

Technical Aspects of EU Emission Allowances Auctions

Consultation Paper

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1. Introduction

1.1 Purpose of the consultation – practical information

1.1.1 The purpose of the consultation

The purpose of this consultation is to seek stakeholder views on the adoption of the forthcoming Regulation (hereinafter the 'Regulation') setting out the modalities for the EU-wide auctioning of emission allowances. The Commission is committed to an inclusive approach when developing and implementing EU policies. Member States, emitters of greenhouse gases (GHGs), in particular CO₂ otherwise known as carbon, that are covered by the European Union's Emissions Trading Scheme (EU ETS) and other stakeholders, including non-governmental organisations involved in the implementation of the EU ETS, as well as participants in the **European carbon market**, have valuable information and experience to contribute to the Commission's decision making process. Their views may inform the Commission how to design and implement EU-wide carbon auctions and how to draft the Regulation.

The present section 1 provides readers with the background information on the objectives of auctioning, the legal basis for the Regulation, the market context and a number of important underlying considerations and trade-offs.

Sections 2 to 5 address the different design and implementation aspects of the EU-wide auctioning of **EU allowances** (also known as allowances or EUAs). Organising auctions of allowances requires decisions on: what to auction and when to auction (section 2); how to design the auction (section 3); how to implement the auction (section 4) and who should carry out the auction in a pan-European context (section 5). Each section provides an analysis of the issues in the context of the objectives set by Directive 2003/87/EC¹ as recently amended by Directive 2009/29/EC² (hereinafter the 'revised ETS Directive'), discusses the possible options, and presents what is at stake for the forthcoming Regulation.

Section 6 addresses the design and implementation aspects for the auctioning of **EU aviation allowances** (EUAAAs),³ in particular where they may differ from the preceding analysis in sections 2 to 5.

At the end of relevant sections, a set of questions solicits the views of stakeholders on the various options. There are three types of questions:

- Closed – Respondents select one or more answers from a number of given answers.
- Numerical – The expected answer is an absolute number or a percentage.

¹ Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC; OJ L 275, 25.10.2003, p.32, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003L0087:EN:NOT>.

² Directive 2009/29/EC of the European Parliament and of the Council of 22 April 2009 amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading scheme of the Community; adopted on 26 March 2009, not yet published in the Official Journal of the EC, <http://register.consilium.europa.eu/pdf/en/08/st03/st03737.en08.pdf>.

³ Directive 2008/101/EC of the European Parliament and of the Council of 19 November 2008 amending Directive 2003/87/EC so as to include aviation activities in the scheme for greenhouse gas emission allowance trading within the Community, OJ L 8, 13.01.2009, p.3, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:008:0003:0021:EN:PDF>.

- Open – To allow respondents to propose some options, elaborate on their views regarding certain issues, or support an answer to a closed or numerical question in a qualitative manner. Answers to open questions should be based on clear, concise, convincing and substantiated arguments.

Terms of art or so-called carbon market ‘jargon’ are highlighted in bold the first time they appear in the text. The reader is referred to their meanings in the glossary attached as Appendix 1. A list of all abbreviations is in Appendix 2 for the reader's convenience. Full references to all legal texts referred to in this consultation paper are listed in Appendix 3 for easy access. This consultation focuses on the auctioning of allowances pursuant to the revised ETS Directive. For more information on the EU ETS in general, see http://ec.europa.eu/environment/climat/emission/index_en.htm. For more information on the recent review of the EU ETS with respect to the post 2012 period, see http://ec.europa.eu/environment/climat/emission/ets_post2012_en.htm.

1.1.2 Practical information

The internet site of the consultation can be accessed through the EU ETS Auctioning webpage on the European Commission's internet site:

http://ec.europa.eu/environment/climat/emission/auctioning_en.htm

The consultation is open for a period of two months, from 3 June to 3 August 2009 inclusive.

Stakeholders' contributions are collected through a web-based questionnaire accessible from the internet site of the consultation (<https://quickplace.icfconsulting.com/eu-ets-auctions-consultation>).

Respondents need to be connected to the internet to fill in the questionnaire. When accessing the questionnaire, each respondent will be asked for a username (e-mail address) and a password. The username and password will allow respondents to save their contribution at any point of the questionnaire and resume their replies to the questionnaire as long as the consultation is open. For a contribution to be valid and registered, respondents have to go through the full questionnaire though respondents are not required to answer all questions. When a valid questionnaire is received, a message to the respondent will confirm receipt and record the contribution.

Received contributions will be published on the internet. It is important to read the specific privacy statement attached to this consultation for information on how respondents' personal data and contributions will be dealt with. There are four questions which solicit confidential information. The answers to these four questions should be sent directly to the European Commission, DG ENV, Directorate C, Unit C2, to the attention of the Head of Unit, Office BU-5 2/1, 1049 Brussels, Belgium.

For any questions regarding participation in, access to, or content of the consultation, please send an e-mail to: contact_ets_auctions_consultation@icfi.com.

1.2 Objectives of auctioning in the EU ETS

The EU ETS is a cap and trade system aimed at cost effective and economically efficient reductions of GHG emissions by creating a market in EUAs and a price signal that reflects the abatement costs as well as the scarcity of allowances and guides decisions on abatement measures. Auctioning as the reference allocation method is intended to strengthen the efficiency of the system. This is reflected in Recital 15 of the revised ETS Directive which states:

"The additional effort to be made by the Community economy requires, inter alia, that the revised Community scheme operate with the highest possible degree of economic efficiency and on the basis of fully harmonised conditions of allocation within the Community. Auctioning should therefore be the basic principle for allocation, as it is the simplest, and generally considered to be the most economically efficient, system. This should also eliminate windfall profits and put new entrants and economies growing faster than average on the same competitive footing as existing installations."

An efficient allocation implies that allowances go to those participants that value them most, i.e. those that have the highest marginal cost of reducing emissions. Participants with lower marginal cost would rather choose to abate their emissions, e.g. by production optimisation and investment in low carbon technology. Auctioning allowances ought to ensure a quick, simple and least bureaucratic allocation process.

In the first and second **trading periods** of the EU ETS the share of allowances auctioned as a percentage of the total cap amounted to about 1 and 4% respectively. The review of the EU ETS will lead to a very important change: as from the third trading period (2013-2020), the share of allowances to be auctioned in 2013 will be at least half of the quantity to be issued that year, hence, the importance of efficient and effective auctioning.

1.3 Legal basis for the Regulation

Article 10(1) of the revised ETS Directive sets forth auctioning as the basic principle for allocation. As from the third trading period, all EU allowances not allocated free of charge must be auctioned. The Commission must determine and publish the estimated amount of allowances to be auctioned by 31 December 2011.

Article 10(4) of the revised ETS Directive requires the Commission to adopt, by 30 June 2010,

"... a regulation on timing, administration and other aspects of auctioning to ensure that it is conducted in an open, transparent, harmonised and non-discriminatory manner. To this end, the process should be predictable, particularly regarding the timing and sequencing of auctions and the estimated volumes of allowances to be made available.

Auctions shall be designed to ensure that:

- *operators, and in particular any small and medium size enterprises covered by the Community scheme, have full, fair and equitable access,*
- *all participants have access to the same information at the same time and that participants do not undermine the operation of the auction,*
- *the organisation and participation in auctions is cost-efficient and undue administrative costs are avoided, and*
- *access to allowances is granted for small emitters."*

The Commission must adopt the regulation through the 'comitology' regulatory procedure with scrutiny, which entails a qualified majority vote in favour in the Climate Change Committee and allows for scrutiny by the European Parliament prior to its adoption.

A regulation is binding in its entirety and is directly applicable (Article 249 EC Treaty). It does not need to be transposed into Member State national law, no national implementing measures are required and its application cannot be contingent on any national discretion. It

creates rights and obligations that apply to all, whether governmental or non-governmental bodies, public or private entities. This implies that the rights and obligations to be created by the Regulation will have to be stipulated in a very clear, precise, and unconditional manner.

A regulation is the strongest form of Community legislation. Choosing this form reflects its importance for the efficiency of the EU ETS and for protecting confidence in the carbon market, particularly as the EU-wide auctioning system will be the largest ever set up to date anywhere in the world. Moreover, it reflects the principle of full harmonisation advocated by the Commission in its proposal for the revised ETS Directive, which in turn echoes the strong preference for harmonisation exhibited by stakeholders in the Commission's review of the EU ETS in 2007.

The objectives for the Regulation as set out in Article 10(4) of the revised ETS Directive can be summarised as: simplicity, fairness, openness, harmonisation, transparency, cost effectiveness, non-discrimination, predictability and efficiency. The Regulation must provide the framework necessary to achieve these objectives within the scope of the revised ETS Directive and in line with the general Community law principles of **subsidiarity**,⁴ **equal treatment**, **proportionality** and **legal certainty**.

Auctioning, together with harmonised rules for allocation for free, will replace the current approach based on **National Allocation Plans** (NAPs), which has been criticised for generating distortions of competition. Indeed, auctions must be carried out without distorting competition in the internal market (not least the **secondary market in EUAs**). The regulation should, furthermore, ensure coherence with other EC legislation concerning the internal market, in particular with respect to value added tax (VAT), public procurement and financial services regulation. Double regulation should of course be avoided.

1.4 The European carbon market

The present section is designed to provide the reader with a non-exhaustive snapshot of the main characteristics of the European carbon market. It does not pretend to be definitive, since the market is fast evolving. All estimates and forecasts included in this section are those of ICF and are not endorsed by the European Commission.

