Policy decision to implement the extended Fixed Price Option as a backstop

Date submitted:	9 April 2020	Tracking #: 2020-B-06585	
Security level	In confidence	MfE Priority:	Urgent

	Action sought:	Response by:
To Hon James Shaw, Minister for Climate Change	1. If you wish to proceed, forward this briefing to • Hon Grant Robertson, Minister of Finance • Hon Shane Jones, Minister of Forestry	16 April
	2. Discuss this briefing with the Minister of Forestry and Minister of Finance	23 April
	3. Jointly agree to the policy changes	23 April
	4. Jointly agree to the issuance of drafting instructions	23 April

Actions for Minister's office staff	**Return** the signed report to MfE.
Number of appendices and attachments: 1	Forestry operational detail to apply the FPO on a pro-rata basis

Ministry for the Environment contacts

Position	Name	Cell phone	1st contact
Principal Author	Justin Wood		
Responsible Manager	Matthew Cowie		✓
Director	Roger Lincoln		

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Key Messages

1. This briefing seeks your decision to include a 'backstop' when implementing policy changes to the fixed price option (FPO). In accordance with delegated authority from Cabinet, you have already jointly approved those FPO policy changes with the Minister of Finance and the Minister of Forestry (refer 2020-B-06518). This briefing proposes an addition to those changes as a contingency measure.
2. If you wish to proceed, your joint approval to adopt the backstop will be incorporated in the drafting instructions issued to the Parliamentary Council Office (PCO). If you do not, the extended FPO will be available for 2020 emission activities only, in accordance with the policy changes you have already decided.

Proposal

3. You recently jointly approved extending the FPO to cover emission unit surrender obligations for activities over calendar year 2020, and raising the price from $25 to $35. These policy changes will be implemented through a supplementary order paper (SOP) to the Climate Change Response (Emissions Trading Reform) Bill (the Bill) at its Committee of the Whole House stage.
4. However, this policy extension makes the $35 FPO available for activities in 2020 only. This restriction poses risks for NZ ETS participants if auctioning of New Zealand Units (NZUs) does not start in early 2021 as planned. First, if auctioning was delayed until 2022, participants could not use the extended FPO to cover any emissions in 2021 at all. Second, any participant ceasing activities could not use the extended FPO to cover their emissions in 2021 up to that date, despite NZUs not yet being available at auction.
5. As a contingency measure, we therefore recommend the $35 FPO remains in place until auctioning actually begins. Implementing the extended FPO in this way acts as a backstop:
    a. It ensures the $35 FPO automatically 'rolls over' to each calendar year after 2020 until auctioning starts.
    b. Once auctioning begins, the $35 FPO is automatically only available to cover activities in 2020 and any *full* calendar year before the date of that auction.
    c. Related changes to the synthetic greenhouse gas levy you have also already approved would be implemented in the same way.
6. If you approve this backstop approach, we will issue drafting instructions for this to be added to the SOP. If you do not, the FPO policy changes will be drafted as already approved, without the backstop approach.
7. The purpose of implementing the $35 FPO in this way is to ensure no further amendments to the Climate Change Response Act 2002 (the Act) are required if auctioning does not start in 2021, for any reason. If auctioning did not proceed in 2021, participants otherwise have to rely on the secondary market exclusively, unless the Act is amended further. We consider it prudent for the Bill to include a contingency allowing for the possibility of a delay to auctioning.

8. The backstop approach will have no fiscal impact if auctioning proceeds in early 2021 as planned. If auctioning is delayed, the backstop approach will increase cash available to the Government. Use of the $35 FPO is revenue the Government would otherwise not receive, as NZU auctioning will not have begun when the FPO is available. However, this revenue would not be recorded as a reduction in the Crown's liability for NZUs currently held in the stockpile.

9. We also recommend the pro-rata approach for post-1989 foresters accessing the $35 FPO you have already approved should be explicitly limited to net emission returns only. Clarifying this operational detail avoids introducing a potential arbitrage opportunity. Full details are attached as an appendix to this briefing.

