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Ministry for the Environment
Manatū Mō Te Taiao



To: Hon Dr Nick Smith, Minister for Climate Change Issues, Hon David Carter, Minister of Forestry, Hon Bill English, Minister of Finance

Joint Briefing: Potential fiscal savings from forestry allocation if offsetting is introduced

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Executive Summary

1. Ministers have requested advice from MFE, MAF and Treasury on the potential fiscal savings from cancelling any or all of the second tranche of pre-1990 forestry allocation if forest offsetting were introduced.
2. The 2011 Emissions Trading Scheme (ETS) Review Panel recommended that the second tranche of pre-1990 forestry allocation be clawed back if offsetting is introduced and taken up by a forest owner. Offsetting significantly reduces the costs of deforestation to foresters under the ETS. The Panel also recommended transitional measures which have been costed at \$580 million over 2013-2020, based on a \$25 carbon price.
3. The introduction of offsetting will require a legislative amendment unless New Zealand signs an international climate change agreement which allows offsetting. Regardless of whether offsetting is agreed internationally, any change to the second tranche of forestry allocation will require a legislative change.
4. Fiscal savings could be generated through either a total or partial cancellation of the second tranche. [Withheld under sections 59(2)(h) and 59(2)(g)(i)]
 [A partial cancellation, such as for forest owners that elect to take up offsetting (ETS Review Panel recommendation), does not meet the costs of the Panel's other recommendations but may have lower risks.]
5. Broad scenarios for the cancellation of the second tranche are outlined below to illustrate the potential savings, with scenarios that are expected to provide sufficient savings to meet the cost of the Panel's other recommendations in bold.

Table 1: Second tranche cancellation – options and estimated fiscal savings

Scenario	Second tranche cancellation	Fiscal savings of cancelling 2nd tranche	Commentary
Status quo	All 2 nd tranche allocated	\$0	No savings, no increased risk.
Total cancellation	Cancel the entire 2 nd tranche for all pre-90 forest owners, whether they elect offsetting or not	\$773m	Maximum savings but potential risks [*] no recognition of unequal impact of ETS on different forest owners.
Partial cancellation	Cancel 2 nd tranche for 39 and 60 NZU categories (ie, all except for Crown forest licence land) whether they elect offsetting or not	\$654m	Significant savings and risks reduced but not eliminated [*] unequal treatment of pre-90 owners).
	Cancel 2 nd tranche for landowners who acquired their land after 2002 (ie, 39 and 18 NZU allocation categories) whether they elect offsetting or not	\$348m	Moderate savings and compensation retained for pre-2002 owners, but potential risks [*] unequal treatment of pre-90 owners).
	Cancel 2 nd tranche only for those electing to offset (ETS Review Panel recommendation)	\$4m to \$148m	Minimal savings, but no inequities and much lower risk.

¹ The final savings figure will be subject to change, depending upon the actual carbon price. A central estimate of \$25 has been used for the purpose of this briefing, so that savings can be compared with ETS Review cost estimates, which have also used a \$25 carbon price in advice to date.

* Withheld under Sections 59(2)(h) and 59(2)(g)(i)

6. Maximum savings of \$773 million (30.9 million NZUs at \$25 carbon price) are generated when the entire second tranche allocation is cancelled for all pre-1990 forest owners, regardless of whether they take up offsetting. This excludes the implementation costs and fiscal risks of offsetting. Fiscal savings are reduced when the second tranche is cancelled for certain classes of forest owners. For example, cancelling compensation for all forest owners who acquired forest after 2002 would create an estimated \$348 million in savings.
7. The potential fiscal savings are further reduced if the second tranche is cancelled only for pre-1990 forest owners who elect to offset (the ETS Review Panel's recommendation). The exact level of savings is uncertain, with forecasts estimating savings of between \$4-148 million depending on the cancellation policy and offsetting uptake.
8. While the cancellation of all or part of the second tranche creates fiscal savings in the short term, there would be fiscal costs if New Zealand were to adopt an international agreement that did not permit offsetting. These costs are uncertain, but range up to \$2.8 billion over 2013-2020, depending on the area deforested. Officials have previously advised that New Zealand's domestic and international policy positions should be aligned so that such costs do not fall on the Crown [B10-637 refers].
9. The Minister for Climate Change Issues has requested interim advice by November 2011 on the policy implications of introducing offsetting.

