

Regulatory Impact Statement: Options for NZ ETS auction oversight, including an auction monitor

Advising agencies	Ministry for the Environment
Decision sought	Amendment of the Climate Change Response Act to enable the appointment of an auction monitor via regulations
Proposing Ministers	Hon James Shaw, Minister for Climate Change

Abbreviations

AML / CFT	Anti-Money Laundering and Countering Financing of Terrorism Act 2009
CCR	Cost containment reserve
GHG	Greenhouse gas
EEX	European Energy Exchange
ETS	Emissions trading scheme
NZU	New Zealand Unit
RGGI	Regional Greenhouse Gas Initiative

Executive Summary

1. The Government has decided to introduce auctioning of New Zealand Units (NZUs) to align the NZ ETS to New Zealand's emissions reduction targets. The Climate Change Response Act 2002 (CCRA) includes provisions that would enable regulations to be made for the sale of NZUs by auction. However, this feature has not yet been used.
2. A number of decisions need to be made before the first auction takes place, and separate impact assessments are covering decisions on (i) auction volumes; (ii) high-level design features (e.g. format, frequency); (iii) operational rules (e.g. auction pre-registration criteria, bidding rules, physical and financial settlement); and (iv) market governance / oversight (i.e. rules for market operation and for overseeing market conduct).
3. This Regulatory Impact Statement (RIS) assesses options for establishing an auction oversight regime. Options include putting in place pre-registration checks for potential auction participants via regulations, and enabling an auction monitor to provide independent oversight of auctions. The auction monitor would verify auction results and publish a report on auction outcomes. It could also oversee the conduct of auctions from a market integrity perspective to detect non-compliance, and provide recommendations for auction design improvements.
4. The preferred option is to enable a stand-alone role for an auction monitor be to appointed via regulations to complement the other oversight settings during the auction pre-registration phase (i.e. pre-registration checks).

Contents

Executive Summary	iii
Contents	iv
Summary: Problem and Proposed Approach	vi
Section B: Summary Impacts: Benefits and costs	vi
Section C: Evidence certainty and quality assurance	vii
Section 1: General information	ix
Purpose	ix
Key Limitations or Constraints on Analysis	ix
Section 2: Problem definition and objectives	11
Context	11
Current regulatory system	12
Policy problem or opportunity	12
Constraints on decision making	13
Stakeholders	14
Section 3: Options identification	15
Criteria to assess options	21
Section 4: Impact Analysis	22
Section 5: Conclusions	24
Preferred options	24
Summary table of costs and benefits	24
Compatibility with regulatory system design expectations	27
Section 6: Implementation and operation	27
New arrangements	27
Implementation risks	28
Section 7: Monitoring, evaluation and review	28
Monitoring of new arrangements	28
Review of new arrangements	28
Annex A: The auction process	30
Annex B: The auction system	31
Annex C: Risk identification, analysis and assessment	33
Annex F: Activities affecting market integrity	37
Figure 1 The auction process	30
Figure 2 The ETS auction system	32
Table 1: key features for auction oversight that would be enabled for each option	16

Table 2: Examples of detailed rules and functions to mitigate and monitor for auction integrity risks under Options 1 & 2.....	18
Table 3: Examples of additional specific functions to address the lack of auction oversight under Option3.....	20
Table 4: Summary assessment of options for the auction oversight regime	23
Table 5 Roles in an auction system.....	31

Summary: Problem and Proposed Approach

5. The Government has agreed to introduce auctioning in the NZ ETS but has not yet made any decisions on the oversight of auctioning. In the absence of adequate oversight settings, there is a risk that the following key attributes of an auction system will not be met:
 - Fair and open access
 - Transparent processes and information, and
 - Competitive and fair price formation.
6. An adequate auction governance regime provides an opportunity to ensure NZ ETS auctions are functioning as intended and are transparent. It provides an opportunity to deter and prevent any misconduct from occurring in the first place, as well as to have well-defined rules and processes to deal with suspicious activity once it has been detected.
7. This paper proposes to enable the establishment of an auction monitor via regulations to provide independent oversight through the analysis and publication of auction results, and through monitoring auction processes and bidding conduct. The auction monitor role will be integral to the way in which NZU auctions are run.

Section B: Summary Impacts: Benefits and costs

Benefits

8. The main beneficiaries from the introduction of an auction monitor will be all NZ ETS participants, whether or not they have mandatory obligations. The role will strengthen auction oversight settings that are needed to promote:
 - Open and fair access to auctions
 - Information transparency, and
 - Competitive and fair NZU price formation.
9. A fair and competitive NZU price is also necessary to enable the NZ ETS to efficiently reduce emissions in line with New Zealand emission reduction targets.

Costs

10. There will be some administrative cost associated with implementing auction oversight via regulations and establishing and running an auction monitor as part of the auction system. The exact nature and amount of these costs will be determined by detailed pre-registration rules and the auction monitor's functions as set out in regulations.
11. Pre-registration checks would be carried out by the agent selling units by auction (the 'auction operator'). As an auction operator is required to sell units by auction under the status quo, it is difficult to assess the marginal impact of introducing pre-registration checks but it is not expected to be a large part of overall auction costs. Current estimates for designing auctions (overall) are approx. s9(2)(f)(iv) [REDACTED] It is possible that the cost of pre-registration requirements could be met within these current estimates as they have been made with reference to overseas emissions trading

scheme auctions and similar markets in New Zealand, where oversight features are included in general auction or market design. A key uncertainty that relates to ongoing costs of auctioning is auction frequency.

12. Appointing an auction monitor would incur some additional cost to the Crown, however, this is not expected to be significant. Current estimates, based on overseas ETS auction experiences, are that the NZ ETS auction monitor role could cost approx. s9(2)(f) per year to run. Exact costs for appointing an auction monitor will depend on its specific functions and the entity performing the auction monitor role. The proposed implementation approach to appoint the auction monitor via regulations, which could enable a private entity to act as the auction monitor, has been recommended to reduce administrative cost.
13. In general, auction oversight settings may cause market participants to bear transaction costs due to the requirement to satisfy auction pre-registration checks.

Section C: Evidence certainty and quality assurance

Agency rating or evidence certainty? How confident are you of the evidence base?

14. Moderately confident.
15. Substantial research has been taken into the oversight settings of auctions from other emissions trading schemes worldwide, and the proposed approach reflects general international practice for auctioning in emissions trading schemes.
16. Policy development work has been undertaken to ensure that the proposed approach is appropriate for the New Zealand carbon market. There has, however, been limited engagement with stakeholders on the options within this RIS. Public consultation in late 2018 focused on market governance and auctioning issues more broadly, and did not specifically seek views on auction oversight functions or a possible auction monitor. Where possible consideration has been given to general views stakeholders have provided about the overall NZ ETS and its design. Future development of regulations will also provide an opportunity to seek stakeholder's views.

Quality Assurance Reviewing Agency:
A Quality Assurance Panel with representatives from the Ministry for the Environment and the Treasury Regulatory Quality Team has reviewed the 'auction monitor' and 'clarity for auctions' Regulatory Impact Assessments (RIA) produced by the Ministry for the Environment and dated April 2019.
Quality Assurance Assessment:
The Panel considers that both RIA meet the Quality Assurance criteria.
Reviewer Comments and Recommendations:
The only matter the Panel highlights is that, while the problems were consulted on, the proposals were not. The proposals appear to be low cost and low risk. The proposals will

also be subject to further analysis and consultation as detail is considered when regulations are made. It will nevertheless be important explore the proposals with submitters at Select Committee.

Impact Statement: Options for an NZ ETS auction monitor

Section 1: General information

Purpose

17. The Ministry for the Environment (MfE) is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final decisions to proceed with a policy change to be taken by Cabinet.

