

NZ ETS Market Governance Q & A from participants

Webinars supporting the market governance consultation were held over the 2-4 of August 2021 and provided an overview of the proposals in the discussion document. It also provided an opportunity for interested stakeholders to ask questions about the direction and scope of the market governance work programme.

Webinar links available here: <https://consult.environment.govt.nz/climate/designing-a-governance-framework-for-the-nz-ets/>

Questions from all three webinars have been grouped into relevant topics and answered below. Where questions overlap, they are listed together and have a single response.

We will note all the feedback from these webinars; however, we need you to add these questions/comments in your written submission so they can be considered in the next stage of policy development.

The New Zealand Emissions Trading Scheme (NZ ETS) market governance consultation ends on the 17 September 2021 concurrently with the industrial allocation consultation. If you have any further questions reach out to etsconsultation@mfe.govt.nz.

Timeframe

1. Does Ministry for the Environment (MfE) have a timeline for implementing these enhancements to the NZ ETS market?
2. Is there any indication of timeframes from turning the consultation/advice into policy?

We will consider all feedback to the market governance consultation and develop next steps. Timing will depend on when final decisions are taken by Cabinet and what options are progressed. Cabinet papers may be proactively released following decisions.

NZ ETS User

3. Does a "user" need to trade NZUs themselves, just have an ETS account in the Register, or could a user just be indirectly impacted by advice about the ETS price - for example advice about the power or gas price which includes an ETS price component?
4. Could you explain how broadly the term "user" is planned to be defined? For example, does a "user" need to trade NZUs themselves, or have an ETS account in the Register?

There are many different types of people and businesses in the ETS. For this consultation when we say 'NZ ETS user' we mean anyone that buys or sells NZUs, who consequently is required to have an account in the NZ Emissions Trading Register.

Financial market questions

5. What is meant by "price discovery" and how does this matter in practice?

Price discovery is the overall process for determining a fair market price for an asset through interactions between buyers and sellers. It is important so that buyers and sellers can make informed trading decisions based on transparent pricing.

6. Do you have any thoughts on who would act as market operator? Could you leverage NZX's expertise and systems?

We are looking at high-level policy options at this stage, but we would be interested to hear any views you have on this.

- 7. Would a transfer of NZUs for no consideration to a related entity be considered a trade or is this out of scope?**

For the purposes of this consultation, we are considering movement of units in the New Zealand Emissions Trading Register as a trade. We welcome your views on this.

- 8. To what extent has this current consultation process researched and consulted how other countries are implementing ETS targets and regulations, and lessons learnt from other industries and past scenarios such as the GFC, real estate, finance etc?**

We have been looking at how other countries' Emissions Trading Schemes have approached market governance and related issues, and how these risks are managed in similar markets.

- 9. Governance of Trading: Have an option C5 where you impose regulations on the high-volume trades. Set a \$ trigger price or NZU volume trigger. This will avoid the cost being added to minor trades.**

Thanks for your feedback, please add these suggestions to your submission and they will be considered.

- 10. What sort of quantum of trading/liquidity are you envisaging under the listed market option? Just trying to get a sense of anticipated scale of trading activities.**

Based on recent trading activity from [[Emissions units transferred](#)], in the NZ ETS we expect an average of 8.8 million units transferred per month based on transaction data for the last 12 months July 202-21. In the EU ETS about 70-80% of transactions occur via an exchange. The remainder occur via over the counter (OTC) and brokers.

- 11. Are you intending that emission obligations can't be pre-managed by participants for future risk management?**

The proposals in the NZ ETS market governance discussion document consider NZUs in isolation. We do not propose any changes to the derivatives markets including NZU futures or options. Therefore, our proposals should not impact future risk management opportunities.

