

Submission by



to the

## **Ministry for the Environment**

on the

## **Reforming the Emissions Trading Scheme: Rules for auctioning**

19 December 2019

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# **RULES FOR NZ ETS AUCTIONING – SUBMISSION BY BUSINESSNZ,<sup>1</sup> AND BUSINESSNZ ENERGY COUNCIL**

## **1.0 INTRODUCTION**

- 1.1 BusinessNZ welcomes the opportunity to provide feedback on the consultation document 'Reforming the Emissions Trading Scheme: Rules for auctioning'.<sup>2</sup>
- 1.2 BusinessNZ supports auctioning and was a strong supporter of its inclusion in the Climate Change Response Act several years ago. We believe that auctions are integral to an effective emissions trading scheme, as they ensure that unit allocation is consistent with the 'polluter pays' principle and can help improve the price discovery process.
- 1.3 In this submission, we are addressing the questions asked in the consultation paper from the lens that a well-functioning auction must have the following characteristics:
  - a) Low transaction costs
  - b) Clear rules and timetable
  - c) Transparent auction outcomes while preserving bidder confidentiality
  - d) Well-calibrated price management mechanisms
  - e) An adequate oversight regime to protect the integrity of auction outcomes.

## **SUMMARY OF RECOMMENDATIONS**

Business NZ:

- a. Supports the introduction of a cost containment reserve to help manage significant increases in the carbon price, however more clarity is required on:
  - The volume of reserve units that will be available, and the criteria for determining this volume
  - The level of the price trigger, and how this will be determined.
- b. Supports the introduction of an auction reserve price – we view this mechanism to be superior to a fixed price floor for the ETS overall.
- c. Recognises that although the risk of market abuse is low, it nevertheless needs addressing. The suitable mechanism for addressing this risk in auctions should be determined as part – rather than in isolation – of a separate work-programme on market governance for the ETS overall.
- d. Suggests that the decision on introducing a technical reserve price should address the issue of timing for publishing the price ahead of the auction. This aspect has not been covered in the consultation paper.
- e. Supports the introduction of an auction monitor to oversee the auction process and validate the auction results.
- f. Seeks account to be taken of commercially sensitive information being revealed through the detail of auction results.

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<sup>1</sup> Background information on BusinessNZ is attached as Appendix One.

<sup>2</sup> Given the BusinessNZ's broad membership, our members have a range of views on the proposed mandatory disclosures of climate-related financial information. Some may provide their own separate submissions on matters of concern or where the individual organisation has particular expertise.

## 2.0 DETAILED ANSWERS

### Rules for the auction process

Q1	Do you agree that auction volumes should be evenly distributed over the calendar year? Yes/No/Unsure
Q2	If no, do you have a suggestion for how volumes should be weighted?

- 2.1 We are in favour of an even distribution of annual auction volumes across the quarterly (or monthly) auctions.
- 2.2 The rationale for a weighted distribution would be to align auction supply with the market participants' cash flows during the year. We see no reason why there would need to be a weighted distribution to take into account members' cash flow during the year. Furthermore, this would be an unnecessarily complex task in practice.
- 2.3 Overall, weighted distribution introduces an additional criterion for determining the bidding strategy over the year, adding unnecessary complexity. Furthermore, it could create incentives for strategic behaviour in the secondary market leading to increased price volatility – e.g. if units are withheld from secondary spot trading prior to a smaller auction in order to increase the auction clearing price.
- 2.4 A derogation could be included to auction off fewer units in periods of known low trading activity (e.g. summary holidays), e.g. as per EU ETS. This would ensure non-discriminatory access to auctions, as larger participants may have better resources to cover the low-activity periods. Such a derogation would be more relevant for monthly rather than quarterly auctions.

Q3	Do you think that unsold units should be? <ul style="list-style-type: none"><li>- All added to the next auction</li><li>- Added to subsequent auctions within a limit (preferred)</li><li>- Other, please specify</li></ul>
Q4	If unsold units are only added to subsequent auctions within a limit, what should it be?

