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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Emissions Trading Scheme Review 2011: Proposed amendments to the Climate Change Response Act 2002

Date:	10 February 2012	**Report No:**	T2012/207

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Note** the contents of this report in advance of meeting with Treasury officials at 4:30pm on 13 February.	Monday 13 February 2012
Associate Minister of Finance (Hon Steven Joyce)	**Note** the contents of this report and **indicate** whether you would like to meet with Treasury officials.	Friday 17 February 2012
Associate Minister of Finance (Hon Dr Jonathan Coleman)	**Note** the contents of this report and **indicate** whether you would like to meet with Treasury officials.	Friday 17 February 2012

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
[s9(2)(a)]	Analyst, Natural Resources	[Withheld under Section s9(2)(a)]		✓
Melody Guy	Manager, Natural Resources	917 6059 (wk)	021 155 3342	

Minister of Finance's Office Actions (if required)

Following the Minister's agreement, forward a copy of this report to the Minister for Climate Change Issues, the Minister responsible for International Climate Change Negotiations, and the Minister for Primary Industries.

Enclosure: No

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10 February 2012

SH-10-8

Treasury Report: Emissions Trading Scheme Review 2011: Proposed amendments to the Climate Change Response Act 2002

Executive Summary

1. The Minister for Climate Change Issues intends to bring a paper to the Economic Growth Committee on 29 February seeking decisions on the first set of proposed changes to the Emissions Trading Scheme (ETS) in response to the recommendations of the 2011 ETS Review Panel (the Panel), National Party manifesto commitments, international policy developments, and further analysis.

2. These ETS-specific decisions should be considered in the broader context of climate change policy issues, including the decision to take an emissions reduction target and/or participate in the second commitment period of the Kyoto Protocol [Treasury Report T2011/1898 refers].

3. This report presents the most politically sensitive and fiscally relevant proposed changes, the linkages between them, and Treasury recommendations based on current evidence, including:

   a. *The introduction of auctioning.* There are two options for reducing the volume of carbon units imported through the ETS: introducing auctioning into the ETS or transitioning to a domestic scheme, which prohibits the import of credits. Auctioning is marginally preferred as it can provide a spectrum of options that capture most of the benefits of a domestic scheme, while reducing the potential risks.

   b. *Slowing the implementation of the ETS.* Treasury supports slowing the implementation of the ETS as proposed by the Panel, as this will reduce costs to businesses and households and support economic growth.

   c. *The Introduction of offsetting for pre-1990 forestry.* Offsetting reduces the upfront costs of deforestation by almost 80% and increases landowners' flexibility to put land to its highest value use. Treasury considers that offsetting should be introduced and that an option to cap the total amount of offsetting be enabled in legislation but not regulated at this time.

   d. *The cancellation of the second tranche of compensation to pre-1990 forest owners.* As the introduction of offsetting provides flexibility to those landowners most negatively impacted by the deforestation liability in the ETS, Treasury considers that the whole of the second tranche should be cancelled. This one-off reduction in costs will provide the savings necessary to make the package fiscally neutral.

4. Ministers have agreed that the package of decisions should be fiscally neutral or positive across the forecast period: reduced revenue from slowing the implementation of the ETS and other decisions (currently estimated at $148 million) offset by savings from cancelling the second tranche of compensation to pre-1990 forest owners (up to $322 million for full cancellation). These impacts vary within the forecast period, with an estimated net negative impact of $28 million in the 2014/15 year.

