

Draft Outline Auctioning Regulation

Stakeholder meeting
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The objectives, Art. 10(4)

- Adopt a Commission Regulation on the timing, administration and other aspects of auctioning
- Aim is to ensure that auctions are:
 - Open
 - Transparent
 - Harmonised
 - Non-discriminatory
 - Predictable auction calendar
 - Cost-efficient avoiding undue administrative costs
 - Equal access to information
 - Access to SMEs covered by the ETS and small emitters

Key features (1)

- Centralised approach
- Exchange-based auction platform
- Spot and/or 'spot futures' only
- Payment, delivery and collateral management: clearing house and/or settlement system
- Seller acting on behalf of Member States
- Competitive dialogue selection process for:
 - auction platform,
 - payment / delivery / collateral infrastructure
 - auction monitor

Key features (2)

- Rolling auction calendar with at least 3 / 1 year(s) predictability
- Specific auction participation requirements
- Access to SMEs and small emitters
- Minimum pre-registration requirements

Key features (3)

- Information disclosure / language regime
- Auction monitor
- Auction fees
- Aviation
- Decision making process / Member State involvement
- Review of Regulation

Auction platform / Clearing house / Auction monitor

- Auction platform = a **regulated market** (RM) or a **multi-lateral trading facility** (MTF) regulated under MiFID and/or MAD
- Payment, delivery and collateral management subject to clearing through a **clearing house** acting as **central counterparty** or a **settlement system** acting as **agent**
- **Auction monitor** selected through the same procedure as the auction platform and clearing house / settlement system

Competitive dialogue tendering process (1)

- Notice to enter into dialogue published in the EC Official Journal (OJ)
- Requests to take part in dialogue submitted
- Assessment of requests (mainly exclusion and selection criteria)
- Invitation to take part in dialogue – option of site visits
- Choice of one or more solutions
- Invitation to tender and specifications to selected candidates
- Submission / opening of tenders
- Evaluation of tenders (mainly award criteria)

Competitive dialogue tender process (2)

- Appointment decision – standstill period – appointment confirmed
- Publication of appointment decision including terms and conditions of appointment in OJ
- Commission conducts process in close co-operation with Member States through Climate Change Committee.
- Member States:
 - Endorse all documents sent out by Commission
 - Receive copies of all documents submitted to Commission
 - Endorse evaluation decisions by Commission

Competitive dialogue tender process (3)

- Participate in competitive dialogues
- Endorse final appointment decision by Commission
- Confidentiality obligations / systems to control compliance / consequences of breach
- Appointment for 5 years.
- Selection procedure to be repeated, taking account of periodic review of Regulation.
 - Commission may adopt other selection procedures by analogy if competitive dialogue no longer necessary to identify appropriate tender specifications.

**European
Commission**

**TENDER
NOTICE** OJ

- To all potentially interested economic operators
- Specify needs & requirements
- Cannot be modified later

min 37 working days

**Invitation to
DIALOGUE**

- Application to take part in the dialogue
- Followed by assessment (exclusion & selection criteria)
- Non-discriminatory & best value for money

sent to at least 3 candidates

DIALOGUE(S)

- Discuss with each qualified candidate every aspect of the tender
- Followed by a choice of solution(s)
- Written record

Invitation to TENDER

- Technical Specifications
- Deadline to submit tenders

AWARD DECISION

- Evaluation of award criteria

Tender documents consist of:

