



3 August 2009

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**Euroclear response to the public consultation  
by the European Commission on the future auctioning  
of emission allowances under the EU Emissions Trading System**

Euroclear is pleased to be given the opportunity to offer its views on the future auctioning of EU Emission Allowances (EUAs) under the EU Emissions Trading System (ETS). As a provider of securities clearing, settlement, custody and collateral management services, we feel that our experience in the post-trade segment of financial markets may be of relevance to the future design of any new solutions for distributing EUAs into the markets.

The parallel between auctioning EUAs and the primary distribution of new issues in domestic and international securities is striking. These markets are supported by procedures and processes which have been well established for decades and which have allowed them to develop and mature. The Euroclear group is a market leader in domestic and cross-border settlement and related services for bond, equity, warrants, derivatives and fund transactions. It comprises the International Central Securities Depository (ICSD) Euroclear Bank in Brussels and Central Securities Depositories (CSDs) Euroclear Belgium, Euroclear Finland, Euroclear France, Euroclear Nederland, Euroclear Sweden and Euroclear UK & Ireland<sup>1</sup>. Euroclear Bank also provides settlement and safekeeping services for emission allowances.

We offer below both general comments relating to the need to create a resilient European infrastructure supporting the auctioning of EUAs and also more specific comments relating to the detailed aspects of the proposed market set-up and design.

**GENERAL COMMENTS**

We welcome the consultation paper and believe that it could lead to an innovative architecture for the development of a resilient European auctioning market infrastructure supporting the EU ETS.

While many detailed design and regulatory aspects of any solution remain to be defined and should find its translation in the envisaged Regulation, we believe that a number of guiding principles should be taken into consideration from the outset to ensure the optimal outcome for Europe.

- Recent turmoil in the financial markets has emphasised the importance of sound market infrastructures as key systemic shock absorbers. The crisis has increased pressure for such infrastructure solutions in areas such as OTC derivatives, although it is noteworthy that existing clearing and settlement solutions for the securities markets have proven to be extremely resilient across the EU.

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<sup>1</sup> The seven Euroclear group Central Securities Depositories (CSDs) represent approximately 65% of the Eurotop 300 equity markets. When including Euroclear Bank, the international CSD, the group covers over 50% of all European domestic debt outstanding. The 2008 business results for the Euroclear group of national and international central securities depositories were resilient. Against equity market capitalisation decreases of more than 45% in Belgium, France, Ireland, the Netherlands and the UK in 2008, the Euroclear group settled 157 million transactions worth approximately EUR 560 trillion in 2008, on par with 2007.



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- We believe that the Commission should seek to leverage existing infrastructures where possible, rather than building entirely new solutions. The last part of this note explains briefly the existing Euroclear service offering for the clearing, settlement and safe keeping of EUA and Certified Emission Rights (CER) allowances.
- The EU post-trade markets have been long criticised for their fragmentation and for the barriers between nationally based securities infrastructures. In recent years many initiatives have been launched (in the securities markets) to overcome these barriers and to provide European-wide harmonisation of market practices and integration of IT platforms. We support the Commission's support for an EU approach to the auctioning of EU Emission Allowances (EUAs) under the EU Emissions Trading System (ETS).

#### **SPECIFIC COMMENTS**

Euroclear has had long experience of managing the results of auction processes in the securities markets (particularly the government debt markets). Although we do not provide auction functionality per se as one of our main services, we provide below our view on how we see the auction process could work.

#### **Question 2: Do you think there is a need to auction futures? If so, why so?**

We do not believe there is a need to auction futures without more analysis.

Futures markets typically exist in their own right and in their nature reflect the value, depending on supply and demand of the underlying emission rights at a certain time in the future. For example, in the advent of EU ETS phase II, a futures market already emerged prior to the emission rights effectively being allocated to the installations. We believe therefore, that futures instruments in primary emission markets are not needed, nor are they suitable since these are long-term instruments that can be used to speculate on the prices in the market. The purpose of auctioning is to distribute allowances to those who need them to comply with Community legislation. Auctioning futures might deviate from this aim, with speculative trading in the market through large bids on futures with a view to selling in more volatile markets.