1.4.1 EUAs, regulatory aspects

Installation operators covered by the EU ETS ('ETS operators') can use a single EUA for **surrendering** with respect to 1 metric tonne of CO₂ (tCO₂) equivalent⁵ emissions. Anyone can hold and transfer⁶ allowances. Allowances are valid for surrendering in any year throughout the trading period, which as from 2013 will have an eight year duration. Allowances can be banked from one period to the next with no restriction, but allowances from future trading periods cannot be borrowed and used in an ongoing trading period.

By⁷ 30 April of each year, ETS operators are required to surrender to their Member States' competent authority a quantity of EUAs equal to the volume of their verified emissions of the previous year (the **surrendering date**). There is a penalty in case of failure to surrender

⁴ Article 5 of the EC Treaty.

⁵ There are no separate allowances for GHGs other than CO₂. The number of allowances to be surrendered with respect to such emissions is calculated by means of a global-warming-potential factor which has been determined through the UNFCCC.

⁶ With a potential exception only with respect to transitional free allocation to the energy sector in certain new Member States during the third trading period.

⁷ Allowances can and in most cases are surrendered before 30 April.

allowances in time. This penalty does not, however, take away the obligation to surrender the required amount of allowances.

Allowances allocated for free in a given year are issued to ETS operators by 28 February of that year (the **issuance date**), so at any given surrendering date they will have been issued with two annual 'portions' of their free allocations. However, at the surrendering date for the final year of a trading period the allowances received with respect to the new trading period cannot be used for emissions in the previous period. Verified emissions of ETS installations are disclosed shortly after the deadline of 31 March for operators to submit their reports.

Allowances traded in the EU ETS are not printed but are held in national electronic registry accounts. Member State registries are overseen by a Central Administrator at EU level which, through the **Community independent transaction log (CITL)**, checks each transfer for any irregularities. In this way, the CITL keeps track of the ownership of allowances through registry accounts. The EU ETS registry does not handle monetary transfers linked to transactions in allowances. These are handled by the banking system.

1.4.2 EUAs, quantitative aspects

In the second trading period, approximately 2.1 billion EUAs are allocated annually to ETS operators, mainly for free. Only a few Member States have opted to auction a small portion (in total about 4% of all allowances), which for most Member States would also include any EUAs left-over from the **New Entrants Reserve (NER)**.

In the third trading period (from 2013 to 2020) and beyond, under the scenario where the EU aims to cut GHG emissions by 20% in 2020, the cap decreases linearly by 1.74% per year to 21% below 2005 levels by 2020.⁸ The average number of EUAs per annum under the cap in the third trading period for sectors currently covered by the EU ETS will amount to around 1.85 billion EUAs, ranging from 1.97 billion in 2013 to 1.72 billion in 2020. The changes to the scope of the ETS, in particular, by adding new sectors (petrochemicals, ammonia, and aluminium), new GHGs (nitrous oxide and perfluorocarbons) is expected to increase the average number of EUAs under the cap by some 6%. Member States will be able to opt-out small installations (emitting less than 25,000 tCO₂ per year) under certain conditions, which will also lead to a corresponding, but small, change to the cap.⁹

For 2013, at least half of the total allowance cap is expected to be auctioned and this level will increase for later years. Full auctioning will be the allocation rule from 2013 onwards for the power sector, with a limited option for transitional free allocation for the modernisation of electricity generation in certain countries.¹⁰ The level of free allocation to other sectors covered by the ETS, except those deemed at risk of carbon leakage, will decrease gradually from 80% in 2013 to 30% in 2020 and to zero in 2027. Installations in sectors or sub-sectors which are exposed to a significant risk of carbon leakage will receive 100% of their allowances free of charge. These percentages refer to an allocation calculated on the basis of a benchmark which refers to the most efficient techniques and the 10% most efficient installations. A preliminary assessment suggests that a significant part of industrial emissions

⁸ Should a satisfactory international agreement be reached, binding the EU by a stricter overall EU GHG reduction target, the EU ETS cap would become more stringent. See Article 1(1) of Directive 2009/29/EC.

⁹ Articles 9a and 27 of the revised ETS Directive.

¹⁰ Article 10(c) of the revised ETS Directive. This option is available only to 10 new Member States and may concern installations currently having a share of some 14% in EU electricity production. The free allocation in 2013 is capped at 70% of average annual emissions in 2005-2007 from the installations concerned and will be phased out by 2020.

stems from sectors that will be deemed to be exposed to such a risk of carbon leakage.¹¹ The assessment will, however, be reviewed in the light of the outcome of the international negotiations on climate change.

5% of the total quantity of allowances in the third trading period is kept in a Community-wide NER. Any allowances that are not allocated to new entrants over the period 2013 to 2020 will be auctioned and the Regulation should determine the relevant modalities and calendar. The NER also includes 300 million EUAs, the value of which is to be used for carbon capture and storage (CCS) demonstration projects and innovative Renewable Energy projects. The support for these projects is to be given *via* the Member States and the EUAs are to be auctioned so as to use the revenues in an administratively sound and efficient manner.

1.4.3 EU aviation allowances

From 1 January 2012, the EU ETS will extend to the aviation sector,¹² for emissions from all flights departing from or arriving at an EU airport (including flights operated by EU-based and non-EU based carriers). EUAAs will be issued, which are not valid for surrendering for emissions by other than aircraft operators. Aircraft operators are allowed to surrender EUAs in addition to EUAAs.

EUAAs will be issued to the amount of 97% of average annual emissions from aircraft operators during 2004-2006. This amount is estimated at some 210 million EUAAs per year. 15% of this quantity will be auctioned, i.e. around 30 million EUAAs per year.

1.4.4 Limited recognition of Kyoto credits

In addition to EUAs, ETS operators may use (up to certain limits) credits that derive from emission reduction projects under the so-called Kyoto Protocol flexible mechanisms pursuant to the United Nations Framework Convention on Climate Change. These encompass **Certified Emission Reductions** (CERs) issued under the **Clean Development Mechanism** (CDM) and **Emission Reduction Units** (ERUs) issued under **Joint Implementation** projects (JI).¹³ Both CERs and ERUs represent a reduction of one tonne of CO₂ equivalent emissions.

Today, there are about 1,500 CDM projects registered which are expected to generate some 1.5 billion CERs. Newly registered projects may result in a further 1.2 billion CERs. Under the revised ETS Directive, for the combined second and third trading periods, ETS operators (including aircraft operators and operators in newly included sectors) may use these credits up to a limit of about 1.6 billion credits (i.e. some 120 million credits per year). CERs and ERUs thus add to EUAs as a compliance option. Given this **fungibility**, their price closely follows the EUA price on the secondary market, although they are generally traded at a discount as compared to EUAs.

1.4.5 Types of trade and trading mechanisms

Trading EUAs takes place both '**over the counter**' (OTC) and on **exchanges**. It is spurring on financial innovation into different types of traded instruments beyond the standard **spot** transactions, to **derivatives**, such as **forward**, **futures**, swaps, options, repos and a

¹¹ See http://ec.europa.eu/environment/climat/emission/carbon_en.htm.

¹² Articles 3c(1) and 3d(1) of Directive 2008/101/EC.

¹³ See http://unfccc.int/kyoto_protocol/mechanisms/items/1673.php.

variety of other more sophisticated structured products. Of particular significance to this consultation paper are the different features of spot and futures trades.¹⁴

- A spot transaction is an immediate exchange of an allowance for payment. Its main advantage is to provide instant access to the allowance. However, the buyer must have the necessary cash to hand and the seller must have the necessary allowances to hand for a spot transaction to take place. This applies whether or not a **central counterparty** or a **clearing house**¹⁵ is involved and regardless of whether the transaction takes place OTC or on an exchange.
- A futures transaction is an exchange-based standardised trade to buy or to sell at a given future date at a pre-set price. Both parties must honour the futures transaction on the **settlement** or **delivery date** in order to **clear the trade**. In case either party **defaults**, the exchange's clearing house acts as a guarantor of execution, stepping in to honour the trade on behalf of the defaulting party, either by settling the payment due or by delivering the allowances due. To cover the risk of default on either side, the exchange's clearing house operates a **margining system** designed to collect enough funds from either side over the life of the futures contract to ensure that it is in a position to step in and execute the contract in case of default by either party. In effect, the clearing house is buyer to every seller and seller to every buyer of a futures transaction.

Holding a **futures position** as a buyer means that one: commits to accept delivery on the delivery date; is said to hold a **long position**; makes profit if prices increase over time and aims to secure a purchase price. Entering a futures transaction as a seller means that one: commits to make delivery on the delivery date; is said to hold a **short position**; makes a profit if prices decrease over time and is aiming to secure a sales price.

Futures transactions tend to command a premium as compared to spot transactions, in particular to reflect the fact that the seller is foregoing payment until a later date and to take account of the interim risk.

In regulatory terms, allowances sold on a spot basis are **commodities**, whereas allowances sold on a futures basis are **financial instruments**, which are regulated under the Markets in Financial Instruments Directive¹⁶ (MiFID) and the Market Abuse Directive¹⁷ (MAD).

¹⁴ Because of the lack of standardisation and the absence of a clearing house, forwards are unsuitable for large scale auctioning.

¹⁵ A clearing house acts as guarantor of the transaction in case of default by either the buyer or seller. A central counterparty merely guarantees execution of the buyer and seller's transfer orders but does not guarantee the performance of the transaction for either side. Moreover, clearing houses provide netting services that central counterparties do not provide. This is why daily margining services for futures transactions covering the period until the maturity date (see section 4.2.2) are ordinarily provided by clearing houses attached to regulated carbon exchanges. Central counterparties are perhaps best suited for payment and delivery in spot auctions whilst clearing houses may be better suited for payment and delivery in futures auctions.

