



## Policy Decision to Amend the Fixed Price Option

Date Submitted:	6 March 2020	Tracking #: 2019-B-06518	
Security Level	In confidence	MfE Priority:	Urgent

	Action sought:	Response by:
To Hon James Shaw, Minister for Climate Change	1. Forward this briefing to <ul style="list-style-type: none"> <li>• Hon Grant Robertson, Minister of Finance</li> <li>• Hon Shane Jones, Minister of Forestry</li> </ul>	9 March
	2. Discuss this briefing with those delegated Ministers	12 March
	3. Jointly agree to the policy changes	12 March
	4. Jointly agree to the issuance of drafting instructions	12 March

Actions for Minister's Office Staff	<b>Return</b> the signed report to MfE.
Number of appendices and attachments: 1	Summary of submissions on fixed price option policy change

### Ministry for the Environment contacts

Position	Name	Cell phone	1 <sup>st</sup> contact
Principal Author	Scott Gulliver		
Responsible Manager	Matthew Cowie		✓
Director	Roger Lincoln		

## Policy Decision to Amend the Fixed Price Option

### Key Messages

1. This briefing seeks your joint in-principal approvals to policy changes regarding the fixed price option (FPO), for the purpose of issuing of drafting instructions to the Parliamentary Council Office (PCO).

### *Proposal*

2. We recommend no changes to the FPO proposals outlined in the New Zealand Emissions Trading Scheme Settings consultation document released in December 2019. Those proposals are:
  - a. That the FPO can be used to meet emission unit surrender obligations arising from activities over calendar year 2020, even if there is an overlap with the start of New Zealand Unit (NZU) auctioning.
  - b. That the price of the FPO is raised from \$25 per NZU to \$35 per NZU for those emission unit surrender obligations.
3. Additions are needed to those proposals for forestry activities and the synthetic greenhouse gas levy. Regarding forestry activities, pre-1990 foresters should be treated the same way as non-forestry activities, in that obligations from activities in 2020 can use the \$35 FPO. Post-1989 foresters can also use the \$35 FPO, but only in proportion to the period being reported on. For example, an emissions return that covers 2018, 2019 and 2020 can use the \$25 FPO for two thirds of their surrender obligations, and the \$35 FPO for one third.
4. We also recommend that the maximum price of carbon underpinning the calculation of synthetic greenhouse gas levy rates for 2021 importing activities be \$35. This would maintain policy consistency between the synthetic greenhouse gas levy scheme and the NZ ETS, which aims to level emissions costs between bulk synthetic greenhouse gas importers and importers of synthetic greenhouse gases in goods.
5. We recommend no expiry date for the FPO, other than it can only be used for activities occurring before 2020 (for the \$25 FPO) or over 2020 (for the \$35 FPO). This is to allow the meeting of future obligations from amendments to emissions returns, and to avoid arbitrarily setting deadlines that will potentially diminish the quality of forestry emissions returns and have operational impacts.
6. Pending your approval and the issuance of drafting instructions, those changes will be enacted by way of supplementary order paper (SOP) to the Climate Change Response (Emissions Trading Reform) Bill (the Bill) at its Committee of the Whole House stage. We expect this could be in late April or early May.
7. The purpose of the policy change is to provide cost certainty for participants in the transition to auctioning NZUs with price controls. Without the proposal, there is a significant risk of short term volatility in NZU prices due to the secondary market being the only source of emission unit supply over 2020. The increase in price from \$25 to \$35 is consistent with the intention to allow NZU prices to increase in order for abatement opportunities to become more commercially viable.

8. Public consultation on the FPO change revealed a wide range of views. The majority considered it to be sound, agreeing with the purpose noted above. Many submitters, including the Climate Change Commission, considered the FPO should be set higher in order to avoid its use and better signal increased ambition from the Government. Some business submitters were concerned about increased emission units prices in general, and the application of the change 'retrospectively' in particular. A full summary and analysis is attached as the appendix to this briefing.
9. Use of the FPO has fiscal impacts. While it creates cash revenue if utilised by participants, it could also delay the discovery of emission reductions in the economy, thereby impacting the cost of achieving emission targets. We have considered those risks and impacts and consider the proposal fairly balances those against the market risks noted above. Full regulatory impact analysis and climate impacts of policy analysis will accompany the Cabinet decision that accompanies the SOP.