Auction futures in the initial auctioning project will bring its own issues. We believe the auctioning process should start with reasonably easier instruments like spot trades where an auction will result in immediate payment and delivery.

Although auctioning futures may offer advantages for large emitters by allowing them to hedge their compliance needs, it raises questions around collateral and price movements which might affect the bidders' ability to cope with the margin calls. Further, auctioning futures may reduce liquidity in the secondary market whereas auctioning spot allowances will increase liquidity as well as meet the requirements of large emitters. We believe it is important that the EU ETS remains competitive and liquid to help ease price fluctuations.



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**Question 3: What share of allowances should be auctioned spot and what share should be auctioned as futures for each year?**

	SPOT	FUTURES
• year n :	100 %	0 %
• year n-1 :	100 %	0%
• year n-2 :	100 %	0 %

Please refer to our comments in Question 2.

**Question 17: Is 1,000 allowances the most appropriate lot size? If not, why not?**

Yes; we believe the regulation should follow the market practice as it exists today in the secondary market.

**Question 33: Do you agree that the level of collateral accepted in EUA auctions should be harmonised for all EU ETS auctions? If so, how should they be harmonised? If not, why not?**

The level of collateral accepted in EUA auctions should be harmonised in order to allow for an orderly pan-European market, and as such should be part of any Regulation.

**Question 34: Do you agree that the type of collateral accepted in EUA auctions should be harmonised for all EU ETS auctions? If so, how should they be harmonised? If not, why not?**

Even though we believe the level of collateral should be harmonised, we do not believe the type of collateral should be harmonised. Referring to longstanding market practices in more mature financial markets (e.g. bonds, equities, repo market) collateralisation minimises the impact of potential default, and bidders typically have the opportunity to use a wide range of asset classes for collateral purposes which gives flexibility to the bidding process. Different hair-cuts are applied, reflecting the difference in quality of the collateral provided (e.g. cash vs. government bonds or high-quality corporates). The more restrictive the range of accepted collateral, the higher the risk that bidders would not have adequate collateral to pledge.

**Question 35: Do you agree that 100% collateral in electronic money transfer ought to be deposited up-front at a central counterparty or credit institution designated by the auctioneer to access spot auctions? If not, why not? What alternative(s) would you suggest? Please provide arguments to support your case.**

We believe collateral should be deposited up-front at a credit institution, CCP or (I)CSD designated by the auctioneer. This institution could be a Central Securities Depository (CSD) which fulfils a central agent role or a CCP that acts as central counterparty, and whose roles complement each other. Similar to securities markets, we believe that an (I)CSD brings all the functionalities required in a primary market by offering an integrated set of clearing, settlement, safekeeping and related collateral management services.



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**Question 36: In case futures are auctioned, should a clearing house be involved to mitigate credit and market risks? If so, should specific rules – other than those currently used in exchange clearing houses – apply to:**

- the level of the initial margin;
- the level of variation margin calls;
- the daily frequency of variation margin call payments?

We agree that clearing houses can contribute to mitigating credit and market risks but we do not support the view that this risk mitigation can be achieved uniquely by means of exchange clearing houses. As suggested for question 35, existing CSD services address these concerns through integrated collateral management solutions. For more details please see the last part of this note which explains briefly the existing Euroclear service offering for emission allowances.

**Question 37: What are the most preferable payment and delivery procedures that should be implemented for auctioning EUAs?**

We believe Delivery versus Payment (DVP) settlement is the safest, most efficient and risk-controlled way for any exchange of assets.

Applied to the settlement of auction results, the bidder and the auctioneer do not need to be members of a central counterparty or clearing house as mentioned in the consultation paper. Our view on how this might work in practice is outlined further under the section "ClimateSettle, a Euroclear Bank delivery and payment service".

**Question 38: Irrespective of the payment procedure, should the Regulation fix a maximum delay of time for payment and delivery to take place? If yes; what should it be?**

- 4 working days
- 5 working days
- 6 working days
- 7 working days
- Other, please specify.

We believe payment and delivery should not take longer than 3 working days following publication of the auction results, comparable to market practices in secondary markets for other financial instruments.

Primary issuance and distribution in international securities markets is generally done on a same day basis (T+0) and we believe that over time the same should be achievable for the EUA market. A delay of 3-4 working days could be foreseen as a maximum delay for resolution of settlement problems that might occur.