- 2.5 Units unsold in an auction should be added to subsequent auctions. Whether or not a limit is warranted depends on the size of the auction. We recognise the benefits of a limit when there is a risk of market over-supply causing the unit price to drop. However, NZ's provisional carbon budget for 2021-2030 suggests that the auction volumes (~44 million) will be much lower than the required abatement task (~203 million). The risk of market over-supply as a result of (unsold) auction volumes is therefore extremely low. In the future, a limit on unsold units could be considered within the five-year rolling decision-making process, in case it is determined that the market is over-supplied. The CCC could be tasked with providing advice on whether the limit is appropriate or not, and what the limit should be given the forecast auction volumes and the extent of market over-supply.
- 2.6 Although the consultation paper does not explicitly address this, there is also the important issue of whether or not unsold units have an expiry term. Our opinion is that they shouldn't, but that it might be worth considering a rule for transferring units unsold

for a long time to the CCR (a similar rule exists in the California cap-and-trade-programme).

Q5	Other than public holidays, and days when important or emissions data is released, are there any dates when auctions should not be held?
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2.7 We agree that auctions should not be held on public holidays and days when important data is released. The latter is important in order to allow the market to internalise the new information, and to help market participants update their expectations of market demand shortfalls. These expectations would then be used to form/update auction bidding strategies.

Q6	The surrender date in the NZ ETS is 31 May. How far in advance of this date should the closes auction be scheduled? Please consider both monthly and quarterly auction scenarios.
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2.8 We agree that auctions should not be held immediately prior to the surrender date. This could create incentives for strategic behaviour in the secondary market. For example, traders may withhold selling their units immediately prior to the auction in order to cause the auction to clear high, and then sell their units at that high price in the secondary marketplace. The auction is likely to clear high if net demand is positive and the surrender deadline is close.

2.9 On the basis above, it would be appropriate to hold the last auction before the surrender deadline 3 weeks prior to the deadline (regardless of whether the auction is monthly or quarterly). Three weeks gives market participants enough time to procure outstanding units in the sport market should they need to do so after the auction.

Q7	Do you agree that the bidding window should the three hours, from 9am to 12 noon on the scheduled auction date? Yes/No/Unsure
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2.10 We agree with this time window. It strikes a good balance between providing enough time to submit bids and avoiding unnecessary transaction costs that would otherwise arise from a longer period of bidding. This timeframe also supports market efficiency by enabling clearing price information to be propagated onto the secondary market on the same day.

### **Price controls for auctions**

2.11 We support the introduction of an auction reserve price as a way to strengthen confidence to invest in low-emissions projects. This mechanism is superior to a hard price floor across the ETS, as it still allows the secondary market price to be discovered by the pure forces of demand and supply. It is our preference for a less, not more,

managed ETS. For more details on BusinessNZ's view on price floors see BusinessNZ's submission to the Productivity Commission.<sup>3</sup>

Q8	<p>When a price trigger is reached in the cost containment reserve, how should the volume of units from the reserve be sold?</p> <ul style="list-style-type: none"><li>- In a separate reserve auction open to all registered participants (preferred)</li><li>- In a separate reserve auction with participants limited to those with surrender obligation</li><li>- In the same auction that triggered the reserve</li></ul>
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The issue of whether or not access to CCR auctions should be restricted is complex. The consultation paper argues for an open access to all on the basis that "this option allows the market to respond to the new supply without intervention from the Government. This would encourage an efficient distribution of reserve units throughout the market, effectively and immediately driving down unacceptably high prices"<sup>4</sup>

It is not clear why it is assumed that this outcome can only be achieved with open access. We elaborate on this below.

If a CCR is triggered, it means that the market is experiencing an external shock that is pushing prices to levels significantly higher than expected. The objective of the CCR is to increase the supply of NZUs into the market, and thereby to lower the prices.

The question then arises as to whether the type of access to a CCR sale has implications for the efficiency with which prices are corrected (i.e. how quickly the price path is corrected to reflect the (shifted) marginal abatement cost curves).

