

Submission by



to the

**Ministry for the Environment**

on the

**Designing a governance framework for the NZ ETS**

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## INTRODUCTION

1. BusinessNZ and BEC<sup>1</sup> welcome the opportunity to provide feedback on the Ministry for Environment (referred to as 'the Ministry') consultation document '*Designing a governance framework for the NZ ETS*' (referred to as the 'document'), published on 8 July 2021.
2. In its document, the Government seeks to improve the current market governance framework to manage the risk of misconduct in relation to the New Zealand Emissions Trading Scheme (referred to as 'the NZ ETS') and protect users from financial harm.
3. Operating at a systems level, the NZ ETS is an important tool to reduce greenhouse gas emissions and promote adaptation to the impact of climate change. Various markets within that system can collectively adapt to establish the most efficient response.
4. We would like to acknowledge that since 2010 great progress has been made in improving the framework with the NZ ETS changing every year since that time. Yet, further development of the scheme is vital to provide a robust and effective tool going forward.
5. An assessment of the status quo is essential to measure the impact of the changes proposed. Framework improvements should be considered in the context of international best practice and current NZ ETS participant obligations. Any changes should enable a successful integration of the NZ ETS with international schemes whilst addressing concerns of domestic participants.
6. This submission provides feedback on the Ministry's proposed advice on designing a governance framework for trading, market conduct and the appointment of a regulator. On balance, the following captures the broad view of the business community. Members have been consulted in preparing this submission. However, we have encouraged members to make their own submissions to raise specific issues in more detail.

## SUMMARY OF RECOMMENDATIONS

7. Our general position is that:
  - Currently, the problem with which the document is concerned seems weakly defined, as is the evidence provided for change
  - Overall, we see a need for a strong evidence base for change as well as the need to better understand the impact on current business practice should the proposed changes be implemented
  - Existing market trading mechanisms have evolved as the NZ ETS has matured due to business innovation rather than government intervention. This innovation should not be stifled
  - In the absence of strong evidence for change, a low intervention / voluntary approach should be considered. Any interventions e.g., to mandated exchange trading, require strong evidence that:
    - There is a problem that requires intervention
    - Solutions are appropriate for all NZ ETS participants with a priority on meeting the needs of those participants with an NZU surrender obligation, both large and small
    - The proposed intervention is required to facilitate international trading
  - Any required changes would not increase costs on participants and the risks of NZ ETS non-compliance through trading restrictions.

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<sup>1</sup> Background information on BusinessNZ and BEC is attached as Appendix One.

## GENERAL COMMENTS

### SECTION 2: MARKET GOVERNANCE FRAMEWORK

#### ***Problem definition***

8. Currently the problem definition outlined in the document seems weakly defined, as is the provided evidence for change. In its document, the Ministry identifies seven risks for market governance (p18), however, there is little acknowledgement of their impact or any mitigation.
9. Perhaps the list could be converted into a risk matrix, prioritising risks categorised as “high / high”. In other words, what significant issues and impacts do we need to tackle to future-proof the NZ ETS?
10. While we note that the EPA recently posted data showing a 33% increase of “speculator” NZU holdings in the June quarter<sup>2</sup>, the proposed regulations will not mitigate the risk of increased speculation.

#### ***Poor overall evidence base***

11. The Ministry’s evidence base for its governance framework proposals / options is weak. It is surprising there is no reference to the prior detailed reports commissioned by the Ministry in 2017/18:
  - a. Provision of information to the New Zealand Emissions Trading Scheme – Sapere (March 2018)<sup>3</sup>
  - b. Market governance of the Emissions Trading Scheme: Options and analysis – Covec & Catalyst (March 2018)<sup>4</sup>
12. The reports listed above were based on interviews and structured information collated from NZ ETS market participants, advisors, and traders. While we understand the document is seeking to address risks that might occur in the future, at the very least, the Ministry should assess and report back on whether:
  - a. Changes have occurred in the NZ ETS market since 2018
  - b. Recommendations from these two reports are still valid and are adequately reflected in the 2021 document

#### ***Linking the NZ ETS with other international schemes should be considered***

13. The appropriate governance approach may be best driven by expectations of what is required for linking the NZ ETS scheme (both existing requirements and those in development) with other ETS schemes in countries such as New Zealand’s trading partners. Changes should enable a successful integration of the NZ ETS with international schemes.
14. Aligning the NZ ETS with other schemes will involve the identification and analysis of desirable markets (e.g., trading partners).

