

Options to manage the consequences of high prices in the private carbon market on fixed delivery contracts under the Emissions Reduction Fund and associated implications

DRAFT Regulation Impact Statement

Department of Industry, Science, Energy and Resources

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Introduction

This draft Regulation Impact Statement (RIS) analyses options to maintain the stability of the Australian carbon market. It has been prepared to inform consideration of a proposal for the Clean Energy Regulator (CER) to introduce a mechanism that will facilitate an orderly transition to allow fixed delivery contract holders to be released from their delivery obligations in order to sell their Australian Carbon Credit Units (ACCUs) to the private market. The RIS was prepared in accordance with the Australian Government Guide to Regulation 2014 and more recent guidance notes issued by the Office of Best Practice Regulation (OBPR) and addresses the seven required questions.

Overview of the Emissions Reduction Fund

The Emissions Reduction Fund (ERF) is a voluntary scheme that supports individuals and organisations to invest in new practices and technologies in the form of projects to reduce greenhouse gas emissions across all sectors of the Australian economy. Projects earn ACCUs that can be sold to generate income, either to the government through a carbon abatement contract, or to private buyers in the private market. The ERF plays an important role in the government's efforts to reduce Australia's emissions while maintaining a strong economy. The ERF backs projects that deliver on-the-ground practical action to reduce emissions, provides benefits to our farming and Indigenous communities, and helps business and industry to offset their emissions. It is enacted through the *Carbon Credits (Carbon Farming Initiative) Act 2011*, the *Carbon Credits (Carbon Farming Initiative) Regulations 2011* and the *Carbon Credits (Carbon Farming Initiative) Rule 2015*.

The government allocated \$2.55 billion to the ERF in 2014–15, and in 2018–19 allocated a further \$2 billion through the Climate Solutions Fund to build on the ERF's success and support additional low-cost abatement. To date, the government has committed around \$2.5 billion through the ERF towards emissions reduction projects across agriculture and the land sector (particularly revegetation projects); landfill and waste; energy efficiency; industry; and transport. This includes \$2.2 billion to projects that reduce emissions in rural and regional areas.

The government's approach to purchasing abatement under the ERF has been very successful. The ERF plays an important role in the government's efforts to reduce Australia's emissions and in incentivising priority technologies identified in the Low Emissions Technology Statement. The ERF now has over 1,100 projects delivering carbon abatement benefits across Australia and has already credited over 106 million tonnes of abatement. In 2021, there were record project registrations under the ERF, with record abatement of over 17 million tonnes delivered. Voluntary demand for purchasing ACCUs has already increased more than 40% in the 2021-2022 financial year relative to the 2020-21 year.

The ERF is one of the world's largest and most sophisticated offsets program underpinned by a robust government administered framework to ensure the integrity of the abatement generated.

The ERF has three elements:

1. **Crediting**—The CER assesses and registers eligible carbon abatement projects using approved methods. The CER issues one ACCU for each tonne of carbon abatement achieved. Scheme participants can sell these ACCUs to the government through a carbon abatement contract, or on the private market.
2. **Purchasing**— The CER enters contracts with participants on behalf of the Commonwealth, agreeing to purchase the ACCUs earned through eligible carbon abatement activities, that is, activities that are subject to a methodology determination. To date this has been through reverse auctions, where the CER purchases the lowest cost abatement offered.

3. Safeguard mechanism—this is designed to ensure emissions reductions, achieved through the ERF are not offset by significant emissions increases above business-as-usual levels in other sectors of the economy.

Carbon abatement contracts

A carbon abatement contract (contract) is an arrangement to sell ACCUs to the Commonwealth. A contract can be secured by participating in an ERF purchasing process such as a reverse auction. Two types of contracts are available: fixed delivery and optional delivery.

Fixed Delivery contract

A fixed delivery contract offered by the CER obligates the seller to deliver an agreed quantity of ACCUs. The CER purchases these ACCUs at the contracted price over a set delivery schedule for the duration of the contract. ACCUs delivered under this contract can be sourced from the nominated project, other ERF projects or from the private market. Fixed delivery contracts are suited to situations where the contract holder wants the flexibility to deliver ACCUs from more than one source.

Fixed delivery contracts contain make good provisions and sellers are expected to deliver the agreed quantity of ACCUs irrespective of the performance of any associated projects. Fixed delivery contracts provide the security of a set price for ACCUs, with a flexible duration of up to 10 years for eligible projects.

If contracted abatement under fixed delivery contracts is not delivered, the government retains its funds and can seek damages for a default. Buyer's market damages (BMD) for non-delivery of ACCUs are currently capped at the contract price plus interest and reasonable costs incurred by the CER.

Optional Delivery contract

An optional delivery contract provides the right, but not the obligation, to sell carbon abatement to the Commonwealth at an agreed price, within a set time. The optional delivery contract provides assurance in the form of a minimum price for carbon abatement from a specified project. It allows contract holders to better manage their price and supply risks with a view to encouraging more carbon abatement projects as a result. Optional delivery contracts may be used in negotiations with lenders or other parties to demonstrate what the Commonwealth will pay for abatement from a specified project, with no contractual barrier to seeking more lucrative contracts from other buyers. ACCUs sold under an optional delivery contract must be derived from a single identified ERF project.

Optional delivery contracts provide security of a set price for ACCUs, with a flexible duration of up to 10 years for eligible projects. The CER introduced the optional delivery contract as a pilot offering for Auction 10 (March 2020). Consultation with industry found significant support for the contract to assist and underpin investment in emissions reduction projects in Australia, enhance supply of ACCUs, offer certainty, and help investors better manage their price risks.

Following the introduction of optional delivery contracts, the proportion of abatement secured at auctions through fixed delivery contracts was only 1% of the volume contracted in 2021. At Auction 13 held in October 2021, no fixed delivery bids were accepted. The volumes bid for fixed delivery were also limited. The carbon market is therefore evolving in a way that suggests there is little appetite for further fixed delivery contracts and optional delivery contracts are preferred. For this reason, no new fixed delivery contracts will be offered at Auction 14 in April 2022.

