

## **EMISSIONS UNITS SETTLEMENT SYSTEMS AND FUTURES BILL**

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### **About Solid Energy**

Solid Energy is New Zealand's largest energy producer, including coal, renewables (biofuels, biomass and solar) and new energy developments, and is one of New Zealand's major exporters. We are also a major energy user, primarily of transport fuels and electricity, in our production and distribution operations. We are directly responsible through our own and our contractors' staff for close to 2,000 direct jobs, and we support around 10,000 indirect jobs through our suppliers and communities.

We have thousands of customers, ranging from New Zealand's largest companies to many small industrial and commercial businesses as well as hospitals, universities, schools and municipalities, and households through our Nature's Flame wood pellet and Switch pellet and solar appliance subsidiaries. Supplying secure affordable energy to these customers makes a significant contribution to New Zealand's economic competitiveness. Our international activities involve regular work on market, technical and policy matters at a senior level with industry and government in the EU, North and South America, South Africa, India, China and Australia.

## SUMMARY

We recognise and support the need to develop appropriate regulations to allow trading of emission units. We consider that the key driver for these regulations should be to support the requirements of participants in the proposed New Zealand Emissions Trading System.

We have concerns regarding the consultation process, the intention and some of the analysis developed in support of this bill. Our concerns are set out in more detail in our submission.

## INTRODUCTION

1. Solid Energy New Zealand Limited will be a significant participant in the New Zealand Emissions Trading Scheme (NZ ETS). For sales of domestic coal, subject to opt-in provisions (and future energy developments), Solid Energy will be obliged to surrender emission units to cover the greenhouse gas emissions resulting from the end use of these fuels.
2. Solid Energy seeks to ensure that market participants have all possible options for trading available to them. These include bilateral settlement, over-the-counter (OTC), and exchange trading of emission units.
3. Competition in the marketplace for the provision of trading services is important to ensure low transaction costs. It is therefore important that New Zealand avoids an overly regulated or single provider trading market.

## CONSULTATION PROCESS

4. Solid Energy has significant concerns with the consultation process for this Bill.
  - a. The issues presented are complex and in many cases new for NZ ETS participants. It would have been beneficial to have had clear presentations and workshops on the content of the Bill and the underlying drivers for it. This in our view is a serious omission in the consultation process.
  - b. It appears from the Cabinet papers released with the consultation document that cabinet decisions have been already made based on consultation with a single commercial party, namely NZX.<sup>1</sup> We are concerned that the timetable for the development of these regulations

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<sup>1</sup> POL-(07)-382 paragraph 82 and the overt support to a single entity NZX "providing them with the assurances they require to continue develop the TZ1 emissions trading platform." CAB-(07)-632 paragraph 87

may be driven more by NZX's requirements than by participants of the NZ ETS.

- c. Solid Energy like other participants, will face significant costs from the introduction of the NZ ETS, while for parties such as NZX there are likely to be upside financial opportunities.

## **INTENTION OF THE BILL**

5. Section 1 of the Consultation Paper highlights that although the original intention of the Bill was to address the requirements for emissions trading, it has been expanded to encompass a wider review of clearing and settlement infrastructure.
6. This merging of two issues markedly increases the difficulty for NZ ETS participants in understanding the issues related to emission units, further hindering the making of informed submissions.
7. We consider that a more appropriate intention of the Bill is to ensure that there is an appropriate regulatory framework to support the purpose of the NZ ETS legislation. All other factors such as the development of a regional emissions trading platform should be secondary to this purpose.
8. In our submission we restrict our comments to those we understand are directly ETS related.

## **CLARIFICATION OF FUTURES AND COMPLIANCE MARKETS**

9. 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.

### **Overseas Experience**

10. Overseas experience of emissions trading, primarily through the EU emissions trading scheme (EU ETS), shows that first and foremost the schemes are a physical compliance market. The NZ ETS is expected to be no different.
11. NZ ETS participants need to be able to trade spot or physical forward contracts through a range of mechanisms. Precedent in overseas emissions markets are that these contracts are successfully traded bilaterally, through brokers, or across formal markets that are not registered futures exchanges.
12. While Section 5.1 of the consultation paper states that:

*"a large portion of trading in ...emissions units...has occurred in the form of a futures market."*

This has not been borne out in the EU ETS market

There seems to be a similar misunderstanding that is apparent in paragraph 17 of the Cabinet Paper POL-07-382 where it was 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”*

13. How the overseas market is working (the low volume of exchange traded futures, and the importance of spot and physical forward transactions ) is set out in:

*“Issues in the International Carbon Market, 2008-2012 and beyond – a study by Point Carbon Advisory Services for the NZ Emissions Trading Group”<sup>2</sup> (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;*

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

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;*
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.*

#### **Recommended Clarification Steps**

14. It is recommended that the Draft Bill and supplementary material specifically acknowledges the availability of other trading options and that the Draft Bill does not oblige parties to trade through a registered futures exchange.
15. The exclusion of emissions unit from the definition of a security is fully endorsed in Clause 41 of the Draft Bill. However to avoid any potential confusion in the market, this clause should be extended to state *"whether traded on a spot or forward physical transaction"*.
16. Similarly Clauses 42-44 of the Draft Bill amends the Securities Markets Act 1988 to include emission units as a commodity but not a security. These amendments should be reviewed carefully to ensure that spot and forward physical transactions can in no way be deemed a futures contract.

#### **REGISTRY ACCESS**

17. The Draft Bill Clause 11 & 34 confirms the registrability of an emissions unit through a designated settlement system. Solid Energy is concerned that this may confer an advantage to designated settlement systems over other systems.
18. It is recommended that the operation of the New Zealand Emissions Unit Register (NZEUR) should have independent criteria for registry services and integration through electronic transfer with the NZEUR. This could be set out in an amendment to the Climate Change (Unit Register) Regulations 2007.

## **EMISSION UNITS AS INVESTMENT SECURITIES**

19. Consultation Paper Page 9 asks Specific Questions on Emissions Units to be investment securities –

### **Voluntary Units**

20. Solid Energy is surprised that the Draft Bill seeks to cover Voluntary Units. As there is no mandatory requirements to trade these units (as opposed to emission units under the NZ ETS) their inclusion seems unnecessary.
21. The voluntary market is also “fractured” with different unit types, standards and representation of emissions abatement. Such issues may cause unforeseen implementation problems with the Bill.
22. It is recommended that all reference to voluntary units be deleted from the Bill

### **Evidence of Title**

23. Evidence of title through a registry is appropriate. For emission units this should be stated to be the NZEUR.

### **Risks of Emission Units not being securities**

24. As emission units eligible under the NZ ETS are solely government or UN issued, there is no requirement to classify them as a security – this is primarily a physical compliance market.