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Ministry for the
Environment
Manatū Mō Te Taiao

To: Hon Dr Nick Smith, Minister for Climate Change Issues

Follow Up to ETS Review: Fiscally Neutral Options

Other Dept Tracking Number:		**MfE Tracking Number:**	11-B-01307
Date Submitted:	21 July 2011	**MfE Priority:**	Non-urgent
Security Level:	IN CONFIDENCE	**Number of Attachments:**	3
Action Sought:	Forward to others	**Response/Signature Needed by:**	29 July 2011

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Executive Summary

1 This briefing note outlines options for addressing the fiscal costs of the proposals set out in the 2011 Emissions Trading Scheme (ETS) Review Panel's final report. Specifically it sets out broad, high-level options for a fiscally-neutral package of amendments to the ETS that would respond to the Panel's recommendations relating to the transition phase, offsetting and agriculture.

2 The high-level options are outlined in Annex 1, and a summary of their impact on sectors and prices is provided in Annex 2. These options could be further developed by officials if required.

3 We understand that Cabinet agreed on 18 July 2011 that you would meet with ministerial colleagues to give further consideration to the response to the ETS Review, and report back orally to Cabinet at its meeting on 8 August. Officials recommend that the attached Annexes 1 and 2 are forwarded to your ministerial colleagues as preparation for this meeting.

4 This briefing note does not assess the feasibility or fiscal costs of each individual Panel recommendations, but rather proposes how the three principle Panel recommendations with significant costs – the transition phase, the moderated agriculture obligation and offsetting - might be implemented as a joint fiscal package with no overall net fiscal cost or risk.

5 The Panel's recommendations may also raise other fiscal costs and risks – for example, the provision of averaging as an option for post-1989 forestry. These require further analysis and are not addressed directly in the options outlined in this briefing note.

6 This analysis should be read in conjunction with Briefing 11-B-01022, which set out the fiscal implications of the ETS Review Panel's key recommendations. Briefing 11-B-01022 further outlined the range of risks and issues that arise from the domestic application of offsetting.

Uptake of pre-1990 and post-1989 forest allocations

7 You have expressed interest in the likely uptake of pre-1990 and post-1989 forestry allocations, and whether lower uptake may deliver fiscal savings that could be used to fund the Panel's recommendations. Lower uptake by pre-1990 and post-1989 forests may result in fiscal savings in the short term - but, in the case of post-1989 forestry, higher contingent liabilities and costs in the long term.

8 Annex 3 provides information on current levels of uptake of pre-1990 and post-1989 forestry allocations. Based on this information, it is not clear that uptake will be significantly below predicted levels and therefore that significant fiscal savings will be realised. For example, uptake rates in pre-1990 forestry are currently at 75% on a per hectare basis once Crown Forest License Land is excluded, and are increasing. There has been a significant increase in applications for new accounts in the New Zealand EUR from foresters in recent months.

9 It will not be possible to be certain about any fiscal saving until the end of 2011 in the case of pre-1990 forestry; and mid-2013 in the case of post-1989 forestry. It may be possible to influence uptake rates by changing the rules governing the ability for post-1989 forests to opt into the ETS post-2012 – but this will require legislative change and so, again, the impacts are unlikely to be certain before the end of 2012. We note that Treasury is likely to resist using an under spend on an existing appropriation to offset the costs of new policy.