1. What is the problem you are trying to solve?

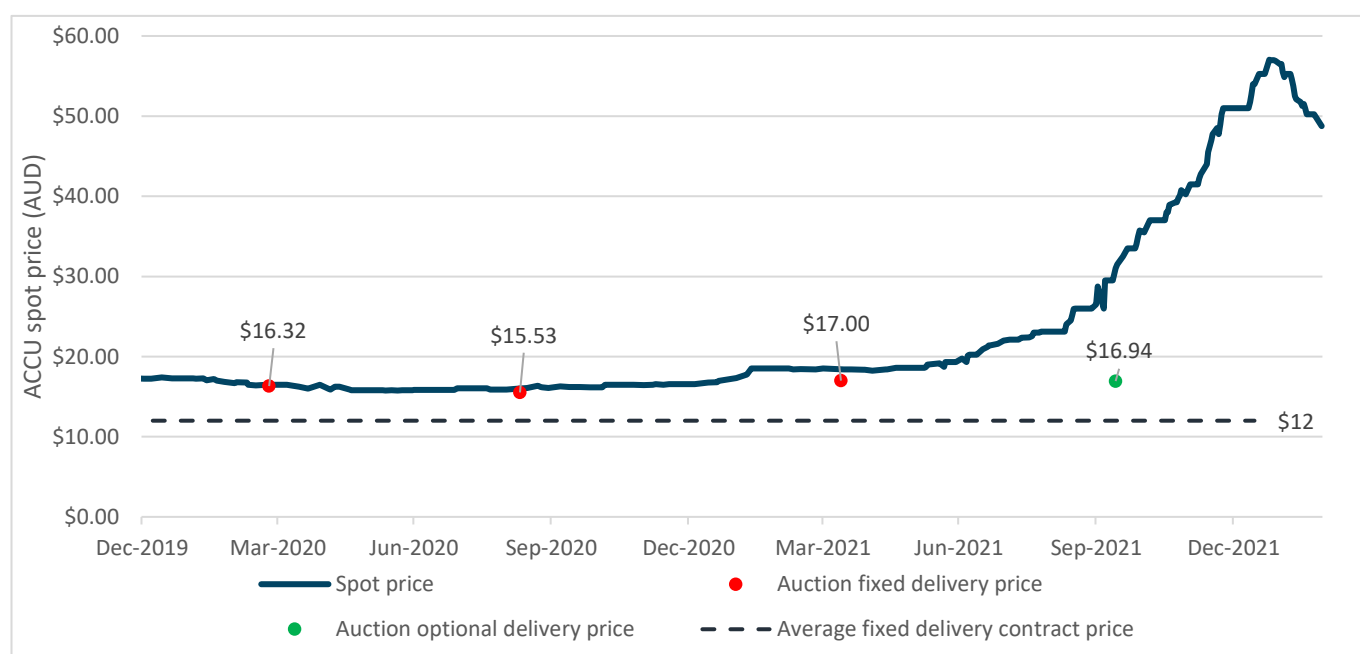
The policy context

Building the private carbon market is a key element of Australia's Long Term Emissions Reduction Plan. The Plan focuses on driving down technology costs and accelerating deployment at scale across the economy. The ERF, which commenced in 2015, targets voluntary reductions in emissions and incentivises uptake of technologies as they approach commercial parity. For sectors where the technology solutions are not yet available, the ERF can help generate offsets that enable businesses to achieve their emission reduction goals.

The Australian carbon market is evolving to support increasing demand from corporations, states and territories, and the public. Voluntary demand (seen through cancellation of ACCUs) increased from 647,675 ACCUs in 2019-20 to 921,544 ACCUs in 2020-21, an increase of more than 40%. Private market activity also grew markedly throughout 2021, with Australian National Registry of Emission Units (ANREU) volumes transacted more than doubling from 2020 to total 7.5 million ACCUs in 2021.

There has been material increases in ACCU prices as demand exceeds supply. Since January 2021, the spot price of ACCUs has increased by 191 per cent from under \$17 to \$49.50 (as at 28 February 2022). This is significantly higher than the average price paid by government under existing ERF fixed delivery contracts of about \$12 per ACCU (Figure 1).

Figure 1: ACCU prices



Note: As no Fixed Delivery contracts were awarded in October 2021, the average optional delivery contract price has been provided for October 2021 instead.

Sources: Clean Energy Regulator, Jarden, TFS Green, February 2022

The problem

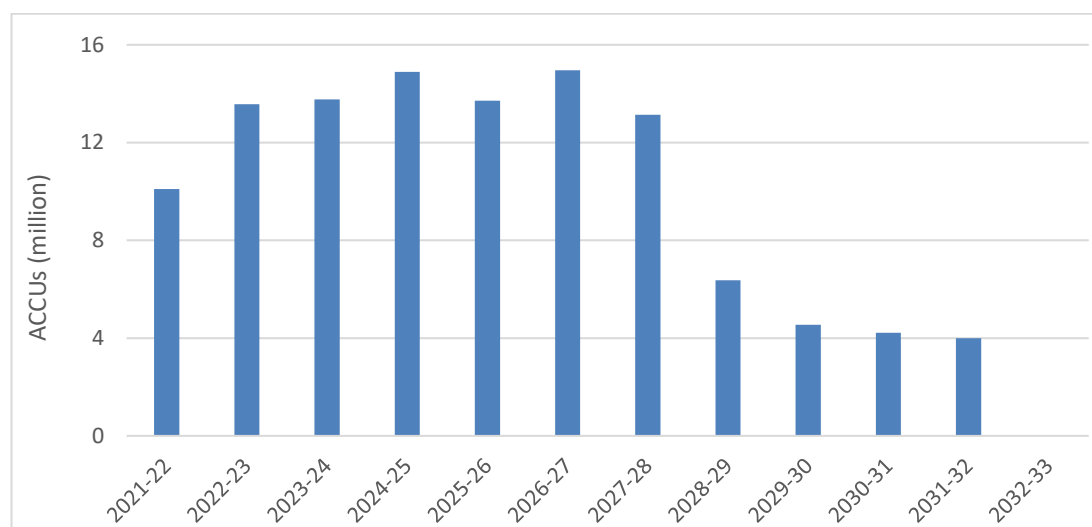
As the regulator responsible for the carbon market, the CER has advised that the sustained increase in ACCU price has created a likely and imminent risk of a disorderly exit from fixed delivery contract obligations. Voluntary demand for purchasing ACCUs has already increased more than 40% in the 2021-22 financial year relative to the 2020-21 year. This increase in demand is anticipated to continue, given the government's commitment to deliver net zero emissions by 2050, together with an increasing number of organisations embracing a corporate net zero target. These settings are putting a growing pressure on ACCU prices. Recent spot prices provide a financial incentive for all fixed delivery contracts to favour delivery to the private market rather than the Commonwealth. Based on a market price of \$50 and average contract price of \$12, contract holders stand to receive \$38 net per ACCU, or an additional \$26 ACCU relative to their current payment for delivery.

Although fixed delivery contract holders are meeting their delivery obligations to date, the sustained increase in ACCU price means the situation is increasingly unstable. It is likely only a matter of time before some contract holders use the BMD mechanism that exists in current fixed delivery contract provisions to avoid delivering contracted ACCUs to the government. Once one contract holder uses BMD to avoid delivery there is likely to be a rush with others following suit to try to pick up high prices before ACCU prices fall due to additional supply coming to the market.

Several ERF contract holders have noted they and the ERF project owners who they may represent, have a strong desire to exit delivery requirements from their fixed delivery contracts. These stakeholders have noted that fixed delivery contracts successfully incentivised material investment in carbon abatement projects but are now creating balance sheet risks that hinder investment. Low prices are also impacting the ability of some companies to operate in the face of increasing competition which could lead to disruption if company restructuring or impacts on abatement projects occurred. Some contract holders have indicated that the tax-payer funding linked to the contracts could be better used to support other ERF projects in sectors and under the methods that have lower uptake due to high project costs. The CER has advised these contract holders that it would not be appropriate to offer individual arrangements, and that the situation is complex situation with potential market and equity implications. However, the need for a resolution is growing and the issue is in the public domain with several specialised media outlets reporting on this issue in January and February 2022. This reporting has further elevated the potential for a disorderly exit and some stakeholders raising concerns that other parties may already be exiting their contracts.

Without a timely resolution, contract holders would likely use BMD provisions to exit contracts in the near future. The CER would be required to pursue damages in relation to up to 392 fixed delivery contracts over the next decade. Around 13 to 15 million ACCUs of the 112 million undelivered contracted portfolio are scheduled for delivery each year from 2022–23 to 2027–28 with smaller volumes out to 2032-33 (Figure 2).

Figure 2: Delivery schedule of abatement under fixed delivery contracts¹



Risks and impacts

The risks associated with a disorderly exit are high. As discussed above, the likelihood of a disorderly exit is both highly likely and imminent. The consequences of a disorderly exit range from moderate to high. The impacts would occur immediately after the first use of BMD provisions and continue until the late 2020s when the undelivered volume under the fixed delivery portfolio tapers down and the market is in a position where it can forecast ACCU supply with higher certainty. These risks are outlined in further detail in the table below.

