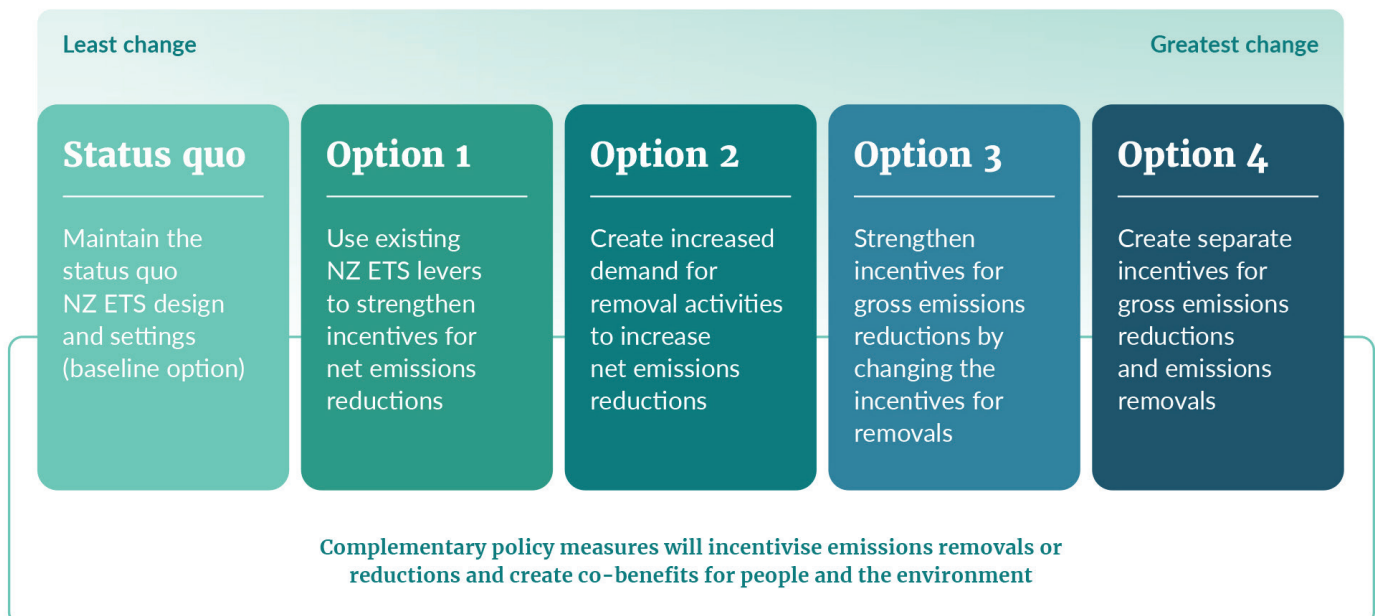




Government Proposed Four Options to Evolve New Zealand's Emissions Trading Scheme

Following the publication of New Zealand's first emissions reduction plan in 2022, the New Zealand Government has now released a discussion document seeking public feedback on four potential options for the future of NZ's Emissions Trading Scheme (ETS), alongside the status quo. There was a second discussion document released relating to the permanent forest category in the ETS. The Government's discussion documents outline perceived concerns regarding the oversupply of New Zealand Units (NZUs) derived from forests, the dominance of pine tree planting, the long-term instability of the NZU price if the ETS is left untouched, and the need for continued efforts beyond 2050 to align with international goals.



[Source: Ministry for the Environment: Review of the New Zealand Emissions Trading Scheme. June 2023] [Click here.](#)

This consultation adds to the uncertainty created in the primary and secondary ETS markets following the Government not accepting the Climate Change Commission's budget and price setting advice for the 2023-2025 years. The Commission's latest advice on New Zealand's second emissions reduction plan including the 2026-2030 emissions budget doubles down on its previous advice and reflects tighter changes to settings and budgets to make up for the 2023-2025 years.

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Forest Planting and NZU Oversupply?

The discussion documents acknowledge the risk of forest-removal NZUs creating an oversupply and potentially causing a decline in NZU prices. It explains how different prices could be needed to force gross emissions down and another price to incentivise removals by forestry. Option three could potentially be used as a transition towards option four, which involves differential pricing for NZUs with forest-removal NZUs outside the ETS.

However, its forecast does not appear to include a decline in forest planting as NZU prices decrease and therefore it fails to address the potential consequences of falling NZU prices on future forest planting.

