

## **Independent Observer's Report on the conduct of the EU ETS Carbon Emissions Allowances Auction on 7 January 2010**

### **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.

### **Non-competitive Bidding**

In this auction a facility for non-competitive bidding was introduced for the first time. The non-competitive element is aimed at smaller emitters of carbon, who only need to buy a few allowances, may not have a trading relationship with a Primary Participant and/or who may be willing to accept a clearing price set by the wider market. Although all EU ETS operators are able to access the non-competitive auction, each greenhouse gas (GHG) permit holder can only make one bid for up to 10,000 EU Allowances per auction, per GHG permit that they hold.

DECC issued a comprehensive guide to non-competitive bidding in November 2009 which contains all the information a bidder should need. DECC has appointed Computershare Investor Services (Computershare) as the Administrator of the non-competitive part of the auctions. Bidders are required to register with Computershare and to pay a deposit. The deposit is set slightly above the expected value of the allowances to be bid for to allow for possible upward price movement in the period between bid submission and auction close. Payments may be in euro or sterling. After deducting the cost of allowances awarded, any surplus funds are returned to the bidder.

The Independent Observer reviewed the proposed non-competitive bidding procedures before the auction with DMO and Computershare and is satisfied that they are appropriate and that they have been well explained to prospective bidders.

## **Before the Auction**

The Independent Observer noted that the price of EUA carbon credits in the secondary market had fallen from around €14.22 in November at the time of the last auction to around €12.17 at the time of this auction. This is in line with a general decline in carbon prices following the Copenhagen summit.

It should also be noted that the auction took place during unusually cold and snowy weather and before the auction there was some concern that participation might be reduced. However, DMO made sensible arrangements to ensure its staff were present at all times during the auction. Although because of the weather one Primary Participant bid by telephone, all other bidders took part electronically as usual. The Independent Observer was impressed that the auction was carried out so successfully in these difficult circumstances.

Apart from the non-competitive element, the administrative arrangements for the auction were unchanged from previous auctions with DMO responsible for the conduct of the auction.

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.

## **The Auction**

The Independent Observer was present at and observed the auction at the DMO's offices on 7 January 2010 from 8am to 10am. Figures in brackets below are the comparative figures from the seventh auction on 5 November 2009.

13,201 allowances were bid for non-competitively and were awarded in full.

There were 26 (26) successful competitive bids for 4.9 million (4.2 million) EUAs (EU carbon allowances) at or above the clearing price of €12.15 (€14.20). The average size of successful competitive bids increased again, this time from 161,520 allowances to 187,950 allowances. On this occasion the increase was principally because of a small number of larger successful bids from Primary Participants; the average size of successful bid from Primary Participants increased from 178,686 allowances to 424,607 allowances.

The total number of allowances for which bids were received was 24,168,201 including non-competitive bids. The total excluding non-competitive bids was 24,155,000 (18,610,000) so the bid cover ratio was 4.93 (4.43). The cover ratio remains encouragingly high. 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 and was again not triggered in this auction.

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 81.5%.

The total proceeds from the auction were €59,534,405 or £53.6 million @ £0.9007 (€59,632,616 or £53.5 million @ £0.8972) before discounts to Primary Participants in respect of successful indirect bidder allocations. This figure includes non-competitive bids for 3,201 allowances made in sterling converted into euro. Since the fourth auction in July the supply of carbon allowances in the UK has been subject to a zero-rate of VAT.

The proportion of units allocated to Indirect Bidders reached an all-time high of 70% at the previous two auctions but reduced back to a lower level for this auction.

% allocation	7 Jan 2010	5 Nov 2009	8 Oct 2009	10 Sept 2009	9 July 2009	4 Jun 2009	24 Mar 2009
Indirect Bidders	39%	70%	70%	46%	39%	58%	60%
Primary Participants	61%	30%	30%	54%	61%	42%	40%

The ECX ICE futures market remains the most liquid secondary market in carbon trading. The prices of secondary futures trades (Dec 10 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 10 Futures	Adjusted to spot price	BlueNext spot EUA contract
Before the start of the auction (08:00am)	€12.50	€12.27	€12.13
Approximate weighted average of trades during auction bidding window	€12.40	€12.17	€12.21
After the end of the auction (10:00am)	€12.43	€12.20	€12.22
Auction clearing price as a discount to weighted average of trades during auction		0.2%	0.5%

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

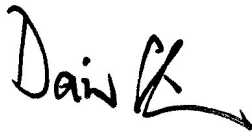
One bid set was received by telephone, entered by DMO staff and an email acknowledgement sent to the bidder. The bid set was then amended by the bidder and the revised figures were re-input and re-acknowledged (bidders are entitled to change bids at any time before the auction closes).

## 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 eighth 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

**Evolve Business Consultancy**

The Independent Observer of EU ETS Carbon Emissions Allowances Auctions

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