Key Limitations or Constraints on Analysis

18. The main constraint on the analysis contained in this paper relates to the inter-dependence between market governance settings for the primary (auction) market and secondary spot markets. A separate work programme is currently assessing broader NZ ETS market governance settings (i.e. for the secondary spot market). The inter-dependence specifically relates to the following:
 - a) Different types of market integrity risks (e.g. price manipulation, use of insider information, or money laundering) may be regulated across the whole NZ ETS market with market supervisor(s) responsible for such regulation. In this case, it would be prudent for these oversight settings to be the same for the primary and the secondary markets. This potential change to the regulatory context will be determined as part of the separate work programme on broader NZ ETS market governance.
 - b) It is conceivable that in the longer term there could be a single market monitor that oversees both the primary and secondary markets in the ETS. This could, for example, be due to enhanced analytics in this case due to having access to market-wide trading data. The auction monitor functions defined in this RIS are not inconsistent with such future settings.
19. Constraints a) and b) above mean that the auction monitor's functions in the short term would be limited compared to its potential scope. In particular, the auction monitor would only be able to access data from the New Zealand Emissions Trading Register (held by the Environmental Protection Authority and the NZ ETS Registrar), and provide information to MfE as the relevant policy agency. The broader market governance work programme may establish a regime where there is increased transparency of detailed data from the secondary market and/or put in place a regulatory regime with additional market rules (e.g. prohibitions on market manipulation) and an associated market supervisor(s). In this case, the role of the auction monitor could be reassessed and potentially expanded in light of the new context.
20. The option of establishing an auction monitor was not explicitly included in the consultation on NZ ETS reform that took place in September 2018, as this consultation covered auctioning and market governance issues more broadly. Following the NZ ETS review and subsequent public consultation on market risks, it was concluded that there may be increasing risk to market integrity as the NZ ETS expands in the future and

becomes more complex (e.g. through the introduction of auctioning). As a result, this RIS is focused on the need for auction oversight following public consultation.

21. The option recommended in this RIS requires amending the Climate Change Response Act 2002 (CCRA). The amendments will provide the framework to allow an auction monitor and its specific functions to be appointed via regulations. As a result, the options analysis in this RIS is limited to high-level options and primarily contains a qualitative assessment. Further decisions on specific detail of auction oversight settings, including pre-registration requirements and specific functions of an auction monitor, require further analysis and consultation.

Responsible Manager (signature and date):

Matthew Cowie
Manager, Climate Change Policy – NZ ETS
Ministry for the Environment

Section 2: Problem definition and objectives

Context

22. The New Zealand Emissions Trading Scheme (NZ ETS) is New Zealand's key tool for reducing greenhouse gas emissions. It came into force in September 2008, with the Climate Change Response Act 2002 (CCRA) providing the legal framework for its implementation, operation and administration.
23. The Government is progressing a set of reforms to the NZ ETS following the 2015/16 Review. In December 2018, Cabinet agreed to a first tranche of decisions for legislative change, including a package of unit supply decisions. These will put in place the regulatory tools required for the NZ ETS to be aligned with New Zealand's emissions reduction targets and will promote regulatory predictability.
24. A full analysis for these decisions is provided in a previous Impact Statement, *Improving the NZ ETS Framework for Unit Supply*, which also provides detail of the new climate change context, including the Paris Agreement and Government's new climate change legislation.
25. Key decisions taken in December 2018 include to:
 - introduce a single round, sealed bid auction mechanism, to align unit supply with New Zealand's emissions reduction targets;
 - move to a new type of price ceiling – a cost containment reserve - that will be implemented through auctioning;
 - limit the future use of international units (if the NZ ETS reopens to international carbon markets); and
 - introduce a coordinated decision-making process for unit supply settings.
26. This RIS is focused on options to enable auction oversight to support the operation of NZ ETS auctioning once it is introduced. Auctioning will be a competitive process through which the Government will sell spot NZUs, with the first auction expected to be held at the end of 2020.
27. Alongside the current amendments to the CCRA, there is also a parallel work programme on governance and oversight of the NZ ETS and New Zealand carbon market.
28. Following the NZ ETS review and subsequent public consultation on market risks, it was concluded that there may be increasing risk to market integrity as the NZ ETS expands in the future and becomes more complex (e.g. through the introduction of auctioning).
29. As a result, in December 2018 the Government agreed to progress work on a broad market governance framework for the NZ ETS. Any regulatory changes developed as a result of this work will likely be implemented after the end of 2020. Therefore, early decisions on auctioning oversight are needed to ensure effective operation of the first auctions.
30. If no specific action on auction oversight is taken, any market participant with a registry account who meets auction participation requirements (for example, having sufficient

financial assurances) would be able to participate in an auction and there would be no independent monitoring or oversight of the auctions.

Current regulatory system

31. The NZ ETS puts a price on greenhouse gas emissions by requiring participants from all sectors of the economy to report their emissions and, with the exception of agriculture, to surrender units to the Government for their emissions. This creates a financial incentive for businesses to invest in technologies and practices that lower emissions.
32. The CCRA currently does not have any market governance provisions relating to the secondary market. However, some types of market misconduct already fall under existing competition¹ and consumer² law, and derivatives are captured through the Financial Markets Conduct Act (FMCA). Financial market regulations, such as those contained in the FMCA, do not, however, apply to NZU spot trading.
33. The lack of specific regulation governing conduct in the NZ ETS market – capturing both primary (i.e. auction) and secondary spot markets – leaves market integrity risks unaddressed. These risks can originate from the following activities affecting market integrity (see also Annex D):
 - Market manipulation through false or misleading statement of information
 - Market manipulation through false or misleading appearance of trading
 - Anti-competitive behaviour
 - Money laundering
 - Insider trading
 - Unfair dealing / non-disclosure of conflicts of interest.
34. The Government is responsible for the rules and trading environment for NZUs as the NZ ETS is a Government-created market.
35. Currently, the CCRA includes provisions that enable regulations to be made for the sale of NZUs by auction, although this feature has not yet been used. An Impact Summary assessing legislative pre-requisites for auctioning regulations is being progressed in parallel to this RIS (see *Impact Summary: Providing Clarity for Auctions in the NZ ETS*)

Policy problem or opportunity

36. Although the Government has agreed to introduce auctioning in the NZ ETS, it has not made any decisions on oversight of the auction regime. In the absence of adequate auction oversight settings, there is a risk that the following key attributes of an auction system will not be met:
 - Fair and open access
 - Transparent processes and information, and
 - Competitive and fair price formation.

¹ The Commerce Act 1986.

² The Fair Trading Act 1986.

37. If at least one of these attributes is not met, there is a risk that the auction's overall objective of helping New Zealand meet its emissions reduction targets will not be achieved.
38. In principle, the NZ ETS market (both primary and secondary) could be left to continue to rely on participants acting in good faith. So far there has been no evidence of abusive behaviour in the NZ ETS. During public consultation in 2018, no submitters provided a clear example of suspicious activity that had occurred with respect to price manipulation, insider dealing, money laundering, or a conflict of interest.
39. However, these risks are difficult to detect and are unlikely to be self-reported. Many submitters also assessed these potential areas as current or future risks to the NZ ETS market. Given parallel work on (i) the governance of the secondary market, and on (ii) the design of an auction system, there is an opportunity to assess options to specifically enable auction oversight settings, so that these can be put in place when the first auction is held.
40. An adequate auction governance regime provides an opportunity to ensure NZ ETS auctions are functioning as intended and are transparent. It provides an opportunity to deter and prevent any misconduct from occurring in the first place, as well as to have well-defined rules and processes to deal with suspicious activity once it has been detected. The types of risks that can affect auction integrity are described in Annex C.