In assessing the two options for CCR auctions, it is worth considering the incentives of market participants under market shock. Non-compliance entities would continue to be driven by arbitrage opportunities arising from the difference between the secondary spot and the auction clearing price. By contrast, when supply is so tight compared to net demand, compliance entities would more likely use their reserve units to settle compliance obligations rather than to on-sell them in the market. To increase their likelihood of success in the auction, non-compliance entities would be incentivised to bid high (but lower than the secondary spot price). Compliance entities, on the other hand, would be incentivised to bid close to their marginal abatement costs (also by virtue of the uniform-pricing sealed-bid format of the auction). Therefore, from a price discovery perspective<sup>5</sup> it is not inconceivable that CCR auctions with restricted access could deliver an efficient outcome.

Furthermore, depending on the reserve auction volumes, wider participation increases the risk of subsequent reserve auctions being triggered due to compliance entities missing out initially (e.g. if the reserve units won by non-compliance entities are not quickly on-sold to compliance entities). This could increase the cost to the government from having to source more reserve units. Over the long term, this cost to the

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<sup>3</sup> BusinessNZ submission to the Productivity Commission entitled 'Low emissions economy', dated 2 July 2018, pages 4-5.

<sup>4</sup> Page 22 in the Consultation paper.

<sup>5</sup> Price discovery being defined here as the process enabling the price to be quickly corrected to reflect the marginal abatement cost for the next unit of pollution.

government will be borne by the economy, especially if NZ enters binding international agreements that set a cap on the number of outstanding rights to pollute in the market.

In summary therefore, the question of access to the reserve cannot be addressed without having more information about the reserve volumes, how the reserve will be replenished, and what the long-term implications are to the economy. Restricting access would be the conservative approach in the absence of this information.

Q9	If you support option 2, should the units sold in the reserve auction be limited for use to meet surrender obligation? Yes/No/Unsure
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2.12 We have not formed a view on this. The reasons that the consultation paper offers against this limitation mostly relate to enforceability. We would like to observe that such a limitation exists in other markets (e.g. California), and is implemented by ensuring that CCR units are directly transferred into a compliance account (and once the units are there, they can only be used for surrender). The analysis lacks other important considerations, e.g. risk of over-supply or higher costs to the government over the long term. We would like to see these aspects discussed prior to a decision being made on whether or not to restrict CCR unit use to meeting compliance obligations only.

Q10	Do you agree that the cost containment reserve should have a single price trigger for all the reserve volume?
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2.13 Yes. We agree that the full reserve should be offered once the price trigger is hit. A single price trigger is the simplest way to offer the full reserve for sale.

### **Bidding rules**

Q11	How far in advance should the auction notice be published? <ul style="list-style-type: none"><li>- 60 calendar days (only an option if auctions held quarterly)</li><li>- 30 calendar days</li><li>- Other, please specify</li></ul>
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2.14 We believe that 60 calendar days is appropriate considering the pre-registration requirements on both the participant and the auction platform (e.g. KYC obligations). Market participants can have complex corporate structures (e.g. with overseas directors), and a longer lead time would facilitate a more orderly process seeking approval from boards for entities representing the companies in auctions.

Q12	Do you have any comments on the pre-registration process?
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The consultation paper indicates that market participants will be required to provide the following information as part of the pre-registration process (as applicable):

- Name of registered account holder
- Trading name, if different
- Principal business address or registered office address
- Company identifier or registration number
- Whether the company is publicly listed
- Names and contact details for authorised representatives of the registered account holder
- Name and contact details of each person authorised to bid in an NZ ETS auction on behalf of the registered account holder
- Registry account number
- Whether the participants has any mandatory or voluntary obligations under the NZ ETS (only required if bidding restrictions are applied)
- Any convictions for serious crimes (by directors, principals or partners)
- Any revoked or suspended permits to conduct business.

