

Policy and Privacy

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Office of the Minister of Climate Change

Cabinet Economic Development Committee

Approval to consult – NZ ETS market governance discussion document for targeted engagement

Proposal

- 1 I seek agreement to release the attached discussion document (Appendix A) for targeted engagement about improvements to ETS market governance, as directed by Cabinet [CAB-22-MIN-0344 refers].
- 2 I am also seeking to:
 - 2.1 s 9(2)(f)(iv)
 - 2.2 s 9(2)(f)(iv)

Relation to government priorities

- 3 The Government declared a climate emergency on 02 December 2020, with the Cabinet Business Committee agreeing that climate change “demands a sufficiently ambitious, urgent, and coordinated response across government to meet the scale and complexity of the challenge” [CBC-20-MIN-0097 refers].
- 4 In 2018 the Productivity Commission recommended reform to deliver effective emissions pricing requires a new agency to exercise stewardship of the New Zealand Unit (NZU) market. In 2021, the Climate Change Commission called for improvements to the governance of the New Zealand Emissions Trading Scheme (NZ ETS). The Climate Change Commission recommended the Government commit to “establishing an effective market governance regime for the NZ ETS as soon as possible to mitigate risks to market function”.¹
- 5 The Prime Minister has also indicated to me by letter on 24 March 2022 that progressing NZ ETS market governance amendments is a Government priority in this parliamentary term.

¹ Climate Change Commission 2021, Ināia tonu nei: a low emissions future for Aotearoa, p 243

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Executive Summary

- 6 A poorly governed NZ ETS market for NZU (NZU market)² could impact our ability to meet our domestic emissions budgets and undermine the robustness of our NZ ETS.
- 7 The government has been aware of market governance risks in the NZU market since 2014. Between 2015 and 2021, Ministry for the Environment (MfE) conducted multiple consultations on the prevalence of risks in the NZU market, the appropriate policy tools to address these risks, and potential market governance scenarios. Cabinet has already agreed to various improvements to the governance of the NZ ETS and NZU market between 2018 and 2022.
- 8 I consider that eight years is sufficient time for planning how to address NZU market risks and decisions and tangible actions are now urgent.
- 9 I am seeking Cabinet's approval to test the impact of the proposed market governance framework with targeted stakeholders, before making final policy decisions in early-2023.

I am seeking Cabinet approval to release a discussion document for targeted engagement

- 10 I am seeking Cabinet agreement to release a discussion document (Appendix A) for targeted engagement, as directed by Cabinet [CAB-22-MIN-0344 refers].
- 11 The attached discussion document seeks feedback from key stakeholders on the impact of treating NZUs as financial products, the leveraging of existing financial market legislation, and seeks feedback on alternative market governance proposals considered as part of the policy design phase.
- 12 This discussion document has been drafted by MfE, in consultation with the Financial Market Authority (FMA), Ministry for Business, Innovation and Employment (MBIE) and the Ministry for Primary Industries (MPI). The paper has also benefited from input from the Environmental Protection Authority (EPA).

I am providing an update on further analysis of the technical requirements for the optional centralised exchange to address governance of trading risks

- 13 In August 2022, Cabinet agreed to progress the optional centralised exchange as a core component of the market infrastructure to support the buying and selling of NZUs. The exchange will also support increased market integrity, efficiency, and confidence in trading NZUs.

- 14 s 9(2)(b)(ii), s 9(2)(f)(iv)

² For clarity, we are using new terminology to distinguish between the NZ ETS as the key tool for emission reduction, and the NZU market as the marketplace for buying and selling NZUs. The market governance risks relate to risks in the NZU market.

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s 9(2)(f)(iv)

15 s 9(2)(f)(iv)

Background

The NZ ETS is complex and some matters require further analysis to address

- 16 Designing a market governance framework is complex and it is challenging to balance the risks of over- and under-regulation of the NZU market.
- 17 Over-regulation risks inhibiting some participation in the NZU market, whereas under-regulation exposes NZ ETS participants with surrender obligations to undue NZU market risks. Getting the balance right is important in the NZ ETS given part of its intentional design includes participants who cannot avoid these NZU market settings.

