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In-Confidence

Office of the Minister of Climate Change

DEV - Cabinet Economic Development Committee

Approval to progress non-legislative tools for market governance framework for the New Zealand Emissions Trading Scheme

Proposal

- 1 I seek Cabinet approval to progress two non-legislative tools which will improve the operation of the New Zealand Emissions Trading Scheme (NZ ETS) market.
- 2 I also seek Cabinet approval to direct officials to develop a discussion document for targeted engagement on broader legislative tools. I will incorporate the outcomes of this engagement into a comprehensive market governance package, to be introduced this parliamentary term.

Relation to Government priorities

- 3 The Government declared a climate change emergency on 2 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 The Prime Minister has indicated to me by letter on 24 March 2022 that progressing NZ ETS market governance amendments is a Government priority in this parliamentary term.

Executive Summary

The NZ ETS is a key tool for meeting our emissions reduction targets

- 5 The NZ ETS is a critical component of the Government’s recently announced Emissions Reduction Plan. A poorly governed NZ ETS market could impact our ability to meet our domestic emissions budgets, our Nationally Determined Contribution (NDC), and undermine the robustness of our NZ ETS and its reputation internationally.

6 s 9(2)(b)(ii) [Redacted]

¹ s 9(2)(b)(ii) [Redacted]

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s 9(2)(b)(ii)

- 7 The government is now taking a greater role in the NZ ETS market in terms of setting price controls and overseeing NZU auctions. Ensuring its integrity, efficiency and confidence is critical so that the NZ ETS remains an effective tool as part of New Zealand's climate change response.

An unregulated market carries risks

- 8 In 2018, the government identified and consulted on seven market governance risks relating to bad advice, transparency issues with trading, and misconduct in the NZ ETS market [2018-C-04973 refers].
- 9 The CCRA is the primary legislation that establishes the NZ ETS and provides the legal framework for its implementation, operation, and administration. Currently, the CCRA does not have provisions to address these market risks.
- 10 The NZ ETS market is maturing and the risk of misconduct has increased. There has been a significant rise in NZU prices, more users are joining the scheme and there is the potential reopening of the scheme to international units.⁴ These factors increase the incentives and risk of market misconduct, and the range of actors who might be able to benefit from this.

I want to ensure the NZ ETS remains fit for purpose

- 11 The government has been aware of bad advice to NZ ETS forestry participants since 2014. A review of the NZ ETS in 2015 indicated that regulations for governance of NZ ETS participants could be improved. This led to a series of decisions by Cabinet to introduce reforms to the NZ ETS in 2018. Specific work on market governance proposals, however, was paused due to competing priorities.
- 12 In 2021, the Climate Change Commission called for improvements to the governance of the 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".⁵

I am seeking Cabinet approval to progress non-legislative tools now

- 13 I consider that eight years is sufficient time to be aware of the NZ ETS market risks and that decisions are now urgent.
- 14 I am seeking Cabinet agreement to progress two non-legislative tools which will improve the market efficiency and operation of the NZ ETS market.
- 15 I am seeking Cabinet approval, subject to funding, to implement:

³ See Ministry for the Environment (2022). June 2022 Auction Results. Available at: https://www.etsauctions.govt.nz/public/auction_noticeboard/26

⁴ In recent years we have seen the NZU price rise to about \$85.

⁵ Climate Change Commission 2021, Ināia tonu nei: a low emissions future for Aotearoa, p 243

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- 15.1 an optional exchange traded, centrally cleared market (optional centralised exchange); and
 - 15.2 education campaign for people interacting with the NZ ETS market during the transition into a more regulated market.
- 16 The objectives of the non-legislative tools are to:
- 16.1 Improves efficiency, liquidity and functioning of the NZ ETS market;
 - 16.2 increase transparency, monitoring and oversight of the NZ ETS market; and
 - 16.3 help NZ ETS users better understand market risks.
- 17 I propose decisions on the non-legislative tools be made now so that we can begin progressing the implementation of these tools immediately.

