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ETS Auction Rules

NZAA submission

The New Zealand Automobile Association Incorporated

342-352 Lambton Quay
PO Box 1
Wellington 6140
NEW ZEALAND

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REGARDING: **ETS Auctioning Rules**

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ATTENTION: NZ ETS Team,

ADDRESS: Ministry for the Environment,

PO Box 10362,

Wellington 6143

SUBMISSION AUTHORISED BY

Mike Noon

General Manager, Motoring Affairs

New Zealand Automobile Association Incorporated

P.O Box 1

Wellington

SUBMISSION AUTHOR

Peter King

AUTHOR E-MAIL

pking@aa.co.nz

AUTHOR PHONE

(04) 931 9981

NOTE TO REQUESTOR

The AA would appreciate an opportunity to discuss this submission with the Ministry in the new year.

Contents

Background on the New Zealand Automobile Association.....	2
Content of this Submission.....	2
Introduction	2
1. Interest of the NZ AA in the ETS.....	3
1.0 Point of Obligation vs Source of Revenue	3
1.1 Conclusions of the Commerce Commission Report into the wholesale fuel market.....	3
1.2 Size of the fuel market within the NZ ETS	4
1.3 Relative size of liquid fuel participants obligations.....	5
1.4 Carbon obligation as a proportion of post tax profit in liquid fuel market.....	6
1.5 Sources of ETS price variability	6
2. Market Strategy and Operations.....	7
2.0 General comments on objectives and criteria.....	7
2.1 Preferred options acceptable unless stipulated	7
2.2 Distribution of volume.....	7
2.3 Unsold units	7
2.4 Cost containment reserve auctions	7
2.5 Bid limits and tied bids	8
2.6 Technical Reserve	8
2.7 Reporting	8
2.8 Auction Monitoring	8
3. International Shock Scenario.....	9
4. Conclusions.....	9

Background on the New Zealand Automobile Association

The New Zealand Automobile Association (NZAA) is an incorporated society with over 1.7 million Members. Originally founded in 1903 as an automobile users advocacy group today it represents the interests of road users who collectively pay over \$400 million in carbon costs each year. The NZAA's advocacy and policy work mainly focuses on protecting the freedom of choice and rights of motorists, keeping the cost of motoring fair and reasonable, and enhancing the safety of all road users.

Content of this Submission

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Introduction

The AA welcomes the opportunity to submit on ETS auction rules consultation.

While the AA is not a participant in the ETS its motorist Members fund the liquid fuel wholesalers who are obligated parties under the Act. This submission is made in light of the Commerce Commission Market Study into the Retail Fuel Sector into the liquid fuel market and looks at the potential for the ETS auction system to exacerbate the imperfect competition of that market as revealed by the Commerce Commission.

Because of the short time frame this submission can only raise issues and identify potential risks for the Ministry. We have not been able to carry out any simulations or modelling to determine the likelihood of those risks eventuating and will leave this to the Ministry to consider the need for more in-depth evaluations of those risks.

Part one explores the relationship between competition within the liquid fuels market and the emission trading scheme. Part two takes this context and explores the Ministry's questions in the technical consultation document. Part three raises the question of how the market should respond to large scale shocks.

Broadly speaking we would like to see the ETS design be at least as transparent as the NZX and more discussion of the role of the Commerce Commission in the ETS, and perhaps more information about the tax treatment of banked NZUs.

Finally we recognise that no market springs into existence perfectly anticipating the demands of its customers, sponsors or the public. We therefore propose a process of intense review in the initial years slowly relaxing as the inevitable problems are ironed out.

1. Interest of the NZ AA in the ETS

1.0 Point of Obligation vs Source of Revenue

For administrative convenience the point of obligation for emissions charges under the Emission Trading Scheme in the fossil fuels sector is the importer of fossil fuels. However this is not the ultimate source of the revenue for the scheme. Ultimately fuel wholesalers purchase NZUs using funds levied from downstream fuel purchasers; a chain that ultimately ends with households. Thus while households have no direct obligations under the emissions trading scheme they do ultimately pay through the ETS for the costs of the carbon they emit.

The New Zealand Automobile Association is concerned that there is a potential differential between the price paid for carbon by wholesalers and the price paid by households. This is because the wholesale fuel market is not particularly transparent or competitive.

The AA is also concerned that the imperfect nature of the New Zealand fuel market means that any marginal disadvantage in carbon markets for pivotal participants such as Gull could have significant repercussions for marginal prices through the entire fuel market. This in turn could have structural implications for the fuel market.