Table 1: Risks and consequences of a disorderly exit from fixed delivery contracts

Risk and cause	Likelihood	Impact	Possible consequences
A disorderly exit occurs	High	High	This scenario would create market uncertainty, falls in ACCU pricing and reward first-movers rather than those who have chosen to meet their delivery obligations.
Significant falls and volatility in the price of ACCUs due to large volumes of ACCUs entering the private market	High	High	Price volatility will impact on market confidence and investment certainty. Price impacts are likely to affect different stakeholder groups in varied ways. Table 2 below outlines stakeholder impacts in further detail.
A lack of transparency and significant information asymmetry in relation to ACCU volumes being released into the private market due to the disorderly and opaque nature of ACCUs being released as a result of BMD	High	Moderate	Investment uncertainty may discourage investment in projects delivering abatement. There would be significant equity implications due to information asymmetry and first-mover advantages. Larger ERF participants are likely to have an advantage over others, such as smaller, independent land holders.

¹ The Clean Energy Regulator, January 2022

Risk and cause	Likelihood	Impact	Possible consequences
Substantial costs and administrative burden are placed on many contract holders due to BMD processes	High	Moderate to high	Administering BMD will involve high administrative and regulatory costs for both the CER and contract holders. Diverting resources to administering BMD could affect the CER's BAU operations. Pursuit of damages could damage market and investor confidence.

A disorderly exit would impact on a range of stakeholders, as outlined in the table below.

Table 2: Stakeholder impacts in a disorderly exit from fixed delivery contracts

Stakeholder	Impacts
Fixed delivery contract holders	The first contract holders to exit their contracts are likely to substantially benefit by selling their ACCUs into a supply-constrained market with high prices. This may create a rush to secure the best financial outcomes.
Non-Commonwealth purchasers of ACCUs	These are highly likely to benefit from increased ACCU supply as it may create a downward pressure on price, and higher market liquidity may decrease the search times needed to secure ACCUs. There may be some costs associated with a low degree of market transparency such as the disruption of purchasing activities in the short term and changed investment appetite due to market volatility and confidence.
Existing holders of ACCUs	The impacts on this group are varied. Some holders of ACCUs hold fixed delivery contracts and may benefit through improved sales prices. However, in a disorderly exit, price reductions may reduce the benefits for all but the first movers. Parties who do not hold fixed delivery contracts will likely be negatively affected if the increased supply of ACCUs places downward pressure on prices. The impact on parties who intend to increase their ACCU holdings in the future is unclear as they may benefit from an increased supply of ACCUs but may be negatively affected by market uncertainty.
Future participants of the ERF	Investment certainty is highly likely to be negatively affected by an unanticipated and unqualified volume of ACCUs being released into the private market. It is possible that a material and unexpected event would also create longer term investment uncertainty.
The Australian Government	Emissions mitigation efforts are likely to be negatively affected. Many policies require investments by third parties and a market disruption is expected to affect investment sentiment in the short term. The costs to the government of pursuing payment of BMD under a disorderly exit would be significant and would divert resources from other scheme enhancement activities.

2. Why is Government action needed?

The objective of government intervention is to minimise risks to the market, and where possible continue to support growth in the private market. These risks and challenges are unlikely to self-correct. A key element of the fixed delivery contract is the ‘make good’ provisions where sellers are expected to deliver the agreed quantity of ACCUs drawing on the private market irrespective of the performance of any projects associated with the contract. If contracted abatement under fixed delivery contracts is not delivered, the government retains its funds and can seek damages for a default.

Risks to the carbon market

Without government intervention, the business-as-usual approach would be to wait and see if the risk of delivery failures eventuates. The CER has advised that several contract holders have requested they be released from their low-priced fixed delivery contracts. There is also a growing number of queries from contract holders and speculation in specialised media outlets about the use of BMD provisions, indicating that the risk of a disorderly exit is both imminent and likely. The risk of contract holders choosing to act in this way will grow as ACCU prices increase.

The ‘do nothing’ approach would mean that once the first contract holder moves to not deliver on their contract, it would be too late to take steps to avoid the almost certain rush of other contract holders moving to obtain the same price advantage and impacts on the market will already have eventuated. It would also be difficult to intervene due to the lack of visibility of private trades.

Pre-emptive risk management by government is therefore warranted to avoid a disorderly exit from fixed delivery contracts. Without intervention, there is a risk of a large, unexpected volume of ACCUs becoming available to the private market leading to significant price falls, investment uncertainty and potentially a loss of confidence in the scheme.

There may also be disproportionate market advantages to some players, particularly first mover advantage.

Regulatory costs

Without government intervention, the CER would be required to pursue BMD as delivery failures occur. This approach would impose significant regulatory costs on contract holders (and administrative costs on the CER), as the process is administratively complex and slow, requiring valuations, negotiations and potential legal action. Contract holders would also face additional financial, administrative, and compliance costs in this process in terms of a range of cost categories under the Regulatory Burden Measurement Framework (RBMF).

In particular, contract holders would face:

- additional administrative costs related to participation in the valuation and negotiation processes noted above.
- substantive compliance costs in relation to:
 - familiarising themselves with the BMD provisions of their contracts
 - contract holders are also required to pay the reasonable costs of the CER. Pursuit of damages could also damage market and investor confidence.

The opportunity

These significant market developments create an opportunity for the government to facilitate an orderly transition from being the dominant purchaser to a supporter and enabler of the market, and allow the private sector to step up to purchase more abatement. This transition is already underway as evidenced by the increasing dominance of optional delivery contracts in the ERF.

The **policy objective of government action** is to:

- Avoid ERF participants defaulting on contract deliveries.
- Manage the flow of ACCUs released into the private market to support market confidence and stability, including reducing volatility in the price of ACCUs.
- Reduce the regulatory costs for both contract holders and the government from contract enforcement.
- Provide more liquidity and investment certainty in the private market which will encourage the private sector to purchase more domestic (rather than international) credits to meet their voluntary commitments.
- Allow ERF participants, including farmers, to access higher private market prices for their ACCUs that may encourage greater participation, delivering more abatement.
- Demonstrate the success of government's investment in the ERF such that the private market can now step in and fund more abatement without cost to the government.

3. What policy options are you considering?

This section outlines three options to manage a large-scale exit from fixed delivery obligations:

- Option 1: Maintain the status quo
- Option 2: Normalised BMD
- Option 3: “Forgive” future fixed delivery contract obligations

Rationale for policy options

Options 2 and 3 are included as alternative pathways to Option 1 (status quo). Both Options 2 and 3 allow contract holders to be released from their delivery obligations in a more orderly manner than Option 1. These options provide more clarity and certainty for both fixed delivery contract holders as well as the broader private carbon market by reducing the risk of market disruptions. These options also avoid the need for administrative and legal processes required under the existing BMD provisions.

The exit arrangement proposed under Option 2 is similar to the existing BMD provisions but instead normalises and streamlines the administration of BMD. Option 3 is similar to proposals from current contract holders who have requested to be released from their fixed delivery contract obligations by turning these into optional delivery contracts. Given the legal and administrative complexities that would be associated with such an option, forgiving delivery obligations is considered here instead, which has similar outcomes to optionalisation for the government, contract holders and the broader market; but is simpler and faster to implement and administer.

Public consultation and an initial pilot program were also considered as possible approaches to implement Options 2 or 3. However, given that feedback has indicated that an urgent response is needed to resolve market risks, a formal public consultation period would have delayed a timely response and implementation, and subsequently increase the likelihood of a negative market shock. The risk of significant market disruption could also be increased if the consultation process encouraged, or was perceived to encourage, some contract holders to become ‘first-movers’ which could trigger the disorderly market exit.

