

Independent Observer's Report on the conduct of the EU ETS Carbon Emissions Allowances Auction on 8 October 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 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

The administrative arrangements for the auction were unchanged from previous auctions with DMO responsible for the conduct of the auction. New secondary legislation, the Community Emissions Trading Scheme (Auctioning of allowances) Scheme 2009, came into force on 23 April. The main change from the earlier Scheme is that Primary Participants are now allowed to earn 5 euro cents on each allowance allocated to an indirect bidder for whom they act. This change was introduced to incentivise Primary Participants to encourage indirect bidders to take part in the auctions. The number of Indirect Bidders who submitted bids in the four auctions since the new Scheme was introduced has risen considerably compared to earlier auctions and the number continues to increase.

The Independent Observer noted that the auction procedures were broadly the same as for previous auctions. 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 market participants. He is satisfied that the adopted procedures are appropriate for the EU ETS auctions.

Seven 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 seven took part in this auction - six took part on their own account and on behalf of clients and one only on behalf of clients.

The proportion of units allocated to Indirect Bidders increased substantially compared to the previous two auctions and reached an all-time high of 70%.

% allocation	8 Oct 2009	10 Sept 2009	9 July 2009	4 June 2009	24 March 2009	19 Nov 2008
Indirect Bidders	70%	46%	39%	58%	60%	24%
Primary Participants	30%	54%	61%	42%	40%	76%

The Auction

The Independent Observer was present at and observed the auction at the DMO's offices on 8 October 2009 from 8am to 10am. Figures in brackets below are the comparative figures from the fifth auction on 10 September 2009.

There were 52 (31) successful bids for 4.2 million (4.2 million) EUAs (EU carbon allowances) at or above the clearing price of €13.36 (€15.05). The average size of successful bids decreased for the second auction in a row, this time from 135,500 allowances to 80,770 allowances. This is principally because in the previous auctions there were some larger successful bids from Primary Participants acting on their own account.

The total number of allowances for which bids were received was 13,883,000 (21,780,000) so the bid cover ratio was 3.31 (5.19). Although this cover ratio is very adequate, it is the lowest in the auctions held to date. The lower cover ratio appears due to a thin, and more bearish, market in carbon trading reflected in the lower prevailing market price for allowances and a lower auction clearing price than in the previous auction. This may possibly be related to Poland's recent successful challenge to the EU's cap on Poland's National Allocation Plan allowances limit, and the prospect of other Eastern European countries also increasing supply into the market. Each allowance covers the emission of one tonne of carbon. The clearing price is the lowest accepted 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 90.5%.

The total proceeds from the auction were €56,110,998 or £51.7 million @ £0.9208 (€63,207,592 or £55.7 million @ £0.8811) before discounts to Primary Participants in respect of successful indirect bidder allocations. It is noted that since the fourth auction in July the supply of carbon allowances in the UK has been made subject to a zero-rate of VAT.

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 in the table below together with the futures prices adjusted to spot prices by discounting using an interpolated 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)	€13.75	€13.71	€13.60
Approximate weighted average of trades during auction bidding window	€13.54	€13.50	€13.53
After the end of the auction (10:00am)	€13.50	€13.46	€13.47
Auction clearing price as a discount to weighted average of trades during auction		1.1%	1.3%

A small discount to the secondary market is to be expected and the discount remained acceptably small, even if it was higher than the very low discounts seen at the previous three auctions.

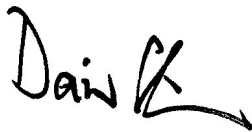
No telephone bids were received, although the facility to make bids by telephone was available to bidders.

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 sixth 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.



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The Independent Observer of EU ETS Carbon Emissions Allowances Auctions

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