¹⁶ Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L 145, 30.04.2004, p.1, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:145:0001:0044:EN:PDF>.

Pursuant to this legislation, exchanges that trade EUA futures are regulated financial markets, whereas exchanges that trade purely spot allowances do not have to be regulated entities. Nevertheless, **spot futures** are also financial instruments traded on regulated markets.

1.4.6 Market participants

(i) Types of participants

Participants in the European carbon market can be divided into ETS operators (also known as compliance participants) and participants other than ETS operators.

The two main categories of ETS operators are power companies and industrial companies be they large, small or somewhere in between. Other operators encompass a mixed bag of mostly **small emitters**. Of course, in the real world, various companies perform both energy and industrial activities.

At present, the scheme covers around 11 000-11 500 installations owned by some 5 000 companies, with emissions ranging from a hundred tCO₂ per installation per year to tens of millions. In 2008, total EU ETS emissions amounted to 2.072 billion.¹⁸ Electricity production accounted for close to 55% of total emissions; iron & steel, oil refining, and cement represented each between 6.5% and 9.0% (24% taken together).

The 25 largest participating *companies* represented more than 50% of 2008 EU-25 emissions (18 power companies, 3 oil & gas companies, 3 steel companies and 1 other company). The smallest 80% of *installations* only counts for some 10% of emissions.¹⁹

The participants other than ETS operators can be divided as follows.

- **Intermediaries**, including both financial and other intermediaries (for instance power utilities, producers/importers of gas, oil and coal).
- Participants trading on their own account ('own-account traders'), including investment banks, commercial banks, carbon funds, insurance companies, hedge funds, project developers supplying CERs and ERUs.

Of course, market participants may carry out activities in different categories at the same time. For instance, power, oil and gas companies (together referred to as energy companies) may have installations covered by the EU ETS (power plants, oil-platforms, refineries, etc.), whilst also being engaged in intermediation through their trading desks and integrating intermediation in carbon products in their other trading activities.

Given the rules on free allocation, the power sector will represent the lion's share of net demand for non-freely allocated allowances both in the EU-wide auctions and the secondary market. Direct participation in auctions by **small and medium sized enterprises** (SMEs) covered the EU ETS and small emitters is unlikely to exceed 10% of overall emissions at the most. These companies are more likely to acquire any allowances they may need through intermediaries, notably the banks with which they already have a business relationship,

¹⁷ Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation, OJ L 96, 12.04.2003, p.16, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:081:0042:0044:EN:PDF>.

¹⁸ ICF International estimates based on "[Verified Emissions for 2007-2008 and allocations 2008 \(.xls\)](http://ec.europa.eu/environment/climat/emission/citl_en.htm)" downloaded from http://ec.europa.eu/environment/climat/emission/citl_en.htm.

¹⁹ The revised ETS Directive provides new rules to exclude some of the smallest emitters from the EU ETS, but the situation will remain similar in the third trading period: a relatively small number of large emitters, a very large number of smaller emitters.

albeit for a premium. This may offer them the advantage of minimal **transaction costs** as well as certainty on the price and quantity. Indeed, competitive and efficient intermediaries are probably the most important means of ensuring access to allowances for SMEs and small emitters.

(ii) Trading profiles

Industrial buyers for whom trading commodities is not a core business, tend to require less sophisticated carbon products (e.g. spot). Large ETS operators, particularly in the energy sector, and participants other than ETS operators for whom trading is a core business tend to trade in more sophisticated products (e.g. forward, futures and so on). The first have often developed in-house expertise on the back of their power and other energy commodities trading desks. Industrial companies for whom trading is not a core business tend to rely on intermediaries to source their needs of the more sophisticated carbon products. The same also seems to hold true of SMEs and small emitters.

Of course, the differences in trading profiles derive from different volumes of emissions and differences in levels of free allocation. There is no need for hedging in as far as operators (continue to) benefit from free allowances. Growing experience and reduced levels of free allocation, may, however, increase the appetite for trading at least amongst industrials with larger emissions.

(ii) Hedging profiles

Most ETS operators trade to **hedge** or protect their emissions position by reducing their exposure to rises in carbon prices. They do so by buying allowances (be it spot or futures) corresponding to their expected emissions and expected or realised sales. Depending on the profile and level of sophistication of participating companies, hedging can take place several days, months or years in advance. Power companies have been the most active 'hedgers' on the market so far.

The demand for hedging is met by other participants such as financial institutions or the trading desks of energy companies. Their activity contributes significantly to **liquidity** on the secondary market, and is necessary for providing ETS operators access to hedging solutions. By efficient portfolio management they can minimize overall risk, thereby minimizing the premium they charge to their customers in forward transactions. Moreover, different participants will have different levels of risk aversion, which induces some to pursue more conservative trading strategies than others.

The distinction between ETS operators and other participants is however blurred. All carbon market participants have to take decisions based on the available information on past and present market conditions and cope with uncertainties as regards future market conditions. Intermediaries and/or own-account traders e.g. do not only provide hedging services but can also buy and sell carbon products for profit based on a variety of trading strategies, either on their own behalf and/or on behalf of one or more clients. Operators may buy allowances for compliance, but may also buy (or sell) larger quantities when they expect the price to increase (or fall).

1.4.7 Market development

(i) Price drivers

The EUA price is in the first place driven by perception of the price necessary to limit CO₂ emissions in the face of a decreasing cap on emissions. Therefore, the fundamental factors are those influencing the level of CO₂ emissions and the cost of reducing them. The most relevant non-regulatory 'market fundamentals' affecting the price of carbon are:

- Relative coal, oil and gas prices. Emissions from various industrial processes are highly dependent on the fuel being used, especially in the power generation sector. Relative fuel prices determine the cost of switching from emission intensive fuels to less emitting fuels.
- Weather. Cold winters and hot summers increase demand for heating/cooling. Rainfall determines the potential use of hydropower. Wind affects the production of wind energy. All these factors affect the need for fossil-fuelled electricity production.
- Economic activity. Lower/higher production implies lower/higher emissions. Lower/higher income affects demand, including the demand for electricity.
- Technologies and the cost of abatement measures. The carbon price triggers abatement measures, including fuel switching and technological development. It also triggers substitution of demand: over time, one can expect products involving high emissions to be replaced by products involving lower emissions in response to the additional cost of high emission products at higher carbon prices.

Not all traders on the carbon market trade (directly) on the basis of the above fundamentals, but trade rather on the basis of market sentiment, market trends, price ranges, price corrections, price fluctuations, market news and the like. Most notably, they may act as **arbitrageurs** by exploiting and trading away different price anomalies or **spreads**, e.g. between the carbon currencies.

As these fundamentals, indicators and sentiments change, carbon market participants' perception of their trading position will change, as will their perception of the overall scarcity of carbon allowances in the market. Participants will react by adjusting their positions *via* the secondary market.

(ii) Market size and liquidity

In 2008, EUAs made up 80% of the world-wide carbon market, CERs 17%, and ERUs 2%. The remaining 1% was made up of all other carbon currencies such as allowances traded in other emissions trading systems in the world.

Albeit relatively young and still maturing, the secondary market for EU allowances is already well established. Standardised transactions have been taking place since before the start of the first trading period and transaction volumes have increased from 262 million tCO₂ in 2005 to reach more than 3 billion tCO₂ in 2008.²⁰ Thus, the market has grown exponentially in a very short space of time. Despite this impressive growth, the secondary market is still very much under development when compared to markets such as those for government debt, company securities, commodities like oil or coal and money markets.

OTC spot and forward transactions were the norm in the early days of the European carbon market but they have receded with the development of standardised exchange-based spot and futures trades. The majority of transactions now take place through exchanges, with the remainder of transactions taking place OTC. At present, various exchanges exist, the largest ones trading between 20 and 30 MtCO₂ altogether per day in Europe.²¹

In 2008, futures accounted for more than 80% of exchange-based transactions, but in early 2009 the share of spot trading has increased significantly as companies sought to raise cash

²⁰ ICF International estimates based on exchange trading data, including OTC transactions cleared through exchanges.

²¹ These are ECX/ICE, Nord Pool and EEX (mainly trading futures), BlueNext (mainly trading spot), Green Exchange (futures and options) and Climex (spot EUA trading).

in the face of the credit crunch by selling their allowances. Futures **maturity dates** currently extend to December 2014, though contracts that mature in December following the trading date are the most liquid.

The current system of free allocation creates long and short positions, which are eventually balanced through transactions occurring on the secondary market. With large scale EU-wide auctions taking place in the third trading period, ETS operators are expected to take part so as to acquire what they need, thereby potentially reducing their activity on the secondary market. This could reduce the overall liquidity of the secondary market. However, in practice, a number of factors will make it essential for market participants to trade or to continue to trade on the secondary market in addition to bidding in the auctions:

- As already mentioned, certain drivers of emissions (hence of demand) are subject to constant variations: fuel prices, economic activity and level of demand in each industrial sector, weather, etc. The flow of new information regarding these drivers will provide a minimum level of market liquidity.
- ETS operators do not have full foresight with regard to their expected emissions.
- At each auction, a number of bidders will not be successful.
- Intermediaries and own-account traders will participate in the auctions and by definition generate subsequent transactions and market liquidity. Exchanges have a key interest in supporting market liquidity as it increases their revenue from their core business.
- Risk management represents a substantial share of trading and will not be affected by auctioning.