Stakeholders have already initiated engagement with the CER, with industry feedback informing the development of the proposed policy response. It is expected that even without a formal consultation and pilot program, some targeted consultation on technical detail of the exit arrangement and an evaluation and refinement of the exit arrangements would be required to settle and refine the design of the mechanism to ensure that it is appropriately managing the identified risks. Sections 5 and 7 further discuss the proposed approach to future consultation and evaluation.

Overview of policy options

Table 3 below outlines the key elements of each option and how this would be implemented. Section 4 then analyses the relative costs and benefits of each option in further detail.

Table 3: Overview of options

Option	Key elements and approach to implementation
Option 1: Status quo	<ul style="list-style-type: none"> • No action would be taken. • There would likely be growing speculation, and pressure for the CER to provide clarity and direction to market participants and contract holders. • The CER would wait until delivery failures occur to seek BMD from contract holders. The risk of delivery failures occurring is likely and imminent, and will increase as the gap between contracted and market prices — and therefore financial incentives to default — grows. • Pursuing BMD will involve undertaking complex and costly administrative processes, with reasonable costs (such as interest, valuation and legal costs) recovered from the contract holders. The contract enforcement and debt recovery process for BMD makes the timing and payment amounts under BMD very uncertain. • Funds from BMD would be paid into the government’s Consolidated Revenue Fund (CRF). Separately, funding for the undelivered milestones would not be expensed through the ERF over the same period. • There may be reputational risks to the ERF and contract holders when contracted deliveries do not occur. This could result in a loss of confidence in the scheme resulting in lower participation and lower abatement generated. • The CER would continue to consider any prior breaches of contract where participants seek contracts at ERF Auctions. This may impact the ability of some participants to invest in new projects • ACCUs would be released into the market in a disorderly and unpredictable way. Once one contract holder uses BMD there is likely to be a rush as others seek to access high ACCU prices before prices fall due to increased supply. There would be significant information asymmetry and first-mover advantages as the BMD process is not public. Larger ERF participants are likely to have an advantage over others, such as smaller, independent land holders.
Option 2: Normalised BMD (recommended approach)	<ul style="list-style-type: none"> • Option 2 normalises and streamlines the existing BMD provisions under fixed delivery contracts. It implements an opt-in and ‘no-fault’ option to contract holders. Contract holders would apply to be released from eligible delivery milestones and subsequently pay an exit fee equivalent to the capped cost of BMD in Option 1 (i.e. the original contract price per ACCU multiplied by the delivery volumes). • This approach avoids the need for market-based quotes and legal negotiations required under the existing BMD provisions reducing costs for participants and government. • An announcement of the government’s intention to develop an alternative pathway to the existing BMD process would provide more clarity and certainty to the market against a backdrop of growing speculation, public commentary and stakeholder enquiries. • Ahead of implementation, the CER would undertake targeted soundings from contract holders to inform technical details of the proposed approach and ensure that the mechanism and process is fit-for-purpose and adequately manages identified risks. • Contracted ACCUs would be released in six-month delivery windows. This would moderate the rate at which volume is released into the market and avoid some of the larger impacts that a disorderly exit would likely create. The six-month windows would also provide

	<p>contract holders certainty about when their milestones would become eligible for normalised BMD and provide time to secure funding to pay the exit fee (if needed).</p> <ul style="list-style-type: none"> • In the first instance, applications could open in April 2022 for contract holders to apply to be released from delivery milestones scheduled between 1 July 2022 and 31 December 2022. Delivery milestones scheduled between the announcement and 1 July 2022 could also be granted extensions and be eligible to apply. Subsequent windows could fall between 1 January and 30 June, and 1 July and 31 December in each year, with applications open two months prior to each window (i.e. in April and October, respectively). • Like Option 1, funds from exit fees would be paid into the CRF, and funding for contracted deliveries would not be expensed through the ERF. • Release of ACCUs into the market will occur in a more controlled, orderly manner and reputational risks would be reduced for both the scheme and for contract holders. • Supply entering the market would moderate as the spot price or exit fee approaches double the contract price. The price would not likely fall below the theoretical price floor that is equivalent to double the contract price.
<p>Option 3: Forgive future fixed delivery contract obligations</p>	<ul style="list-style-type: none"> • Option 3 involves contract holders being released from their delivery obligations without requiring an exit payment, by forgiving their fixed delivery contract obligations. It implements an opt-in and ‘no-fault’ option to contract holders. • This option would be administratively simple and relatively easy to implement. • However, this option could set a precedent of allowing contract holders to walk away from their contractual obligations with the government without penalty. • Like Option 2, funding for contracted deliveries would not be expensed through the ERF, however, no exit fees will be provided to the CRF. • Depending on the price response of the private market, removing BMD could result in greater and more rapid take up by participants. The release of volume would be more rapid than for the disorderly exit expected under Option 1. • While additional demand may emerge as a result of lower prices, the rapid released of contracted ACCUs would likely lead to significant price falls and investment uncertainty. • There is a risk that this option will be seen as a significant intervention by the government to reduce the ACCU price. This could create a perception of sovereign risk discouraging further investment in the market by both suppliers and purchasers of ACCUs.

4. What is the likely net benefit of each option?

The three options carry different benefits and costs, with costs for participants associated with changes to their contracts with government as a result of different options for the exit arrangement; and other impacts on the market, equity and reputation varying considerably under each option. While the quantitative estimates of regulatory burden relate directly to the administrative and compliance costs for contract holders, there are also broader indirect impacts of each option for the government and other market participants, which are out of scope of the regulatory burden estimate in accordance with the OBPR guidance. Nonetheless these impacts are discussed qualitatively in this section given the significance of the implications.

Option 1: Maintain the status quo

Under Option 1, no action is undertaken. The CER would wait for delivery failures to eventuate, anticipated to be in the form of a disorderly exit, and subsequently seek BMD from contract holders.

This approach would not be subject to any specific or legislative review processes. The general operation of the ERF would be reviewed through reviews of emissions reduction policies and their impacts, including by the Climate Change Authority and under the Government's Long-Term Emissions Reduction Plan.

Benefits

Maintaining the status quo would reduce the risk that changes to scheme policy are perceived to be directly influencing or impacting on carbon markets.

Costs

Regulatory costs

This option involves high administrative costs for both government and contract holders as it requires complex and costly administrative and potentially legal negotiations. Using the BMD process specified under contract, the CER would be required to seek market valuations and calculate damages and reasonable administrative costs for each delivery milestone for each contract engaging in the process (around 1,800 ACCU delivery milestones outstanding under 392 fixed delivery contracts). Fixed delivery contract holders would be required to pay damages or face legal proceedings. The damages are capped at the contract price plus reasonable costs (including interest and administration and legal expenses) and would be provided to the CRF. The reasonable administrative costs incurred by the CER that are passed onto contract holders have been included in the regulatory burden estimate below, while damages have been excluded in accordance with OBPR guidance, as this is a direct financial cost.

The existing BMD process would be challenging and resource intensive for the CER to manage and administer. Contract holders would also face a high administrative burden, including potentially significant legal costs, as a result of the process, and face uncertainty about the financial and non-financial costs of the damages process. Participants of the ACCU market would also face uncertainty related to the unknown volume and timing of ACCU volumes being released from Commonwealth contracts.

There is substantial uncertainty around the potential timing, uptake and costs of BMD under Option 1, which will be driven by multiple economic and behavioural factors. It is not certain that all contract holders will exit their contracts, or by when and whether the government would successfully recoup BMD. Further, the contract enforcement and debt recovery process for BMD is subject to significant uncertainty and it may take some time to conclude legal proceedings and for payments to be made.

