Stakeholder meeting of the European Climate Change Programme (ECCP) Working Group on Emissions trading, Monday 13 December 2010

Auctioning EU Allowances prior to 2013 pursuant article 10(1) of the Auctioning Regulation ('early auctions')

Minutes

1. Introduction

The Commission summarised previous discussions on the question what volume of allowances should be auctioned prior to 2013 ("early auctions"), the way the Auction Regulation addresses the issue, the rationale, the regulatory procedure as well as the main elements to be taken into account for the determination of the volume of early auctions (see power point presentation). The Commission highlighted that the market will continue to evolve over time and the determination of the volume is not an exact science. The Commission invited the participants to give their views on the discussion paper and answer two questions in particular. First, do you agree that all relevant factors for fixing early auction volumes have been determined? If not, what is missing? Second, is the range of 100 to 300 million allowances as potential early auction volume an appropriate basis for further work by the Commission and Member States? All the stakeholders - including those not present at the meeting - were invited to submit their reasoned views by means of the public consultation launched on the topic and open till the 8th of February 2011.

2. Presentation by Mr Turner (Bloomberg New Energy Finance)

Mr Turner confirmed the relevance of the factors mentioned in the Commission's discussion paper. The analysis focused on the year 2012 and was based on the assumption that 300 million of allowances from the New Entrants Reserve in order to support Carbon Capture and Storage (CCS) and renewable energy projects ("NER300") are to be sold or auctioned by the EIB entirely in 2012 and that no early auctions would take place in 2011. On the basis of modelling hedging profiles of four different groups of compliance buyer, he estimated 2012 demand for European Union Allowances (EUAs) stemming from hedging needs and from compliance needs in view of actual 2012 emissions in excess of free allocations at 817 million. On the supply side, the presentation addressed: phase 2 surplus of EUAs held by industry and sold on the market, estimated at 44 million; remainders from phase 2 new entrants reserves (NERs) to be sold/auctioned estimated at 146 million; phase 2 auctions as foreseen under the National Allocation Plans estimated at 96 million; and Certified Emission Reductions (CERs) stemming from projects under the Clean Development Mechanism (CDM) and Emission Reduction Units stemming from Joint-Implementation projects (JI), combined referred to as "international credits", available for ETS operators estimated at 141 million.

The main uncertainties would concern

- the volume of international credits: the overall number to be used in the EU ETS phase 2 was estimated at 611 million;
- the share of the surplus (free allocations minus surrendering needs) held by industry that might be sold on the market. In 2008 and 2009 significant shares of the surplus had been sold in order to raise cash in the midst of the recession. However, in view of

long term fundamentals significantly smaller shares were expected to be sold for 2011 and 2012.

Mr Turner concluded that, in 2012, around 100 million of phase 3 allowances to be auctioned in addition to the NER300 would be necessary to balance demand.

Mr Turner added the following considerations. First, the figures are based on 2012 demand and do not consider the cumulative surplus at the start of 2012 (estimated at 45 million). Second, regarding the risk pertaining to a scenario where the determined volume of early auctions would be too high or too low, he noted that the market has shown more capacity to bank than borrow. Last, he raised the need to look at market conditions in 2013 and 2014, noting that less early auctions would mean more volume sold in 2013 and 2014, which could exacerbate a slightly bearish market in these years and thereby increase volatility.