I am also seeking Cabinet approval to begin targeted engagement for broader legislative tools

- 18 Beyond the non-legislative tools, governance of the NZ ETS market needs to be further considered to ensure the integrity of the scheme. Officials have advised me on potential tools to address outstanding concerns relating to poor advice and market misconduct in the NZ ETS.
- 19 Specifically, MfE have advised that I consider developing a market governance policy framework that treats NZUs as a financial product and leverages the financial market tools and institutional structures of the Financial Markets Authority (FMA) to oversee the identified market governance risks in the NZ ETS market.
- 20 I note that the approach of regulating NZUs as a financial product and leveraging financial market legislation has not been tested in the marketplace. I am also aware that some agencies have indicated reservations on treating the NZU as a financial product.
- 21 I want to better understand these concerns while we are still at a stage of considering alternative approaches to market governance.
- 22 I am seeking Cabinet's approval to direct MfE, TSY, MBIE and MPI to prepare a discussion document for targeted engagement. I will return to Cabinet in early-November with the discussion document seeking approval to begin targeted engagement with key stakeholders including Māori.
- 23 The objective of the targeted engagement is to seek stakeholder feedback on:
- 23.1 impacts and prioritisation of the market governance risks on NZ ETS participants and those trading NZUs
 - 23.2 a proposal to treat NZUs as a financial product and financial advice relating to NZUs as a financial advice service;

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- 23.3 the financial and administrative impacts of leveraging the FMCA and its financial market tools;
- 23.4 the impact on stakeholders of leveraging the Anti-Money Laundering and Counter-financing of Terrorism Act 2009 in the NZ ETS market;
- 23.5 the impact on stakeholders of increased disclosure obligations under an improved transaction reporting framework;
- 23.6 scope and overlap between the proposal, to treat financial advice relating to NZUs as financial advice, and forestry adviser services under the Forests Act 1949⁶ and the appropriate legislative approach ; and
- 23.7 any feedback on alternative market governance proposals to achieve the same outcomes of mitigating the seven risks.

Background

The NZ ETS is a key tool for New Zealand's emissions reduction efforts but lacks provisions to regulate market risks and misconduct

- 24 The CCRA is the primary legislation that establishes the NZ ETS and provides the legal framework for its implementation, operation and administration. Currently, the CCRA does not have sufficient provisions to regulate market risks and misconduct.
- 25 The governance of the NZ ETS market is currently subject to a patchwork of regulation that leaves gaps. There is also no single regulator responsible for market oversight.
- 26 Financial markets regulations, such as those contained in the FMCA, do not apply to the NZ ETS market (with the exception of derivatives). Many different Acts and regulatory systems cover a small aspect of NZ ETS market governance, but none provide full coverage of the market.
- 27 A poorly governed ETS could impact our ability to meet domestic emissions budgets, meet our NDC, and undermine the robustness of our NZ ETS and of its reputation internationally. Ensuring its integrity, efficiency and confidence is critical to the success of New Zealand's climate change response.
- 28 I am concerned a poorly regulated NZ ETS market represents a fiscal risk to the Crown. The NZ ETS is maturing and the price of NZUs has increased recently. There is a growing risk of market misconduct and price manipulation in a market the Government is responsible for.

Review of NZ ETS and the identification of seven market governance risks

- 29 In 2014, the government received complaints relating to poor advice to forestry participants in the NZ ETS. These included situations where NZ ETS

⁶ the application of the emissions trading scheme to forestry activities (within the meaning of the Climate Change Response Act 2002) and the financial benefits of forests:"

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forestry participants received bad advice on their forestry obligations, as well as wrong NZU advice on the returns on their investments.

- 30 A review of the NZ ETS in 2015 found that the NZ ETS could be improved. The review identified that the current market governance framework in the NZ ETS is not fit for purpose. It does not ensure NZ ETS market trading integrity, efficiency and confidence, nor addresses the risks of misconduct. The impacts could distort the price of NZUs and reduce the confidence in the NZ ETS.
- 31 In 2018, the government consulted on improving the NZ ETS market and identified seven key risks in relation to market governance. These risks were categorised into three key themes in **Table 1**.