- 12. To reduce the risk of money laundering (and to give effect to the physical purpose of the units – ie, as a permit to pollute), have you considered limiting government auctions or the ability to hold units to parties who actually pollute in NZ? If not, why not?**

The NZ ETS is a relatively small market by international standards. Restricting the number of buyers and sellers in the market would decrease liquidity. This would negatively impact price discovery and efficiency of the NZ ETS market.

- 13. Are you wanting to encourage financially motivated trading in the ETS market, including institutional investor participation etc (c.f. more focused trading between NZU generators and emitters)? This may also impact on your preferred design options.**

We recognize that financial institutions do participate in the purchase and sale of NZUs. However, the aim of addressing market governance is to create a level playing field for all buyers and sellers of NZUs and ensure the market operates with integrity.

- 14. Due to the wider value chain and domestic banks obligations for prescribed transaction monitoring and reporting for all transactions, and ETS registry ownership that requires ID and NZ resident "individual" what is the laundering risk you are trying to mitigate?**

This is a risk-based approach to regulation. There is evidence of this occurring in similar markets, both internationally and in New Zealand. Our consultation paper notes the risk of misconduct may increase as the NZ ETS matures. If you consider that the NZ ETS is sufficiently covered by existing AML/CTF obligations, please include this when you make a submission.

- 15. As an existing and functioning market, what thoughts has MfE given to the potential impacts to existing participants and or platforms, services or partners that could be negatively impacted through full drive via exchange?**

We are currently looking for feedback on the impacts to various NZ ETS users to be considered in our analysis. Please provide us with details of how you would be impacted so we can consider the impact as part of our consultation process.

- 16. Will an NZ ETS participant who has the primary reporting / surrender obligation, and who recovers units from customer / polluters down the chain, be considered an NZU adviser vis-a-vis its dealings with its customers?**

Our working definition of an NZU adviser is: A person or entity that gives NZU financial advice services or guidance in their ordinary course of business. Services may include: NZU financial advice; investment planning relating to NZUs and discretionary investment management of NZUs, including buying and selling on behalf of a client, or managing some or all of a client's NZUs. We are interested in your views on our working definition and what should change.

- 17. Government Auctions: Why are Users able to put in multiple bids in the actions. Surely if you wanted people not to control the price of NZUs or influence the market you would regulate this to a one bid policy.**

Thanks for your feedback on the auctions. This is outside the scope of the market governance proposals. If you feel that this should be included, please add this to your submission.

Market risks

- 18. One point that is unclear to me in respect of insider trading is how this concept applies in a context where parties can be required to trade in order to meet ETS obligations. What if you're an information insider but need to purchase shares?**

Our consultation paper defines insider trading as:

“Buying or selling NZUs while in possession of material information that is not generally available to the market

passing on and sharing material information that is not generally available to the market.

Information as ‘material’ if a reasonable person would expect the information to influence the price of NZU if it were generally available.”

Generally, our definition aligns with the definition under the Financial Markets Conduct Act 2013. We'd be interested in your views on our definition of insider trading and how the definition could be improved.

- 19. What would happen if an offshore party cornered the auction volumes and pushed prices way over the Cost Containment Reserve trigger price?**

Thanks for your feedback on the auctions. This is outside the scope of the market governance proposals. We value your input on the options we're considering and any risks you perceive.

20. You should be stating these are risks - not actualities. Do you have evidence that any of this has occurred or is occurring?

In the forestry sector, we are seeing some behaviour which is raising concerns due to the impact on foresters. Three examples include where risks from poor advice could be leading to real impacts are:

- 1) People buying recently harvested pre-1990 forest then deforesting it. They then fail to meet their obligations for several years. The lack of advice on the ETS around the land sale means they are unaware of their obligations.
- 2) It is possible that land advertised where it is hard to tell if there is a misunderstanding of the ETS or it is deliberately misleading both with regard to pre-1990 status, or post-1989 eligibility.
- 3) There exists publicly available advice from consultants which is incorrect on how forestry land is treated in the ETS. Consultants charge significant amounts for this incorrect advice.

