

Independent Observer's Report on the conduct of the EU ETS Carbon Emissions Allowances Auction on 24 March 2009

Role of the Independent Observer

The Independent Observer is David Steeds, a senior partner of Evolve Business Consultancy, who was appointed by HM Treasury through an open competition. His role under Regulation 12 of the Community Emissions Trading Scheme (Allocation of Allowances for Payment) Regulations and Scheme 2008 is to oversee an auction and to provide a report to HM Treasury on the conduct of an auction as soon as reasonably practicable after the auction has taken place. HM Treasury and the Independent Observer take the view that his role is essentially to monitor the conduct of the auctions to provide assurance that the published procedures have been followed and that all Primary Participants have been treated fairly and equally in accordance with the Regulations and the Scheme.

Primary Participants are parties who are approved to bid both on their own account and on behalf of other parties (who are known as Indirect Bidders). Primary Participants must have an office in an EEA state, have the ability to meet their financial commitments, the ability to participate effectively in an auction on behalf of others and systems to prevent the disclosure of confidential information.

Before the Auction

Before the auction the Independent Observer discussed the proposed procedures with officials from HM Treasury, the UK Debt Management Office ('DMO') and Department of Energy and Climate Change ('DECC'). The Independent Observer noted that HM Treasury has appointed DECC to conduct auctions of EU ETS allowances and the Secretary of State for DECC is now responsible for the conduct of auctions. It was also noted that DECC has engaged the DMO to act as its agent for administrative purposes. The Independent Observer noted that the auction procedures were broadly the same as for the first auction on 19 November 2008. They are based on DMO's procedures for gilt auctions using Bloomberg's Auction System which have a long history and are widely accepted by all the market participants. He is satisfied that the adopted procedures are appropriate for the EU ETS auctions.

Six Primary Participants had been approved before the auction by DECC on advice from the DMO and their contact details were published on the DMO website. All 6 took part in this auction. Four Primary Participants were approved and took part in the previous auction on 19 November 2008. The Independent Observer welcomed the increase in the number of Primary Participants.

The proportion of units allocated to Indirect Bidders also increased considerably in this auction compared to the first auction on 19 November 2008.

% allocation	24 March 2009	19 November 2008
Indirect Bidders	60%	24%
Primary Participants	40%	76%

The Auction

The Independent Observer was present at and observed the auction at the DMO's offices on 24 March 2009 from 8am to 10am. Figures in brackets below are the comparative figures for the first auction on 19 November 2008.

There were 54 (55) winning bids for 4 million (4 million) EUA's (EU carbon allowances) at or above the clearing price of €10.98 (€16.15). The total number of allowances for which bids were received was 23,055,000 (16,586,000) so the bid cover ratio was 5.76 (4.15). Each allowance covers the emission of one tonne of carbon. The clearing price is the lowest bid price, above a Reserve Price set by HM Treasury, at which all allowances for sale would be allocated. The Reserve Price is not disclosed.

The scaling ratio applied to bids at the clearing price (where there are not enough allowances being auctioned to meet all the bids made at the clearing price) was 7.2%.

The total proceeds from the auction were €43,911,501 or £40.5 million @ £0.9216 (€64,597,981 or £54.4 million @ €1= £0.8428) before VAT.

Although the amount of trading on the spot market is rising, the ECX ICE futures market remains the most liquid secondary market in carbon trading. The prices of secondary trades (DEC-09 contract) on this market at the time of the auction are shown below together with the futures prices adjusted to spot prices by discounting using the nearest Euribor interest rate. The BlueNext spot prices are shown alongside.

	ECX ICE Dec 09 Futures	Adjusted to spot price	BlueNext spot EUA contract
Before the start of the auction (08:00am)	€11.58	€11.43	€11.25
Approximate weighted average of trades during auction bidding window	€11.50	€11.35	€11.25
After the end of the auction (10:00am)	€11.48	€11.33	€11.15
Auction clearing price as a discount to weighted average of trades during auction		3.3%	2.4%

A small discount to the secondary market is to be expected. A discount of 3.3% (2.5%) to average secondary spot prices would appear acceptable. The difference between the ECX ICE adjusted spot price and the BlueNext spot price would appear to arise because the majority of carbon market participants are not at present able to borrow at Euribor rates and are therefore discounting futures prices using a higher cost of funding rate.

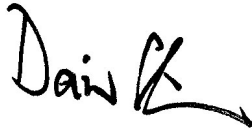
No telephone bids were received, although the facility to make bids by telephone was available to bidders.

Conclusions

Based on his observation of the conduct of the auction, it is the Independent Observer's view that:

- The auction was conducted in a fair and transparent manner in accordance with the published procedures;
- The auction results were consistent with the published procedures and the bids received;
- Sensitive information was treated appropriately by the auction administrator;
- There were no indications of hardware or software problems, communications issues, security breaches, or other problems with the auction platform;
- All the information that he requested had been provided to him.

In summary, the Independent Observer confirms that the results of his monitoring of the second EU ETS auction to be held in the UK raise no material concerns about the conduct of the auction in terms of either the process or its results.



David Steeds

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The Independent Observer of EU ETS Carbon Emissions Allowances Auctions

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