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<sup>2</sup> Privately held units | EPA

<sup>3</sup> Provision of information to the New Zealand Emissions Trading Scheme | Ministry for the Environment

<sup>4</sup> Market governance of the Emissions Trading Scheme: Options and analysis | Ministry for the Environment

## SECTION 3: GOVERNANCE OF ADVICE

### Lack of Clarity on Adviser Issues

15. In respect to “adviser issues”, the only examples given are for forestry, yet these have been addressed recently through the 2020 **Forests (Regulation of Log Traders and Forestry Advisers) Amendment Act’s**<sup>5</sup> requirement for forestry advisers:

63M Meaning of forestry adviser service

A person provides a forestry adviser service if, in the ordinary course of business, they provide any of the following services to a client:

(a) giving advice that relates to —

(v) the application of the emissions trading scheme to forestry activities (within the meaning of the Climate Change Response Act 2002):

(2) However, a person does not provide a forestry adviser service if their only activity covered by subsection (1) is —

(a) incidental to, and not the principal part of, their business; or...

(c) the provision of advice only in their professional capacity as a member of an occupation that is subject to a licensing or registration regime under another Act (for example, the Real Estate Agents Act 2008, the Financial Service Providers (Registration and Dispute Resolution) Act 2008, the Lawyers and Conveyancers Act 2006, or the New Zealand Institute of Chartered Accountants Act 1996); or...

16. Notably, adviser issues reflected in the document’s first two case studies (pp60-61) do not provide direct support for any of its proposals:

a. The first study relates to an Australian case where a Solicitor, Financial Planner and Accountant were fined A\$9.4 million for deforestation. All three professionals would be exempt under the Forests (Regulation of Log Traders and Forestry Advisers) Amendment Act 2020 (refer s63M(2)(c) above), and the relevant legislation under which they were fined is not mentioned

b. The second study concerned a US investment fraud case. Again, the details of the relevant legislation under which imprisonment was imposed and penalties were levied is missing. Was this outright financial fraud or an “adviser issue”?

17. Under consultation questions 1-2, the Ministry is seeking evidence / experience of adviser issues in “Poor and conflicted advice”. It is questionable whether a public consultation is the correct way to obtain such evidence (e.g., defamation risk if published).

18. While the Financial Markets Conduct Act is an appropriate and existing framework to help manage issues relating to advisors and conflicts of interest, it is unclear whether the document’s focus is on advice to retail investors / small land holders who may get into forestry or to corporates. There is no mention of the reference under the **Financial Markets Conduct**

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<sup>5</sup> Forests (Regulation of Log Traders and Forestry Advisers) Amendment Act 2020 No 43, Public Act 7 New Part 2A inserted – New Zealand Legislation

**Act 2013**<sup>6</sup> to a “wholesale client / investor” “person” e.g., a company with turnover > \$5M or with net assets > \$5M to which a different advisory compliance or exemption regime may apply. The Act’s Schedule I contains the following definitions:

### **36 Meaning of wholesale investor**

(1) A person is a *wholesale investor*, —

- (a) in relation to an offer of financial products, when the person is a wholesale investor under the definition of that term in [clause 3](#); or
- (b) in relation to the supply of a discretionary investment management service or any other relevant transaction, if (at the relevant time) the person—
  - (i) is an investment business (*see* [clause 37](#)); or
  - (ii) meets the investment activity criteria specified in [clause 38](#); or
  - (iii) is large (*see* [clause 39](#)); or
  - (iv) is a government agency (*see* [clause 40](#)); or
  - (v) is an eligible investor (*see* [clause 41](#)).