- Invitation to tender
- Specifications
- Model Appointment Decision

min 14 working days standstill

**APPOINTMENT
DECISION**

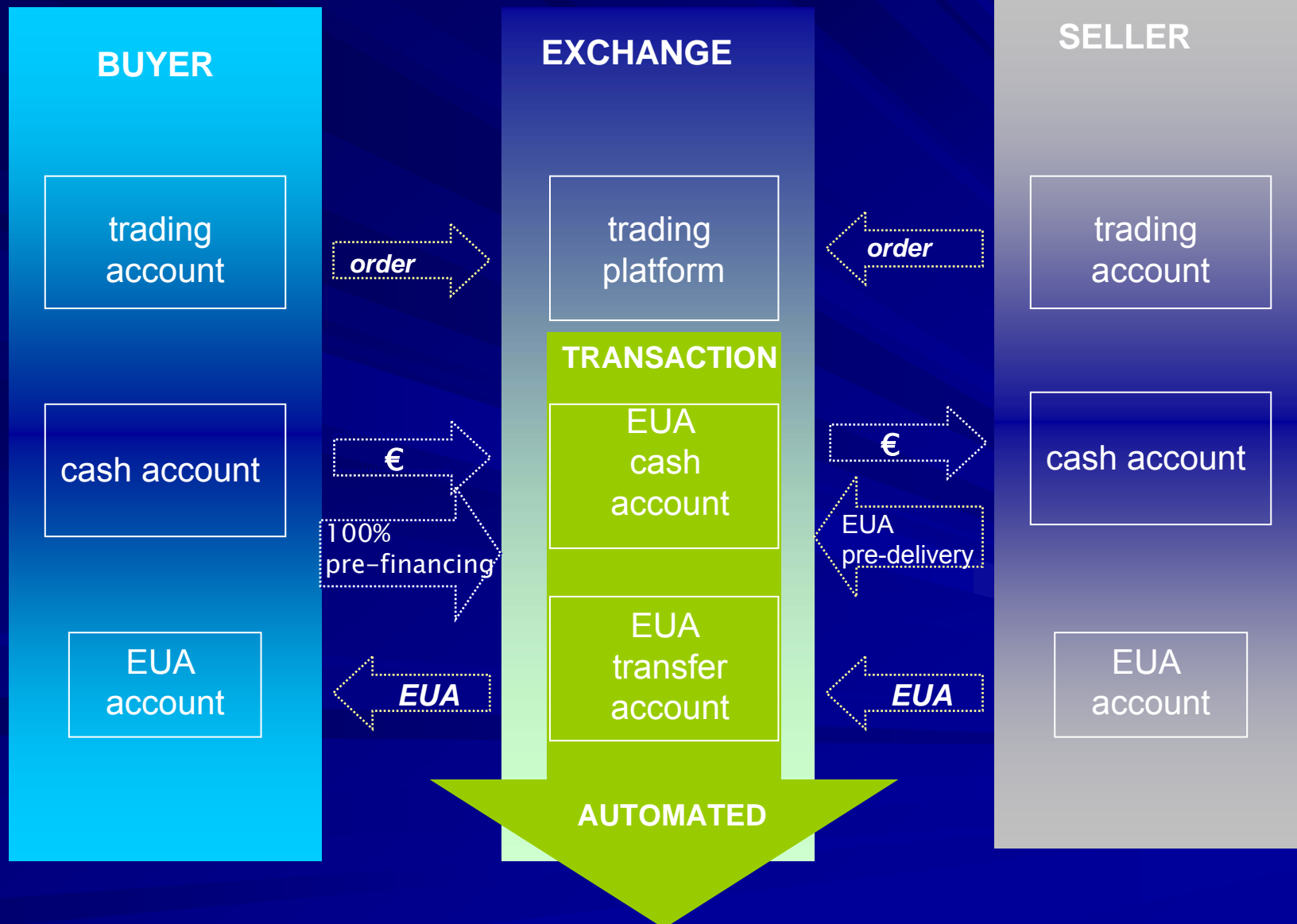
max 48 working days

**AWARD
NOTICE** OJ

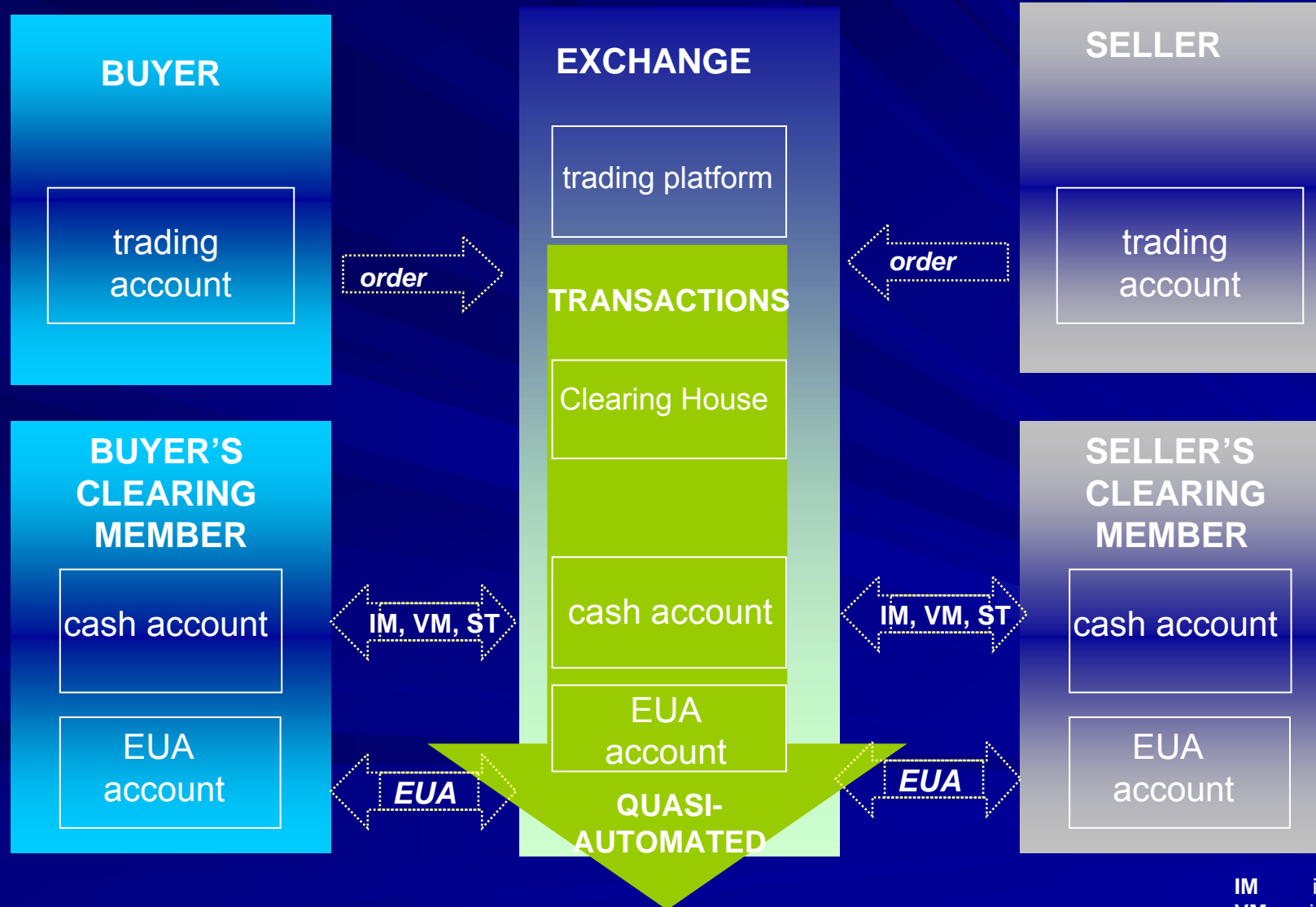
Tentative time schedule

- Terms of reference to be decided in parallel with the Regulation to be adopted in June 2010.
- Deadline for submission of offers: July/August 2010.
- Selection process (assuming 10 offers) may be expected to take 3 to 6 months.
- Climate Change Committee endorses February/March 2011.
- Commission adopts appointment decision.
- Appointment confirmed March/April 2011.
- Auctions could begin 4th quarter 2011 or soon thereafter allowing time for set up, training etc.
- Adopting a roll out programme across the EU rather than a big bang approach could make early start of auctions easier.

2ndry market SPOT delivery versus payment settlement process



2ndry market FUTURES payment before delivery clearing process



IM initial margin
VM variation margin
ST settlement

Auctioned allowances (1)

- “Strictly spot” or “spot futures”: choice to be made in competitive dialogue tender process
- “Spot futures” = financial instruments under Annex I Section C (7) of MiFID if:
 - Traded on an RM / MTF
 - Cleared by a clearing house or central counterparty or margined
 - Standardised re price, lot size, delivery date – info publicly available
 - Allowances are physically delivered no earlier than 2 trading days and no later than 4 trading days following the auction date(See Article 38 of Commission Regulation 1287/2006)