## Recommendations

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10. We recommend that you:

- a. **Note** an increase and extension of the fixed price option was proposed in order to resolve an NZ ETS market risk of limited supply sources
- b. **Note** consultation on that proposal and other NZ ETS settings closed 28<sup>th</sup> February
- c. **Note** the proposal was generally supported by submitters
- d. **Agree** to these policy changes:
  - i. That the FPO can be used to meet emission unit surrender obligations arising from non-forestry activities and pre-1990 forestry activities over calendar year 2020 Yes / No
  - ii. That the FPO used by post-1989 foresters is determined on a pro rata basis that considers the time period covered by an emissions return Yes / No
  - iii. That the price of the FPO is raised from \$25 per NZU to \$35 per NZU for emissions from the calendar year 2020 Yes / No
  - iv. That the maximum price of carbon used to set synthetic greenhouse gas levy rates for 2021 activities be \$35 Yes / No
  - v. That the \$35 FPO will remain in the Act, with no expiry, as a way for participants to meet surrender obligations arising from activities over calendar year 2020 and for recommendation ii above Yes / No
  - vi. That the \$25 FPO will also remain in the Act, with no expiry, as a way for participants to meet surrender obligations arising from activities before the start of calendar year 2020 and for recommendation ii above. Yes / No
- e. **Agree** to the issuance of drafting instructions for a supplementary order paper for those policy changes Yes / No
- f. **Note** Cabinet will be asked to confirm the above policy decisions when the SOP is presented as soon as practicable, supported with a regulatory impact analysis

## Signature

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Roger Lincoln  
Director  
Climate Change Directorate:

Hon James Shaw  
**Minister for Climate Change**

**Date**

Hon Grant Robertson  
**Minister of Finance**

**Date**

Hon Shane Jones  
**Minister of Forestry**

**Date**

# Policy Decision to Amend the Fixed Price Option

## Supporting material

### Purpose

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11. This briefing seeks your joint in-principal approvals to policy changes regarding the fixed price option (FPO), for the purpose of issuing of drafting instructions to the Parliamentary Council Office (PCO).
12. Cabinet agreed through the Climate Change Response (Emissions Trading Reform) Amendment Bill (the Bill) policy Cabinet paper [2020-C-06351] to delegate authority for in-principal policy decisions and issuance of drafting instructions to yourself, the Minister of Finance and the Minister of Forestry. We recommend that you approve the recommendations in this note, forward it to those Ministers and discuss and obtain their agreement.
13. The policy changes are intended to be enacted by way of supplementary order paper (SOP) to the Bill, currently before the Environment Select Committee. We expect the Committee of the Whole House stage will occur in late April or early May.

### Context

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14. The FPO is currently used as a price ceiling mechanism that allows participants to pay a specified amount of money directly to the government as an alternative to purchasing and surrendering NZUs. This provides participants with a guaranteed maximum compliance cost. The FPO is currently \$25, and available for use in 2020 for activities in 2019. There is no volume limit on the use of the FPO.
15. The Bill currently proposes that the FPO is replaced with a cost containment reserve (CCR) mechanism that will release additional units onto the NZ ETS market when a specific trigger price is reached. This will increase NZU supply and reduce the risk that prices within the NZ ETS reach an unacceptably high level. The Bill currently proposes that the FPO is removed as soon as NZU auctioning begins within the NZ ETS, as that is the same time that the CCR is implemented.
16. Officials realised late in 2019 that the arrangements above contained risks for NZ ETS participants. Auctions are not expected to begin until early 2021. If the FPO is removed immediately at that point of time, it means participants will not be able to use it to meet surrender obligations resulting from activities in 2020. Consequently, participants have no certainty on their maximum compliance costs for their current activities, and holders of NZUs have market power over 2020 as they are the only suppliers of emissions units. In response to the risks realised, a proposal to extend the fixed price option was included in the Government's public consultation on the proposed NZ ETS settings.

## Analysis and Advice

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17. Policy decisions relating to changes to the FPO are primarily based on trade-offs between three key factors:
  - a. allowing for market predictability, stability and a smooth transition to the reformed scheme,
  - b. encouraging emissions reductions and achieving emissions reduction targets, and
  - c. fiscal considerations.
18. Increasing the price of the FPO to \$35 signals the expectation for increased emissions prices, whilst providing a smooth transition and no sudden and significant price impacts on businesses and/or households.
19. By signalling to the market through the consultation document that the Government proposed to extend and increase the cost of the FPO, businesses may have already used this as a basis for emissions cost estimates, and passed these costs through to consumers.
20. No expiry date is proposed for the \$35 FPO, other than it can only be used for activities occurring in 2020. This allows participants who have emissions returns amended in the future to use it to meet surrender obligations if those obligations relate to 2020 activities.