Table 1: Summary of Risk Themes and Market Risks

Theme	Risk
Theme A: Governance of Advice	Risk 1: Inadequate, false or misleading financial advice relating to NZUs
	Risk 2: Conflicts of interest while providing financial advice relating to NZUs
Theme B: Governance of Trading	Risk 3: Potential lack of transparency, oversight, and monitoring of trades in the NZ ETS market
	Risk 4: Credit and counter-party risks
Theme C: Governance of Market Conduct	Risk 5: Insider trading and information asymmetry
	Risk 6: Manipulation of NZU prices
	Risk 7: Money laundering/financing of terrorism in the NZ ETS

'Insider trading' and 'market manipulation' risks were prioritised to be treated in the same manner as under the Financial Markets Conduct Act 2013

- 32 In 2018, as a result of the introduction of auctioning in 2020, Cabinet agreed to address the risks of 'insider trading' and 'market manipulation' as a priority because of the increased likelihood of misconduct. Other driving factors included higher NZU prices in the future, potential linking with other international markets, and potential addition of new participants in the NZ ETS [2018-C-04973].
- 33 Cabinet agreed in-principle to [CAB-18-MIN-0606.01]:
- 33.1 prohibit insider trading and market manipulation in the NZ ETS market and, as much is practical and appropriate, approach these two risks in the same manner as they are treated in the FMCA; and
- 33.2 as much is practical and appropriate, have penalties and offences for insider trading and market manipulation in the NZ ETS that mirror the equivalent relevant penalties and offences in the FMCA.

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Cabinet subsequently decided on a work programme to address all seven market governance risks as a comprehensive package

- 34 In July 2019, Cabinet decided to create a separate work programme on a longer timeframe to address all seven market governance risks. Cabinet agreed that MfE, alongside MPI and the Ministry for Business, Innovation and Employment (MBIE), would work on the design of an overarching market governance framework for the NZ ETS [ENV-19-MIN-0019 refers].
- 35 The rationale for not addressing the risks in the wider NZ ETS reform through the Climate Change Response (Emissions Trading Reform) Amendment Bill 2020 at that time, was that market governance is complex, and further work was required to understand the impact on NZ ETS market participants.

2021 consultation on market governance risks and options

- 36 In July 2021, MfE consulted on the seven market governance risks in **Table 1**. The consultation included a range of proposed regulatory and non-regulatory options, and possible market governance scenarios without recommending a preferred solution. The approach allowed stakeholders to express their opinion on their preferred direction, helping the government gather varied perspectives before making policy decisions.
- 37 I informed Cabinet at the time that legislative amendments will be required to the CCRA and potentially, depending on preferred policy options, to other relevant legislation.
- 38 At consultation, most feedback agreed that the NZ ETS needed market governance amendments to be implemented. Feedback supported a code of conduct, licensing and registration of NZU users and an optional centralised exchange for greater transparency.
- 39 There was also support for the appointment of an appropriately skilled regulator as a way to improve trust, efficiency and confidence in the NZ ETS. A lot of this feedback supported using existing frameworks to regulate the NZ ETS.

The Climate Change Commission and Productivity Commission have stated that market governance is needed

- 40 Both the Climate Change Commission and the Productivity Commission have called for improvements to NZ ETS market governance:
- 40.1 The Climate Change Commission, in its final advice, 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.”⁷

⁷ Climate Change Commission (2021). Ināia tonu nei: a low emissions future for Aotearoa, p 243

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40.2 The Productivity Commission in 2018 recommended reform to deliver effective emissions pricing which requires a new agency to 'exercise stewardship of the NZU market.'⁸

41 Good governance will help ensure the integrity and efficiency of the scheme and promote confidence in market trading. This will reduce risks of misconduct distorting the price of NZUs which could undermine confidence in a key part in our climate change regime.

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

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

43 I instructed officials at MfE to work through these complex matters with MBIE and MPI. MfE has identified legislative and non-legislative tools that will support improving market efficiency, integrity and confidence in the NZ ETS market.

44 The agencies are in agreement that the NZ ETS market needs to be better regulated. But more analysis is needed before progressing with legislative proposals.

Progressing non-legislative tools in the NZ ETS market

45 I propose a set of non-legislative tools that can be progressed to strengthen the operation of the NZ ETS. I propose Cabinet agrees to implement these changes to immediately improve the operation of the NZ ETS market.

46 These non-legislative tools are:

46.1 An optional centralised exchange; and

46.2 conducting an education campaign for all people interacting with the NZ ETS market during the transition into a more regulated market.

47 Progressing these tools would improve the market infrastructure for participants to buy and sell NZUs, to monitor and oversee the market, and be informed of further incoming changes to the NZ ETS market.