Recommended Action

We recommend that you:

a) **Note** the information provided in this briefing on potential levers and broad options for achieving a fiscally-neutral response to the ETS Review Panel's recommendations on the transition phase of the ETS, pre-1990 forest offsetting, and agriculture.

b) **Note** that, if Ministers wish to pursue a fiscally-neutral response to the ETS Review Panel's recommendations on the transition phase, pre-1990 forest offsetting and agriculture:

- On balance, MfE officials would recommend Broad Option 1 or a variation thereof, maintaining the status quo on the transition phase and not introducing offsetting until there is an international agreement. This is the lowest risk/cost option for New Zealand.
- If Ministers wished to implement the Panel's recommendations on a slower transition phase and introduce offsetting at least in part, officials would recommend further exploration of Broad Option 3 - implementing a restricted offsetting regime and a slightly faster phase out of the transition phase measures than that proposed by the Panel. This option could allow the fiscal and international risks to be managed slightly more easily, but would potentially be administratively complex.

c) **Note** that these options will require further analysis to explore detailed policy rationale, feasibility and settings. They also do not take into account other ETS review Panel recommendations that have not yet been costed, and which would need to be assessed separately.

d) **Note** that this analysis does not assess the feasibility, practicality or cost of individual Panel recommendations, but provides only broad options for a net fiscally-neutral response overall.

e) **Agree** to forward copies of this briefing, or Annexes 1 (the commentary) and 2 (the table) of this briefing, to the Prime Minister, the Minister of Finance, the Associate Ministers of Finance, the Minister of Agriculture and the Acting Minister of Energy and Resources, well in advance of your meeting with them.

Agreed / Not Agreed

f) **Instruct** officials on what other information you would like in advance of your meeting with colleagues on the response to the ETS review, prior to your oral report back to Cabinet on 8 August 2011.

Agreed / Not Agreed

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/ /2011

Annex 1: Follow Up to ETS Review: Broad Options for Fiscal Neutrality

Fiscal implications of ETS Review Panel recommendations

1 The ETS Review Panel's recommendations have significant fiscal implications, in particular:

- Fiscal costs of $580million: from their proposals to extend and phase out the 2 for 1 surrender obligation (including application to the synthetic gas and waste sectors); and to apply a transition phase to agriculture.

- Fiscal risks of $200m to $3bn: from their proposal to apply pre-1990 offsetting, subject to a *'hard headed assessment . . . taking account of the international position, the potential fiscal impact/ risk and the potential impact/ benefit to foresters and other stakeholders'*. These fiscal risks would become fiscal costs if New Zealand were to apply offsetting domestically and sign an international agreement that did not include this rule.

2 The Panel's recommendations may also raise other fiscal risks – for example, the provision of averaging as an option for post-1989 forestry. These require further analysis and are not addressed directly in the options outlined below.

Levers Available to Mitigate Fiscal Costs

1 If Ministers wish to adopt a fiscally-neutral package of amendments to the ETS that would respond to the Panel's recommendations relating to the transition phase, offsetting and agriculture, they appear to have 3 main levers:

- **Adjusting the speed of the phase out of the transition measures applied to sectors already covered by the ETS and the application of new transition measures to agriculture.** The government could phase out the transition measures more quickly than the Panel proposes - with the implication that ETS participants will face higher costs in the short term.

- **Only sign up to an international climate change agreement that includes offsetting/flexible land use.** If the international framework post-2012 allows offsetting/flexible land use, New Zealand will no longer have an international obligation to pay for emissions associated with deforestation of pre-1990 forest. The government could decide to introduce a requirement that New Zealand only sign up to an agreement that includes offsetting/flexible land use—but with the implication that negotiating flexibility will be curtailed and the risk that, in practical terms, it may prove difficult to stick firmly to this line under pressure in negotiations.

- **A potential claw-back of the second tranche of pre-1990 forestry allocation if offsetting is implemented.** The second tranche is worth up to $675m. The government could claw some or all of it back - with resistance from those foresters who do not expect to apply offsetting.

2 If the uptake of pre-1990 and post-1989 forestry allocations is lower than expected, it is possible that fiscal savings may be achieved which could be used to fund the Panel's recommendations. However, at this stage it is not clear that significant savings will be achieved. It will not be possible to be certain about any fiscal saving until the end of 2011 for pre-1990 forestry; and mid-2013 for post-1989 forestry.