Situation Analysis

Purpose

10. Ministers have requested advice on the potential fiscal savings from partially or wholly cancelling the second tranche of pre-1990 forestry allocation if offsetting is introduced. In addition to the implementation of offsetting, the Panel has recommended extensions to the current transitional measures for sectors entering the ETS, which have been broadly estimated at \$580 million over 2013-2020 (MfE BN 11-B-01022 and 11-B-01307 refers).
11. This briefing does not provide detailed analysis of the range of risks and issues that arise from the decision to implement offsetting for pre-1990 forests, as these have been outlined in previous briefings (MfE 11-B-01221 /MAF B10-637 refers). Nor does it include a full analysis of the risks of cancelling the second tranche of the forestry allocation.
12. There is parallel work currently in progress to provide advice on the options for how offsetting might be implemented and the second tranche cancelled. Officials will provide interim advice to Ministers on these issues in November 2011, which will also inform the February 2012 report back to Cabinet on the wider government response to the 2011 ETS Review.

Background

13. Under the Climate Change Response Act 2002 (the Act), the Government provides a one-off free allocation of New Zealand Units (NZUs) to pre-1990 forest landowners as partial compensation for the decrease in land value caused by ETS deforestation rules. The maximum value of the allocation is \$1500 per hectare at a carbon price of \$25/t, compared with an estimated ETS deforestation liability of \$20,000-24,000 per hectare of harvest-age radiata pine.
14. The current projections (October Baseline Update) of the total pre-1990 forest allocation indicate that it is expected to comprise 50.2m NZUs. This expenditure is recognised in

the 2010/11 and 2011/12 financial years, when all applications are lodged. The second tranche is equivalent to 30.9 million NZUs or \$773 million. This revised baseline updates the previous projected second-tranche cost of \$672.5 million (at a \$25/t carbon price), due to updated forestry data.

15. The Act and the Pre-1990 Forest Land Allocation Plan provide for a free allocation of NZUs to eligible pre-1990 forest landowners depending on when they acquired their land. The NZUs are transferred to landowners in two tranches, with the first tranche being transferred now and until 31 December 2012, and the second tranche in 2013. The allocation categories are as follows:

- 60 NZUs per hectare for eligible pre-1990 forest land acquired prior to 1 November 2002;
- 39 NZUs per hectare for eligible pre-1990 forest land acquired on or after 1 November 2002;² or
- 18 NZUs per hectare for eligible pre-1990 forest land that was Crown forest licence land on 1 January 2008, including that transferred under a Treaty settlement after that date.^{3,4}

16. The different levels of allocation acknowledge that not all pre-1990 forest landowners are impacted equally by the ETS, with higher allocation to landowners who acquired their land before 2002 when the Government first signalled deforestation controls.

17. If an offsetting regime were introduced under the ETS, landowners would not face a deforestation liability provided they establish new forests elsewhere. Landowners would, however, incur the costs of establishing new forests on alternative land and would forgo any carbon benefits from those new forests, which would accrue to the Crown.

Advice

Current provisions to cancel the second tranche

18. Provision was made in the Climate Change Response (Emissions Trading) Amendment Act 2008 (Section 53) to introduce offsetting should this rule be adopted in an international agreement to which New Zealand is a party. The introduction of offsetting without an international agreement would require a legislative amendment.

19. Any cancellation of the second tranche of pre-1990 forestry allocation, whether as a result of introducing offsetting or otherwise, requires a legislative amendment to the Act. Section 30F of the Act already signals that the second tranche could be cancelled if the Act is amended, and the Government has drawn forest landowners' attention to this possibility when notifying them of their second tranche entitlements.

² This allocation category also applies to land acquired before this date where beneficial ownership has changed in the way set out in the allocation plan (s 72(2)(b)(ii)(B) CCRA),

³ These units are in compensation to iwi for the restrictions on future land use of pre-1990 forests transferred under Treaty of Waitangi settlements since 1 January 2008. Crown forest licensed land transferred to Ngati Awa and Te Uri o Hau under Treaty of Waitangi Settlements receives 60 NZUs per hectare, as this settlement was agreed prior 1 November 2002.

