

# Regulatory Impact Statement

## Regulatory Impact Statement

### Re-registration arbitrage by post-1989 forest land participants in the ETS

#### Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by the Ministry for the Environment and the Ministry for Primary Industries. It provides an analysis of options to address re-registration arbitrage by post-1989 forest land participants in the New Zealand Emissions Trading Scheme (ETS).

Re-registration arbitrage creates potentially significant fiscal costs to the Crown. There are uncertainties around the exact fiscal cost because we cannot be certain of the rate of re-registration that may occur and the future carbon price. A range of potential costs have therefore been provided. In spite of this uncertainty, re-registration arbitrage is an unintended consequence (arising from the price difference of Kyoto units and New Zealand Units (NZU), and certain design features of the ETS), and it carries significant fiscal and reputational risks that should be addressed immediately.

Officials have not publicly consulted on this policy proposal because it risks accelerating the rate of re-registration arbitrage.

The preferred option will restrict post-1989 forest land participants to the use of NZUs when surrendering the unit balance of a carbon accounting area deregistered from their participation. This may be perceived as unfair by the sector because it imposes a restriction on their use of Kyoto units, whereas other sectors continue to have unrestricted use. We consider this option equitable because arbitrage through deregistration is an opportunity unique to the sector, and this policy will continue to enable post-1989 forest land participants to access a similar range of least-cost abatement options that exist for other sectors.

There are uncertainties in how this policy will play out post-2020 when we expect to have a new global agreement on climate change mitigation and potentially more ambitious emissions targets. This policy may need to be reviewed in the future to ensure consistency with any changes.

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Date:

Date:

## Background

### *The New Zealand Emissions Trading Scheme*

1. The New Zealand Emissions Trading Scheme (ETS) came into force in September 2008. Its key objectives are to assist New Zealand in meeting its international climate change commitments and to reduce emissions below business-as-usual levels. The Climate Change Response Act 2002 (CCRA) provides the legal framework for the implementation, operation and administration of the ETS.
2. The ETS is based around a trade in emissions units that represent a tonne of carbon dioxide equivalent. Eligible emission units in the ETS include the domestic New Zealand Unit (NZU) and international Kyoto Protocol units. Most emitting sectors face mandatory obligations under which they must surrender emissions units to the government annually. Those who remove greenhouse gases, such as post-1989 forest land participants can receive NZUs.

### *Post-1989 forestry participation in the ETS*

3. As a voluntary sector in the ETS, persons with an interest in post-1989 forest land may register in, or deregister from the ETS at any time and may register as little or as much of their land as they choose. At February 2014, there were 2,364 post-1989 forestry participants registered in the ETS representing approximately 330,000ha of land.
4. Post-1989 forest land applicants are required to define one or more carbon accounting areas (CAA)<sup>1</sup> when they register into the ETS. A running balance (the 'unit balance') of carbon dioxide removals and emissions is maintained for each CAA. Participants must make emissions returns covering statutory five-year periods (mandatory emissions reporting period or MERP<sup>2</sup>), but may make voluntary returns covering a year or years within a MERP.
5. On deregistration of a CAA, participants are required to surrender its unit balance. Participants are able to surrender any eligible unit (including Kyoto units) to meet their surrender obligations. This is consistent with surrender obligations for other sectors.

### *Arbitrage in the ETS and relevant Cabinet decisions*

6. Since late 2012/early 2013 the prices of Kyoto units have dropped dramatically (from around NZD\$20 per unit in June 2011 to NZD\$0.35 in February 2014). Trends in NZU price have followed this drop in price and are trading at a price higher than that of a Kyoto unit (NZD\$3.50). This price divergence is due to an oversupply in international markets for Kyoto units (notably within the European Union Emissions Trading Scheme) which have led to a drop in prices for these units.
7. As a result of this price difference, certain participants in the ETS have engaged in arbitrage by receiving NZUs from the government (either as free allocations or

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<sup>1</sup> A CAA is an area of post-1989 forest land determined by the participant during ETS registration process that is the basic unit for which accounting of carbon gains and losses is calculated.