The regulatory burden of Option 1 has been estimated in the tables below based on the following assumptions:

- On average, there are 180 delivery milestones scheduled per year, across 39 fixed delivery contracts. This is based on around 1,800 fixed delivery milestones under 392 contracts divided by 10 years (2022-23 to 2032-33) to approximate an annual average. In practice these delivery milestones and associated costs would be skewed to nearer years, and delivery milestones would not be evenly distributed across contracts.
- 30% of milestones are delivered each year, leaving 70% (or 126 milestones across 27 contracts) as delivery failures and thus triggering the BMD process.
- The BMD process would involve significant administrative costs, including notifying, providing information to and potentially negotiating with the CER. This would require an estimated 20 hours per delivery milestone.
- The BMD process would also involve compliance costs, including dedicating resources needed to understand and meet contractual and regulatory requirements. It is expected that these costs would only need to be incurred once per contract and require an estimated 20 hours per affected contract.
- In addition, contract holders would be required to pay the reasonable costs of the Commonwealth in market testing, administration and if challenged, legal costs. It is assumed that this will include the cost of one APS staff member and one Executive Level staff member at \$48 and \$60 per hour respectively. At an assumed 15 hours spent per occurrence of BMD, this totals \$1,620 per occurrence. Recoverable procurement costs include seeking three market quotes in line with contractual requirements to cost and supply ACCUs is costed at \$1,000 per quote - this comes to \$3,000 per occurrence.
- Of the damages due to delivery failures, 30% of damages are paid in the same year leaving 70% (or 88 milestones) taken to legal proceedings. On average, this could require an additional 20 hours per delivery milestone associated with undertaking the administrative, compliance and legal costs associated with legal proceedings. It would also require the Commonwealth to recover legal fees. This is estimated to cost an average of \$4,000 per occurrence, based on an average cost of \$500 per hour and a day of work required. In practice, some disputes may be relatively straight-forward while others could be complex and time-intensive.
- The hourly cost of all other resources is \$73.05 per hour.

Table 4: Option 1 – Average annual regulatory burden estimate

Requirement/activity	No. of delivery milestones/contracts	Unit	No. of units	Cost per unit	Total cost
Administrative costs (including notifying, providing information to and negotiating with the CER)	126	Hours per delivery milestone	20	73.05	184,086
Compliance costs (including resources needed to understand and meet regulatory requirements)	27	Hours per contract	20	73.05	39,447
Reasonable CER costs – administrative costs	126	Occurrence per delivery milestone	1	1,620	204,120
Reasonable CER costs – valuer fees	126	Occurrence per delivery milestone	1	3,000	378,000
Reasonable CER costs – legal fees	88	Occurrence per delivery milestone	1	4,000	352,000
Administrative, compliance and legal costs associated with legal proceedings	88	Hours per delivery milestone	20	73.05	128,568
Total additional regulatory burden					1,286,221
Average annual regulatory costs					
Change in costs	Individuals	Business	Community organisations	Total cost	
Total, by sector	\$0	\$1,286,221	\$0	\$1,286,221	

There are also broader costs for other market participants as a result of lower market transparency. However indirect costs, including costs arising from changes to market structure and competition impacts, are considered out of scope for the purposes of estimating regulator burden.

Market impacts

As contract holders choose to use BMD and supply more ACCUs into the private market, there would be some downward pressure on ACCU prices. The overall magnitude of the price fall is uncertain and depends on the volume that the private market can absorb. Supply entering the market would moderate as the spot price or exit fee approaches double the contract price. The price would not likely fall below the theoretical price floor that is equivalent to double the contract price, however the disorderly nature of the process makes prices difficult to predict.

Option 1 would likely result in more disruptive impacts on the private market relative to Option 2. Once one contract holder uses BMD to avoid delivery there is likely to be a rush with others following suit to try to pick up high prices before ACCU prices fall due to additional supply coming to the market. It is possible that a very large volume is made available to the private market at once, leading to significant price falls. Other adverse market impacts including significant investment uncertainty are also likely to occur.

Other impacts

Contract holders would face reputational impacts from not delivering under their contracts. The ERF would also face policy credibility risks if a large-scale exit from fixed delivery obligations results in significant market shocks and investment uncertainty. This could reduce confidence in the ERF which may in turn reduce participation and abatement delivered under the scheme.

There are also equity implications under Option 1:

- Only contract holders that default and undergo the BMD process will have access to higher prices on the private market

- There could be significant information asymmetry and first-mover advantages as the existing BMD process is not a public process, meaning that some larger participants are likely to have an advantage in the carbon market over others, such as smaller, independent land holders.

Option 2: Normalised Buyer's Market Damages

Option 2 normalises and streamlines the existing BMD process to release contract holders from delivery obligations. Contract holders will be eligible to apply to be released from delivery obligations falling within six-month windows to moderate the rate at which volume is released into the market.

Benefits

Option 2 allows the government to be responsive to changing dynamics in the carbon market and industry feedback by providing the government with a mechanism to manage a large-scale exit from fixed delivery obligations in a manner that is consistent with existing contractual requirements maximising market stability.

Option 2 provides a framework that gives fixed delivery contract holders the flexibility to sell their ACCUs for higher prices on the private market or to continue to meet their delivery obligations. This flexibility minimises the need for contract holders to break their contractual obligation and the subsequent burden and uncertainty of being pursued by the CER for damages. This option also allows for ACCUs to be released in a more managed manner than a disorderly exit process. This framework would substantially reduce, administrative and compliance costs for both contract holders and the government compared with Option 1.

By providing a streamlined and normalised arrangement to exiting fixed delivery obligations, the CER can provide increased certainty, clarity and transparency to both contract holders and the broader market, thereby reducing the risk of a disorderly exit and the associated market disruptions, including impacts on prices and investor confidence. Option 2 will also increase the volume of abatement available to the private sector in a period of increasing demand and relatively low liquidity.

Costs

Regulatory costs

Option 2 would require a new streamlined framework and process to administer exits from delivery obligations to be established. Participants wishing to exit would be required to apply to exit their fixed delivery obligations under the new framework. After the framework and process is established it would be relatively simple for the CER to administer and for contract holders to participate in.

Option 2 reduces the net regulatory costs relative to Option 1. Contract holders would face much lower administrative costs from a streamlined exit process and avoiding the need to undergo BMD. There would be no need for the CER to seek market-based quotes, as the exit fees would be set to equal the contract price multiplied by the volume, and the risk of legal proceedings would be reduced. There would also be cost-savings for contract holders (who under Option 1 would be required to pay interest and reasonable costs) and contract holders would also face lower internal administrative costs through the streamlined approach.

The regulatory burden of Option 2 has been estimated in the tables below based on the following assumptions:

- On average, there are 180 delivery milestones scheduled per year, across 39 fixed delivery contracts. This is based on around 1,800 fixed delivery milestones under 392 contracts divided by 10 years (2022-23 to 2032-33) to approximate an annual average. In practice these delivery milestones and associated costs

would be skewed to nearer years, and delivery milestones would not be evenly distributed across contracts.

- Contract holders request to be released from all delivery milestones as they become eligible.
- Contract holders would be required to submit an application to the CER requesting to be released from eligible delivery milestones. This would involve filling in an online form, requiring an estimated 1 hour per delivery milestone.
- Contract holders would also be required to dedicate resources to understand and meet new contractual requirements. It is expected that these costs would only need to be incurred once per contract. This would involve reading guidance published on the CER website (requiring an estimated 10 hours per contract). Where relevant, this would also involve negotiating benefit sharing arrangements with landholders where they are not the contract holders (requiring an estimated average of 80 hours per contract). This is likely to vary significantly from contract holder to contract holder as some parties may already have sharing arrangements in place.
- Compliance costs would also involve contract holders organising finance (potentially in advance of their delivery milestone) requiring an estimated 10 hours per delivery milestone. These costs do not include the exit fee itself, which is out of scope of the regulatory burden estimate, in accordance with OBPR guidance.
- There would be no need for the CER to pass on reasonable costs to contract holders as there would be no need to undergo time-consuming BMD processes, including seeking market quotes and undergoing legal proceedings.