### *Forestry activities and the single year \$35 FPO*

21. We recommend pre-1990 deforestation activities should be treated like non-forestry activities, where surrender obligations arising from land use changes in 2020 can use the \$35.
22. Regarding post-1989 forestry activities under the Act, we recommend the ability to access the FPO is determined by the time period the participant is filing the emissions return for. This would mean, for example, if the emission return filed in 2021, covers 2018-2020, we would pro-rata the net emission to the relevant FPO available at the time of the activity (eg, for up to 2/3 of net emissions the \$25 FPO would be available to the participants, and for up to 1/3 of net emission the \$35 FPO would be available). As is currently available, the participant may elect not use the FPO for some or all of their new emissions.

### *The link to the synthetic greenhouse gas levy*

23. Given the FPO sets the maximum cost of compliance for ETS participants, it is equitable to provide this also for people who are subject to the synthetic greenhouse gas levy. An emissions price methodology in regulations determines the underlying 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 Bill removes this.
24. We recommend the maximum price of carbon underlying the calculations for levy rates for 2021 be \$35. This will ensure 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.

## Consultation feedback

25. Public feedback on changes to the fixed price option was gathered through a consultation on proposed NZ ETS settings that closed on the 28<sup>th</sup> of February. Through this consultation, 133 written submissions were received.
26. There were a wide range of views on the proposal to change the fixed price option to \$35 for the 2020 calendar year. Our summary and analysis is in the table below. Further detail on the feedback and a short analysis is provided in Appendix 1.

Point raised	Number of submitters who raised this point	Rationale	Analysis
Fixed price option should be higher than \$35	25	To support greater ambition on emissions reductions and to avoid increasing the stockpile of units in the market	We disagree: \$35 was proposed as an interim price step and signal of likely increased prices. By providing a transitional setting, it balances emissions goals with economic considerations.
Support Fixed price option at \$35	23	As a transitional measure to provide predictability about the direction of change and time to adjust	
Does not support increasing the Fixed price option because of costs	8	Impacts on costs and production and risk of emissions leakage	We disagree: While not dismissive of potential economic impacts on some businesses, the increase is modest and addresses significant market risks
Does not support increasing the Fixed price option because of 'retrospectivity'	7	Undermines price certainty given it will apply to activities from the start of 2020	We disagree: Use of the FPO will occur after the change is enacted, so there is no retrospectivity

27. Consequently, we recommend no changes to the proposals for the FPO.
28. The Treasury and the Ministry for Primary Industries were consulted in the development of this briefing note, including its recommendations.

## **Risks and mitigations**

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29. Use of the fixed price option delays the reduction of the stockpile of emission units. Participants may decide to retain their NZUs for meeting surrender obligations in the future and instead use the fixed price option to meet obligations. This delays the discovery of emission reductions in the economy and therefore makes it more challenging to meet emissions reduction targets.
30. However, the proposal addresses a significant market risk, as noted above. On balance, we consider the proposed \$35 setting reduces the risk of high use and resulting impact on emissions budgets, while providing for appropriate signalling of increased emissions mitigation ambition and avoiding market shocks.
31. A regulatory impact analysis and a climate impacts of policy analysis will accompany the April Cabinet paper that seeks confirmation of the in-principle policy decisions in this briefing and introduction of the supplementary order paper.

## **Legal issues**

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32. Following your decisions on the proposals and agreement to the issuance of drafting instructions, officials will work with the Parliamentary Counsel Office to draft a supplementary order paper for introduction at the Bill's Committee of the Whole House stage.

## **Fiscal implications**

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33. In 2019 approximately half of emissions surrender obligations were met by using the \$25 FPO. Our expectations are of considerably greater use this year given emission unit prices in the secondary market are currently higher than the \$25 FPO. We are unsure regarding potential use in 2021 for the \$35 FPO.
34. Use of the FPO has increased the cash available to the Government by around \$500 to \$600 million per annum. As a result, this has meant a reduction in the amount the Government needs to borrow, reducing the net core Crown debt track by around 0.6% of GDP by 2023/24. Although the FPO option has a positive impact on net core Crown debt, it does not reduce the Government's obligation under the ETS which will need to be settled in the future.

## **Next Steps**

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35. The amendment and policy decision will be presented at the Cabinet Legislative Committee meeting on the 17<sup>th</sup> April. Several other policy changes will be progressed through this Cabinet paper and be presented at the Committee of the Whole House stage of the ETR Bill. Cabinet will be asked to confirm your in-principle policy decisions and introduce the SOP.

