



NZ Carbon Exchange

10 March 2008

Caroline Ramsey
Manager, Financial Sector Competition, Trade & Investment Branch
Ministry of Economic Development
33 Bowen St, PO Box 1473,
Wellington 6011, New Zealand

Dear Caroline,

Submission on the Draft Emissions Units, Settlement Systems and Futures Bill

New Zealand Carbon Exchange Limited (NZCX) welcomes the opportunity to submit on the Draft Emissions Units, Settlement Systems and Futures Bill.

Our written submission is attached.

If you have any queries, or require further information, please feel free to contact one of our directors:

Murray Dyer , or telephone
Stuart Frazer at or telephone
Karen Price at , or telephone

Yours sincerely

Murray Dyer
Director

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Submission to the
Ministry of Economic Development
on the
Draft Emissions Units, Settlement Systems
and Futures Bill

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Introduction

- 1) New Zealand Carbon Exchange Limited (NZCX) welcomes the opportunity to make this submission on the Draft Emissions Units, Settlement Systems and Futures Bill.
- 2) NZCX is an emissions trading intermediary or “broker”. The company was formed in 2004 and is New Zealand owned. The company directors have considerable experience in climate change policy, markets and law.
- 3) NZCX has an exclusive relationship with CantorCO2e, the world’s leading provider of transaction services for greenhouse gas (GHG) markets with an international network of over 70 brokers and advisers.
- 4) This CantorCO2e connection provides NZCX with significant international insight on emissions trading scheme design and operation.

Summary of our Position

- 5) NZCX supports the Government’s policy to reduce greenhouse gas emissions at least cost to the NZ economy through the introduction of an efficient emissions trading system; the NZ ETS.
- 6) NZCX endorses the absence of restrictions in the NZ ETS design on how emission units should be traded.
 - a) Participants in the New Zealand Emissions Trading Scheme (NZ ETS) should have access to the full range of transaction options, among them bilateral, through a broker (over the counter or “OTC”) or across an exchange platform.
 - b) This is best facilitated by the Government’s retention of the control of registry services as proposed in the Climate Change (Emissions Trading and Renewable Preference) Bill.
- 7) The Draft Emissions Units, Settlement Systems and Futures Bill could have the consequence of restricting transaction options and/or conferring advantage on parties with respect to registry access unless carefully drafted; it is in these areas that NZCX focuses its submission.
- 8) NZCX is particularly concerned over potential ambiguity in the definition of “forward physical trades” and “futures transactions” in emission units; the latter is a derivative and should be subject to securities regulations while the former is not.

Submission Points

Consultation Process & Context

- 9) NZCX welcomes the opportunity to make a formal submission on this important Bill.
- 10) As previously noted in dialogue with the Ministry of Economic Development and in written communication to Ministers, NZCX is concerned that :
 - a) Cabinet decisions made last year were based on consultation with a single commercial party; NZX. [refer POL-(07)-382 paragraph 82]; and
 - b) there has been overt support to NZX “providing them with the assurances they require to continue to develop the TZ1 emissions trading platform” despite it being recognised that there exists other parties with competing commercial interests [refer CAB-(07)-632 paragraph 87].
- 11) NZCX appreciates the more open consultation process that is now occurring however the combining of emission unit specific issues with the wider reform of clearing and settlement process regulatory environment may inhibit potential submitters.
- 12) NZCX supports legislative changes that will improve the operation of New Zealand’s financial markets. Therefore, in principal, NZCX supports the concept of a designated settlement system.
- 13) However, this is a broader market issue and should be consulted on a full and open basis covering all markets and potential instruments, including foreign exchange, fixed income, energy and commodities.
- 14) NZCX is concerned that the emissions trading issues are not being dealt with separately from these wider market measures as part of the primary NZ ETS legislation, or alternatively via a narrow focussed consultation process, both of which would be more appropriate when a new and complex emissions trading regime is being introduced to New Zealand.
- 15) NZCX is aware that many firms who will be participants with obligations in the NZ ETS have struggled to identify the emissions trading specific issues amongst the wider market regulatory measures and therefore are not making submissions on this draft Bill. This is a serious matter as it is these firms who will face the cost and complexity of trading.
- 16) Should there be few submissions from NZ ETS participants, NZCX suggests a workshop to explain the implications of the Draft Bill followed by a supplementary submission process would be appropriate.