Note that these examples are anecdotal and not evidence that Ministry for the Environment is basing our proposals on. For this reason, we call them risks in the NZ ETS market. We want to hear from you if you have been impacted by poor advice in the NZ ETS.

21. Are the issues you wish to address real or imagined? The ETS should be robust enough to not need more regulation. If a problem arises then the ETS could be adjusted. No bureaucrat will champion a low bureaucrat option. Bitcoin seems to be self-regulating. Maybe some lessons there.

As pointed out above there is some anecdotal evidence of these risks in the market. With the growth of the NZ ETS market these risks are likely to increase. We would like to get your views on the risks in the market.

Workability of options

- 22. Are you concerned about the impact of position limits on historical deals? Introducing these now affects deals done as much as a decade ago.**
- 23. If position limits were imposed how would this impact forward hedging for compliance entities?**
- 24. How would position limits affect participants with an already large existing position if they were to exceed these limits upon conception of these new interventions?**
- 25. What quantity of units are you thinking of at the moment re limits?**

We are looking for your feedback on what the appropriate threshold would be for various NZ ETS users. Please note in your submission what impact position limits would have on you. We would be interested to know what you think would be reasonable and workable - limits could be linked to surrender obligations for example. We have seen separate, higher position limits for compliance participants in other international schemes.

- 26. Can you please explain in which way you believe that position and purchase limits will limit money laundering? How will position and purchase limits stop money laundering? It will inhibit participants ability to manage price and procurement risk and secondary market activity.**

A combination of options are required to detect and limit money laundering. We consider position and purchase limits reduce the risk of money laundering because it limits the amount

of cash someone could get through the system in one go. There are several other benefits of position and purchase limits, such as limiting the impact of misconduct on other NZ ETS users.

27. How would position limits improve transparency?

This would make any limits (if applicable) visible for NZ ETS Users so they can make informed decisions about NZU buying or selling.

28. In the process of increasing market transparency, how do you plan on improving the available information to the public?

The consultation paper asks what type of information would be useful for NZ ETS users to make informed NZU buying and selling decisions. We'd welcome your views on an appropriate place and/or mechanisms to help increase the availability of information for NZ ETS users – such as where we could publish this information for transparency purposes.

29. Are you looking at these options as mutually exclusive or would you consider a transitional period of, say, option A3 moving to A4 over time?

The options presented are not necessarily mutually exclusive - if the best approach to address a risk was some hybrid version or the example you use, that may be considered. We would be keen to hear what type of approach you think would be best.

30. Are you suggesting that there would be specific criminal provisions in respect of these forms of market misconduct?

If you have a view on how misconduct can be dealt with do include this in your submission.

31. Presenting the different scenario packages, I wonder if you have done any cost/benefit analysis of these options?

For each option the Ministry has performed an initial impact analysis and a risk mitigation analysis. This includes an initial estimate of cost and complexity for progressing with each option. This analysis is provided in the appendices of the discussion document. We will be working on a more detailed Regulatory Impact Assessment with detailed cost benefit analysis in the next phase of policy development.

32. It would be useful to give examples of existing regulators that have the D4 -> D6 powers in NZ. For example, is the electricity authority a D5 regulator or a D6?

All the proposed regulator types are based on existing agencies in New Zealand. The Electricity Authority (Te Mana Hiko) is an example of the type of regulator envisioned in D6.

33. What education paths are you proposing for people to become an NZU advisers and are any courses offered by universities or polytechnics?

At this stage, we are considering if the guidelines or Code of Conduct are viable options to deal with the governance of advice risks. The Ministry is not considering developing an education path at this stage.

34. The slide (Governance of Trading options) appears to indicate a single centralised, regulated trading platform. There are already three platforms in the market. What is expected to happen to those platforms and how much interaction have you had with existing platform operators?