Cabinet previously agreed to progress non-legislative tools for market governance framework

- 18 In August 2022, following reference from the Cabinet Economic Development Committee [CAB-22-MIN-0344 refers], Cabinet:
 - 18.1 **directed** MfE, in consultation with Treasury, MBIE and MPI, to prepare a discussion document for targeted engagement by end of September 2022, for Cabinet's consideration in November 2022.
 - 18.2 **Noted** what the engagement package should seek feedback on, including:
 - 18.2.1 treating NZUs as a financial product and treating financial advice relating to NZUs as a financial advice service.
 - 18.2.2 including the NZ ETS market [NZU market] under existing financial frameworks legislation; and
 - 18.2.3 alternative market governance proposals to achieve the same outcomes of mitigating the seven risks.

Cabinet previously directed officials to undertake further analysis on an optional centralised exchange

- 19 In August [CAB-22-MIN-0344 refers], Cabinet:

³ s 9(2)(f)(iv)

⁴ s 9(2)(f)(iv)

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- 19.1 **directed** MfE, in consultation with MBIE and MPI, to undertake further analysis on an optional centralised exchange to address governance of trading risks to better understand:
- 19.1.1 the technical requirements of the optional centralised exchange and the legislative changes required;
 - 19.1.2 how future decisions on potential legislative tools to support a comprehensive package for market governance of the NZ ETS [NZU market], including those on whether or not NZUs should be treated as a financial product, might have implications on how this optional centralised exchange is designed, implemented and operated;
 - 19.1.3 the level of funding required, and to whom, in order to give effect to the preferred approach to design, implementation and operation as identified through the work described above.

Content of the discussion document for targeted engagement

- 20 The discussion document aims to understand the impacts of leveraging existing financial markets frameworks to address the risks in the NZU market. The document considers four different market governance topics and presents options for each.
- 21 This discussion document (Appendix A) has been drafted by MfE in consultation with FMA, MBIE and MPI, with input from the EPA. It will act as an interim RIS.
- 22 The feedback from this targeted engagement will help with considering any modifications that may be required to tailor financial markets frameworks to NZUs and whether alternative options may better achieve overall policy objectives.

Topic 1: Regulating the market based on financial legislation

- 23 The objective of this topic is to ensure the NZU market is fair, efficient, and transparent.
- 24 The discussion document tests with key stakeholders the impact of a proposal to utilize an Financial Markets Conduct Act 2013 (FMC Act) approach. The FMC Act approach would:
- 24.1 apply market manipulation and insider trading prohibitions and offences like those in the FMC Act;
 - 24.2 introduce licensing requirements which are proposed to apply to any facility for trading of NZUs that meets the definition of a financial product market (a licensed NZU exchange); and

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24.3 provide greater oversight of some trading activity on secondary markets generally, as well as mechanisms for detecting insider trading and market manipulation on those licensed NZU exchanges.

25 s 9(2)(g)(i)

26 The discussion document also seeks feedback from stakeholders on alternative proposals considered to achieve similar outcomes. These alternatives are:

26.1 Status Quo – Crimes Act 1961 only

26.1.1 Section 105A of the Crimes Act 1961 prohibits officials corruptly using or disclosing information gained in their official capacity to obtain an advantage for themselves or another person. There are limitations associated with this approach, as it does not address insider trading and market manipulation. Nor does it extend to market participants beyond officials.

26.1.2 This option is included as the status quo.

26.2 Crimes Act 1961 and market manipulation prohibitions

26.2.1 As with the status quo, this option would also utilise Section 105A of the Crimes Act 1961 to manage insider trading risks. However, market manipulation risks would be addressed in this option using prohibitions similar to those in the FMC Act.

26.2.2 This option is included as an alternative method which bolstered the status quo by prohibiting some forms of market manipulation, does not prohibit insider trading or impose additional obligations on market operators.

