Coversheet: Extending access to the fixed-price option to emissions from the start of 2020 at $35

Advising agencies	*MfE, MPI*
Decision sought	*Amend the Climate Change Response (Emissions Trading Reform) Amendment Bill (the Bill) via supplementary order paper to extend access to the fixed-price option to emission activities from the start of 2020 at $35*
Proposing Ministers	*Minister for Climate Change, Minister of Forestry, Minister of Finance*

Summary: Problem and Proposed Approach

Problem Definition **What problem or opportunity does this proposal seek to address? Why is Government intervention required?**
The Climate Change Response (Emissions Trading Reform) Amendment Bill (the Bill) currently proposes to repeal the fixed-price option (FPO) when auctioning of emission units begins in the NZ Emissions Trading Scheme (NZ ETS), likely in 2021. Participants must therefore largely rely on the secondary market to buy units to meet their surrender obligations for their 2020 emission activities. Participants then face significant uncertainty about their costs, and the risk of existing emission unit holders exercising market power.

Summary of Preferred Option or Conclusion (if no preferred option) **How will the agency's preferred approach work to bring about the desired change? Why is this the preferred option? Why is it feasible? Is the preferred approach likely to be reflected in the Cabinet paper?**
Amend the Bill (via supplementary order paper) to extend the FPO to cover emission activities from the start of 2020, and raise its price from $25 to $35 to signal the expected increase in emission prices. The $35 FPO would remain in place until auctioning actually begins under the Bill's reformed NZ ETS unit supply framework. That framework sets net emission budgets on a rolling five-year basis, which determines a limit on the supply of emission units each year (the cap). After allowing for units allocated for free, the remaining unit volume within that cap will be sold at auction.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
NZ ETS participants would benefit from certainty about their maximum compliance costs, and reduced volatility of emission unit prices on the secondary market. Government and

society would benefit by a more robust and effective NZ ETS playing its central role in meeting New Zealand's climate change targets.

Where do the costs fall?
Monetised capital costs to implement the $35 FPO through operational changes to the NZ ETS Registry system are estimated at $102,000.

What are the likely risks and unintended impacts? how significant are they and how will they be minimised or mitigated?
Use of the extended FPO in the transition to auctioning emission units risks inflating the existing unit stockpile (or reducing it less than without the FPO). In turn this risks enabling total net emissions covered by the NZ ETS to exceed the intended emission cap under auctioning. These impacts would reduce the effectiveness of the NZ ETS reforms in meeting Aotearoa New Zealand's emission reduction goals. These risks are mitigated by: • Setting the FPO to a higher price (raised from the current $25 to $35), to reasonably dampen its use for 2020 emission activities. • The Government's proposed settings for the reformed NZ ETS, which encourages drawdown of the stockpile by setting total unit supply below the intended net emission budget. This adjustment could be modified in future years to offset any increase in emissions from the transitional $35 FPO, if that occurred.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
We are generally confident with our scoping of the problem and the options considered. However, this analysis is primarily qualitative, given the objective is to manage the broader transition to auctioning of emission units. We provide estimated costs to implement the change operationally.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Ministry for the Environment
Quality Assurance Assessment:
The quality assurance panel at the Ministry for the Environment has reviewed the Regulatory Impact Assessment (RIA) and considers it meets the quality assurance criteria.

Reviewer Comments and Recommendations:
The panel considers the RIA provides a clear description of the proposed change (extension of the fixed price option) and the problem it is intended to address. Consultation has taken place and been taken into account in the assessment of options. Monetised values have been estimated only for operational costs. Other expected costs and benefits have been indicated qualitatively. However, the panel is satisfied that the assessment includes the available information. The options considered are limited to technical legislative changes that would extend the fixed-price option for 2020 activities. This scope is made clear and the panel considers it appropriate given the purpose of the assessment, which is to inform decisions about providing transitional measures in a Bill in progress.

Impact Statement: Extending access to the fixed-price option to emissions from the start of 2020 at $35

Section 1: General information

1.1 Purpose
Ministry for the Environment is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing: • final decisions to proceed with a policy change to be taken by or on behalf of Cabinet
This proposal seeks to amend the Climate Change Response (Emissions Trading Reform) Amendment Bill (**the Bill**) via supplementary order paper to extend access to the fixed-price option (**FPO**) to emission activities from the start of 2020 at $35. In-principle decisions were taken by the Minister for Climate Change, the Minister of Forestry, and the Minister of Finance under delegated authority from Cabinet [CAB-20-MIN-0062 refers], prior to the final Cabinet decision this RIS accompanies.

