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Auctioning emission allowances: Key issues

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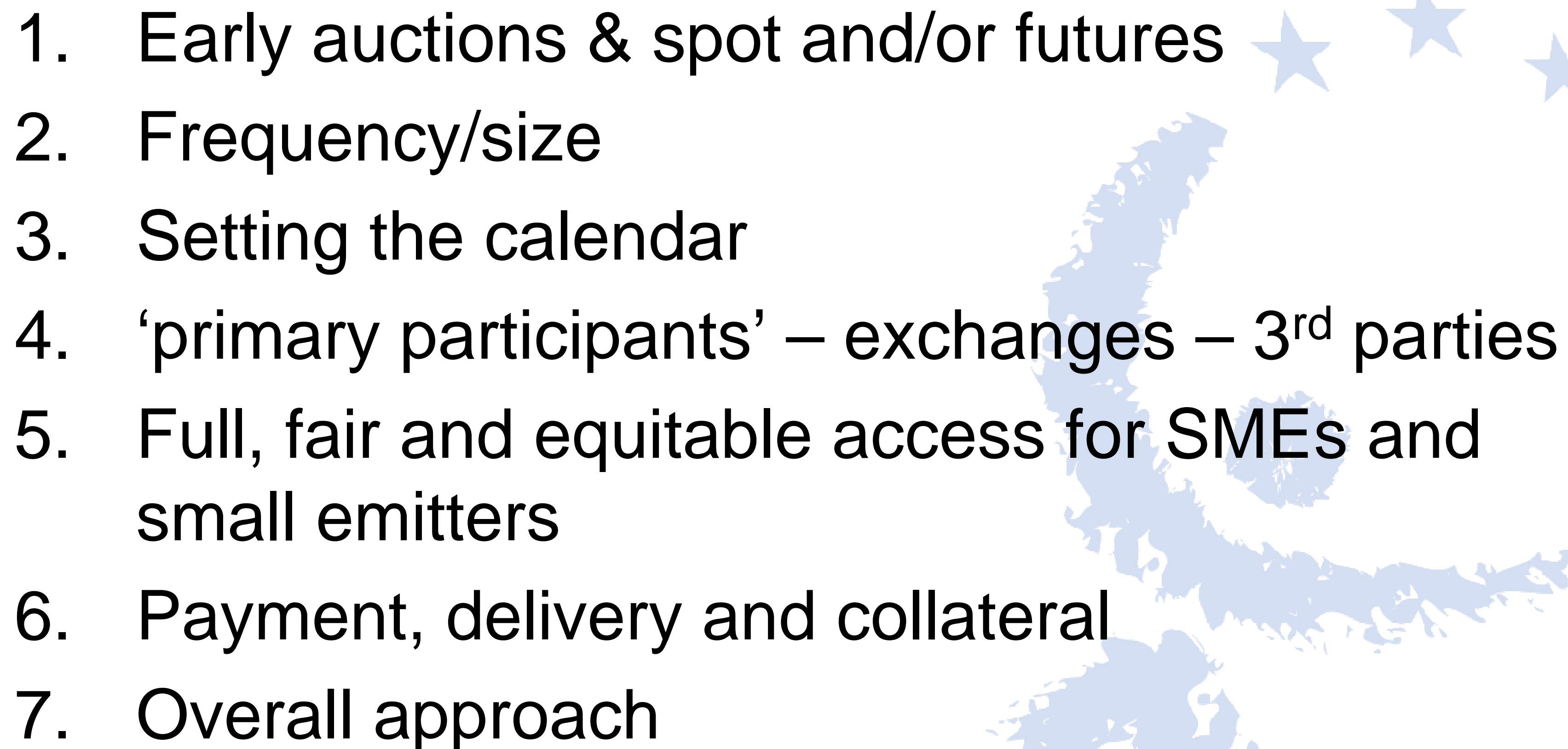
Overview



1. Early auctions & spot and/or futures
2. Frequency/size
3. Setting the calendar
4. ‘primary participants’ – exchanges – 3rd parties
5. Full, fair and equitable access for SMEs and small emitters
6. Payment, delivery and collateral
7. Overall approach