Topic 2: Regulating NZU financial advice, transactional and/or custodial services

27 NZU advisers need to be competent and to act ethically, and those who receive financial advice relating to NZUs should have confidence that the advice they receive will help them meet their investment goals.

28 The discussion document tests with key stakeholders the impact of leveraging the existing financial advice framework via an FMC Act approach.

29 In general terms, the document recommends a person that provide a financial advice service must:

29.1 comply with FMC Act fair dealing rules;

29.2 comply with certain statutory financial advice duties;

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- 29.3 if they provide a service to retail clients, comply with additional statutory duties about the provision of financial advice;
- 29.4 hold or operate under a licence;
- 29.5 belong to a mandatory dispute resolution scheme; and
- 29.6 comply with client money and property obligations⁵ in the same manner under the FMC Act if that person transacts or hold NZUs on behalf of clients.

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s 9(2)(g)(i)

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The discussion document also seeks feedback from stakeholders on alternative proposals considered to achieve similar outcomes. These alternatives are:

31.1 Status quo

31.1.1 Under the Status quo, advice relating to NZUs is partially covered by four Acts, including:

31.1.1.1 Fair Trading Act 1986;

31.1.1.2 Forests Act 1949;

31.1.1.3 FMC Act; and

31.1.1.4 Financial Service Providers (Registration and Dispute Resolution) Act 2008.

31.1.2 These are included as obligations under the Status Quo. However, MfE consider that together, these create a complex framework for regulating advice, and impose lower standards than the comprehensive FMC Act framework does for financial advice.

31.2 Moderate regulatory option for NZU financial advice: applying FMC Act settings that apply to wholesale only clients

31.2.1 Under this approach, the regulator would require a person providing NZU financial advice to be registered but not be licensed when providing NZU financial advice. This also

⁵ Client money and property services are a new obligation in the NZU market. The obligations will automatically apply if NZUs are defined as a financial product under the FMC Act. The discussion document will seek feedback whether the scope and obligations of client money and property service obligations are appropriate for the NZU market.

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includes an exemption to hold relevant qualifications to provide NZU financial advice.

- 31.2.2 This option is presented as an option with lower administrative burden to financial advisers.

Topic 3: Improved Transaction Reporting

- 32 Currently information asymmetry is observed in the NZU market. Information asymmetry occurs when some parties have access to useful market information which, if public, would affect NZU buying and selling decisions. Improved transaction reporting increases transparency in the market, and could help to mitigate these risks.
- 33 The discussion document tests with key stakeholders a proposal to increased transparency in the market and bridge an information gap that exists among stakeholders.
- 34 Under the proposal, there would be new reporting fields would be required in addition to existing reporting fields for each NZU trade. These new fields include:
- 34.1 the price at which the NZUs were bought or sold, or otherwise the total value of the transaction;
 - 34.2 whether the trade is with someone else or between your own accounts in the NZETR; and
 - 34.3 the transactor's primary reason for holding an account.
- 35 These additional fields reflect the other types of information stakeholders identified as important as part of the 2021 market governance consultation⁶. Individual and commercially sensitive information collected would remain non-public.
- 36 There would be the option to trade through an optional NZU exchange where transaction reporting is done automatically. If trading NZUs over the counter (OTC), reporting would need to be done manually;
- 37 Improved transaction reporting is preferred by MfE as it considers the option captures key data gaps in the NZ ETS and NZU market and provides a more proportional response to addressing the market risks.
- 38 Collecting this additional information supports the EPA in their role of monitoring and providing oversight of trades. Additionally, there would be oversight to guard against the risks of manipulation of the price, insider trading and anti-competitive conduct.

⁶ See Ministry for the Environment. 2021. Designing a governance framework for the New Zealand Emissions Trading Scheme: Summary of submissions, page 16.

