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Auctioning Rules under the revised EU Emission Trading Scheme: A view from EU industrial energy users

Introduction

An efficient auctioning regime is essential for Europe's energy-intensive industry, whose installations are largely included within the ETS scope. ETS installations need access to allowances to operate their European installations. It should therefore be a crucial role of auctions to make allowances available to compliance buyers as simply and efficiently as possible, thereby aiding the sustainability and international competitiveness of EU manufacturing. Energy-intensive industries are particularly concerned that market power could be unduly exercised in auctions, given for example the large weighting of the generation sector within the scheme and this sector's ability to pass through costs to its customers – an ability the majority of manufacturing industry does not share. This concern should be addressed.

Energy-intensive industries expect that the auctioning regime will be designed:

- With a price setting mechanism that minimizes secondary market volatility and decreases the risk of price manipulation. In other words, the CO_2 price should be as transparent as possible.
- With low market entry barriers (i.e. low transaction costs and simple operational requirements) to foster direct participation of all compliance participants.

Position

1. **There should be one central EU auctioning platform** because it is the most efficient approach (i.e. low transaction costs, high liquidity and competition), ensures a level playing field (equality of access and common rules) and is therefore least likely to create market distortions or discriminate between participants. Furthermore, a centralized auction is simpler to monitor. Finally, a central auctioning system is consistent with the centralized allocation of allowances in Phase III. The central auction should build upon existing auction systems and rules. The auction would be conducted in several languages simultaneously and the revenues would be distributed proportionally between Member States.

   There are some concerns whether a centralized system can be set up in time for Phase III, especially to allow for early auctions. In view of the overwhelming advantages of a centralized system, we call on the Commission and the Member States to make all necessary efforts to create a centralized auctioning system for Phase III. If necessary, Phase III allowances could be auctioned through existing Phase II auction platforms already in 2011 as a transitional measure.

200 Avenue Louise Box 132 B- 1050 Brussels **tel**: 32 2 542 06 87 **fax**: 32 2 542 06 92 **e-mail**: ifieceurope@ifieceurope.org **web**: www.ifieceurope.org
a.i.s.b.l. NI 436 343 513

The hybrid approach and the coordinated approach are viewed as alternatives should it not be possible to create a centralized system in time. IFIEC is concerned that these approaches are more complex, imposing greater burdens on compliance participants and that the set-up is more time-consuming than for a centralized approach. With regard to the hybrid approach, exchanges have already warned about the difficulty to link different national IT systems to one central clearing platform. Furthermore, these approaches risk discrimination and arbitrage if Member States are unwilling to harmonise their rules. In case of a hybrid approach, it would therefore be essential that the rules for the conduct of auctions are defined in the Regulation. Furthermore, it would have to be ensured that the coordinated or the hybrid approach is not more expensive for bidders than the central approach.

2. IFIEC is concerned about the risk of insufficient early supply of allowances to enable participants to hedge their positions prior to the commencement of Phase III. An "artificial scarcity" could lead to an increase of allowance and electricity prices. To supply sufficient certificates while avoiding oversupply, **early auctions should commence in 2011 at the latest,** as foreseen in the Emissions Trading Directive[1]. If the European registry is not ready in time, spot certificates for early auctions could be provided by introducing "Phase III EUAs" in the existing national registries while maintaining close segregation from "Phase II EUAs" (i.e. replicating the coexistence of Phase I and Phase II EUAs safely enacted in 2008). Alternatively, futures may be a means to provide for early auctions.

3. **Both direct and indirect bidding should be allowed**. Direct bidding should be allowed for all emitters. There is no need for a "middle-man" where an emitter has the means and expertise required to participate directly in auctions. Current experience of an intermediary only model, e.g. the UK Phase II auctions, is not positive for compliance participants. While intermediation can be beneficial and should also be allowed, there should be no requirement or obligation to use intermediaries. As Chinese walls within some primary participants might be ineffective, ETS operators should not be obliged to reveal their bidding strategy to an intermediary. It is often argued that direct bidding will increase the administrative burden for the auctioneer (i.e. due to "Know-your-Customer" checks). However, auctions in Phase II have shown that simplified registration procedures may be applied to ETS operators.

4. **The advantages and disadvantages of auctioning futures should be carefully assessed**. Within IFIEC, there is no agreement whether – in addition to spot products – futures should be auctioned. Some IFIEC members argue that the secondary market is best placed to meet the demand for futures - when sufficient allowances are made available. In fact, a secondary market already exists for EUA futures in 2013 and 2014 (although liquidity is currently low). Furthermore, introducing futures in the primary market could have the following disadvantages:
   - By introducing an additional product (or several), futures segment the primary market and thereby decrease liquidity.
   - Futures sold through primary auctions are likely to reduce liquidity ('crowding out') in secondary market.
   - Different types of national futures (i.e. maturity dates) would threaten the uniformity and stability of the secondary market.
   - Futures impose specific qualities (credit worthiness, management of the daily positions and margin calls) which restrict the ability of industrials to participate in these auctions.