If you believe the optimistic assumptions on falling gross emissions, New Zealand has potentially already planted enough forests to reach its goals by 2035. However, additional forest planting is necessary to achieve net-zero emissions by 2050. Beyond 2050, sustained efforts are required to align with international standards, as limiting global temperature increases to below +1.5 or +2.0 degrees Celsius will necessitate countries becoming net-negative emitters.

The discussion document is silent on the issue of grandparenting existing forests and offtake agreements within the current ETS. This lack of clarity raises concerns about how these aspects will be addressed and regulated in future ETS arrangements. We expect any changes implemented would likely include "grandparenting", as retrospective changes are infrequent in governmental policies, but there is potential that removals by forestry will not be able to be used after 2024.

We expect there will be minimal trees planted until the uncertainty is resolved which isn't good for encouraging emissions removals and will potentially require a higher carbon price in the future to suppress New Zealand's gross emissions.

Climate Change Focus and the Political Decision

In the discussion document, the Government emphasised that a higher emissions price is critical to decarbonisation and meeting New Zealand's climate goals. The four options discussed consider different ways to encourage emission reductions, alongside the existing ETS offsetting mechanism, to attempt to have the greatest long-term chance of climate change mitigation. However, the challenge is the options that may utilise both levers optimally are also more complex and will take time to engage on and design to ensure the additions are fit for purpose.

What was clear on the public zoom meeting held on the 27th of June was the outcome of this current consultation will not be communicated prior to the election and it will be over to the new Government to determine the outcome and next steps. If the Government chooses to move to the more complex options 3 or 4 which will require "multiyear implementation", how much uncertainty associated price suppression are they prepared to allow in the meantime and what are the consequences of the lower price in meeting New Zealand's Paris Agreement commitments? Some commentators believed that New Zealand was already on track to miss its Paris commitments for the 2020 to 2030 period by over 100m tonnes of emissions. At a nominal \$50 per tonne to make good on our commitment equates to a cost to the taxpayer of \$5.0 billion.

Implications for NZU Prices

Our research indicates that, on average, an NZU price of over \$40 would be required to generate appropriate rate of return (IRR) on a new radiata pine forest that was planted under a framing timber regime and harvested at 27 years. The economic implications of creating uncertainty in a market that requires long term investment horizons

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will be clearly demonstrated as investment in new forests stops due to dwindling returns. We are also hearing of offtake agreement negotiations being put on hold and we would expect the lawyers for emitters will be dusting off the existing offtake agreements looking for ways to get out of them (force majeure). All of this will have a significant negative impact on further forestry planting. There is major damage being done to the investment profile of New Zealand forestry at a time when it was already struggling with low log prices, the impacts of climate change, and surging costs.

The failure of the first two NZU auctions in 2023 shows how the NZU market moved to fix the Government's decision to ignore the Climate Change Commission advice to reduce the amount of NZUs it was selling into the auctions. There will be no pressure on emitters to buy in the auctions for the next two years as they will likely be able to source and surrender forestry-removal NZUs at a discounted price. Consequently, there is now a high probability that the September 2023 and December 2023 auctions will also not see any NZUs sold by the Government resulting in a reduction of 17.9m tonnes of NZUs that were forecast to be available in 2023.

Conclusion

The New Zealand Government's discussion document presents four potential options for the future of the ETS. While it highlights certain concerns, such as oversupply and the dominance

of pine tree planting, it lacks detailed forecasts and clarity on crucial aspects such as grandparenting and offtake agreements.

To meet New Zealand's NDC and emission reduction goals to mitigate climate change, we need a much higher carbon price than \$40 to incentivise gross emissions reductions and encourage removals by forestry, and we need to plan for continued efforts beyond 2050 to align with international targets.

The current slump in the NZU price due to the uncertainty created by the release of vague review options that will be decided by someone, sometime in the future, will see the forestry industry react by not planting more trees, and the pressure come off emitters to reduce their gross emissions.

Industry commentators expect the market to increasingly price forest-removal NZUs ("NZU_FA" and "NZU_FE") at a discount to other types of NZUs. The manager of the Carbon Fund has moved to protect the interests of unit holders from this potential price dislocation and the Fund no longer holds any forest-removal NZUs having switched entirely into other NZUs. However, the Manager is investigating opportunities this potential dislocation of NZU pricing may present for the Fund.

The final decision and its impact on climate change mitigation efforts will ultimately be a political one but it needs to be a priority for the next Government.

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