Accordingly, a number of analysts and market participants believe that secondary market trading volumes will keep increasing over the second and third trading periods, as more compliance participants join the market and market participants become more and more sophisticated. It is not expected that large scale EU-wide auctions will lead to a material fall in market liquidity. However, no detailed study exists on this issue, and given the uncertainties, any estimate must be treated with due caution.

Up to now, the share of physical delivery in the European CO₂ futures market is significantly higher than in other derivatives markets, i.e. futures are not only used for hedging strategies, but as a means of buying or selling allowances. There is no specific reason to expect this to change, given the nature of EUAs compared to other exchange traded commodities, i.e. the fact that they are delivered electronically rather than physically at a variety of locations making them ideally suited for exchange-based futures. In any event, the volume to be auctioned in the third trading period will be considerable compared to trading volume. An assumed volume of allowances to be auctioned of at least 1 billion per year corresponds to some 5 million per day over say 200 trading days.

(iii) Risk of anti-competitive behaviour and market abuse

To date, the following elements may have mitigated the risk of **anti-competitive behaviour** and/or **market abuse** (see section 4.9.1 for more details).

- The size of the market is relatively large compared to the needs of individual players, also when taking into account the concentration of emissions with a relatively limited number of large emitters. ETS operators effectively compete with intermediaries and other market participants trading on their own behalf. The number of active traders on the secondary market and its liquidity has steadily increased.

- Regulatory features provide flexibility and liquidity.
 - EUAs can be used in any year within the trading period. This provides flexibility to operators. This also mitigates the impact of individual price drivers as they may have a relatively small impact on overall scarcity over the (remaining) trading period and many of them may balance out in the medium term. In this respect, EUAs are very different from a product like electricity which cannot be stored and where anti-competitive behaviour and market abuse can have a much quicker pay-off because wholesale prices for immediate delivery are determined in short intervals (typically hourly).
 - The issuance date lies two months before the surrendering date for the previous year, so at the latter date ETS operators dispose of two annual tranches of free allocations. Furthermore, although subject to certain limits, operators have the possibility to use CERs and ERUs.
- The carbon market is rather transparent. Information on individual allocations for free and verified emissions of individual installations is publicly available. Exchanges and specialised news services provide information on trading on a daily basis or even more frequently. Analysts' reports are generally available to any potential buyer and various companies make a business of providing quality information services to market participants. Most information on the main drivers is also generally available to all market participants.
- So far, most ETS operators receive allowances for free for a major part of their needs. This limits the incentives for hoarding.
- Markets are open and entry is relatively easy. The administrative burden to open an account is not onerous.²²
- The dynamics of developing a new market have generated competition between exchanges to attract business. In order to be as attractive as possible, a number of them have measures to ensure competitive trading and avoid market abuse and supervise trading on their exchanges. To this end, they enforce their own rules, sometimes regardless of whether the trade in question is itself regulated or not.

In the final year of a trading period, the flexibility of using allowances issued for later years does not exist, which may render the situation somewhat different. However, ETS operators may be expected to build up a buffer of allowances, being able to bank it if not needed. In addition, if the price goes up, one would expect there to be competition to serve any ETS operator in need of allowances at the last moment. At the end of the trading period, attention to potential **hoarding** (e.g. by stockpiling more than anticipated compliance needs) and/or **cornering strategies** (e.g. by stockpiling allowances to create price peaks at given dates such as surrendering dates) may be relatively more important, whilst **banking of allowances** to the next trading period may reveal information on the strategies followed.

However, the increase of auctioning will generate large net buyers on the market with compliance needs that exceed 10% of the total volume auctioned. Because of their size,

²² Annex IV of Commission Regulation (EC) No 2216/2004 of 21 December 2004 for a standardised and secured system of registries pursuant to Directive 2003/87/EC of the European Parliament and of the Council and Decision No 280/2004/EC of the European Parliament and of the Council Text with EEA relevance, OJ L 386, 29.12.2004, p.1, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:386:0001:0077:EN:PDF>.

market strategies followed by such actors may more easily influence prices. These large buyers are mostly active in the power generating sector, which is a sector with relatively high market concentration and less than satisfactory degree of competition.²³ In addition, power generators largely or fully pass through the cost of allowances in the prices they charge to their customers. Indeed, higher carbon prices may increase profitability in particular for those power generators selling electricity from low-carbon sources and in particular when they sell in markets where the price is determined by supply based on the use of fossil fuels involving higher emissions.

For these reasons, ensuring an adequate supply of allowances into the market, which takes into account hedging strategies pursued, is of key importance for avoiding cornering strategies. In any event, in accordance with Article 10(5) of the revised ETS Directive, the Commission will monitor the functioning of the European carbon market, submit an annual report and may propose any measures as appropriate.

1.5 Important underlying considerations

When assessing the various options outlined in each section of the present consultation to achieve the Regulation's objectives, the following considerations are important to bear in mind to ensure not only the "economic efficiency", but also the "financial integrity", and "institutional credibility" of the EU ETS auctioning system. They highlight the different trade-offs that will need to be considered when shaping the Regulation.

1.5.1 Simplicity

EU allowances have a small individual value, there are no differences in qualities (except the trading period and the sub-category for aviation) and they are large in number. In principle, these features make them a relatively easy product to auction and allow for a simple design overall. However, complexity may derive from differences between product types and auction processes (if more than one). Moreover, the Regulation will have to take into account the heterogeneity of bidders and auctioneers (if more than one). Simplicity is crucial to foster participation and competition, which in turn is crucial for avoiding market abuse and other non-competitive behaviour.

The present document provides, however, for a large number of options and choices on the details and this inevitably involves some complexity. However, the greater the degree of differentiation or flexibility in **auction design** and **auction process**, the more complexity is injected into the whole process.

1.5.2 Openness, fairness and the secondary market

The revised ETS Directive requires auctions to be open and puts emphasis on fair access to allowances for SMEs covered by the EU ETS and small emitters. Auctions must be open regardless of nationality or place of establishment within the EU.

Direct access does not mean that there is no role to play for financial or other intermediaries. To the contrary, excluding intermediaries would disadvantage smaller players that do not have the required skills to take part directly in auctions or for whom developing such skills is simply not cost-effective in view of the fixed and marginal costs of direct participation. The smaller the volume of trade the higher the fixed costs will be for the participant in proportion to the value of the resulting transaction. This also applies to the

²³ See e.g. the European Commission's inquiry into competition in gas and electricity markets, <http://ec.europa.eu/competition/sectors/energy/inquiry/index.html>.

auctioneer. Therefore, the ultimate level of openness to SMEs and small emitters will necessarily have to be balanced against the need to ensure cost effectiveness and reduce any undue administrative burden.

Auctions where SMEs and small emitters participate indirectly may therefore need to be subject to conditions on the direct participants so as to ensure full, fair and equitable access for SMEs and small emitters.

A well functioning secondary market is of high importance for efficient intermediation and for those emitters that choose to rely on intermediaries. A clear price signal from the secondary market is also important as a reference point for individual bidders in the auctions and for ensuring a competitive outcome: anti-competitive behaviour and market abuse is less likely to be successful in case it requires influencing not only the EUA auctions, but also the entire secondary market.

In addition, established practices on the secondary market as regards procedures, technical systems, delivery and payment processes, to mention but a few, may provide relevant lessons for the development of reliable and secure auctioning systems. Consistency between auctions and the secondary market can be expected to foster efficiency.

This consultation paper will seek to canvass views on all of these issues. In addition, ICF is surveying small emitters that were short on allowances in the first trading period to find out how they sourced their allowance shortfall.

1.5.3 Participation costs and competition

Designing auctions with low transaction and participation costs is desirable as it encourages wider bidder participation, thereby effectively increasing the competitive pressure and reducing the possibility of **market manipulation** and **collusion**. Where there is a choice, participants can be expected to prefer the most efficiently organised auctions and discount their offers at less efficient auctions to reflect the additional costs, thereby reducing auction revenues.

Many design issues can affect the cost of participating in each auction: the participation requirements e.g. financial guarantees; the type of contracts auctioned e.g. spot or futures; and the integrity of the system in terms of equal access to auction information and the protection of confidential bidding information.

In addition, an insufficient degree of harmonisation across Member States, for instance on the administrative, financial, or technical conditions for participating in auctions, would also increase the costs of participating in different auction processes, and reduce overall participation increasing the risks of market manipulation and collusion.

1.5.4 Predictability of large scale auctioning

The increase in the share of allowances to be auctioned in the third trading period represents a sea change compared to auctioning in the first and second trading periods. A substantial **primary market** will emerge and supplement the existing secondary market. It remains to be seen what the relationship between the primary and secondary market turns out to be.

This underpins the need for predictability as required by the revised ETS Directive. Design and organisation of the auction(s) must lead to a predictable flow of allowances being available to market participants. Volume predictability is important to build market participants' confidence, ensure clarity and reliability of the carbon price signal, and create conditions for ETS operators to make sound investment and trading decisions.

As in many other markets, EU allowances' market dynamics are influenced by a variety of uncertain elements and events. The rules governing the supply of EU allowances through the primary market should not add a layer of regulatory uncertainty.

1.5.5 The need for harmonisation and non-discrimination

The need for harmonisation in the Regulation stems very much from the very same premise for harmonisation underpinning the revised ETS Directive alluded to in section 1.3 above. It stems from a desire to ensure that the allocation of allowances is carried out in the same way across the EU in order to avoid competitive distortions across Member States. It is grounded in the call for harmonisation expressed by stakeholders during the Commission's review of the EU ETS in 2007.