1.2 Key Limitations or Constraints on Analysis
The proposed amendment would provide a temporary measure during the transition to auctioning emission units under the Bill's major reforms of the NZ Emission Trading Scheme (**NZ ETS**). For that reason we have constrained our analysis to moderate 'tactical' changes to the existing NZ ETS framework only. We are generally confident with our scoping of the problem and the options considered. However, this analysis is primarily qualitative, given the objective is to provide a transitional measure while implementing the broad reforms to the NZ ETS. We provide estimated costs to implement the proposed change operationally, but quantitative analysis of potential costs and effects on the emission unit stockpile are necessarily indicative.

1.3 Responsible Manager (signature and date):

Matthew Cowie

ETS Policy

Climate change directorate

Ministry for the Environment

6 May 2020

Section 2: Problem definition and objectives

2.1 What is the current state within which action is proposed?

Under current NZ ETS arrangements, participants with surrender obligations can choose to purchase New Zealand Units (**NZUs**) from the Government at a fixed price of $25, as an alternative to using other sources of supply. There is no limit on purchasing NZUs using this FPO. Any NZUs purchased from the Government are immediately and automatically surrendered to meet the participant's obligations.

The FPO therefore improves certainty for participants about their maximum compliance costs in meeting their obligations — they know they don't have to pay more than $25 per tonne CO_2-e to cover their emission activities. As a result, the FPO tends to act as a de facto price ceiling for the secondary NZU market.[1]

The FPO was introduced to the NZ ETS in 2009 (intended at that time as a transitional measure), to protect participants from excessive costs. It has not been modified since.

In 2019, NZ ETS participants used the current $25 FPO for about half of their emissions (accounting for around 20.2 Mt CO_2-e).

The FPO remains available for use in 2020 to cover activities in 2019. It is also available to cover emissions in 2020 (the current emission year) for any participant ceasing activities, such as by going out of business.

Under the current NZ ETS reform Bill, the FPO would be repealed

In late 2019, the Government introduced the Bill.[2] The Bill implements a package of major reforms to the NZ ETS, designed to help Aotearoa New Zealand meet our emissions reduction targets. A major focus of the Bill is establishing a cap on the total supply of NZUs into the NZ ETS, and moving to selling those NZUs by auction.

As part of moving to a capped NZU supply, the Bill requires the FPO be repealed on the same date the first auction of NZUs under the NZ ETS is held. If auctioning begins in early 2021, participants could no longer use the FPO to meet surrender obligations for their 2020 emission activities as of that first auction date. It would also no longer be available to cover emissions in 2021 for any participant ceasing activities in that year.

Our assessment of options is relative to the introduced version of the Bill

Repealing the FPO immediately when auctioning starts poses problems, as detailed in 2.3 below. Our assessment of extending the FPO to mitigate these problems is therefore relative to the current version of the Bill: the counterfactual where it is repealed entirely.

During December 2019 to February 2020, the Government consulted on proposed settings for NZ ETS unit supply and price controls (ie, the new settings under the coordinated unit supply framework introduced by the Bill).[3] This consultation included a proposal to extend the FPO to cover 2020 activities as a transitionary measure, raising

[1] Though NZU prices in the secondary market can rise above the FPO level if participants (or other buyers) adopt hedging strategies to hold or obtain NZUs for use in later years. That is, NZUs hold 'option value' beyond immediately surrendering them to meet current obligations.

[2] Introduced 24 October 2019, http://www.legislation.govt.nz/bill/government/2019/0186/latest/LMS143384.html.

[3] *Reforming the New Zealand Emissions Trading Scheme: proposed settings* was published 19 December 2019, and submissions closed 28 February 2020. See https://www.mfe.govt.nz/consultations/nzets-proposed-settings.

the price from $25 to $35. Submissions on this proposals have been considered in this assessment.

2.2 What regulatory system(s) are already in place?

The FPO for meeting surrender obligations under the NZ ETS is provided in sections 178A and 178B of the Climate Change Response Act 2002 (**the Act**). The FPO is administered by the Environmental Protection Authority (**EPA**). In normal circumstances, participants can access the FPO from 1 January each year, the first date when annual emission returns can be submitted (for the previous calendar year). The FPO is available for that purpose until the surrender deadline of 31 May.

However, if a participant will cease their activities (such as due to bankruptcy), the EPA can direct them to submit a final emissions return for the current year (under s 118(5)). Participants can also use the FPO to meet their obligations for this emissions return; ie, use the FPO to cover their emissions in the same year they cease activities.

The Bill introduces a new coordinated unit supply framework, removing the FPO

Under the Bill, the NZ ETS will transition to a full ‘cap-and-trade’ scheme under a reformed unit supply framework. In summary, net emission budgets will be set on a rolling five-year basis, and these determine a limit on the total supply of NZUs each year (the cap) for emission activities subject to the NZ ETS. After allowing for NZUs allocated for free to eligible activities and any negotiated greenhouse gas agreements, the remaining volume within that limit will be sold at auction (every three months). Controlling the unit supply through auction therefore restricts allowable emissions to the cap.