### **39 Meaning of large**

(1) A person is *large* if at least 1 of the following paragraphs applies:

- (a) as at the last day of each of the 2 most recently completed financial years of the person before the relevant time, the net assets of the person and the entities controlled by the person exceeded \$5 million;
- (b) in each of the 2 most recently completed financial years of the person before the relevant time, the total consolidated turnover of the person and the entities controlled by the person exceeded \$5 million.

19. The NZ Forest Service has also indicated that it will be consulting in the near future on the associated regulations and requirements for forestry advisers, which will help define the scope to which the existing legislation will apply. It therefore seems unwise to pre-empt that work with this consultation.

## **SECTION 4 AND 5: GOVERNANCE OF TRADING & MARKET CONDUCT**

### ***Risk of position and purchase limits***

20. The proposals for position or purchase limits fail to recognise the wide range of annual surrender obligations inherent in the “all sectors<sup>7</sup>, all gases” NZ ETS, with an upstream point of obligation on the primary energy sector and the inclusion of small foresters.
- a. Individual fossil fuel participants have surrender obligations of many million NZUs per annum
  - b. Small foresters may have surrender obligations from harvesting a few thousand units
21. Any restrictions on position or purchase limits may also inhibit decarbonisation activity where forward sale or the purchasing of units is required to de-risk an investment from carbon price volatility.
22. Similarly, NZU trader<sup>8</sup> position reporting may undermine long-term decarbonisation due to disclosure leading to stakeholder pressure to release held units to market earlier than planned. Mandated disclosure might undermine a firm’s negotiating position in the market.

<sup>6</sup> [Financial Markets Conduct Act 2013 No 69 \(as at 15 March 2021\), Public Act – New Zealand Legislation](#)

<sup>7</sup> excluding agriculture for now

<sup>8</sup> MfE definition of NZU trader is a registered person or entity that buys and sells NZUs in the NZ ETS

### **Contractual opt-in trading arrangements are not considered**

23. The document has not considered the common practice of “contractual opt-in” trading arrangements in the NZ ETS for large energy buyers. These were well documented by the IRD back in July 2010 when an amendment to the GST Act was introduced<sup>9</sup>. Figure 1 illustrates the example of supply of gas.

Figure 1 – GST treatment of certain emissions unit transactions, example, gas supply<sup>10</sup>



24. This standard arrangement, which keeps the energy supply carbon price neutral for sellers and buyers may not be compatible with the document's proposals, e.g.:
- Mandated exchange-based trading (Option B4, p29) would have collateral, cashflow and trading cost impacts as energy buyers were forced to transact across an exchange a sale of NZUs (perhaps received via industrial allocation), to raise cash to transfer to energy sellers who then must buy the NZUs associated with that energy sale.
  - The NZU value is set nominally at zero in many cases, to avoid a GST merry-go-round. This is consistent with the GST Act where parties can agree on price. This will have an impact on any voluntary or mandatory reporting of the traded “NZU price”.
25. Existing market trading mechanisms have evolved as the NZ ETS has matured due to business innovation rather than government intervention. Options include banks, OTC traders (domestic and internationally based), market platforms and direct forestry unit purchase and sale.
26. For example, OTC trades enable forward trades and other derivatives. NZ ETS participants need to be able to use intermediaries to help source their units.
27. We therefore suggest that in the absence of a strong evidence base for changes, a low intervention / voluntary approach is warranted. Any interventions e.g., to mandated exchange trading, should be based on strong evidence that:
- There is a problem that requires intervention
  - Solutions are appropriate for all NZ ETS participants with a priority on meeting the needs of those participants with an NZU surrender obligation, both large and small. Criteria to assess this could include the cost of transaction and parcel size flexibility
  - Solutions will not reduce liquidity and inhibit participants with surrender obligations from obtaining the units they require to meet their annual obligations. The recently

<sup>9</sup> Several businesses with liabilities under the Emissions Trading Scheme (ETS) require their large commercial customers to pay for supplies received with a combination of monetary consideration and the agreement to transfer emissions units in the future.

