

Addendum to Regulatory Impact Assessment: Forestry ETS proposals

Agency Disclosure Statement

This regulatory impact statement is an addendum to the Regulatory Impact Assessment (RIA) *Emissions Trading Scheme forestry accounting proposals*.

This addendum should be read in conjunction with Chapter J of that RIA. In particular, the paper provides additional analysis of the likely outcomes, costs, benefits, and risks of the proposal to extend temporary adverse events (TAE) liabilities exemptions to stock change forests so that all categories of post-1989 forests registered within the New Zealand Emissions Trading Scheme (NZ-ETS) can access them. This addendum provides additional impact analysis to inform the final policy decisions on the ETR Bill, which Cabinet is expected to consider in early May.

Two options are assessed in this RIA addendum. Option J1 (see below) would apply TAE liabilities exemptions to new forests and existing post-1989 forests that move to averaging accounting. Option J2 extends option J1 to apply to all post-1989 participants. Earlier analysis of these two options can be seen in the original RIA.

The Ministers of Forestry and Climate Change are due to report back to Cabinet on final policy decisions for the ETR Bill in May 2020. The primary limitation to the following analysis is a range of significant data constraints. These constraints include the availability of relevant data, uncertainty about participant decisions and behaviour, and the number and scale of adverse events in any given year. Collectively, these limit the ability to fully analyse the reconsidered proposal against a range of options, and to carry out a detailed assessment of the impact of the proposals on cost-benefit of extending TAE liabilities exemptions to all post-1989 forests registered in the NZ-ETS. The timescale also prevents us from undertaking a detailed consultation with stakeholders on the proposed change. Despite this, we are confident that consultation undertaken to date clearly shows that this change is strongly supported by foresters and an exemption from the requirement to consult has been requested in the associated cabinet paper (2020-C-06541).

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Original proposals and analysis

The original RIA (pp.86-89) compared two options relating to the removal of temporary adverse event unit surrender liabilities for participants in the ETS. The two options were:

Option J.1. Participants are not liable for carbon loss from a temporary adverse event that damages their forest if they are using averaging accounting, and can continue to earn NZUs once the forest regains the same carbon storage as immediately before the event (preferred)

Option J.2. Participants are not liable for forest carbon loss from a temporary adverse event that damages their forest (regardless of if it uses stock change or averaging accounting).

All other options for removing temporary adverse events emissions liabilities were discarded as they could undermine the replanting incentive for participants, create fiscal risk for the Crown, or lead to environmental integrity concerns (see the original RIA's Appendix 3, p.138).

In the original RIA, analysis supported option J.1 on the basis that it encouraged ETS participation, afforestation and quick forest re-establishment. Additionally, it would only result in a small increase to Crown financial risk relating to participants using averaging accounting. Also, the administrative and participant effort impacts were deemed likely to be manageable.

When the original decision was made to grant TAE liabilities exemptions to forests using averaging accounting, it was thought that existing stock change forests would be able to transition to averaging accounting. This transition would allow gaining access to TAE exemptions. Cabinet subsequently decided not to allow this transition due to the costs involved, but committed to revisiting the decision in late 2021. This means that current stock change forests cannot access TAE liabilities exemptions before that time without a policy change.

This addendum and further impact analysis has been carried out as a result of feedback received from stakeholders during the Select Committee process for the Emissions Trading Reform Bill. Here, several large forest organisations raised the issue of TAE liabilities exemptions. The New Zealand Forest Owners Association and Ngati Porou Forests Ltd, a large Māori forest management company, argued for extending liability exemptions on equity grounds. As well as raising equity concerns Forest Management Limited, a production forestry company which manages land for over 150 clients in the ETS (predominantly small forest owners and farm forestry), cited the need to align domestic policy with international obligations.

The following paragraphs re-assess the proposals based upon primary and secondary criteria as set out in the original RIA. It should be noted that the proposals being considered only affect the Crown and those participants using the stock change accounting methodology, as those using averaging accounting are treated the same under each option.

Increase Incentives to Store Carbon in Forestry

Averaging accounting

Offering TAE liabilities exemptions to participants using averaging accounting could encourage ETS participation and afforestation, as it would lower the financial risk of registering forests. The pause and re-earn design of Option 1 would incentivise the quick re-establishment lost forest carbon stock (in order to begin re-earning NZUs).

