

EFET technical paper on EU ETS auction design Recommendations on auction implementation and institutional questions

BACKGROUND

The Commission's proposal on the EU-ETS states that auctioning will be the main method for the allocation of European Union Allowances (EUAs). It is likely that from the start of phase 3, the power generation sector (accounting for about half of the CO₂ emissions of the ETS-regulated sectors) will not receive free allocations, meaning it will have to buy all the allowances it needs from 2013. Other industries will continue to receive free allowances, although the amount will be reduced.

Auctioning will therefore play a key role in the revised scheme. It will be an important feature in assessing the ability of the EU-ETS to reach its ambitious environmental targets (emission reductions). At the same time, it should aim to minimise abatement costs so as not to penalise economic growth.

The current proposal entails provisions by which Member States will auction still-to-be-defined amounts of allowances (volumes for auction will be known once the amount of free allowances is set). This partly explains why the Commission has decided not to develop a centralised scheme, preferring instead to leave auctioning responsibility with Member States. Member States will benefit from the revenues and it is considered important that the recycling of auction revenues should neither create market distortions nor be in conflict with European state aid legislation.

In the Commission's proposal it is stated that: *"By 31 December 2010, the Commission shall adopt a Regulation on timing, administration and other aspects of auctioning to ensure that it is conducted in an open, transparent and non-discriminatory manner. Auctions shall be designed to ensure that operators, and in particular any small and medium size enterprises covered by the Community scheme, have full access and any other participants do not undermine the operation of the auction. That measure, designed to amend nonessential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article [23(3)]."*

It seems that the Commission's preferred approach is to restrict the ETS proposal to very general criteria. The specific details of auction design will be subject to Comitology.

The auctioning of EUAs under the current proposal of the EU ETS Directive for phase 3 will affect a large number of emitting installations (approx. 12.000) and companies. By the Commission's estimate, in 2013 at least two thirds of

all allowances will be auctioned. The implementation of the right auction model will determine success.

EFET BASIC PRINCIPLES

Auctioning of EUAs is fundamentally a method of distribution; and should not be designed to maximise revenues for the auctioneers. Keeping that in mind, and in order to facilitate fair, transparent and liquid trade, some basic principles for auctioning should be acknowledged:

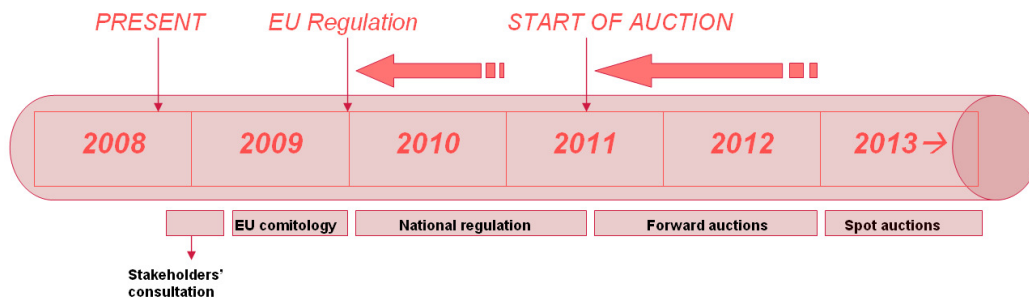
- **Clarity and predictability.** *Clear, harmonised auction rules. Clear and timely communication on auction frequency and volumes. Minimal distortion of the secondary market. Frequent auctions to facilitate frequent trading.*
- **Non-discrimination.** *Participation should be open to all entities that comply with (commercially) reasonable participation requirements.*
- **Transparency and trustworthiness.** *Early disclosure of auction results. An independent supervisory body. Clear legal title over allowances by winning bidders.*
- **Simplicity.** *Simple rules to ensure easy access and low organizational burdens.*
- **Liquidity.** *Early auctions to 'frontload' EUAs, providing liquidity and enabling the hedging of forward electricity contracts*
- **Reliability and timeliness.** *Sound auctioning organisation and no risk of delays.*

In this technical paper EFET's recommendations have been made under the present assumption of EU law makers that auctioning should be the method for EUA distribution. However, as non-auctioning distribution models, such as the release of EUAs at market prices through the energy exchanges, could also be effective, EFET does not exclude considerations of other methods.