Establishing an optional centralised exchange

48 For the optional centralised exchange tool, I had instructed officials to consider options which best address the Governance of Trading risks:

48.1 **Risk 3:** Potential lack of transparency, oversight, and monitoring of trades in the NZ ETS market; and

⁸ Productivity Commission (2018). Low-emissions economy, p 138

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48.2 **Risk 4:** Credit and counter-party risks.

49 MfE have advised progressing with an optional centralised exchange could address some Governance of Trading risks.

50 I intend that the use of the centralised exchange be optional for all buyers and sellers of NZUs. Market participants seeking greater transparency would have the option to use this exchange in addition to their current arrangements.


51 The objective for introducing an optional centralised exchange is to ensure there is a fit-for-purpose market facility that contributes to the broader objectives of the market governance proposal. These objectives include increased:

51.1 market efficiency, liquidity and transparency; and

51.2 transparency, monitoring and oversight of the NZ ETS market.

52 The optional centralised exchange could also ensure effective market operation and development, with the ability to supervise and monitor NZU trading by using and adapting established licensed exchange infrastructure and tools.

53 s 9(2)(f)(iv)



54 I consider there are various benefits to government for introducing an optional centralised exchange in the NZ ETS. These include:


54.1 creating an exchange is a step towards creating a secondary market in line with global best practice and driving forward emission reduction goals;

54.2 addressing two key market governance risks of lack of transparency, and credit and counterparty risk;

54.3 incentivising and supports current market traders and participants with surrender obligation to access the market for NZUs by reducing market risks and costs associated with executing trades; and

54.4 improving the oversight and monitoring of trades in the market by requiring the optional centralised exchange to share this information with the appropriate regulators, once established as part of the broader market governance proposals.

⁹ s 9(2)(f)(iv)



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55 I consider there are benefits to NZ ETS participants for introducing an optional centralised exchange. These include:

55.1 improving market transparency and public access to market data through aggregate data reporting, such as live price and volume data;

55.2 ensuring anyone who buys and sells NZUs can be treated fairly through a common set of rules when buying or selling, with fair market prices available; and

55.3 addressing credit and counter-party risks through exchange rules relating to participant transaction default obligations, trading collateral and/or margins.

56 s 9(2)(f)(iv)

[Redacted content]

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

[Redacted content]

57.1 s 9(2)(f)(iv)

[Redacted content]

57.2 s 9(2)(f)(iv)

[Redacted content]

58 I propose MfE and EPA undertake the necessary work now to better understand the technical and legislative changes required to support the market governance framework. I expect MfE and EPA to report back to Cabinet with the technical and legislative changes needed.

Progressing with an education campaign in the interim

59 I propose that Cabinet agrees to begin designing an education campaign prior to implementing:

59.1 the optional centralised exchange to manage information and trading risks; and

59.2 the broader market governance framework.

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60 The education campaign will inform all people interacting with the NZ ETS market of market risks in the NZ ETS and the benefits and implications of upcoming market changes. The education campaign is supported by Cabinet's decision in 2019 to prioritise non-legislative tools relating to poor advice, such as an education campaign [2019-C-05488 refers].

61 An education campaign would serve as a foundational, preliminary component to the proposed regulatory advice on how to treat market governance risks. Aiding knowledge of the NZ ETS market and its changes would assist the transition into a more robust market governance landscape.

62 s 9(2)(f)(iv) [Redacted]

s 9(2)(f)(iv) [Redacted]

63 s 9(2)(f)(iv) [Redacted]

64 s 9(2)(f)(iv) [Redacted]

65 s 9(2)(f)(iv) [Redacted]

Further policy decisions to be considered after targeted consultation

66 I propose to return to Cabinet with a comprehensive market governance proposal later this parliamentary term. This proposal will seek to create a robust market governance legislative framework that addresses all market risks in the NZ ETS.

Consideration of treating the NZU as a financial product to leverage existing financial markets frameworks

67 I have received advice from MfE that treating the NZU as a financial product and bringing them under the FMCA can regulate the market governance risks in the NZ ETS market.

68 This would provide consistency in dealing with similar risks in the NZ ETS with the way they are treated in financial markets. I consider that, with appropriate modifications to reflect the unique nature of NZUs, the financial market framework can be applied to the NZ ETS market.