Recommendations

10. We recommend that you:

a. **Note** you have already approved extending the FPO to cover 2020 emission unit surrender obligations for activities over calendar year 2020 at an increased price of $35, and related changes to the synthetic greenhouse gas levy for 2021

b. **Note** that if these policy changes are implemented as agreed but auctioning does not proceed for any reason in 2021, NZ ETS participants would then have to rely on the secondary market exclusively for emissions from 2021 and onwards

c. **Agree** to implement these policy changes for the backstop approach:

i. That the $35 FPO is available from the date the amended Act takes effect for emission activities occurring in calendar year 2020 and for emission years indefinitely thereafter — Yes / No

ii. That on the date of the first NZU auction the $35 FPO is restricted to be available only for activities in 2020, and any full calendar years up to that auction date — Yes / No

iii. That the $35 FPO can be used to meet emission unit surrender obligations arising from non-forestry activities and pre-1990 forestry activities in any year included in c(ii) above — Yes / No

iv. That the $35 FPO is available to post-1989 foresters on a pro rata basis for activities in any year included in c(ii) above — Yes / No

v. That until the day of the first NZU auction the maximum price of carbon used to calculate synthetic greenhouse gas levy rates is $35 — Yes / No

d. **Agree** this backstop is included in the drafting instructions for a supplementary order paper with the policy changes noted in recommendation (a) — Yes / No

e. **Agree** post-1989 foresters should only be permitted to access the extended FPO when submitting net emission returns — Yes / No

f. **Note** Cabinet will be asked to confirm the above policy decisions when the SOP is presented, supported with a regulatory impact analysis.

Signature

This briefing was electronically approved by

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**

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Supporting material

Purpose

11. This briefing seeks your joint approval of certain implementation details about policy changes regarding the fixed price option (FPO) you have already agreed [via 2020-B-06518]. Your further approval will be used to add to drafting instructions issued to the Parliamentary Council Office (PCO). If you do not approve the recommendations in this note, the SOP will be drafted according to the policy decisions you have already approved.
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-principle policy decisions and issuance of drafting instructions regarding the FPO to yourself, the Minister of Finance, and the Minister of Forestry. We recommend you approve the recommendations in this note, forward it to those Ministers, and discuss and obtain their agreement.
13. The policy changes will 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 May.

Context

14. Through Briefing Note 2020-B-06518 you have already agreed to extend the FPO to cover 2020 emission activities at an increased price of $35, and to make related changes to the synthetic greenhouse gas levy for 2021 activities.
15. However, these policy changes did not consider the possibility that auctioning may not proceed in 2021 as planned. If auctioning does not start in 2021, NZ ETS participants would have to rely on the secondary market exclusively to meet their surrender obligations for their 2021 activities.
16. In these circumstances, NZ ETS participants would face effectively the same risks the extended FPO was intended to mitigate. Participants would have no certainty over their maximum compliance costs for 2021, as the FPO would not be available and auctioning has not begun. Current holders of NZUs (the stockpile) would therefore have market power as the only suppliers of emission units.

Analysis and Advice

17. Given the Government's current focus on the COVID-19 pandemic and the uncertainty of economic impacts in early 2021, the likelihood that auctioning is delayed has increased; although officials still regard the risk of a delay as low at this stage. Officials therefore consider it prudent to further extend the $35 FPO as a contingency measure ('the backstop approach'). The $35 FPO would instead continue automatically until auctioning actually

starts, mitigating the risks to participants noted above. Government could still decide to start auctioning in 2022 (or later).

How the $35 FPO terminates under the backstop approach

18. Adopting our proposed backstop approach means any participant ceasing activities can also access the $35 FPO to cover their emissions in that same calendar year, until auctioning begins. Once auctioning starts, the $35 FPO could only be used for emissions in 2020 and any further full calendar years where there were no auctions. Participants ceasing activities the year auctioning begins could then obtain NZUs at auction; they would not have to rely on the secondary market. Note this outcome is broadly the same as repealing the FPO entirely on the date of the first auction under the current Bill; although this new proposal focuses on calendar year periods rather than specific calendar dates.

19. To illustrate the extended FPO terminating:

    a. If auctioning begins on 1 March 2021, participants could use the $35 FPO for their 2020 emission activities. Until 28 February, any participant ceasing activities and surrendering units as a result could access the $35 FPO for their 2021 emissions, but could not do so after 1 March 2021.

    b. If auctioning begins on 15 June 2022, participants could use the $35 FPO for their emission activities in both 2020 and 2021. Until 14 June 2022, any participant ceasing activities and surrendering units as a result could access the $35 FPO for their 2022 emissions, but not after 15 June 2022.

