Tschach Solutions

Adjusting Auctioning Schedules to Reduce Interest Costs for EU-ETS Compliance Companies

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Analyst: Ingo Tschach

Executive Summary

- Regular TP3-auctions are planned to be stretched from January to December for each year
- Allowances will be auctioned spot
- Compliance date for companies under the EU-ETS is 30th April of following year
- Compliance companies have to hold EUAs bought in the auctions between 16 and 4 months
- In January to end of April of year+1, full volume of yearly auctions is held by companies, but not used / required
- The unnecessarily held auctioning volumes are posing significant capital requirements on EU-ETS compliance companies, implying huge interest costs
- While keeping a 12-months-period for auctioning phase-3-allowances, a **shift of the auctioning period** from January to December (of the year for which the auctioning volumes are intended) to May to April (the last 4 months: year+1), i.e. a shift **of 4 months**, would reduce the capital requirements significantly, thus easing the economic burden the EU-ETS places on compliance companies. The shift would **save interest costs of about 500 Mio € per year**
- A shift of the auctioning period by four months would require an amendment of the auctioning regulation. However, the decision on the opt-out auctioning platforms need an amendment anyway, and a shift of the auctioning period could be discussed and adopted together with the opt-out platforms

⇨ **Shifting the auctioning period by 4 month** to align it with the carbon calendar **reduces interest costs** for EU-ETS for compliance companies **by about half a billion Euro per year!**

Introduction

Starting 2013, about half of the entire EU-ETS cap will be auctioned. This is a major shift from current policy, as in the second Trading Period about 95% of the cap is allocated to companies for free. The auctioning process is governed by the Auctioning Regulation, and allowances will be sold spot, i.e. with delivery and payment within a couple of days. While the spot trading is reasonable as it avoids credit risks for the seller, it also imposes significant capital requirements and thus interest costs for compliance companies.

This report is meant to start a discussion about a possible solution to both keep the spot format while at the same time reduce the interest costs for EU-ETS compliance companies.

Legal limits imposed by the Auctioning Regulation

Article 4 calls for auctions in the form of either two-day spot or five-day futures. In Article 8 & Article 32 of the Auctioning Regulation, the text sets tight limits for both timing and volumes of individual auctions.

The relevant restrictions are

- Volumes shall be evenly distributed over the year
- No auction in the two weeks during Christmas and New Year
- In August only 50% of volume compared to other auctions

The current regulation allows for no shifting of volumes within the year and provides a clear frame for the timing of the individual auctions.

The regulation can, however, be changed by adopting amendments. These amendments have to be proposed by the EU-COM and need to be adopted by the Climate Change Committee. After a positive vote of the Climate Change Committee, a scrutiny period of three months provides the EU-Parliament and the EU-Council with the opportunity to veto the amendment, otherwise it becomes binding regulation after the end of the scrutiny period.

The Auctioning Regulation needs to be amended anyway, as the decisions on the opt-out auctioning platforms need to be added to the annex of the Auctioning Regulation.

Assessment of the current regulation on compliance companies

The Auctioning Regulation requires that auctioning volumes are evenly spread over the year, with some exceptions for summer and Christmas breaks. While a limited deviation from this requirement might be helpful to account for some seasonal patterns in carbon demand, it is all in all still a reasonable regulation, especially compared to alternatives like selling all or most of the volumes over a short period of time, e.g. in November.

The Auctioning Regulation also requires for spot or quasi-spot auctions. This is a legitimate requirement, as public institutions are not ideally placed to assess and bear credit risks of companies.

The drawback of this rule is, however, that companies need to pay cash for the auctioned allowances way before they need them for compliance. When the auctioned volumes are sold evenly distributed over the calendar year, the average time they are sold is end of June.

The compliance date for the companies is, however, only end of April in the following year, i.e. 10 months later.

The average yearly auctioning volume in the 3rd Trading Period is slightly above 1 Gt. If one calculates with a carbon price of 10€ and (marginal) interest rates for companies of 15%, the combination of spot-auctions and the timing of the auctions implies interest costs of 1.25 billion € per year. [It should be noted that changing to futures auctions would not significantly alleviate the problem, as many companies do not have the financial infrastructure in place to participate in futures trading at all, and the rest would be confronted with significant margining requirements that also cut into the credit lines of companies.]

Calculating with a lower interest rate would obviously decrease the interest costs accordingly. One should, however, keep in mind that with increasing debt levels the interest rates for a company rise. Additional debts have thus not only a direct effect on interest payments, but also an indirect effect, as the additional debts increase the total debt level of the company and thus also the interest rates for the other debts. For this reason, 15% should to be a proper assumption for calculating the impact on interest costs, a level also used by many companies in internal calculations.

Proposed changes

We propose a change in the auctioning schedule to align it with the "Carbon Calendar". The "Compliance Year" ends with the compliance date, i.e. 30th April of the following year. As this is the final date at which companies need to have the allowances at hand, the period in which the volumes are auctioned should end at this date.

We support the current rule that volumes should be spread evenly over 12 months (including the current exceptions). Therefore, we propose to start with the auctions in May of the year for which the volumes are sold, and to end the auctions in April of the following year.

Adopting this simple rule change would **shift the average selling date by** slightly more than **4 months**, and would therefore **reduce the interest costs** for compliance companies by roughly **500 Mio € per year**.

Contact

Tschach Solutions GmbH
Bachstrasse 43
76185 Karlsruhe
Germany

Tel: +49 / 721 16 08 96 30
e-mail: info@tschach-solutions.co