1.1 Conclusions of the Commerce Commission Report into the wholesale fuel market

The Commerce Commission published its final report on the wholesale fuel market 5 December 2019. It concluded that

- 1) *"...many fuel companies are achieving a level of profitability in New Zealand that is persistently higher than what we estimate a reasonable return would be in a workably competitive market"* (X10)
- 2) *, ..."the core problem is that an active wholesale market does not exist in New Zealand. This is weakening price competition in the retail market"* (X12)
- 3) *"New Zealand's only other fuel importer, Gull, has succeeded in entering some North Island retail markets and will shortly open its first South Island retail site. It has had a positive impact in reducing prices for consumers in some areas where it operates. However, it is also incentivised to maximise its own profits and can do so by setting its prices beneath the majors' average retail prices, without the threat of further competition driving prices down"*. (X14)
- 4) *"New Zealand's fuel industry is now essentially a vertically integrated oligopoly. The three majors (Z Energy, BP and Mobil) benefit from the cost efficiencies of their infrastructure sharing arrangements. They supply more than 90% of the retail fuel sold through a network of retail sites they own and operate, dealer owned retail sites that carry their brands, and distributors which in turn supply their own dealers and/or retail sites that they own and operate"* (X21)
- 5) *"New Zealand's only other fuel importer, Gull, is not party to any of the infrastructure sharing arrangements. Gull imports fuel into its Mt Manganui terminal and from there trucks it to its North Island retail outlets. Gull has recently opened its first South Island site and plans to open six more sites over the next two years. However, its ability to expand and compete in the South*

Island depends on securing wholesale supply arrangements. Gull has had a positive impact in reducing prices for consumers in some areas where it operates. However, it is also incentivised to maximise its own profits and can do so by setting its prices beneath the majors' average retail prices, without the threat of additional competition driving prices down further."

6) *"There are indications that returns may have now peaked but their future trajectory appears stable. The majors and financial market analysts expect profitability to remain at elevated levels for some time. This is an indication that competition is not working well to bring profitability back to a more competitive or 'normal' level. It is uncertain what will happen to margins and returns in the future. However, we are not convinced the industry's experience of excess returns has come to an end under current policy settings. The underlying factors affecting retail fuel competition have not changed."*

1.2 Size of the fuel market within the NZ ETS

Using MBIE fuel data and MFE emission factors it is possible to readily determine the size of the fuel market within the ETS.

Latest four quarters:

	<i>MT CO₂e</i>	Petrol	Diesel	Jet*	Fuel* Oil	Total
2018	Dec	1.938	2.394	1.282	0.399	
2019	Mar	1.783	2.325	1.286	0.358	
2019	Jun	1.853	2.46	1.072	0.328	
2019	Sep	1.823	2.284	1.168	0.569	
	12 months	7.397	9.463	4.808	1.654	23.322

*NB By convention the international Jet and fuel oil emissions are not classed as a national liability.

Which over a ten year average at an ETS price of \$25 per tonne (the fixed price charge under the previous regime) translates to approximately the following quarterly obligations.

\$M	Petrol	Diesel	Jet*	Fuel oil*	Total
Mar	\$ 48.36	\$ 50.39	\$ 25.01	\$ 11.42	\$ 135.18
Jun	\$ 47.86	\$ 52.19	\$ 22.38	\$ 11.65	\$ 134.07
Sep	\$ 44.19	\$ 48.20	\$ 22.80	\$ 12.20	\$ 127.39
Dec	\$ 49.01	\$ 53.07	\$ 24.13	\$ 11.25	\$ 137.45
					\$ 534.10

*international jet or shipping fuel oil is not liable, domestic is.

According to the 2018 New Zealand Emissions Trading Scheme Report as at 30 June 2019 there were four liquid fuels participants in the ETS out of 275 total.

Liquid fuels accounted for 18.7MT CO₂ out of 67.8MT (a quarter) exceeding all other single sources including dairy (15.7MT) and meat (14.4MT) of emissions reported.

While the market saw 33.5 million units surrendered oil companies have to date simply paid the \$25 per tonne monetary penalty which yielded \$420m in that financial year.