- Auctioning of “spot futures” means that MiFID / MAD market supervision rules apply to auction transactions / auctioned allowances

Auctioned allowances (2)

■ “Strictly spot” =

- Traded on MTFs only
- Not cleared by a clearing house acting as counterparty but settled through a settlement system
- Standardised re price, lot size, delivery date – info publicly available
- Physically delivered no later than 1 trading day following the auction date

Auctioned allowances (3)

- Advantages of “**strictly spot**” over “**spot futures**”:
 - No involvement of clearing house, no **clearing fees**.
Vice versa in case of “spot futures”
 - Earlier delivery – even immediate **delivery versus payment** shortly after publication of auction results –
c.f. to **payment before delivery** in “spot futures”
 - Direct access for SMEs and small emitters – bidders need only pre-register with auction platform / have a cash account and registry account for settlement c.f. to indirect access for SMEs and small emitters

Auctioned allowances (4)

- Disadvantages of “**strictly spot**” compared to “**spot futures**”:
 - Not a financial instrument traded on RMs but a commodity traded on MTFs - so MAD provisions do not apply / different supervisory regime under MiFID / *vice versa* in case of “spot futures”
 - Normally no clearing house acting as **counterparty payment risk taker** – to mitigate risk bidder must pre-finance by putting up **100% cash collateral** with settlement system that acts as agent c.f. to **10-20% initial margin** for spot futures