2.15 The list of information required for pre-registration seems appropriate. We prefer a single pre-registration form to simplify the process.

Q13	Do you agree that an intention to bid form must be submitted a minimum of 28 calendar days in advance of an auction? Yes/No/Unsure
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2.16 This is appropriate for quarterly auctions if the auction notice is published 60 days prior to the auction, leaving 32 days to complete the intention to bid form.

Q14	Do you agree that bidders should have to provide collateral to participate in an auction? Yes/No/Unsure
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2.17 Yes, this is a common requirement for trading. It reduces the risk of default and discourages bidders that are not genuine.

Q15	<p>If collateral is required, how much should it be?</p> <ul style="list-style-type: none"> <li>- Between 10 and 25 percent of the maximum bid value (preferred)</li> <li>- 100 per cent of the maximum bid value</li> <li>- A flat rate payment, please specify amount</li> <li>- Other, please specify</li> </ul>
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2.18 Our preference is for the collateral to be between 10% and 25% of the maximum bid value. This option has a lower opportunity cost of money compared to 100%. We prefer the collateral to be in proportion of the bid value (as opposed to a flat rate) as it will be difficult for the government to determine (and update) an appropriate flat rate such that it is not disproportionate to small bidders and is not too low for larger bidders.

Q16	What forms of collateral should be accepted? <ul style="list-style-type: none"><li>- Cash</li><li>- Bank guarantee</li><li>- Irrevocable letter of credit</li><li>- Credit rating (not preferred)</li><li>- Other, please specify</li></ul>
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2.19 We support providing collateral in the form of cash, bank guarantee, and ILOC. Options should include non-cash instruments to provide entities with more flexibility with regards to their cash management requirements.

Q17	How many days before an auction do you think is sufficient lead time for provision of collateral (Government suggests five business days)?
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2.20 We agree with five business days – this strikes a good balance between (i) minimising the opportunity cost of cash for participating entities, and (ii) providing the auction administrator with sufficient time to process the collateral.

Q18	Do you agree that collateral (depending on its form) should be used against payments for successful bids, if the bidder requests? Yes/No/Unsure
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2.21 Yes

Q19	Do you agree that bidders should be able to choose to have their collateral automatically returned, released at their request, or retained for future auctions? Yes/No/Unsure
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2.22 Yes

Q20	What should be the minimum number of NZUs that can be sold at auctions? <ul style="list-style-type: none"><li>- 100 NZUs</li><li>- 500 NZUs (preferred)</li><li>- 1000 NZUs</li><li>- Other, please specify</li></ul>
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Q21	<p>Bids are only accepted in multiples of the minimum lot size. What should be the minimum number of NZUs that can be sold at auctions?</p> <ul style="list-style-type: none"> <li>- 100 NZUs</li> <li>- 500 NZUs (preferred)</li> <li>- 1000 NZUs</li> <li>- Other, please specify</li> </ul>
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2.23 We agree with the preferred option of 500 NZUs.

Q22	<p>What would the minimum price increment be?</p> <ul style="list-style-type: none"> <li>- \$0.01-\$0.02</li> <li>- \$0.05 (preferred)</li> <li>- \$0.10</li> <li>- Other, please specify</li> </ul>
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2.24 We agree with the preferred option of \$0.05. This strikes a good balance between avoiding a too many tied bids (participants are more likely to bid at specific price points) and ensuring the efficiency of the bidding process so that process for determining the clearing price is not unnecessarily protracted by very small bid increments.

Q23	Do you think a maximum bid limit should be set? Yes/No/Unsure
Q24	<p>If set, should the maximum bid limit apply to:</p> <ul style="list-style-type: none"> <li>- All bids made by a single participant</li> <li>- All bids made by related participants</li> </ul>
Q25	If there is a maximum bid limit, what should it be?