⁴ Section 72(2)(b)(i)(A) of the CCRA also includes Crown forest licence land that will not have been transferred to iwi as part of a settlement by the date of the allocation plan (i.e. regular CFL, or CFL that may be part of a settlement but has not been transferred at the date of the allocation).

Potential scenarios for fiscal savings

20. Fiscal savings could be made by cancelling all or part of the second tranche. Broad scenarios for cancellation are outlined below to illustrate potential savings. These include:
- cancelling the entire second tranche;
 - cancelling allocation for some categories, eg, those forest owners who bought after 2002 (eligible for 39 NZUs); and
 - the ETS Review Panel's recommendation, to only cancel the second tranche of allocation for participants who take up offsetting.
21. More analysis will be required to explore and identify the relative benefits and risks of any of these approaches.

Scenario 1: Total cancellation

22. This scenario assumes the entire second tranche is cancelled when offsetting is introduced, regardless of whether pre-1990 forest landowners elect offsetting. This option would realise the maximum possible fiscal savings.
23. One rationale for cancelling the entire second tranche is that the introduction of offsetting would provide all pre-1990 forest landowners with the opportunity to significantly reduce the costs of deforestation.
24. While offsetting would not remove the deforestation liabilities, it could reduce them significantly.⁵ The extent to which offsetting would reduce the impacts of the ETS on the forest land value would depend on the current forest land's value, alternative uses and present deforestation liability, as well as the owner's ability to take up offsetting.
25. The cancellation of the second tranche would affect all pre-1990 forest owners, and could result in a number of risks (listed under 59(2)(h) & 59(2)(i)). Many of the forest owners with an allocation have no intention or economic reason to deforest and use the offsetting provision. Some may also have forward contracts in place to trade their units. These and other risks are discussed in further detail below.

Scenarios 2 to 4: Partial cancellation

26. If the government does not wish to accept the risks of a total cancellation, then it may wish to look at a partial cancellation. There are different scenarios for partial cancellation, three of which are outlined below.

Scenario 2: Cancel compensation for foresters who take up offsetting (ETS Review Panel recommendation)

27. This option was recommended by the ETS Review Panel on the basis that offsetting reduces the actual cost of deforestation for an owner who has converted their land to another use.
28. The potential fiscal savings of this approach would depend on (i) the amount of land offset, and (ii) the NZU allocation category of the landowners electing offsetting. Previous advice estimated offsetting uptake could range from 15,000 to 160,000 hectares over 2013-2020 (MfE 11-B-01221 /MAF B10-637), resulting in estimated potential fiscal

⁵ For example, if the deforestation liability for mature radiata forest was \$20,000-\$24,000, the cost of purchasing new land for offset planting was \$7000-9000 per/ha and the cost of replanting and forest management was \$2500-3000 per/ha, then offsetting might reduce a forest owner's costs by \$10,000-\$12,000 (excluding costs of harvest and any emissions from the new land use).

savings of between \$4m to \$148m. The approach for recording these savings in the Crown's financial statements would need to be confirmed, should this option be agreed.

29. The lower estimate of \$4m assumes that only landowners in the 18 NZU allocation category elect for offsetting and that 15,000 hectares of land is offset. The upper estimate of \$148m assumes that only landowners in the 60 NZU allocation category elect offsetting and that 160,000 hectares of the land is offset. The actual offsetting uptake would be influenced by the design of the domestic offsetting policy. The actual distribution of foresters across the three allocation classes would be influenced by a range of factors, including the proportion of land in those classes that has higher economic uses. Both estimates assume 100% ETS participation by all pre-1990 foresters.