- 17) NZCX has constrained its submission points to those it sees as directly relevant to the proper operation of the NZ ETS market.

Primary Objective

- 18) The discussion paper's introductory section outlines the desire to ensure that:
- a) New Zealand's trading of emissions units (both mandatory and voluntary) is properly integrated with international carbon markets, it is also important that New Zealand's emissions trading platforms are able to have credibility in international markets; and
 - b) New Zealand's regulatory environment will enable the development of robust trading and clearing and settlement infrastructure in relation to emissions units, which meet standards of international best practice.
- 19) NZCX considers that a prime objective for emission unit regulations should be to retain full flexibility in the manner in which emission units can be traded, minimising costs and ensuring competition in trading services.
- 20) Government should therefore seek to:
- a) avoid an overly regulated or single provider trading market; and
 - b) preserve a suite of options as exhibited overseas.
- 21) The discussion paper fails to outline the range of emission unit trading options, instead it focuses on futures alone. In addition, NZCX considers that there is inadequate delineation between futures trading and forward physical transactions.

How is Trading Done Overseas?

- 22) It is important that the Bill clearly recognises the difference between a compliance market and a derivatives or futures market for trading risk management purposes.
- 23) First and foremost emissions trading schemes are physical compliance markets where participants need to be able to trade spot or physical forward contracts through mechanisms other than registered futures exchanges.
- 24) Precedents in overseas emissions markets show that these contracts are successfully traded bilaterally, through brokers or across formal markets that are not recognized investment exchanges.
- 25) Section 5.1 of the consultation paper incorrectly states that:

“a large portion of trading in ...emissions units...has occurred in the form of a futures market.”

Section 5.1 seems to build on the misinformation underlining paragraph 17 of the Cabinet Paper POL-07-382 which stated that:

“Overseas experience has shown that a large proportion of emissions trading has occurred in the form of futures contracts. Therefore, it is important to ensure that New Zealand’s regulatory environment for futures exchanges allows for emissions trading”

- 26) The Government has received papers from international third parties which clearly explain the nature of the overseas emission markets including the low volume of exchange traded futures and the importance of spot and physical forward transactions:

“Issues in the International Carbon Market, 2008-2012 and beyond – a study by Point Carbon Advisory Services for the NZ Emissions Trading Group”¹(emphasis added)

“The European carbon market includes both spot and forward trading of allowances. The forward market includes contracts with monthly, quarterly and annual expiration (typically December expiration) for the final year of the first trading period (2005-2007), and contracts with annual expirations (typically December expiration) for the second trading period 2008-2012.

Trading of EUAs is split between an over-the-counter (OTC) market and numerous exchanges. So far in 2007, exchanges have had around 30% of the market share, with the European Climate Exchange (ECX) taking over 80% of the exchange volume.

Derivative markets include various forms of futures and option contracts where no physical exchange of commodities will take place and these assist market participants in managing price risks. Derivative contracts involve a financial settlement between the parties which is determined by the difference between the contract price and an agreed price index. As of yet, the derivatives market for emission allowances is not very well developed and these currently represent a very small portion of the market size. The instruments available include:

- 1. Futures: some of the allowance futures contracts can be considered as hybrids because a contract party can opt out of physical delivery and the contract effectively becomes a financial instrument;*
- 2. Calendar spreads: these can be used to capitalise on the idea that the price of EU emissions allowances change in a specific way between two expiration dates. This allows traders to take advantage of the price differences over time between the contracts;*
- 3. Options: the European Climate Exchange is the only exchange to offer option contracts on EUAs and Certified Emission Reductions (CERs) at present although other exchanges may follow suit as this market develops. Options are also carried out through the brokered OTC market;*