The framework includes two price control mechanisms: a minimum auction price (or price floor), and a cost-containment reserve (**CCR**). The price floor will be implemented as a simple minimum price accepted when submitting auction bids. The Government proposed the price floor be set to $20.

The CCR will work by releasing a fixed volume of additional NZUs for sale at auction if a specific auction trigger price is reached. By increasing NZU supply, these CCR units reduce the risk of auction prices rising to an unacceptably high level. Though auction prices are not restrained to the CCR trigger level, final auction prices will be lower than they would be without that additional CCR supply. The Government proposed the CCR price trigger be set to $50.

As the CCR effectively replaces the FPO, the Bill requires the FPO is repealed on the date of the first auction (or otherwise on 1 January 2023).[4]

The Bill provides for the detailed auction rules, and the unit supply and price control settings, to be specified in regulations. The price controls only apply to NZUs sold at auction, and hence take effect on the same date auctioning begins. They do not apply to or directly affect NZUs traded on the secondary market.

[4] Clause 2(2) of the Bill.

2.3 What is the policy problem or opportunity?

Removing the FPO as proposed in the current Bill causes two problems

The major problem is the risks for NZ ETS participants in the transition to auctioning:

- Government expects auctions to begin in early 2021. Repealing the FPO immediately from the date of the first auction means participants can no longer use it to meet outstanding surrender obligations for their 2020 activities.[5] The FPO would simply be 'turned off' on that auction date. NZ ETS participants therefore have significant uncertainty over the maximum compliance costs they face in 2021 for their 2020 emissions, and difficulty in passing accurate emissions costs through to consumers.

- As a result, the major source of NZU supply available to participants for their 2020 activities would be the secondary market. Holders of existing NZUs — the NZU stockpile — will therefore have substantial market power during 2020, and potentially until the surrender deadline on 31 May 2021. This is because the FPO could no longer act as a de facto ceiling on NZU prices in the secondary market (sellers know the FPO won't be available to cover 2020 emissions at the surrender deadline in May 2021).

- Further and for the same reason, prices in the secondary market may become inefficiently volatile until auctioning is bedded down over 2021: because sellers would have market power, the potential for price spikes would be substantial.

Repealing the FPO entirely also causes a secondary problem. Once repealed, the current $25 FPO could not be used when emission returns are subsequently *amended* under s 120 of the Act. This is consistent with Cabinet's decision to remove the FPO. However, other amendments to s 178A in the Bill introduce the ability for participants to use the FPO for any new liabilities resulting from an amended return. Participants would therefore only be able to use this new ability up to the date of the first auction.

Even if the $25 FPO is removed for ongoing use, we consider it should remain available for amended returns covering the years when it was legitimately available.

Auctioning NZUs means unit supply is now 'forward looking'

In the current NZ ETS, the FPO is essentially backward looking. Participants use the FPO to meet their surrender obligations for their emission activities occurring in the *previous* calendar year.[6]

Unit supply under auctioning is instead forward looking. The NZU supply cap for each year is determined by the available emission budget for that same year. Participants therefore need to buy NZUs at auction throughout each year to cover their emissions occurring *in that year*, or plan to hold for future years. These NZUs bought at auction are

[5] Though the $25 FPO will still be available in 2021 for 2020 emission returns from 1 January until the earlier of the first auction date or the surrender deadline of 31 May.

[6] With the exception that a participant ceasing activities can use the FPO to meet surrender obligations for their emissions in that same year.

in addition to any NZUs they already hold (including being allocated for free) or buy on the secondary market.

If auctioning begins in early 2021 as expected, this means the NZUs supplied at auction are tied to the allowable emissions budget for 2021. Participants could buy these NZUs and surrender them for their 2020 emission liabilities, but doing so necessarily reduces the amount available to cover 2021 emissions. Because there would only be one auction before the 31 May 2021 surrender deadline, it's also highly unlikely the NZUs available at auction would be sufficient to cover all obligations for 2020 emissions.[7]

The new CCR price control mechanism will not restrain the secondary market in this transitionary period

There is ample liquidity in the existing NZU stockpile to meet participants' needs. As of June 2019, the stockpile is estimated to hold 132 million NZUs, around four times the number of NZUs surrendered in 2019.[8]

The problem, as set out above, is that NZU suppliers in the secondary market will hold significant market power in these circumstances. Because many buyers in the secondary market will have no other source of NZUs to meet their surrender obligations, sellers can demand very high prices — perhaps up to the cost of any penalties participants would incur from failing to meet their obligations. This is not caused by a lack of volume in the stockpile, simply that sellers know buyers have little alternative. Such an outcome would impose substantial and unjustifiable costs to participants, which flow on through the economy. It may also undermine the integrity and regulatory durability of the NZ ETS.

