Submission

By

To the Ministry for the Environment

on

Designing a governance framework for the New Zealand Emissions Trading Scheme

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INTRODUCTION AND SUMMARY[1]

Thank you for the opportunity to submit on "Designing a governance framework for the New Zealand Emissions Trading Scheme," by the Ministry for the Environment ("MfE").

This submission is made by The New Zealand Initiative, a think tank supported primarily by chief executives of major New Zealand businesses. The purpose of the organisation is to undertake research to contribute to the development of sound public policies in New Zealand to help create a competitive, open, and dynamic economy and a free, prosperous, fair, and cohesive society.

The New Zealand Initiative supports the government's emissions targets, including commitments under the Paris Climate Agreement and to net zero emissions of long-lived greenhouse gases from 2050. We consider the New Zealand Emissions Trading Scheme ("ETS") is among the world's leading cap-and-trade systems for reducing greenhouse gases.

The consultation document describes problems clearly, identifies various solutions, and provides a logical assessment of the options. The consultation is timely given recent increases in the ETS price.

We support the focus on protecting public confidence in the ETS through good governance. In our view, the primary constraint on the ETS and other emissions policies is their ability to sustain public confidence and a majority in Parliament through 2050 and beyond. Appropriate governance is essential for the integrity of the system.

We also support MfE's focus on price discovery. We interpret price discovery as referring to processes which lead to all available information being incorporated in a market price.

It is important to recognise what supports or undermines price discovery:

- The fundamental drivers of price discovery are market liquidity and open market access, which allow information to enter the market price.
- Perhaps counterintuitively, market manipulation and insider trading *support* price discovery by rewarding market liquidity.[2]
    - However, we recognise manipulation and insider trading is likely to threaten public confidence in the ETS. Accordingly, there is a trade-off to consider.
- Regulations can undermine price discovery if they lead to transaction costs which lower liquidity or deter entry. These potential regulation costs should be weighed against other benefits of regulation.

Officials list various risks in Table 2 of the consultation document. We suggest officials take into account existing protections against manipulation and market dominance, including:

- Market liquidity and open market access;

[1] Disclosure: the author of this submission owns a limited number of New Zealand Units through SALT Funds Management.
[2] See, for example, Hanson, Robin, Ryan Oprea, and David Porter. 2006. "Information aggregation and manipulation in an experimental market." *Journal of Economic Behaviour and Organization*. 60(4), pp.449-59. See also Hanson, Robin, and Ryan Oprea. 2008. "A Manipulator Can Aid Prediction Market Accuracy." *Economica*. 76(302), pp. 304-14.

- The opportunity to access freshly-issued New Zealand Units ("NZUs") via removals;[3]
- The stockpile of more than 120 million NZUs; and
- The option to access offshore mitigation, which is recognised under the Paris climate agreement and the Climate Change Response Act, as a check on any use of market power and a deterrent to obtaining market power in the first place.

Existing legislation guards against insider trading and money laundering. Beyond those protections, increasing market depth, and the development of an ecosystem of financial services including advisory services, will help manage the risks identified by officials. Any case for regulation must consider existing protections.

The ETS is essentially a commodity market like any other. Accordingly, we suggest the government's regulation strategy should be to:

- import existing regulations and processes from other markets; and
- favour self-regulation where possible, or
- extend the responsibilities of existing regulators to include the ETS, rather than establish a new regulator.

Most if not all of the potential risks identified for the ETS are common to other markets. Accordingly, it is difficult to see any merit in building a new regulatory framework over importing existing frameworks from other markets.

OTHER COMMENTS

OTC trading: Officials are quite critical of over-the-counter ("OTC") trading (pp. 26-27). We question officials' concerns. The privacy of OTC trading ("poor transparency") does not plausibly affect price discovery by lowering liquidity or deterring entry. As far as we are aware, there is no theory which ties market efficiency to the identity and positions of traders being public knowledge. Even if counterparty risk is higher for OTC trading, traders can manage this risk by limiting the size of transactions. It is difficult to understand officials' concerns about OTC trading.

We oppose position and purchase limits as detrimental to price discovery. Worse, restrictions on positions can make it harder for firms to plan their positions over time. Firms may wish to hedge against the risk of future price increases by purchasing options, or by purchasing or shorting units. Position and purchase limits can disrupt those activities. The government should rely on established protections under the Commerce Act against the use of market power. With more than 120 million NZUs outstanding, and the option to access offshore mitigation, it is difficult to see how any trader could sustain a dominant position in the market.

Price discovery is not supported by disclosure of trading positions. As we have noted, price discovery depends on liquidity and entry as means for information to be reflected in the

[3] For example, carbon capture and storage by forestry.

market price. Officials should be aware of the potential for regulation to disrupt price discovery by imposing transaction costs on traders.

Market manipulation does not directly undermine emissions reduction. The ETS emissions cap is binding. Emissions come down because a) the government issues a declining number of NZUs and b) penalises non-compliance. Price manipulation does not prevent the ETS from reducing emissions. However, manipulation could change how and where emissions fall and raise the cost of reducing emissions, probably marginally. Manipulation can indirectly impair efforts to reduce emissions by undermining public confidence in the ETS.

We also note that, to the extent market manipulation could be perceived as a concern, it could easily be the case that expectations of continued adjustment of the price ceiling fuels the kind of transactions that worry MfE.

Thank you for considering this submission. We would welcome the opportunity to discuss the contents of this submission further with you.

Matt Burgess
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