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Ministry for the Environment
Wellington

By email: etsconsulting@mfe.govt.nz

Submission on 'Designing a governance framework for the New Zealand Emissions Trading Scheme'

Introduction

- 1 Lawyers for Climate Action NZ Inc (**LCANZI**) is a society comprising over 250 lawyers and an additional number of non-lawyer associate members. Our goals are to:
 - (a) raise public awareness and understanding of the threat of climate change;
 - (b) advocate for legislation and policies to ensure New Zealand meets or exceeds its commitment under the Paris Agreement and achieves net zero carbon emissions as soon as possible; and
 - (c) facilitate free or reduced cost legal assistance to community groups working to fight climate change.
- 2 LCANZI welcomes the opportunity to provide comments on: *Designing a governance framework for the New Zealand Emissions Trading Scheme* (the **Consultation Paper**). In particular, we note that a well-designed governance framework for the New Zealand emissions trading scheme (**ETS**) has significant potential to improve the effectiveness of the ETS in contributing to New Zealand's decarbonisation efforts. Our submission focuses on how a governance framework can address risks relating to the performance of the ETS against its purpose – reducing emissions and transitioning to a low-carbon economy.

Context

- 3 The impacts of climate change pose an incredible threat to humanity, our economy and our natural environment. The recently released August 2021 IPCC report sets out the most up to date scientific evidence on climate change and shows that these impacts are accelerating rapidly. Many of the changes we are already seeing will take hundreds if not thousands of years to reverse. The science is unequivocal that immediate, rapid and large-scale reductions in global emissions are required to limit global warming to 1.5°C or even 2°C.
- 4 There are two important points to bear in mind in considering a governance framework for the ETS.
- 5 The first is that the ETS exists for instrumental reasons; price discovery and trading are a means to the end of rapidly reducing emissions.

- 6 The ETS, as a means of pricing emissions, is our primary policy tool for reducing emissions and responding to the threat of climate change.¹ As such, the primary consideration in designing the governance framework of the ETS must be how to ensure this tool is effective. The governance framework of the ETS must first and foremost ensure the environmental integrity of the ETS by providing sufficient oversight and control of the level of national emissions.
- 7 Secondly, it is important to acknowledge that the current ETS is not an emissions trading scheme in its pure form, whereby all emissions are covered, allowances are capped, and the market determines the price.
- 8 In particular, the following design features of the ETS are preventing it from effectively capping emissions to levels required by our emissions budgets:
- (a) Agriculture: the agriculture industry, representing almost 50% of our national emissions, is not required to surrender allowances. There is no ability to cap emissions in this industry nor are there any means of compensating for this industry overshooting its budgeted emissions by adjusting allowances in other industries.
 - (b) Banking: the ETS permits unrestricted banking of units and there is a significant stockpile of NZUs and international units in the Emissions Trading Register which may be surrendered at any time. This means that the current supply of allowances currently far exceeds our emissions budgets. Thus, there is no mechanism for capping emissions, even in those industries that are covered by the ETS.
 - (c) Free allocations: certain industries are still provided with free allocation of units. While in theory the requirement to surrender units still incentivises mitigation activities where units are allocated at zero cost, this relies on an efficient NZU market which presently does not exist. Instead, free allocations under the current ETS are more likely to simply reduce incentives for mitigation and add to the oversupply of units in the market.
- 9 In order to ensure environmental integrity of the ETS (that is, for it to serve the end of decarbonising our economy), active stewardship of the market design is required. Changes to the high-level design of the ETS are necessary in the short term, such as extending coverage to agriculture, or at least requiring these emissions to be taken into account when setting caps, discontinuing free allocations and addressing the stockpile of existing units.
- 10 In addition to these necessary changes to capping emissions, to promote a sustainable and efficient transition to a low-emissions economy, the ETS must:
- (a) set a single price for all ETS participants in order to incentivise economically efficient mitigation activities; and
 - (b) provide enough clarity and stability of price and policy to incentivise long-term investment in low-emissions technologies.