We are yet to decide whether exchange-based trading is the preferred option and are seeking your feedback on the impact of this option. This may also be implemented in conjunction with other trading mechanisms, such as over the counter or trading via a broker. The EU ETS uses a

variety of mechanisms to suit users' differing needs. If we progress with exchange-based trading, we will take into consideration the impacts on existing market service providers.

35. Does MfE think a single exchange represents a procurement risk? We currently have multiple channels and platforms to buy NZUs.

We would be interested in your thoughts as to the extent of procurement risk and options to leverage the existing channels.

36. Also, what about an info pack to be targeted at real estate agents?

We are interested in your feedback about what kind of information would be useful. Please add this to your submission and we will consider this in our analysis.

37. Is it intended that position reporting would include derivatives such as forward trades and options?

At this stage, we are proposing position reporting on NZUs themselves. We would be interested in your view whether derivatives of NZUs should be a matter considered under position reporting.

38. Is it intended that position and purchase limits would take into consideration derivatives such as forward and option trades?

At this stage, we are proposing position and purchase limits of NZUs themselves. We would be interested in your view whether derivatives of NZUs should be a matter considered under position reporting.

39. Which way are you leaning, or option do you prefer? A low regulatory or balanced or risk mitigation?

There is not yet a preferred option - the feedback gathered as part of this consultation will inform our final policy advice on preferred options.

Government conflict of interest

40. As the primary creator of units and end recipient of surrenders how will MfE manage and consider their own perceptions of conflicts of interest and market conduct if an independent oversight governance framework such as FMA is not accessed?

41. As primary issuer, has MfE considered and discussed issuer obligations and alignment to NZ Treasury debt issues and what challenges they face as a govt market player?

42. If the MfE is the primary issuer into the market and they receive trade reporting information that is not public, is this not inside information and a conflict of interest? Does this not also create issues for MfE under section 36 of the Commerce Act?

Issuance of NZU's is outside the scope of market governance which focuses on the secondary market. Conflict of interest discussed in our consultation document is defined as "conflict of interest that can arise when an NZU adviser has several interests, financial or otherwise, and serving one could involve working against another."

NZUs and financial products

43. Carbon credits are financial products overseas - ACCUs, EUAs etc

44. A number of these risks are similar to those experienced in the financial markets. Given the governance framework in the NZ financial markets is established, will MfE consider pulling

the NZU trading in the financial market oversight regime? In some markets, emissions units are regarded as financial products but of course the position in NZ currently is different.

45. Have you contemplated using existing and functioning regulation by defining NZU as a financial instrument to bring in line with FMA supervision which would include Advice, Market Conduct, supervision, anti-money Laundering and registration and exemptions for NZU's as required by Government?
46. Make NZUs a financial product and all of this falls under FMCA and AMLCFT - two regimes that already exist and don't need to be created? Have you not considered that?
47. Just make it a financial product like it is everywhere else in the world.

Thanks for your feedback, please put this on your submission where we can further consider this point. At this stage we are considering high-level options on the type of interventions and regulator we should consider appointing. The specific legislative vehicle by which these options could be implemented will be worked on in the next stage of as part of the final policy framework design.

Other

48. **Given the current fragmentation, conflict of interest, bias and differing levels of priority around international trade obligations and profitable contracts- how do you foresee MFAT, MPI, EPA, and MFE working together?**

We are engaging and working closely with various agencies across government on the market governance framework and how they will fit into various components of the framework. As the policy develops, we will continue to work with other departments on this policy area (particularly with MPI/ Te Uru Rakau) in the forestry space.

49. **Regarding the climate change commission 2018 consultation paper, aspects of this are already out of date as we head towards 2022, will there be provision for rapid changes to research and data - example sedimentation, chemical and pollutant waste interlinkages that are not considered applicable to emissions?**

This is outside the scope of market governance. However, we are always interested in hearing new evidence and research, as we aim to make the NZ ETS as effective as possible.