The new CCR price control mechanism will not address this problem. Even if prices in that single NZU auction (before 31 May) rose to the proposed CCR price trigger of $50, the CCR volume released is still a small fraction of the total NZU supply for the year. For the same reason as above, this extra supply would not be enough to cover all 2020 obligations. Participants would still need to rely on the secondary market for the majority of their NZU supply — prices in the secondary market would therefore not be restrained by auction prices during this transitional period, even where the CCR is triggered.[9]

Once auctioning is established over 2021 and into 2022, prices in the secondary market are likely to much more closely align to auction prices and hence affected by the CCR.

[7] The Government intends to run quarterly auctions, releasing one quarter of the annual supply at each.

[8] Further details are given in pages 43 – 45 of the NZ ETS settings consultation paper.

[9] Further, the CCR will reduce auction prices relative to what they would be without the extra reserve units, but final prices will still be at or above the CCR price trigger level.

2.4 What do stakeholders think about the problem?

The key stakeholders affected by repealing the current FPO in the transition to auctioning are the voluntary and mandatory participants in the NZ ETS. Ultimately all New Zealanders have a stake in the success of the NZ ETS, as the Government's key tool to reduce emissions. The economic costs imposed by the scheme — and the benefits of technology and behavioural changes it encourages — are shared across the economy.

In its public consultation on proposed NZ ETS settings in December 2019, the Government proposed extending the FPO to cover 2020 activities, raising the price to $35. Submitters generally agreed there is a risk for participants transitioning to auctioning, but expressed a range of views on the Government's proposed response. We discuss these views in section 5.1 below.

2.5 What are the objectives sought in relation to the identified problem?

The principal objective of the proposal is to mitigate the risks to NZ ETS participants described in section 2.3 above. More certain compliance costs during the transition to auctioning supports participants while they build confidence in the reformed ETS and develop expectations about future prices. In turn this helps avoid unwarranted flow-on impacts to society from inefficiently high or volatile NZU prices on the secondary market.

However, limiting costs for participants during the transition must be balanced against the broader objectives for reforming the NZ ETS in the first place. The relevant objectives from the regulatory impact assessment of the Bill's reformed unit supply framework are:[10]

- alignment with New Zealand's emission reduction targets under the Zero Carbon Act and the Paris Agreement
- improved regulatory certainty and predictability for NZ ETS participants
- consistency with broader NZ climate policy.

As its use is not constrained, extending the FPO undermines the cap on unit supply into the NZ ETS under auctioning. The more participants using the FPO to meet obligations for 2020 activities the greater the volume of NZUs not required for that purpose. Two outcomes are possible, and the final result will be a mix of both:

- The quantity of emissions covered by the NZ ETS but not subject to the cap rises. Using the FPO rather than buying an NZU at auction means that NZU is available for other emission activities. Total net emissions in any year where the FPO and auctioning are both in effect may therefore be higher.
- Participants may opt to use the FPO while retaining freely allocated NZUs or buying them at auction to bank for use in future years. The NZU stockpile could grow as a result, or reduce less than it otherwise would without the FPO. This delays the discovery of abatement opportunities in the economy and therefore makes it more challenging to meet emissions reduction targets. Banked NZUs also allow total net emissions in future years to exceed the NZU cap.

[10] Full details are set out in the regulatory impact statement accompanying the Bill: *Improving the NZ ETS Framework for Unit Supply*, https://www.mfe.govt.nz/node/25034.

Any intervention to extend the FPO should therefore seek to minimise these impacts and preserve the NZ ETS' effectiveness in driving emission reductions.

Overall, successful intervention would mean no or substantially reduced price spikes in the secondary market during the transition (by addressing market power). Combined with better certainty for participants, emission prices would be relatively stable with a smoother rise to the longer term trajectory under auctioning and a declining NZU supply cap.

Section 3: Option identification

3.1 What options are available to address the problem?

We have constrained options to three variations of the FPO as a temporary measure in transitioning to auctioning of NZUs. Again, the counterfactual is enacting the Bill in its current form where the FPO is repealed entirely from the date of the first auction.

Option 1: Extend the current $25 FPO to cover 2020 activities

The existing FPO is extended to cover 2020 emission activities at the current rate of $25. It would remain in place after auctioning starts in 2021, but restricted to activities in 2020 and earlier. The FPO would not be available for activities in 2021 or later years.

Option 1 essentially preserves the status quo for an overlap period in the transition to auctioning. Participants could continue meeting their surrender obligations broadly as they do today (through the FPO, the secondary market, and any free allocation), while also gaining experience with auctions.

Preferred Option 2: Extend the FPO to cover 2020 activities, raised to $35

As for Option 1, but the FPO is raised to $35 for 2020 activities, as proposed in the Government's ETS Settings consultation. The $35 price is the mid-point between the proposed price floor of $20 and the proposed CCR trigger price of $50.

