Implementation of the Emission Trading System under the Directive 2003/87/CE

Assessment of any allowances to be auctioned prior to 2013 pursuant article 10(1) of the Auctioning Regulation

DG CLIMA Discussion paper for the Stakeholder meeting of 13 December 2010

Introduction and objective

Having received unanimous support from the Member States, on 12 November 2010 the Commission adopted the regulation on the timing, administration and other aspects of auctioning of greenhouse gas emission allowances pursuant to Directive 2003/87/EC of the European Parliament and the Council establishing a scheme for greenhouse gas emission allowances trading within the Community, hereinafter the Auctioning Regulation. The Regulation was published in the Official Journal on 18 November.

To provide predictability to all participants in the carbon market, Article 10(1) of the Auctioning Regulation provides: "*The volume of any allowances covered by Chapter III of the Directive 2003/87/CE to be auctioned in 2011 or 2012 [so-called "early auctions"] and the auctioned products by means of which the allowances are to be auctioned shall be set out in Annex I to this Regulation*". The Commission will prepare an amendment of the Regulation to complete Annex I. The procedure for adopting this amendment is the same comitology procedure as the one under which the Auctioning Regulation itself has been adopted.

The justification for early auctions stems from the common practice to sell products in advance. In particular the power sector sells electricity up to three years in advance. At the time of such forward sales, the company normally also buys the required fuels and emission allowances so as to avoid the risk of price fluctuations (so-called "hedging"). The key question for the stakeholder meeting is what is the appropriate volume of EU allowances and timing for early auctions?[1] The foremost objective in defining the volume is to ensure a smooth transition from the second to the third trading period of the EU ETS that underpins rather than disturbs the proper functioning of the secondary market.

Key elements to be taken into account

There seems to be a growing consensus on the relevant elements to be taken into account in the determination of the appropriate volume of early auctions.

On the demand side:

1. Hedging needs for phase 3 compliance, taking into account the emissions forecast for the power sector post 2012, the share of electricity production that is actually hedged and different hedging profiles in the power sector as well as any potential free allocation pursuant to article 10c of the ETS Directive.[2]

[1] This document addresses the key elements for determining the volume and timetable of early auctions. The determination of the auctioning products falls outside the scope of the present paper.

[2] Demand for hedging can be met not only by phase 3 allowances, but also by phase 2 allowances since the latter can be banked.

2. The demand for allowances needed for phase 2 compliance, mainly coming from the power sector.

On the supply side:

3. The surplus of phase 2 allowances held largely by the industrial sectors; and the likely amount of this surplus that may be sold.
4. Auctions of phase 2 allowances, including the auctioning of any remainder from New Entrant Reserves or allowances to be auctioned following the closure of installations.
5. CDM and JI credits available for hedging or for surrendering by ETS operators.
6. Monetisation of phase 3 allowances from the new entrant reserve (NER300) for support of demonstration projects of carbon capture and sequestration and innovative renewable energy technologies.

Minimising risks of regulatory-driven temporal price fluctuations

Determining an appropriate volume for early auctions is not an exact science. Furthermore, market conditions will evolve following the determination of the volume and market actors will adjust to the amount fixed. It is, however, inherent to the nature of a cap and trade system such as the ETS to determine the volume for early auctions upfront and allow the market to take this determination into account. That being said, it is appropriate to consider the risks pertaining to a scenario where the determined volume of early auctions would be too high or too low.

The main risk of the decision on the volume of early auctions in the two aforementioned scenarios is a temporary undue price fluctuation upward or downward. The risk of either outcome depends on (inter alia):

- The selling behaviour of the operators holding phase 2 surplus allowances.
- The intermediaries' behaviour to take advantage of price variations.
- The operators' flexibility concerning hedging and the means at their disposal to deal with price variations.

A reliable carbon price that reflects the underlying scarcity in the allowances throughout the trading periods is fundamental to the efficiency and effectiveness of the ETS. In the optimal development, there is an efficient balance between short term abatement measures such as fuel switching and long term abatement measures, notably investment in low-carbon technology.

In case of an undue temporary price increase, the macro-economic cost of abatement would increase in particularly in the short term (e.g. fuel switching to a relatively high and costly degree), which would actually be mirrored by higher auction revenues. In case of an undue temporary price fall the macro-economic cost of abatement would increase particularly because of delay of long-term investment in low-carbon technology. Under this scenario, at least in the short term, auction revenues would be lower.

Range of appropriate volumes quoted by analysts and stakeholders

The Commission has attentively studied analytical output and followed stakeholder views. Analysis and models based on the aforementioned elements show a range of figures that evolved over time as more information about the progress of Phase 2 and economic recession and recovery have emerged. Stakeholders, in particular electricity producers, have also expressed views on the desirable volume. The volume currently deemed to be appropriate by analysts, on top of the 300 million allowances expected to be monetised by the EIB before 2013, and electricity producers to ensure a smooth transition to the third phase ranges from 100 to 300 million allowances.

As far as the timing is concerned, given the time needed for conducting the procurement procedures for the common auction platform(s) and the single auction monitor jointly with Member States the question arises by when first auctions can realistically be held. In view of the further work needed a start of phase 3 auctions in 2011 is hardly feasible.

Expression of opinions

The discussion in the meeting will focus in particular on the following questions:

- Do you agree that all relevant factors for fixing early auction volumes have been determined? If not, what is missing?
- 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?

The Commission invites interested parties to express reasoned and substantiated views on the appropriate volume and timing of these early auctions and to respond to the above questions through a consultation, which can be accessed on http://ec.europa.eu/clima/policies/ets/auctioning_en.htm. Such views should be submitted by 7 February 2011.