Therefore, the governance framework must also facilitate an effective and efficient market, that enables efficient price discovery, strong price signalling to the market and fair

¹ As stated on the Ministry for the Environment's and Environmental Protection Authority's websites.

outcomes for all stakeholders. This will require improved market infrastructure and regulation of the primary and secondary market.

- 11 The current design of the ETS means that an additional level of governance will be required to ensure it performs consistently with its purpose. The ETS needs a governing body with deep technical expertise that will play an active role in stewarding the market towards optimal function.

Summary of Submissions

- 12 **Environmental integrity of the ETS:** The Consultation Paper does not consider risks relating to failing to meet our emissions budgets or how a governance framework can manage those risks. LCANZI emphasises that the ETS does not currently create a cap on national emissions and, in fact has only limited capacity to influence them. Additional governance of the supply of NZUs is urgently needed through changes to the ETS design or through oversight by an independent authority (and ideally both).
- 13 **Technical ETS compliance:** The quality of technical ETS advice represents a risk to participants (particularly those in the forestry industry) and to ensuring compliance with reporting and surrender requirements. However, many ETS participants are sophisticated entities. Resource should be focused on providing access to information on the ETS and oversight of compliance by the entities themselves, rather than their advisors. The forestry industry is an exception to this, where experience shows regulation of advisors would be desirable in a form similar to that of other professional services.
- 14 **Secondary market infrastructure:** The design of the NZU market infrastructure should facilitate transparency, liquidity and confidence in the market to enable efficient price discovery and price signalling. Exchange based trading will best achieve market efficiency and should be the preferred approach for trading on the secondary market.
- 15 **Regulation:** The regulation of market conduct by participants (particularly where the majority of trades are made on an exchange) and NZU financial advisors will be a necessary element of an efficient market in NZUs in the same way that it is in financial markets. The easiest way to achieve this is likely to be by regulating NZUs as financial products. This is consistent with the approach taken in other jurisdictions. Position limits are also desirable to minimise the risks of market manipulation.
- 16 **Independent authority:** A Carbon Markets Authority should be implemented with a mandate to oversee an efficient and effective market that controls the supply of units consistent with achieving the Government's emissions budgets. In addition to a compliance regulator, the market needs a body with technical expertise responsible for market stewardship and overseeing its operations. We consider that the Carbon Markets Authority should be an independent Crown entity. It would be analogous to the Electricity Authority.

Environmental Integrity of the ETS

- 17 The Consultation Paper states that the Government's objectives for creating a governance framework are to ensure:
- (a) that the ETS functions well and continues to be an effective tool to respond to climate change; and

(b) that there are enough rules and regulations to protect users.²

LCANZI strongly urges the Ministry to place greater focus on the first of those objectives in designing its governance framework. To date, the ETS has been an ineffective tool for incentivising emissions reductions and will continue to be ineffective without additional reform.