The effect would be similar to Option 1, but the higher price may decrease the proportion of participants opting to use the FPO.

Option 3: Extend the FPO to cover 2020 activities, tied to cost-containment reserve's price trigger

As for Option 1, but the FPO is tied to the CCR price trigger of $50. Operationally this could be set at $50, or some level close to it. While participants could still access the FPO at a known price and with no limit, this cost is by definition at the upper end of the Government's price expectations.

3.2 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

We have assessed these options against the following three criteria. They map to the objectives given in 2.5, but provide more specific guidance for assessing the transition from the FPO to full auctioning. The criterion to give participants certainty must be balanced with the other two criteria to preserve an effective cap-and-trade NZ ETS.

Minimise any distortion of the NZU supply limit and increases to the NZU stockpile

This maps to the objective of aligning with emission reduction targets.

An extended FPO must not completely undermine the limit on NZU supply into the scheme under auctioning. Closely related to this, it should not allow the existing NZU stockpile to grow significantly. Because the FPO has no volume limit, minimising distortion of the cap and growth of the NZU stockpile requires a higher FPO price.

Give participants certainty about maximum compliance costs in the transition to full NZU auctioning

This maps to the objective of improving regulatory certainty and predictability.

Certainty about maximum costs for meeting their surrender obligations for their 2020 activities addresses the risks for NZ ETS participants identified in 2.3 above. It should therefore mitigate the risk of existing NZU holders exercising market power in the lead up to auctioning (assuming this begins in early 2021).

Sends appropriate signal of expected future emission prices

This maps to the objective of consistency with broader climate policy.

The FPO price (and any flow-on effects for NZU prices in the secondary market) should be consistent with the Government's expectation for emission prices to rise. A rising price in tandem with a strengthening cap on NZU supply is a major expected outcome of the reformed NZ ETS.

3.3 What other options have been ruled out of scope, or not considered, and why?

As stated above, any intervention to modify the Bill as introduced is a temporary measure in the transition to full NZU auctioning, likely beginning in 2021. For that reason we have constrained our analysis to moderate 'tactical' changes to the existing NZ ETS framework only; ie, to the FPO and how it should be removed over time. We have not developed any alternative options requiring more extensive intervention, or any changes to the new auction price controls or other aspects of the reformed unit supply framework.

Section 4: Impact Analysis

Marginal impact: How does each of the options identified in section 3.1 compare with taking no action under each of the criteria set out in section 3.2?

	Extend $25 FPO for 2020	Extend FPO for 2020 at $35	Extend FPO for 2020 at ~$CCR
Minimise impact to NZU cap	**- -** Relative to the proposed auction price controls, the $25 FPO would encourage increases in the NZU stockpile and enable total net emissions to exceed the NZU supply cap	**-** As for the $25 FPO, but the higher price would likely weaken growth in the NZU stockpile or emissions exceeding the cap	**0** At such a price level use of the FPO is likely to be muted
Certainty about compliance costs	**+** Provides cost certainty by reintroducing the existing FPO	**+** Provides cost certainty	**+** Provides cost certainty
Appropriate price signal	**-** The existing price level does not signal the expectation for emission prices to rise under the reformed NZ ETS. The FPO would tend to suppress prices at auction and on the secondary market; though participants may still buy above that price to obtain NZUs for future years	**+** As the mid-point between the proposed auction price controls, a $35 transitional FPO sends a reasonable signal about the expected direction of emission prices	**-** The FPO at or near the $50 CCR trigger level sends a strong price signal. However, as the CCR is intended to restrain unacceptably high auction prices, setting the FPO at the trigger price may be 'over signalling' expected price trends
Overall assessment	**- -**	**+**	**0**

Key:

++	much better than doing nothing/the status quo
+	better than doing nothing/the status quo
0	about the same as doing nothing/the status quo
-	worse than doing nothing/the status quo
- -	much worse than doing nothing/the status quo

Section 5: Conclusions

5.1 What option, or combination of options is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

We prefer *Option 2: Extend the FPO to cover 2020 activities, raised to $35*. Option 2 appropriately balances more certain maximum compliance costs for participants with the need to ensure the NZ ETS is effective. At $35, the FPO sends a reasonable signal about the expected direction of emission prices under the NZ ETS reforms. Compared to keeping it at the current $25, the higher price also reduces the potential for the NZU stockpile to grow or for net emissions to substantially exceed the NZ ETS cap.

We consulted on this preferred option

The Government proposed this preferred option as part of its public consultation on the proposed NZ ETS settings, published in December 2019.[11] A wide range of views were given in the 133 submissions received, though not all submitters addressed the transitional FPO proposal. Several themes were evident:

General support for $35 FPO proposal

Twenty three submitters showed general support for the $35 FPO proposal. Seven of these submitters highlighted its merit as a transitional measure to provide predictability about the direction of change and time to adjust. These included Carbon and Energy Professionals New Zealand, Trustpower, NZX Limited & European Energy Exchange AG, Vector, Oji Fibre Solutions, and Tāne's Tree Trust.