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1.1 The case for futures in the consultation paper

- Meeting the hedging needs of the electricity generators
- At the same time:
  - Hedging needs fully substantiated
  - Futures are fully fungible standardised products
  - Member States do not need to put up margin (be it initial or variation margin) but can put up EUAs in a blocked account

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1.2 Obstacles to the auctioning of futures

- Clearing houses remain flat at the end of the trading day
- EUAs could be used for 10% initial margin but not the variation margin
- Clearing house needs to take cash from the party making a loss and pay to party making a profit upon daily settlement

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1.3 Consequences of the need for variation margin

- Member States will not only bear the cost of funding the delay in payment
- Futures will attract a higher clearing price compared to spot reflecting price differentials in the secondary market
- Member States will have to fund cash variation margin payments being made to bidders if the price goes up

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1.4 Futures from an EU perspective

- Member States with a lower cost of carry than the implicit cost of carry in the secondary market would benefit from auctioning futures
- Member States with a higher cost of carry than the implicit cost of carry in the secondary market would lose out from auctioning futures
- Is this optimal from a total welfare / efficiency perspective?

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1.5 Alternative to futures

- Design an auction product that does not require initial/variation margin payments by the Member States
- Such product already exists: Nordpool forward
- Down side:
  - Whilst standardised less fungible than futures
  - Introducing an additional product into the secondary market – impact on liquidity of other products
  - May need to incentivise exchanges to offer such product
  - Cannot have auctions of the forward product until it is possible to deliver EUAs into a blocked account – 2012?

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1.6 Hedging needs

- Very limited response to request for evidence
- Main hedging by electricity generators: no allocation for free as from 2013
- Some hedge significant shares of output 3 to 4 years in advance. Depends on:
  - ➢ Forward output sales – geographical variation – uncertain demand – uncertainty over transmission capacity - ongoing market liberalisation
  - ➢ Trading strategies and risk profile
    - Use standardised products or tailor-made?
  - ➢ Forward electricity sales with CO_2 indexation?

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1.7 Implicit interest rate

- When auctioning futures, the clearing price would be determined by reference to the secondary market price of comparable futures
- But potential discount of the auction clearing price?
- Carbon price of 24 Sep on ECX: Dec12 = €14.91, Dec09 = € 13.34. This implies an annual interest rate of 3.78%

1.8 Cost of carry – an example

- Anyone wishing to hedge, but having an internal cost of carry below 3.78% will buy spot rather than futures / forwards
  - What is the implicit interest rate on other exchanges and OTC?
  - Need to take into account transaction costs?
  - Impact of early spot auctions on secondary market spot and/or futures prices?
  - What discount for the auction clearing price compared to the secondary market?

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1.9 Technical issues when auctioning futures

- Requires margining and a clearing house
  - De facto restricting access and openness
- Fungibility
  - Futures versus forwards
  - Limited secondary market liquidity on the auctioning exchange?
  - Reducing liquidity for existing products?
- Potential impact on competition
  - Trading of the auctioned futures / forwards is bound to take place on the exchange/clearing house involved

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1.10 Cost of futures to Member States – an example

- Delayed payment:
  - MS A: assuming 5.0% cost of carry, 1 year delay of revenues of 100 million EUAs x €13 **costs** (5.0 -3.78%) x 1.3 bn = about **€15.8 million**
  - MS B: assuming 3.0% cost of carry, 1 year delay of revenues of 100 million EUAs x €13 **generates** (3.78-3.0%) x 1.3 bn = **€10.1 million**
- Margining:
  - Typically 10% initial margin: 100 million EUAs x €13 x 10% = €130 million
  - Variation margin: assuming price increases to €15: 100 mln EUAs x €2 = €200 million
  - Cost for Member State A: (130 + 200 million) x 5% = **€16.5 million**
  - Cost for Member State B: (130 + 200 million) x 3% = **€9.9 million**
- So total cost for one year auctioning for MS A amounts to **€32.3 million**, whereas for MS B it generates **€0.2 million**. Why would MS A be willing to bear this burden?