Stock change accounting

Extending TAE liabilities to existing participants using stock change accounting would also encourage re-establishment and reduce financial risk for participants, but will not directly increase afforestation or the incentive to store carbon in forestry. This is because participants using stock change accounting are already registered in the ETS and their forests are already growing. It may, however, indirectly result in additional afforestation by freeing up foresters' working capital, as they will no longer be required to purchase insurance for carbon loss from adverse events. The quick re-establishment incentive could be weaker for stock change participants dependent upon the age of their forest, because the difference between their deforestation and harvest liabilities may be small.¹ This is not the case, as noted above, for forests using averaging accounting.

Allocates entitlements and obligations to Support Alignment with Climate Change Targets

Granting TAE liabilities exemptions to participants using averaging accounting would align NZU payments more closely with international climate change accounting rules. The option to pause and re-earn NZUs reflects the significant impact for international accounting of not re-establishing forests. Though it does represent an increased risk to the Crown (which loses out in the short term on NZU surrenders from temporary adverse events).

However, this approach creates inconsistency, with two different approaches to TAE for stock-change and averaging accounting methodologies. The rules for international accounting of TAE are the same regardless of the type of forest. Extending TAE liabilities exemptions to stock change foresters will remove this inconsistency with international accounting rules.

Improves ease of compliance for participants (including financial impact)

For participants

TAE liabilities exemptions remove the need for participants (currently, only those who will use averaging accounting) to surrender NZUs for an event that they may not have planned for. This rebalances the risk from the forester incurring a surrender

¹ Deforestation liabilities are those resulting from clearing a land of forest and not replanting it within a set period of time (4 years). Harvest liabilities are liabilities resulting from harvesting an area of forest with an intention of subsequently re-foresting the area harvested. In both cases the liability is a quantity of NZUs equivalent to carbon lost through deforestation/harvesting, though harvesting liabilities are generally lower because carbon stored in the roots of trees is not counted as lost if trees are replanted.

liability for events they cannot accurately foresee. There will remain a small financial cost to participants associated with the submitting of a temporary adverse event return submitted, which is a requirement for the use of this exemption.

Because of the costs involved in submitting a return, participants will not be required to undertake reporting obligations for forest areas where the cost to apply for the exemption would outweigh the NZUs that would need to be surrendered.

However, granting TAE exemptions liabilities only to participants using averaging accounting leaves those using stock change accounting exposed to the financial risk of unit surrender. Option J2 extends this rebalancing of risk equitably to all post-1989 forestry participants of the ETS. Temporary adverse events are, by their nature, unexpected, and can impose significant unit surrender costs on participants using stock change accounting. The 2019 Pidgeon Valley Fire (the largest in New Zealand history) saw 2,400 hectares of forest burned down, which would have led to a \$36 million penalty in units for a forester (assuming a carbon price of \$25 per NZU). However, an event of this scale is uncommon. The majority of adverse events affect less than 5 hectares and occur every 1-5 years in most forests.

This is a high penalty for participants to pay for events that are often beyond their control may damage the reputation of the ETS, which relies on voluntary participation. Currently, only about half of eligible post-1989 land is registered in the ETS. Extending liabilities exemptions removes this financial risk for forestry participants. Many of whom are smaller foresters rather than larger commercial organisations, often with limited liquidity, and who are likely to find it more difficult to cover these costs. There are around 1,700 voluntarily registered forestry participants with less than 100 hectares of forests each.

Though we are unable to provide detailed financial information on insurance costs, some submissions to the Emissions Trading Reform Bill highlighted that it can be challenging to access insurance for TAE. This is because in some instances relevant insurance products are not available, particularly for small foresters, and also because of the financial barrier to accessing insurance, which is exacerbated as insurance costs rise over time as the carbon price increases. For example, Forest Management Ltd noted that the cost of insurance, which could rise to over \$100 per hectare per annum for fire and wind cover, was 'a significant cost hurdle' for smaller foresters. They also highlighted that insurance premiums were likely to rise with anticipated increases in carbon price. This would create a perverse incentive to further afforestation. Aratua Forests agreed, expressing concern that high insurance premiums would reduce the financial returns of forestry investments, 'disincentivising continued participation in the ETS' on affected land. The positions in these submissions represent the views of the organisations named and cannot be independently verified within the timescale available. Despite this, they represent expert opinion from the forestry sector and suggest that extending the scope of TAE liabilities exemptions avoids these inequitable insurance premiums for most existing foresters (though they would still need to insure against losses of timber in adverse events).