Constraints on decision making

41. The scope of this RIS is restricted to options for addressing the lack of auction oversight and focuses on options for how best to enable auction oversight in the NZ ETS. Further decisions on specific detail of auction oversight settings, including the specific functions of an auction monitor, require further analysis and consultation. This RIS is therefore limited to assessing the high-level impacts of options for how to best enable auction oversight.
42. Broader NZ ETS market governance, including oversight of the secondary market for NZU trading, is out of scope of this RIS. This is being considered separately and over a longer timeframe through a broader market governance work programme. Auction oversight settings, however, should be consistent with any settings required to ensure the integrity of secondary market trading. The broader market governance work programme could establish a comprehensive regime for the NZ ETS market that includes both the primary (i.e. auction) and secondary markets, which might require auction oversight settings to be reassessed at that time. Areas where the settings across the two markets would likely overlap are:
 - Definition of different market abusive behaviour, e.g. what constitutes insider dealing and market manipulation, unfair dealing and anti-competitive conduct
 - The potential role of a market supervisor(s) or regulator for different market abusive behaviour
 - Disclosure of trading data from the secondary market
 - Offences or penalties for misconduct
43. Due to the ongoing nature of the broader market governance work programme, the analysis in this paper includes some assessment of possible interactions between auction oversight and possible broader market governance settings (e.g. discussions of insider trading and market manipulation provisions). However, this RIS is focused on

seeking decisions now to enable auction oversight settings in time for the first auction (expected to be held in late 2020). Analysis on impacts of outcomes from the broader market governance work programme on auction oversight settings will be undertaken as part of that work programme.

Stakeholders

44. The stakeholders relevant to the issues analysed in this RIS are:
 - All NZ ETS market participants, including mandatory and voluntary NZ ETS participants
 - Traders in the market, which could include those that only participate in auctions (i.e. any entity with an NZU account in the registry), only participate in the secondary market, or both
 - Entities that would provide advice on bidding in auctions (these entities may be required to disclose conflicts of interest), and
 - Government agencies that administer the NZ ETS, including the EPA.
45. Following the conclusion of the 2015/16 NZ ETS Review in mid-2017, consultation on proposals to improve the NZ ETS through legislative reform was undertaken in August and September 2018.
46. Although this consultation did not explicitly seek views on auction oversight or the option of establishing an auction monitor, it covered auctioning and market governance issues broadly. The consultation document identified several areas as being sources of potential risk for the NZ ETS market, and sought submitters' assessment of the level of risk (current and future) for each area. These areas were: inadequate, false or misleading advice; lack of transparency, monitoring and oversight; risk of manipulation of the NZU price; insider trading; money laundering risks; credit and counterpart risks; and potential conflicts of interest.
47. Most stakeholders that responded to these questions, including several large emitters and other NZ ETS market participants, assessed potential market risks as increasing in future. The "lack of transparency, monitoring and oversight" was assessed as a current risk by 54 percent of respondents (32 submitters) and 71 percent (42 submitters) considered it to be a future risk. In addition, the potential "risk of manipulation of the NZU price" was considered a current risk by 51 percent of respondents (30 submitters), increasing to 81 percent (48 submitters) when considering future risk.
48. Some submitters also provided feedback linking increased market risk with the introduction of auctioning. For example, Genesis Energy's submission stated "We note that the introduction of auctioning and the carefully managed re-linking to the international market will add considerable complexity and significant sophistication to the ETS. This necessitates the immediate strengthening of the ETS governance framework". Carbon Farm Limited (a forestry sector stakeholder) also noted in its submission that "[t]he current market works fine in our experience in these respects. Auctioning, with the introduction of new sources of supply potentially governed by unpredictable and/or infrequent price discovery, creates new risks in this space."
49. Following this consultation on market risks, it was concluded that there may be increasing risk to market integrity as the NZ ETS expands in the future and becomes more complex (e.g. through the introduction of auctioning). As a result, this RIS is focused on the need for auction oversight and enabling the establishment of an auction

monitor through regulations. The full scope of market risks assessed during consultation will be addressed, if appropriate, as part of the work programme on broader market governance.

50. Further public consultation on NZ ETS regulations, including auctioning regulations and potentially auction monitor regulations, is planned for mid-2019. This will provide stakeholders with the opportunity to provide feedback on detailed auction design settings, including any relevant oversight settings. It is envisaged that this consultation will occur alongside Select Committee consultation for the proposed bill to amend the CCRA. This will allow the public to understand and provide feedback on the broad set of CCRA legislative and regulatory changes as a package.

Section 3: Options identification

51. Alongside the status quo, two options for auction oversight have been identified:
 - Option 1 (Oversight regime established through auctioning regulations): Under this option, the lack of auction oversight would be addressed by establishing in regulations pre-registration requirements that potential bidders must meet to qualify to participate in an auctions. This option relies on the entity running the auction (the 'auction operator') to undertake such checks, and to detect and report any relevant suspicious activity or breaches of regulation. The auction operator could report suspicious activity to a relevant regulator or market supervisor(s), if relevant.
 - Option 2 (Oversight regime established through regulations, with specific auction monitor functions enabled): This option includes the oversight regime as for Option 1 above, and also enables the appointment of an 'auction monitor' to provide independent oversight of auctions, with its specific functions prescribed in regulations. The auction monitor could potentially have functions across the pre-bidding, bidding, and post-bidding auction stages. At a minimum it would validate auction results and publish a report on auction outcomes. The auction monitor could also monitor the conduct of auction participants and, if appropriate, the auction operator. In addition, under this option both the auction operator and the auction monitor could report any suspicious activity to a relevant regulator or market supervisor(s), if relevant.
52. For the purpose of this RIS, the overall design for auctioning is assumed to be the same across both options. This includes design choices relating to the auction format and operational rules such as rules for dealing with tied bids. The Government has already decided that the auction format will be single-round, sealed-bid, with uniform pricing (see *Impact Summary: High Level Design of An Auction System for the NZ ETS*). Other relevant design choices, such as rules for addressing tied bids, will be assessed as part of the regulation-making process for auction operational rules.
53. As this RIS assesses the high-level options for enabling auction oversight, the two options above have been informed by the experience of international carbon markets, particularly the North American markets (RGGI, California and Quebec programmes), which have a separate auction monitor. These options have also been identified with reference to the overall high-level design of the NZ ETS auction.
54. Key features of the two options are described more detail in the sections overleaf.

Table 1: key features for auction oversight that would be enabled for each option

	Oversight regime established through auctioning regulations(Options 1 & 2)	Specific auction monitor functions enabled (marginal impact of Option 2 only)
Relevant rules or functions	<p>An auction oversight regime would be established as part of auctioning regulations by putting 'pre-registration checks' in place. These would be requirements that potential auction participants would have to meet before participating in an auction.</p> <p>The CCRA currently enables regulations for the effective conduct of the auction, so no legislative change is required to enable this option. A parallel RIS (see <i>Impact Summary Providing Clarity for Auctions in the NZ ETS</i>) provides analysis on providing increased clarity about what must or may be included in auctioning regulations.</p> <p>Decisions on specific pre-registration checks would be made at a later date following further consultation and analysis. Examples of possible pre-registration checks are provided in Table 2 below.</p>	<p>An auction monitor would be enabled to provide independent oversight of auctions. Its functions would be to validate auction results and calculate additional specified metrics, and to publish a report on auction outcomes. Its functions could also include monitoring the conduct of auction participants and the auction operator, and providing periodic assessments of the auction system with recommendations for improvement.</p> <p>The auction monitor role (as described above) would need to be enabled through amendment to the CCRA, with its specific functions provided for in regulations.</p> <p>Decisions on the monitor's specific functions would be required at a later date following consultation and analysis. Examples of possible specific functions are provided in Table 2 and Table 3 below.</p>
Structure & relevant entities	<p>The 'pre-registration checks' would be undertaken by the entity carrying out the auction (the 'auction operator'). The CCRA currently allows the Minister for Climate Change to sell NZUs by auction once regulations have been established and to 'appoint agent(s) to conduct the sale on the terms and conditions the Minister thinks fit'. Any agent appointed to sell units by auction (the 'auction operator') would, therefore, be appointed by the Minister for Climate Change</p> <p>Appointing an agent to sell units by auction will require a separate decision and is not covered by this RIS. As well as carrying out any oversight functions, this agent would need to undertake other functions relevant to selling units by auction and therefore meet associated criteria related to holding auctions more broadly. The marginal costs of including pre-registration requirements is difficult to establish. Examples of possible entities the Minister for Climate Change might choose to appoint include the Ministry for the Environment, the Environmental Protection Authority, or an external entity contracted by the government to provide auction services.</p>	<p>The auction monitor should be enabled in a way that allows for it to be independent as its functions require it to provide independent oversight. In terms of 'independence', the primary criteria are that :</p> <ul style="list-style-type: none"> A. it has no conflict of interest with regards to trading activity in the primary or secondary markets, and B. its activities being at arm's length from policy decisions concerning the NZ ETS and its auctions. <p>The independence criteria is important because the auction monitor could be required to monitor the auction operator as the operator would be the entity carrying out checks on pre-registration requirements. The monitor could also provide recommendations for policy design improvement, and, in future, it could report on activities that may trigger investigations by the relevant market supervisor(s) if desired under a broader market governance regime.</p> <p>Appointing an auction monitor via regulations allows for an assessment of independence to be undertaken at the time of appointment, taking the current context into account.</p> <p>Appointing the auction monitor is a later decision, not covered by this RIS, and would require further analysis and consultation. In principle, auction monitoring services could be provided by a private entity (e.g. contracted through a public tender) or by a Crown entity. It is possible that a private entity would be able to leverage some existing know-how and</p>