- 18 There is very little recognition in the Consultation Paper that the ETS is a market created for a very specific purpose – responding to climate change by pricing emissions and thus incentivising the reduction of emissions. Instead, it focuses almost exclusively on the second of the above objectives – protecting ETS users. While this objective is important, it is unclear to LCANZI why the Ministry has taken such a narrow view to the consultation on a governance framework. Especially given that the 2015/2016 review of the ETS, and reports by the Climate Change Commission and the Productivity Commission (which are referenced in the Consultation Paper) all acknowledge the need for a broader governance framework to ensure the effectiveness of the ETS as a tool to incentivise decarbonisation.
- 19 In its current form, the ETS does not create a cap on national emissions. Its limited coverage (only 40% of New Zealand's total emissions) and the significant level of free allocations means that the ETS has little to no influence over the majority of emissions in New Zealand. The large stockpile of NZUs and international units means that even where emissions are covered by the ETS, there is no mechanism to limit the quantity of those emissions. The Government has recently implemented price controls (or price guard rails), but modelling by the Productivity Commission suggests that the price parameters set by government are significantly lower than what would be required to drive necessary abatement levels.³ In essence, the Government has taken the important step of setting emissions budgets, but has no means of giving effect to those budgets.
- 20 The Productivity Commission, as part of its suite of recommendations on reform to the ETS, recommended the creation of an independent agency whose mandate and responsibility would be an efficient and effective NZU market that controls the supply of units in a manner aligned with Government's emissions budgets.⁴ In response to this suggestion, the Government noted that it was developing a broader governance framework, which would include the issue of market stewardship.⁵ While the Government has adopted most of the Productivity Commission's recommendations, the issue of market stewardship, and in particular the issue of control of supply of NZUs, has not been addressed and is notably absent from the Consultation Paper. The independent agency was an integral part of the Productivity Commission's overall recommendations. Adopting the other recommendations without the overseeing body has left a gaping hole in the governance framework of the ETS which significantly affects its effectiveness as a tool to respond to the threat of climate change.
- 21 The Productivity Commission suggested the following model for sharing the governance of the ETS between the Government and an independent agency.

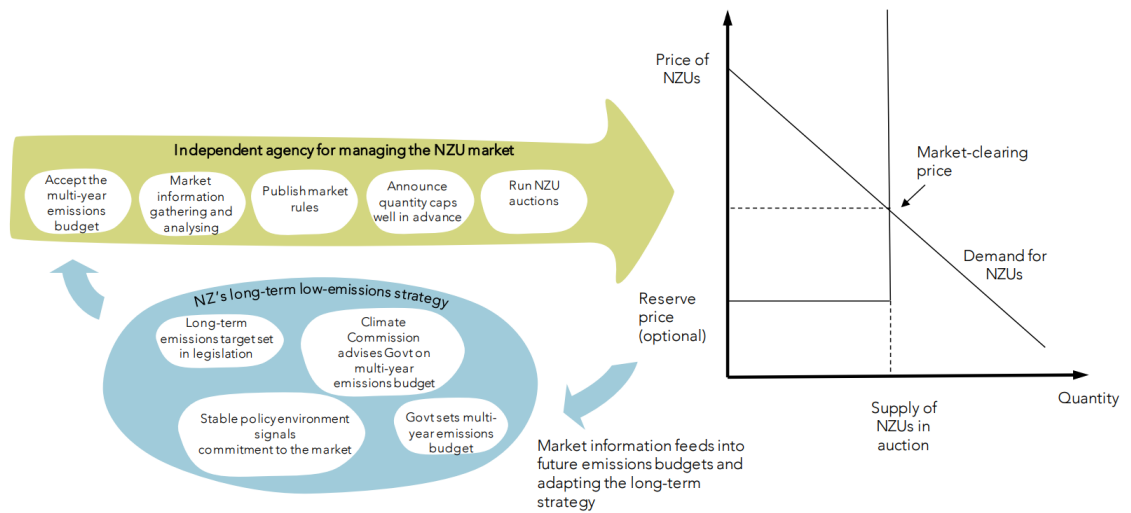
² Consultation Paper, p 17.

³ New Zealand Productivity Commission *The Low Emissions Economy* August 2018, p5.

⁴ Ibid, p 137.

⁵ Ministry for the Environment *Transition to a low-emissions future – the Government response to the Productivity Commission's Low Emissions Economy report* August 2019, p 2.

Figure 5-5 An independent agency to oversee the NZU market and auction NZUs



22 LCANZI strongly supports the formation of an independent and expert Carbon Markets Authority to oversee NZU auctions and the secondary market. The Authority should have a broad remit to ensure an effective and fair ETS. This remit should include:

- (a) Covered emissions, including making decisions in relation to agriculture and shipping/aviation;
- (b) Leakage management, including border tariffs;
- (c) Compliance monitoring and enforcement of surrender obligations; and
- (d) Addressing the stockpile of units.