**Question 39: Should the Regulation provide any specific provisions for the handling of payment and delivery incidents or failures? If yes, what should they be?**

While we understand that a Regulation might wish to specify that processes for handling delivery incidents or failures should apply, we do not believe that it would be appropriate for EU regulation to specify precise operational procedures that should be followed by the market. Rather the regulation should set out only the broad principles that should be applied to avoid the risk of arbitrage between multiple



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service providers and/or national regulations. Relevant best practices can be found in other more domestic and international financial markets.

The provision of collateral should cover non-payment by the bidder. Euroclear Bank clients can benefit from the integrated provision of credit to support the settlement process. This could also be beneficial for bidders or their agents to fund their participation in the auction of EUAs.

Where the auctioneer cannot carry out the delivery of the allowances sold in the auction for any technical reason, we believe the auctioneer could deliver the EUAs to a designated 3rd party/agent prior to action taking place.

It is equally important to note that overall failures due to technical problems cannot be disregarded (e.g. force majeure) and even though these are unpredictable, typically markets have organised themselves to have certain procedures in place to handle such situations. In the UK Equities Market for example, these are covered by contractual agreements between Euroclear UK & Ireland (EUI) as CSD and its participants and operational procedures have been implemented accordingly.

**Question 45: If the primary participants' model is used, what conflict of interest requirements should be imposed? (More than one answer possible)**

- **Separation of client registration and trading on behalf of clients from all own account trading activities.**
- **Separation of collateral management, payment and delivery on behalf of clients from all own account trading activities.**

We would like to regard this question in the broader context/evolution following the market crisis whereby account segregation for client assets is gaining more importance than before. We believe both of these separation rules would fit within the logic of existing securities market regulations.

**Question 47: Under what conditions should auctioning through exchanges be allowed (more than one answer possible)?**

We believe that auctioning through exchanges or any third parties should be decided by national authorities.

**OUR VIEW – REALISING FUNCTIONAL SYNERGY**

Based on the Consultation document we understand the EU Commission's approach of an European-wide auctioning of emission allowances under the so called Hybrid set-up is built around four key functionalities, i.e. one or several auctioning platforms, one central clearing platform, a community registry, and a payment/delivery system.

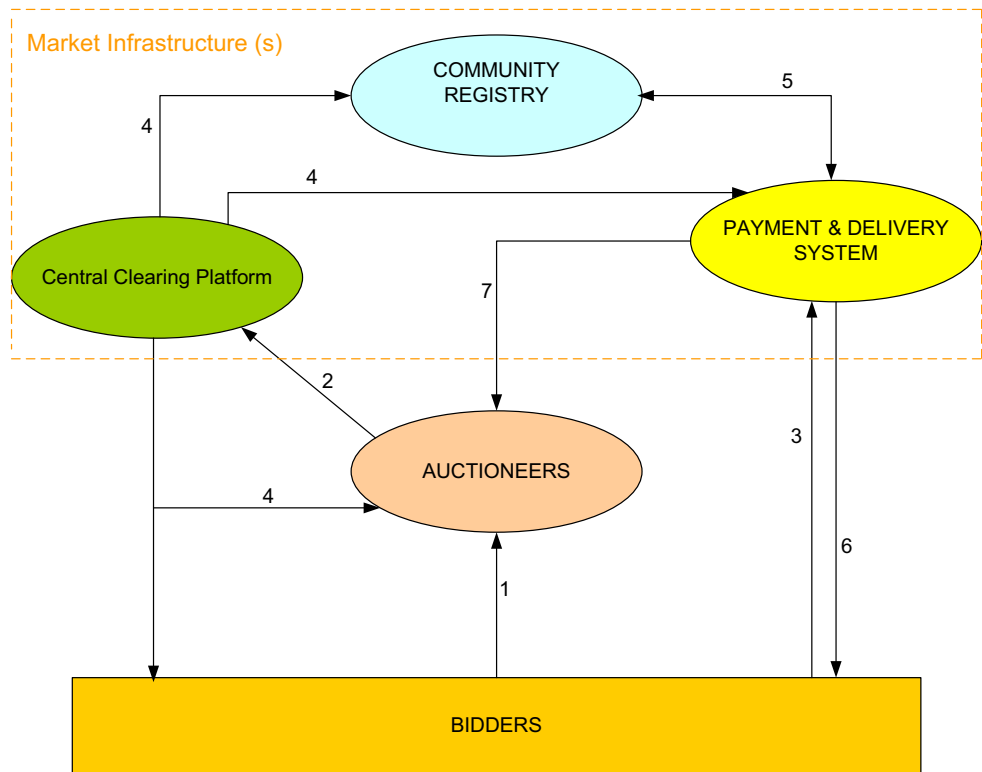
While indeed these are the key functionalities, each of which can be provided by different entities, experience in the financial markets has demonstrated that synergies and significant efficiency gains can be realised by combining some functionalities (e.g. the Eurobond market). We see this in particular in the combination of the central clearing platform with the payment and delivery system. In addition, combining the payment and delivery system with the servicing of the Community Registry (in a servicing or outsourcing mode) would provide incremental synergy.