FPO price should be higher

The largest proportion of submitters who commented on the FPO believed its price should be higher. This opinion came from twenty six submitters, including the Climate Change Commission (the Commission), Citizens' Climate Lobby New Zealand, Environment and Conservation Organisations of NZ Inc, Lawyers for Climate Action New Zealand, New Zealand Carbon Farming, New Zealand Wind Energy Association, Pan Pac Forest Products Limited, and Zero Carbon Nelson Tasman.

One predominant driver of this opinion was the belief that NZU prices need to rise significantly to drive greenhouse gas abatement and investment in low emissions technology. Another commonly discussed view was that the $35 FPO, combined with the proposed $50 CCR trigger price, leads to expectations of rising NZU prices. As a result, many participants may choose to use the $35 FPO for 2020 surrender obligations. As noted by many submitters, including the Commission, this risks increasing the NZU stockpile through free allocation and forestry removals; ie, because the FPO would continue to operate outside the cap on NZU supply. The Commission recommended setting the FPO 'at a higher level that is closer to the CCR trigger price' to help mitigate this impact.

[11] *Reforming the New Zealand Emissions Trading Scheme: proposed settings* was published 19 December 2019, and submissions closed 28 February 2020. See https://www.mfe.govt.nz/consultations/nzets-proposed-settings.

Opposition to increasing the FPO price and timing of changes

Two main themes emerged from submitters who strongly opposed the proposal: a general opposition towards NZU prices increasing, and a belief the proposal is retrospective and therefore unreasonable.

Eight submitters opposed the $35 FPO due to a general opposition towards NZU prices increasing and the impacts this would have. Temperzone and Tailored Energy Solutions Limited argued local manufacturing already has financial burdens that offshore competitors do not face. They believed increasing NZU prices would drive emissions leakage. Genesis Energy objected to the scale of price increase, arguing NZ ETS participants bear a disproportionate burden of emission costs. Genesis also discussed potential impacts on electricity prices and costs of production. Gisborne District Council was concerned about the impacts of passed down costs on low socio-economic households.

Seven submitters including EnviroNZ, Methanex New Zealand Limited, Mobil Oil New Zealand Limited, Petroleum Exploration and Production New Zealand, Realcold NZ Limited, and Todd Corporation, thought that it was unreasonable to increase the FPO to $35. These industry submitters described the $35 FPO proposal as 'retrospective' or retroactive, concerned this undermines the forward-looking cost certainty the FPO seeks to facilitate. Submitters opposing the proposal for this claimed reason suggested it would detract from price certainty (though they didn't oppose price increases generally).

Ten individual submitters said they were unsure if they supported the proposal. Reasons for uncertainty varied. Some were concerned the FPO's extension undermines the Government's efforts to reduce the NZU stockpile. Other generally supported extending the FPO but were concerned that $35 is an arbitrary price that may not be the best option.

Analysis of submitter views

A large number of submitters accepted the extended FPO mitigates risks of short term volatility in NZU prices during the transition to auctioning, and the higher price is consistent with allowing NZU prices to rise to make more abatement options economic.

$35 FPO price is a reasonable balance

We consider setting the FPO at $35 is not arbitrary. As the mid-point between the proposed price floor ($20) and CCR trigger ($50), $35 gives a reasonable and smooth price path to the cap-and-trade NZ ETS framework. Many submitters argued the price increase was too moderate; others expressed great concern about the impacts of the higher price. We consider the $10 increase to $35 appropriately balances these concerns, reducing the chance the FPO will be used extensively in 2021 while honouring the principles of a just transition.

We also share submitters' concerns over the need for NZU prices to be high enough to drive abatement, and the risk of too low a price further inflating the NZU stockpile. However, we consider setting the FPO near or at the proposed $50 CCR trigger would not adequately address the risks to NZ ETS participants in the transition to auctioning. As stated in section 4 above, the CCR is intended to restrain unacceptably high auction prices — setting the FPO at the $50 trigger price instead suggests this is an expected or target price level.

We consider the $35 price would reasonably dampen use of the $35 FPO for 2020 emission activities, mitigating the risk of inflating the stockpile. At current NZU prices in the secondary market below the current $25 FPO, few participants are likely to use the $35 FPO. Further, the Government's proposed NZ ETS settings explicitly adjusts NZU auction volume below the target cap, to encourage drawing down the stockpile.[12] This auction volume adjustment can be modified in future years if there is evidence the NZU stockpile had increased substantially.