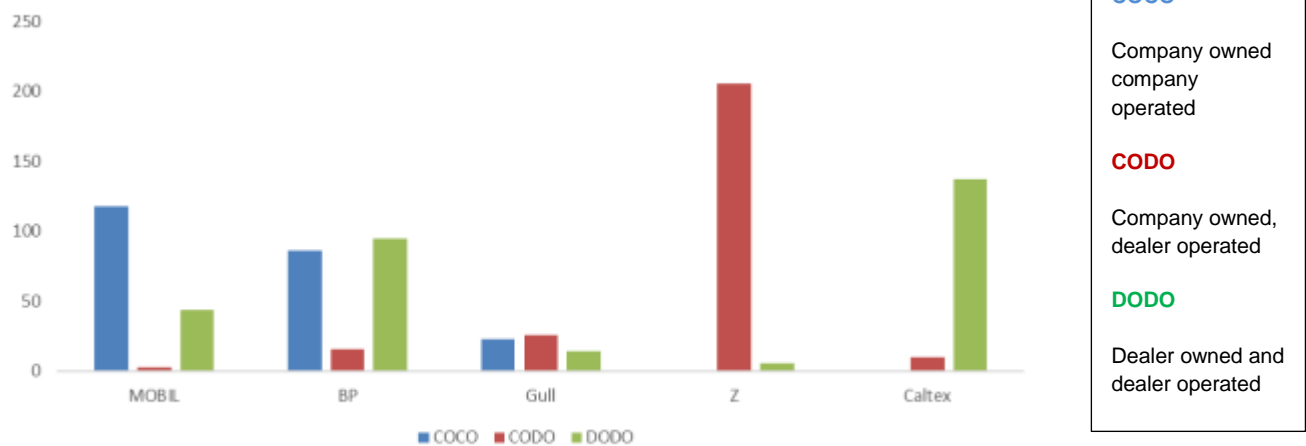
AA submission: ETS Auctioning Rules

The changes under the Climate Change Response (Zero Carbon) Amendment Act means that the wholesale liquid fuel industry will now need to become active traders in the ETS market.

1.3 Relative size of liquid fuel participants obligations

The retail fuel market is dominated by three major fuel importers plus Gull

Figure 7 Service stations operated by the majors and Gull



Source: MBIE

Source: New Zealand fuel market financial performance study 2017

While approximately 65% of retail sites are operated under non-major brands, these sites only accounted for 20% of fuel volumes sold as at March 2019 (Commerce Commission fuel market: X30)

In addition to their own brands:

Z/Chevron supplies wholesale fuel to McKeown, Challenge, Farmlands and Southfuels;

BP supplies wholesale fuel to Rural Fuel, RDP, Gasoline Alley, Spirit;

Mobil supplies wholesale fuel to Foodstuff supermarkets, NPD, Allied and Waitomo.

The financial size of the fuel importers:

Mobil (2018/17 revenue: \$2,676m, net profit after tax: \$177m);

Z (FY2019/18 revenue: \$5,450, net profit after tax \$186m);

BP (2018/17 revenue \$3,220m, net profit after tax \$243m);

Gull (2018 revenue:\$581m, net profit not disclosed, guess is 10% revenue).

1.4 Carbon obligation as a proportion of post tax profit in liquid fuel market

We can assume that the proportion of the carbon obligation carried by fuel companies is broadly proportionate to the size of their businesses. From this we can estimate the obligation is spread roughly: Mobil 22%, Z 46%, BP 27% and Gull 5%,(petrol and diesel combined). This suggests the following approximate obligations:

Mobil 3.78 million tonnes CO₂e, which at \$25 would cost \$94.6m per year (53% of profit)

Z 7.7 million tonnes CO₂e, which at \$25 would cost \$192.6m per year (over 100% of profit)

BP 4.55 million tonnes CO₂e, which at \$25 would cost \$113.8m per year (46% of profit)

Gull 821 thousand tonnes CO₂e, which at \$25 would cost \$20.5m per year (guess 50% of profit)

Although these values are estimates they total \$420m which is the same as the total cash payments received by the ETS in lieu of unit surrender in the financial year to June 2019.

While NZUs are a tax deductible cost of business in the year of surrender we provide this comparison to demonstrate that marginal increases in ETS prices could constitute a significant increase in their marginal effective tax rate.

1.5 Sources of ETS price variability

While most taxes are a fixed proportion of a price or income New Zealand Unit prices are subject to the supply and demand curves of the ETS markets.

We note there has been considerable variability in the number of removal credits brought to the ETS secondary market over the past few years.

Year	Total quantity of removals previously reported (tCO ₂ e)	Total quantity of removals after amendments and including forestry emissions (tCO ₂ e)	Change in removals reported (tCO ₂ e)
2017	21,398,143	21,398,143	0
2016	11,077,867	11,026,601	-51,266
2015	9,892,015	9,899,473	7,458
2014	14,383,182	14,383,182	0
2013	19,527,871	19,527,871	0
2012	24,186,672	24,186,672	0

The figures relate to actual removals for each period reported.

Source: 2018 New Zealand Emissions Trading Scheme Report

The number of forestry credits brought to the scheme each year has varied by half the total number of credits required to cover the liquid fuel obligation (not forgetting the number of units surrendered in 2019 was 33 million reportedly not including the 18 million liquid fuels).

This suggests that there is considerable scope for price volatility in the secondary (open) market for NZ units).

2. Market Strategy and Operations

Section one has set the scene for the prospect of the liquid fuel market participating in trading operations within the ETS.