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1.11 "The market can take care of it"

- Financial markets intermediate between those with low cost of carry and those with high cost of carry – they can react to changing cost of capital
- Why should the Regulation mandate Member States to sell futures / forwards? Regulation lacking in flexibility as cost of carry for Member States evolves over time
- How much 'spot' is needed for a properly functioning secondary market?

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2.1 Frequency/size

- Strong support for high frequency, in particular 'weekly'.
- Key arguments:
  - Minimise impact on secondary markets
  - Avoid nervousness by making it a 'big event'
  - Mitigate risk of market abuse:
    - Anyone can always go to the next auction
    - Repetitive attempts of market abuse are more easily detected
  - Spreading 'price risk'
- Some argue for daily auctions others for monthly

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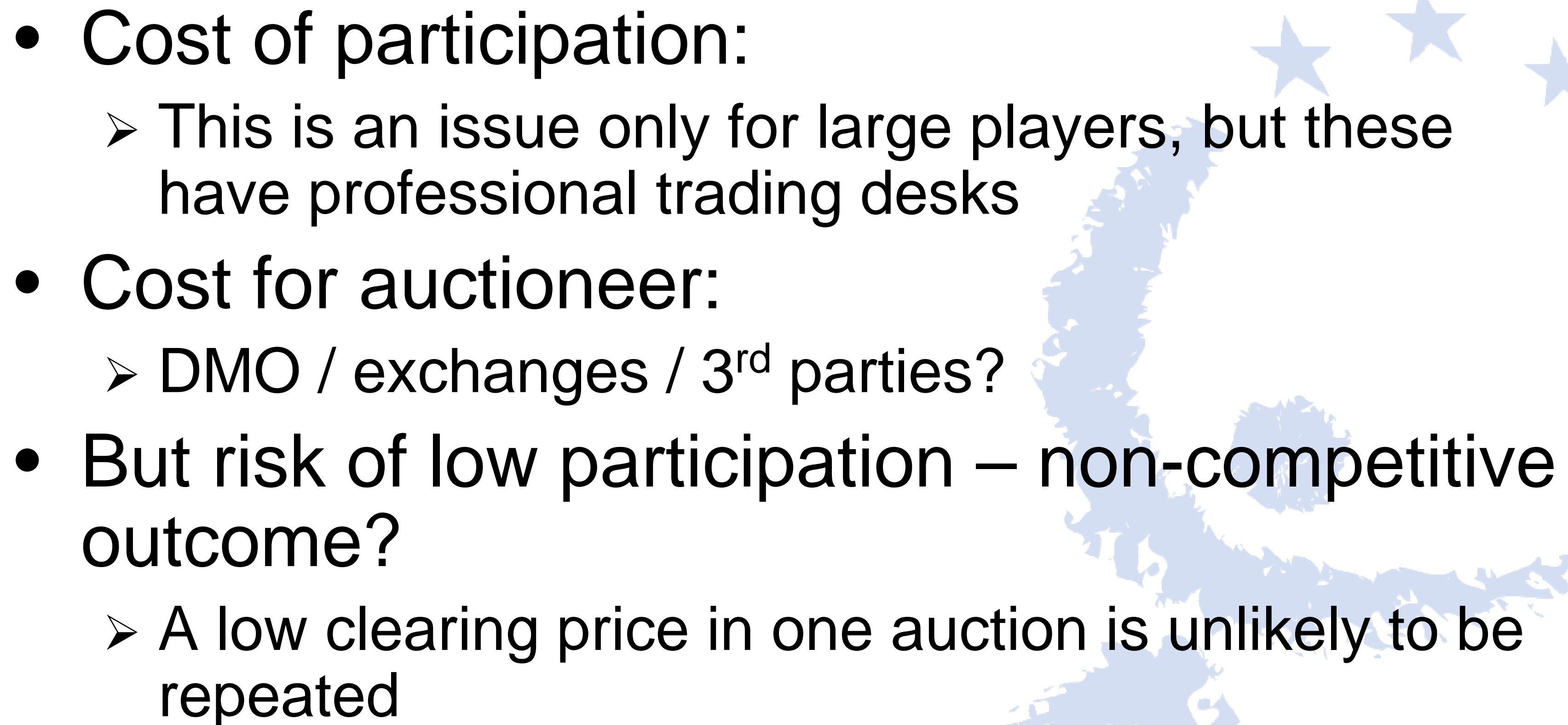
2.2 Counter-arguments