resources from services similar to auction monitoring, which would provide some cost savings through economies of scale. By contrast, requiring a Crown entity to fulfil this role would likely require building the necessary in-house capability and infrastructure from scratch. As a result, solely based on cost-effectiveness, the preferred option might be to contract auction monitoring services from a third party with relevant experience. Current estimates are that an auction monitor would cost approx. s9(2)(f) per year to operate.

55. Although the decision in this RIS is focused on how to best enable auction oversight, examples of specific oversight settings that could be taken in future under Options 1 & 2 help to inform the high-level impact analysis in this RIS.
56. Table 2 below provides examples of possible rules or specific functions that could be included in regulations in order to increase auction oversight by mitigating or monitoring auction integrity risks. These examples have been arranged in relation to the types of integrity risks that need addressing. This table includes examples of pre-registration requirement that could be included under Options 1 & 2 and specific ways the auction participants' or the auction operator's conduct could be monitored in auctions under Option 2. Further analysis and consultation is required before decisions on these rules and functions could be made through regulations.
57. In addition to the types of functions described in Table 1 above, under Option 2 the auction monitor could also provide increased oversight through validating auction results and calculating pre-specified metrics and through reporting functions, either publicly or to relevant NZ ETS policy agencies and/or regulators. The auction monitor could also provide assessments and recommendations relating to auctioning more broadly. Table 3 below provides specific examples related to these high-level functions. Further analysis and consultation is required before decisions on specific functions could be made through regulations.

Table 2: Examples of detailed rules and functions to mitigate and monitor for auction integrity risks under Options 1 & 2

	Examples of establishing an oversight regime through settings pre-registration checks in regulations (Options 1 & 2)		Examples for specific auction monitor functions enabled under Option 2
	Auction participants	Auction operator	Auction monitor
Collusion	<p>Provide attestations (e.g. to past criminal requirements) as part of pre-registration</p> <p>Prohibition to disclose information related to auction participants, e.g. intent to participate, bidding strategy, bid price and volumes at past or future auctions, information on bid guarantee.</p>	<p>Refuse application to bid in the auction if required attestations are not provided, and if the applicant does not meet criteria with regards to criminal records</p>	<p>Review acquisition patterns based on review of auction bids / purchases, information on account holders in the registry, and possibly secondary market activity (e.g. use of benchmarks)</p> <p>Verifies that the auction operators fulfils its obligations with regards to preventing and detecting collusion as per agreed specifications</p>
Misuse of market power	<p>Provide attestations (e.g. to past criminal requirements) as part of pre-registration</p> <p>Disclose beneficial ownership of allowance holdings</p>	<p>Refuse application to bid in the auction if required attestations are not provided, and if the applicant does not meet criteria with regards to criminal records</p>	<p>Review acquisition patterns based on review of auction bids / purchases, information on account holders in the registry, and possibly secondary market activity (e.g. use of benchmarks)</p> <p>Verifies that the auction operators fulfils its obligations with regards to preventing and detecting misuse of market power as per agreed specifications</p>
Money laundering	<p>Disclose beneficial ownership of allowance holdings</p> <p>Provide attestation to past criminal infringements</p>	<p>Carry out AML checks either directly or by involving third-party AML service providers</p> <p>Refuse application to bid in the auction if required disclosures are not provided or AML checks are not passed</p>	<p>NA</p>
Unfair dealing and conflict of interest	<p>Disclose conflict of interest prior to bidding</p> <p>Provide attestation to past criminal infringements</p>	<p>Refuse application to bid in the auction if required disclosure is not provided</p> <p>It is possible that the presence of some conflicts of interest may prohibit an entity from bidding</p>	<p>The auction monitor may have the function of validating conflict of interest disclosures prior to the start of the auction</p> <p>Review acquisition patterns based on review of auction bids / purchases, information on account holders in the registry, and possibly secondary market activity (e.g. use of</p>

	Examples of establishing an oversight regime through settings pre-registration checks in regulations (Options 1 & 2)		Examples for specific auction monitor functions enabled under Option 2
	Auction participants	Auction operator	Auction monitor
			benchmarks)
Market manipulation	Provide attestation to past criminal infringements	Refuse application to bid in the auction if required attestations are not provided, and if the applicant does not meet criteria with regards to criminal records	Review acquisition patterns based on review of auction bids / purchases, information on account holders in the registry, and possibly secondary market activity (e.g. use of benchmarks)
Insider dealing	Provide attestation to past criminal infringements Disclose inside information Sign agreement to not use inside information for submitting, modifying or withdrawing a bid	Refuse application to bid in the auction if required disclosures / signed agreements are not provided	The auction monitor may have the function of validating inside information disclosure prior to the start of the auction Review acquisition patterns based on review of auction bids / purchases, information on account holders in the registry, and possibly secondary market activity (e.g. use of benchmarks)

Table 3: Examples of additional specific functions to address the lack of auction oversight under Option3

Functions related to	Non-reporting functions	Reporting functions
Validating auction results	<p>Calculate pre-specified metrics on auction outcomes. For example:</p> <ul style="list-style-type: none"> • Detailed volume statistics, e.g. average volume bid per bidder, average volume won per bidder • Detailed statistics on number of bids: e.g. average number of bids per bidder, number of bids submitted, number of successful bids • Any relevant aggregate information (e.g. largest bids as % of total volumes sold, % volumes awarded to entities with mandatory obligations) • Any relevant distributional information (e.g. number of units awarded to which winner, with the bid names withheld) • Distribution of successful bids amongst market participants with and without mandatory compliance obligations • Any relevant information to solve tied bids • Market concentration as measured by the HHI 	Report auction results and metrics in a public report released to the public
Ensuring the integrity of the auction process (e.g. monitor integrity of market participants and auction operator)	<p>Monitor the conduct of auction participants and the auction operator as per the examples in Table 2 above.</p> <p>Monitor the conduct of the auction operator (e.g. monitor auction operator's compliance with its duties as specified in regulations or via the contract appointing the operator. This could include reviewing that the auction operator:</p> <ul style="list-style-type: none"> • Provides open and fair access to the auction. This would account for pre-specified pre-registration requirements • Correctly applies auction rules such as bid limits as applicable during the bidding stage (if applicable) 	<p>Potentially report any deviations/market trends to the MfE/EPA</p> <p>TBD the extent to which the public report on auction results should include a brief commentary on any deviations and remedial action, especially if the deviations mean that the auction results had to be invalidated</p>
Assessment of auction design and propose improvements	Analyse auction information collected through reviews and monitoring	Recommend auction design changes to improve auction access, information transparency, auction integrity (process and conduct), with all of these ultimately impacting auction price formation

Criteria to assess options

58. Four criteria are used to judge the options for an auction monitor within the NZ ETS auction system. The criteria are defined in terms of implications for

- Minimising administration costs (including transaction costs)
- Consistency and proportionality
- Market integrity, and
- Market transparency.