Options for Fiscal Neutrality

3 In this context, if Ministers wished to decide on a fiscally-neutral policy package, there are three broad options they could pursue. More analysis would be required to explore and develop the detailed policy rationale, implementation mechanisms and settings under each of these options. In particular, the administrative costs and feasibility of each option have not been examined or included in this analysis. In addition, as noted above, these options do not take into account other ETS Review Panel recommendations that have not yet been costed, which would need to be assessed separately.

4 The broad options are as follows:

Broad Option 1: Maintain the status quo on the transition phase, forestry rules and agriculture (or, if preferred, defer decision-making on a transition phase for agriculture).

5 This would be the simplest approach, and may not require amendment of primary legislation. But it would mean the government deviating significantly from the Panel's key recommendations. In addition, the economic benefits of introducing offsetting would not be realised.

6 Costs for sectors covered by the ETS will double at the end of 2012. But effective carbon prices will remain below those in the proposed Australian Carbon Pricing mechanism, except for those receiving high levels of allocation under the NZ ETS (where effective prices will be very slightly higher). Overall impacts will remain relatively low (1-2c per KWh of electricity, 6-7c per litre of petrol/ diesel in total, compared to no ETS and assuming a carbon price of $25).

7 Ministers could choose to make a decision now on a transition phase for agriculture, or defer this decision. Deferring the decision may allow Ministers to re-assess the fiscal profile at a future date (e.g. in the event of lower uptake of forestry allocation), but would also create significant uncertainty for the sector.

Broad Option 2: Introduce the Panel's recommendations on offsetting, the transition phase and agriculture, and fund through a full claw-back of pre-1990 2nd tranche allocations, supported by clear international positioning:

- **Introduce offsetting (unlimited or with relatively few restrictions).**
- [Withheld under Section s9(2)(j)]
- **Cancel all of the 2nd tranche of allocation to pre-1990 forestry and use that to fund the Panel's transition phase recommendations.**

8 This option would require amendment to primary legislation (to implement offsetting and 2nd tranche of pre-1990 allocation). It would see the government adopting some of the Panel's recommendations and would allow the full economic benefits of offsetting to be realised.

10 However, there would also likely be significant resistance from foresters to the withdrawal of the 2nd tranche of allocations. [Withheld under Section s9(2)(j)]

9 Domestic offsetting may also affect the perceived integrity of the NZ ETS in international markets and the trading of units, if it is not accepted as part of international accounting rules.

Broad Option 3: Implement the Panel's recommendations on transition measures and offsetting in part and fund through a partial claw-back of pre-1990 allocations:

- **Introduce a time and quantity-restricted offsetting mechanism (or mechanism that achieved the same effect as offsetting) at a relatively low level (e.g. 2,000ha per annum).**
- **Cancel most of the second tranche of pre-1990 allocations (e.g. 50-60%).**
- **Review the continuation of this mechanism in 2015 in the light of progress internationally.**
- **Implement a faster phase out of the transition phase than the Panel recommended (e.g. 75% obligation in 2013, full obligation in 2014).**
- **Do not introduce a transition phase for agriculture, or defer a decision on this.**

10 Again, this option would require amendment of primary legislation. It would allow the government to adopt the Panel's recommendations in part. Part of the economic benefit of offsetting would be realised, but in a controlled manner that would provide more scope to limit the fiscal cost in the event of a future international agreement not permitting offsetting.

11 There would be resistance from foresters to the withdrawal of the majority of the 2nd tranche of allocations - particularly since offsetting will not be available or feasible to all, and could potentially only be available for a limited time. But government would retain flexibility to continue to provide some allocation.

12 However, the practical application of a time and quantity-restricted offsetting mechanism would require further consideration and could be problematic. A clear rationale would be needed for the quantity restriction and basis for allocation. Such a system would inevitably be controversial and is likely to be administratively complex and costly.

13 As with broad option 2, the scope for getting international agreement to offsetting will be significantly reduced. However, the impact on the perceived integrity of the NZ ETS might be lessened by the quantity and time limited availability of the offsetting option.