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We believe that the Euroclear ClimateSettle service platform offers a good basis to provide qualitative pan-European clearing, settlement, and safekeeping services to improve overall settlement of emission allowances on the back of auctions. Based on our experience, functionalities could be expanded to also cover the central auction clearing and (outsourced) Community Registry.

The approach we envision gives bidders flexibility to receive EUAs through any of the decentralised auctioning processes of their choice. The diagram below is based on our understanding of the Hybrid solution; however our service can accommodate other auction processes.



**FLWS:**

- 1- Bids being put to the Auctioneers
- 2- Auctioneers communicate the bids to the Central Clearing Platform where the auction process will take place
- 3- Bidders provide collateral
- 4- Announce Auction Results
- 5- Two-way communication for Delivery as well as Positions
- 6- Delivery of Allowances
- 7- Cash Payments



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### **ClimateSettle, a Euroclear Bank delivery and payment service**

ClimateSettle is a robust and secure web-based application that leverages our strength as an International Central Securities Depository specialising in securities settlement and related services to allow participants to settle emission allowances.

Clearing and settlement takes place on Delivery vs. Payment (DVP) basis, which reduces the settlement risk.

Once the auction results would be communicated, Euroclear would be able to process the settlement on a DVP basis on any settlement cycle required by the Commission. This would give bidders the chance to get their emission allowances on settlement date, and the centralised body to collect payment for these allowances. Bidders and/or the centralised body could use the Climate Settle safekeeping service for the allowances they have obtained as a result of the auction(s).

Not only would we be able to help reduce the settlement risk, our automated service would also assist participants in reducing their back-office resources. The cost of manual processes could be reduced and with existing reporting tools, there would be no need for bidders to check proactively their registry accounts.

Settlement in ClimateSettle is based on multilateral netting which reduces bidders' funding costs in the case that bidders wish to sell their EUAs immediately on receipt after an auction.

To use Climate Settle, EUAs would need to be transferred to a designated Euroclear account where the settlement instructions would be verified to ensure all the conditions for settlements have been met. This would prevent any failures as a result of the auctioneer not being able to deliver the allowances in a timely manner. Our reporting functionality also notifies bidders of any possible settlement failure due to insufficient credit before settlement takes place.

Euroclear would also be able to provide the existing services to non-financial players via an intermediary agent which is a common practice in financial markets. With our account segregation process the intermediary could act for its own account as well as for its underlying clients by opening a number of ClimateSettle accounts.

As well as our efficient settlement and delivery solution, we would be able to offer Euroclear's Tri-party collateral management service whereby the bidder could transfer non-cash collateral into a segregated Tri-party account prior to the delivery or the auction taking place. In the case of the bidder supplying insufficient credit, the non-cash collateral would be used to fund the bidder's settlement activity. In this case the auctioneer should be willing to accept non-cash collateral from the bidders.



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In conclusion, we hope that the European Commission will recognise that there are significant opportunities to leverage existing market solutions, which may facilitate and accelerate the implementation of one or more infrastructure solutions that respond to the need of the European markets for an efficient auctioning and distribution mechanism of EUAs.

We remain available to discuss the above proposals with the Commission.