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39 The discussion document also seeks feedback from stakeholders on alternative reporting obligations considered to achieve similar outcomes. These alternatives are:

40 Status quo

40.1 Under the status quo, The NZ ETR records and tracks all emission units used in the NZ ETS. At present, the NZ ETR collect the following information for transactions:

40.1.1 The parties involved in the trade;

40.1.2 The number of units in the trade;

40.1.3 The time and date of transaction; and

40.1.4 Who set up the transaction, who authorised it, and how they got their transaction authorization code.

40.2 Information on transactions currently collected by the NZ ETR provides a great deal of data that is useful for the NZU market.

41 Full transaction details

41.1 This option replicates many of the prescribed wire transaction reporting obligations in the Anti-Money Laundering and Countering Financing of Terrorism (Prescribed Transactions Reporting) Regulations 2016.

41.2 This would apply to transaction details (including those in relation to the originator or beneficiary) and customer details.

41.3 Summary of submissions from the 2021 consultation⁷ on designing a market governance framework showed that most submitters did not support full transaction reporting, stating it could undermine business activity and impose undue costs.

Topic 4: Applying the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (AML/CFT Act) framework

42 The AML/CFT Act and regulations have a role in any financial market by placing obligations on New Zealand's financial institutions to detect and deter money laundering and terrorism financing. Certain financial activities carried out in the NZU marketplace are captured today. Engaging in a captured activity means that certain obligations will apply to an entity.

43 I propose the following to be included in the targeted engagement:

44 The Status Quo (preferred):

⁷ See Ministry for the Environment. 2021. Designing a governance framework for the New Zealand Emissions Trading Scheme: Summary of submissions. Wellington: Ministry for the Environment, page 22

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- 44.1 Under this option, no further AML/CFT obligations would apply to the NZU market than what already applies today.
- 44.2 The purpose of highlighting the status quo is to communicate how the AML/CFT Act already captures activities of interest within the NZU market to deter money laundering and financing of terrorism.
- 44.3 Basic obligations apply to reporting entities that are captured. These include:
 - 44.3.1 assessing the money laundering and financing of terrorism risk that it may reasonably expect to face in the course of its business;
 - 44.3.2 establishing, implementing, and maintaining an AML/CFT programme (procedures, policies and controls) to detect, manage and mitigate the risk of money laundering and the financing of terrorism;
 - 44.3.3 Customer Due Diligence (CDD) (identification and verification of identity) and ongoing CDD;
 - 44.3.4 suspicious activity reporting; and
 - 44.3.5 record-keeping.
- 44.4 Noting that the AML/CFT Act is currently under review, no alternative options have been proposed at this time.

I am seeking Cabinet approval to release the discussion document for targeted engagement

- 45 The discussion document outlines the full detail of proposed options, assesses the preferred options against a set of criteria, and evaluates how they address the NZ ETS market [NZU market] risks relative to the status quo. This discussion document will act as an interim Regulatory Impact Statement (RIS).
- 46 A further, more comprehensive, RIS will be provided before Cabinet's final policy decisions. I intend to present this to Cabinet in early 2023.
- 47 I intend to run a targeted engagement, with submissions received up until 24 December 2022 being considered.
- 48 MfE will run workshops for these targeted stakeholders to discuss the proposal, answer questions, and facilitate feedback.
- 49 Engagement will be targeted to cater for the diverse range of stakeholders with an interest in these proposals, including iwi and Māori and NZ ETS forestry participants.

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- 50 The proposed options are likely to directly affect all participants in the NZ ETS, those who advise them, anyone who directly trades in NZUs, and any NZU trading platforms and/or brokers. The magnitude of these effects will vary according to the degree to which individuals are carrying out trading activities in the NZU market.
- 51 I intend to allow agencies to notify a subset of relevant stakeholders from their mailing lists and explicitly ask that they pass this on to their own networks.
- 52 I seek approval to make minor design, editorial and technical changes to the discussion document as needed.

Update on technical requirements for the optional centralised exchange.