<sup>2</sup> A MERP is a five-year accounting period for calculating carbon stock change over time for a CAA. At the end of the period all post-1989 forestry participants must file a mandatory emissions return which includes a reconciliation that takes into account any emissions returns voluntarily filed during the five-year period, and any units received/surrendered as a result of those returns. The first MERP was 2008-12.

entitlements for removal activities), acquiring lower value Kyoto units directly from international markets or through carbon traders, surrendering these to the Crown to meet their emissions obligations, and retaining their higher value NZUs. These retained NZUs can be either be sold in the domestic market with the participant profiting from the price difference or using them for future liabilities (referred to in this paper as broader arbitrage).<sup>3</sup>

8. The high surrender rate of Kyoto units by all sectors in the ETS has led to **withheld** NZUs being held in private accounts (representing **withheld** years' worth of obligation), and increased the Government's holding of Kyoto units beyond the level required to meet its international commitments<sup>4</sup>. This presents fiscal risks for the Crown, as any units held in excess of those required to meet international commitments may not be able to be traded. The stockpile of NZUs also represents a mounting provisional liability.
9. In response to this stockpiling issue, Cabinet agreed on 25 November 2014 to restrict participants' access to Kyoto units from 31 May 2015 [CAB Min (13) 41/12 refers], essentially making the ETS a domestic-only scheme from this point onwards. As a result of this decision, opportunities for arbitrage by all sectors in the ETS will cease from this time. However, re-registration arbitrage by post-1989 forest land participants carries potentially significant fiscal costs and reputational risks from now until May 2015.

## Status quo and problem definition

### Status quo

10. Post-1989 forest land participants have additional opportunities to arbitrage NZUs (that other ETS participants do not have) by their ability to opt-in and out of the ETS multiple times for the same area of forest land. Each time they receive an allocation of NZUs for what is effectively the same area of land back to the start of the current MERP (1 January 2013). This is referred to as re-registration arbitrage.
11. From June to December 2013, the Ministry of Primary Industries (MPI) received 550 applications to deregister land from the ETS (representing approximately 40% of post-1989 forest land area in the ETS). 208 of these have subsequently applied to re-register.
12. Re-registration arbitrage is unique to post-1989 forest land participants as they are the only sector able to both sequester and produce emissions (thereby earning and repaying units) and voluntarily opt-in and out in the ETS. The first opportunity for participants to claim NZUs for increases in their carbon stock that occurred in 2013, started on 1 January 2014. We therefore have only seen the beginning of potential re-registration arbitrage activity for the current MERP.
13. Re-registration arbitrage may be done once a year, or multiple times within a year. Between the start of 2014 to mid-February, 16 participants (accounting for 4% of the

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<sup>3</sup>For example, emission intensive and trade exposed industries (EITE) are able to arbitrage as they receive free allocations of NZUs from the Government as compensation for the costs imposed by the ETS. Some of these EITE industries are also participants and are able to surrender lower cost Kyoto units rather than NZUs.

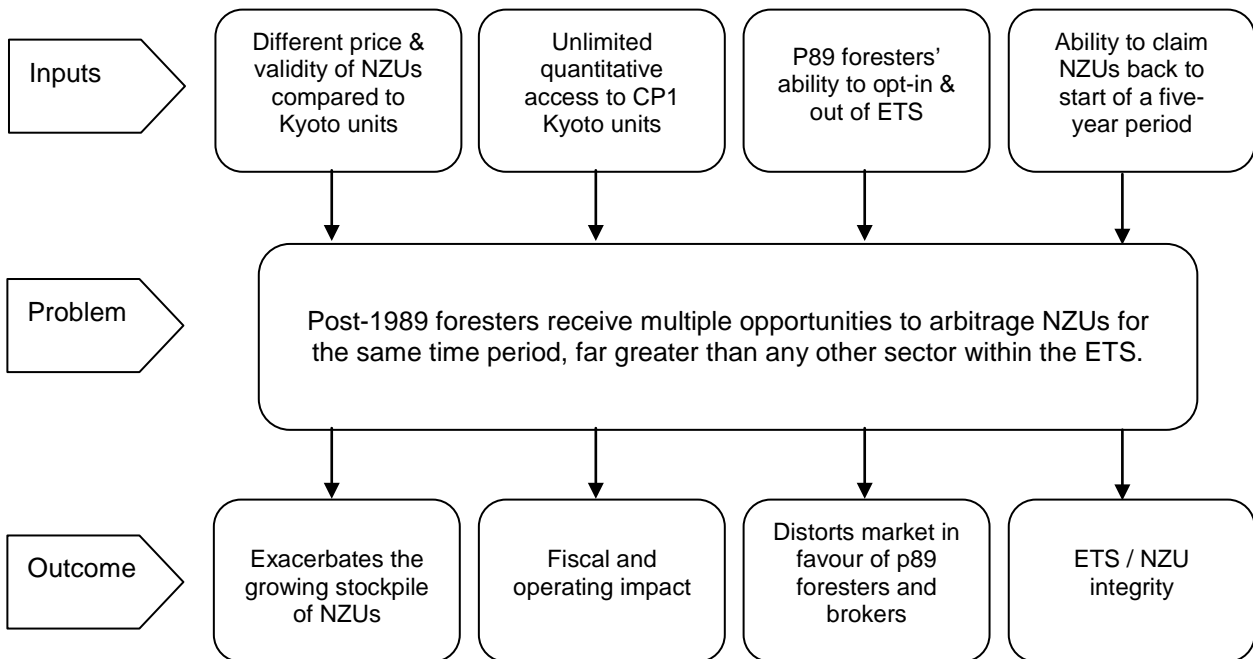
<sup>4</sup> Approximately 97% of total emissions liabilities have been surrendered using the cheaper Kyoto units for the 2012 compliance year. By comparison, the figure was approximately 5% for the 2010 compliance year.