Auctioned allowances (5)

disadvantages of auctioning futures

- More complex than auctioning spot, restricted access due to need for margining, particularly problematic for SMEs and small emitters
- (much) stronger impact on the secondary market as trade in the auctioned product is 'locked in' until its maturity
 - If fungible product: greatest impact. If non-fungible product: carving up the secondary market
- Liquidity in spot market not increased until maturity
- Product specification may not be suitable for all. No immediacy: not possible to buy in an auction and buy a fuel future at the same time ('spread trading')
- Reduced participation – higher risk of market abuse
- Cost of carry: potentially high cost for Member States

Auction calendar (1)

- Weekly auctions of equal distribution, but
 - ½ volumes in August
 - no auctions 2 weeks over Xmas
- Time slot 9:00 to 11:00hrs on Wednesday of each week except if public holiday for the auction platform
- *Force majeure* – cancel auction and spread volume over next four auctions

Auction calendar (2)

- Minimum 3-year predictability for indicative/provisional annual volumes
 - So volumes for 2015 to be determined by 1 January 2012
 - Indicative because precise volumes depend on intervening events e.g. closures
- Minimum 1-year predictability for detailed/definitive annual volumes and auction dates
 - So detailed calendar for 2013 to be determined by 1 January 2012
- Calendar to be determined by Commission in consultation with Member States, auction platform and auction monitor

Auction calendar (3)

getting started – early auctions

- Indicative 2012 volume and, if any, definitive 2011 volume to be determined within 3 months of adoption of the Regulation
- If any, 2011 auctions, would be conducted under transitional provisions.
 - Potentially based on limited number of Member States willing to auction futures through an existing auction process that is capable of auctioning futures for delivery by December 2013 :
 - Prior notification of auction process to the Commission mid-2010
 - Commission approves auction process 2010-2011
 - Commission approval may be subject to modification, conditions or obligations to ensure compatibility with objectives
 - Possibility for auctioning promissory notes, **under consideration!**
- 2012 definitive volume to be confirmed in appointment decision of the selected auction platform or as soon as possible thereafter

Auction design

- Single-round, sealed-bid, uniform-price auctions
- Tied-bids resolved randomly
- Clearing price
- Lot size = max 500 tons per lot
- *Force majeure* = cancellation of auctions in certain pre-defined circumstances e.g. abnormally low clearing price, technical failure, unforeseen circumstances
 - Volume spread over the following 4 auctions
- Option to introduce maximum bid size per bidder if necessary and effective

Auction participants (1)

- Seller(s) acting on behalf of Member States appointed by individual or groups of Member States in accordance with a single standard pro-forma terms of appointment approved by Commission and endorsed by Climate Change Committee
- Terms of appointment must be compatible with EU ETS Directive / Regulation / appointment decision
- In particular, need to avoid conflicts of interest, insider dealing, market manipulation

Auction participants (2)

- Buyers bidding for the allowances =
 - Must be established in the EU
 - EU ETS operator a/c holders bidding on own account
 - **Credit / financial institutions** covered by the **AML** bidding on own account or on behalf of clients e.g. banks / investment firms
 - Clients must be either EU ETS operator account holders or credit / financial institutions subject to AML or authorised **non-financial commodity traders** covered by “**ancillary activity**” exemption in Article 2 (i) of MiFID