## Appendix: Summary of FPO submissions

Submitters held a range of opinions on the proposal to increase the fixed price option to \$35 for obligations arising from activities over 2020. Submitters' responses were complex, and could often not be categorised as simply supporting or opposing the proposal. However, several themes clearly emerged.

### *FPO price should be higher*

The largest proportion of submitters who commented on the fixed price option believed its price should be higher. This opinion came from twenty six submitters, including the Climate Change 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 point was that the \$35 FPO, combined with the \$50 cost containment reserve (CCR) trigger price, leads to expectations of rising NZU prices and in turn many participants may choose to use the FPO for 2020 surrender obligations. The risk of this, noted by many submitters including the Climate Change Commission, is that the stockpile could increase as a result, through free allocation and forestry removals. The Climate Change Commission recommended that setting the FPO for 2020 emissions "at a higher level that is closer to the CCR trigger price" would help mitigate this impact.

### *General support for FPO proposal*

Twenty three submitters showed general support for the proposal to increase the fixed price option to \$35 for obligations arising from activities over 2020. Seven of these submitters highlighted the merit of the proposal as a transitional measure to provide predictability about the direction of change and time to adjust, including Carbon and Energy Professionals New Zealand, Trustpower, NZX Limited & European Energy Exchange AG, Vector, Oji Fibre Solutions, and Tāne's Tree Trust.

### *Opposition towards increase in 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 that the proposal is retrospective and subsequently unreasonable.

Eight submitters opposed the fixed price option proposal due to a general opposition towards NZU prices increasing and the impacts this would have. [REDACTED] and Tailored Energy Solutions Limited argued local manufacturing already has financial burdens that offshore competitors do not face, and subsequently believed increasing NZU prices would drive emissions leakage. Genesis Energy discussed potential impacts on electricity prices and costs of production, while Gisborne District Council was concerned about the impacts of passed down costs on low socio-economic households.

Seven submitters including EnviroNZ, [REDACTED], 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 for surrender

obligations in 2021 for emissions produced in 2020. These industry submitters described the FPO proposal as retrospective or retroactive, and held concerns that this undermines the forward-looking cost certainty that the FPO seeks to facilitate. Submitters opposing the proposal for this reason highlighted it was not the increase in price they opposed but the lack of price certainty it might bring.

Ten individual submitters said they were unsure if they supported the proposal. Reasons for uncertainty varied, from concern about the FPOs extension mitigating the Government's efforts to reduce the NZU stockpile, to general support for extending the FPO but concern that \$35 as a midpoint between \$20 and \$50 is an arbitrary price that may not be the best option.

## **Analysis**

Consistent with the opinions of a large number of submitters, the proposal to increase the fixed price option to \$35 for obligations arising from activities over 2020 has the purpose of providing cost certainty for participants in the transition to auctioning NZUs with price controls. Its extension mitigates risks of short term volatility in NZU prices during this transition period, and the increase in price from \$25 to \$35 is consistent with the intention to allow NZU prices to increase in order for abatement opportunities to become economical.

### *FPO price*

While some submitters criticised the setting of the proposed FPO price as arbitrary, we continue to recommend \$35 as the mid-point between the proposed initial price floor (\$20) and price ceiling (\$50) to provide the smoothest possible price path from the existing NZ ETS settings to the new. Many submitters argued that this increase in price was too moderate, while others expressed great concerns about the impacts of increasing its price. We consider the increase from \$25 to \$35 as an appropriate balance between these concerns to reduce the likelihood of it seeing extensive use in 2021 while remaining in line with the principles of a just transition.

### *Retrospectivity and cost uncertainty*

We do not regard the proposal as retrospective. The \$35 FPO cost would not be incurred until participants chose to use it in 2021. The fixed price option is only one way that participants can meet emission unit surrender obligations arising from activities in the previous year. Participants can alternatively chose to purchase emissions units from the secondary market ahead of those surrender obligations. Given the current emission unit price is significantly less than \$35, this appears to be a prudent option.

One of the objectives for the NZ ETS reform is to reduce regulatory uncertainty through the five-year rolling process for announcement of NZ ETS settings, including the total annual cap on emissions, auction volumes and price controls. New uncertainties will exist until those measures are legislated and implemented, and the proposed extension and increase to the fixed price option has the purpose of reducing risks created by this transition.

Consequently, we recommend proceeding with the proposal to extend and increase the fixed price option to \$35 for obligations arising from activities over 2020.