The following sections describe the criteria in more detail.

Minimising administration costs (including transaction costs)

59. The auction system should minimise administrative and transaction costs

- Administrative costs are incurred by the Government as a result of implementing, running or overseeing the auction system. Third-party entities could perform the role of an auction operator or monitor. It is assumed that the role of an auctioneer (i.e. the entity that allocated allowances for sale and receives payments) is retained by the Government.
- Transaction costs are incurred by market participants depending on the complexity of the auctioning system. In the context of auction oversight, direct transaction costs would arise due to reporting and disclosure requirements as part of the pre-bidding registration process. Indirect transaction costs could also arise if (some of) the cost of providing market integrity services are recovered from the auction participants.

Consistency and proportionality

60. The auction system should ensure consistency and proportionality. This criterion covers:

- Accessibility and fairness: The auctioning function should be open to all qualifying bidders (e.g. qualification standards will enable broad access) and designed so all have equal access (e.g. one bidder does not have an advantage over another). For example, pre-registration requirements should not have the unintended consequence of making the access to auctions unaffordable to smaller participants.
- Simplicity: The auctioning system should be simple, easy to use and understand, so that any qualifying bidder, regardless of their auctioning training or experience, can participate effectively.

Market integrity

61. The auction system should preserve market integrity by:

- Having adequate oversight settings in place to deal with activities that may negatively affect market integrity. These activities are described in Annex F.
- Establishing adequate governance settings to ensure auction roles are fulfilled at arm's length from the Government's role as a policy decision-maker, with operating rules in place to control the Government's release of market-sensitive information. For example, an auctioning function could display integrity through having the independence accorded to a Crown agent, rather than a government department.

Market transparency

62. The auction design should provide an adequate level of transparency. Pre-auction information (e.g., auction qualification criteria, bidding rules, schedule and quantities) and auction results should be publicly available and accessible to all in a timely manner.

Section 4: Impact Analysis

63. Option 2 would establish a strong auction oversight regime. This would be due to the combination of pre-registration requirements for potential auction bidders and the auction monitor's ability to detect untoward market conduct through post-bidding analytics, and increased transparency through publication of auction outcomes. The auction monitor would also support oversight by having the ability to monitor the conduct of auction participants (e.g. to confirm pre-registration checks) as well as the auction operator and its performance/compliance with auction rules and settings. The publication of reports by the auction monitor would provide a level of public scrutiny not available under Option 1.
64. The table overleaf provides a summary assessment of the options for auction oversight.

Table 4: Summary assessment of options for the auction oversight regime

	Minimise administration costs (including transaction costs)	Ensure consist. & proportion.	Ensure market integrity	Ensure clarity & transparency
No oversight (status quo)	0	0	0	0
Oversight regime via pre-registration checks	- <u>Administration costs:</u> If regulations were set, there would be an increased cost to the Crown for implementing and operating NZ ETS auctions. It is difficult to assess the marginal impact but it is not expected to be a large part of overall auction costs. Current estimates for designing auctions are approx. s9(2)(f)(iv) . It is possible that the cost of pre-registration requirements could be met within these current estimates as they have been made with reference to overseas ETS auctions and similar markets in New Zealand, where oversight features are included in general auction or market design <u>Transaction costs:</u> Potential auction bidders would incur transaction costs, however the exact nature and extent of these costs would depend on the specific pre-registration requirements. Minimising transaction costs will likely be a criterion used when making future decisions on specific requirements.	- The requirement for pre-registration checks may discourage smaller participants. Some exclusions may need to apply (e.g. for smaller participants to be exempt from some disclosures)	+ Increased auction oversight via pre-registration checks would support overall market integrity	0
Oversight with auction monitor	-- As above plus: <u>Administration costs:</u> Some ongoing increased costs for the Crown would be required to appoint an entity to carry out auction monitor roles. Current estimates, based on overseas experiences, are that the auction monitor role would cost approx. s9(2)(f) per year to run. Exact costs of appointing an auction monitor will depend on its exact functions and the entity performing the auction monitor role. <u>Transaction costs:</u> there would be no transaction costs for auction participants, however, NZ ETS regulators (the EPA and Registrar) would be required to share information with the auction monitor in order for it to carry out its functions. This would result in transaction costs for these regulators. These are likely to be relatively low but would depend on the specific nature of the auction monitor's functions and information required. Further analysis would be undertaken when setting auction monitor functions in regulations.	- Same as above	++ Same as above plus: The independent auction monitor would further strengthen the auction oversight regime by undertaking all or some of the following activities (i) validating the auction results, (ii) monitoring the auction operator, (iii) monitoring the integrity of the auction pre-registration process, (iv) undertaking detailed post-bidding analysis, and (v) based on this analysis, report suspicious activity to the relevant market regulator(s)	++ The auction monitor would provide a third-party (independent) public report that would typically include more detailed metrics/statistics on auction results than otherwise available, enhancing market transparency. Market transparency could also be enhanced through the enhanced reporting role that the auction monitor would have by virtue of its detailed post-bidding analysis

Key:

++ much better than doing nothing/the status quo + better than doing nothing/the status quo 0 about the same as doing nothing/the status quo - worse than doing nothing/the status quo -- much worse than doing nothing/the status quo

Section 5: Conclusions

Preferred options

65. This RIS recommends Option 2 – that auction oversight be enabled through putting regulations in place to set up pre-registration requirements for potential auction bidders, and that the CCRA enable the establishment of the role of an auction monitor.
66. Although introducing an auction monitor carries additional costs (to select and operate the monitor), the increased benefits to auction integrity while ensuring open access outweigh these costs.
67. The independent nature of the auction monitor role would allow it to monitor how existing market design choices, auction pre-registration requirements and bidding rules help mitigate the risk of market abuse. The auction monitor would also perform its own analysis of auction results and make public a report of auction outcomes. Through these functions, the auction monitor could potentially also determine intent to manipulate auction outcomes. Finally, the auction monitor could also provide recommendations for auction design improvements, and, in future, it could report on activities that may trigger investigations by the relevant market supervisor(s), if desired under a broader market governance regime. These activities provide increased oversight of auctions by themselves and also work to reinforce the oversight provided through the establishment of pre-registration checks.
68. The summary table below provides detail of the costs and benefits of Option 2 compared to the status quo.

Summary table of costs and benefits

Affected parties (identify)	Comment: nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks	Impact \$m present value, for monetised impacts; high, medium or low for non-monetised impacts	Evidence certainty (High, medium or low)
--------------------------------	--	---	---

Additional costs of proposed approach, compared to taking no action			
Regulated parties	There would be some degree of transaction costs incurred by potential auction participants to meet pre-registration requirements. These costs would likely be a mixture of one-off (when a participant first registers for auctioning) and ongoing (to ensure they remain compliance with the requirements) transaction costs. The	Low	Medium