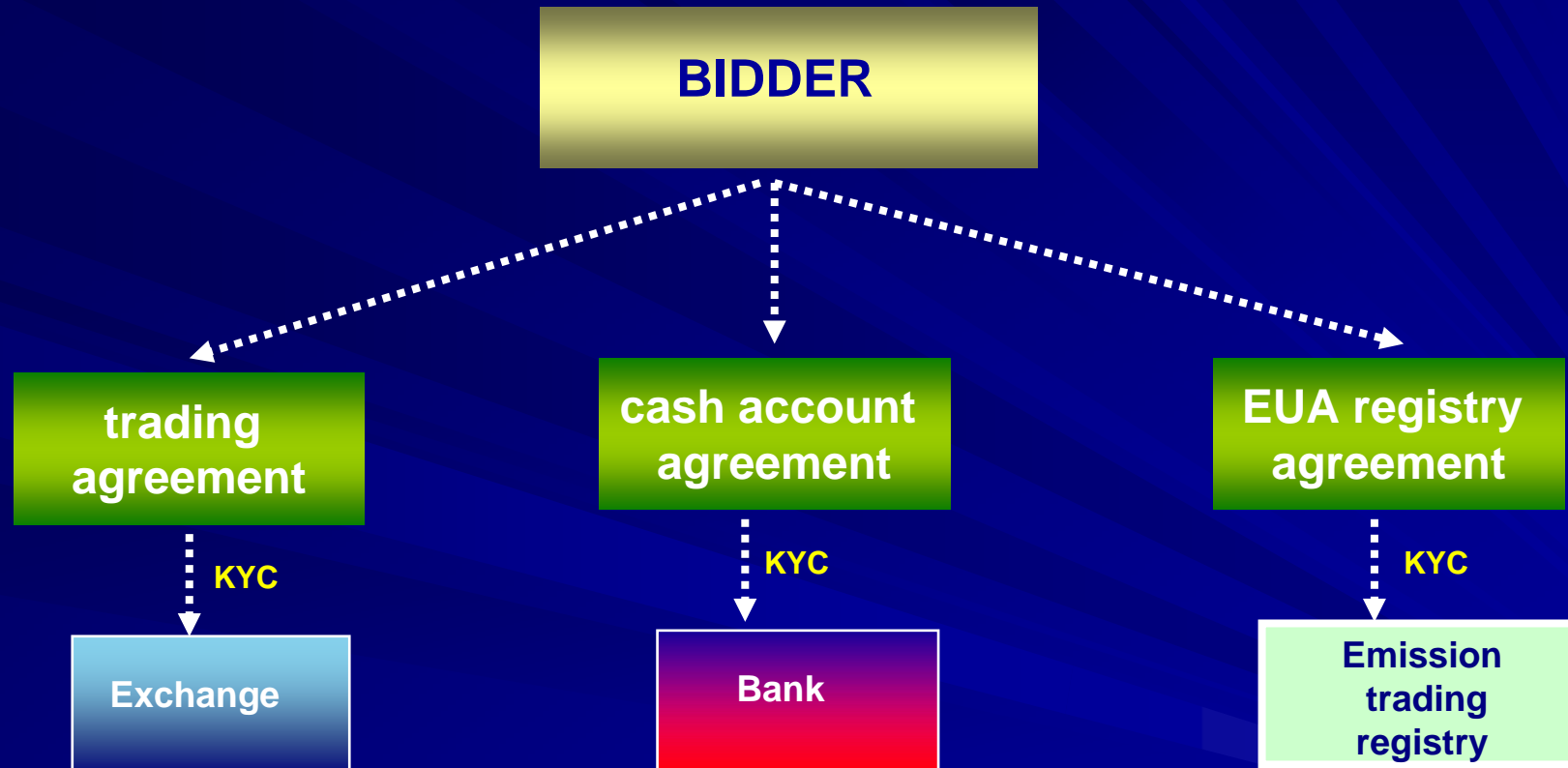
Auction participants (3)

- **Non-financial commodity traders** e.g. oil and gas traders covered by the “**ancillary activity**” exemption in Article 2 (i) of MiFID provided that they:
 - are entities regulated by law, regulatory provisions in the Member States
 - provide intermediated access to the auctions to clients of their main business
 - are authorised to do so by competent authorities of the Member States
 - authorisation is conditional on:
 - fulfilment of investor protection measures comparable to Chapter 2 Section 2 MiFID
 - having systems and controls in place to ensure compliance with AML / protection against fraud