- 53 s 9(2)(f)(iv), s 9(2)(b)(ii)
- 53.1 s 9(2)(f)(iv), s 9(2)(b)(ii)
- 53.2 s 9(2)(f)(iv), s 9(2)(b)(ii)
- 53.3 s 9(2)(f)(iv), s 9(2)(b)(ii)
- 53.4 s 9(2)(f)(iv), s 9(2)(b)(ii)

Update on funding implications for progressing this work

- s 9(2)(f)(iv)
- 54 s 9(2)(f)(iv)
- 55 s 9(2)(b)(ii)
- 56 s 9(2)(b)(ii) s 9(2)(T)(iv)

⁸ s 9(2)(b)(ii)

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s 9(2)(f)(iv)

57 s 9(2)(f)(iv)

58 s 9(2)(f)(iv)

59 s 9(2)(f)(iv)

60 s 9(2)(f)(iv)

61 s 9(2)(f)(iv)

62 s 9(2)(f)(iv)

s 9(2)(f)(iv)

63 s 9(2)(f)(iv)

Legislative Implications

64 The proposal to release the discussion document has no direct legislative impacts.

65 Legislative and regulatory changes will be required to implement the proposals once final policy decisions are approved in early-2023. Drafting approval for legislative amendment would be sought at the time of policy decisions in 2023.

Te Tiriti o Waitangi

66 Māori have a significant stake in climate change action, and a significant interest in the NZ ETS. Māori have a large economy and asset base sitting

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largely in the primary industries, as well as Treaty-based rights and interests in natural resource use and management.

- 67 It will be critical when developing final proposals to act consistently with the principles of the Treaty of Waitangi, including as provided by Section 3A of the CCRA.
- 68 The market governance proposals will affect iwi and Māori differently, depending on the role iwi and Māori have in engaging with the NZ ETS. Introducing exchange-based trading could reduce the risk of financial harm from price manipulation, insider trading, and credit and counter party risk.
- 69 In designing the exchange, agencies will be mindful of the costs to ensure smaller NZU market participants, including iwi and Māori who can currently trade bilaterally with minimal administrative cost, are not disproportionately impacted.
- 70 Officials are carrying out a Treaty impact assessment to analyse the interests of affected Māori, any impact on settlement legislation, the likely impact of the outcomes of decisions on affected Māori and any active steps necessary or intended to protect the affected interest.
- 71 This will be covered in the final RIS that I provide to Cabinet when I return with the comprehensive market governance proposal.

Impact Analysis

- 72 A panel consisting of representatives from the Ministry for Primary Industries has reviewed the Discussion Document "Market Governance of the New Zealand Emissions Trading Scheme". The review panel considers that the discussion document meets Cabinet's impact analysis requirements.
- 73 The review panel considers that a wider range of questions could have been used in the discussion document, to elicit more unknown information. However, given the extent of previous consultation on this topic, the review panel is satisfied that, in combination with this discussion document, enough information should be available for successful completion of the subsequent Regulatory Impact Statement to inform final policy decisions.

Climate Implications of Policy Assessment

- 74 The Climate Implications of Policy Assessment (CIPA) team has been consulted and confirms that the CIPA requirements do not apply to this proposal as the threshold for significance is not met. Any emissions impacts of this proposal will be reassessed and disclosed to Cabinet as they are advanced.
- 75 While these specific proposals do not have an explicit objective to reduce emissions, they are intended to support the effective functioning of the NZ ETS which is a key driver of emissions reductions.

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Population Implications

76 This targeted engagement involves no population implications beyond those outlined in paragraphs 66 to 71.

Human Rights

77 There are no inconsistencies between these proposals and the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993.

Consultation

78 The agencies consulted in the development of this discussion document were: MBIE, FMA, MPI, EPA, and the Treasury. Departmental comments are outlined below.