3. Comments by analysts

Mr Fages (Orbeo) confirmed the share of surplus to be sold to the market as the major source of uncertainty and underlined that industrial operators that hold a surplus still do not know their exact position for phase 3 as the discussion on the level of the benchmarks for free allocation was still ongoing.[1] In addition, he argued that sales are closely related to price and that currently in the market - as a consequence of the experienced price patterns - there seems to be no interest to sell at a carbon price of € 12 and high interest to sell at carbon price of € 16. He raised that these values were not related to the cost of abatement but rather to market perceptions. He estimated that for the period up to and including 2012 the sum of the share of phase 2 surplus held by industry and sold into the market, the remainders from phase 2 NERs to be sold/auctioned, phase 2 planned auctions and available international credits would amount to 500 million. This supply would come in addition to the NER300. He highlighted that due to the low dark and spark spread, forward power sales had decreased very significantly over the past year, resulting in a corresponding fall in demand for allowances for hedging purposes. By mid November 2009, RWE and E-ON, e.g., had sold 40% of their 2011 capacity forward, where this year the same figure in relation to 2012 capacity was zero. Due to low electricity prices and high coal prices, there was no demand from utilities now; the last month where utilities were very active would have been April. The impact of this change in behaviour is strong also because power companies hedge nuclear and low carbon intensity electricity production before carbon intensive electricity production. He estimated hedging needs in 2010, 2011 and 2012 at zero to 50, 300 million and 800 million respectively, so 1.15 billion in total. On this basis, he concluded that for balancing the market, without accounting for any additional emission reduction, the volume for 'early auctions' should be around 300 million. For incentivising additional emission reduction, 200 million could be a more appropriate volume. Finally, he highlighted methodological differences compared to the approach followed by Mr Turner, notably the use of a cumulative approach rather than looking at 2012 in isolation.

Mr Schjølset (Point Carbon) confirmed that the factors referred to in the Commission's discussion paper are the relevant factors; the main outstanding issues concern the assumptions for these factors. He focused the attention on the potential impact of any early auctions on the carbon price. Assuming all 300 million allowances from NER300 coming to the market in 2012, there would be no need for early auctions. In accordance with Point Carbon's model, which is based on a 25% EU target scenario, the carbon price would be € 22 in 2011 and € 25 in 2012. The Commission's impact assessment concerning an increase of the overall

[1] On 15 December, the Climate Change Committee gave a favourable opinion to the draft Decision on the rules for free allocation. The Commission will submit the draft Decision to the European Parliament and the Council for scrutiny and, provided no objections are raised, will adopt the Decision thereafter.

reduction target to 30% gave as a potential surplus of phase 2 allocation to industry above verified emissions in the range of 500 to 800 million. Point Carbon's modelling resulted in a lower figure of some 400 million. He estimated the remainders of phase 2 NERs to be sold/auctioned at the end of phase 2 183 million. This volume would be scattered over many Member States and he stressed the importance of more information on how and when these Member States would sell or auction these allowances. The Commission and the Member States should jointly enhance transparency on the issue as soon as possible.

Mr Tschach (Tschach Solutions) agreed that there is no need for any early auctions. On two specific issues his views deviated from previous speakers. First, he supported Mr Fages' estimate of total hedging needs in 2012 to the amount of 1.1 billion, which is significantly below Mr Turner's estimate and which would be explained by a significant change in hedging behaviour of the power companies. As an example, he mentioned that RWE reduced its hedging profile from 70% to 40% over the last year. All in all, this would result in a figure some 250 million lower than the estimate given by Mr Turner. In any event, hedging needs would not be static and it would be no disaster if demand would not be met, as the utilities would adopt their hedging strategies. Second, he signalled that the amount of international credits available for hedging purpose would be higher than the amount estimated by the others for two reasons. Firstly, at least 150-200 million ERUs from JI projects would be available to the EU ETS operators. Secondly, some 200-250 million of credits to be issued in 2013-2015 in relation to projects already registered in the current trading period would be available for hedging purposes provided that contracts in these credits were listed at the trading places. He expected this to happen soon, as it was also the case prior to the start of the second trading period. As a result, the total amount of credits to be considered available for hedging purpose would amount to some 800-1000 million, i.e. some 300-400 million more than estimated by Mr Turner. This volume would ensure ample supply to the market. On another point, he did not expect industry to hold on to more than 50% of their phase 2 surplus for banking into phase 3. So all in all, he recommended zero early auctions.