[1] Recital 22: "In order to ensure an orderly functioning of the carbon and electricity markets, the auctioning of allowances for the period from 2013 onwards should start by 2011 and be based on clear and objective principles defined well in advance."

Despite the above mentioned concerns, other IFIEC members support the auctioning of futures as they would like to hedge their risks independent of the private sector. Furthermore, they are concerned that the secondary market may not offer a sufficient quantity of futures.

This heterogeneous situation makes clear: In case the Commission and Member States decide to auction futures, they should proceed with caution to avoid a disturbance of the secondary market.

In any case, where spot could not be used for some early auctions, limited use of futures may be an unavoidable **temporary measure** to allow compliance participants, particularly generators, to hedge a portion of their early Phase III requirements as the secondary market evolves. However, significant caution must be exercised that these auctions are not self-defeating in that they crowd out the development of the secondary market.

5. **The auction design shall be a single round, closed order book, single clearing price** as it keeps transaction costs low due to simplicity, fosters market entry, is known to bidders (used in electricity markets and for auctioning in certain Member States), and information deficits of smaller bidders are not punished (since all pay the same price). Furthermore, anti-competitive behavior is more easily detectable under such a system because a bidder will bid a high price to acquire large volumes of allowances.

6. **There should be no administrative fees for bidders to participate in an auction.** The auction costs should not be charged to bidders. Instead the auction revenues should be used to cover the costs of running the auction. This will reduce market entry barriers and thereby increase participation, especially of SMEs. Furthermore, this may act as a driving force to control costs. This request is in line with the Emissions Trading Directive, which foresees that at least 50% of the revenues generated from the auctioning of allowances should be used for certain activities, including “to cover administrative expenses of the management of the Community scheme”[2].

7. There should be no obligation or need to provide **collateral** for spot transactions given normal arrangements for prompt or in advance payment. As deterrent for market manipulation, collaterals are less relevant in weekly spot auctions. If a successful bidder should default, there could be some form of participation deterrent and the unsold quantities could be transferred to the next auction. EUAs should be accepted as collateral, if/where these are required.

8. To minimize costs and implementation risks, an **existing auction / exchange / clearing platform should be utilized**. The competitive tender for such service provision provides the opportunity to maximize the efficiency of the platform.

9. **Auctions should take place weekly**. Weekly auctions strike an adequate balance between ensuring sufficient participation and limiting the scale of the auction to prevent shocks to the secondary market.

10. **Effective solutions must be found to deal with the risk of market abuse and non-competitive behaviour.** Energy-intensive industries are particularly concerned about the possible abuse of market power in view of the imbalance between the actors in the primary market. Dominant participants must not - intentionally or unintentionally - cause market distortions, insider dealing and market manipulation must be prevented. It should be examined if existing rules are sufficient to mitigate market abuse risks. It may be appropriate to consider abuse in the EUA market in the context of the regulatory system under development for energy markets.

[2] Article 10 paragraph 3i

Furthermore, existing practices of exchanges to avoid market abuse could be made mandatory in the context of EUA auctioning.

An EU regulatory body ("watchdog") should be established to carry out market surveillance and to identify and prevent market abuse. To ensure that this body is aware of the particular situation of energy consumers, energy-intensive industries should be represented in its supervisory body.

11. **Transparency**: A general and frequent reporting system on EU level is necessary. Ample and timely communication on the auctioning schedule, the number of allowances to be auctioned as well as on the outcome of the auctions will be crucial.

    In the past, the yearly publications of verified emissions had a strong impact on the price of ETS allowances. To stabilize the ETS market, it should be considered whether the publication of intermediate non-verified aggregated data - respecting the cost constraints of issuers - may be useful and feasible. Such additional reporting requirement should be limited to significant sources to avoid too onerous requirements for smaller emitters. For example, a threshold could be set at 500.000 t CO_2/year with the aim to cover about 85% of ETS emissions.

For questions, please contact:

Dr. Annette Loske, Chairwoman WP Climate & Energy Efficiency, IFIEC Europe,
Tel. (+49) (0)2 01 / 8 10 84 – 10, e-mail: a.loske@vik.de

About IFIEC Europe

The International Federation of Industrial Energy Consumers represents companies in energy intensive industries in Europe for which the cost and availability of energy and power are significant factors affecting their ability to compete in world markets.