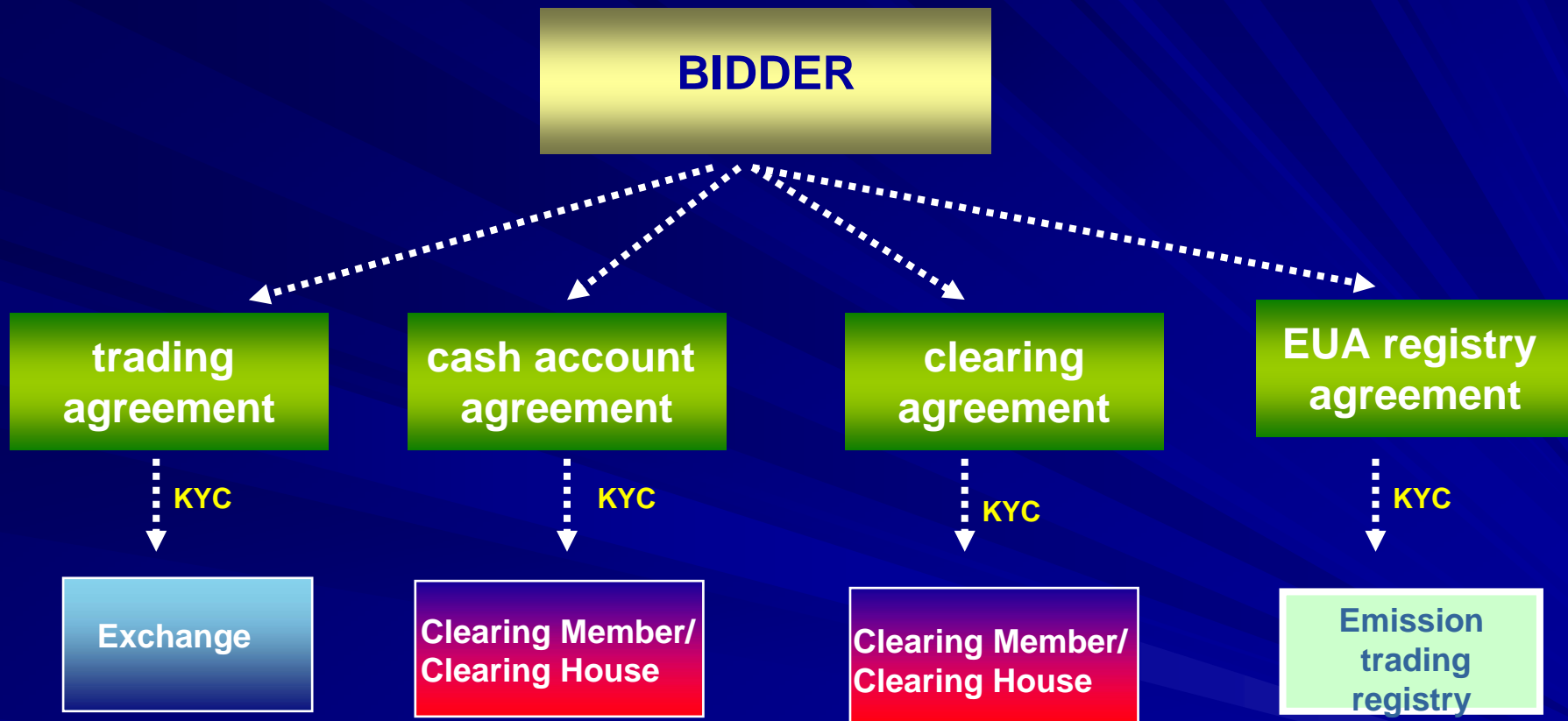
Auction participants (4)

- Option for Commission to add other categories of bidders including bidders not established in the EU subject to appropriate guarantees regarding integrity of the European carbon market from financial crime:
 - On an interim basis in appointment decisions of auction platform and clearing house / settlement system
 - To be confirmed in the Regulation upon its periodic review

SPOT membership process



FUTURES membership process



Participation requirements (1)

- Regulation could provide for certain minimum pre-registration requirements subject to modification in the appointment decision: auction platform / clearing house / settlement system could go further if necessary on a risk-based approach basis
- Seller(s) – appointed by Member States in consultation with candidate auction platform and clearing house or settlement system
- Before its appointment, the seller must
 - Pre-register with auction platform
 - Have an agreement with clearing house / settlement system

Participation requirements (2)

■ Buyer –

- if bidding on own account, direct bidders need to pre-register with auction platform, enter into clearing agreement with clearing house or settlement system, hold a registry account
- if bidding on behalf of client direct bidder must in addition:
 - disclose to auction platform identity of client and place of establishment in the EU,
 - certify that client is beneficial owner and if not disclose intervening clients and ultimate beneficial owner,
 - show that client is EU ETS operator a/c holder, credit/financial institution covered by AML, and/or an authorised non-financial commodities trader

Participation requirements (3)

- Web-based pre-registration backed by paper trail of supporting documents. Option of face-to-face interview / site visit if necessary

Payment, delivery and collateral (1)

- Minimum requirements in the Regulation
- Terms agreed in appointment decision of the clearing house / settlement system based on value for money evaluation
- Payment to be made by bidders before or upon delivery at the latest
- Pending payment, bidders must pay **collateral** to clearing house or settlement system in accordance with rules agreed in the appointment decision

Payment, delivery and collateral (2)

- All collateral covered by the Financial Collateral Directive may be accepted by the clearing house or settlement system at their discretion – i.e. collateral is protected in the event of insolvency
- Level of collateral accepted by clearing house or settlement system is at their discretion but modalities must be specified in the Commission's appointment decision / auction rule book

Payment, delivery and collateral (3)

- Protection against insolvency in the Settlement Finality Directive does not apply to auction payment and delivery instructions because physically delivered allowances \neq financial instruments
- Therefore, need to define **settlement finality** in the Commission's appointment decision appointing clearing house / settlement system + contractually in clearing / settlement agreement(s) with seller(s) / bidders

Payment, delivery and collateral (4)

- Regulation may require Member States to remove national obstacles regarding acceptance of EUAs as collateral from bidders admitted to the auctions – **under consideration!**
- For **early futures auction** – **initial** and **variation margin** would apply both to auctioning Member States and winning bidders
- For **spot futures** - only collateral taken from Member States is delivery of EUAs into a blocked account with the clearing house / settlement system
- Central Administrator of Single Community Registry is responsible for issuance of the EUAs