23 The ETS is our central policy lever for incentivising the reduction of emissions. We simply cannot afford for it not to perform in a manner that achieves necessary abatement levels. As a technically complex mechanism with a very particular purpose, the ETS requires stewardship by technical experts that are free from political pressures to ensure Government's policy decisions (such as emissions budgets) are implemented.

24 In the same way that the Climate Change Commission was established to depoliticise the setting of emissions budgets, so to should a Carbon Markets Authority be established to be responsible for the ETS and related issues, and to ensure that reform occurs outside of the political process. It should be an independent Crown entity and would be analogous to the Electricity Authority.

Managing Supply of NZUs

25 LCANZI suggests that a primary function of a new Carbon Markets Authority should be to oversee the supply of NZUs in the market that can be used to meet surrender obligations.

26 Managing the supply of NZUs in the market will be a challenging and complex task that will require significant technical expertise. This is a not a task that can be achieved by prescribing a set of regulations or rules around auction quantities. In determining auction quantities, a responsible authority will need to assess and respond to market activity and trends, consider progressive decarbonisation ambitions and have a detailed understanding of how their actions will impact the market at a point in time and over the longer term to meet the short and long term goals of the ETS.

Price Controls

- 27 The alternative approach to improving environmental integrity would be to implement oversight of price and price controls in the secondary market as well as at auctions. The price of emissions must be high enough to encourage necessary levels of abatement. Where an emissions trading scheme caps emissions, the price set by the market would automatically satisfy this requirement, but without a cap on emissions, this is clearly not a given.
- 28 As noted above, the price floor will need to be significantly higher than its current setting to achieve this. As with quantity controls, it would be best for price controls to be implemented by an independent authority that is free from political pressures to ensure that the primary driver of price controls is achieving emissions targets.

Encouraging long-term investments

- 29 Clarity around how we will meet our emissions targets is also important for incentivising investment in low-emissions technologies that will enable future emissions reductions. At the moment, the disconnect between emissions budgets and the mechanisms for achieving them creates policy uncertainty and inhibits the long-run price signals that we know are essential for encouraging this investment.

Managing volatility

- 30 Another important objective of the ETS is transitioning to a low carbon economy without unnecessary disruption. One aspect of this is setting a carbon price corridor that achieves emissions reductions following a predictable path that avoids unintended social and fiscal shocks. A carbon price that rises too fast can be damaging to the purpose of the ETS by undermining broad political and public support. The increasing role of speculators, including in the latest government NZU auction is a case in point. The NZU price has increased 30% since the start of the year 2021 and is now trading above the \$50 cost Containment Reserve Price. Our carbon market is following trends in the EU ETS where speculators' role in the EUA price spike is prompting concerns over a lack of liquidity and a possible bubble. A Carbon Markets Authority role should include ensuring price stability and NZU availability for ETS participants.

Technical ETS Compliance

- 31 Consultation Paper rightly identifies the risks to ETS users from poor advice, the consequences of which have become more significant this year due to increased ETS penalties for non-compliance and the surge in the NZU price.
- 32 Participants with ETS compliance obligations broadly fall within two distinct groups: a small number of large, sophisticated, and well-resourced emitter entities who surrender NZUs; and a large number of smaller and less sophisticated forest owning entities who earn NZUs. This latter group are particularly vulnerable to poor advice due to the complexity of the ETS forestry rules.
- 33 LKANZI generally supports the Ministry's preferred approach for governing advice through sector guidelines and education, particularly if partnered with regulation and overseen by a compliance regulator. However, such an approach is inadequate for ETS users within the forestry sector who are more vulnerable.
- 34 It is noted that the Forests (Regulation of Log Traders and Forestry Advisers) Amendment Act 2020 imposes obligations and standards for forestry advisers, and this extends to giving advice relating to forestry under the ETS. While the detail on these obligations is currently

undergoing separate consultation by Te Uru Rākau, we wish to emphasise the following comments in relation to ETS forestry advice.