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Recommended Action

We recommend that you:

a **note** that the Economic Growth and Infrastructure (EGI) Committee is scheduled to consider a suite of decisions on the Emissions Trading Scheme on Wednesday 29 February

b **note** these decisions on the ETS are linked to broader climate change policy issues, including the decision to take an emissions reduction target and/or participate in the second commitment period of the Kyoto Protocol [Treasury Report T2011/1898 refers]

c **consider** the following proposed decisions, which are integral to the package:

   i. Reducing the volume of international carbon units imported through the ETS, either through auctioning units or transitioning to a domestic scheme *(Treasury supports the introduction of an enabling provision for auctioning).*

   ii. Slowing the implementation of the ETS to reduce costs for some sectors, reducing the operating balance by a total of $148 million between 2012/13-14/15 *(Treasury supports).*

   iii. Cancelling compensation to pre-1990 foresters, with a positive impact of up to $322 million in the 2011/12 year, to accompany the introduction of offsetting into the ETS and to make the ETS package fiscally neutral or positive *(Treasury supports full cancellation, subject to consultation with iwi and other stakeholders).*

d **discuss** these issues with Treasury officials at your meeting scheduled for 4:30 pm on Monday 13 February 2012, and

e **consider** whether to meet with the Minister for Climate Change Issues and other key Ministers on these issues in advance of consideration of this paper by EGI to discuss, in particular, approaches for consulting with iwi and other groups on the cancellation of the second tranche of compensation for pre-1990 forest owners.

Melody Guy
Manager, Natural Resources

Hon Bill English
Minister of Finance

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Treasury Report: Emissions Trading Scheme Review 2011: Proposed amendments to the Climate Change Response Act 2002

Introduction

1. In July 2011, Cabinet invited the Minister for Climate Change Issues to report to Cabinet by February 2012 on proposed changes to New Zealand's ETS taking into account the recommendations of the 2011 ETS Review Panel (the Panel), National Party manifesto commitments, international policy developments, and further analysis.

2. The Minister for Climate Change issues will bring a paper to the EGI Committee on 29 February seeking decisions on the most significant of these proposed changes. Proposals for further, more technical amendments will be outlined in a second paper, to be brought to Cabinet later in March. Of the decisions for consideration on 29 February, the most politically sensitive and/or fiscally relevant proposed changes are presented and assessed in this report.

Proposed changes: Fiscal impacts summary

3. The ETS package is designed to be fiscally neutral across the forecast period. However, within the forecast period there are differing impacts on the operating balance, as shown in the table below. The table below presents the main items that have been costed by officials to date. These figures are subject to change, particularly dependant on the proportion of the second tranche of forestry compensation Cabinet decides cancel and whether a final decision on this issue is taken in 2011/12 or 2012/13:

	increase/(decrease) in operating balance					
$ million	**2011/12**	**2012/13**	**2013/14**	**2014/15**	**2015/16 outyears**	**Total**
Transition phase—slowing the implementation of the ETS		(34.3)	(80.6)	(32.9)	-	(147.7)
Other sector-specific policy exemptions and proposals[1]		(0.7)	(1.4)	(1.4)	(1.4)	(5.0)
Gas-specific climate change levy initiatives[2]		0.3	0.5	0.5	0.5	1.8
ETS carbon methodology change[3]		1.1	2.5	5.7	8.4	17.6
Sub-total: Impacts of changes on the operating balance		(33.6)	(79.1)	(28.0)	7.5	(133.3)
Cancellation of the second tranche of pre-1990 forestry compensation	321.7					321.7
Impact on the operating balance	**321.7**	**(33.6)**	**(79.1)**	**(28.0)**	**7.5**	**188.4**

Note: These estimates are based on the prevailing carbon price of $10.41, which, for consistency, will be used for costing this package of decisions.

[1] Sector-specific proposals are to change the points of obligation for synthetic gases in electrical switchgear, and exempt certain small and isolated waste landfill operators from the ETS, as recommended by the Panel.

[2] Gas-specific levy increases include levies for Synthetic Gases on motor vehicle imports and other goods, as recommended by the Panel.

[3] Officials propose to update the methodology for calculating emissions (AR2-AR4) to align with New Zealand's required international reporting from 2013, agreed by Parties to the United Nations Framework Convention on Climate Change in Durban in December 2011. This methodological change has the most significant impact on methane emissions, and therefore the agriculture sector.