69 There have been two external reports¹⁰ that have recommended the NZ ETS requires the kinds of regulatory policies and infrastructure currently in place in the financial market to address the seven market risks in the NZ ETS. This

¹⁰ Covec (2017). Market Governance of the Emissions Trading Scheme: Options and Analysis; EY (2019). Managing the ETS Market as it evolves.

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includes NZUs being treated as a financial product. Some agencies have raised concerns about these reports and the application of this advice.

- 70 Further, as part of the 2021 market governance consultation, some industry stakeholders urged the Government to consider treating NZUs as a financial product and leveraging existing financial market legislation.

I propose targeted engagement on the proposals

- 71 The approach of regulating NZUs as financial products and leveraging financial market legislation has not been tested in the marketplace. I am aware that some agencies have indicated reservations on treating the NZU as a financial product and their inclusion under existing financial market legislation.

- 72 I want to better understand these concerns while we are still at a stage of considering how financial market legislation may need to be amended. This will assist in accommodating the peculiarities of the NZ ETS market while it is still possible to consider alternative approaches to market governance.

- 73 I am seeking Cabinet approval to direct MfE, with TSY, MBIE and MPI, to develop a discussion document for targeted engagement with key stakeholders. The intention is to better understand the impacts on stakeholders.

- 74 This discussion document will include proposals to:

74.1 treat NZUs as a financial product, treat financial advice relating to NZUs as a financial advice service, and treat market risks in the NZ ETS as financial risks;

74.2 give the FMA regulatory oversight in relation to the seven market governance risks;

74.3 better understanding the prioritisation of the seven market risks for stakeholders;

74.4 implement specific regulatory tools to regulate the NZ ETS market risks; and

74.5 seek feedback on alternative proposals.

- 75 I will return to Cabinet later this parliamentary term with the outcome of the targeted engagement and a comprehensive market governance proposal for Cabinet's approval.

Financial Implications

- 76 The non-legislative tools proposed in this Cabinet paper will have financial implications.

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77 s 9(2)(b)(ii) [Redacted]

s 9(2)(f)(iv) [Redacted]

78 s 9(2)(f)(iv) [Redacted]

79 s 9(2)(f)(iv) [Redacted]

80 s 9(2)(f)(iv) [Redacted]

81 s 9(2)(f)(iv) [Redacted]

82 s 9(2)(f)(iv) [Redacted]

s 9(2)(f)(iv) [Redacted]

