

## Amendments for a Moderated Emissions Trading Scheme - Addendum

You have asked for further advice on the following:

- Costs and benefits of continuing to include forestry-related NZUs under the proposed export ban.
- The process for reviewing the NZ ETS.
- The cost impacts of delaying the entry of the agriculture sector to 2015.

### Application of the Export Ban to Forestry

A decision to allow the export of forestry-related units would have impacts in four key areas: fiscal; implications of a possible link with the Australian Carbon Pollution Reduction Scheme (CPRS); economic (for post 1989 forests only); and stakeholder acceptance. The general nature of each of these impacts is described immediately below, and then assessed separately for the possible export of pre-1990 and post-1989 forests units. **[withheld]**.

#### *Fiscal impact*

The potential fiscal impact of allowing the export of forestry-related units arises from the possible impact on the domestic supply of NZUs. All other things held constant, when a greater number of NZUs are exported the possible future domestic supply of NZUs is directly reduced. As a result, the number of units purchased from the government under the price cap will increase. Since providing units to the domestic market under the price cap mechanism is costly, forcing participants to sell their units domestically can lead to savings.

However, it is important to note that participants have the ability to bank units.<sup>1</sup> If the ban on exports simply leads to a greater number of units being banked than would otherwise be the case, there will be no impact on the level of domestic supply.<sup>2</sup> A large number of participants are expected to bank units if exporting is not allowed. *So there is only a low risk of significant fiscal impact, and no risk if the international price of carbon is lower than the price cap.* The size of this fiscal risk will be greater:

- If participants expect the price of carbon internationally to fall in CP2 (in which case exporting the units immediately at a high price is more attractive than banking them).

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<sup>1</sup> It is possible to prohibit unit banking. However there are a number of downsides associated with a banking ban. Firstly, it would add to the complexity of the NZ ETS. Secondly, it would lead to a very small domestic market for units while the price cap is in place that is vulnerable to market manipulation. Finally, it could cause difficulties for post 1989 forestry participants who would be unable to accumulate units while forests grow in order to meet future emissions liabilities.

<sup>2</sup> Domestic supply is effectively the number of New Zealand units that are issued, less the number of units either exported or banked.

- The longer that the export ban is expected to remain in place.

A second possible short term fiscal cost would arise if the ability to export post-1989 units led to a greater number of forest owners opting to join the ETS. While this would provide long term benefits, it would reduce the number of units available to the Government in CP1, and therefore increase short term costs.

#### *Implications of a possible link with the CPRS*

The current design of the CPRS includes a price cap until 2016. As part of this design, it is also the case that no exports of units will be allowed until the price cap is removed.<sup>3</sup> Therefore, given the intent to harmonise with the CPRS when practicably possible, allowing the export of units in the short term could well lead to incentives to export as many units as possible prior to harmonising with the CPRS. If such a situation were to arise then the fiscal costs of allowing export of units may increase.

#### *Economic impact*

For post 1989 forests, an export ban may suppress investment (both domestic and foreign) leading to a reduction in rates of new planting, and imposing an economic cost over the longer term.

#### *Stakeholder acceptance*

While the actual cost on participants of an export ban may be low in practice (given that banking is allowed), many in the forestry sector are likely to see the ban as reducing the value of their units in the short run. In contrast to other sectors, for forestry participants this cost is not offset by a corresponding benefit arising from the introduction of the price cap, as little deforestation is expected to occur in New Zealand at a price of \$25 per tonne (this is by design). To the extent that this cost occurs, forest owners – though not being able to maximise the prices they receive for their units – would in effect be cross-subsiding the activities of emitting sectors and/or the cost of the price cap policy.

Forestry stakeholders, including Maori, will therefore see the export ban negatively and are likely to express opposition to it.

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<sup>3</sup> It may be possible to negotiate an exemption to the export ban for units created from post-1989 forests – but this is only a possibility and should not be relied upon.

### ***Post 1989 Forests***

For units earned by owners of post-1989 forests that opt into the ETS, the question of whether to allow the export of units rests on an assessment of the relative size of all three types of impact.

The likely fiscal cost of allowing exports from post 1989 forestry is considered to be low. However, there is a small probability that the cost could run to a large amount; at an extreme up to the low to mid hundreds of millions of dollars.

This fiscal risk needs to be weighed against the economic benefit associated with increased rates of planting. The Ministry of Agriculture and Forestry estimates that new planting of up to 100,000 hectares per year could occur as a result of the introduction of the ETS, providing a significant and low-cost source of abatement (MAF have previously noted that a carbon price of \$20 could theoretically result in a planting rate of 100,000 hectares per year). A ban on the export of units earned from post 1989 forests is likely to see an increase in the use of the PFSI (which is not covered by the ban) relative to the ETS. More generally, a ban may add to uncertainty, further undermining confidence in the forest industry, and result in a reduction in rates of new planting.<sup>4</sup> The size of this impact is very difficult to estimate, but could be significant, particularly if the uncertainty is perceived as remaining for some time.<sup>5</sup>

Balancing that, it is possible that linking of the NZ ETS with the Australian CPRS will require a ban on the export of post 1989 forest units. It would be undesirable to first allow, and then later ban, the export of units from post 1989 forests.

Stakeholder resistance to a ban on the export of these units will be high.

### ***Pre 1990 Forests***

For units allocated to pre-1990 forest owners, only fiscal impacts and stakeholder considerations are relevant.

Allowing the export of units allocated to pre-1990 forests is again expected to come at a low fiscal cost, but with upside fiscal risks. Stakeholder resistance to a ban will again be high, as it would reduce the value of the forestry compensation package.

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<sup>4</sup> The potential damage to confidence would be increased if a ban on export of forestry units is prolonged (as it may be to facilitate linking with the Australian CPRS).

<sup>5</sup> The key issue is the uncertainty created. Forest plantings are a long term investment; if stakeholders were fully confident that a price cap and export ban were only to last for 2 and a half years then the effect on planting rates would probably be minimal.

## **Review of the NZ ETS**

The Act provides for a mandatory process for reviewing the NZ ETS. I propose that a review of the NZ ETS is undertaken (ideally in 2011) once future international frameworks are clear). The review should be undertaken by an appointed panel to ensure a degree of independence. Matters to be considered include any post 2012 international climate change agreement, emissions policies of New Zealand's trading partners and competitors, and experience gained from the operation of the NZ ETS. Any consequential legislative amendments should be made in 2012, prior to the entry of agriculture, waste and synthetic gases into the NZ ETS in 2013.

## **Cost impact of agriculture delay**

Ministers have discussed the merits of delaying the entry of agriculture until 2015 in order to align more closely with the current proposals for the Australian Carbon Pollution Reduction Scheme. The fiscal costs of delaying the entry of agriculture to 2015 would be approximately \$70 - 80 million in total relative to the current proposals for agriculture in the Moderated ETS Cabinet paper. This involves an additional cost of approximately \$50 million per annum in 2013 and 2014, and a potential saving of \$30 million in 2015 relative to the current proposals of a 50% progressive obligation for two and a half years.