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4. The table below shows preliminary estimates for operating costs for implementing policy changes as provided by officials, the most significant being an auctioning platform and forestry offsetting monitoring regime. These implications are subject to cost-benefit analysis, and where possible cost pressures are expected to be funded from existing baselines. Treasury is considering recommending a Contingency be established for the significant items that may not be able to be funded through baselines, so that Ministers can consider business cases at a later stage:

	increase/(decrease) in operating balance					
$ million	**2011/12**	**2012/13**	**2013/14**	**2014/15**	**2015/16 outyears**	**Total**
Agency operating cost estimates		(5.2)	(1.6)	(1.8)	(2.0)	(10.5)

Proposed changes: Detailed analysis and recommendations

Introducing auctioning into the ETS

Proposal

5. Officials are proposing legislative change to allow the auctioning of New Zealand Units (NZUs) by the Government and to place restrictions on the number of international units imported into the ETS. These changes would allow the Crown to adjust the volume of international units and cash received through the ETS from 2015, e.g., in line with a domestic or international emissions reduction target.

Analysis

6. There is a strong case for reducing the volume of international units imported through the ETS, as the ETS is currently forecast to achieve emissions reductions well in excess of New Zealand's 2020 conditional target. The total cost of imported units is estimated at more than $4 billion between 2013-20 based on a $25 carbon price, or approximately $1.7 billion at current carbon prices.[4]

7. Excessive international unit purchasing should be avoided, as it results in a net cash outflow from New Zealand. It also results in the accumulation of a Crown carbon unit asset that, given an over-supply in the global market and falling prices, may have limited value and be difficult to sell.

8. There are two options for addressing this problem, either auctioning units and retaining a link to the international carbon market, or making the ETS a domestic scheme akin to a carbon tax. The latter option would involve the Government effectively setting the price, either by fixing the price or pegging it to an international carbon price.

4 The prevailing carbon price valuation is $10.41, the January 2012 Certified Emission Reduction (CER) average price.

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9. Table 1 details some of the trade-offs between an auctioning approach and a domestic scheme:

Table 1: Trade-offs between an auctioning approach and domestic scheme.

Features	Auctioning Approach	Domestic scheme
Price	Subject to international carbon market prices, unless a tight restriction is placed on imports.	A fixed price or pegged to an international price.
Volume of emissions reductions	Can be adjusted to broadly align with a reduction target through changing volumes auctioned.	Any emissions target would be met through the Crown directly purchasing units.
Fiscal implications	Auctioning will raise a cash asset, which will depend on volumes auctioned. Crown revenue is likely to be valued at international prices.	Maximises cash asset, and reduces the Crown's net debt. Revenue prices could be set by the Crown.
Fiscal risk	Creates a unit-based asset and devolves price risk to ETS participants.	Creates a cash-based asset that is not subject to price fluctuations.
ETS market design	Continues to link the ETS to international carbon markets.	Removes the link to international carbon markets.

10. In the Treasury's view the two options are analytically reasonably well balanced. However, taking a broader view, auctioning is preferred as it can provide a spectrum of design options that capture most of the benefits of a domestic scheme, while reducing the potential risks associated with a domestic scheme – particularly the potential to destabilise trading markets and move to a mechanism that could be perceived as akin to a carbon tax.

11. The design of an auctioning system is important. It needs to provide flexibility for the Government to adjust the volume of units imported in line with an emissions reduction target, while also providing a reasonable degree of certainty for market participants.

12. The Ministry for the Environment (MfE) is proposing to hold a pilot auction in 2014, ahead of introducing auctioning in full from 2015. If the implementation of the ETS is slowed approximately 12 million international carbon units will be imported across 2013-14, currently valued at $124 million. Ministers may wish to consider an earlier introduction of auctioning to reduce the volume of imported units, subject to agencies having the capacity to successfully design and implement an auctioning scheme.

Fiscal implications

13. Introducing auctioning does not impact on the forecast net revenue of the ETS and the operating balance, but replaces unit revenue with cash revenue. This in turn reduces the Crown's net debt.

14. Auctioning will require investment in a sophisticated auctioning platform and operating expenses. MfE has initially indicated that these costs will total $2.5 million in the 2012/13 year, and $0.5 million in 2013/14 and outyears. These costs are subject to a business case and cost-benefit analysis.