Forestry activities and the $35 FPO as a backstop

20. Consistent with the policy changes you have already approved, we recommend pre-1990 deforestation activities be treated like non-forestry activities for any year the $35 FPO applies. Similarly, we recommend the pro-rata approach for accessing the $35 FPO for post-1989 forestry activities continues to apply to any year the $35 FPO is available.

Consistent treatment of the synthetic greenhouse gas levy

21. You have already approved raising the maximum price of carbon for calculating the synthetic greenhouse gas levy to $35 for 2021 activities. This ensures the maximum cost of compliance for ETS participants subject to the synthetic greenhouse gas levy is equitable with participants accessing the $35 FPO. We also recommend extending this $35 maximum price of carbon until auctioning begins. For example, if auctioning does not begin until 2022, then because SGG levies are calculated in late 2021, the maximum carbon price will be $35 for 2022 activities.

Clarifying post-1989 forestry access to the extended FPO

22. Clarification on how the pro-rata approach for post-1989 forestry should work across the full range of forestry returns is also required. Officials from the Ministry for Primary Industries advise this is needed even if the $35 FPO is not implemented as a backstop (ie, if it applied for 2020 emission activities only). Specifically, we recommend access to the $35 FPO should only be permitted for net emission returns. This operational restriction

avoids any potential for post-1989 forestry participants to arbitrage NZU prices against the $35 FPO before net emission returns become mandatory on 1 January 2022. Full details are attached in Appendix 1.

Risks and mitigations

23. The backstop approach was not included in the Government's proposal to extend the FPO to 2020 activities at $35, as part of public consultation on proposed NZ ETS settings. However, we consider the backstop approach is consistent with the underlying policy intent, and will have no practical effect if auctioning proceeds as planned in early 2021.

Legal issues

24. Following your decisions on implementing the extended FPO using the backstop approach, officials will continue to work with PCO to draft a supplementary order paper for introduction at the Bill's Committee of the Whole House stage.

Financial, regulatory and legislative implications

Fiscal impacts

25. Our assessment of fiscal impacts is relative to the counterfactual where the already agreed policy changes are implemented: the $35 FPO and related changes for the synthetic greenhouse gas levy are only for 2020 activities.

26. If auctioning starts in early 2021 as planned, the backstop approach is equivalent and has no further fiscal impacts for the Crown.

27. If auctioning is deferred in 2021, the backstop approach may increase cash available to the Government; ie, any use of the continuing $35 FPO for activities after 2020 is revenue the Government would otherwise not receive, as NZU auctioning has not begun. However, use of the FPO after 2020 also means the NZU stockpile and hence the Crown's liability is not reduced where it otherwise would have been. Without the FPO (and no auctioning), participants would have to obtain NZUs from the secondary market. Surrendering those NZUs (ie, sourced from the stockpile) is recorded as an increase in revenue for the Crown and a corresponding reduction in liability. Conversely, while use of the FPO also increases revenue, it is accounted as an increase in cash rather than a decrease in liability.

Changes to earlier decisions on legislation

28. These policy changes extending the FPO to cover 2020 activities at $35 in effect override previous Cabinet decisions to set an end date for the FPO [ENV-19-MIN-0011 refers]. Those earlier decisions are reflected in the current version of the Bill, which repeals the FPO entirely either from the date of the first auction or on 1 January 2023, whichever is the earlier. This 2023 end date was intended as a deadline in the Act to ensure the Government begins NZU auctioning, while allowing for unexpected events.

29. Amending the Bill to extend the $35 FPO strictly for 2020 activities has the same effect as repealing the FPO from 2021 (it cannot be used for emissions past 2020). The 1 January

2023 end date would no longer be relevant. Implementing the backstop approach we propose in this Briefing Note instead is more closely aligned to Cabinet’s earlier decisions: the FPO continues in the event auctioning does not begin in 2021, as a contingency. In this form, we do not consider the 1 January 2023 end date is required.

