BUDDLE FINDLAY

How should emissions trading be regulated?

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In July 2021 the Ministry for the Environment published a new consultation document, *"Designing a governance framework for the New Zealand Emissions Trading Scheme"* (the consultation document). The consultation document considers at a high level whether, and how, the New Zealand Emissions Trading Scheme (ETS) should be regulated. This article summarises its findings.

The status quo

The ETS is a scheme designed to reduce greenhouse gas emissions in New Zealand. Broadly speaking, the scheme requires businesses to surrender New Zealand Units (NZUs) to the Government in exchange for their emissions. NZUs are initially issued by the Government, but they can be bought and sold by businesses who wish to cover existing emissions or offload unused NZUs.

Currently, there is no specific regulatory framework or regulator which governs the ETS market. While the ETS market is subject to commercial legislation of general application (for example, the Commerce Act 1986 may apply in respect of anti-competitive behaviour in the ETS market, and the Fair Trading Act 1986 may prohibit false and misleading advertising by traders of NZUs), the current approach does not protect against all risks in the ETS market.

At the moment, trading is largely conducted over-the-counter (OTC), with the buyer and seller dealing directly with each other without the use of an exchange. Because OTC trades are negotiated directly between the parties, there is no public record of the trading details or price.

Potential problems with the status quo

The consultation document identifies seven risks which might arise if the status quo is maintained. These risks are grouped together under three themes (governance of advice, governance of trading, and governance of market conduct). The risks are:

Under the governance of advice theme	• Users receiving poor, false or misleading advice from NZU advisers (people and organisations who provide ETS users with advice) who do not have to go through any accreditation process • NZU advisers hiding or disguising conflicts of interest (for example, an adviser may not disclose that they accept commissions for referrals).
Under the governance of trading theme	• A lack of transparency, oversight and monitoring in the secondary market. Because information about trades is not made public, traders can hide misconduct or anti-competitive behaviour • Credit and counter-party risk. This is the risk that one of the parties to an NZU trade defaults on their contractual obligations, meaning the trade is unable to be settled.
Under the governance of market conduct theme	• Insider trading and information asymmetry • Manipulation of NZU prices • Money laundering and financing of terrorism.

Other countries have already taken steps to address these risks (for example, South Korea's Emissions Trading Scheme requires trades to take place on the Korean Exchange, so that transactions can be monitored). For this reason, the consultation document suggests the status quo should not be maintained. Instead, it recommends the Government take steps to mitigate the risks identified.

Regulatory options

The consultation document sets out options the Government could pursue to mitigate the risks found in each theme.

The options discussed to address the risks found in the 'governance of advice' theme include maintaining the status quo, creating a consumer education campaign (the aim of which would be to educate ETS users about ETS advisers), creating sector guidelines for NZU advisers (which would benchmark an expected level of service from advisers), and creating a code of conduct whilst also requiring the licensing and registration of NZU advisers (the competency of advisers could be assessed on application to hold a license, and the code of conduct would set a benchmark for behaviour).

The options discussed to address risks found in the 'governance of trading' theme include maintaining the status quo, encouraging users to voluntarily report transactions to a regulator (which might improve transparency of the market), requiring NZU traders and ETS participants to disclose the total number of NZUs they hold or borrow (which would make the market more transparent and provide information about distribution of market power), and requiring most or all NZU trades to take place on one or more regulated exchanges (this would provide the most information to the public, and a common set of rules could be imposed to ensure users are treated equally and able to buy and sell at a fair market price).

The options discussed to address the risks found in the 'governance of market conduct theme' include maintaining the status quo, setting position and purchase limits (which would prevent one user or group form acquiring such a large share of NZUs that they could wield unfair market power), encouraging users to voluntarily report the price of NZUs traded, and requiring mandatory full transaction reporting (under which users would have to report a comprehensive list of transaction details to the regulator).

The consultation document also considers whether a regulatory body should be appointed to oversee the market. Six options are discussed in relation to this. The Government could:

- Maintain the status quo
- Appoint a self-regulating industry body. Under this option, one or more members of the industry could assume the responsibility of overseeing the sector. This body could work independently or in concert with government entities
- Appoint an advisory regulator. This would be an independent body with the power to give strategic advice to the Government on the ETS
- Appoint a market monitoring regulator. This would have the same powers as above, but the body would also be able to collect information to expose misconduct or provide data to the Government
- Appoint a market compliance regulator. This would have the same powers as above, but the body would also be able to investigate and enforce compliance with market rules set in primary legislation or regulations
- Appoint a market design regulator. This would have the same powers as above, but the body would also be able to make market rules.

The consultation document assesses the advantages and disadvantages of each option. The risk coverage of each option (the ability of each option to adequately address the risks of each theme) is also analysed. Generally speaking, the consultation document finds that options requiring regulation have the best risk coverage.

Conclusion

As the consultation document makes clear, there are risks associated with maintaining the status quo. For this reason, it seems likely the Government will seek to regulate the emissions market. The question is how far the Government will look to go. The consultation document suggests the Government would like to move toward exchange-based trading, as well as establish a regulatory body with the power to enforce compliance, but nothing is certain at this point.

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