	<p>exact pre-registration requirements would be developed in auctioning regulations and have associated impact analysis undertaken at that point in time. There would be no costs to regulated parties to introduce an auction monitor.</p>		
Regulators	<p>Introducing pre-registration checks would not place any additional costs on current NZ ETS regulators. If an auction monitor were implemented via regulations, there would be a cost incurred by NZ ETS regulators (i.e. the EPA and the Registrar) as they would be required to share information with the auction monitor. These costs are not assessed in this RIS as the decision would be taken at a later date.</p>	Low	Medium
Wider government	<p>Under Option 2, there would be some increased cost to the Crown as the auction operator would need to implement and run NZ ETS auctions with pre-registration checks in place. It is difficult to identify the marginal impact of these checks compared to the status quo need to establish an auction platform. Current estimates for designing the auction is approx. s9(2)(f)(iv) [REDACTED]</p> <p>It is possible pre-registration checks could be included in this estimate.</p> <p>If an auction monitor is implemented via regulations, there would be costs incurred by the Government for the appointment, and ongoing operation, of the auction monitor. The extent of this cost would depend on the specific functions of the auction monitor and the entity that was appointed to be the auction monitor. Current estimates, based on overseas experiences, are that the auction monitor role would cost approx. s9(2)(f) [REDACTED] per year to run. Exact costs for appointing an auction monitor will depend on its exact functions and the</p>	<p>Medium (total)</p> <p>Cost for pre-registration checks undertaken by auction operator: low marginal impact on overall operator costs</p> <p>Cost for operation of auction monitor role: approx. s9(2)(f) [REDACTED] per year</p>	Low

	entity performing the auction monitor role. These decisions are not assessed in this RIS as they would be taken at a later date.		
Other parties	N/A		
Total Monetised Cost		s9(2)(f)(iv) per year	Low
Non-monetised costs		Low/Medium	Medium

Expected benefits of proposed approach, compared to taking no action			
Regulated parties	NZ ETS and market participants will be more confident in the good functioning of the auction system through increased independent oversight. The proposed approach will also support NZU auctions to ensure it meets objectives to support competitive price formation and a credible price signal. The proposed approach will also create a more transparent primary market. These benefits to NZ ETS participants and other market players difficult to measure but real.	High	Medium
Regulators	The benefits for regulators are less clear but there may be increased understanding of the NZ ETS market or options for improvement identified by the auction monitor.	Low	Low
Wider government	The functions of the auction monitor include providing recommendations about how to improve the auction system. This will provide benefits for policy makers as a tool for monitoring NZ ETS auctions. Strong oversight of NZ ETS auctions will increase the overall integrity of the NZ ETS, which is the Government's key policy to reduce emissions in line with its emissions budgets.	High	High
Other parties			
Total		Nil	N/A

Monetised Benefit			
Non-monetised benefits		High	Medium

Compatibility with regulatory system design expectations

69. There are no areas of incompatibility with the Government’s ‘Expectations for the design of regulatory systems’.

Section 6: Implementation and operation

New arrangements

How to implement the auction monitor

70. The proposal in this RIS is to enable auction oversight settings, with specific settings to be included in regulations. These oversight settings are pre-registration checks for potential auction participants and enabling the appointment of an independent auction monitor via regulations to provide independent oversight.
71. The Government is currently reforming the NZ ETS. Decisions to amend the scheme’s establishing legislation, the CCRA, are being progressed in two tranches. The first tranche was agreed in December 2018. The second tranche comprises a series of discrete papers taken to Cabinet over March to May 2019. Legislative amendment for auction oversight would be included in the Climate Change Response Act Bill, expected to be introduced to the House in mid-2019.
72. Further regulatory changes would be required to set up pre-registration checks and to implement an auction monitor would require a regulatory change. These decisions would require further consultation and policy analysis and, if progressed, will form part of consultation for auctioning regulations in mid-2019.
73. It is most appropriate for the detailed functions of the auction monitor to be contained within regulations as the context will be important for assessing these specific functions (for example, the outcomes of the market governance work stream could impact the auction monitor’s potential functions). To support regulatory predictability, the potential scope of the auction monitor’s functions should be included in legislation as described in Section 3. These are that, at a minimum, the auction monitor’s function should include requiring the auction monitor to validate auction results and provide additional analysis, and making this information available in a public report. The auction monitor’s function could also include monitoring the conduct of participants or the auction operator, providing assessments and recommendations of the auction system, and anything else considered necessary for the auction monitor’s effective conduct
74. This option requires that the CCRA be amended as the auction monitor would require information from the auction operator (including auction results, details of the bidding

process, and information regarding pre-registration checks) and from the EPA.³ This will require information sharing provisions with the current NZ ETS regulator, namely the EPA and the Registrar, as well as the agent appointed to sell units by auction (the auction operator). This information sharing should be only for the auction monitor to be able to carry out its specified functions and the auction monitor should be subject to the usual CCRA confidentiality provisions. Beyond one-way information sharing with the monitor, establishing pre-registration checks for potential auction participants would not require any changes to CCRA information sharing as this activity would be carried out by the agent selling units by auction (the auction operator) and only be relevant to the auction operator's functions.

Implementation risks

75. The role of auction monitor has not been consulted on explicitly so stakeholder's views are not well understood, which would pose an implementation risk. However, there is an opportunity to mitigate implementation risks during the development of regulations to appoint an auction monitor and specify its detailed functions. This process would include public consultation on the detail of any regulations. In addition, we will work with the current NZ ETS implementing agencies to draw from their experience implementing the NZ ETS to identify and mitigate such risks.

Section 7: Monitoring, evaluation and review

Monitoring of new arrangements

76. The CCRA already contains monitoring and review mechanisms and we are not proposing to change these.
77. MfE will continue to monitor the effectiveness of the CCRA to ensure the legislation is fulfilling its desired purpose, including if the legislation is being fulfilled in an administratively efficient way.
78. Monitoring arrangements for the auction monitor would be designed and put in place if an auction monitor were appointed through regulations. The auction monitor itself will also strengthen overall monitoring, evaluation and review of the NZ ETS auctioning system through its ability to monitor auctions and make recommendations for improvement.

Review of new arrangements

79. Regulatory stewardship over the NZ ETS remains the responsibility of MfE. Implementation agencies (including the EPA) will contribute data and evidence to support assessments of the NZ ETS legislation. The independent Climate Change Commission may also have a future role in providing oversight and recommendations for the NZ ETS.

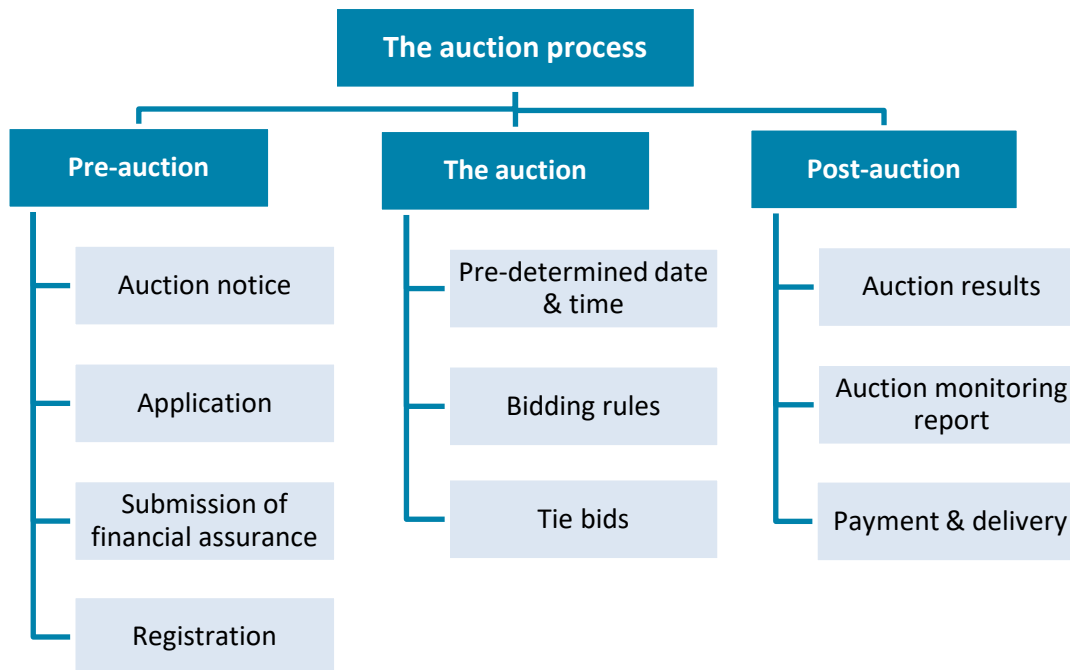
³ A potential example of the sort of information to be shared includes detail of the compliance balance of market participants, which can be determined from the registry unit holdings, to determine whether the size of a bidder's offer genuinely reflects bidder's net demand or is a sign of suspicious activity.