Consequences of default (1)

- In case of payment default – clearing house / settlement system steps in and pays Member States' seller in place of the defaulting bidders
- In case of **repeated payment default** auction platform / clearing house / settlement system could:
 - Suspend / withdraw auction participation and/or connectivity to auction platform
 - Suspend / terminate clearing / settlement agreement
 - Impose penalties etc

in accordance with market conduct rules,
clearing / settlement agreements

Consequences of default (2)

- In case of **delivery default** – bidder may either request refund of collateral plus interest or agree to take postponed delivery of allowances at a later date at auction clearing price
- Clearing house / settlement system have no other liability exposure to bidders – i.e. no financial liability, **under consideration!**

Access to SMEs and small emitters (1)

- Whatever the auction platform, auctioned product, payment and delivery infrastructure, SMEs covered by the EU ETS and small emitters may access auctions in 3 ways:
 - Direct access to auction platform and clearing house or settlement system
 - Pre-registration with auction platform, registry and clearing house / settlement system
 - Direct access to auction platform only, payment/delivery through intermediaries e.g. clearing members or so-called order-routers
 - Pre-registration with clearing member, but no pre-registration with auction platform, clearing house or settlement system
 - Or outsource participation in entire auction process to an intermediary trader
 - procuring its trading expertise for a fee, allowing for aggregation of demand/reduction of market price exposure

Access to SMEs and small emitters (2)

- Full direct access = multiple participation costs / fees borne by individual SME / small emitter alone. Likely to be disproportionate to volume of allocation being sought
- Partial direct access = can trade directly through web-based platform whilst benefiting from reduced costs due to efficiencies gained from aggregating relatively small demand with others
- Outsourcing access = SME / small emitter may outsource auction participation entirely to an intermediary who participates in the auctions on its behalf

Access to SMEs and small emitters (3)

- Aggregating / outsourcing demand =
 - Enter into one agreement with intermediary plus another agreement to open a registry account
 - Pay a single fee to intermediary plus registry account fees
 - Payment can be made through the SEPA payment system
 - no need to open cash a/c with clearing house / settlement system
 - Efficiency gains from aggregation of demand
 - Cost/fees proportionate to volume of allocation being sought
 - When outsourcing can buy-in intermediary's trading expertise, reduce market price exposure, save time and effort reducing compliance costs

Access to SMEs and small emitters (4)

- To be pre-selected for competitive dialogue: auction platform / clearing house / settlement system must demonstrate:
 - Either, all options are equally available to EU ETS SMEs and small emitters as for any other bidder
 - Or, full direct access is available to EU ETS SMEs and small emitters as for any other bidder on a fair and equitable basis

Access to SMEs and small emitters (5)

- Access to SMEs and small emitters provided without creating:
 - preferential pre-registration rules – not necessary given risk-based approach to pre-registration
 - non-competitive auction format – not necessary since uniform-price paid by all bidders

Information disclosure (1)

- Minimum requirements on the timing and content of pre- and post- auction information disclosure in the Regulation
- Precise format to be determined in decision appointing auction platform / auction monitor
- Requirements of auction website and training module to be determined in the decision appointing auction platform / clearing house / settlement system

Information disclosure (2)

- Auction rulebook to be prepared by auction platform / clearing house / settlement system and approved by auction monitor in consultation with Commission
- Language common to international financial markets
- Member States can provide for translation / interpretation in their national languages. Same applies to auction website, training module and auction rulebook

Auction monitor (1)

- Fulfils Member States' reporting obligations under the EU ETS Directive
- Impartiality and independence from the auction platform / clearing house / settlement system / seller (s) / bidders must be assured
- Mandate is irrevocable for its duration to ensure impartiality / independence
- Appropriate conflict of interest provisions

Auction monitor (2)

- Approves auction rulebook / auction website / training module, any other information disclosure
- Reports within one month of the auction on its conduct and results, especially regarding:
 - Compliance with objectives of the EU ETS Directive / provisions of the Regulation
 - Any collusion and/or market abuse
- Monitors / reports on dispute settlements on exchange
- Monitors / reports on compliance with conflict of interest provisions e.g. **Chinese walls**
- Makes recommendations for review of auction organisation, if needed

Auction monitor (3)

- Auction platform / clearing house / settlement system / seller (s) / bidders required to co-operate with and provide access to auction monitor
 - duty of full and frank disclosure / faithful co-operation
- Exchange of confidential information subject to confidentiality undertakings

