

Independent Observer's Report on the conduct of the EU ETS Carbon Emissions Allowances Auction on 5 November 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 five auctions since the new Scheme was introduced has risen considerably compared to earlier auctions.

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. Six took part in this auction both on own account and on behalf of clients.

The proportion of units allocated to Indirect Bidders reached an all-time high of 70% at the previous auction and remained at this level for this auction.

% allocation	5 Nov 2009	8 Oct 2009	10 Sept 2009	9 July 2009	4 Jun 2009	24 Mar 2009	19 Nov 2008
Indirect Bidders	70%	70%	46%	39%	58%	60%	24%
Primary Participants	30%	30%	54%	61%	42%	40%	76%

The Auction

The Independent Observer was present at and observed the auction at the DMO's offices on 5 November 2009 from 8am to 10am. Figures in brackets below are the comparative figures from the sixth auction on 8 October 2009.

There were 26 (52) successful bids for 4.2 million (4.2 million) EUAs (EU carbon allowances) at or above the clearing price of €14.20 (€13.36). The average size of successful bids increased markedly from 80,770 allowances to 161,520 allowances. This is principally because of a number of larger successful bids from Indirect Bidders which increased the average size of successful bid from Indirect Bidders from 69,640 allowances to 155,200 allowances.

The total number of allowances for which bids were received was 18,610,000 (13,883,000) so the bid cover ratio was 4.43 (3.31). The increase in the cover ratio, from the lower level of the previous auction towards the higher levels reached earlier this year, is positive. 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 16.8%.

The total proceeds from the auction were €59,632,616 or £53.5 million @ £0.8972 (€56,110,998 or £51.7 million @ £0.9208) 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)	€14.25	€14.23	€14.24
Approximate weighted average of trades during auction bidding window	€14.24	€14.22	€14.25
After the end of the auction (10:00am)	€14.22	€14.20	€14.23
Auction clearing price as a discount to weighted average of trades during auction		0.1%	0.4%

A small discount to the secondary market is to be expected. After an increase in the previous auction, the discount was once again satisfactorily small.

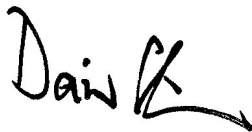
One telephone bid was received and entered by DMO staff and an email acknowledgement sent to the bidder.

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 seventh 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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