Scenarios 3 & 4: Cancellation for specific classes of owners, independent of offsetting

30. Under this approach, the second tranche would be cancelled for some allocation categories irrespective of whether forest landowners in those categories elect offsetting. The fiscal savings depend on which allocation category is cancelled.
31. Justifications for this approach include that categories of pre-1990 forest landowners face differing impacts on their land value as a result of the ETS, or that the risks associated with cancelling the second tranche are lower for some allocation categories than others.
32. Scenarios where a partial cancellation might either target or exclude certain allocation categories include:
- a) Cancelling allocation for forest landowners who acquired their land after 2002 (39 NZU category). The rationale for this is that these landowners acquired their land after the government had announced its intentions to control deforestation, and therefore could have included ETS impacts in their valuation of the land at the time (scenario 3 in Table 2 below).
 - b) Retaining allocation for iwi who received their pre-1990 forest as part of a negotiated Treaty settlement (18 NZU category) after 2008. [withheld]
[under section 59(2)(b)]
33. Partial cancellation may provide one way of mitigating some of the risks associated with a total cancellation, but could be perceived as inequitable for some land owner classes, or at odds with the rationale for the original decision to compensate.
34. More work is needed to fully quantify the implications and risks of these partial savings scenarios.

Fiscal savings

Potential fiscal savings

35. The potential fiscal savings from the second tranche if offsetting is introduced are summarised in Table 2 below. Annex 1 provides a more detailed breakdown of these estimates (Table 3).

Table 2: Estimated fiscal savings options relative to status quo from cancelling the second tranche of allocation (at a \$25 carbon price)

Scenario	Offsetting policy	Second tranche cancellation	Fiscal savings from cancelling the second tranche	Commentary
Status quo	None	All second tranche allocated	\$0	No savings, no increased risk.
Scenario 1	Available for all pre-90 owners	Cancel entire second tranche for all pre-90 forest landowners, whether they elect offsetting or not	\$773m	Maximum savings but potential risks [*] no recognition of unequal impact of ETS on different forest owners).
Scenario 2	Available for all pre-90 owners	Cancel the second tranche only for those electing to offset (ETS Review Panel recommendation)	\$4m to \$148m	Minimal savings, but no inequities and much lower risk.
Scenario 3	Available for all pre-90 owners	Cancel the second tranche for landowners who acquired their land after 2002 (ie, the 39 and 18 NZU allocation categories) whether they elect offsetting or not	\$348m	Moderate savings and compensation retained for pre-2002 owners, but potential risks [*] unequal treatment of pre-90 owners).
Scenario 4	Available for all pre-90 owners	Cancel second tranche for 39 and 60 NZU categories (ie, all except for Crown forest licence land) whether they elect offsetting or not	\$654m	Significant savings and risks reduced but not eliminated [*] unequal treatment of pre-90 owners).

* Winiteti under sections 59(2)(h) and 59(2)(i)

Note: The potential fiscal savings do not take into account any implementation costs of the offsetting policy, or potential legal costs as a result of cancellation.

36. These estimates show that the savings are maximised when the second tranche allocation is cancelled for all pre-1990 forest owners, irrespective of whether they decide to offset (\$773 million). The savings are minimised when the second tranche allocation is only cancelled for those pre-1990 forest owners that decide to offset (\$4 to \$148 million). However, the exact level of savings is uncertain as this will depend on the amount of pre-1990 forest land that is offset and the allocation those owners were entitled to.

37. These savings estimates do not include administrative, legal or compensatory costs potentially arising from the cancellation of the second tranche, the implementation costs of offsetting, or any cost-recovery estimates.

Fiscal risks

38. Briefing 11-B-01022/B10-637 outlined the range of risks and issues that arise from the domestic application of offsetting.

39. If New Zealand signs up to an international agreement after 2012 which does not allow offsetting, the Crown must meet the international deforestation liabilities created by offsetting in the short term. The fiscal costs of covering this shortfall are estimated to

range up to \$2.8bn over the 2013-2020 period, depending on the scale of deforestation.⁶ A summary of the potential fiscal costs under this scenario is included in Annex 1 (Table 4).

Conclusions

40. Cancelling all or part of the second tranche could potentially provide between \$4 million and \$773 million in potential fiscal savings in the 2012/13 financial year, provided legislation is passed, less any potential legal or compensation costs and depending on the offsetting policy, the allocation cancellation approach adopted and the fiscal risks associated with offsetting.