Retrospectivity and cost uncertainty

The proposal does not retrospectively affect participant costs. The $35 FPO cost would not be incurred until participants chose to use it in 2021.[13] The FPO is only one way participants can meet their surrender obligations for activities in the previous year. Participants can still choose to buy NZUs from the secondary market ahead of those surrender obligations. Given the current secondary market price is significantly below $35, this appears to be a prudent option.

Further, the intent to remove the FPO was announced in December 2018 (with substantial consultation prior).[14] Most importantly, the Bill repeals the FPO entirely, and this information has been clearly communicated widely. Participants should not reasonably have expected the FPO to be available for their 2020 emissions in 2021 when auctioning starts. Of course this change is not certain, because the Bill has not yet passed into law. In this context, the proposed transitional $35 FPO therefore improves certainty about costs to be incurred in 2021.

The NZ ETS reforms seek to improve regulatory certainty through the coordinated unit supply framework: the five-year rolling emission budgets and associated NZ ETS settings (the annual total NZU supply cap, auction volumes, and price controls). New uncertainties will exist until those settings are made in regulations and implemented through the new auctioning mechanism. Extending the FPO at $35 for 2020 activities addresses risks created by this transition, as described in section 2.3 above.

On balance, we recommend the preferred option of extending the FPO to cover obligations arising from activities over 2020 as a transitional measure, increasing the price to $35.

Māori/iwi interests

Iwi/Māori have significant interest in the NZ ETS, particularly through substantial investments in forestry.

A series of 14 regional hui were held throughout New Zealand by the Ministry of Environment in February 2020 to discuss a range of the Ministry's work programmes with Māori/iwi groups. The proposed $35 FPO (as part of the NZ ETS setting consultation) was included on the agenda at these hui and was discussed with attendees. Māori/iwi were invited to participate in consultation on the proposed NZ ETS settings (including the $35 FPO), and notice of the consultation was included in a regular Ministry iwi newsletter.

[12] See pages 43–47 of the NZ ETS Settings consultation document.

[13] The $35 price would apply to any participant ceasing activities in 2020 from the date it came into effect, but they are not required to use the FPO.

[14] See the announcement on 12 December 2018 at https://www.beehive.govt.nz/release/government-announces-set-improvements-new-zealand%E2%80%99s-emissions-trading-scheme.

Māori/iwi NZ ETS participants would benefit from the proposed $35 FPO providing improved certainty about maximum compliance costs for emission activities in 2020. Māori/iwi forestry participants would benefit from access to the $35 FPO for net emission returns spanning multiple years (see details in 6.1), if they chose to do so. As forestry participants, Māori/iwi also benefit from higher emission prices in the general sense.

5.2 Summary table of costs and benefits of the preferred approach

Affected parties	Comment:	Impact	Evidence certainty
Additional costs of proposed approach compared to taking no action			
Regulated parties	No change in cost to use the extended FPO in general (the $35 charge is not a cost of implementing this option). Post-1989 forestry may incur minor administrative costs in managing emission returns for multiple years spanning both the current $25 FPO and the extended $35 FPO.	Low	High
Regulators	Capital costs will be incurred to implement the $35 FPO through operational changes to the NZ ETS Registry system. Note that system changes will be incurred even under the status quo (to remove the existing $25 FPO).	$102,000	
Wider government	None		
Other parties			
Total Monetised Cost		$102,000	High
Non-monetised costs		*Low*	
Expected benefits of proposed approach compared to taking no action			
Regulated parties	NZ ETS participants benefit from more certain maximum compliance costs. They would also benefit from relatively lower financial costs, if the $35 FPO acts to dampen (and reduce volatility of) NZU prices on	Medium	Medium

	the secondary market. Note this will not be a de facto price ceiling as such, because NZUs bought from the secondary market or at auction hold 'option value' through banking for use in future years.[15]		
Regulators	None		
Wider government	The transitional extended FPO is likely to reduce volatility in NZU prices both on the secondary market and at initial NZ ETS auctions. This is because these initial auctions would not be the only new source of NZU supply to cover surrender obligations for 2020 emission activities (as detailed in 2.3 above). This reduced volatility combines with greater confidence of NZ ETS participants to ensure the reformed scheme is durable and operating effectively, helping the Government (and New Zealand) meet its climate change targets and objectives.	Medium	Medium
Other parties			
Total Monetised Benefit			
Non-monetised benefits		*Medium*	Medium

[15] In the current NZ ETS, the $25 FPO is always available, so the incentive for participants to pay more than $25 to obtain NZUs for future use is muted — they can use the FPO now and wait for a better price.

5.3 What other impacts is this approach likely to have?

The principal uncertainty is how much the $35 FPO would be used, and hence any impact on the NZU stockpile and net emissions in 2021 (see discussion in 2.5).

At time of writing NZUs are trading below the existing $25 FPO level. It is difficult to project use of the $25 FPO in 2020 in these conditions (ie, to meet obligations for 2019 emission activities), given the NZU stockpile is sufficient to fully supply participant requirements.