It is therefore essential that the Regulation harmonises the rules of the game for auctioning across the EU wherever necessary to ensure a level playing field between bidders across the EU. Moreover, harmonisation is particularly relevant to avoid the possibility of Member States discriminating in favour of national companies in auction processes.

In short, having opted for a harmonised Community approach under the revised ETS Directive, auctioning must not become a vehicle for the fragmentation of the European carbon market along national lines.

1.5.6 Efficiency and the number of auction processes

Many of the questions in this consultation hang together with the question of who should carry out the auction(s). At the heart of the matter is the degree of (de-)centralisation that should be mandated in the Regulation in terms of the number of separate auction processes allowed. The revised ETS Directive does not lay down the number of auction processes to be used in order to meet its objectives, but leaves this for the Regulation.

Auction process refers to the whole process of organising an auction, encompassing the following functions: setting the date and volume of auctions to take place; registering and pre-qualifying participants; providing the platform and infrastructure; collecting bids, managing collateral, running the auction, calculating the results and resolving eventual ties, ensuring payment and delivery and monitoring. **Auctioning platform** refers to the IT system used by an auctioneer to run the auction.

It needs little assessment to conclude that an approach of **full decentralisation**, where each Member State runs its own auction process(es), delivers an unsatisfactory outcome potentially fragmenting the European carbon market and multiplying administrative costs. Efficiency and a level playing field may be better ensured by the opposite approach of **full centralisation**, where auctions are run on behalf of all Member State through a single EU-wide auction process along a predetermined calendar and set of rules. This is the approach adopted by the **Regional Greenhouse Gas Initiative**²⁴ (RGGI) in the United States (US) which so far is the only example of how to organise auctions on behalf of different states.

An intermediate, **coordinated approach** may consist of limiting the number of auction processes that could be set up by Member States either individually or jointly to a manageable number so as to reduce the risk of distorting the carbon price signal. In this approach, each Member State can auction the allowances it is responsible for through one auction process or more, whilst several contractual relationships can be envisaged between Member States and auctioneers. This approach requires coordination between the different auction processes, e.g. in terms of auction calendar.

²⁴ For more information on RGGI auctions, see <http://www.rggi.org/co2-auctions>.

Another intermediate **hybrid approach** divides the auction process in two. Auctions would be held at pre-determined, common time slots. Individual auction processes (e.g. in different Member States) would be responsible for pre-registering participants and collecting bids and submit all the bids received to a centralised auction platform. On the basis of aggregated demand (all orders collected by Member States/platforms) and aggregated supply (all allowances auctioned by all Member States), the auction platform determines the **clearing price** and announces the results. Managing **collateral, payment** and **delivery** would be done most timely and cost-effectively by means of a centralised clearing house.

It goes without saying, that auction revenues will belong to the Member State responsible for the relevant EUAs as laid down in Article 10(2) of the revised ETS Directive. This applies to all approaches. In the hybrid approach, this applies irrespective of the volume of winning bids for a given auction process.

The advantages and disadvantages of these approaches are discussed in section 5, though each option has different implications for many of the other aspects dealt with in other sections.

2. What and when to auction?

2.1 What to auction and how early?

The product auctioned will be mainly characterised by the following attributes.

- Nature: EUAs or EUAAs, trading period concerned.
- Date of delivery: date at which winning bidders will receive the allowances on their registry account.
- Date of payment: date at which payment will be required from winning bidders.
- Lot size: number of allowances associated with one unit of the auctioned good.

2.1.1 Early auctions: why?

Early auctions refer to auctions held prior to the relevant year in the trading period. An allowance which falls under the cap calculated e.g. for the year 2014 may be auctioned already in 2012 or 2013.

As set out in section 1.4.6, hedging price exposure is a widely used practice for firms, at least for the largest ones, and in particular for electricity producers. Such a need for hedging does not arise to the same extent when companies know they will receive allowances for free, but from 2013 onwards, free allocation will be reduced significantly.

Currently, future carbon emissions are primarily hedged by buying futures, although spot may also be used especially nearer the surrendering date. At present, the secondary market fulfils these hedging needs. With respect to the third trading period, however, the accepted view seems to be that, without early auctions, some participants (intermediaries or others) will have to take large short positions (e.g. sale of futures not covered by purchases). To cover price exposure, and for some of the participants in line with the **Basle II accords**,²⁵ they will have to put up capital reserves. Therefore, this may lead to:

- an increase in the premium charged on futures; and
- an increased risk of systemic dysfunction of the carbon market if any of the intermediaries were to fail to deliver the contracted EUAs upon maturity in case of scarcity.

Early auctions may address the concerns either by allowing compliance buyers to fulfil part of their hedging needs directly through the auctions, or by enabling intermediaries to offer hedging contracts at improved conditions.

Early auctions however, also have risks.

- First, auctioning too many allowances early on may depress prices in the short term especially if the secondary market turned out to be well supplied with EU allowances due for instance to lower than expected carbon emissions.
- Second, not all market participants may be interested in taking part in early auctions, especially if the secondary market was longer rather than shorter, so participation in early auctions may be more limited, thereby increasing the risk of market manipulation or collusion.

²⁵ International Convergence of Capital Measurement and Capital Standards: A Revised Framework, <http://www.bis.org/publ/bcbs128.htm>.

Apart from potential hedging needs, the importance for the first auctions to take place early (notably 2011) may reside in providing certainty to the market that all arrangements for auctioning are in place well in time for a proper functioning of the primary market.

2.1.2 Auctioning spot or futures?

Spot auctions refer to auctions resulting in (near) immediate payment and delivery. **Futures auctions** refer to auctions of allowances which will be delivered e.g. several months or years after the auction date.²⁶ Spot or futures auctions by definition concern standardised transactions, tradable on the secondary market. Auctioning futures will necessarily involve exchanges.

Some argue that auctioning futures is more attractive to bidders as it requires less initial outlay of cash as compared to spot auctions where immediate full payment is required. The auctioneer will, however, require **initial** and **variation margin calls**, in order to mitigate the risk of default by the buyer ("credit risk") and the risk of post-auction market price fluctuations should the bidder default ("market risk"). This involves a clearing house to act as counterparty between the auctioneer and the bidder. Depending on which way the post-auction price fluctuates variation margin calls can be quite substantial for the bidder. The risk of default of delivery by the auctioneer could conceivably be mitigated by having the auctioneer delivering the contracted EUAs into a blocked registry account at the outset.

Auctioning futures would have the advantage of allowing large emitters under the EU ETS to source at least part of their hedging needs directly from the primary market without having to go through intermediaries, thereby reducing overall transaction costs in the market. This would, however, also imply reduced liquidity in the secondary market. Moreover, the choice may affect the revenues from auctioning.

Auctioning futures requires important decisions on the precise design (maturity dates, clearing and margining systems). However, liquidity of the secondary market hinges on the use of standardised contracts in all futures auctions throughout the EU, which should mirror as closely as possible prevailing secondary market futures and clearing house rules. If not, futures auctions should be discounted as an option altogether, since the proliferation of a variety of different types of national futures transactions would threaten the current relative uniformity and stability of the secondary market.

As regards the choice of the common maturity date, there may be a case for having the maturity date shortly before the surrendering date, though not too shortly given potential risks in the payment and delivery system (see section 4.3.2 below). Another argument is to follow closely the existing practice on the secondary market where futures mature in December, providing operators with flexibility to (re-)balance their portfolio's at the end of the year, taking into account any fiscal and accounting considerations. With a view to safeguarding the liquidity of the secondary market, having more than one common maturity date per year does not appear desirable, despite the fact that this could match hedging practices on other markets such as those for oil, gas and coal.

The additional burden associated with futures as compared to spot auctions will hardly be justifiable if auctions are held closer to the maturity date of the futures transaction in question (e.g. less than six months between the day the auction takes place and the delivery

²⁶ The revised ETS Directive does not preclude physical delivery of allowances to take place before the beginning of the trading period, despite the fact that these allowances can only be used for compliance purposes in the trading period concerned. Delivery before 2013 will, however, require adaptation of the CITL, which will not be possible to implement before 2012 it seems. If necessary, the feasibility of interim solutions will need to be considered by the Commission.

date). Conversely, if futures are to be auctioned far in advance (e.g. 2 years or more in advance, in line with the hedging needs of some ETS operators), the actual demand for these products should first be confirmed.

Finally, spot transactions are much simpler than futures, which in view of the issues raised above, involve much higher complexity. This could increase the administrative and financial burden thereby reducing participation and increasing the risk of market manipulation and/or collusion.