14 The impacts of these three options are considered further in Annex 2.

Annex 3: Estimated forestry allocation fiscal costs based on alternative take-up scenarios

Pre-1990 forest uptake scenarios

Under the Pre-1990 Forest Land Allocation Plan, 16.9 million units have been appropriated for the 1st tranche and 26.9 million units for the 2nd tranche, making 43.7m units in total. This is equivalent to $422.5m for the 1st tranche and $672.5m for the 2nd tranche and $1.1 billion for the two in total, at a carbon price of $25 per tonne.

To date, applications under the Allocation Plan have been received by the Registry for approximately 75% of the total area estimated to be eligible for pre-1990 forest allocations, once Crown Forest License Land is excluded (see **Figure 1** below). Of the 16.9m units appropriated for the 1st tranche, 6.9m (40.8%) have been allocated to date, at a fiscal cost of $172.5m at $25/tonne.

MAF predicts increasing uptake of pre-1990 forest allocations up until the application deadline (30 November 2011), based on both the rate of applications to date, and the increasing number of accounts that are being opened in the Registry (see **Figure 2** below).

Current fiscal forecasts are based on a predicted 100% uptake from eligible forest land, based on the 16.9 million units available for the 1st tranche of allocations ($422.5m at $25 per tonne). Lower take-up scenarios would produce relatively modest savings. For example, a 90% uptake scenario would reduce total allocation costs of both tranches by only $109.5m (see Table 1 below).

Table 1: Pre-1990 uptake scenarios

Pre-1990 uptake scenarios		1st Tranche	2nd Tranche	Total
100% up take	NZUs	16.9m	26.9 m	43.7m
	$	$422.5m	$672.5m	1,095m
90% up take	NZUs	15.2m	24.2m	39.4m
	$	380.25	605.25	985.5m
Fiscal savings from 90% uptake		$42.25	$67.25	$109.5m