- Cost of participation:
  - This is an issue only for large players, but these have professional trading desks
- Cost for auctioneer:
  - DMO / exchanges / 3rd parties?
- But risk of low participation – non-competitive outcome?
  - A low clearing price in one auction is unlikely to be repeated

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3.1 Auction Calendar

- Strong support for predictability
- Strong support for even spread throughout the year, even for spot. Also when *only* auctioning spot?
  - Significantly lower trading activity during the Summer and Christmas periods
- Strong support 10-12h CET slot. Any views on UK preference for 9-11h CET?

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3.2 Predictability

- Cap established in Directive – free allocation to be determined by 2011
- Art 10(1): publication by 31.12.2010 of estimated amount of allowances to be auctioned.
- Uncertainties:
  - Scope of Directive: new sectors, opt-outs, opt-ins
  - Closures – potential remainder in New Entrants' Reserve
  - Potential free allocation pursuant to Art 10(c)
  - Post-Copenhagen?

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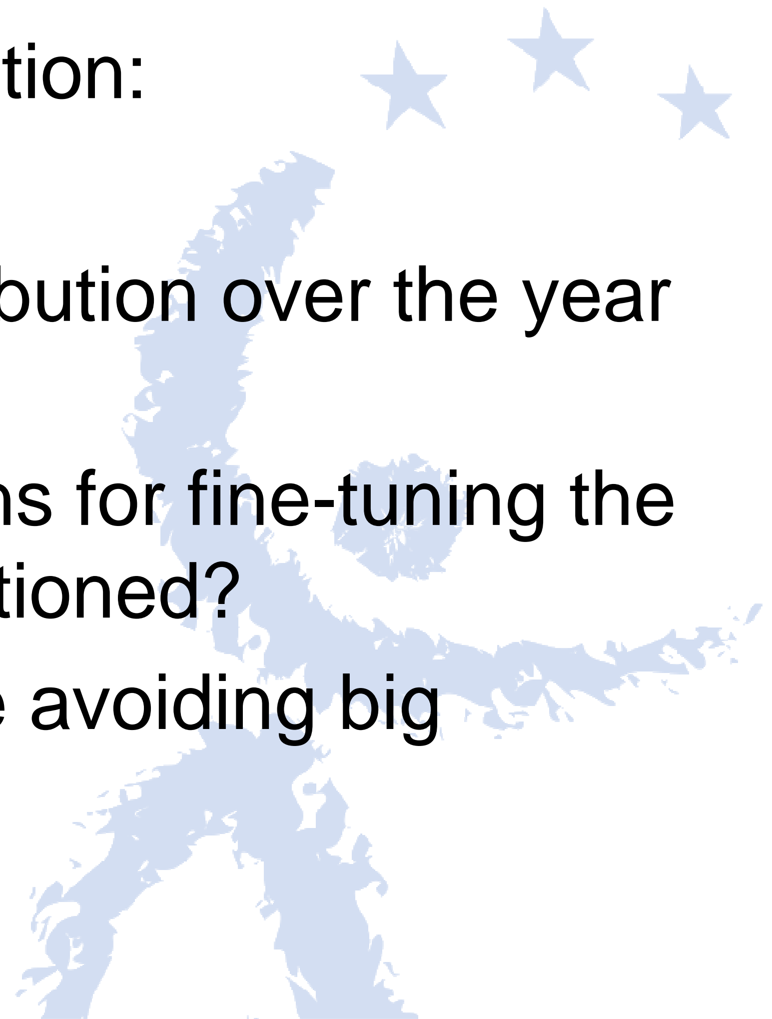
3.3 The Regulation and a regularly extended calendar

To be included in the Regulation:

- Spot/futures/forwards?
- Number of auctions / distribution over the year (including for 2011-2012)?
- Annual volumes / provisions for fine-tuning the precise volumes to be auctioned?
- *Force majeure* rule? (while avoiding big auction volumes)



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3.4 How to set and extend the detailed calendar?