post-1989 forest land in the ETS) had deregistered from the ETS and are now seeking re-registration. When they are re-registered, these participants could claim in 2015 a second round of NZUs for 2013 and one round of NZUs for the 2014 year. Although only 16 participants have confirmed their intention to date, we consider that the number will increase. MPI has received 48 applications (representing approximately 10% of total post-1989 forest land area in the ETS) to deregister for which units have been allocated for the 2013 voluntary emissions return period.

14. It is also possible for forestry participants to de-register and re-register multiple times within the same calendar year. The maximum additional fiscal risk arising due to this activity could range from \$9M to \$124M. While it is theoretically possible for this to happen, the risk is mitigated by the time it takes to process applications for registration. The process can be complex, and when considered against the wider work programme of the MPI spatial analysis team, and the analysis of past service delivery by MPI, it supports a conclusion that it is unlikely that there would be sufficient time for a participant to claim NZUs more than once in a single calendar year. This has therefore not been included in the estimated fiscal costs.
15. The NZUs held by post-1989 forest land participants as a result of deregistering from the ETS are obligation free as these participants have cleared their liability using cheaper Kyoto units. These NZUs may be sold onto the domestic market.

**Problem definition:**

16. The problem associated with re-registration arbitrage is illustrated below:



17. The core of the problem is that post-1989 forest land participants are receiving multiple opportunities to arbitrage NZUs for the same time period through deregistering from the ETS and re-registering back in. Although it is a permitted activity under the CCRA, it is an unintended consequence resulting from the interplay of the current difference in value between an NZU and Kyoto unit, and other ETS design features (including the voluntary nature of the sector in the ETS, and the perpetual validity of NZUs compared to the limited validity of Kyoto units, the majority of which must be used for surrender by

31 May 2015). While it was anticipated that the voluntary nature of post-1989 forestry participation in the ETS would incentivise participation, it was not anticipated that their ability to repeatedly register and deregister for the purposes of arbitrage would impose such significant fiscal costs to the Crown

18. Broad scale arbitrage by post-1989 forest land participants was identified in July 2013 shortly after the emergence of a price differential between NZUs and Kyoto units. The magnitude of the problem was only fully understood following analysis undertaken to support decisions to restrict access to Kyoto units in the ETS beyond May 2015<sup>5</sup>. This analysis identified a large number of NZUs being stockpiled in private accounts and an increase in the Government’s holding of Kyoto units beyond the level required to meet its international commitments. It became apparent that post-1989 forest land participants’ ability to arbitrage through deregistration was contributing significantly to this issue.
19. Forestry sector commentary suggests foresters consider the current situation enabling arbitrage through voluntary deregistration a ‘loophole’ in the legislation, and it is assumed the Government will take steps to address this activity at some point (see Appendix 2 for a forestry consultant’s view on arbitrage opportunities in the ETS).

*Potential fiscal costs*

20. The potential fiscal cost from re-registration arbitrage is presented below. The wide range reflects the spread of potential rates of re-registration and future carbon prices.

	<b>\$million – Increase/(decrease)</b>		
	<b>2014/15</b>	<b>2015/16</b>	<b>Total</b>
<b>Low Range<sup>6</sup></b>	(\$11.5)	(\$27)	(\$38.5)
<b>Mid-Range<sup>7</sup></b>	(\$36.3)	(\$84.7)	(\$121)
<b>High Range<sup>8</sup></b>	(\$66)	(\$165)	(\$231)

21. There are uncertainties around the rate of re-registration arbitrage because it is a relatively new opportunity in this current MERP, and at this point in time there is limited evidence of market behaviour to accurately indicate the likely rate of uptake in the coming years. The biggest risk is that forestry consultants are publicly promoting the financial benefits of this arbitrage opportunity, which is likely to significantly increase uptake. We also expect re-registration arbitrage to increase over time as the benefits of such an opportunity become more apparent and foresters gain more experience in the process.