- (a) LCANZI supports the more robust governance framework forestry advisors set out in the Consultation Paper, namely a code of conduct, licensing, and registration.
- (b) The obligations and standards for ETS forestry advice is best placed within the governance framework being consulted on separately by Te Uru Rākau, and the Ministry should not duplicate the regulatory burden. However, a single overarching regulatory body such as a Carbon Market Authority should play a central role in co-ordinating compliance oversight between different sectors including the forestry sector.
- (c) It is noted a number of professional exemptions are proposed under the Log Traders and Forest Advisors regulations, including real estate agents, accountants, and lawyers. We do not support these proposed exemptions.

Secondary Market Infrastructure

35 The Ministry has identified lack of transparency, oversight and monitoring of trading in the secondary market as a risk. The secondary market in NZUs has a crucial role to play in price discovery and price signalling and so LCANZI agrees that there is a need to put additional market infrastructure in place to enable this.

36 Efficiency of emissions reductions is desirable in order to ease the impact of the transition on the global economy. The ideal outcome of NZU market infrastructure is that all market participants have fair and equal access to a single 'market price' that will incentivise mitigation activities below that price and not those above it. In a general sense, a well-functioning market that enables efficient price discovery and clear price signalling requires transparency, liquidity and confidence in the market.

37 We see these issues as coming within the scope of the proposed Carbon Markets Authority.

38 Below we set out the qualities of a well-functioning NZU market and the infrastructure required to achieve them:

	Contribution to NZU market function	Required Infrastructure
Transparency	Transparency of transaction data enables market price discovery and creates price signalling that incentivises efficient emissions reductions.	<ul style="list-style-type: none"> • Transaction reporting and/or oversight of exchange-based trading. • Governing body to collect, analyse and distribute market data.
Liquidity	Liquidity is required for efficient price discovery and fair and equal access to NZUs at the market price.	<ul style="list-style-type: none"> • Exchanges • Market makers • Variety of market participants

Confidence	Confidence in the integrity of the market (i.e. that it will operate fairly in line with market fundamentals) will promote trading which increases market efficiency.	<ul style="list-style-type: none"> • Transparent and liquid market • Regulation of market conduct • Stable and clear policy setting
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39 The market price of NZUs and clear price signals are central to the function of the ETS. LCANZI therefore believes that exchange-based trading should be preferred for spot and derivative trading on the secondary market to maximise liquidity and market efficiency. Exchange-based trading will also facilitate market oversight to enhance transparency of trading activity, regulatory compliance and market performance. If price controls were to be implemented in the secondary market, exchange based trading would be the easiest way to monitor this. However, we do not have a final position at this stage as to whether additional privately run exchange platforms and OTC trading should be constrained.

40 Care must be taken to ensure exchange-based trading is implemented effectively and to ensure market confidence. LCANZI emphasises that, should the Government seek to set up an exchange, implementation will require independent expert advice and that ongoing oversight will be required, ideally by a Carbon Markets Authority described in more detail below, but at the very least, by an independent expert advisory body.

41 Regulation of market conduct in the secondary market (as well as the primary market) will be essential for a well-functioning market and is discussed further in the next section.

Market Regulation

42 The Ministry has identified a number of risks relating to market conduct of advisors and NZU traders. LCANZI agrees that addressing these risks will be necessary to enable an efficient market. We note that the regulatory response to the risks identified has already been considered at length in the context of financial markets and a comprehensive regulatory framework has been developed to mitigate those risks. LCANZI does not believe there are any characteristics of the NZU market that necessitate a different regulatory approach to those risks, with the exception of position limits discussed further below.

43 The majority of trading activity in the secondary market is in the form of derivatives which are already regulated as financial products. Spot trading should be regulated in the same way to maintain the integrity of the NZU market, particularly where trading is done on an exchange. The most efficient way to do this is likely to include NZUs within the definition of financial product under the Financial Markets Conduct Act 2013 (**FMCA**). This will make bidding at auction and trading on the secondary market subject to:

- (a) general fair dealing provisions;
- (b) protections for retail investors;
- (c) the regime for regulating financial advisors (including advisors' duties and a licensing regime where advice is provided to retail investors);
- (d) regulation and licensing requirements for market operators (i.e. exchange operators); and

(e) regulation of market conduct on licensed markets (including provisions relating to insider trading and market manipulation).