- Depends on overall approach:
  - In case of centralised or hybrid approach: central auctioneer, in consultation, can set the calendar
  - In case of limited number of coordinated platforms: Commission, in consultation, could set the calendar, in line with principles laid down in the Regulation - e.g. principle of allocating dates randomly.
  - If details are left to comitology, the Regulation must provide for a fall back provision in case of disagreement.

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4.1 Costs of the 'primary participants model'

- Limited set-up cost: DMOs have relevant experience, tools and relations with (potential) primary participants
- Cost of indirect bidding: UK pays 5 € cents per winning indirect bid (which is only a share of the total number of winning bids)
- A "public service" option? What should be the appropriate level of transparency?
- Pre-registration costs:
  - For primary participants
  - For indirect bidders:
    - pre-existing clients
    - new clients
  - Any other costs?
    - Only few have direct access
    - Chinese walls?
- Discount of auction clearing price compared to prevailing secondary market price?

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4.2 Cost of auctioning via an exchange

- Limited set-up cost: exchanges have relevant experience, tools and relationship with their members
- Cost of bidding: transaction fees vary, usually € cents per tonne of CO_2 processed through the exchange
- Cost of membership / pre-registration: fees vary,
  - large buyers may already be members of the exchange anyway
  - add cost of an ‘auctioning-only membership’ for others
- Clearing price discount compared to prevailing secondary market price?

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4.3 Cost of 3rd party service providers

- Perceived as potentially costly and time-consuming given its bespoke nature
- But its bespoke nature is potentially its own unique selling point
- With previous models Regulation might have to be drawn around existing market infrastructure / capabilities / market practices
- With 3rd party model it is the other way round
- Emphasis on existing models exhibits a static view of future market developments / potential for interference with market dynamics in the secondary market
- Source of potential competition / new entry from experienced service providers

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4.4 Other aspects

- Who will participate in the auction?
- To what extent does this depend on:
  - ➢auctioning spot and/or futures?
  - ➢auctioning early in 2011 or later on in 2012?

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5.1 Options for SMEs or small emitters

- Participate directly in auction:
  - Does direct access = full, fair and equitable access?
  - Costs of direct access? KYC & trading expertise
  - Benefits of direct access – freedom of choice
- Buy from an intermediary:
  - A financial intermediary whether or not directly participating in the auctions
  - Its electricity, gas or oil supplier, airport manager. Do they need to be MiFID compliant to offer such services or can they do so under the "ancillary activities" exemption?
  - Benefits of intermediation?
    - Buying in trading expertise
    - Simple commodity sourcing solutions
    - Spreading "price risk"
- Buy OTC or at an exchange on the secondary market – might be same price as the auction clearing price minus the uncertainty!

