

## Proposed changes to the NZ Emissions Trading Scheme and Permanent Forest Category

**Following a recent review of the New Zealand Emissions Trading Scheme by the Climate Change Commission, the government is consulting on both its proposal to reform the ETS and re-design the permanent forestry category.**

In March 2023, the Climate Change Commission undertook a review of New Zealand's emission trading scheme (ETS), looking to provide the government with advice on unit limits and price control settings. The Climate Change Commission concluded at the end of this review that the ETS is not currently incentivising emissions reductions, as it is cheaper to buy units than invest in reducing greenhouse gases. It found that the current structure of the ETS will see even greater areas of New Zealand planted in exotics. That land would then be locked up permanently, unable to be converted to other uses. Currently the ETS scheme allows an unlimited number of NZUs generated from forestry to offset emissions, meaning there is essentially an 'unlimited' amount of New Zealand Units (NZUs) circulating within the market.

To address this, the government has proposed four options which aim to incentivise emitters to prioritise the actual reduction of emissions as opposed to planting trees. The first and second option involve relatively minor changes to the way the market operates, whereas the third and fourth option involve much more fundamental changes.

### ETS Reform

#### *Option 1*

The first option is to reduce the number of NZUs sold through auction, which would raise the carbon price. The idea is that this would incentivise polluters to reduce their emissions faster. However, this option does not address the unlimited supply of NZUs generated from forestry, and could result in more trees being planted in order to drive the price down again.

#### *Option 2*

Option two would allow the government and / or overseas buyers to buy NZUs, increasing the demand for NZUs and again raising the carbon price in the short-term. However, this is seen as likely having minimal impact as there is uncertainty around both the government's appetite to do this and overseas demand for NZUs (and whether they actually meet the international standards for carbon credits).

#### *Option 3*

Option three aims to change incentives by creating two prices for NZUs – one for emission reduction activities and another, lower, price for removal activities. This would therefore make removal activities less financially attractive. There are suggestions however that this option may go too far in removing incentives for removals, which New Zealand still needs in order to meet its climate goals.

#### *Option 4*

Option four proposes the most radical change, removing forestry completely from the ETS and creating a separate system to incentivise such removal. Under this option, emitters could not use NZUs generated from forestry to offset their emissions. The government would have far more control on the cost for businesses emitting by taking over as the sole supplier of NZUs. This would allow a greater focus from the other market on reductions. This option has been viewed most

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favourably by the government. It could however take several years to implement.

A fifth option, of removing forestry from the ETS altogether, was disregarded.

The release of the government's consultation document has attracted criticism from the forestry sector and has created further uncertainty in the market, with the price of NZUs falling to \$39.25 (as at 13 July 2023), an almost two-year low. By way of comparison, the price of NZUs peaked at \$88.50 in late 2022. The next government auction of NZUs is in September and it could be that no units will be sold due to this increasing uncertainty.

### Permanent Forest Category

At the same time as consulting on the reform of the ETS, the government is also consulting on the redesign of the Permanent Forest Category, being forest land that will not be harvested for at least 50 years. This redesign involves reconsidering:

- (a) the types of forests within the category,
- (b) the management of transition forests; and
- (c) the management of permanent forests.

### *Which forests should be allowed into the Permanent Forest Category?*

This is arguably the most important decision as it fundamentally affects the redesign's overall outcomes. The Ministry for Primary Industries (**MPI**) are considering two options:

- (a) allowing only transition forests and indigenous forests to enter the Permanent Forest Category (**Option 1**); or
- (b) allowing exotic forests to enter the Permanent Forest Category, but only under limited circumstances (i.e. only certain types / locations / ownership categories of exotic forests to be allowed) (**Option 2**).

There is commentary in the carbon market / forestry industry that Option 1 would better support the establishment of long-term indigenous carbon sinks. MPI has indicated that additional management may be required for transition forests to ensure they transition from exotic to indigenous species effectively. Accordingly, MPI is also proposing that transition forests may need a new, specific carbon accounting method in order for them to be considered a feasible option within the Permanent Forest Category.

Under Option 2, MPI proposes to limit exotics in the Permanent Forest Category as follows:

- (a) only long-living exotic species would be allowed;
- (b) only Māori-owned land would be allowed; and / or
- (c) only small scale forests on farms (less than 50 hectares) would be allowed.

The rationale behind this is that it would enable higher levels of afforestation, better support Māori aspirations for their land and provide more flexibility for participants to utilise a broader range of forest species and models that are best suited to their land. However, this could also drive exotic afforestation due to the financial incentives within the ETS, and would require the government to clearly define the exceptions / conditions.

We understand that the government's intention is that either Option 1 or Option 2 will be adopted, and the Permanent Forest Category will be changed in approximately 2025. It is not clear what will happen to non-complying forest land that has been registered in the Permanent Forest Category prior to this point. Our assumption (which is based on recent comments by Minister Shaw) is that the government will allow a degree of grand-fathering (i.e. allowing non-complying exotic forests registered in the Permanent Forest Category prior to the change to remain in the Permanent Forest Category and continue to earn NZUs), but this is by no means certain.

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(Continued)

**Consultation**

The consultation period for both the reform of the ETS and redesign of the Permanent Forest Category ends on 11 August 2023. Any recommendations resulting from the consultation will not be enacted until after the general election in October, which means that clarity on these proposals may be some time away.

**Want to know more?**

If you have any questions about the ETS and / or the Permanent Forest Category, please contact our specialist [Carbon Trading, Emissions trading Scheme and Climate Change team](#).