Risks and Mitigations

41. Ministers can expect strong opposition from pre-1990 forest landowners to any cancellation of the second tranche. Many of the pre-1990 forest owners that have an allocation have no intention to deforest and use the offsetting provision. Some could have forward contracts in place to trade their second-tranche units. They may argue that offsetting does not completely remove the impact on their land value or the cost of deforestation and that compensation is still required. Consultation is therefore recommended on any changes.
42. Further work is required to assess the implementation feasibility, risks and benefits of the Panel recommendation on offsetting, and any cancellation of the second tranche of allocation, as well as on options to mitigating the fiscal risks of offsetting. This analysis would be necessary to support a RIS to underpin Cabinet decision-making.

Risks to New Zealand's CPT Net Position

43. Signalling a potential change to deforestation policy could cause pre-1990 forest owners to bring forward deforestation projects into the first commitment period which the Crown will be liable for in its Kyoto Protocol accounting. There are currently about 55,000 hectares of harvested forest awaiting restocking.⁷ A proportion of this belongs to owners that are in the process of making a decision as to whether they will convert the land use to agriculture.
44. Any communication around offsetting should ensure a clear indication that the proposed start of a new regime is not earlier than 2013 and will not cover land deforested in the first Kyoto Commitment Period.

Legal risk

45. [Withheld under section 59(2)(h)]

the Crown remains legally required to transfer the second tranche during 2013.] Without an amendment,

46. If the Act is amended to allow offsetting and any corresponding cancellation of the second tranche, the forest land owner's entitlements or legal rights to the second tranche will be changed and/or terminated according to the approach decided. [withheld]

[under section 59(2)(h)]

⁶ This large range is in relation to the uncertainty of the likely level of deforestation and land use conversion.

⁷ This land is not deemed as deforested until conversion to agriculture occurs or if after 4 years there has not been any replanting

[Withheld under section 59(2)(h)]

Treaty of Waitangi risks

47. Approximately 29% (350,000 ha) of all pre-1990 forest land has been transferred to Māori under Treaty settlements. This area could potentially increase as Treaty claims on the remaining land under Crown Forestry Licences (CFL) are settled and the land transferred to Māori.⁸ There is currently little information about what proportion of Māori forest land could be economically converted to agriculture or how much area remains in Māori ownership.

48.

[Withheld under section 59(2)(h)]

49. Māori are likely to view the forestry allocation as part of their overall settlement package value and argue against any cancellation. The Crown's policy view is that the allocation is additional to the settlements and a result of climate change policy.

50. In addition, Māori as well as other owners could face barriers to electing offsetting, some of which are related to the costs of conversion, or constraints due to cultural connections to land. This could result in Māori strongly advocating against forfeiting the second tranche of allocation.

51. If Māori feel prejudiced by a change in the allocation policy, they may allege the change is in breach of Treaty principles and lodge a claim with the Waitangi Tribunal. Further work would be needed to assess the nature and scale of these risks.

Financial, Regulatory and Legislative Implications

52. Cancellation of the second tranche of the pre-1990 forestry allocation requires legislative amendment to the Act in 2012.

53. Provision was made in the Climate Change Response (Emissions Trading) Amendment Act 2008 to introduce offsetting, should this be adopted in an international agreement to which New Zealand is a party. The introduction of offsetting without international agreement would require a legislative amendment.

Next steps

54. Officials will continue to progress options to implement offsetting and the cancellation of the second tranche of forestry allocation. This will be considered by Cabinet in February 2012, in the context of the wider Government response to the 2011 ETS Review Panel's recommendations.

55. Officials will provide Ministers with an interim briefing in November 2011 on the implications and mechanics of introducing offsetting.

⁸ Note that these figures are as at June 2009.