Widening the TAE liabilities exemptions could increase the compliance burden for participants, as more forest land would be eligible to receive them. This would depend on the scale and regularity of the adverse events, which is highly unpredictable. However, foresters' submissions on the ETR Bill were strongly in favour of providing stock change forests access to the TAE exemption, which suggests benefits strongly outweigh the costs from their perspective, including any additional compliance requirements.

For the Crown

A full assessment of the financial impact to the Crown of extending TAE liabilities exemptions to all forests in the NZ-ETS could not be completed in the time available.

However, the policy change would be fiscally neutral in the long term as under the current system unit surrenders made for temporary adverse events are paid back to participants by the Crown if a forester replants their forest (which is highly likely given the financial liability of TAE surrenders). Under averaging accounting unit flows are paused until the forest reaches the level it was at when the TAE occurred.

This pause in NZU payments from the Crown provided by the TAE exemption in effect 'cancels out' the credits that would have otherwise been surrendered for the TAE. Providing exemptions for temporary adverse events stops this circular flow of units. Similarly, across the entire ETS, data collected by Te Uru Rākau from a range of foresters during consultation for ETS forestry regulation changes suggests that the amount of land impacted by temporary adverse events which results in a carbon loss (and therefore unit surrenders) is low.

This policy change will result in an additional 330,000 hectares of land being covered by TAE exemptions. Though there will be short term losses to the Crown in terms of less units surrendered for temporary adverse events, any short term changes in NZU surrenders will be taken into account in regular baseline updates for the ETS. Looking forward, forecasts will account for the pause in issuing units as the forest grows, decreasing expected allocations (and thus expenses) over that period.

Administrative efficiency and effectiveness for regulators

The granting of TAE liabilities exemptions in any circumstance will require new systems and administrative effort from Te Uru Rākau.

Averaging Accounting

Granting TAE liabilities exemptions to participants using averaging accounting and the proposed new permanent forest category requires the creation and administration of a system to manage liabilities exemptions. The cost of processing the applications for exemptions would be variable (differing depending upon the forest area affected) and would need monitoring and verification to confirm the contents of an application (which could include site visits).

One disadvantage from a compliance perspective of only granting exemptions to participants using averaging accounting would be that the regulator would need to administer dual systems to manage TAE liabilities for forests using averaging and

stock change accounting, though the cost to support these changes is likely to be low.

Stock Change Accounting

Extending the provision of TAE liabilities exemptions to participants using stock change accounting will result in slightly increased costs to the regulator as more land, approximately 330,000 hectares of additional forestry (of a total plantation forestry estate of 1,700,000 hectares), would be eligible for the TAE liability exemption. It would also be easier for some forest owners to game the system because of the way they earn units. For instance, a forest owner could use an adverse event as an excuse to undertake some harvesting without surrendering units, claiming this was necessary to manage the impact of the temporary adverse event. These costs would remain highly variable for the reasons outlined above but should be low enough to be met within baselines.

Though this scenario would be unlikely, Te Uru Rākau would be obliged to conduct more stringent compliance checks on any claims for TAE exemptions made by stock change foresters. The level of additional compliance would vary depending upon the scale, nature, and location of events, and how many applications were received from stock change forests in any given period.

Provides durable regulatory certainty and predictability

Extending TAE liabilities exemptions to forests using the stock-change accounting methodology removes an incentive for participants to move from stock change to the averaging accounting methodology if this option ever became available. Averaging accounting is preferred by the Government as it more closely aligns with how we account for our forests internationally (see original RIA for wider rationale). This means that some forests may continue to use the stock-change method of accounting.

A number of large forest owners have existing stock change forests but are also planning new forests (which are required to use averaging accounting). If access to the TAE exemption is not broadened, some participants would have an inconsistent insurance cover for different parts of their forest portfolio. Extending TAE liabilities exemptions means that all forest types are treated the same.

Reduced incentives for adopting averaging should be weighed against the wider confidence foresters have in the ETS as a whole. Also, there are other strong incentives for participants to transition to averaging accounting, such as offsetting provisions and the fact that some participants will have access to a greater number of units which will not have to be surrendered to the Crown upon harvest. These are known as low-risk units as they are able to be traded with emitters rather than retained for future surrender.