Next Steps

30. We expect to present the amendment and policy decision to Cabinet on 11 May. 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 reform Bill. Cabinet will be asked to confirm your final in-principle policy decisions and introduce the SOP. Full regulatory impact analysis and climate impacts of policy analysis will accompany the Cabinet decision.

Appendix: Forestry operational detail to apply the FPO on a pro-rata basis

The following information is provided by officials of the Ministry for Primary Industries. Note that policy decision 2 (use longest time period) is already provided by your existing in-principle approval and is therefore not included in the Recommendations.

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1. Due to the diversity of returns and the period that can be covered in a single return, we have identified two policy areas where additional ministerial direction is required to ensure the drafting of changes to the FPO matches the policy intent.

There are two types of returns for post-1989 forestry, which can cover a range of time periods:

2. There are a two types of post-1989 forestry emissions returns:
   - Mandatory Emissions Return (MERs)[1]; and
   - Voluntary Emissions Return (VERs).[2]

3. A MER will cover the period from 2018 (or the most recent MER[3]) to a specific end date for that carbon accounting area[4] (e.g. then end of the Mandatory Emissions Return Period). All post-1989 forestry participants will need to file a MER in 2023, the majority of which cover the period from 2018-2022. In certain cases, some participants will need to file MERs before 2023, for example if their forest land is subject to a transmission of interest (e.g. sale) or deregistration from the ETS.

4. A VER covers the period since the participant's most recent emissions return. It can include some or all of a participant's carbon accounting area (CAA), at their discretion. Any units surrendered or issued as a result of a VER are netted off against the participant's entitlement in their next MER so that they receive only their true entitlement of units.

Policy decision 1: Limit the use of pro-rata FPO to those returns which are 'net emissions returns':

5. A 'net emissions return' is one which calculates the participant's net entitlement or surrender obligations across all CAAs the return covers. Effectively, the participant does not receive units for forest growth only to need to surrender some of the units for emissions in another part of their forest. The netting off is done before their final entitlement is calculated.

6. Until 2022, participants have the option to file net emissions returns or to have each CAA's entitlement/surrender obligations determined individually. The Bill changes all forestry

[1] These are being renamed 'Final Emissions Returns' in the Bill, and the current range of MERs are being standardised.

[2] These are being named 'Provisional Emissions Returns' in the Bill, as currently VERs are not formally detailed in the Act.

[3] For example, if person A sells land to person B in 2019, person A files a MER starting in 2018. The first MER filed by person B would only go back to the date on which they became the participant for that land.

[4] A carbon accounting area (CAA) is how the participant records their ETS registration. All forest held by a participant must be in a CAA but there is no limit on the number of CAAs a participant can hold, provided each is at least 1 hectare in size.

returns to require net emissions returns from 1 January 2022, as it reduces the risk of non-surrender of units.

7. If participants are able to access the pro-rated FPO option for non-netted returns submitted before 31 December 2021, there is an arbitrage opportunity if the market price of an NZU exceeds the FPO. That is, the FPO would be used for those CAAs with surrender obligations, while they would be entitled to receive more valuable NZUs for those CAAs with a positive stock change.

8. To reduce this risk we propose to limit the use of pro-rata FPO for forestry returns to those returns which are 'net emissions returns'.

Policy decision 2: Apply the pro-rata period to the longest period covered in the emissions return:

9. In any emissions return it is possible that the carbon stock change of the different CAAs will be calculated for different time periods. This is particularly likely for MERs at the end of the current Mandatory Emissions Return Period (2018-2022).[5]

10. For simplicity, we propose that the pro-rata approach is based on the longest time period covered by the return. For example, if one CAA is reported from 2018 and a second starts in 2020 the pro-rating would begin in 2018.

11. Treating each CAA separately would risk the arbitrage opportunity outlined above. It would also increase the complexity involved in processing returns, thereby slowing the delivery of units to participants and the surrender of units to the Crown.

12. Compared to applying a range of periods, the preferred approach does not significantly increase the cost to participants. This is because a range of periods could result in a greater proportion of participants needing to use the $35 dollar FPO. Additionally, the preferred approach is unlikely to create significant costs for the Crown, despite the possibility of a proportionately greater use of the $25 dollar FPO as participants could submit VERs to access the lower price.

[5] For example, a CAA can only report from when the land became forest so forest planted in 2020 would report from 2020 to 2022.