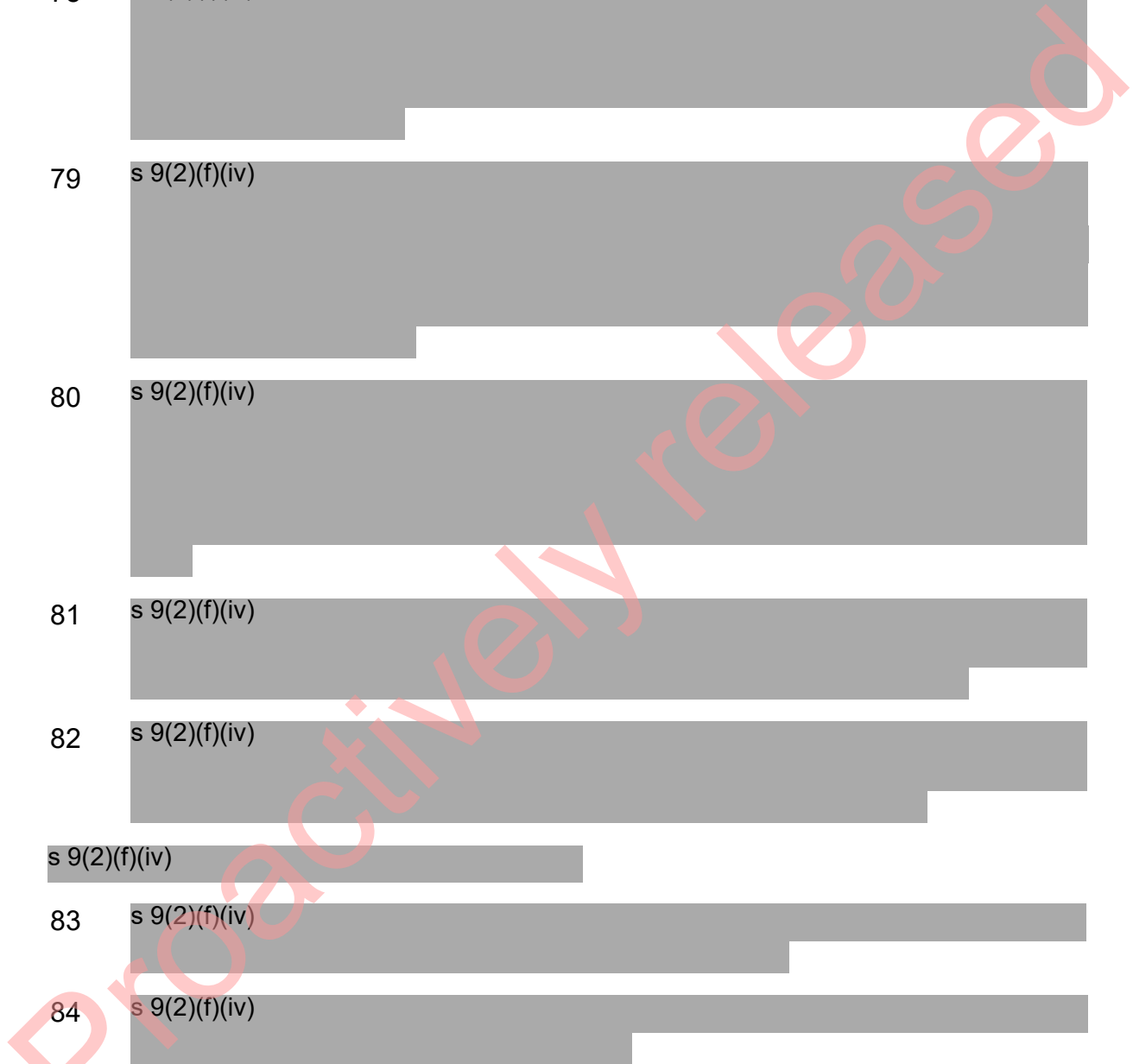
83 s 9(2)(f)(iv) [Redacted]

84 s 9(2)(f)(iv) [Redacted]

s 9(2)(f)(iv) [Redacted]

85 s 9(2)(f)(iv) [Redacted]

86 s 9(2)(f)(iv) [Redacted]



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- 87 s 9(2)(f)(iv) [Redacted]
- 88 s 9(2)(f)(iv) [Redacted]
- 89 s 9(2)(f)(iv) [Redacted]

Legislative Implications

- 90 I note that any proposals that I return with later this parliamentary term will require amendments to the CCRA. A new Bill will need to be included in the 2023 legislative programme if it is to be progressed in 2023.
- 91 I will be putting forward a legislation bid for the 2023 legislation programme.

Te Tiriti o Waitangi

- 92 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 largely in the primary industries, as well as Treaty-based rights and interests in natural resource use and management. 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.
- 93 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. In designing the exchange, agencies will be mindful of the costs to ensure smaller NZ ETS market users, including iwi and Māori who can currently trade bilaterally with minimal administrative cost, are not disproportionately impacted.
- 94 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. This will be covered in the Regulatory Impact Analysis that I provide to Cabinet when I return with the comprehensive market governance proposal.

Impact Analysis

Regulatory Impact Statement

- 95 This paper contains non-legislative proposals to improve market efficiency in the NZ ETS market and therefore Cabinet’s regulatory impact analysis requirements do not apply.

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- 96 A Regulatory Impact Statement will be provided when policy decisions are sought on legislative changes to the NZ ETS market after targeted consultation.

Climate Implications of Policy Assessment

- 97 The Climate Implications of Policy Assessment (CIPA) team has been consulted and confirms that the CIPA requirements do not apply as there is no direct emissions impact.

- 98 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.

Population Implications

- 99 There are no population implications of the proposed policy changes in addition to those already outlined in paragraphs 92 to 94. We considered the impacts on the various population groups, such as: children, seniors, disabled people, women, people who are gender diverse, Pacific peoples, veterans, rural communities, and ethnic communities.

Human Rights

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

Next steps

Next steps on non-legislative tools

- 101 Subject to Cabinet agreement, I will direct officials to implement the non-legislative tools for market governance:

101.1 for the optional centralised exchange, for officials to initiate a Request for Information (RFI) or tender process having fully specified the requirements of the exchange; and

101.2 for the education campaign, for officials to initiate an education campaign for all people interacting with the NZ ETS market.