[REDACTED]

79 s 9(2)(g)(i) [REDACTED]

[REDACTED]

80 s 9(2)(g)(i) [REDACTED]

81 s 9(2)(g)(i) [REDACTED]

82 s 9(2)(g)(i) [REDACTED]

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s 9(2)(g)(i)

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s 9(2)(g)(i)

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s 9(2)(g)(i)

Communications

- 85 Officials will directly contact targeted engagement parties to inform them of the engagement prior to its commencement.
- 86 Announcements about the NZ ETS need to be managed carefully to avoid any inconsistencies and market risks, including sudden NZU price changes. In addition, information should not be disseminated in a way that advantages some market participants over others and compromises NZ ETS investments. <https://dpmc.govt.nz/publications/guidelines-government-advertising>.

Proactive Release

- 87 This paper will be proactively released on the Ministry for the Environment's website, subject to redactions as appropriate equivalent to those under the Official Information Act 1982.


Recommendations

The Minister of Climate Change recommends that the Committee:

- 1 **Note** that a poorly governed New Zealand Emissions Trading Scheme (NZ ETS) market for New Zealand Units (NZU market) could impact our ability to

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meet our domestic emissions budgets and undermine the robustness of our NZ ETS.

- 2 **Note** the government has been aware of substandard advice to NZ ETS forestry participants since 2014.
- 3 **Note** a review of the NZ ETS in 2015 indicated that regulations for governance of the NZU market could be improved.
- 4 **Note** in 2018, the government identified and consulted on seven NZU market governance risks relating to bad advice, transparency issues with trading, and misconduct.
- 5 **Note** in 2018 the Productivity Commission recommended reform to deliver effective emissions pricing requires a new agency to exercise stewardship of the NZU market
- 6 **Note** that in 2021, the Climate Change Commission called for improvements to the governance of the New Zealand Emissions Trading Scheme (NZ ETS).
- 7 **Note** in July 2021, the Ministry for the Environment (MfE) consulted on the seven market governance risks in the NZU market and potential market governance scenarios. The feedback to this consultation has been incorporated into the proposed market governance framework.
- 8 **Note** in August 2022, Cabinet directed agencies to prepare a discussion document for targeted engagement, for Cabinet's consideration in November 2022.
- 9 s 9(2)(b)(ii) 
- 10 **Note** in August 2022, Cabinet directed MfE, in consultation with Ministry of Business, Innovation and Employment (MBIE) and Ministry for Primary Industries (MPI), to undertake further analysis on an optional centralised exchange to address governance of trading risks.

Discussion document for targeted engagement

- 11 **Authorise** the Minister of Climate Change to make minor design, editorial and technical amendments to the discussion document as required prior to publication
- 12 **Note** the discussion document outlines the full detail of proposed options, assesses MfE's preferred options and alternative options against a set of criteria, and evaluates how they address the NZU market risks relative to the status quo.
- 13 **Note** this discussion document will act as an interim Regulatory Impact Statement (RIS).

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- 14 **Note** a further, more comprehensive, RIS will be provided alongside Cabinet's consideration of final policy decisions in early 2023.
- 15 **Note** the Minister of Climate Change intends to run a targeted engagement, with submissions received up until 24 December 2022 being considered.
- 16 **Note** MfE will run workshops to discuss the proposal, answer questions, and facilitate stakeholder feedback.
- 17 **Note** engagement will be targeted to cater for the diverse range of stakeholders with an interest in these proposals, including iwi and Māori and NZ ETS forestry participants.
- 18 **Agree** to release the attached discussion document (Appendix A) for targeted engagement.

Technical requirements for the optional centralised exchange.

- 19 s 9(2)(f)(iv)
- 20 s 9(2)(f)(iv)
- 21 s 9(2)(f)(iv)
- 22 s 9(2)(f)(iv)
- 23

Funding implications for progressing this work

- 24 s 9(2)(f)(iv)
- 25 s 9(2)(f)(iv)

Proactive release

- 26 **Agree** that the Minister of Climate Change will proactively release this paper on the Ministry for the Environment's website, subject to redactions as appropriate equivalent to those under the Official Information Act 1982.

Authorised for lodgement

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Hon James Shaw

Minister of Climate Change

Proactively released

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**Appendix A: Market Governance of the New Zealand Emissions Trading
Scheme Discussion document**

Proactively released