2.1.3 How much and how early? Availability of allowances

As explained in section 2.1.1, the optimal quantity and the optimal timing of early auctions may depend on the actual aggregate hedging strategies: how much and how early? The assessment should also take into account the volume of EUAs and rights to use CERs and ERUs available for banking from the second to the third trading period. With more than 3 years of the second trading period ahead, any estimate of this volume is highly uncertain, but it cannot be excluded that the combined volume available for banking from the second to the third trading period will amount to around 1,400 to 1,800 million EUAs and rights to use CERs and ERUs.²⁷

The examples below illustrate possible levels of early auctioning and the different proportions of spot versus futures auctions, assuming 1 billion allowances being auctioned per annum.²⁸

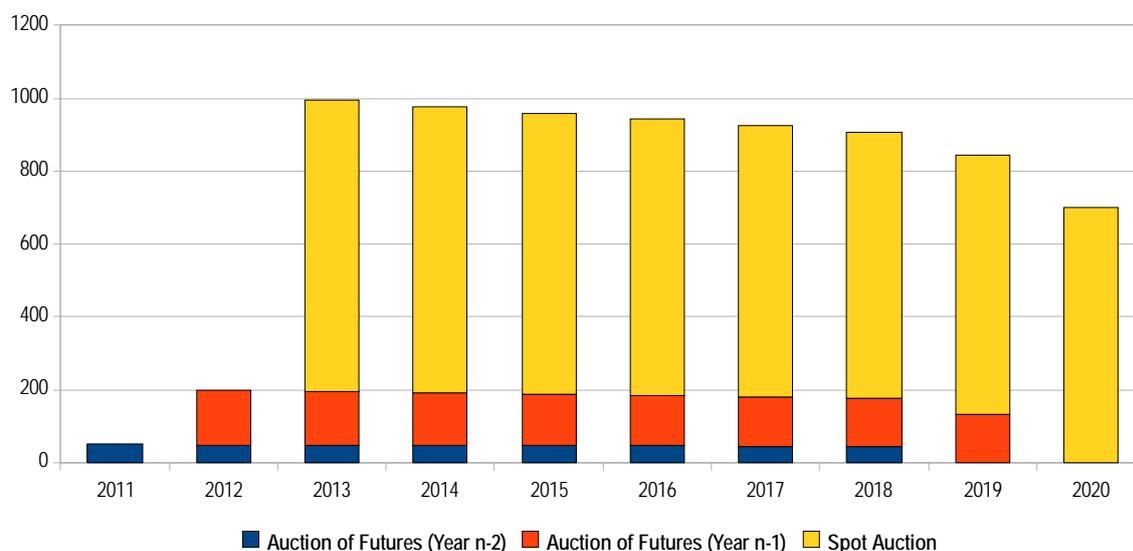


Figure 1 – Annual auction volume, assuming for the annual cap of year n: 5% futures in year n-2, 15% futures in year n-1 and 80% spot in year n

²⁷ ICF International estimates, corresponding to the scenario where the EU aims to cut GHG emissions by 20% in 2020 compared to 1990.

²⁸ Year n refers to any given year in the third trading period. Year n-1 refers to the previous year. Year n-2 refers to the year that is two years earlier.

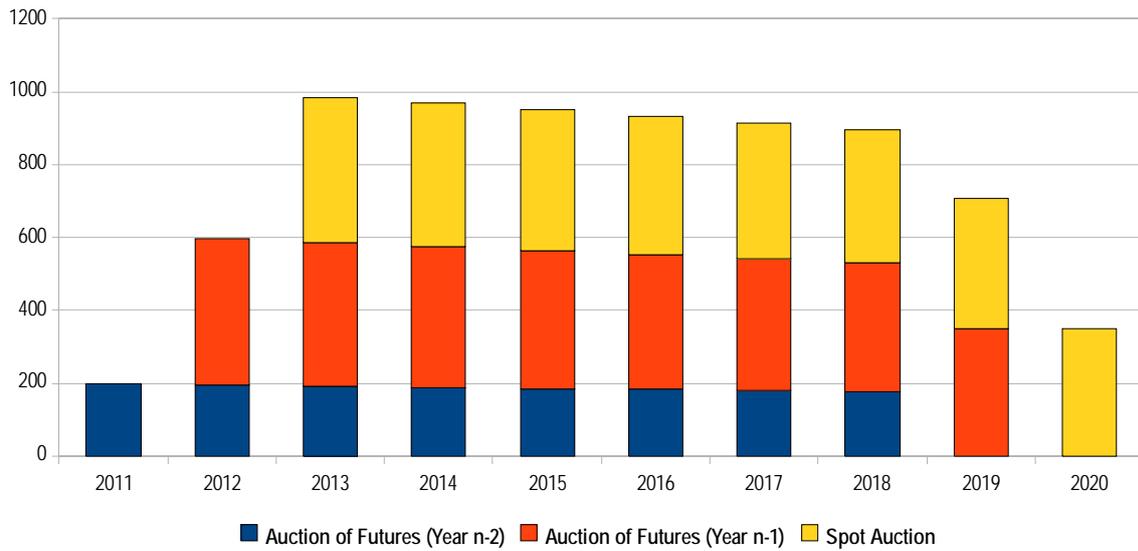


Figure 2 – Annual auction volume, assuming for the annual cap of year n: 20% futures in year n-2, 40% futures in year n-1, 40% spot in year n

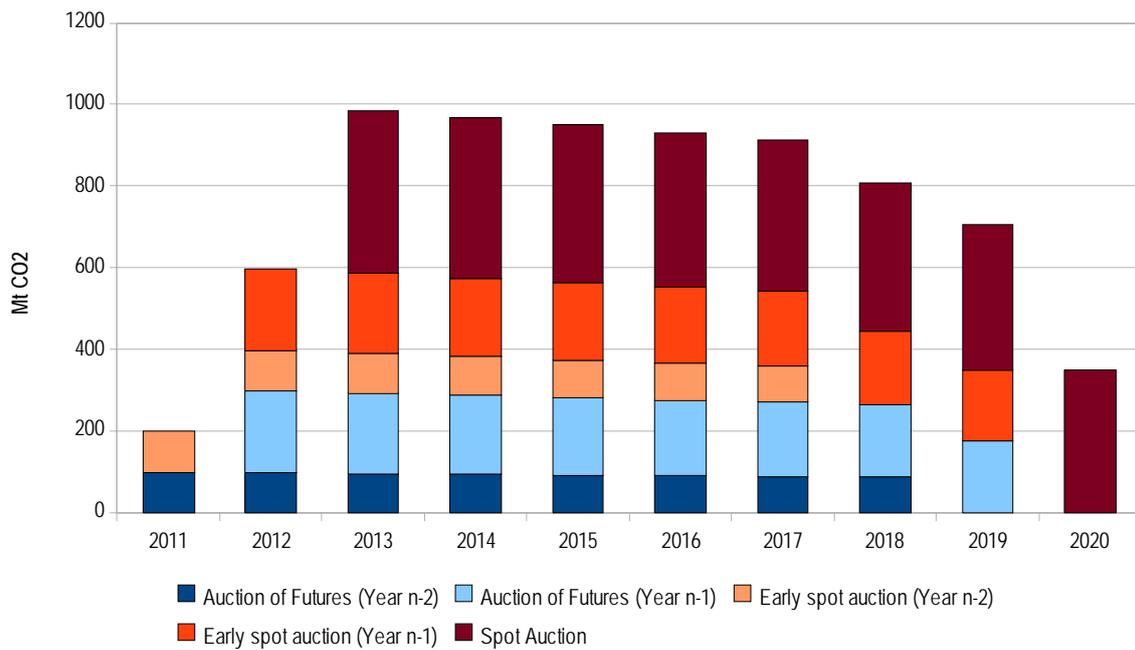


Figure 3 – Annual auction volume, assuming for the annual cap of year n: 20% early auctions in year n-2 (half spot; half futures), 40% early auctions in year n-1 (half spot; half futures), 40% spot in year n

So the allowances available in April 2014 for compliance with respect to emissions during 2013 will be the sum of:

- a) the volume of allowances auctioned spot during that year (2013) and during earlier years if any (including any such allowances stemming from the cap for later years);
- b) the volume of 'early auctions of futures' during earlier years, if any, with a maturity date before 30 April 2014;

- c) the portion of allowances delivered through spot auctions during the first months of 2014; and
- d) allowances banked from the second trading period.

To this must be added rights to use CERs and ERUs:

- a) unused in the second trading period; and
- b) awarded for the third trading period.

For subsequent years the quantities are adapted correspondingly. Theoretically, one would expect the quantities of EUAs, CERs and ERUs banked from the second trading period to be consumed throughout the third trading period, though at the end some banking into the fourth trading period may take place.

Artificial lack of allowances around surrendering dates (30 April in the year following the issuance of allowances) could lead to unexpected price volatility or favour hoarding and cornering strategies to the detriment of the proper functioning of the carbon market. However, all allowances under the cap determined for a given year and not allocated for free would be auctioned by the end of that year. Therefore, one would not expect any such artificial scarcity to arise (the situation would be different only for the last year of the trading period). The examples above demonstrate that at surrendering dates, the quantity of EUAs, CERs and ERUs available for surrendering is well above expected compliance needs. This depends in particular on the:

- a) expected quantity of EUAs, CERs and ERUs banked into the third trading period;
- b) proportion of early spot auctions and early auctions of futures that have matured and been delivered; and
- c) proportion of spot auctions in the first four months of the year (see section 2.2.2 below).

Question 1 As a general rule throughout the trading period, in your opinion, are early auctions necessary? If so, what should the profile of EUA auctions be?

- 5-10% in year n-2, 10-20% in year n-1, remainder in year n
- 10-20% in year n-2, 20-30% in year n-1, remainder in year n
- 20-30% in year n-2, 30-35% in year n-1, remainder in year n

Other? Please specify.

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

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 : _____% | _____ %
- year n-1 : _____% | _____ %
- year n-2 : _____% | _____ %

Please provide evidence to support your case.

NB: The answer to this question will be published as part of the public consultation. Please do not submit confidential information as part of your answer to this question.

Question 4

Should the common maturity date used in futures auctions be in December (so the maturity date would be December in year n, both when auctioning in year n-2 as when auctioning in year n-1)? If not, please suggest alternative maturity dates and provide evidence to support your view.