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<sup>5</sup> This analysis was undertaken following New Zealand’s decision to take a commitment under the UNFCCC Convention Framework rather than take a commitment under the second commitment period of the Kyoto Protocol. Under UNFCCC rules agreed in Doha in late 2012, access to Kyoto markets was restricted to countries taking a commitment under the second commitment period of the Kyoto Protocol.

<sup>6</sup> Low range assumes 35% of post-89 forest land area arbitrage; an NZU price of \$3.50; and Kyoto unit price of \$.50. A maximum of 11M NZUs is forecast to be issued to post-1989 foresters for the each year. This number has been used for all scenarios.

<sup>7</sup> Mid-range assumes 55% of post-89 forest land area arbitrage; an NZU price of \$7; and Kyoto unit price of \$1.

<sup>8</sup> High range assumes 75% of post-89 forest land area arbitrage; an NZU price of \$10; and Kyoto unit price of \$2.

22. In relation to uncertainty around future carbon prices, the current carbon price is fluctuating at around \$3.50 for NZUs, the decision to close the ETS to international units (making the NZU the only eligible unit in the ETS from May 2015) which could cause prices to rise.
23. Considering the potentially significant fiscal costs, there is urgency in addressing this issue as soon as practicable, preferably in the current fiscal year in order to avoid costs incurred in 2014/15.

#### *Other associated issues*

24. Re-registration arbitrage results in increased costs to the Crown with no added reduction in emissions (it is neutral from an environmental impact perspective). It creates a reputational risk for the ETS in that it lowers perceptions of the integrity of the ETS and NZUs through allowing individuals to “game” the system. Such perceptions would contribute to concerns internationally as to the environmental integrity of carbon units from planted forests.
25. Although this problem has been presented in terms of the 2014 to 2015 years, it may continue as a long-term problem. The decision to restrict access to Kyoto units from 31 May 2015 is not permanent and the Government has indicated that it will review its decision once international conditions are better suited to our domestic needs. Should these market conditions occur again and the policy settings remain, the problem is highly likely to resurface.

## Objectives

26. The objectives of the preferred option are to:
  - prevent re-registration arbitrage quickly and efficiently, while ensuring fairness across sectors within the ETS; and
  - maintain the general intent and design features of the ETS (the voluntary participation of the post-1989 forestry sector in the ETS; access to low-cost abatement options, such as Kyoto units; and incentivising afforestation of post-1989 forest land).

## Assessment criteria

27. In order to meet the objectives, the following criteria should be met:
  - a. **Effectiveness:** the option can reduce or prevent the potential fiscal costs associated with re-registration arbitrage;
  - b. **Timeliness:** the option can be implemented quickly (preferably in the current fiscal year);
  - c. **ETS integrity:** the option maintains consistency with the intent of the ETS;
  - d. **Equity:** the option is fair and does not significantly advantage / disadvantage a sector in comparison to other sectors within the ETS; and
  - e. **Efficiency:** the costs on society for adopting and implementing the option are justified by the benefits to society.

## Regulatory impact analysis

### Options

28. The following options have been identified to prevent post-1989 forestry re-registration arbitrage:
1. *Regulations*: amend the methodology used to calculate carbon stock (and therefore NZU entitlement) for post-1989 forest land to exclude carbon stock included in previous emission returns for the same forest land
  2. *Legislation*: amend the CCRA to ensure emissions returns can only account for changes in carbon stock since the date of the previous return in the current MERP for an area of post-1989 forest land
  3. *Legislation*: amend the CCRA to only allow post-1989 forest land to be registered once in a MERP
  4. *Legislation*: amend the CCRA to restrict post-1989 forest land participants to the use of NZUs when surrendering the unit balance of a carbon accounting area deregistered from participation in the ETS.
29. Only option four deals with both elements of the problem (i.e. arbitrage at deregistration and the allocation of multiple rounds of NZUs at re-registration), while options one to three target the problem at the point of re-registration.
30. Other options considered but deemed ineffective **withheld** include a non-regulatory approach of adopting a different interpretation of the CCRA which would not allow re-registration arbitrage; and regulations to restrict post-1989 foresters to the use of NZUs when surrendering the unit balance of a CAA on deregistration.