Potential use of the extended $35 FPO in 2021 is even more uncertain. With current market prices it is highly unlikely any participant would use it.

If use of the $35 FPO does cause the NZU stockpile to grow, the volume of NZUs supplied at auction in 2022 onwards can be reduced to compensate, as noted in 5.1. Reducing auction volume below the cap to encourage use of the stockpile, as proposed in the Government's NZ ETS settings methodology, can largely mitigate this risk.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

The preferred option would be given effect via a supplementary order paper to the Bill. The amended Act would provide for:

- the FPO to be available for activities in 2020 at $35, from the date the amended Act takes effect (note the $35 FPO is then available under s 118 of the Act for any participant ceasing activities during 2020)
- indefinitely retaining the existing $25 FPO for pre-2020 activities, and the $35 FPO for 2020 activities. This allows for amended emission returns in future years (addressing the secondary problem identified in 2.3) and for post-1989 forestry emission returns spanning multiple years (as detailed below).

Related transitional changes

Arrangements for forestry activities

Pre-1990 deforestation activities should be treated like non-forestry activities. Surrender obligations arising from these land use changes in calendar 2020 could use the $35 FPO.

The applicable FPO available for post-1989 forestry activities should be determined by the time period covered by the emissions return, using a pro-rata approach. For example, for an emission return filed in 2021 covering 2018–2020: the $25 FPO would be available for 2018–2019 (or 2/3 of net emissions in that return, if the participant opted to use the FPO), and the $35 FPO for 2020 (1/3 of net emissions). As is currently the case, the participant may elect not use the FPO for some or all of their net emissions. Only net emission returns would be permitted to use this pro-rata approach.

Consequential changes to the synthetic greenhouse gas levy

As the FPO sets the maximum cost of compliance for NZ ETS participants, it is equitable to provide similar cost certainty for people subject to the synthetic greenhouse gas levy. The levy is calculated under a methodology set in regulations which determines the emissions price each year, by averaging market prices over the preceding financial year. The Act currently states the maximum price of carbon underpinning levy rates is $25. The current Bill will remove this.

The maximum price of carbon underlying the calculations for levy rates for 2021 should be set to $35, commensurate with the $35 FPO being incurred in 2021 for 2020 activities. This ensures importers of synthetic greenhouse gases in goods and subject to the levy continue to face reasonably equivalent emissions costs to importers of bulk synthetic greenhouse gases, who are mandatory participants in the NZ ETS.

Operation

The Environmental Protection Authority (EPA) will be responsible for implementing the $35 FPO and the transitional arrangements, as for the current $25 FPO under the Act.

Retaining the FPO in the Registry system indefinitely to allow for amended emission returns and multi-year forestry returns will have minor operational impacts for the EPA. Compared to removing the FPO entirely (such that amended returns could not access it), the EPA will require ongoing operational processes to handle these uses.

6.2 What are the implementation risks?

If the extended $35 FPO were available *only* for 2020 emission activities, NZ ETS participants face the same risks described in section 2.3 if auctioning does not start in 2021 for any reason. With no FPO available for activities in 2021 and no supply of NZUs through auctioning, participants would have to rely on the secondary market exclusively. The Government would need to further amend the Act to address this situation.

We therefore recommend the $35 FPO should remain in place until auctioning actually begins, as a contingency measure. Implementing the extended FPO in this way acts as a 'backstop':

- It ensures the $35 FPO automatically 'rolls over' to each subsequent calendar year after 2020 if auctioning does not start in that year.
- Once auctioning begins, the $35 FPO is automatically restricted to be available only for activities in 2020 (and any subsequent full calendar year until auctioning became available).
- The synthetic greenhouse gas levy would be implemented in the same way (the maximum price of carbon would be $35 from 2021 up to and including the year auctioning begins).

The backstop approach ensures the extended $35 FPO is available during the transition to auctioning, whenever that occurs. No further intervention would be required, even if auctioning is delayed well beyond its planned 2021 start.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
Take up of the $35 FPO for 2020 activities will be monitored and reported by the EPA as part of existing NZ ETS arrangements. As a transitional measure, the extended $35 FPO will only be available for emission activities in 2020 and any full calendar year until auctioning begins. Use of the $35 FPO for amended emission returns and multiple-year post-1989 forestry emission returns would be reported as under existing NZ ETS arrangements.

7.2 When and how will the new arrangements be reviewed?
As the $35 FPO for 2020 activities is a transitional measure only until auctioning begins, no review is warranted. As an indicator of success, there would be no or comparatively minor price spikes in the secondary market, providing a smoother rise to the longer term trajectory under auctioning. NZ ETS participants should also not perceive they have substantial uncertainty about their maximum compliance costs during this transitional period.