Request for potentially confidential information 1

Please send the answer to this question in paper and electronic format, marked on the envelope "Strictly Private and Confidential – Auctioning consultation", directly to the European Commission, DG ENV, Directorate C, Unit C2, to the attention of the Head of Unit, Office BU-5 2/1, 1049 Brussels, Belgium. It will be treated confidentially and will not be disclosed publicly.

For ETS operators: what share of your expected emissions covered by the EU ETS in a given year n do you hedge and how much in advance?

- year n : _____%
- year n-1 : _____%
- year n-2 : _____%
- earlier years (please specify) : _____%

Request for potentially confidential information 2

Please send the answer to this question in paper and electronic format, marked on the envelope "Strictly Private and Confidential – Auctioning consultation", directly to the European Commission, DG ENV, Directorate C, Unit C2, to the attention of the Head of Unit, Office BU-5 2/1, 1049 Brussels, Belgium. It will be treated confidentially and will not be disclosed publicly.

What share of the annual quantity of allowances you intend to purchase *via* auctions would you wish to buy spot or futures respectively?

- | | | SPOT | | FUTURES |
|---|----------|------|--------|---------|
| • | year n | : | _____% | _____ % |
| • | year n-1 | : | _____% | _____ % |
| • | year n-2 | : | _____% | _____ % |

Please specify whether you are an:

- ETS operator; or
- other participant.

2.2 Auction calendar

A credible and firm auction calendar is of crucial importance for protecting the integrity of the European carbon market.

The **auction calendar** would cover the:

- annual volume of auctions;
- distribution over spot and futures (if any);
- dates of individual auctions spot or futures (if any);
- auction processes used for each individual auction; and
- size of each individual auction.

The auction calendar will largely be determined by the:

- number of different products to be auctioned: spot or futures;
- desirable number of auctions per year;
- desirable auction size; and
- distribution of quantities to be auctioned throughout a given year.

Ensuring a predictable auction calendar is evidently relatively easy in the case of full centralisation or if the hybrid approach were adopted. It becomes more complex in the case of the coordinated approach with multiple auction processes.

2.2.1 Size and frequency

(i) *Optimal auction size*

The optimal size for an individual auction raises different views.

Arguments in favour of bigger and fewer auctions are as follows.

- Auctions should be important events so as to draw attention and foster participation thereby ensuring competitive results.
- Each auction involves administrative costs and requires lead-time to prepare, both for the auctioneer(s) and for participants, even though a significant part of the costs may be fixed with the marginal costs of holding/participating in an additional auction diminishing over time. With large numbers of diverse participants throughout the EU, it may be challenging to have auctions more frequently than quarterly.
- Small and frequent auctions are likely to reduce the need for ETS operators to adjust their position on the secondary market, thereby reducing liquidity. The same may apply as well to other market participants. Low liquidity in the secondary market may increase price volatility reducing the overall efficiency of the EU ETS.

Arguments in favour of smaller and more frequent auctions are as follows

- Auctions that are big compared to normal trading volumes in the secondary market could result in a low clearing price and depress the price on the secondary market after the auction. It may be more difficult to match a large supply at a certain moment in time with sufficient demand.
- With 'big auctions', participants may lower their market activity before the auction or even try to move the market price down in order to influence auction results. More frequent and smaller auctions would lower these risks and provide a smoother process for delivering allowances to participants.
- More frequent auctions may make it more difficult for a player to acquire a volume of allowances big enough to be able to manipulate the market, as it would need to do so in a series of auctions, not just one. The higher frequency increases the chance of such a strategy being spotted. The value of this argument must, however, not be overestimated, since large players can be expected to participate in most auctions anyway and any player seeking to build up a strong position may also turn to the secondary market.

For the purposes of comparison, the average daily volume of EUA transactions (spot and futures) on the secondary market during 2008 amounted to around 15 million.²⁹ Trading activity increased significantly since the beginning of 2009. Assuming an average daily volume of EUAs of 50 to 60 million by 2012-2013, monthly auctions with an average auction size of 80 million EUAs or more would seem to be the minimum level of frequency for avoiding disturbance of the secondary market.

(ii) Maximum number of auction days per year

Practical constraints limit the maximum number of auctions that may be envisaged over the year. A higher frequency of auctions is likely to lower the level of participation in each individual auction and increases the risk that they interfere with each other. Given this possibility, weekly auctions with an average size of 20 million EUAs appear to be a maximum in terms of frequency for operating auctions in the EU ETS.

Simultaneous auctions, i.e. independent auctions run at the same time in case of full decentralisation or in the coordinated approach, should be strictly avoided: how should a participant distribute its bids over the two auctions?³⁰ If a bidder participates in both, bidding in one auction without knowing the outcome in the other may lead to more cautious bidding. It may also favour differentiated bidding strategies in the two auctions that may lead to a gap in the clearing price.

(iii) Need for coordination

The following example, provided only for illustration purposes, highlights the complexity in case of full decentralisation. The example assumes a weekly auction constraint (50 auction days per year, taking into account end of year holidays) and is based on a rough estimate of at least 1,000 million allowances to be auctioned every year for the third trading period.

Appendix 4 provides an estimate of the Member States' shares in the total quantity of allowances to be auctioned. In case each Member State were to be given a number of auction slots corresponding to the volume of allowances it is responsible for, 17 Member States would receive a single auction slot per year, whereas the largest recipient of

²⁹ ICF International estimate based on World Bank, ECX, BlueNext, EEX, and NordPool data.

³⁰ The issue of simultaneous auctions and the associated strategic behaviour does not apply to the fully centralised or hybrid approaches.

allowances for auctioning, Germany, would receive 7 slots. In this approach, individual auction sizes would range from 1 to 30 million EUAs.

	Volume (million)	No. of auctions per year	Auction size (million)		Volume (million)	No. of auctions per year	Auction size (million)
MT	1	1	1.00	NL	33	2	16.50
LU	2	1	2.00	GR	34	2	17.00
LV	2	1	2.00	CZ	46	2	23.00
CY	3	1	3.00	RO	49	2	24.50
SI	4	1	4.00	FR	54	2	27.00
LT	5	1	5.00	ES	84	3	28.00
IE	9	1	9.00	IT	94	4	23.50
SE	9	1	9.00	UK	102	4	25.50
EE	9	1	9.00	PL	122	5	24.40
DK	12	1	12.00	DE	196	7	28.00
AT	14	1	14.00				
SK	15	1	15.00				
HU	15	1	15.00				
FI	16	1	16.00				
PT	17	1	17.00				
BE	25	1	25.00				
BG	30	1	30.00				

No. of auctions	MIN SIZE	MAX SIZE
50	1 million	30 million

Table 1 - Number of auction days per Member States with weekly auctions and full decentralisation

This approach appears rather inefficient. On the bidder's side, participating in the smallest auction (1 million allowances, corresponding to 1,000 lots of 1,000 allowances) will be less cost effective. The smaller auctioneer, risks a lower clearing price and lower revenues, due to lower participation and reduced competition during the auction. Such an outcome would be detrimental to the functioning of the EU ETS, as discrepancies in the price paid for allowances by ETS participants in different auctions would arise, without any objective justification. It would be a direct outcome of the inefficiencies of the multiplicity of means adopted for the auction process. A reduced frequency in auctions will further increase the discrepancies between auctions (e.g. with 3 slots per month / 35 slots per year, auction sizes will range from 1 to 50 million EUAs).

Further complexity would arise when auctioning spot and futures and if early auctions were added to the equation: in case smaller Member States would auction both types throughout the timeframe, the total number of auctions would increase exponentially.

Establishing a minimum size for auctions may help to ensure a more efficient outcome. For example, if the Regulation sets a lower size limit for the auction of, e.g. 10 million allowances, 9 Member States will not reach the threshold for organising their own auctions. Table 2 (below) summarises the effect of different minimum auction size thresholds on the number of auctions.

Threshold	Number of Member States required to collaborate with others	Number of Member States reaching the thresholds individually	Number of auctions (per year)
20 million	15	12	50
40 million	19	8	25
80 million	22	5	13

Table 2 - Number of auctions per year based on different minimum auction sizes

Table 2 also illustrates the fact that setting a minimum auction size *per se* is not a sufficient and satisfactory approach for achieving a harmonised auction calendar. However, limiting the number of very small auctions is inevitably desirable for efficiency reasons.

2.2.2 Distribution of allowances over the year

The auction calendar must also address the distribution of the total annual volume of allowances over the year. Three main views can be put forward in this respect.

One view advocates a flat and homogeneous distribution over the year. This option has the beauty of simplicity, making it easier for participants to determine their strategies accordingly. It also corresponds to demand stemming from hedging needs from electricity producers which seems rather evenly spread throughout the year. Therefore, this approach may apply in particular to auctions of futures, if this type of auctions were found desirable.

A second view is that volume distribution should put more weight on the period prior to the deadline for surrendering. This may apply in particular to spot allowances, as participants may have a preference for a relatively larger share of spot auctions in the period prior to the deadline for surrendering.