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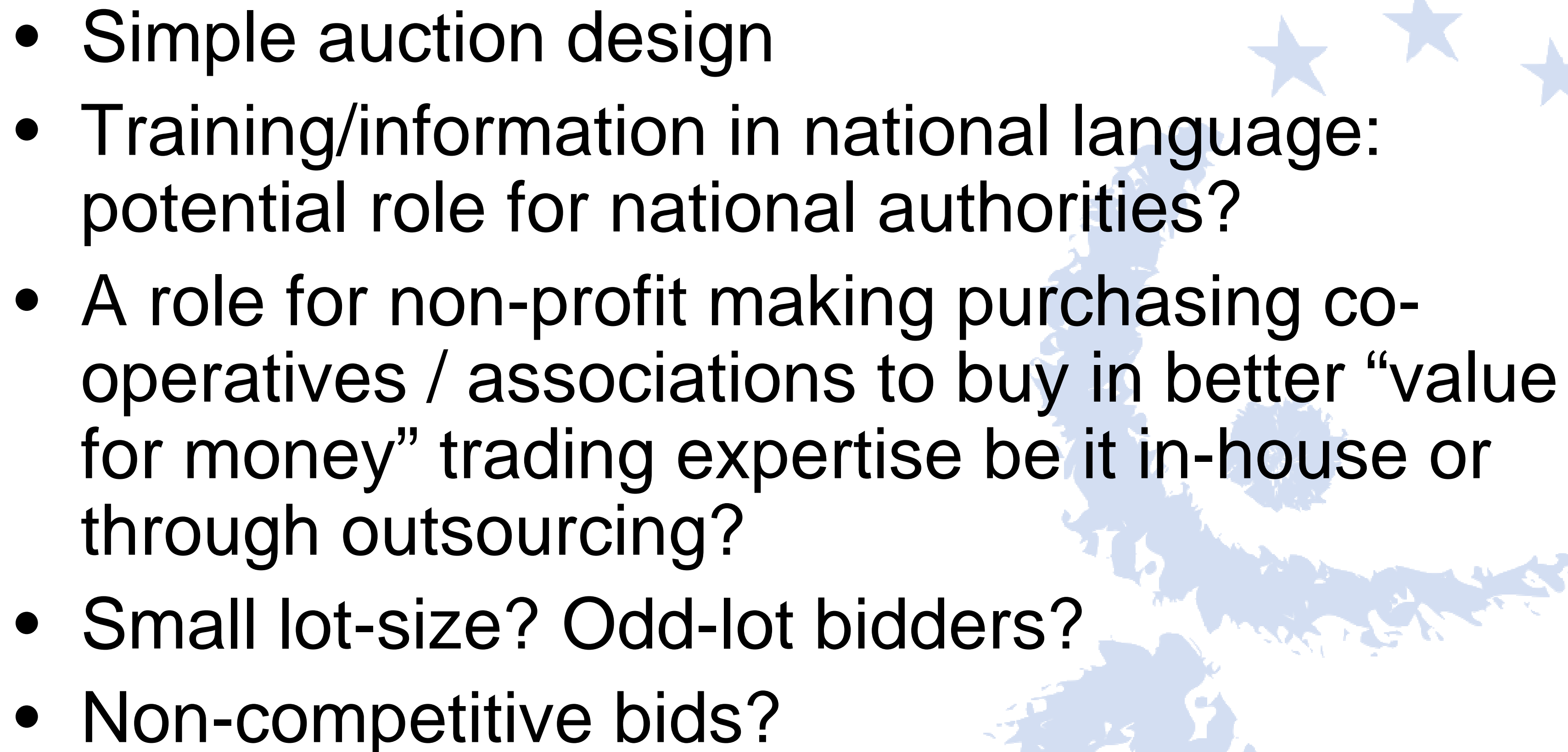
5.2 Facilitating auction participation for SMEs or small emitters



- Simple auction design
- Training/information in national language: potential role for national authorities?
- A role for non-profit making purchasing co-operatives / associations to buy in better “value for money” trading expertise be it in-house or through outsourcing?
- Small lot-size? Odd-lot bidders?
- Non-competitive bids?

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6.1 Payment & delivery, collateral

- Delivery versus payment preferred to payment before delivery – makes sense to mitigate post-auction default risk
- Regulation needs to take account of existing EC financial market legislation i.e., the:
  - Settlement Finality Directive (SFD)
  - Financial Collateral Directive (FCD)
- For futures and/or forwards – no problem as both of these Directives should apply in case of an intervening insolvency

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6.2 More on collateral

- For spot, however, only the FCD applies but not the SFD - yet only a minority of in favour of putting up cash collateral
- Could extend collateral to all financial collateral covered by the FCD and not just cash collateral

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6.3 Even more on collateral

- Exchanges argue that they should decide on level of collateral
- If auctioneer guarantees payment to the Member States then it is not unreasonable for it to decide on collateral
- If auctioneer acts as mere agent for the Member States then Member States must decide on level of collateral in the Regulation
- S/he who bears the risk decides on level / type of acceptable collateral

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7.1 Centralised approach

- By far the most preferred approach for Member States and bidders alike
- Avoids duplication and added complexity of managing an auction calendar with multiple platforms
- Ensures a uniform auction rules allowing for non-discriminatory access regardless of nationality
- Requires a single EU auction monitor – reduces the costs of such monitoring
- Any costs are borne by all Member States pro-rata to their share of the revenue
- Auction revenue belong to Member States and are transferred directly to the Member States without going through the EU budget