2.25 As the consultation paper states, the main purpose of a maximum bid limit is to “prevent one entity from dominating the market by purchasing a large number of units and using this to their advantage.” The consultation paper states that although there has been no evidence of such behaviour in the NZ ETS secondary market, the potential exists. Further, the ETS market is a simple spot market with little forward contracting activity and supply controlled through government policy, so the risk of market abuse is low. We acknowledge the fact, though, that were any attempt market abuse to occur is low, the impact on market confidence should this risk eventuate would be significant. At the same, attempts to mitigate this risk through bid limitations may have the unintended consequence of deterring some of the larger participants to bid in auctions (especially if auction volumes are small), resulting in a less efficient price discovery process. It is worth therefore asking the question of whether the mechanism of bid limitation delivers the desired outcome at least cost given the specific settings of NZ ETS auctions. Generally, the risk of abuse of auction outcomes should be viewed as part of the wider context for ETS integrity, in order to ensure that the mix of instruments/policies chosen to deal with risks are synergetic and complementary. Our opinion is that decision on bid

limits should be put on the work-programme on NZ ETS governance. Meanwhile, the risk of manipulating auction outcomes is mitigated by introducing the role of an auction monitor, so long as the auction monitor has access to the relevant data needed to assess patterns of how NZU positions are being built up by market participants.

Q26	<p>How do you think tied bids should be resolved?</p> <ul style="list-style-type: none"> <li>- Random assignment to the entire bid</li> <li>- Random assignment by lot (preferred)</li> <li>- On a pro-rate basis, with rounding</li> <li>- Other, please specify</li> </ul>
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2.26 We agree with the preferred option of random assignment by lot. Compared to random assignment to the entire bid, this option reduces the probability that a participant bidding at the clearing price misses out altogether on the units bid for at that price.

Q27	<p>Do you agree that a technical reserve price should be set for auctions? Yes/No/Unsure</p>
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2.27 We agree in principle that indexing the minimum auction price to the price in the secondary market supports price discovery, and therefore market efficiency. Our concern relates to the timing for publishing this price prior to the auction. Given that the technical reserve price is indexed to the secondary market price, we assume that it would be published immediately prior to the auction itself, leaving no time for market participants to update their bidding strategies. Although we recognise that a similar mechanism is implemented in the EU ETS, the timing issue is less of a problem there because the frequency of auctions is almost daily. An entity that misses out on units today has the opportunity to re-bid the next day. By contrast, the cost of missing out in auctions due to inadequate bidding strategies is much higher when auctions are quarterly.

Q28	<p>If a technical reserve price is set, do you agree that the methodology for calculating the price be kept confidential? Yes/No/Unsure</p>
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2.28 We agree with the assessment that publishing the methodology would create incentives to pre-determine the auction clearing price, thereby cause a certain estimated price level to become an undesirable focal point for bidding strategies. This issue arises from the fact that the chosen format for auctions is sealed-bid uniform pricing. What is important however is that the process for determining and maintaining the methodology is robust and resilient to political changes – this is important to provide market participants with confidence in the integrity of auctions despite the methodology being kept confidential. We would like to see more detail around the decision-making process for this methodology:

- what actors are involved
- how responsibilities are shared
- what high-level criteria/principles are used to guide the level of indexing
- what the process for reviewing the effectiveness of the tool looks like.

Q29	<p>What results should the auction operator publish as soon as practicable following an auction? Please select all that apply</p> <ul style="list-style-type: none"> <li>- Clearing price</li> <li>- Total volume of units auctioned</li> <li>- Total volume of bids</li> <li>- Average bid size</li> <li>- Number of bids</li> <li>- Cover ratio (total volumes bid divided by total volumes for sale)</li> <li>- Total number of bidders and the number of successful bidders</li> <li>- Number of unsold units, if any</li> <li>- Other, please specify</li> </ul>
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2.29 It would be preferred if all of the information above is published immediately after the auction. This process should be straightforward with automated IT processes for data collection and analysis. We would like to observe, however, that the oversight role of the auction monitor implies that the auction results will have to undergo some scrutiny for validation against market abuse. This implies that there will be “preliminary” and “final” auction results. We would like more clarity on what preliminary vs final data will be released, and on the lag between auction closure and the release of each of those types of data. In our view, preliminary data should include the clearing price and total volumes at minimum.