### Options analysis

31. This section provides a discussion on the key advantages and disadvantages of each option in relation to the criteria, and summarises our assessment of the impacts in Table 1.

#### *Option 1: Regulations*

32. This option involves an amendment to the methodology in regulations used to calculate carbon stock change (and therefore NZU entitlements) for post-1989 forest land to exclude changes in carbon stock since the date of the last emissions return made in a MERP for an area of post-1989 forest land.
33. A key disadvantage to this option is the time it takes to develop and implement the regulations (approximately one year), and the legislative requirement to consult which risks accelerating the rate of re-registration in the 2014/15 year.
34. It is also administratively complex and costly for both participants and administering departments, and undermines the intent of both the legislation and existing regulations to ensure accurate accounting of carbon stock change because:
- As the agency responsible for administering post-1989 forest land emissions returns, MPI would be required to track forest land between periods of registration to ensure emissions returns are consistent with the history of that land. Currently, when land is deregistered MPI is not required to keep records of that land because if it is re-entered in the ETS it is considered new and can claim NZUs back to the start of the MERP. Tracking land for either the same or a different participant raises significant operational issues associated with data management and added complexity in GIS assessments. If this requirement is introduced, MPI operating processes and databases would require substantial updating. Additional

resources would also be required to ensure MPI meets its statutory timeframes for processing emissions returns.<sup>9</sup>

- For post-1989 forest land participants, this option would require them to have knowledge of the history of an area of post-1989 forest land in terms of its registration status in the ETS, including time periods during which they may not have owned the land. There would also be increased administrative complexities for participants who add or remove land, or reconfigure their CAAs, which is likely to go beyond the capabilities of the majority of participants for calculating the changes in their carbon stock<sup>10</sup>. These complexities are likely lead to an increase in erroneous emission returns which could result in compliance action.
- Restricting emissions returns to consecutive periods also risks weakening the key principle of providing for returns to be reconciled to improve the accuracy of forest carbon accounting. These returns purposefully operate over an entire MERP, and over-ride any earlier less accurate voluntary returns. Improved accuracy substantially reduces the potential fiscal risk to the Crown of over-allocation of emissions units to afforestation on erosion-prone pasture lands with poor growth rates, and provides equity for ETS participants. The Field Measurement Approach (FMA) was implemented in the forestry sector regulations in 2011 specifically to provide tables with greater accuracy.

35. The costs associated with this administrative complexity are not expected to be greater than the potential costs associated with the status quo, but will require additional resources above MPI's baseline, estimated at approximately \$0.75m.

36. **Withheld**

37. This option is **not preferred** because it is less effective and cannot be implemented quickly; **withheld**; and is inefficient from an administration point of view.

#### *Option 2: Legislation*

38. This involves amending the CCRA to ensure emissions returns can only account for changes in carbon stock since the date of the previous return within a MERP for an area of post-1989 forest land (whether registered by the current participant, or any previous participant).

39. This approach will effectively prevent re-registration arbitrage in the long term by providing that claims for emissions units must be sequential, and is considered consistent with the intent and design features of the ETS. However, a key disadvantage is the time it takes to implement the changes, estimated at one year, due to the operational changes required (as explained in paragraphs 34 and 35).

40. Further, there are likely to be significant complexities in drafting such an amendment to the CCRA. The forestry provisions in the CCRA are complex and intertwined, and it would require significant additional detail to be added into the voluntary and mandatory

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<sup>9</sup> Costs for updating MPI processes and operations are estimated to cost \$0.75 million and take a year to implement. An additional 3 – 5 FTEs are required.

<sup>10</sup> Approximately 2000 post-1989 forest land participants currently use MPI's online mapping tool for self-amping during registration. As such, MPI would need to develop more sophisticated online mapping software to assist these participants.



emission return provisions. An amendment of this nature carries the risk of creating further unintended consequences to the post-1989 forestry regime within the CCRA.

41. This option is **not preferred** due to the added complexities it would create in administering post-1989 forestry in the ETS and the time it would take to implement.

#### *Option 3: Legislation*

42. This option involves amending the CCRA to only allow post-1989 forest land to be registered once in a MERP. While it would effectively prevent re-registration arbitrage, it would fundamentally alter the voluntary nature of post-1989 forestry participation in the ETS. Placing restrictions on when forest land can be registered could discourage afforestation, whereas the ETS is part of a policy suite to incentivise increased afforestation.
43. There are equity implications with this option, as it effectively excludes any land that is deregistered for genuine reasons (e.g. due to sale of the forest) from being re-registered. This is likely to discourage participation in the ETS.
44. As with options one and two, it would require the tracking of areas of forest land in relation to ETS registration, resulting in significant administrative burdens. However, the administrative costs of this option are likely to be less than options one and two because it will only require the auditing of registration status rather than tracking of emissions returns submitted for that forest land. This option is **not preferred**.