Table 5: Option 2 – Average annual regulatory burden estimate

Requirement/activity	No. of delivery milestones	Unit	No. of units	Cost per unit	Total cost
Administrative costs (including notifying, providing information to and negotiating with the CER)	180	Hours per delivery milestone	1	73.05	13,149
Compliance costs (including resources needed to understand and meet regulatory requirements)	39	Hours per contract	80	73.05	227,916
Compliance costs (arranging exit fee)	180	Hours per delivery milestone	10	73.05	131,490
Reasonable CER costs – administrative costs	n/a	n/a	n/a	n/a	n/a
Reasonable CER costs – valuer fees	n/a	n/a	n/a	n/a	n/a
Reasonable CER costs – legal fees	n/a	n/a	n/a	n/a	n/a
Administrative, compliance and legal costs associated with legal proceedings	n/a	n/a	n/a	n/a	n/a
Total additional regulatory burden					372,555
Average annual regulatory costs					
Change in costs	Individuals	Business	Community organisations	Total cost	
Total, by sector	\$0	\$372,555	\$0	\$372,555	

Market impacts

Option 2 will result in greater supply and liquidity, placing downward pressure on prices. Compared with Option 1, Option 2 supports greater market stability by improving transparency in the market and allowing a managed release of volume which may soften the impact on the private market and prices. As with Option 1, supply entering the market would moderate as the spot price or exit fee approaches double the contract price. The price would not likely fall below the theoretical price floor that is equivalent to double the contract price.

While government purchasing currently dominates ACCU transfers and demand, as noted above, private sector demand is increasing rapidly. However, the government's visibility of the depth of private market demand is limited. It relies on media reporting of trades and spot prices, and stakeholder feedback. The reported market is thin – current record prices are based on trades of up to around 5,000 - 10,000 ACCUs (relative to the 112 million ACCUs held in fixed contracts). It is possible that some ERF contract holders will not take up the proposal if private sector demand growth does not absorb the additional available abatement and prices soften or because of the relative security of a government contract compared with those offered by the private sector. However, there are strong signs the private market is increasing rapidly including consistent anecdotal advice from market participants and increasing private transactions, which doubled in 2021 to 7.5 million ACCUs traded. In addition, many corporates have adopted ambitious emissions reduction goals and may be seeking to lock-in offset agreements. Stakeholders have advised that large, long-term agreements for significant volumes of ACCUs are using prices above the spot price.

Other impacts

Option 2 reduces reputational risks for both contract holders and the ERF. In contrast to Option 1, contract holders will not be required to default on contracts in order to access higher private market prices. The government will be able to act responsively to a rapidly changing carbon market. Implementing the mechanism in six-month windows at a time will help to manage the rate at which ACCUs are released from contractual obligations. The implementation of this option will be reviewed and the impacts to be monitored so that the process can be refined over time if required.

Option 2 also results in more equitable outcomes by:

- Simultaneously informing and providing clarity to all contract holders about the exit process.
- Allowing all contract holders to apply to exit delivery obligations and access higher prices as their delivery milestones are due.
- Allowing the CER to provide clarity on potential volumes entering the private market, supporting participants to trade in the private market in a fair and equitable manner.

Option 3: Forgive future fixed delivery contract obligations

Option 3 forgives future fixed delivery contract obligations without requiring any exit payment. That is, contract holders could be released from their delivery obligations at no cost.

Benefits

Option 3 allows the government to be responsive to the costs likely to be borne by contract holders as they seek higher prices for their ACCUs. Forgoing delivery obligations is the simplest approach, and is likely to be supported by fixed delivery contract holders. However, this option would involve the Commonwealth forgoing substantial

revenue and intervening in the market in a way that will have more material impacts on the broader market than both Options 1 and 2.

Costs

Regulatory costs

Option 3 would be relatively simple to administer. Contract holders would not be required to pay damages or exit fees where they choose not to deliver against their existing fixed delivery contracts.

The regulatory burden of Option 3 has been estimated in the tables below based on the following assumptions:

- On average, there are 180 delivery milestones scheduled per year, across 39 fixed delivery contracts. This is based on around 1,800 fixed delivery milestones under 392 contracts divided by 10 years (2022-23 to 2032-33) to approximate an annual average. In practice these delivery milestones and associated costs would be skewed to nearer years, and delivery milestones would not be evenly distributed across contracts.
- Contract holders request to be released from all delivery milestones as they become eligible.
- Contract holders would be required to submit an application to the CER requesting to be released from eligible delivery milestones. This would involve filling in an online form, requiring an estimated 1 hour per delivery milestone.
- Contract holders would also be required to dedicate resources to understand and meet contractual and regulatory requirements. It is expected that these costs would only need to be incurred once per contract. This would involve reading guidance published on the CER website (requiring an estimated 2 hours per contract). Where relevant, this would also involve negotiating benefit sharing arrangements with landholders where they are not the contract holders (requiring an estimated average of 80 hours per contract). This is likely to vary significantly from contract holder to contract holder as some parties may already have sharing arrangements in place.
- There would be no need for the CER to pass on reasonable costs to contract holders as there would be no need to undergo time consuming BMD processes, including seeking market quotes and undergoing legal proceedings.

Table 6: Option 3 – Average annual regulatory burden estimate

Requirement/activity	No. of delivery milestones	Unit	No. of units	Cost per unit	Total cost
Administrative costs (including submitting an application to the CER)	180	Hours per delivery milestone	1	73.05	13,149
Compliance costs (including resources needed to understand and meet regulatory and benefit sharing requirements)	39	Hours per contract	82	73.05	233,614
Reasonable CER costs – administrative costs	n/a	n/a	n/a	n/a	n/a
Reasonable CER costs – valuer fees	n/a	n/a	n/a	n/a	n/a
Reasonable CER costs – legal fees	n/a	n/a	n/a	n/a	n/a
Administrative, compliance and legal costs associated with legal proceedings	n/a	n/a	n/a	n/a	n/a
Total additional regulatory burden					246,763
Average annual regulatory costs					
Change in costs	Individuals	Business	Community organisations	Total change in cost	
Total, by sector	\$0	\$246,763	\$0	\$246,763	

Market impacts

As damages or an exit fee is not required, there is a greater downside risk for price impacts. Under Options 1 and 2 it would only be profitable for contract holders to undergo the BMD or exit process if the ACCU price is at least double the contract price. As such, supply entering the market would moderate as the price approaches this level, and the price would not likely fall below the theoretical price floor that is equivalent to double the contract price (\$24, based on double the average contract price). Under Option 3, the theoretical price floor is the average contract price (\$12).

Depending on the price response of the private market, removing BMD could result in greater take up by participants at lower prices. The private market could see the entire fixed delivery portfolio of 112 million tonnes of ACCUs seeking either spot trades (for near-term volume) or long-term offtake contracts (for ACCUs expected to be generated beyond the short-term). Such an influx of near-term and long-term volume would create greater downside price risk than the preferred approach.

Other impacts

There are mixed equity and reputational implications. All contract holders would be simultaneously informed and the approach could be equitable if broadly applied.

However, Option 3 effectively allows contract holders to walk away from their obligations to the government without penalty, which could set a precedent and integrity risks for other government contracts. It may also create investment uncertainty for both suppliers and purchasers of ACCUs and introduce a perception of sovereign risk.

Net impact of each option

Option 1 has the highest regulatory costs, as well as the highest indirect impacts of not acting, including high risks of market disruptions and reputational impacts for contract holders and the scheme. Option 1 does not require a change in scheme policy.