Auction fees

- No fees for Member States to sell through auctions. Option for deduction of specified auction-related expenses from auction proceeds e.g. auction monitor fees
- Minimum requirements in the Regulation regarding structure of fees for bidders – e.g. registration fees, trading fees, clearing fees etc
- Fees cannot be higher than fees charged in the secondary carbon market but may be lower
- Level of fees to be negotiated in the selection process based on the principle of best value for money

Conflict of interest (1)

- Auction platform / clearing house / settlement system / auction monitor :
 - Prior-declaration of any ties that might compromise impartiality vis-à-vis one another / seller (s) / bidders
 - Proposals for preventing / handling any potential conflicts of interest to be specified in appointment decision
 - Cannot take part in auctions
- Seller - would have privileged access to inside information:
 - Preference in selection to entity not active participant in the secondary carbon market on own account or on behalf of clients
 - Chinese walls to ensure segregation of auction selling activities and secondary carbon market activities
 - Cannot take part in auctions on own account or on behalf of any bidders

Conflict of interest (2)

- Bidders – **Chinese walls** between **own account** and **client account trading activities** – key pre-registration requirement – subject to site visits by auction platform and on-going monitoring by auction monitor
- Advantage of early futures auction / spot futures = financial instrument – MAD rules on insider trading would apply if auction platform is an RM – to be extended to MTFs in due course
- Preference in selection process to auction platforms / financial instruments where prohibition of insider dealing applies, **under consideration!**

Enforcement (1)

■ In case of:

- collusion e.g. bid rigging or price fixing/ market abuse i.e. insider dealing or market manipulation by seller (s) or bidders - EC / national competition rules and MiFID/MAD enforcement rules, exchange market conduct rules would apply
- serious breach of Regulation by sellers (s) or bidders, auction platform may suspend or withdraw auction participation or apply any other market conduct remedies in consultation w auction monitor
- serious breach of Regulation or appointment decision, by auction platform, clearing house, settlement system, auction monitor, Commission may serve notice to comply, if non-compliance persists Commission may terminate appointment

Enforcement (2)

- Fall-back – Commission may appoint replacement on interim basis *via* an accelerated negotiated procedure w/out prior publication of notice until further selection process takes place
- Auction platform under duty to report suspicious trading to competent national authorities under MiFID / MAD **but only if trading in financial instruments** / systems and controls to prevent and detect AML / fraud
- Auction platform will be under same duties vis-à-vis auction monitor and Commission
- Commission may co-operate with competent national authorities in their enforcement activities if needed to preserve the integrity of the EU ETS and/or the European carbon market

Aviation

- Everything is the same except that:
 - Two-monthly auctions: 6 auctions of about 5 million tons of EUAAs spread over the year

Decision making

- All Commission decisions under the Regulation are taken with support of a majority of Member States in Climate Change Committee, except that:
 - Auction calendar is adopted by Commission in consultation w Member States

Review of Regulation

- Regulation will be subject to review circa 2015
- Periodic review may trigger renewal of appointments of auction platform / clearing house / settlement system / auction monitor
- Renewal of appointments shall be subject to going out to market

Centralised, hybrid or co-ordinated approach (1)

- Central approach is most cost efficient:
 - set-up cost, management and maintainance
 - Transaction: competitive procedure – best value for money
 - Cost of pre-registration: single pre-registration (also in hybrid approach), as opposed to multiple pre-registration in co-ordinated approach (otherwise bidder must accept price-risk by accessing only part of the auctions)

Centralised, hybrid or co-ordinated approach (2)

- Central approach is most open and transparent:
 - simplicity. Hybrid approach is complex, though not so much for potential bidders. Under co-ordinated approach bidders have to get familiar with several platforms and/or evaluate which choice may suit best.
- Co-ordinated approach bears highest risk of *de facto* discriminatory rules.
- Central and hybrid approach best mitigate risk of market abuse. Spreading volume and participation over several platforms increases risk of market abuse.

Centralised, hybrid or co-ordinated approach (3)

- With a central and co-ordinated approach, competition between exchanges is limited to the selection procedure, thereafter volume is 'locked in'. With hybrid approach, exchanges continue competing for winning bids.
 - Actual development remains uncertain under all three models: under the co-ordinated approach, the same exchange could be selected several times; under the hybrid approach, winning bids may be concentrated with one single exchange.
 - Time limited appointment and repeating the selection procedure will maintain sufficient level of competition, particularly when auctioning spot or spot futures instead of futures.
 - Fully transparent and open selection procedure is best ensured under the central approach.
- Centralised approach will be understood most easily abroad and (further) strengthens reputation of EU ETS

**YOU CONTROL
CLIMATE CHANGE.**



TURN DOWN. SWITCH OFF. RECYCLE. WALK. CHANGE

Info on the Climate Action and Renewable Energy Package at
http://ec.europa.eu/environment/climat/climate_action.htm