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7.2 Timely delivery

- Some doubts persist about delivering a centralised approach in time
- But where there is a will there is always a way forward

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7.3 A hypothetical timetable

- Regulation mandates Commission to select auctioneer / platform through a competitive selection procedure.
- Terms of reference could already be decided in the Regulation to be adopted in June 2010.
- Deadline for submission of offers could be September 2010.
- Selection process (assuming 10 offers) may be expected to take 3 to 6 months.
- Climate Change Committee decides January / February or April / May 2011.
- Appointment could be confirmed as early as May 2011 or by September 2011 at the latest if European Parliament scrutiny is needed.
- Auctions could begin January 2012 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.

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7.4 Transitional measures

- Meanwhile, the Regulation could provide for transitional measures allowing the auctioning of phase 3 allowances through existing phase 2 auction platforms already in 2011, to the extent it may be technically feasible.

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7.5 Hybrid approach

- The second best option in case a centralised approach is not agreed - very much a compromise solution
- EU-wide supply and demand is channeled through a central auction clearing platform
  - Central auction clearing platform takes in bids from local platforms, runs the auction and announces results
  - But does not get involved in pre-registration of bidders, collecting bids, payment, delivery or collateral management
  - One single auction clearing price for one homogeneous product – reduces rules arbitrage between different auction platforms
  - A single auction calendar - obviates the need for managing auction calendar between different platforms

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7.6 Accessing the central auction clearing platform

- Multiple entry points to access the auctions through various auctioneers:
  - DMOs?
  - Exchanges?
  - National or regional platforms?
  - 3rd party service providers?
- So it does not avoid duplication in the costs of setting up multiple local auction platforms
  - But bidders potentially have a choice of platform from which to access all the EUAs being auctioned
  - Provided there is a sufficient range of different platforms serving different client needs - no need to worry about uniform access rules?

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7.7 Relationship between local auctioneers & central platform

- Participating platforms must:
  - Carry out pre-registration of bidders
  - Collect bids and pass them on to the central auction clearing platform
  - Manage collateral, payment & delivery
- The auctioning relationship is between the bidders and the local auctioneers – central auction clearing platform provides a service to the local auctioneers – cost of service?

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7.8 Incentives of the local platforms

- What are the platforms' incentives to participate?
  - Pre-registration of bidders / collecting bids comes at a cost
  - They must connect to central auction clearing platform
  - Why should DMOs take part if they will get a share of the revenue in any case?
  - Why should exchanges invest in face of uncertainty of volumes passing through their exchange?

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7.9 Fair competition between platforms

- Platforms will compete on:
  - Cost of participation – transaction fees
  - Cost of pre-registration – membership
  - KYC: must remain solid – race to the bottom!
- Could exchanges and DMOs co-exist within one hybrid model?
  - Reward for indirect bids in DMO model paid by the HMG
  - Exchanges charge bidders for the use of their facilities
  - Should the fee structure be harmonised?
- Competition between different exchanges:
  - Regulated markets / Multi-lateral trading facility / Others?
  - Convergence over time?
  - Would the system develop towards specialised platforms or would only one or two remain?

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7.10 The co-ordinated approach

- Last and very much the least preferred option
- Duplication and added complexity of managing an auction calendar with multiple platforms that may be coming on-stream at different times
- Diverse auction rules / cost structures promoting arbitrage between platforms
- Potential for *de fact* if not *de jure* discriminatory access rules based on nationality – why should Member States bear the cost of setting up their own platform to auction their allowances to non-nationals?
- *Domino effect* - keeping up with one's neighbours - where to draw the line on the number of platforms?
- Countdown towards delivery unpredictable – no single streamlined delivery timetable possible
- Multiplies the workload / cost of the EU auction monitor

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7.11 Opt-ins & opt-outs

- Some Member States suggest the potential use of opt-ins and/or opt-outs
- Opt-ins – default is national auctions but MSs may opt-into a central EU platform
- Opt-outs – default is central EU platform but MSs may opt-out of it
- Bottom line – central EU platform requires legal certainty re volumes passing through it without which it cannot get off the ground

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http://ec.europa.eu/environment/climat/climate_action.htm