#### *Option 4: Legislation*

45. This option involves amending the CCRA to restrict post-1989 foresters to the use of NZUs when surrendering the unit balance of a CAA when deregistering as a participant for that CAA. This option simply requires participants to pay back the same type of unit they received from the Government if they decide to deregister from the ETS.
46. This option would effectively prevent re-registration arbitrage, and does not impinge on key design features of the ETS in relation to the post-1989 forestry sector. However, it is a divergence from the general principle in the CCRA that any eligible unit type (including Kyoto units) may be used to meet ETS liabilities.
47. This change may be perceived as unfair by post-1989 forest land participants because it imposes a restriction on their use of Kyoto units whereas other sectors continue to have unrestricted use. This option is considered equitable as the ability to deregister from the ETS for arbitrage purposes is unique to the sector, and will still allow post-1989 forest land participants to use Kyoto units for actual emission obligations (such as obligations arising from harvesting) or repaying any over-allocation of units. The post-1989 forestry sector will therefore have the same range of least-cost abatement options that exist for other sectors.
48. Of all the available options, option four places a more comprehensive restriction on post-1989 forestry arbitrage as it prevents it at the point of deregistration, rather than only targeting at the point of re-registration. This proposal will affect the rate of post-1989 forest land participants filing emissions returns as these participants will no longer have an incentive to deregister from the ETS in order to take advantage of the current arbitrage opportunity. Reducing current arbitrage activity will also reduce the fiscal

costs from the scheme, as well as avoiding the potential costs mentioned above from foresters re-registering and conducting a second round of arbitrage.

49. However, the likely amount of this additional fiscal benefit (and when the Crown will incur this benefit) is unclear, as the proposal will change the profile of emissions returns across financial years. Without the ability to deregister and surrender Kyoto units, foresters will delay returning units to the Government until they face obligations from actual emissions (harvesting). This is likely to reduce revenue in 2014/15, and increase revenue in later years, as participants return higher value domestic units.
50. This proposal will also reduce the level of stockpiling of NZUs on behalf of post-1989 participants by creating further demand for NZUs.
51. This option can effectively prevent re-registration arbitrage. It is the simplest, quickest and least costly option for the post-1989 forest land participants and administering departments to implement. All costs of implementation can be met through current baselines. This option is therefore **preferred**.



## Regulatory impact analysis

### Summary of Options Analysis

(Criteria: A = Effectiveness, B = Timeliness, C = ETS Integrity, D = Equity, E = Efficiency)

ü = meets the criteria — = partially meets the criteria X = does not meet the criteria (assessment based on information provided in paragraphs 32 to 51)

Options	Criteria					Impacts	Net Impact
	A	B	C	D	E		
<p><u>Objectives:</u></p> <ul style="list-style-type: none"> <li>to prevent or limit the potential fiscal costs associated with re-registration arbitrage; and</li> <li>maintain the general intent and design features of the ETS (the voluntary participation of the post-1989 forestry sector in the ETS; access to low-cost abatement options, such as Kyoto units; and incentivising afforestation of post-1989 forest land).</li> </ul>							
<p><b>1. Regulations:</b></p> <p>Amend the methodology used to calculate carbon stock (and therefore NZU entitlement) for post-1989 forest land to exclude carbon stock included in previous emission returns for the same forest land</p>	X	X	—	ü	X	<p><b>ECONOMIC:</b></p> <ul style="list-style-type: none"> <li>Likely to disadvantage those post-1989 foresters that have purchased Kyoto units in anticipation of committing re-registration arbitrage. <b>Withheld</b></li> <li>A significant portion of these participants are pre-1990 foresters and most of these units are likely to be used for deforestation liabilities. Although, post-1989 foresters can no longer use Kyoto units they may hold for re-registration arbitrage, they can still use them for liabilities incurred for harvesting or deregistration or may be on-sold.</li> <li>Removes the economic opportunities presented to post-1989 foresters through re-registration arbitrage.</li> <li>Increased costs and time for participants to calculate</li> </ul>	<p><b>Improves</b> – this option will prevent re-registration arbitrage as long as it withstands any legal challenge that might arise. It will result in increased complexity in administering post-1989 forest land in the ETS for participants and administering departments</p>