80. It is anticipated that stakeholders will be able to raise concerns through the legislative process, through submissions to Select Committee, and through consultation on regulations.
81. As this RIS is not appointing an auction monitor, there is not specific need for the arrangement to be reviewed. If a decision to implement an auction monitor through regulations were taken, this review arrangements would be assessed then.

Annex A: The auction process

82. The operational design options can be distinguished by three stages of the auctioning process: pre-auction, the auction itself and post-auction. Figure 1 below lists the different elements in each stage. A design decision needs to be made in relation to each of the listed elements.
83. In the pre-auction stage, an announcement is issued about an upcoming auction, and potential bidders are registered to participate in the auction after successfully providing the auction application and financial assurances. As part of the application process, potential bidders could undergo due diligence checks (e.g. anti-money laundering checks).
84. The auction stage is where the actual auction is held following pre-determined bidding rules (e.g. lot size, limits on bid size etc.). The post-auction stage involves the release of auction results, publishing information on auction conduct, and conducting the financial and physical settlement of successful bids.

Figure 1 The auction process



Annex B: The auction system

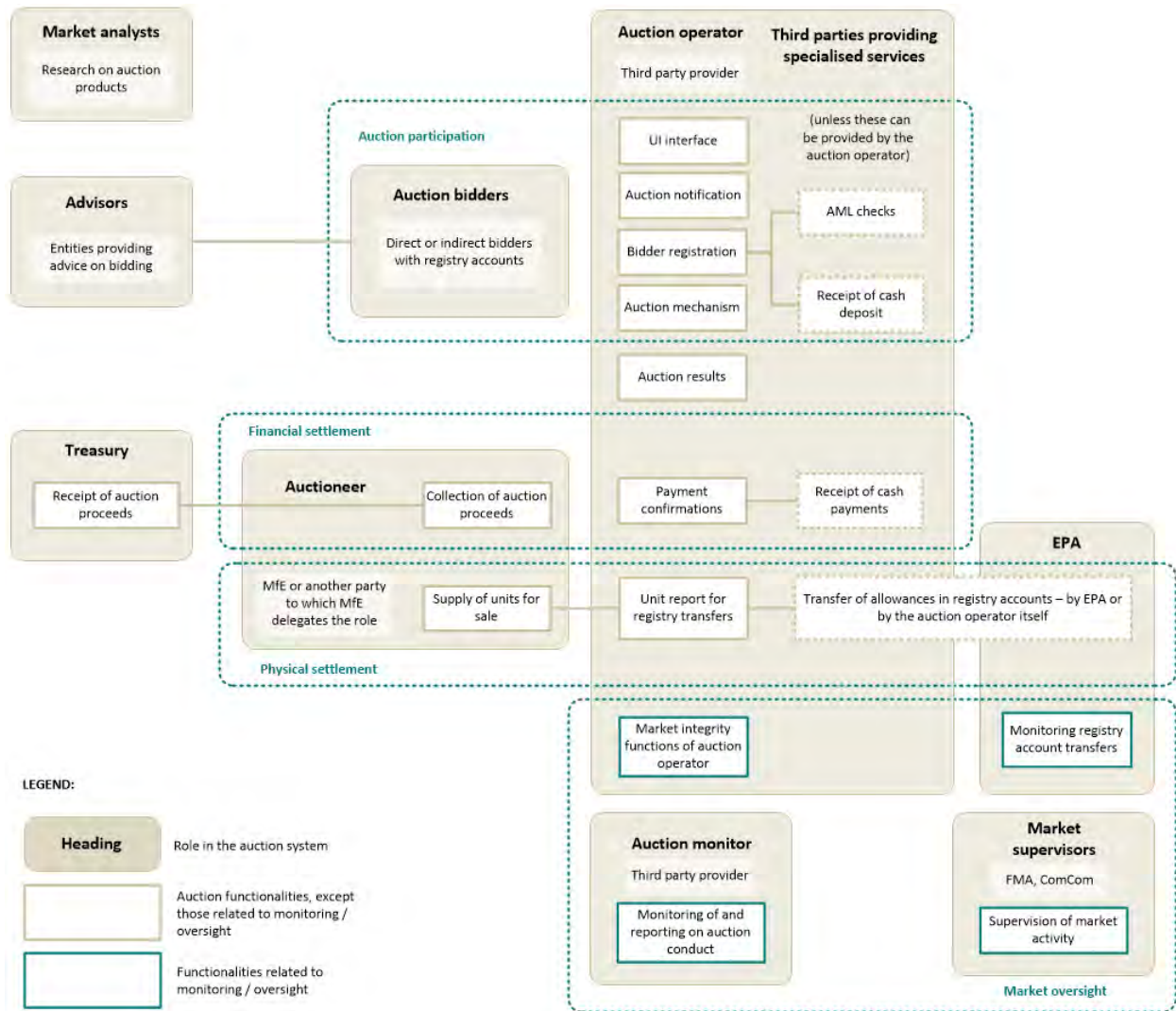
85. The auction system is defined as the totality of roles, functionalities and IT system required to implement and run an auction in accordance with the auction's design requirements supporting the auction's objectives.
86. The IT system includes the software, hardware, environments, processes and roles necessary to run the auction. Functionalities include different auction functionalities and interaction of functionalities supported by the IT system and managed by the different auction roles.
87. The roles in an auction system are described in Table 5 and Figure 2 below.

Table 5 Roles in an auction system

Role	Description of role
Auction bidders	Direct bidders are those are bidding in auctions on their own account. Indirect bidders are entities that bid in auctions on behalf of their clients. These entities may provide other financial services in the financial market or can be set up solely for the provision of NZU-related services, and can include business groupings of regulated entities, who can act as agents on behalf of their members.
Auctioneer	The auctioneer is a public entity responsible for auctioning a pre-determined volume of allowances and receiving the payments. Auctioneer obligations would include announcing the volumes of NZUs to be auctioned, and providing allowances as collateral before the start of the auction. ⁴
Auction operator	The auction operator is the entity that administers the auction. The operator would ensure that the required IT systems are in place to run the auction according to agreed specifications. The operator is responsible for pre-registering potential bidders, issuing the auction notice, running the auction and determining the clearing price, settling payments and ensuring that units are delivered into the accounts of the winning bidders.
Auction monitor	The auction monitor is responsible for monitoring and reporting on how each auction is held with respect to key auction attributes, e.g. providing fair and open access, ensuring transparency, and reporting on how prices are formed and technical and operational matters.
Market supervisors	These are the public authorities that would supervise relevant market participants with regards to how they comply with their obligations for the purpose of ensuring fair and orderly auctions. Different supervisors may be responsible for different aspects of market integrity.
EPA	EPA is the NZ ETR administrator.
Treasury	Treasury is the final beneficiary of auction proceeds.
Market analysts	Market analysts produce or disseminate research on auctioned products, and can disseminate information suggesting an investment strategy via private or public distribution channels. For example, they can provide opinions about the auction closing price depending on their research of the demand-supply balance in the market.
Client advisers	For the purpose of ETS auctions, advisers are those entities that provide advice with regards to bidding strategies, on the bid volumes, bid price and the timing of the bid. These entities may or may not also provide other financial services in the definition of the FMC / FSP legislation. Advisers are different from market analysts in that the former would provide advice tailored to the client's specific circumstances and needs, e.g. considering the auction products as part the client's entire portfolio of investment instruments.

⁴ Prior to the start of an auction, the auctioneer may need to give allowances as collateral to be held in escrow by the clearing / settlement system, or into a separate account in the registry system.