Figure 1: Area of Pre-1990 Forestry Allocation Plan Applications

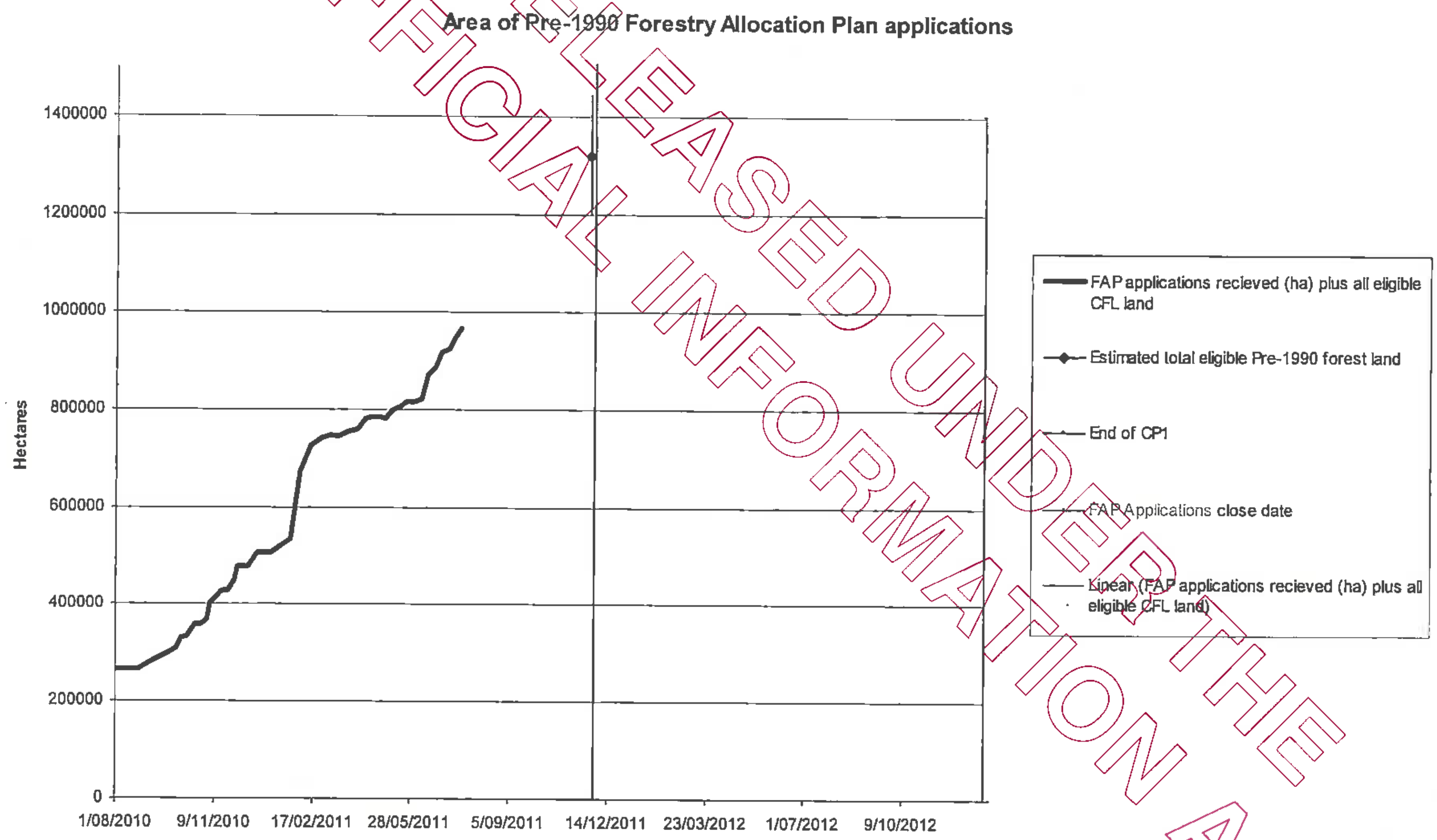
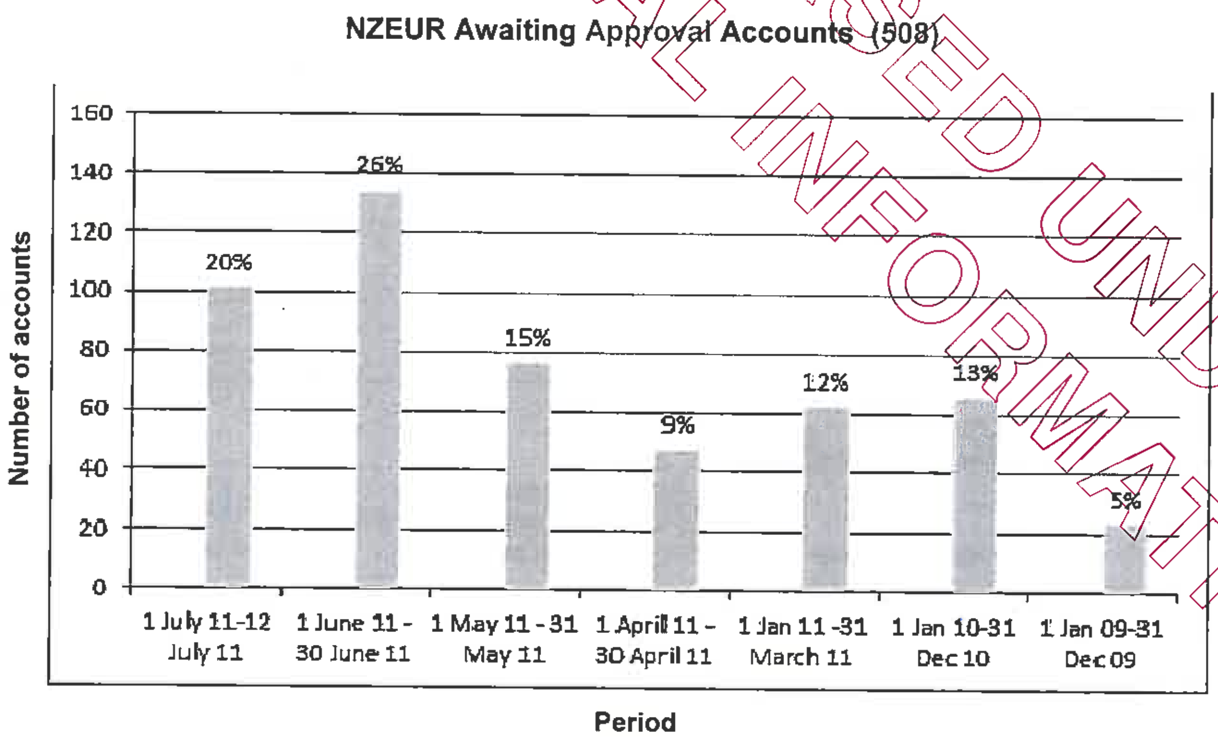


