool.

25. The sector currently reduces New Zealand's gross carbon emissions which provides considerable benefit, much of which is retained by the Crown. Of the eligible post-1989 forests that could participate in the ETS, only around 50% are actually registered. This leaves a potentially significant level of credit and associated liability that is not being devolved to the industry.

26. It is proposed that a portion of this benefit be managed by government to establish an industry good funding pool for the benefit of wood processing.

27. Such an approach would uncouple the processors' allocation from direct HWP accounting, minimise compliance costs and avoid potential product mix distortion.

28. Clearly this support would favour domestic wood processing over exporting logs, which is something that the Government and industry are trying to encourage. The pull-through factor would create an investment environment that would also enhance forest planting, replanting and avoided deforestation.

29. In recent years a significant amount of forest conversion has taken place in the central North Island. This land conversion, which has reduced critical supply to the main processing investments established in the area, is unlikely to be reversed despite the collapse of dairy prices. Ensuring that adequate market signals are in place to recognize the carbon contribution and other significant environmental benefits of the industry can reduce the likelihood of further land conversion.

30. The value associated with the carbon storage that has not been devolved voluntarily to the post-1989 forest owners is considered the most appropriate basis for determining the scale of industry good assistance. Other options potentially exist including the use of funds from auctioning.

31. The forest and wood processing industry is acutely aware of the regional and central government constraints it is forced to operate under, in contrast to those of other sectors such as the agriculture. Providing an industry good fund from the government proceeds arising from work by the forest industry would go a long way towards leveling the playing field.

Application of funds

32. It is proposed that funding be targeted at specific pan-sector good activities that are consistent with enhancing increased processing capacity and increased on-

shore processing in line with government's objectives and the Wood Council Strategic Action Plan.

Such activities could include, but are not limited to:

- In-market activities to combat the imposition of the substantial non-tariff trade barriers that have been identified as impacting on wood exports;
- Revision of industry standards, standards harmonisation and support of third party certification schemes to guarantee product quality compliance and sustainability of production systems
- Research in to high value manufacturing and solid wood, biochemical and bioenergy packaging with the potential to reduce carbon emissions;
- Toolkits and training in the use of new wooden products for engineers, architects and builders;
- Construction of demonstration buildings utilising engineered timber products including industry competitions.

Other considerations

33. The diagram below, taken from a presentation on the ETS by MfE officials, illustrates the fact that emissions below the national target (i.e. below the lower dotted line) are shared across all sectors of the economy. Free allocations of carbon credits within this allowance are determined by the government, whose object appears to be to manage the national economy in terms of employment, investment, export earnings and regional development at least cost and without generating critical inter-sectoral tensions.

34. However, the relative value of forestry as an investment is critically impacted by these policy settings, including the decision to leave agricultural emissions (methane and nitrous oxide) out of the ETS. The relative contribution of other sectors in the ETS including energy-intensive and trade exposed industries is adversely impacted by the subsidization of agriculture. The Wood Council would like to see agriculture included in the ETS so that there are clear incentives to reduce or offset agricultural emissions. While this would not change our international obligations it would certainly increase the price of carbon credits, encourage owners to afforest unproductive farmland and reduce our gross emissions.

35. The devolvement of HWP benefits as proposed by Woodco would be a small but important step forward in addressing the imbalance caused by leaving agricultural emissions out of the ETS.

Domestic alignment