<sup>10</sup> [GST treatment of certain emissions unit transactions \(ird.govt.nz\)](http://ird.govt.nz)

increased penalties for non-surrender of a 3\*C-Price cash penalty, plus an ongoing surrender obligation, makes this critically important

28. It is also important that any changes do not increase the cost for participants and risk ETS non-compliance through trading restrictions.

## **SECTION 6: APPOINTING A REGULATOR**

29. We are unsure to what extent the appointment of a regulator would improve trust, efficiency, and confidence in the NZ ETS.
30. Trust, efficiency, and confidence in the NZ ETS have not yet been defined or measured. The NZ ETS has been subject to government intervention at short notice on significant parameters affecting pricing. This is the biggest issue in terms of market efficiency and a regulator will not solve this difficulty.
31. Regardless of our concerns outlined above, we note that the Ministry has provided some estimated costs for the introduction of a regulator. However, it is not clear from the document the amount NZ ETS participants would be charged to recover those costs.

## **CONSULTATION QUESTIONS**

### **Transparency of trades**

*Questions 11 and 12: To what extent would more visibility on the price or volume of other NZU trades improve transparency in the NZ ETS, and better inform your decisions about buying and selling? What other types of information would make trades more transparent?*

32. It is important to provide the market with confidence that the price discovery process is effective and efficient. To support this, daily aggregate price and volumes could be collated from traders or platform operators willing to provide data on a voluntary basis. This would provide more confidence in market liquidity and a government published price benchmark.
33. There is more clarity needed from EPA reporting on whether transaction volumes in the register include those between related parties or just true third parties. More information is also needed on the definition of a primary participant in unit holdings accounts (e.g., does it include all EITE firms even if they have no surrender obligation)?

### **Voluntary transaction reporting**

*Question 14: As a NZ ETS user, what impact would voluntary transaction reporting have on your business or trading activity?*

34. Transaction reporting could lead to the disclosure of commercially sensitive information including contracted volumes and price for short and long-term purchasing. Any changes should respect commercial sensitivity e.g., through aggregated reporting.

*Question 15: As a NZ ETS user, what impact would position reporting have on your business or trading activity?*

35. As with Question 15, reporting could lead to the disclosure of commercially sensitive information as well as to a weakened position in unit purchasing.
36. In other words, through increased NZ ETS related reporting requirements of an individual organisation's emissions footprint, annual unit demand can be readily calculated. If

additionally, an organisation's NZU holdings are known (through position reporting), a seller has the advantage of knowing the position of a buyer i.e., how long (enough units) or short (too few units) are needed to meet the buyer's surrender obligations. In the case of an Over the Counter (OTC) trade, or if the buyer is trying to arrange a long term NZU supply (e.g., from a forester), this information is valuable to the seller who can judge how far to push the price.

*Question 16: As a NZ ETS user, what impact would introducing exchange-based trading have on your business or trading activity?*

37. It might cut across existing long term unit purchasing agreements or contractual opt-in arrangements. It could also lead to increased compliance costs (exchange fees and collateral costs) as well as limit decarbonisation projects in conjunction with 3rd parties (e.g., forestry).

### **Insider trading, price manipulation and money laundering**

*Question 18: To what extent would position and purchase limits protect all users against price manipulation, money laundering, and financing of terrorism?*

38. Position and purchase limits are not supported as they could impede contracts and force unit balance sales. They could also expose participants with surrender obligations to an increased risk of non-compliance.
39. Cash transfers are already monitored by banks and the IRD. Furthermore, OTC Brokers, Banks and Platforms should have AML/KYC provisions already in place.
40. Restrictions on "investors" could be considered if market liquidity is reduced due to speculative "Hold" plays, however, this requires very careful assessment to avoid restricting "market makers", such as banks or other traders, who provide liquidity.

### **Full transaction reporting**

*Questions 19 and 20: As a NZ ETS user, what impact would full transaction reporting have on your business or trading activity? What information should be disclosed as part of full transaction reporting?*

41. Full transaction reporting will lead to increased regulatory costs and the risk of loss of confidentiality of commercially sensitive material. It may also lead to a loss of trading flexibility if reporting cost requirements result in market withdrawal by some parties.
42. NZ ETS aggregate data only should be required. No organisational level, individual trade data or counterparty identification should be disclosed.