Figure 2: Indications of the likely increase in forestry allocation up-take towards the end of CP1

The chart below shows a significant increase in the applications for accounts as at 12 July 2011 (approximately 235 accounts applied for in June to 12 July) which are still awaiting approval. The assumption by MED is that a major proportion of these accounts are being opened for the pre-1990 forestry allocation plan as the deadline for application is 30 November 2011, however, it not possible to prove this.

MAF considers that this information from the Registry indicates that the uptake under the Forestry Allocation Plan (for pre-1990 forests) and/or post-1989 forest will continue to increase.



Post-1989 forest uptake scenarios

The post-1989 scenarios are based primarily on the 2010-11 Nielsen survey on ETS participation intentions, which is the only current evidence on which to forecast what post-1989 owners may intend to do. Under the current ETS settings, forest owners can join any time until the end of 2012 and still claim units for 2008-2012. Therefore current take-up figures could change significantly, as some owners may therefore perceive as in their best interest to delay registering as long as possible.

Table 3: Post-1989 forest

ETS take-up scenarios	Percent take-up before Dec 2012	Estimated fiscal cost			Fiscal savings (costs) 2013-2017 compared with 65% take-up ($25/t)	
		Units claimed[1] 2008-2010	2011-12[2]	2013-2017	Units	$m
1 Current predicted take up[3]	65%	14m NZUs	43m NZUs	63m NZUs	0m NZUs	$0m
2 Capped at current level[4]	35%		17m NZUs	34m NZUs[5]	29m NZUs	$725m
3 *Low uptake scenario*	*42%*		*23m NZUs*	*41m NZUs*	22m NZUs	$550m
4 *High uptake scenario*	*74%*		*53m NZUs*	*73m NZUs*	-10m NZUs	($250m)
5 *Maximum possible*	*100%*		*75m NZUs*	*98m NZUs*	-35m NZUs	($875m)

Notes:

- Intentions surveys and the trend of participation indicate that forest owners are increasing their participation as CP1 ends. Scenarios 2-5 exclude any uptake post-2012
- Low uptake scenario: Based on actual uptake in ETS (08/09, 09/10 and 10/11). Based on the survey, assumes all the forest owners that are unsure do not enter the ETS.
- High uptake scenario: Based solely on the Nielsen survey results. Includes uptake up to 2012 and respondents unaware they have to join in 2012 to claim credits from 2008.

[1] Not all participants claim units yearly.
[2] For the rest of CP1 (financial years 11/12; 12/13).
[3] Latest MAF forecast from March 2011. This scenario includes some uptake post-2012.
[4] This scenario is included for illustrative purposes only – it is unlikely to be feasible to implement in practice.
[5] This assumes that the Crown will honour the credits from these participants (not freeze them).