Next steps on legislative tools

- 102 Subject to the views expressed in targeted engagement and further analysis, I intend to return to Cabinet to seek approval:

102.1 on the NZ ETS legislative tools; and

102.2 for the Parliamentary Counsel Office to proceed with the drafting process of the market governance proposals.

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103 I expect a full package of amendments to result in a new Climate Change Response Amendment Bill with a view of this being introduced this parliamentary term.

Consultation

General public

104 MfE consulted on a range of options and proposals on the seven market governance risks in July 2021. The approach allowed stakeholders to express their opinion on their preferred direction, helping the government gather varied perspectives before making policy decisions. The consultation was conducted over a ten-week period in parallel with consultation on options to realign NZ ETS industrial allocation policy.

105 To complement the release of the consultation document, a series of workshops and online webinars were also scheduled. Engagement was targeted at a wide range of different groups with an interest in these proposals, including iwi and Māori and NZ ETS forestry participants.

Departmental consultation and comments

106 The Ministry of Business, Innovation and Employment (MBIE), Financial Markets Authority (FMA), Ministry for Primary Industries (MPI), Environmental Protection Authority (EPA), Ministry of Justice (MOJ), Department of Prime Minister and Cabinet (Policy Advisory Group), Ministry of Foreign Affairs and Trade (MFAT), The Treasury, and Te Arawhiti were consulted.

107 The following sections outline agency-specific departmental comments.

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108 s 9(2)(g)(i) [Redacted]

109 s 9(2)(g)(i) [Redacted]

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110 s 9(2)(g)(i) [Redacted]

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s 9(2)(g)(i)



111 s 9(2)(g)(i)



112 s 9(2)(g)(i)



112.1 s 9(2)(g)(i)



112.2 s 9(2)(g)(i)



112.3 s 9(2)(g)(i)



112.4 s 9(2)(g)(i)



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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)

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s 9(2)(g)(i)

116.1 s 9(2)(g)(i)

116.2 s 9(2)(g)(i)

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s 9(2)(g)(i)

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s 9(2)(g)(i)

118.1 s 9(2)(g)(i)

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s 9(2)(g)(i)

118.2 s 9(2)(g)(i)

Communications

119 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.

Proactive Release

120 This paper will be proactively released and is 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 the New Zealand Emissions Trading Scheme (NZ ETS) market is subject to a patchwork of regulation that leaves gaps. There is also no single regulator responsible for market oversight;
- 2 **Note** that the NZ ETS market risks were identified in 2014 and work on the NZ ETS market governance project has been ongoing since 2015;
- 3 **Note** the 2015 review of the NZ ETS found that market governance of the NZ ETS could be improved and was not fit for purpose;
- 4 **Note** that the Minister of Climate Change's view is that eight years is sufficient time for consideration and that decisions are now urgent;
- 5 **Note** that the identified market risks in the NZ ETS market require regulation;
- 6 **Note** officials will undertake further work to consider regulatory options to address the market risks;
- 7 **Note** that Cabinet agreed in-principle [CAB-18-MIN-0606.01], subject to final decisions on the broader, coherent market governance framework to:

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- 7.1 prohibit insider trading and market manipulation in the NZ ETS market; and
- 7.2 as much as is practical and appropriate:
 - 7.2.1 to approach insider trading and market manipulation in the same manner as they are treated in the Financial Markets Conduct Act 2013 (FMCA); and
 - 7.2.2 to have penalties and offences for insider trading and market manipulation in the NZ ETS mirror the equivalent relevant penalties and offences in the FMCA.
- 8 **Note** that officials consulted on market risks, options, and market governance scenarios in 2018 and 2021;
- 9 **Note** that progressing amendments to the NZ ETS market governance framework is a priority area for the Government.

Progressing non-legislative tools to improve market efficiency and operations of the NZ ETS

- 10 **Direct** officials from the Ministry for the Environment (MfE), with Ministry for 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 to better understand:
 - 10.1 the technical requirements of the optional centralised exchange and the legislative changes required;
 - 10.2 how future decisions on potential legislative tools to support a comprehensive package for market governance of the NZ ETS, 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
 - 10.3 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.
- 11 **Note** that I intend to return to Cabinet in November 2022 with:
 - 11.1 the technical requirements of the optional centralised exchange;
 - 11.2 how future decisions on potential legislative tools might have implications on how this optional centralised exchange; and
 - 11.3 the level of funding required.
- 12 **Note** that I also intend to return to Cabinet in early-2023 to seek agreement for any supporting legislative amendments identified to be required for the

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optional centralised exchange alongside consideration of a comprehensive market governance package for the NZ ETS.