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Recommendation

15. Treasury recommends an enabling legislative provision to allow auctioning be introduced so long as it provides flexibility for the Government in the design of the mechanism. We would also suggest Ministers consider that full auctioning be implemented earlier than 2015 in order to reduce the volume of international units imported. This timeline is subject to agencies' capacity to successfully design and implement an auctioning regime.

Extension of the transition settings

Proposal

16. The Minister for Climate Change Issues may propose to slow the implementation of the ETS by:

    a. Progressively phasing out the one-for-two obligation for non-forestry ETS sectors[5] over 2013-15 to a full obligation (50%, 67%, 100%), instead of introducing a full obligation in 2013, and

    b. Maintaining the $25 price cap, rather than removing the price cap in 2013.

17. This proposal, reflecting National Party's election manifesto, differs from the Panel's recommendations, in that it:

    a. Does not apply a progressive phase out to Agriculture between 2015-18, by deferring decisions on Agriculture to 2014, and

    b. Maintains a $25 price cap, instead of raising the price cap by $5 per annum between 2013-17.

Analysis

18. Implementing a full obligation in 2013 would result in the ETS delivering emissions reductions of more than 30 percent on 1990 levels between 2013-15, well in excess of the Government's conditional 2020 target. This would create costs for businesses and households over and above any external reduction target potentially faced by the Government.

19. Table 2 includes estimated household expenditure cost impacts of the proposed extension of transition settings as compared with a full obligation in 2013.

Table 2: Impact on household expenditure between 2013-15: slowing the ETS as compared with no transition settings.[6]

Impact on expenditure	Proposed extension of transition settings 2013-15	Full obligation in 2013 – no transition settings
Average household expenditure per annum	$92 at $10.41/tonne $221 at $25/tonne	$111 at $10.41/tonne $268 at $25/tonne
% of gross annual household income	0.1 %	0.1%

5 Stationary Energy, Liquid Fossil Fuels, Industrial Processes, Waste, Synthetic Gases.

6 MfE analysis based on Statistics New Zealand's Household Economic Survey (2010) and current carbon price calculations.

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20. It could be argued that current low carbon prices justify removing any transition settings, in order to raise the effective carbon price and incentivise emissions reductions domestically. Any benefits of this approach are expected to be minimal, as the carbon price is a small component of relatively inelastic petrol and electricity commodities.[7] Carbon price modelling undertaken by officials estimates that between 2013-15 a $25 carbon price would reduce emissions in the energy sector (including transport) by two percent of New Zealand's gross emissions over this period.[8]

21. Economic modelling has suggested that, as a result of New Zealand's export-centric emissions profile, aggressive domestic climate change policies result in a net loss in national economic welfare when trading partners and other key countries do not undertake similar policies.[9]

22. Table 3 shows the estimated price effects of removing the transition setting in 2013, versus the current 1:2 obligation. The actual price impacts will depend on how companies in each sector pass on carbon emission costs.

Table 3: Price impact on petroleum and electricity prices of current 1:2 obligation as compared with no transition settings.[10]

Commodity	Current 1:2 obligation	Full obligation – no transition settings
Average petroleum price increase per litre	1.4 cents at $10.41/tonne 3.3 cents at $25/tonne	2.7 cents at $10.41/tonne 6.5 cents at $25/tonne
Average electricity price increase/ KWh	0.3 cents at $10.41/tonne 0.7 cents at $25/tonne	0.5 cents at $10.41/tonne 1.3 cents at $25/tonne

23. Maintaining the $25 price cap provides some price insurance for ETS participants, by shifting upward price risk from ETS participants to the Crown. If the international price rose above $25 and the Crown needed to purchase more international units to meet an obligation, then it would need to meet the difference between $25 ETS cap and the international price for that volume of units. The magnitude of this fiscal risk depends on whether the Crown is subject to an emissions reductions target requiring international units and the price of units for that obligation. Current price forecasts indicate that EU ETS units will remain below $25 in the short term.