Under Option 1 it is expected that a disorderly exit would occur in the near-term. This creates the risk of market shocks, significant falls and volatility in the price of ACCUs, investment uncertainty, and reputational risk to contract holders and the scheme. Significant levels of defaulting on government contracts may be perceived as the market or scheme failing reducing confidence in the market for ACCUs and further lowering their value. Price volatility will impact on investment certainty and may discourage investment in projects delivering abatement. The BMD process would require ERF participants to take on time consuming and costly administrative and compliance costs associated with their contract.

Under Options 1 and 2, project developers who do not have fixed delivery contracts and parties who have accumulated ACCU holdings may feel they are negatively affected by downward pressure on ACCU prices. On the other hand, price moderation benefits stakeholders who are seeking to purchase ACCUs.

Option 2 results in significantly lower regulatory costs than Option 1 by removing the need to undergo a BMD process. The CER would be able to provide guidance and mechanisms to support the process, which would substantially lower administrative and compliance costs and provide certainty, clarity and transparency to both contract holders and the broader market. Clear guidance and a moderated release of ACCUs would reduce the risk and severity of market disruptions. Option 2 requires some additional administrative and compliance costs, including contract holders raising funds to pay the exit fee in advance of their delivery milestone, and scheme participants negotiating benefit sharing arrangements.

Option 3 is administratively the simplest option with lower administrative costs than Options 1 and 2, although contract holders would still need to negotiate benefit sharing arrangements. This approach has higher integrity risks than Option 2 due to the precedent that this approach establishes regarding government contracts and the approach also has higher market and reputational risks than Option 2.

The relative costs and benefits of each option are summarised in the table below.

Table 7: Overview of the relative costs and benefits

Options	Cost	Benefit
<p>Option 1 – Status quo</p>	<p>Regulatory burden estimate: \$1,286,221</p> <ul style="list-style-type: none"> • High administrative and regulatory costs • Damages required to be paid • High risk of market disruptions • High risk of sharper initial price contractions and higher price volatility • Theoretical price floor of around \$24 (based on double the average contract price) • High risk of equity implications, including first mover advantage • High risk of reputational damage to contract holders • High risk of reputational damage to the scheme 	<ul style="list-style-type: none"> • Lower risk of perceptions that changes to scheme policy is directly impacting on the carbon market • Provides revenue to the government consistent with contractual requirements
<p>Option 2 – Normalised BMD</p>	<p>Regulatory burden estimate: \$372,555 Change from Option 1: -\$913,666</p> <ul style="list-style-type: none"> • Lower administrative and regulatory costs • Exit fees required to be paid • Lower risk of market disruptions • A more transparent and controlled release may place a more gradual downward pressure on prices • Theoretical price floor of around \$24 (based on double the average contract price) • Lower risk of equity implications • Lower risk of reputational damage to contract holders • Lower risk of reputational damage to the scheme 	<ul style="list-style-type: none"> • Allows the government to be responsive to changing dynamics in the carbon market and industry feedback • Allows contract holders to benefit from higher prices in the private market without breaking contractual obligations • Provides revenue to the government consistent with contractual requirements • Reduces administrative and regulatory costs • Improves certainty, clarity and transparency for both contract holders and other market participants • Ensures the integrity of government contracts
<p>Option 3 – Forgive delivery obligations</p>	<p>Regulatory burden estimate: \$246,763 Change from Option 1: -\$1,039,458</p> <ul style="list-style-type: none"> • Lowest administrative and regulatory costs • No damages or exit fees required to be paid • High risk of market disruptions • Transparency may reduce volatility, although larger volumes available over the short and long-term may result in greater downside price risk • Theoretical price floor of around \$12 (based on the average contract price) • Moderate risk of equity implications • Low risk of reputational damage to contract holders • Moderate risk of reputational damage to the scheme 	<ul style="list-style-type: none"> • Allows the government to be responsive to changing dynamics in the carbon market and industry feedback • Allows contract holders to benefit from higher prices in the private market without breaking contractual obligations • Reduces administrative and regulatory costs • Improves certainty, clarity and transparency for both contract holders and other market participants

- | | | |
|--|---|--|
| | <ul style="list-style-type: none">• Moderate risk of setting precedent for other government contracts | |
|--|---|--|

5. Who did you consult and how did you incorporate their feedback?

Consultation to date

A number of carbon service providers representing a range of different ERF participants have been approaching the Minister for Industry, Energy and Emissions Reduction, the Department of Industry, Science, Energy and Resources, and the CER over the last 18 months or so seeking to exit their fixed delivery contracts or convert their fixed delivery contracts to optional delivery contracts.

Stakeholder carbon service provider views were that:

- There was growing economic pressure to use the existing BMD provision in fixed delivery contracts in the context of very high private market prices,
- Fixed delivery contracts have successfully incentivised material investment in carbon abatement projects but are now creating balance sheet risk hindering further investment,
- Contract non-compliance may occur by other contract holders and a managed approach would be preferred for scheme and market integrity and market stability,
- Releasing fixed delivery obligations would provide much needed liquidity in the private market, with substantial demand not currently being met, and
- They would be willing give undertakings to share the benefit with landholders if fixed delivery obligations are relaxed.

Carbon service providers have also advised that they are under increasing pressure from landholders to realise better returns than available through their lower price fixed delivery contracts.

Some carbon service providers suggested allowing contract holders to optionalise an agreed proportion of their fixed delivery obligations, accompanied by contract length extensions. However, the CER advises that this approach would be administratively burdensome for all parties as it would require negotiation on the percentage of ACCUs to be released from each contract, and would be more difficult to provide transparency to the market and control the release of ACCUs to support market stability. It might also offer disproportionate market advantages to some players, such as a first mover advantage.

The payment of a fee to turn fixed contracts into optional contracts was also considered. However it was not supported due to the high legal and administrative complexities of that approach (as per above, a full contract renegotiation would be required). Some carbon service providers also suggested allowing optionalisation without the payment of an exit fee – this was not supported for the reasons above, and also, because as with Option 3, it would allow contract holders to walk away from their contractual obligations to the government without penalty, which could set a precedent for other government contracts. Some market participants advised that allowing contract holders to exit contracts without paying the fee would be seen as a substantial intervention by the government and risks creating a perception of sovereign risk.

There has been growing public speculation from external market commentators, including Reputex², Market Advisory Group³ and Carbon Pulse⁴, around the growing likelihood of delivery failures (which would trigger BMD) for fixed delivery contracts.

There has been market commentary and analysis speculating about possible policy responses and subsequent market outcomes. Expected market outcomes have varied considerably, from minimal to significant impacts, depending on the assumptions used in the analysis. Both Reputex and Market Advisory Group commentary indicated that the additional volumes that would be supplied into the private market under BMD would not likely materially impact prices. Subsequent modelling from the Market Advisory Group in partnership with the Carbon Market Institute indicates that if fixed delivery contract volumes were released into the market (without the moderating factors prescribed under option 2) there would be a drop in net demand for ACCUs and a reduction of the spot price.

There has been a record increase in ACCUs held in Australian National Registry of Emissions Units (ANREU) accounts of 12 per cent from Q2 in 2021⁵ and this has been increasing for some time. Given this trend, it is likely that participants would strategically limit releases to the private market to avoid large falls in the price.

Some industry groups have advised that investors may perceive significant intervention by the government in the carbon market as a potential sovereign risk. This perception could result in reduced demand, as purchasers would worry about the long term value of ACCUs. The preferred option addresses these risks by:

- focusing government's intervention to mitigate against a larger, imminent market shock (the proposal normalises buyer's market damages provisions in existing contracts)
- adopting a systematic and transparent approach to implementation
- clearly communicating the potential volumes that could be released onto the private market
- moderating the release of ACCUs into the market through the six-monthly delivery windows and exit fee, both of which are expected to place a more gradual downward pressure on ACCU prices and reduce volatility compared to other options

Future consultation

As the need for the proposal has been in prospect for many months and is well understood by stakeholders, it is proposed that there will be some further highly targeted consultation between the CER and contract holders to settle the technical design of the mechanism, to improve implementation and reduce risk.