IMPLEMENTATION TIMELINE

To provide clarity, predictability and trust in the market, and also to enable a timely start of the auctions, the auction framework should be in place well in advance of the start of phase III.

While acknowledging that enough time will be needed for thorough preparation, EFET proposes that the first auctions should be held in 2011 (i.e. 1,5 years before the start of phase 3) in order to correspond with the general hedging strategies of electricity companies for forward contracts. To achieve this, an implementation timeline is suggested below, which aims for a more compact preparation schedule than the current Commission proposal.



With an early start, there is the issue that physical phase 3 allowances will not exist until 28th February 2013. As winning bidders in early auctions will not receive allowances into their accounts, Member States may ask winning bidders either to pay promptly for auctioned allowances or to provide financial collateral. Collateral requirements should be kept to reasonable, existing market standards.

AUCTION DESIGN RECOMMENDATIONS

A centralised institutional framework

EFET strongly advocates an EU-wide harmonised approach for phase 3 architecture. The Commission's proposal goes some way towards ensuring uniform rules. To achieve a fair and transparent price signal, it is logical to have a single and binding EU-wide EUA auctioning institutional framework.

However EFET is also aware that some Member States will prefer to maintain national responsibility for auctions. With this in mind, EFET considers the following two options to be feasible.

Option A: Centralised Auction Platform

EFET recommends a Centralised Auction Platform (CAP), providing maximum clarity, simplicity and minimum transaction costs, but also guaranteeing Member State's rights to auction revenues. It is envisaged that a CAP could conveniently release standardised volumes of new allowances into the market via one central release channel and on a daily basis.

Each Member State would delegate its right to hold auctions to the CAP but retain its right to the revenues. The CAP would conduct the auctions and return revenues to the Member States on a pro rata basis. Daily auctioning means that Member States will ultimately realise the average EUA price over the entire phase 3 period. Therefore for all Member States the revenue per EUA will, by definition, be equal. This has an additional advantage of preventing any undesirable competition between Member States.

It is important to note that the CAP is not intended to be a substantial bureaucracy. Instead it would undertake all the key functions of auctions that would otherwise be conducted by a number of Member States or joint auction platforms. It offers a relatively simple way to distribute new EUAs, while retaining national ownership of revenues.

Option B: Supervisory Body with Auction Trustees

Another option that EFET could support, in case a CAP could not be established, is a model in which a centralised approach is still present, but in which *supervision* on the one hand and the actual *conducting* of auctions on the other are separated.

Firstly, the EU would issue Guidelines on auctioning, which serve as minimum requirements for the detailed auction rules.

Secondly, through a legislative process, the EU would create a Supervisory Body or Regulator overseeing the auctions of EU Allowances. Each Member State would delegate its right to hold auctions to the Supervisory Body but retain its right to revenues from the auctions.

Thirdly, the Supervisory Body may appoint (private) entities to act as Auction Trustees. Prior to accreditation, those entities would have to demonstrate that their auction rules comply with the corresponding EU Guidelines and that they possess the technical and managerial capabilities to conduct the auctions.

The following table gives an overview of the functions that would be performed by the different bodies.

EU guidelines on auctioning (EU Commission)	
Supervisory Body	Auction Trustee
<ul style="list-style-type: none"> - Appointed by the EU - Accreditation of Auction Trustees - Approval of auction rules of individual Auction Trustees in compliance with the EU Guidelines - Supervision of auctions - Communication of auction results - Deal with appeals and conflict resolution 	<ul style="list-style-type: none"> - Accredited by the Supervisory Body - Contract with and act on behalf of the Member State auctioning allowances through them - Register auction participants - Conduct auctions - Settlement of auction results

The main advantages of the proposed model are:

- It draws on the existing expertise of professional Auction Trustees
- Member States could choose between the services of the Auction Trustees. This would introduce competition and ultimately lower transaction costs
- Decentralised implementation would cater to the particular requirements of participants in different regions of the EU.

Maximum harmonisation

Rules shall be provided at a European level to offer maximum harmonisation amongst Member States on auction methodology, auction design options, frequency, volumes, participation requirements and transparency. By doing so, undesirable, and potentially price-distorting, competition between Member States will also be prevented.