13 **Note** a Request for Information (RFI) or tender process will help inform the technical requirements and/or legislative changes requires;

14 s 9(2)(f)(iv)

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

Progressing legislative amendments to regulate market risks in the NZ ETS

16 **Note** that the proposal to treat NZUs as financial products has not been tested with the marketplace;

17 **Direct** MfE, with Treasury, MBIE and MPI, to prepare a discussion document for targeted engagement by end of September 2022, for Cabinet to consider in November 2022;

18 **Note** that the consultation package should:

18.1 Seek feedback on:

18.1.1 treating NZUs as a financial product;

18.1.2 treating financial advice relating to NZUs as a financial advice service;

18.1.3 treating market risks in the NZ ETS as financial risks;

18.1.4 including the NZ ETS market under existing financial frameworks legislation;

18.1.5 appointing the Financial Markets Authority (FMA) to oversee and regulate the NZ ETS market;

18.2 seek to better understand the impacts and prioritisation of the seven market risks for stakeholders;

18.3 seek feedback from stakeholders on the financial and administrative impacts of:

18.3.1 leveraging the FMCA and applying the following policy tools to the NZ ETS market:

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- 18.3.2 introducing a Code of Conduct, licensing and registration on framework using a similar approach as the FMCA to regulate the provision of financial advice relating to NZUs;
 - 18.3.3 applying the licensed market framework using a similar approach as the FMCA to regulate market operators;
 - 18.3.4 prohibiting insider trading and market manipulation using a similar approach as the FMCA; and
 - 18.3.5 any other FMCA provisions that may be relevant to addressing the seven market governance risks.
- 18.4 seek feedback on the impact on stakeholders of leveraging the existing Anti-Money Laundering and Counter-financing of Terrorism Act 2009 in the NZ ETS market;
 - 18.5 seek feedback on the impact on stakeholders of increased disclosure obligations under an improved transaction reporting framework to include transaction price and value reporting via the New Zealand Emissions Trading Register;
 - 18.6 seek feedback on the scope and overlap between the proposal, to treat financial advice relating to NZUs as financial advice, and forestry adviser services under the Forests Act 1949 and the appropriate legislative approach;
 - 18.7 seek feedback on alternative market governance proposals to achieve the same outcomes of mitigating the seven risks.
- 19 **Note** that the Minister of Climate Change intends to return to Cabinet in November 2022 to seek agreement to commence the targeted engagement with stakeholders;
 - 20 **Note** that subject to the outcomes of this targeted engagement and further analysis, the Minister of Climate Change intends to introduce any comprehensive market governance package this parliamentary term;
 - 21 **Note** that MfE will provide a regulatory impact analysis when seeking policy decisions.

Funding implications

- 22 s 9(2)(b)(ii) [Redacted]
- [Redacted]
- [Redacted]
- [Redacted]

IN CONFIDENCE

23 s 9(2)(f)(iv) [Redacted]

24 s 9(2)(f)(iv) [Redacted]

24.1 s 9(2)(f)(iv) [Redacted]

24.2 s 9(2)(f)(iv) [Redacted]

25 s 9(2)(f)(iv) [Redacted]

26 s 9(2)(f)(iv) [Redacted]

27 s 9(2)(f)(iv) [Redacted]

28 s 9(2)(f)(iv) [Redacted]

29 s 9(2)(f)(iv) [Redacted]

30 s 9(2)(f)(iv) [Redacted]

Legislative implications

31 **Note** that any proposals for legislative amendments will likely require an amendment Bill to the Climate Change Response Act and other legislation;

32 **Note** that the Minister of Climate Change will put forward a legislation bid for the 2023 legislation programme.

Proactive release

33 **Agree** that the Minister of Climate Change will proactively release this paper on MfE's website, subject to redactions equivalent to withholdings under the Official Information Act 1982.

Authorised for lodgement

Hon James Shaw

Minister of Climate Change