						<p>carbon stock change.</p> <p><b>FISCAL:</b></p> <ul style="list-style-type: none"> <li>· If implemented prior to 1 January 2015 most costs will be avoided in the 2014/15 year (ranging from \$11.5m to \$66m); and all costs avoided for the 2015/16 year (\$27m to \$165m).</li> <li>· Increased MPI operating costs estimated at \$0.75m, with an additional 3-5 FTEs, above baselines.</li> </ul> <p><b>RISKS:</b></p> <p><b>Withheld</b></p> <ul style="list-style-type: none"> <li>· Administrative complexities risks MPI not meeting statutory timeframes to process emissions returns.</li> </ul>	
<p><b><u>2. Legislation:</u></b></p> <p>Amend the CCRA to ensure emissions returns can only account for changes in carbon stock since the date of the previous return in the current MERP for an area of post-1989 forest land</p>	ü	x	ü	ü	x	<p><b>ECONOMIC:</b> Same impact as option 1.</p> <p><b>FISCAL:</b> Same impact as option 1.</p> <p><b>RISKS:</b></p> <ul style="list-style-type: none"> <li>· The complexity in drafting risks creating further unintended consequences to the post-1989 forestry regime in the CCRA.</li> <li>· Administrative complexities risks MPI not meeting statutory timeframes to process emissions returns.</li> </ul>	<p><b>Improves</b> – this option will effectively prevent re-registration arbitrage but will result in increased complexity in administering post-1989 forest land in the ETS for both the participant and administering departments.</p>
<p><b><u>3. Legislation</u></b></p> <p>Amend the CCRA to only allow post-1989 forest land to be registered once in a MERP</p>	ü	ü	x	x	x	<p><b>ECONOMIC:</b> Same impact as option 1.</p> <p><b>FISCAL:</b></p> <ul style="list-style-type: none"> <li>· Fiscal costs prevented in 2014/15 and 2015/16 (\$38.5 to \$231m). Same operating impact as option 1.</li> </ul> <p><b>RISKS:</b></p> <ul style="list-style-type: none"> <li>· May affect land transfers/sales of land where the land</li> </ul>	<p><b>Improves</b> – this option will effectively prevent re-registration arbitrage but is contrary to the voluntary nature of the post-1989 forestry sector in the ETS, and may result in</p>

						<p>has already been registered once in MERP.</p> <ul style="list-style-type: none"> <li>Administrative complexities risks MPI not meeting statutory timeframes to process emissions returns.</li> </ul>	<p>decreased participation. It will also result in increased complexity in administering post-1989 forest land.</p>
<p><b>4. Legislation:</b></p> <p>Amend the CCRA to restrict post-1989 foresters to the use of NZUs when surrendering the unit balance of a carbon accounting area on deregistration from the ETS</p>	ü	ü	—	—	ü	<p><b>ECONOMIC:</b></p> <ul style="list-style-type: none"> <li>Removes the economic opportunities of arbitrage through deregistration.</li> <li>May disadvantage foresters who hold Kyoto units in anticipation of arbitraging through deregistration. These foresters will be able to use such units for emissions liabilities (e.g. harvesting) or on-sell them.</li> </ul> <p><b>FISCAL:</b></p> <ul style="list-style-type: none"> <li>Reduced fiscal costs of the ETS as it targets arbitrage at deregistration (amount and timing of fiscal savings is currently unclear). Fiscal costs associated with re-registration arbitrage prevented in 2014/15 and 2015/16 (\$38.5 to \$231m).</li> <li>Reduced provisional liability due to reduced stockpiling of NZUs.</li> <li>Implementation costs met at current baselines.</li> </ul> <p><b>RISKS:</b></p> <ul style="list-style-type: none"> <li>Risk of incentivising post-1989 foresters to bank their NZUs for future use rather than sell them to the market for cash flow which may affect liquidity.</li> </ul>	<p><b>Improves</b> – this option effectively stops re-registration arbitrage, continues to allow post-1989 foresters to meet their emissions obligations in the most cost-effective manner, and is administratively straightforward for participants and administering departments.</p>

52. Option four is recommended because it addresses the problem in an effective and timely manner; it provides a straightforward and unambiguous approach for participants; and will not result in significant operational changes for departments administering the ETS.