Conclusions

This is a highly complex issue, for which potential costs and barriers created by a universal grant of TAE exemptions liabilities must be considered against the risks arising from potential high insurance costs to participants, the relatively low cost to the Crown of extending these exemptions, and the wider impact on the attractiveness of the ETS for forestry. Our reassessment of the options suggests that protecting the wider integrity of the ETS outweighs the small increased cost to the Crown and reduced incentive to take up averaging accounting. Therefore, we recommend extending the TAE liabilities exemptions to all existing forests in the ETS, irrespective of whether they use stock change or averaging accounting.

Impact analysis table 1: Proposal to remove participants' temporary adverse event liability

Key: Variations from Status Quo	
++	Much better
+	Better than
0	About the same
-	Worse than
--	Much worse

Primary Criteria	SQ – stock change accounting, NZU entitlements based on carbon storage	1. Participants are not liable for carbon loss from a temporary adverse event that damages their forest using averaging accounting and can continue to earn NZUs once the forest regains the same carbon storage as immediately before the event.	2. Participants are not liable for forest carbon loss from a temporary adverse event that damages their forest (regardless of whether it uses stock change or averaging accounting).
Increase incentives to store carbon in forests	0	<p>+</p> <ul style="list-style-type: none"> • Encourages ETS participation and forestry by reducing financial risk of entering the ETS. • Pause and re-earn design incentivises participants to quickly re-establish lost forest carbon stock. 	<p>+</p> <ul style="list-style-type: none"> • Providing the suspension to forests already established and registered in the NZ ETS will not directly increase afforestation. However, it may indirectly result in additional afforestation by freeing up participants' working capital

			<p>— they will no longer be required to purchase insurance for carbon loss from adverse events and this will help build confidence in the NZ ETS.</p> <ul style="list-style-type: none"> • Weaker quick re-establishment incentive but does not impact on afforestation incentives provided by the averaging accounting method.
Allocates obligations and entitlements to support alignment with climate change targets	0	<p>+</p> <ul style="list-style-type: none"> • Small increase to potential Crown risk. • Creates inconsistency through different approaches to TAE for stock-change and averaging accounting methods, where the TAE international rules are the same for both type of forest. 	<p>+</p> <ul style="list-style-type: none"> • Greater cost to the Crown than under option one, as more forest will be eligible for exemptions • Results in fairer and consistent treatment of forests in the ETS irrespective of accounting method, in line with international climate change rules.
Improves ease of compliance for participants (including financial impacts).	0	<p>-/0</p> <ul style="list-style-type: none"> • Leaves participants using the stock change methodology exposed to financial risk of surrendering NZUs for highly unpredictable temporary adverse events. 	<p>0/+</p> <ul style="list-style-type: none"> • Participants with forests using both stock change and averaging accounting would still have an increased compliance burden compared to option

		<ul style="list-style-type: none"> Participants with forests that use stock change accounting and averaging accounting would need to adopt two different approaches to TAE, potentially increasing compliance burden. 	<p>1 (as more land would be eligible for applications).</p> <ul style="list-style-type: none"> Reduced costs of compliance for all participants as per option 1. Removes the need for all participants to surrender NZUs to the Crown at an unexpected time.
Secondary Criteria			
Administrative efficiency and effectiveness for regulators	0	<p>-</p> <ul style="list-style-type: none"> Would add ongoing administrative effort for Te Uru Rākau to process temporary adverse event applications. Cost per application would differ depending on the forest area affected. Would require monitoring and verification, and could include a site visit. The cost to set up the IT systems to support this change is likely to be low. 	<p>--</p> <ul style="list-style-type: none"> Would be more costly compared to option 1 as more land would be eligible for the TAE liability exemption. Increased compliance effort for regulator to prevent gaming of the system.
Provides durable regulatory certainty and predictability	0	<p>-/0</p> <ul style="list-style-type: none"> Creates an incentive for current participants to move to the averaging accounting methodology, which supports long-term domestic-international accounting alignment. Inconsistent treatment between similar forest types could reduce confidence in the ETS for foresters. 	<p>+</p> <ul style="list-style-type: none"> Ensures the TAE liabilities exemptions apply to all forests meaning that all participants are treated consistently, which could increase confidence in the ETS.

Overall assessment	<p>On reconsideration MPI prefers option J.2 as it reduces financial burden on participants and maintains confidence in the ETS at a negligible cost to the Crown.</p> <p>Though it removes the ability to incentivise participants to move their existing forests to averaging accounting to access the TAE exemption (if existing forests are given this option in the future) there are still other benefits to moving from stock change accounting to averaging, such as reduced compliance burden and access to the offsetting provisions, and for some increased low risk units that will make moving to averaging accounting attractive.</p>		