The AA's concerns with the auction process is whether there is scope for gaming the system in order to:

- a) Improve profitability at the expense of the motoring public
- b) Conduct market operations to increase NZU prices for competitor obligated parties
- c) Conduct market operations to drive smaller competitors out of business in order to secure structural benefits from a less competitive liquid fuels market.

2.0 General comments on objectives and criteria

The objectives and criteria for analysing options for the ETS auctioning system are generally sound although the AA would like to see more consideration given to wider government objectives such as those addressed by the Commerce Commission. We would also be interested to see more discussion on the role of the Commerce Commission with respect to the ETS and any market authority.

The AA is pleased to see recognition of the scope for collusion and manipulation, strategic bidding and the like. The liquid fuels industry is global and hard-nosed. Auction system designers cannot assume that New Zealand's small market is any defence to opportunism.

That said it must be recognised that given the primary market is intended to tighten over time the ultimate determinant of the New Zealand ETS price on the secondary market will be marginal cost of removals over time. This in itself will be affected by 1) land prices 2) log (and other primary export) prices and 3) the penalties regime.

2.1 Preferred options acceptable unless stipulated

In general the AA considers the Ministry's preferred options acceptable, except where we comment otherwise below.

2.2 Distribution of volume

The distribution of demand for liquid fuels across the quarters is not even. We note that the fiscal year, and the ETS surrender year are not aligned. We would therefore suggest that it would be more convenient if volumes were distributed unevenly across the year to match demand from sectors.

2.3 Unsold units

Another option worth considering would be to hold unsold units in reserve either to act as part of cost containment reserve or for release in the final auction of surrender year.

2.4 Cost containment reserve auctions

The cost containment reserve will only be triggered if NZUs are more expensive than international units recognised by the New Zealand government (as this is the source of the

additional carbon volume the NZ government must take responsibility for). This could happen if there is a collapse in international carbon prices or if the secondary market becomes oversubscribed in any given year (for example if forest fires destroy a large enough area of potentially saleable removals) at which point any price up to the penalty becomes feasible.

If the secondary market does become oversubscribed and the combination of volume from the primary and secondary markets is less than the total annual obligation it could prove opportune for some large market participants to drive up prices in the reserve auction given 1) there is evident scarcity and 2) they can reap long term profits by pushing competitors out of the market.

It might therefore be helpful if cost containment reserve auction volumes were limited to those with actual surrender obligations who have a potential deficit to meet them.

2.5 Bid limits and tied bids

Given section 27 of the Commerce Act (Restrictive Trade Practices) the AA suggests that bids should be subject to the scrutiny of some agency such that those participants who appear to be bidding for units to bank as opposed to surrender are disadvantaged in some way.

Thus any participant should have an annual limit of their surrender obligation. This does not prevent them buying units on the secondary market but simply prevents deep pocketed organisations from buying NZUs to bank in anticipation of higher prices and better margins in their main businesses.

2.6 Technical Reserve

The principal concern with a technical reserve price (to prevent price collapses at auction) is that it potentially ratchets up prices in both the primary and secondary markets (depending on available volumes). If the secondary market is “drying up” it is even conceivable that the technical reserve price (set with reference to the secondary market) ends up higher than the cost containment trigger price. If the secondary market is awash in volume than the technical reserve will be redundant.

If the primary market price is significantly below the secondary market price, this simply means that the volume being released is too high. It might be better to trigger a containment of volume rather than a restriction in price given that the ultimate aim is to reduce emissions.

2.7 Reporting

The AA would prefer the ETS to be as open as the NZX. We see no good reason why the ETS should be any less transparent.

2.8 Auction Monitoring

New markets are always tricky to establish and full of unforeseen circumstances. We suggest Annual reviews for the first three years of operation, biennial reviews for the next four years and once every five years after that.

3. International Shock Scenario

International carbon markets are inevitably affected by international liquidity. As seen during the Global Financial Crisis the cost of carbon becomes relatively unimportant when the banking system seems on the verge of imminent collapse.

While the auction system has been designed for a business-as-usual environment the AA suggests that options for a market suspension should be put in place to deal with those circumstances where the assumptions underpinning the market are no longer valid.

We have no expertise or suggestions to offer on what this would look like, merely the observation that given it has happened once there is clearly no guarantee it can't happen again.

4. Conclusions

The AA is concerned that the ETS may impact the very delicate balance in the liquid fuels market. The liquid fuels market will constitute roughly a third of the ETS each year and is a market which underpins the New Zealand economy and whose sales constitute four percent of GDP.

The difficulties the Commerce Commission has experienced obtaining information about the liquid fuels market and the questions of the effectiveness of competition regulation in this respect should give ETS system designers pause when considering the implications of their work.

We wish you well in your work and are happy to assist in any way in which we are able.