¹ <http://www.climatechange.govt.nz/files/point-carbon-briefing-report-2.pdf> p18 and p20

4. *Swaps: a large swap market has developed for EUAs and CERs. This allows companies to import large quantities of CER credits into the EU ETS and to swap these for EUAs in order to respect the limits on the use of credits for compliance*"

Focus on Futures Inappropriate

- 27) In the discussion paper, Section 2.4 (a) states that the scope of the Bill ... "expressly provide for the trading of futures contracts in emission units".
- 28) Noting the overseas experience as highlighted above, the focus on futures contracts in emissions units is potentially misleading. It also demonstrates a misguided view as to how the market will likely develop in New Zealand.
- 29) NZCX submits that the Draft Bill and supplementary material should specifically acknowledge the availability of other trading options and explicitly state that the Draft Bill does not oblige parties to trade through a futures exchange.

Defining a Security

- 30) NZCX endorses the exclusion of emissions unit from the definition of a security in Clause 41 of the Draft Bill.
- 31) However, the Bill is somewhat ambiguous regarding physical forward transactions. These physical forwards are settled through various mechanisms including bilateral settlement as well as centrally cleared.
- 32) Accordingly, NZCX submits that the Bill should make clear that physical forward transactions are not futures and that therefore they too are not a 'security'. On this basis, Clause 41 should be amended by adding the words "...whether traded on a spot or forward physical transaction...".
- 33) Similarly Clauses 42-44 of the Draft Bill amend the Securities Markets Act 1988 to include emission units as a commodity but not a security. These amendments require careful review to ensure that spot and forward physical transactions cannot be deemed a futures contract.

Other settlement mechanisms should be recognised

- 34) The Draft Bill Clause 6, New Part 5C Section 156N Designated Settlement System should be amended to make clear this is an opt-in mechanism and acknowledge that:
- a) there are non-designated settlement systems currently operating in New Zealand; and
 - b) overseas experience shows that efficient operation of financial and commodity markets requires formal settlement mechanisms of all types as well as bilateral

settlement through standard industry contracts, such as European Federation of Energy Traders and ISDA contracts.

- 35) No exclusivity for trading should be conferred on a designated settlement system.

No Preferential Treatment for Registry Access

- 36) The Draft Bill Clause 11 & 34 confirms the registrability of an emissions unit through a designated settlement system. NZCX is concerned that this may confer an advantage to designated settlement systems over other systems.

- 37) It is recommended that the operation of the New Zealand Emissions Unit Register (NZEUR) should have independent criteria of, fit and proper persons, and technical capability for registry services, and integration through electronic transfer with the NZEUR. The Climate Change (Unit Register) Regulations 2007 should be amended to incorporate such criteria.

Emission Units as Investment Securities

- 38) The Discussion Paper asks Specific Questions on Emissions Units to be investment securities (p9):

a) Voluntary Units

- i) NZCX recommends that Voluntary Units are excluded from the Bill.
- ii) There is no mandatory requirements to trade these units (as opposed to emission units under the NZ ETS) hence their inclusion seems unnecessary.
- iii) The voluntary market is also “fractured” with different unit types, standards and representation of emissions abatement. Such issues may cause implementation problems within the Draft Bill.

b) Evidence of Title


- i) Evidence of title through a registry is appropriate.
- ii) For emission units the register should be the independent NZEUR.

c) Risks of Emission Units not being securities

- i) As emission units eligible under the NZ ETS are solely government or UN issued, there is no requirement to classify them as a security.
- ii) As with other emissions markets, the NZ ETS will be primarily a physical compliance market.

Requested Action

NZCX would welcome the opportunity for further dialogue on the issues raised by the Draft Bill.



Murray Dyer
Director