44 Position limits are an additional piece of regulation that make sense in the NZU market to avoid the risk of market manipulation. The small size of the market and its resulting sensitivity make it vulnerable to manipulation, especially due to the large size of some of the ETS participants. Position limits will need to be specific to the market and should be set by a regulator (or ideally the an independent authority) with sufficient market information and ability to oversee their effects.

Independent Authority

45 An expert overseeing body will be an essential element of a governance framework for a well-functioning ETS. As noted throughout this submissions, there is a clear need for an independent authority with technical market expertise to play a role in stewarding the carbon market consistently with its intended purpose and the policies set by Government. LCANZI supports the creation of an independent Carbon Markets Authority with a mandate to promote an efficient and effective carbon market consistently with achieving the Government's emissions budgets. This authority would play a similar role to that of the Electricity Authority in respect of the electricity markets and could be modelled on this example.

46 A compliance regulator will be a necessary element of the governance framework of the ETS. However, compliance is just one element of a well-functioning market (especially an instrumental market that exists for a specific purpose) which is why a Carbon Markets Authority with a broader mandate to oversee market function is required.

47 The role of compliance regulator could sit with a new authority or might more efficiently sit with the Environmental Protection Agency (**EPA**) in respect of technical ETS compliance (the current enforcement body) and the Financial Markets Authority (**FMA**) in respect of market conduct. The FMA already play the role of market conduct regulator for financial markets, so its involvement makes particular sense where NZUs are brought under the FMCA as financial products.

48 LCANZI sets out below the role of a new Carbon Markets Authority:

Environmental Integrity	Determining the appropriate rules and parameters for the operation of the ETS including coverage, leakage management, and management of the stockpile. Analysing and controlling supply of NZUs in the market consistently with budgets set by government.
Transparency	Setting reporting requirements, collection and analysis of transaction data and communicating market information to the market in order to enhance price discovery, price signalling (short and long term) and confidence in the market.
Market Infrastructure	Overseeing auctions and trading on the secondary market, including designing and enforcing participant rules, implementing market stability provisions and outsourcing to market operators and market makers.

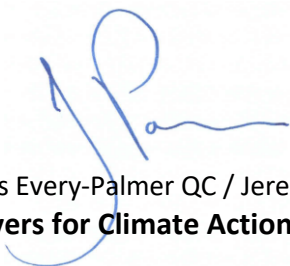
Compliance

Monitoring and enforcing market participant rules, monitoring market conduct (potentially in a supporting role, with FMA as regulator of market conduct) and setting position limits.

Conclusion

- 49 In summary, LCA NZI wishes to strongly emphasise that the Ministry's development of a governance framework for the ETS must place a much heavier emphasis on the purpose of the ETS and its desired outcomes. While risks to participants must be considered, the risks presented to all other stakeholders by the impacts of climate change must be at the forefront of all policy development relating to the ETS.
- 50 With the current ETS settings, there is a clear need for market stewardship to ensure the ETS functions as intended. LCA NZI strongly supports the creation of a Carbon Markets Authority modelled on the Electricity Authority. A key function of a Carbon Markets Authority should be to control of supply of NZUs into the market to achieve targeted levels of abatement.
- 51 LCA NZI agrees that additional secondary market infrastructure and regulation of the primary and secondary markets are needed to improve the performance and efficiency of the ETS. Both primary and secondary market infrastructure should be overseen by an expert authority with market expertise which fits well with the creation of a Carbon Markets Authority.
- 52 Regulation of technical ETS compliance currently sits with the EPA. While we do not have a strong preference, it would make sense for this to be managed by the new Carbon Markets Authority.

Yours faithfully



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