### **Appointing a regulator**

*Questions 22 and 23: To what extent would appointing a regulator improve trust, efficiency, and confidence in the NZ ETS? What functions and powers would a regulator require to improve trust, efficiency, and confidence in the NZ ETS?*

43. We are unsure to what extent the appointment of a regulator would improve trust, efficiency, and confidence in the NZ ETS. Trust, efficiency, and confidence in the ETS have not yet been defined or measured. The NZ ETS has been subject to government intervention at short notice on significant parameters affecting pricing. This is the biggest issue in terms of market efficiency and a regulator will not solve it.



### **Material information**

*Questions 24 and 25: Do you agree with the definition of 'material information' as it relates to NZUs? Do you agree that the Government should be required to disclose 'material information' about NZUs to the market in a way that encourages equal access to information?*

44. We agree with the definition of "material information". We agree the Government should be required to disclose material information about NZUs to the market in a way that encourages equal access to information.
45. Improvements have been made over the past 12-18 months; however, market participants are still missing price sensitive notices due to the Government's use of e-mail distribution providers. Many corporate systems filter the notices as spam.

### **Risk coverage analysis and impact analysis**

*Questions 27, 28 and 29: Do you agree with the Government's approach to assessing risk coverage analysis? Do you agree with the Government's approach to assessing impact analysis? If not, please provide your assessment of the impact. What, other factors, if any, should the Government consider in its decision-making?*

46. The evidence base presented in the report is too weak for the Government or any submitter to reach the conclusions presented on p47.
47. Other factors for the Government to consider should be the ability of firms to contract for NZUs from abatement flexibly and over long-time horizons. It should also be recognised that intervention could increase participant risk of non-surrender or market failure.

### **Preferred scenario**

*Questions 31-35: To what extent would the low-regulatory scenario, balanced scenario or risk mitigation scenario address the market governance risks?*

48. In the absence of evidence for stronger interventions our preferred option is the low-regulatory scenario. We caution against the document's simplistic scenario approach as it is bundling quite separate issues together. Each issue must be properly assessed individually.

## Appendix One - Background information on BusinessNZ and BEC



BusinessNZ is New Zealand's largest business advocacy body, representing:

- Regional business groups [EMA](#), [Business Central](#), [Canterbury Employers' Chamber of Commerce](#), and [Employers Otago Southland](#)
- [Major Companies Group](#) of New Zealand's largest businesses
- [Gold Group](#) of medium sized businesses
- [Affiliated Industries Group](#) of national industry associations
- [ExportNZ](#) representing New Zealand exporting enterprises
- [ManufacturingNZ](#) representing New Zealand manufacturing enterprises
- [Sustainable Business Council](#) of enterprises leading sustainable business practice
- [BusinessNZ Energy Council](#) of enterprises promoting affordable, sustainable and secure energy
- [Buy NZ Made](#) representing producers, retailers and consumers of New Zealand-made goods

BusinessNZ is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

In addition to advocacy and services for enterprise, BusinessNZ contributes to Government, tripartite working parties and international bodies including the International Labour Organisation ([ILO](#)), the International Organisation of Employers ([IOE](#)) and the Business and Industry Advisory Council ([BIAC](#)) to the Organisation for Economic Cooperation and Development ([OECD](#)).



The [BusinessNZ Energy Council \(BEC\)](#) is a group of New Zealand's peak energy sector organisations taking a leading role in creating a sustainable energy future. BEC is a division of BusinessNZ, New Zealand's largest business advocacy group. BEC is a member of the [World Energy Council \(WEC\)](#). BEC members are a cross-section of leading energy sector businesses, government and research organisations. Together with its members BEC is shaping the energy agenda for New Zealand.

Our vision is to support New Zealand's economic wellbeing through the active promotion of the sustainable development and use of energy, domestically and globally. With that goal in mind, BEC is shaping the debate through leadership, influence and advocacy.