Fiscal implications

24. The fiscal impact of slowing the implementation of the ETS would result in a negative impact on the operating balance of $206 million across the forecast period, including $206 million in the 2014/15 year.

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7 Kennedy, D., & Wallis, I. (2007.) "Impacts of fuel changes on New Zealand transport." *Land Transport New Zealand.*

8 Based on SPRAT-2 MfE modelling tool, taking into account gross emissions at $0 and $25 prices.

9 Stroombergen, A., Schilling, C., & Ballingall, J. (2009, May.) "Economic modelling of New Zealand climate change policy." *New Zealand Institute of Economic Research Inc. and Infometrics.*

10 MfE analysis based on MED Energy Data File (2010).

25. Maintaining a $25 price cap presents fiscal risks for the Crown, if the Crown is subject to an international obligation or was to allow trading of domestic ETS units for international units. The Treasury would recommend removing the exchange of domestic for international units if the international price rose above the price cap, to avoid the risk of arbitrage.

Recommendation

26. The Treasury recommends extending the transition settings as proposed by the ETS Review Panel to reduce costs on emitters, and maintain the $25 price cap through to 2015. The Treasury also recommends removing the ability to trade domestic units for international units, if the international unit rises above the price cap.

Introduction of offsetting for pre-1990 forestry

Proposal

27. Under the existing ETS, pre-1990 forest owners do not accrue credits as their trees grow, nor are they required to pay a carbon liability at harvest, unless the land is deforested and put to a new use. Should deforestation occur, forest owners are responsible for surrendering credits equivalent to the full carbon stock of the forest prior to harvest. This deforestation liability, depending on the carbon price, may be prohibitive and thereby limit the flexibility of land use.

28. As some pre-1990 forest land may be better suited to alternative land uses, e.g., agriculture, and it would be economically suboptimal to keep land forested when it could be used more productively, the Panel recommended that offsetting be introduced for pre-1990 forestry from 2013. Offsetting would allow a pre-1990 forest owner to deforest, so long as an area- and ultimately carbon stock-equivalent forest were established elsewhere. The National Party manifesto commits to introduce offsetting from 2013.

29. Variations include a cap on total offsetting, restriction on harvest based on the age of trees, and a requirement that, regardless of the age of the original forest at harvest, the offset forest be maintained for a full rotation length.

30. New Zealand was able to secure the Flexible Land Use (FLU) provision in the rule set governing accounting for emissions and removals from pre-1990 forestry in the second commitment period of the Kyoto Protocol. It is proposed that offsetting in the ETS be subject to the same requirements as the FLU rule, in order to eliminate any liabilities for the Crown that might arise from a different definition.

Analysis

31. As shown in Table 4 below, on a per hectare basis, offsetting significantly reduces the upfront costs of deforestation for pre-1990 forests under the ETS. Were a forest owner required to buy the land for the offset forest, offsetting decreases upfront costs by nearly 80%.

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Table 4: Cost-benefit analysis of the status quo and offsetting for individual forest owner converting original forest land to dairy farming.[11]

Current ETS		Offsetting	
Costs ($ per hectare)			
Deforestation liability	-18,900		
Conversion to pastoral	-19,800	Conversion to pastoral	-19,800
Emissions liability for agricultural production	-440	Emissions liability for agricultural production	-440
		Offset forest land	-4,300
Total cost	*-39,140*	*Total cost*	-24,540
Benefits ($ per hectare)			
Deforest log sales	+43,100	Deforest log sales	+43,100
Net income from agricultural production	+28,200	Net income from agricultural production	+28,200
		Net income from offset forest	+850
Total benefit	*+71,300*	*Total benefit*	+72,150
Net	**+32,160**	**Net**	**+47,610**

32. These benefits to individual forest owners only come at a cost to the Crown in the event that offsetting exceeds expected levels, and New Zealand is subject to rules as currently agreed under the Kyoto Protocol.