Consultation will seek feedback to inform the detailed implementation of the preferred approach, including:

- How the mechanism could be designed to ensure that the additional revenue generated as a result of being released from fixed delivery arrangements and selling ACCUs at a higher price in the private market are being appropriately shared between relevant parties (please see below for further details).

² Reputex (2022) A closer look at the Australian carbon market in 2021 – a year of records, 20 January 2022, RenewEconomy, accessed at <https://reneweconomy.com.au/a-closer-look-the-australian-carbon-market-in-2021-a-year-of-records/>

³ Market Advisory Group (2021) MAG Carbon Monthly December 2021 and January 2022

⁴ Carbon Pulse (2022), Analysts expect regulator to unchain Australian offset contracts, 20 January 2022

⁵ Quarterly Carbon Market Report (2021) September Quarter, accessed at <http://www.cleanenergyregulator.gov.au/Infohub/Markets/quarterly-carbon-market-reports/quarterly-carbon-market-report-%E2%80%93-september-quarter-2021>

- The development of the application, invoicing and payment process and relevant IT infrastructure to ensure that these are fit-for-purpose and meet client needs.

Consultation will encompass contract holders who are representative of participants in different financial circumstances. For example, views on benefit sharing may need to be tested directly with project proponents as these parties may have very different views to their agents/representatives. It will also be important to assess the views and needs of small scale participants, some of whom may find it difficult to pay the exit fee up-front (prior to receiving ACCUs), or may face challenges accessing legal or financial advice to inform their decision about participating in this proposal.

Some additional targeted consultation may occur as a result of stakeholder requests on other matters such as timeframes. These will be managed through bilateral consultation.

Benefit sharing arrangements

There are a range of different business models underpinning fixed delivery contracts, and it will be important to ensure that the benefits are appropriately shared, for example between contract holders and landholders who supply ACCUs to meet fixed delivery obligations, but who are not themselves the contract holders. The targeted consultation could seek stakeholder views on:

- Possible mechanisms to support benefit sharing arrangements (for example, requiring consent from landholders to be eligible), and
- Communication strategies needed to clarify the government's expectations that the benefits should be shared while setting clear boundaries around the CER's role in these processes.

6. What is the best option from those you have considered?

The government is proposing reasonable adjustments to introduce a normalised use of the existing BMD provisions in fixed delivery contracts to provide a consistent, systematic and transparent process for exiting contracts, while supporting stability in the Australian carbon market.

Option 2 creates a framework to allow fixed delivery contract holders to exit delivery obligations via an orderly and transparent process, with reduced administrative costs and market risks relative to Option 1, and lower market and reputation risks than Option 3.

Option 3, while administratively simpler with lower regulatory costs than Option 2, is not preferred due to the precedent that it may set for government contracts more broadly and integrity risks that this approach establishes regarding government contracts and the potential market and reputational risks.

The risks with Option 3 are deemed to outweigh the regulatory cost savings for government from this approach.

7. How will you implement and evaluate your chosen option?

Implementation approach

The announcement of the preferred option is expected to be made in March 2022. An early announcement would assist with providing more clarity and certainty to the market, given growing speculation, public commentary and stakeholder enquiries.

Ahead of implementation in April, the CER would:

- undertake highly targeted consultation with contract holders to settle the design of the mechanism, and
- develop the processes, IT infrastructure and communications materials to support the implementation of the mechanism, provide clarity to the market and ensure that affected stakeholders understand the requirements and potential implications.

Implementation would be conducted within the existing resourcing and agency structure, and use the IT framework that ERF participants are familiar with.

Items that may be subject to targeted consultation include: mechanisms to share the additional revenue that contract holders may receive; the application, invoicing and payment processes; and other matters that may improve implementation and reduce risk. The CER will settle these implementation matters as it manages the administration of carbon abatement contracts and the ERF.

Aspects not within scope of the targeted consultation and implementation include changes to the quantum of payments that would be offered under the normalised BMD process or the provision of optional delivery contracts for exiting contract volume.

Contracted ACCUs will be released in six-month delivery windows, to moderate the rate at which volume is released into the market. In the first instance, applications could open in April 2022 for contract holders to apply to be released from delivery milestones scheduled between 1 July 2022 and 31 December 2022. Delivery milestones scheduled between the announcement and 30 June 2022 will be granted extensions and also be eligible to apply. Subsequent windows could fall between 1 January and 30 June, and 1 July and 31 December in each year, with applications open two months prior to each window (i.e. in April and October, respectively).

Implementation risks

As the proposal will involve new processes, there are a range of potential risks including:

- Unanticipated and significant adverse market impacts,
- Applications and payments cannot be administered in a timely manner, and
- Third party conflicts and disputes arise around benefit sharing arrangements.

The consequences from these risks include reputation impacts to the scheme and CER. The likelihood of these risk events varies.

The CER will work closely with the Department and other relevant areas to ensure that risks are adequately managed, through:

- Adopting a transparent approach to implementation and clearly communicating the potential volumes that could be released onto the private market. Existing communication tools such as the Quarterly Carbon Market Report and the carbon abatement contract register will also be utilised to report outcomes to the market,
- Closely monitoring market trends and intelligence, and
- Arranging bilateral meetings with key stakeholders to seek feedback on key aspects of the proposal, including benefit sharing arrangements.

Evaluation

The mechanism will be internally reviewed by the CER by June 2023 to ensure that the mechanism is fit-for-purpose and sufficiently manages potential risks and adverse impacts. This will allow processes to be refined if necessary.

The scope of the review is anticipated to consider the timing and manner in which information is communicated to the market, the administrative effort required by both contract holders and the CER in administering the release of contract volume, and matters that have been identified as part of the implementation and administration of the policy.

A range of evaluation metrics could be used to monitor and measure policy outcomes and subsequently identify areas for improvement and refinement where necessary, these metrics could include:

- The avoidance of widespread delivery failures and BMD, measured through uptake of the policy and the number of BMDs administered after the policy has been implemented.
- The regulatory burden for both contract holders and the Government from contract enforcement is lower than what would have otherwise occurred under a disorderly exit. This could be measured through the time taken to administer each released milestone, and feedback from stakeholders about the application and payment process.
- Higher market confidence and stability than what otherwise could have occurred under a disorderly exit. This would be supported by more transparency, clarity and moderation with respect to the flow of ACCUs being released into the private market. This could be measured by monitoring market trends, such as ACCU prices and the number and volume of transactions and the rate at which new projects are being registered.
- The Government and the CER are seen to be responsive to changing market conditions. This could be measured through stakeholder feedback.

Broader evaluations of the ERF, Australia's Long Term Emissions Reduction Plan and the annual Low Emissions Technology Statement also provide opportunities to examine the success of this mechanism in contributing to the ERF's objective of delivering emissions reductions and incentivising low cost abatement:

- The Climate Change Authority is required to review the ERF every three years as set out in the *Carbon Credits (Carbon Farming Initiative) Act 2011*. The Climate Change Authority will provide its next independent review of the ERF in 2023.

Australia's Long Term Emissions Reduction Plan is a whole-of-economy plan to achieve net zero emissions by 2050. The Long Term Emissions Reduction Plan includes five-yearly reviews to evaluate progress and adapt to technology advancements. The annual Low Emissions Technology Statement provides an annual review of technology priorities and investments, and is an important element of Australia's Long-Term Emissions Reduction Plan.