Figure 2 The ETS auction system⁵



⁵ The supporting IT infrastructure is not shown here

Annex C: Risk identification, analysis and assessment

Note – addressing these NZ ETS market risks broadly is out of scope for this RIA (which is focused on auction oversight). Much of the policy work to assess and (if required) address these risks work will be undertaken as part of the broader NZ ETS market governance work programme.

Risk identification and analysis

Collusion

88. In the context of auctions, the relevant issue related to collusion is price fixing. This would happen, for example, if prior to the auction one or more participants acting in collaboration bought and sold NZUs on the secondary market with the effect of fixing the auction clearing price at an abnormal level.
89. Price fixing could also happen if a participant or more participants acted in collaboration to secure a dominant position over the demand of NZUs in auctions. Compared to other auction formats, this type of risk is diminished in sealed-bid uniform-pricing auctions. Nevertheless, the risk remains, particularly if the auctions are small; in this case, colluding parties have a higher chance of determining the marginal bid that sets the clearing price.

Market power

90. An entity has market power when it can influence the price of an asset through asset purchase or asset sale. In competitive markets, participants are price takers. In non-perfectly competitive markets an entity with market power can be a price maker.
91. Not all price-making in this sense represents untoward conduct. This outcome can simply reflect the size of the entity relative to other participants in the context of limited supply.⁶
92. It is when an entity conducts itself with the *intent* to influence the price that the market is manipulated through the exercise of market power. In an auction, this would take place when a bidder can create a strategy that allows him to determine a high clearing price (e.g. by acquiring all the units up for sale), and then sell off an existing position in the secondary market at the high price, making a profit overall across his trades in the primary and secondary spot markets.
93. The risk of manipulating the auction clearing price by a single or a collaboration of large participants can be mitigated by applying a limit on the number of units that any single entity can win relative to the volumes up for sale in an auction. However, this limit must account for the size of the auction; as if it too restrictive it may discourage the larger

⁶ In order to differentiate between genuine and untoward price outcomes, especially as a result of a large trades, regulators typically apply tests to determine if the market has been manipulated. For example, the US Commodity Futures Trading Commission uses the following test: (i) the accused had the ability to influence market prices; (ii) the accused specifically intended to do so; (iii) artificial prices existed (ie those that do not reflect the basic forces of supply and demand); and (iv) the accused caused the artificial price. See <http://www.justice.gov/osg/briefs/2009/0responses/2009-0669.resp.pdf>

participants from bidding altogether. This issue is discussed in more detail in the RIS on operational matters for an NZ ETS auction.

Money laundering and other criminal activity

94. An ETS may be at risk of “layering” (a common money-laundering / terrorist-financing technique) given that allowance trading involves transfers of value (often using financial intermediaries) without any underlying goods needing to be moved. The EU experience shows that an ETS could also be susceptible to other criminal activity, such as VAT fraud and unit thefts. Therefore, before any auction is held it is important to establish the business integrity of potential bidders, including the source of money flows.

Unfair dealing and conflict of interest

95. This issue relates to ensuring that participants acting on behalf of their clients (indirect bidders) do so in the best interest of their clients during the auction. For example, this would imply having an agreement with the client with regards to maximum acceptable bid price and total cost, and adhering to this agreement during the auction. It would also require indirect bidders to disclose any conflicts of interest.

Market manipulation through false or misleading statement/provision of information, and through false or misleading appearance of trading (market manipulation through deceit)

96. These issues relates to direct and indirect bidders, and market analysts providing misleading statements or information to the market. For example, the perpetrator could provide misleading projections of an increased demand from the larger market participant, in an effort to drive up the unit price at which the perpetrator would then sell its existing unit holdings.
97. Market manipulation also relates to direct and indirect bidders conducting false or misleading appearance of trading with the effect of fixing the auction clearing price at an abnormal or artificial level with the intent to mislead bidders in the auction. Examples of trade based manipulation include “wash sales,” where the perpetrator places contemporaneous buy and sell orders so as to convey renewed interest in the unit, or “making the close,” where the perpetrator buys or sells units near the end of the trading day, in an effort to alter the closing price of that unit. Although these activities relate to trading in the secondary market, they can also affect auction outcomes due to the impact they have on the market’s *perception* of the overall supply and demand balance.

Insider dealing

98. The issue relates to direct or indirect bidders using material information not available to the market by submitting, modifying, or withdrawing a bid. Inside information is any information that has not been made public, relates directly or indirectly to NZUs, and if it were public, would have a significant impact on bid prices.

Risk assessment

99. However, there was a general consensus that the risk to market integrity can increase in in the future as the market grows in size (e.g. through the inclusion of new participants) and in complexity (e.g. through the introduction of a cost containment reserve, or international linking).

Price manipulation through market power

100. The risk of price manipulation is particularly important considering that auctions are likely to be small relative to the size of the secondary market. Smaller auctions imply that large bidders may find it easier to dominate the offers and determine the marginal price that will set the auction clearing price.

101. The risk of auction price manipulation is affected by the combination of two factors:

- The liquidity of the secondary market in terms of the number of buyers and sellers, and
- The net position of large participants in the market.

Price manipulation through collusion

102. The risk of collusion is reduced through two auction design features: (i) using the uniform-pricing, single-round and sealed-bid format, and (ii) using the random approach for solving tied bids. These are discussed in more detail in the RIS on high-level auction design and in the RIS on auction operational rules respectively.

Insider trading

103. Inside information is price-sensitive information that is not available to the market and which a reasonable investor would likely use as the basis of their investment decisions.

104. At a high level, the nature of insider trading information can be classified as follows:

- Information that affects the unit supply by and demand of market participants, and
- Information that relates to the conduct of auctions, and which is originated by the Government.

105. The first type of information can include acquisition of new businesses by a participant (especially a large one), which would affect the participant's compliance balance. Trading on the basis of inside information would also occur when a participant has information that an emitter plans to shut down its operations, and then uses that information to sell its current holdings anticipating a drop in price due to the large emitter exiting the market.

106. The second type of information can include changes in auction volumes and frequency, or decisions on future supply of international credits.

107. Any entity can possess insider information by virtue of its:

- Membership of the administrative/management/supervisory bodies of the auction platform, auctioneer or auction monitor
- Holding in the capital of the auction platform, auctioneer or auction platform
- Having access to information through the exercise
- Criminal activities.

108. The current market is dominated by bilateral trading, which means that it is almost impossible for any single market participant to have the complete picture of the ETS at any point in time. The bilateral nature of trading, together with the non-public disclosure of post-trade information from existing marketplaces means that it is currently difficult to gain insights into the supply or demand forces that would move the market. On the one hand, this means that incentives to use inside information for the purpose of gaining a

price advantage is reduced given that the resultant price impact is difficult to predict. On the other hand, this also means that if inside information is used, the low transparency of trade information makes such behaviour difficult to detect.

109. For the purpose of auctions, addressing the risk of inside information is important given the objective of ensuring fair access to auctions and a fair price formation. To meet these objectives, appropriate rules will need to be established to require public and effective disclosure of inside information. As mentioned previously, some exemptions may be warranted for smaller participants to minimise the transaction costs resulting from the implementation of these rules.

110. There is also a risk of trading on the basis of information held by the Government. The best way to deal with this risk is to establish an adequate information transparency regime. For example, pre-auction information will need to be kept confidential until it is released publicly to the entire market at the same time. The regime would also need to address instances of leaked information. For example, an inadvertent leak should be followed by a prompt market-wide disclosure of leaked information, and rules may need to be put in place to guide the conduct of bidders to which such information was leaked accidentally.

111. Specific requirements can be put in place to mitigate the risk of market abuse through the use of insider information. These include (but are not limited to):

- The auctioneer, the auction operator and the auction monitor drawing up a list of those persons working for them, under a contract of employment or otherwise, who have access to inside information
- Persons discharging managerial responsibilities within the auction platform, the auctioneer, or the auction monitor to notify the relevant market supervisor the existence of bids submitted, modified or withdrawn on their account.

Annex F: Activities affecting market integrity