50. **The regulations keep changing so it's very difficult for non ETS advisors such as real estate agents to keep up. Accountants and Solicitors are the same.**

Under the Governance of Advice theme, we are considering what types of information and guidelines could be useful to service providers. We'd appreciate if you provided a response with the type of information that would support your industries.

Iwi/Māori-related

51. **Do Māori landowners have their own ETS? If not, then the minister needs to look at this soon.**

Iwi and Māori have a significant stake in the NZ ETS, we have a section in the consultation document with an initial treaty analysis page 48. We want to hear from you what impacts our proposed options and risks will have on you and on iwi and Māori.

52. **Can Māori have their own ETS and trade only with the government?**

Our current proposals relate specifically to the existing NZ ETS. We are keen to hear any thoughts you have about these proposals.

Forestry

- 53. The lack of advice from MPI on the eligibility of land to qualify as post-89 forest land is an issue that has a large effect on investors and the quality of decisions. Is this inside the scope of improving advice?**

Assessing the Land eligibility of specific areas of land is outside the scope of this work.

- 54. Would being a registered forestry advisor automatically grant you permissions to provide advice, undertake ETS transactions etc. under the proposed regulations?**

In this consultation there are four options and depending which option is chosen in those A1/A2/A3/A4 from the status quo through to the code of conduct and registration, this will impact on how the market governance regulations interact with the forestry adviser regulations.

It would be helpful through submissions if people provide evidence or information about their experiences in the market and particularly around receiving or providing advice. This will help us to identify which advice is technical forestry advice, and which advice is ETS advice more appropriately governed through ETS market governance.

- 55. Do you anticipate that an individual with an ETS account would find it more difficult to engage in selling/buying credits? Could smaller users' risk being seen as an undesirable counterparty? Forestry clocks may be held in a company, but also smaller woodlots can be held personally.**

The status quo provides has no special provisions for smaller users. However, the purpose of these proposals is to introduce transparency, efficiency, and a fair playing field for all participants. We are seeking your feedback in terms of how these proposals could affect you.

- 56. Will the outcomes of this consultation process have any flow through impact to the proposed amendments to the ETS for Forestry?**

In June 2020 the *Climate Change Response (Emissions Trading Reform) Amendment Act 2020* (ETR) received Royal Assent. This sets out a staged implementation of the new policies for forestry in the ETS (e.g. the introduction of averaging and the new Permanent post-1989 classification). Advice is being prepared to regulations to implement these changes before the 'main' date they have effect on 1 January 2023.

Outcomes from this market governance consultation will likely only have a marginal impact of ETR forestry regulations. That said, we will always look to improve the ETS and could incorporate this feedback into future policy options.

- 57. How would long term supply contracts/pricing for NZU supply from forests be impacted by this?**

There are effectively two types of impacts on supply contracts as we work through the packages: the near terms implications to manage through the transitions to the new regulations and system but also over the longer term any future contracts that are signed. This starts to become more complex as there will be impacts based on who is getting the advice, who is providing the advice, what it is on and how we work through conflict of interest. We also need to define what good advice is.

We value advice providers, reserves and other interested people submitting on how we can navigate these issues in a practical way.

58. It's difficult to advise clients when the framework keeps changing and new systems are rolled out before the regulations have been set. Averaging and PP89 are classic examples of this. People are making big decisions based on lack of information.

It is one of those big challenges we have to wrestle with as regulators because we are still working on the policy options and Ministers still have to consider what the final regulatory settings on those are, so there will always be a little bit of uncertainty in this space.

This is a pertinent question when it comes to judging what good advice is and what is bad advice in the context of NZ ETS advice. If you have ideas around how to manage or improve that framework it would be valuable to put that into a submission to help us to understand what people think about how to manage that uncertainty.

Through submissions, please tell us what you think and how we can usefully frame up the ETS specific component of this in the wider context of what is quite an uncertain piece of advice.