33. Higher than anticipated timber demand and prices could drive increased harvest in the whole of the pre-1990 forest estate or higher than expected uptake of offsetting, e.g., for younger forests. However, officials at the Ministry of Agriculture and Forestry (MAF) have advised that it is far more likely that offsetting will occur at or below expected levels.

Fiscal implications

34. MAF has indicated that, depending upon the final design of the offsetting policy, operational implementation costs could amount to between $4-5 million over five years, with approximately 50% expected in the first year. These costs are subject to a business case and cost-benefit analysis.

35. Apart from these operational costs, the only fiscal costs arising from the introduction of offsetting will be linked with New Zealand's participation in the second commitment period of the Kyoto Protocol. Under Kyoto, offsetting is linked with the harvesting of pre-1990 forests more generally. [Withheld under Section 9(2)(j)]

Recommendation

36. As offsetting decreases the upfront costs of conversion for landowners by 80% thereby enabling the flexibility of use that will promote higher value land utilisation and economic growth, Treasury considers that offsetting should be introduced into the ETS.

11 MAF analysis. Assumes original forest deforested at age 28; forest owner must purchase land for offset forest; 87% of pastoral land used for dairy and 13% for sheep and beef farming; carbon price of $25; surrender obligation for agricultural emissions from 2015. Costs of establishing and maintaining the offset forest are included in net income. All estimates on the basis of net present value using 8% discount rate where future cash streams are expected.

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37. With respect to scheme design, it is clear that an alignment with the FLU provision will minimise fiscal risks to the Crown in the event that New Zealand is party to the second commitment period of the Kyoto Protocol or undertakes a domestic emissions reduction target with Kyoto-like accounting rules. As the international rule sets a standard for environmental integrity and trading partners are likely to see these rules as the baseline for acceptable treatment of forestry emissions, Treasury considers that an alignment with this rule is in the best interest of New Zealand in the long run, regardless of New Zealand's taking up a legally-binding commitment in the short-term.

38. Treasury considers that a cap on offsetting or a restriction on the age of the original forest at harvest should be provided for in legislation but not enacted at this stage. Officials have advised that it is unlikely that total harvest and deforestation for offsetting in the pre-1990 forest estate will exceed expected levels and the implementation of offsetting will be further complicated by the use of a cap.

Cancellation of the second tranche of allocation for pre-1990 forestry

Proposal

39. As partial compensation for the constraint placed on pre-1990 foresters by the deforestation liability under the ETS and corresponding decrease in the value of land, the Act provides for the allocation of 55 million NZUs to pre-1990 forest owners, equivalent to the initial projected emissions associated with deforestation of 5.2% of the entire pre-1990 forest estate between 2008-20.

40. The so-called first tranche of 21 million NZUs were allocated over 2008-12 and the second tranche of 34 million NZUs were intended to be distributed post-2012. Based on current applications for allocation, the total value of the second tranche is estimated at 31 million NZUs, or up to $322 million at the current carbon price of $10.41

41. Allocation to pre-1990 forest owners was done on the basis of the size, age, and purchase date of their forest landholdings.[12]

42. As offsetting for pre-1990 forestry significantly decreases the upfront costs faced by forest owners should they deforest, the Panel recommended that the Government introduce a claw-back provision for the second tranche of pre-1990 forestry allocation if offsetting is introduced and taken up by an ETS participant. The National Party manifesto commits to review the second tranche of compensation for pre-1990 forest landowners in light of the introduction of offsetting.

43. The cancellation of the second tranche, either in whole or in part, represents one of the only and certainly the largest opportunity for fiscal savings in the suite of proposed changes to the ETS. As Ministers agreed and the National Party manifesto commits to fiscal neutrality for the complete package of ETS amendments, the Minister for Climate Change Issues suggests that cancellation could be done on a pro rata basis to provide sufficient savings to pay for the costs incurred by other components of the package. MfE has not yet settled on a definitive recommendation on how or how much of the second tranche should be cancelled.