Responding to the comments of the panellists, Mr Turner explained firstly, that views on any impact of the cumulative surplus by the beginning of 2012 would depend on the assumptions as regards the efficiency of the market: would the carbon price reflect the fundamentals over time? Secondly, he would see whether an adjustment of his estimated hedging profiles would be appropriate in the light of the changes that would have occurred recently in the companies' behaviour. He noted however that the lower hedging volumes currently being seen in countries such as Germany could be temporary. Thirdly, he found estimates of the share of industrial surplus to be sold raised by the other analysts too optimistic, in particular in the light of a potential shortfall in the middle of phase 3. Finally, he expressed some scepticism about the possibility that 800 million international credits would be contracted prior to 2013.

Mr Tschach expressed the view that the much higher hedging profiles from the past would not return in the next one or two years.

3. Round table discussion

Mr Campbell (BusinessEurope) underlined two priorities: timeliness of having the auction platforms up and running and timeliness of having the registry system up and running. Both would have to be thoroughly tested. He urged to stay on the safe side and to take all appropriate precautionary measures in the procurement (e.g. a penalty clause) as well as a sound risk management plan. Finally, he suggested organising training for the operators, since they would all have to buy allowances during the third trading period. He closed by pointing out that these are personal comments and will be complemented by a written contribution by BusinessEurope.

Dr Macken (Environment Protection Authority, Ireland, expressing his personal views) emphasised the need of having a smooth transition from the second to the third period. He supported Mr Campbell on staying on the safe side, but this would also apply to the need to avoid depressing the market by excessive supply. There is a need to balance a smooth transition to the third trading period with the need of predictability. He underlined the differences in timing: allowances free of charge are allocated before 28 February of a year, whereas auctions would take place throughout the course of the year. He agreed that the range 0-300 million allowances seemed appropriate, though he underlined the desirability of assessing the risks.

Ms Ruiz (IETA) also stressed the importance of the timely implementation of the relevant auctioning and registry infrastructure. She agreed on the identification of the relevant factors for determining the early auctions volumes and she asked for more clarity on the potential impact of different dates for the entry into force of the restriction of credits from certain types of CDM and JI projects as proposed by the Commission and on the form and timing of the 300 million allowances from the NER300 to be sold or auctioned by the EIB. Zero early auctions would not be an option as timely testing of the system would be essential.

Mr Wilson (Eurelectric) asked for more certainty and clarity, especially on the monetization of the NER300 by the EIB and on the implementation of the registry. He also agreed on the importance to use a certain volume of early auctions to test the systems. He agreed that the pattern of forward power sales and corresponding hedging needs had significantly changed over the past year, and noted the difficulty in projecting an exact figure. As regards the 100-300 million allowances range mentioned in the Commission's discussion paper, he said that Eurelectric would not be unhappy if the decision would be at the higher end of the range, rather than the lower. He argued that the risks of "too many" or "too few" are not symmetrical and highlighted that the market has proven to be capable to manage over-supply but under-supply scenario would be a problem. Finally, the decision on the volume of early auctions would only have consequences for the short term and have limited impact on investments based on long term market fundamentals. Mr Wyns (CAN Europe (Climate Action Network)) suggested not to exaggerate the problem of early auctions: industrial sectors would not face any serious shortage even if the benchmarks would be stringent, since the production data on which free allocations are to be based would cover the pre-recession period with highest production ever seen. Therefore, zero early auctions would be the better option. He added that many CDM and JI credits would be used in phase 2 because of the proposed restrictions on the use of credits from certain types of projects to apply as from January 2013. He warned that a lower carbon price resulting from a too large volume of early auctions would also reduce the value of the 300 million allowances in the NER300 programme and thereby reduce the amount available for supporting the development of CCS and renewable energy projects. He concluded that the EU should rather decide to step up its overall reduction target to 30%.