Participation criteria

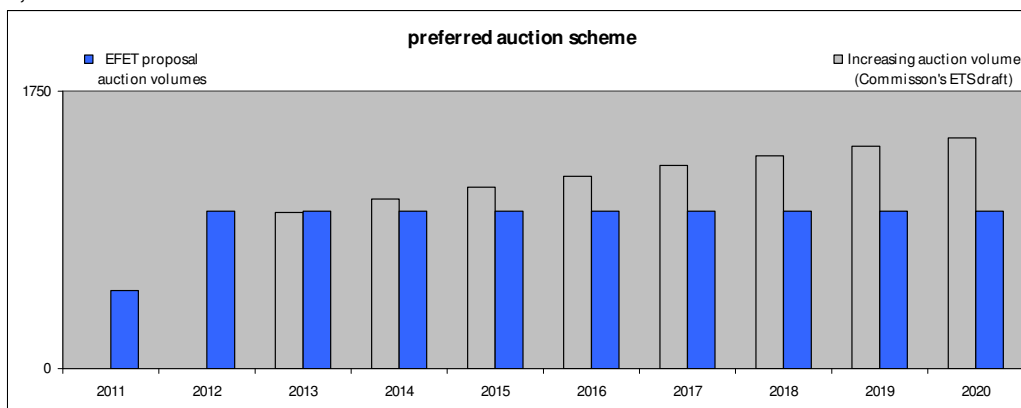
EFET supports non-discriminatory access to auctions for all interested parties. Auction design should be envisaged in such a way as to allow competitive price discovery and reduce the risk of abusive practices by encouraging broad participation, having high levels of transparency and frequent sales. Confidence in the price formation process will mean that the costs of compliance will be at an efficient level based upon the fundamental supply and demand for allowances.

Timing of auctions

Timing of auctions is one of the features the Commission specifically refers to as being a component of the Regulation. It is clearly a vital issue. Referring again to the recommended institutional framework options - and therefore assuming a central, coordinated approach - EFET proposes a system of frequent auctions, preferably daily or weekly, to provide a consistent supply of new allowances without affecting the secondary market price signal. It is envisaged that Member States will divide their entire phase 3 allowance volumes equally by the number of trading days or weeks, from the first auction in 2011, through to the end of the phase.

EFET reasons that many of the potential problems arising from EUA auctioning could be mitigated by such a system of very frequent, equal volume auctions. With a regular flow of new allowances into the market, questions over financial speculation, participation criteria, detailed auction design and governance are made less significant.

We envisage an equal distribution by volume for the period mid-2011 to 2020. In practice this means that auctions are front loaded in the first year of phase 3, as the volumes sold in 2011 and 2012 will not be delivered until 2013:



In the event that the final auction design does not accommodate very frequent auctions, we note that additional complexity may need to be added to the auction rules to ensure equitable access to new allowances. For example, with infrequent auctions, it may be necessary to set a maximum bid volume. In our view the question of fair access for smaller parties need not require bureaucratic manual solutions, such as ring-fencing a portion of allowances for non-competitive bidding. A frequent supply of new allowances into a liquid market will ensure fair access to all buyers.

Auction type

Very frequent auctions will mitigate any distortions that could occur where certain parties have market power, and will also provide for a simple method of responsive price discovery. As the choice of a specific type of auction is then less significant, EFET stresses the importance of simplicity and efficiency. To this extent, EFET considers a small number of feasible auctioning systems, reflecting best-practises in similar commodity markets, such as auctions for virtual power plants and gas auctions.

Common auction types like an **ascending multi-session** bidding auction or a **single-round, sealed-bid** auction, both based on the system marginal price (i.e. the price of the last unit which is exchanged) could be feasible.

To ensure an accurate price signal is set, the following measures should be included:

- Reasonable credit and collateral requirements.
- No reserve prices or price caps.
- A lot size of 1000 certificates, which will help commoditise allowances and be fine enough to suit small players.
- Immediate release of the results: showing aggregated bid and offer curves and the clearing price, well before the next auction. This will ensure suitable transparency and bidding strategy confidentiality.