Q30	<p>What is the best approach for settlement of successful bids?</p> <ul style="list-style-type: none"> <li>- Payment before delivery (preferred)</li> <li>- Delivery versus payment</li> <li>- Other, please specify</li> </ul>
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2.30 We agree with the preferred option for payment before delivery

Q31	<p>Do you have a view on the time for settlement (suggested it may take 4 business days)?</p>
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2.31 4 business days for settlements is reasonable.

## The role of an auction monitor

Q32	<p>What information should the auction monitor report include? Please select all that apply</p> <ul style="list-style-type: none"> <li>- Detailed volume statistics (e.g. average volume bid per bidder)</li> <li>- Detailed statistics on number of bids (e.g. average number of bids per bidder, number of bids submitted, number of successful bids)</li> <li>- Relevant aggregate information (eg largest bid as percentage of total volumes sold, percent of volumes awarded to entities with mandatory obligations)</li> <li>- Relevant distributional information (eg number of units awarded to each winner, with bidder names withheld)</li> <li>- Distribution of successful bids among market participants with and without mandatory compliance obligations</li> <li>- Relevant information to resolve tied bids</li> <li>- Other, please specify</li> </ul>
Q33	<p>Do you think that releasing information on the number of NZUs won by each successful bidder, who will not be named, would raise any issues with data confidentiality?</p>
Q34	<p>Does auction monitor reporting raise any concerns for you with respect to commercially sensitive information?</p>

2.32 We do not see any concerns with the disclosure of information listed in Q32, so long as the proposed level of aggregation is sufficient to mask away any individual details that could otherwise provide insights into the commercial operation of market participants.

2.33 We reiterate the significance of preserving bidder confidentiality when publishing analysis of auction results.

Q35	<p>How often do you think the auction monitor should review the auctioning system?</p> <ul style="list-style-type: none"> <li>- After one year initially, then every two years thereafter (preferred)</li> <li>- Annually</li> <li>- Other, please specify</li> </ul>
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2.34 We do not see any concerns with the preferred option.

## Appendix One - Background information on BusinessNZ



BusinessNZ is New Zealand's largest business advocacy body, representing:

- Regional business groups [EMA](#), [Business Central](#), [Canterbury Employers' Chamber of Commerce](#), and [Employers Otago Southland](#)
- [Major Companies Group](#) of New Zealand's largest businesses
- [Gold Group](#) of medium sized businesses
- [Affiliated Industries Group](#) of national industry associations
- [ExportNZ](#) representing New Zealand exporting enterprises
- [ManufacturingNZ](#) representing New Zealand manufacturing enterprises
- [Sustainable Business Council](#) of enterprises leading sustainable business practice
- [BusinessNZ Energy Council](#) of enterprises leading sustainable energy production and use
- [Buy NZ Made](#) representing producers, retailers and consumers of New Zealand-made goods

BusinessNZ is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

In addition to advocacy and services for enterprise, BusinessNZ contributes to Government, tripartite working parties and international bodies including the International Labour Organisation ([ILO](#)), the International Organisation of Employers ([IOE](#)) and the Business and Industry Advisory Council ([BIAC](#)) to the Organisation for Economic Cooperation and Development ([OECD](#)).



The [BusinessNZ Energy Council \(BEC\)](#) is a group of New Zealand's peak energy sector organisations taking a leading role in creating a sustainable energy future. BEC is a division of BusinessNZ, New Zealand's largest business advocacy group. BEC is a member of the [World Energy Council \(WEC\)](#). BEC members are a cross-section of leading energy sector businesses, government and research organisations. Together with its members BEC is shaping the energy agenda for New Zealand.

Our vision is to support New Zealand's economic wellbeing through the active promotion of the sustainable development and use of energy, domestically and globally. With that goal in mind, BEC is shaping the debate through leadership, influence and advocacy.