### **Consultation**

53. We have not consulted with any interest groups on this matter. A key reason for this is that consultation will indicate to the market that the Government is considering intervention on this activity, which could accelerate the rate of re-registration arbitrage. It is considered that this risk outweighs the value that consultation on this matter may bring.
54. Putting the deregistration and re-registration application process on hold while consultation occurred was considered. However, this is not possible as the CCRA prescribes the timeframe and process for treating deregistration applications.
55. The Treasury and the Environmental Protection Authority (EPA) were consulted and support the preferred option.

## Conclusions and recommendations

56. Option four is recommended as it will prevent re-registration arbitrage quickly and efficiently; and maintains the intent of certain design features in the ETS (voluntary nature of the sector in the ETS; continued access to low cost abatement through the use of Kyoto units; and providing incentives for afforestation).
57. It should be noted that there are uncertainties in how this option will play out in post-2020 when we expect to have a new global agreement on climate change mitigation and potentially more ambitious emissions targets. This policy may need to be reviewed in the future to ensure consistency with any changes.

## Implementation

58. The new provisions of the CCRA will not apply to deregistration applications received by MPI prior to the enactment of amendments to the CCRA.
59. **Withheld**
60. Considering the fiscal implications of this issue, amendments to the CCRA will be introduced as part of the Budget 2014 process. A press statement will accompany the introduction of the bill. MPI will ensure that all participants are aware of the new rules through promotion on its website and the Sustainable Forestry Bulletin. Workshops may also be run to provide interested parties with information on why changes were made and how it affects them.
61. The EPA is responsible for the management of participants' unit obligations and entitlements under the CCRA, including ensuring compliance with obligations to surrender units. The EPA is confident that the preferred option for addressing re-registration arbitrage can be administered within its baseline. MPI is responsible for administering post-1989 forestry land area in the ETS. The proposed policy may result in additional GIS work but this can be met by current baselines.
62. For auditing the compliance of this policy, the ETS takes a self-assessment approach whereby participants are responsible for measuring, reporting and verifying emissions while central government has the power to audit applications and impose penalties. This policy proposal will not introduce additional auditing work as MPI already audit post-1989 forestry emission returns.

## Monitoring, evaluation and review

63. The Ministry for the Environment is currently establishing a monitoring and evaluation project of the ETS. This will put in place on-going monitoring and data collection of the ETS, and assess over time how well the ETS is delivering and will deliver its intended outcomes and outputs; and whether the ETS is efficient from an administrative and operational point of view. Data will be routinely collected over time related to the effectiveness of this policy (e.g. whether this policy has a significant impact on liquidity in the market; or if it has impacts on post-1989 forestry participation in the ETS), and how it works with any advancement in international negotiations to ensure that it remains fit for purpose.



64. Although there are no statutory requirements to review the ETS regularly, a formal review of the ETS is currently proposed for 2015. This review will be a comprehensive review of ETS policy and will provide an opportunity to report back on this amendment.



## Appendix 2: Website promoting arbitrage within the ETS

Carbon Forests Services website: <http://www.carbonforestservices.co.nz/exit-ets.html>

# Now is the Time to Act- Wipe Your ETS Carbon Liability

## The Opportunity

Right now the price of international Kyoto units (ERUs) are less than NZUs. The NZ government accepts these as replacement credits for foresters wishing to exit the ETS.

## Why Exit?

Every NZU issued to a post-1989 forest has an associated contingent liability. Meaning that the unit has to be repaid to the Government at time of harvest or in the event of loss such as through a fire. By exiting the ETS this liability is wiped clean by giving the Government cheap foreign credits. This means at time of harvest (or if there is an adverse event) no carbon needs to be repaid. While the NZU price is currently low it could be back at >\$20/unit at time of harvest. Leaving the ETS zeros that risk.

## Benefits

The major benefit is wiping the liability associated with issued NZUs.

For some this opportunity provides a significant windfall having sold NZUs at \$20/unit and now paying back for cents. There is also an opportunity to cash in on your existing NZU holdings. NZUs are worth more than ERUs (**contact us** for up to date pricing). Another option is to 'bank' your NZU holdings if you believe the NZU price will increase into the future.

## Why Act Now?

The market and regulatory settings are right now. But these will change. International credits will not be able to be used in New Zealand from 2015 onwards, however it is possible that the loophole may get closed earlier. Also the price of ERUs may increase. Acting now eliminates that risk.

## What to do After exiting the ETS?

Once you have exited the ETS and wiped your carbon liabilities you can rejoin again and start earning credits from 2013 forwards. It is a no regrets strategy to do this as you can sit and bank your NZUs. Best of all, if the market and policy settings remain in place or come up again in the future you can repeat the exercise all over again.