Recommended Action

MfE, MAF and the Treasury recommend that you:

- a) **Note** that the Climate Change Response Act provides for a free allocation of NZUs to pre-1990 forest landowners as partial compensation for reduced land value due to the deforestation costs imposed by the ETS, and that the introduction of offsetting would provide pre-1990 forest landowners with an opportunity to reduce these deforestation costs.
- b) **Note** that the potential fiscal savings from the total cancellation of the second tranche of forestry allocation are estimated at \$773 million, which could be used to meet the costs of the ETS Review Panel's transitional measures, estimated at \$580 million between 2013-20.
- c) **Note** that partial cancellation options may be able to mitigate some of the risks associated with a total cancellation, and include:
 - a. cancelling the second tranche only for forest owners who take up offsetting (ETS Review recommendation), which would potentially save \$4m to \$148m;
 - b. cancelling the second tranche only for specific forestry allocation classes, which would potentially save \$348m to \$654m.
- d) **Note** that these estimated savings do not take account of implementation costs, and are based on estimated ETS participation rates, NZU prices and forest area data which are subject to change.
- e) **Note** that any cancellation of the second tranche of forestry allocation has a number of risks [withheld under sections 59(2)(h) and 59(2)(g)(i)]
- f) **Note** that officials will provide an interim briefing in November 2011 on the implications and mechanics of introducing offsetting.

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ANNEX 1: POTENTIAL FISCAL SAVINGS – DETAILED ESTIMATES

Table 3: Potential fiscal savings under different compensation scenarios

Scenario	Offsetting policy	Scenario of second tranche cancellation	% of 2nd tranche cancelled	2nd tranche savings (\$m)
Status Quo				
0	None	First and second tranche are allocated	0%	\$0
A. Total or Categorical Cancellation of 2nd Tranche				
A.1	Available for all pre-90 owners. No link with 2nd tranche cancellation	Cancel all second tranche for all pre-1990 forest owners regardless of whether they elect offsetting or not	100%	\$773
A.2		Cancel all second tranche except for Crown Forest Land (ie for the 39 and 60 NZU allocation categories) whether they elect offsetting or not	85%	\$654
A.3		Cancel second tranche for land purchased/transferred after 2002 (ie, the 39 and 18 NZU allocation categories) whether they elect offsetting or not	45%	\$348
B. Option to choose Offsetting or 2nd Tranche Allocation. Cancel the second tranche only from those who take up offsetting (ETS Panel recommendation). Assumed all 'offsetters' had a 60 NZUs allocation (Max. possible savings)				
B.1	Available for all pre-90 owners. Linked with 2nd tranche cancellation	15,000 ha are offset.	1.8%	\$14
B.2		30,000 ha are offset.	3.6%	\$28
B.3		55,000 ha are offset.	6.6%	\$51
B.4		83,000 ha are offset.	9.9%	\$77
B.5		160,000 ha are offset.	19.1%	\$148
C. Option to choose Offsetting or 2nd Tranche Allocation. Cancel the second tranche only from those who take up offsetting (ETS Panel recommendation). Assumed all 'offsetters' had a 18 NZUs allocation (Min. possible savings)				
C.1	Available for all pre-90 owners. Linked with 2nd tranche cancellation	15,000 ha are offset.	0.5%	\$4
C.2		30,000 ha are offset.	1.1%	\$8
C.3		55,000 ha are offset.	2.0%	\$15
C.4		83,000 ha are offset.	3.0%	\$23
C.5		160,000 ha are offset.	5.7%	\$44

Note: The value of second tranche fiscal savings or costs is determined by the value of the NZUs, and is calculated here based on \$25/unit.

Table 4: Potential fiscal costs/risks of introducing domestic offsetting if New Zealand ratifies an international agreement with no offsetting/FLU

Scenario of pre-1990 forest deforestation area that will be offset	Total Pre-1990 deforestation area in 2013-2020 (hectares)	Potential Fiscal Cost at \$25 (\$m) for 2013-2020			
		<i>International agreement with no offsetting</i>			
		Emissions		Removals	Total
Deforestation	Agriculture	New post-1989 offset planting			
1. Based on 2010 deforestation intentions-survey (1)	15,000	-\$302	-\$7	\$32	-\$280
2. Based on 2010 deforestation intentions survey (2)	30,000	-\$604	-\$15	\$63	-\$560
3. Based on stock unit carrying capacity of the land	55,000	-\$1,098	-\$27	\$115	-\$1,019
4. Based on best land use capability for agriculture	83,000	-\$1,660	-\$40	\$173	-\$1,540
5. Based on the 2007 deforestation	160,000	-\$3,219	-\$78	\$336	-\$2,987

Note:

These estimates were provided previously in the MAF briefing B10-637.

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