In the discussion that followed, concerns were raised as regards the monetisation of the NER300 allowances by the EIB: would all allowances come to the market in 2012 and how would this be done? Concerns were also raised as regards the timetable of the registry implementation. These uncertainties would make it difficult to evaluate the appropriate volume of early auctions. The Commission clarified that the agreement signed with the EIB ensures inter alia transparency and prior publication on the methods and timing of the monetisation, the respect of the principle to recuperate fair value from the monetization and avoidance of any speculative behaviour. As regards the implementation of the registry the Commission clarified that no further information could be given at this stage. Some concerns were voiced as regards a potentially bearish market in 2013 and 2014 and for that reason the volume of early auctions might better be recouped over a longer period, but the Commission reminded that recouping early auctions in 2013 and 2014 had already been decided in the Auctioning Regulation.

4. Member States' comments

According to the United Kingdom and Germany the (administrative) cost of early auctions should be taken into account as well, in particular in case such early auctions would require the appointment of transitional auction platforms for the auctioning of forwards and futures. Ireland underlined that starting early auctions in the beginning of 2012 would be quite different from starting such auctions in late 2012. Belgium and the Netherlands expressed doubts on the necessity of any early auctions and the latter questioned the risk of not having early auctions. France agreed with early auctions if deemed necessary to provide harmonious transition to phase III and suggested taking a decision as soon as possible in order to allow the market to adapt to that decision.

5. Open discussion

Mr Wyns asked how the market dealt with demand for allowances prior to 2005 and 2008. Mr Tschach agreed to the validity of the question; a major difference would be the free allocation in the first two trading periods, but for the second trading period ample supply of credits from CDM credits were instrumental to balance demand.

According to Mr Turner, the risk of zero early auctions could be in the order of € 2-3 carbon price increase over the part of the year where the market would be unable to meet demand, which could be some 6 months roughly. The price increase would certainly not be expressed in double digits. Mr Tschach and Mr Schjølset agreed on this range; the latter did not expect excessive price volatility given the substantial buffers available. Mr Fages held, however, that a higher price increase would be possible, which would be detrimental to the reputation of the system. A discussion followed on the degree to which supply would respond to any carbon price increase. Mr Fages raised that market dynamics would be influenced by perception and not only fundamentals and that the reaction of the market might not be linear: a price increase beyond a certain level (e.g. € 16) could also trigger an opposite reaction where holders of excess allowances would hoard their allowances in expectation of potential further increase of the price. Mr Turner added that the price level beyond which industry would sell surplus allowances could change over time; currently it could be € 16, but it could be higher in 2012. All analysts agreed that the financial sector would not bridge any gap between supply and demand, as they would not be willing to engage in open positions. Mr Marty (European Federation of Energy Traders), agreed to this latter view as well. He agreed as well on the key elements to be taken into account as listed in the discussion paper and confirmed the significant reduction in hedging activity, though he was not sure this would remain the same in the future. He added that increases of the carbon price would have a knock-on effect on the power market. In contrast, a price decrease would have no impact on the investments since these would be based on long term fundamentals. He stressed the importance of a quick decision on the early auctions volume and of timely implementation of the registry infrastructure and the NER300 monetisation. He raised that restrictions on the use of certain types of credits would spur operators to use these credits as much as possible in the current phase, but 'forcing' operators to use their 'swapping potential' would not be optimal.

Mr Thompson (Oil and Gas Producers association) pleaded for a decision on a single figure rather than a range for early auctions and advised to err on the side of more early auctions rather than less. The decision should be taken as early as possible.

The Commission draw the following conclusions:

- The main factors have been identified, though some uncertainty remains in one way or the other for all of them. Moreover, it is a dynamic context and these factors themselves are influenced by the decision on early auctions.
- The range of 100-300 million tonnes is broadly accepted, while some argue we should consider going lower and have no early auctions at all.
- There is wide consensus on the urgency to take a decision first half next year to allow the market to adjust to the regulatory decision.

The Commission reiterated it was looking forward to receive written contributions.