12 Owners of forests bought on or before 31 October 2002 that qualify as pre-1990 forests would be allocated an estimated 60 NZUs per hectare. Those who purchased their forest after 31 October 2002 would receive 39 units per hectare. In addition, 18 units per hectare would be provided for post-2008 Treaty claimants who receive Crown Forest Licence land.

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Analysis

44. As described in the previous section, offsetting in the ETS both reduces the cost of conversion by eliminating the deforestation liability for pre-1990 forest and increases the flexibility of land use. However, offsetting may not be attractive to all pre-1990 forest owners as approximately 75% of the pre-1990 forest estate is best suited to forestry.[13] Only approximately 6% of the total estate or 70,000 hectares, at the outside, is considered better suited for much higher value land uses.

45. That only a fraction of the pre-1990 forest estate is actually better suited for higher value land uses calls into question the fitness for purpose of the original compensation package provided to forest owners. The purpose of the allocation was to compensate forest owners for the impact on the value of their land as a result of reduced flexibility imposed by the ETS. The variation in these impacts across pre-1990 forest owners clearly varied widely, but it was considered too difficult to compensate in a more targeted fashion.

46. By distributing compensation to all forest owners regardless of the actual impact on their land values, the original compensation package undercompensated those owners with land suited to higher value use and either overcompensated or compensated unnecessarily landowners with no incentive to deforest. The availability of an offsetting option provides an economical alternative to those forest owners who were most impacted by the ETS and the cancellation of the second tranche reduces or eliminates compensation to those forest owners whose land values did not suffer by virtue of the ETS.

47. The ETS package may be perceived as a wealth transfer from the forestry sector to the industrial and energy sectors, as the cancellation of the second tranche may provide the savings necessary to meet the most substantial costs of reducing obligations for the stationary energy, industrial processes, and liquid fossil fuel sectors.

Legal advice

48.

Withheld under Sections
S9(2)(h) and S9(2)(g)(i)

13 MAF analysis.

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[Withheld under Sections s9(2)(h) and s9(2)(g)(i)]

Māori issues

49. The Iwi Leaders Group on Climate Change have previously supported the introduction of offsetting as providing greater flexibility to develop iwi land. However, as all iwi may not be in a position to take up offsetting and/or those iwi able to utilise offsetting [Withheld under Sections s9(2)(g)(i) and s9(2)(h)]

50. Should Cabinet decide that a partial or whole cancellation of the second tranche is desired, the timing of announcement, consultation, and/or negotiation with iwi will need to be carefully thought through [Withheld under Section s9(2)(g)(i)]

Fiscal implications

51. To achieve fiscal neutrality across the package of changes, officials estimate between 50-60% of the second tranche would need to be cancelled, which would realise savings of between $160-200 million at the current carbon price of $10.41. Were compensation to be cancelled for only those forest owners taking up offsetting, an additional savings of between $1-31 million could be generated.

52. The Panel's recommendation, to cancel compensation only for those forest owners that take up offsetting, would result in highly uncertain savings and prevent the proposed package from being fiscally neutral. The value of the entire second tranche is currently estimated at up to $322 million.

53. A cancellation of the second tranche, in whole or in part, would result in a reduction ETS expenses and a positive impact on the operating balance when the decision takes effect. Should Cabinet decide to cancel all or part of the second tranche, the savings will be recognised in the fiscal year the decision takes effect, i.e., 2011/12 or 2012/13. It is important to note that while this cancellation may provide the bulk of the savings necessary to offset the costs of other proposed changes in the package, savings from cancelling the second tranche will be recognised in one lump sum in a single fiscal year while costs from other proposals will be distributed across the forecast period.

Recommendation

54. Treasury considers that the second tranche of compensation for pre-1990 forest owners should be clawed back in full. Offsetting provides an option for pre-1990 forest owners which confers greater flexibility in land use and allows foresters to significantly reduce the costs of deforestation. The original allocation plan was a blunt mechanism that is forecast to overcompensate all pre-1990 forest owners generally and distribute benefits among forest owners unequally.

55. [Withheld under Sections s9(2)(h) and s9(2)(g)(i)]

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