A third view is that volume distribution should put more weight on periods during which EU allowances are expected to be more heavily traded. However, trading statistics for the years 2007 and 2008 do not highlight specific parts of the year during which market activity would justify a significantly increased volume of auctions.³¹

On balance, this suggests that auctioned volumes should be evenly spread over the year, though auctions of futures (if any) would end a few months before the maturity date, compensated by a higher share of spot auctions. One exception to the flat distribution of auction activity over the year can be envisaged with regards to the period immediately prior to the surrendering date for spot auctions and the corresponding period immediately prior to

³¹ In 2009 significant trade arose after large Member States issued the first free allowances for the second trading period. This market activity seems to have stemmed mainly from the economic recession, as some ETS operators sold or leased allowances in order to improve their cash flows.

the maturity date for futures auctions. In order to limit the risk of incidents or any unexpected interference with the secondary market, auctions could be suspended during a short period of time (e.g. 2 weeks to 1 month) before the surrendering and maturity dates.

2.2.3 Auction dates and times

Not all days of the year are suitable for auctions. Public holidays, in particular those common to most Member States, should be avoided. Likewise, the days between Christmas and New Year's Eve are not preferred. Another category of days to be avoided are those where important relevant data is released. This concerns first and foremost the day where the first set of verified emissions for a given year are published. This category may also include days where the International Monetary Fund (IMF), European Central Bank (ECB), Organisation for Economic Cooperation and Development (OECD) and International Energy Agency (IEA) publish relevant economic data.

In case more than one auction process is used, and given the need to avoid simultaneous auctions, auction dates should be allocated in a balanced manner. Specific rules such as a lottery or any other predetermined rule for allocating slots amongst auctioneer(s) would have to be envisaged with a possibility for rotation on a periodic basis.

Auctioning at a harmonised time slot minimises the chances for mistakes. A two-hour window from 10-12 am Central European Time (CET) for submitting bids, where bidders can alter submitted bids until the last moment in the time window, seems most in line with common market practice. This allows for effective participation and for the results to be absorbed by the secondary market the same day.

2.2.4 Setting the auction calendar – dates, volumes and product types

The revised ETS Directive requires the auction process to be predictable, particularly regarding the timing and sequencing of auctions and the estimated volumes of allowances to be made available. The Regulation should thus provide for an auction calendar which should cover the:

- annual volume of auctions, as well as the distribution spot/futures;
- dates and auction process/platform for individual auctions; and
- size of individual auctions.

In order to maximise predictability, the calendar should be fixed as much as possible in advance and in a credible manner. There should be no scope for Member States to game the EU-wide auction process by adapting the calendar opportunistically in function of short term market developments. Doing so would infringe the requirement of predictability laid down in Article 10(4) of the revised ETS Directive. It would also be highly counterproductive, as market participants would try to guess and anticipate potential responses, thereby increasing uncertainty and volatility in the market with potentially a very significant negative impact on the efficiency of the EU ETS.

There are, however, a number of uncertainties which may justify a certain degree of flexibility.

With respect to annual volumes:

- economic and technological developments will affect verified emissions and the quantity of EUAs, CERs and ERUs to be banked from the second into the third trading period; and

- market behaviour, such as the preference between spot and futures, may change over time.

With respect to individual auctions:

- experience with different ongoing auctions will increase. Proper evaluation may show that initial choices do not deliver the desired result; and
- unforeseen issues arising from the development of the auction platform(s) (in particular in the first few years) and, if more than one, changes to the list of auctioneers.

Furthermore, updating the calendar will be necessary:

- in case of significant changes to the estimated volume of allowances to be auctioned following implementing measures on carbon leakage and benchmarking and/or following a review of the revised ETS Directive in the light of the outcome of the international negotiations on climate change; and
- with respect to any remainder of the NER allowances not allocated for free due to the closure of installations.

In view of these uncertainties, the auction calendar may determine all variables on a rolling basis. For the immediate years the calendar would be definitive and binding, whereas for the later years it would be indicative and non-binding.

The calendar can take different legal forms and establishing the calendar may involve different legal procedures, all of these implying different balances between predictability and flexibility.

- Predictability and legal certainty would be highest if the calendar takes the form of an annex to the Regulation. Whenever needed, such an annex could be updated following the 'comitology' procedure foreseen in Article 10(4) of the revised ETS Directive (i.e. regulatory procedure with scrutiny).³² This may be most appropriate for determining the quantities to be auctioned each year and possibly the distribution over spot and futures.
- The Regulation could provide for the adoption of the calendar on the basis of another 'comitology' procedure that offers more flexibility, e.g. the advisory or management procedures. This could be appropriate for determining the precise dates and quantities for each individual auction and auction process involved.

For any detail of the calendar which is not decided as part of it, the Regulation should provide for a fallback position in case the procedure for setting the details does not lead to a timely conclusion.

Finally, a '*force majeure clause*' is appropriate with respect to unforeseen events like major disasters, breakdown of IT-systems, and the like. If triggered, it must be ensured that the respective volume is auctioned without unnecessary delay, even if this would require the use of another auctioneer.

³² Council Decision 1999/468/EC of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission, OJ L 184, 17.07.1999, p.23, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1999:184:0023:0026:EN:PDF>, last amended by Council Decision 2006/512/EC, OJ L 200, 22.07.2006, p.11, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:200:0011:0013:EN:PDF>.

Question 5

For spot auctions:

What should be the **optimum** frequency of auctions?

- Weekly?
- Fortnightly?
- Monthly?
- Quarterly?
- Other?

What should be the **minimum** frequency of auctions?

- Weekly?
- Fortnightly?
- Monthly?
- Quarterly?
- Other?

What should be the **maximum** frequency of auctions?

- Weekly?
- Fortnightly?
- Monthly?
- Quarterly?
- Other?

Please provide arguments to support your case.

Question 6

For spot auctions, what should be the:

- Optimum auction size?
- Minimum auction size?
- Maximum auction size?

If deemed appropriate, please indicate a range and/or distribution over different sizes.

Please provide arguments to support your case.

Question 7

For futures auctions:

What should be the **optimum** frequency of auctions?

- Weekly?
- Fortnightly?

- Monthly?
- Quarterly?
- Other?

What should be the **minimum** frequency of auctions?

- Weekly?
- Fortnightly?
- Monthly?
- Quarterly?
- Other?

What should be the **maximum** frequency of auctions?

- Weekly?
- Fortnightly?
- Monthly?
- Quarterly?
- Other?

Please provide arguments to support your case.

Question 8

For futures auctions, what should be the:

- Optimum auction size?
- Minimum auction size?
- Maximum auction size?

If deemed appropriate, please indicate a range and/or distribution over different sizes.

Please provide evidence to support your case.

Question 9

Should volumes of spot allowances be auctioned evenly throughout the year? If not, how should volumes be distributed? (more than one answer possible) Please specify:

- A larger proportion in the first 4 months of the year?
- A larger proportion in December?
- A smaller proportion in July and August?
- Other? Please specify.

Question 10

In case futures are auctioned, should the volumes for spot and futures

auctions be spread over the year in the same manner? If not, how should they differ? (more than one answer possible)

- No futures auctions less than six months before the maturity date.
- A larger proportion in December.
- A smaller proportion in July and August.
- Otherwise? Please specify how and comment.

Question 11

Does the Regulation need to have provisions to avoid holding auctions during a short period of time before the surrendering date (30 April each year)?

If yes, how long should this period be:

One week 2 weeks 3 weeks 1 month

In case futures are auctioned, should there be similar provisions with respect to the period immediately prior to the maturity date?

If yes, how long should this period be:

One week 2 weeks 3 weeks 1 month

Question 12

Which dates should be avoided? (more than one answer possible)

- Public holidays common in most Member States?
- Days where important relevant economic data is released?
- Days where emissions data are released?
- Other?

Please specify the dates you have in mind in your answers.

Question 13

Is a harmonised 10-12 hrs CET auction slot desirable? If not, what alternative(s) would you suggest?

Question 14

How long in advance should each element of the calendar be determined?

Annual volumes to be auctioned:

- 1 year in advance

- 2 years in advance
- 3 years in advance
- more years in advance

Distribution of annual volumes over spot and futures (if applicable):

- 1 year in advance
- 2 years in advance
- 3 years in advance
- more years in advance

Dates of individual auctions:

- 1 year in advance
- 2 years in advance
- 3 years in advance
- more years in advance

Volume and product type for individual auctions:

- 1 year in advance
- 2 years in advance
- 3 years in advance
- more years in advance

Each auctioneer carrying out auction process (if more than one):

- 1 year in advance
- 2 years in advance
- 3 years in advance
- more years in advance

Please provide arguments to support your case.

Question 15

What should be the volume of allowances to be auctioned in 2011 and 2012?

- in 2011: ___ % of the 2013 volume and ___% of the 2014 volume
- in 2012: ___% of the 2013 volume and ___% of the 2014 volume

What percentage of these shares should be auctioned as futures?

- in 2011: ____% of the 2013 share and ____% of the 2014 share
- in 2012: ___% of the 2013 share and ___% of the 2014 share

Please provide evidence to support your case.

Question 16	<p>What should be the rule with respect to allowances not auctioned due to <i>force majeure</i>?</p> <ul style="list-style-type: none">• They should automatically be added to the next auction on the calendar, irrespective of the auction process.• They should be auctioned within one month, though leaving flexibility as to which auction(s) the EUAs should be added.• They should be auctioned within three months, though leaving flexibility as to which auction(s) the EUAs should be added.• Other? Please specify.
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2.3 Lot size

Lot size refers to the number of allowances associated with one unit of the auctioned product. Lot size should be consistent with existing secondary market practices. On the main European carbon exchanges, lot size is 1,000 allowances (i.e. 1,000 metric tonnes of CO₂). This size is small enough so as not to restrict participation in auctions (the order of magnitude of annual emissions of the smallest ETS participants is one thousand tonnes of CO₂) whereas participating in an auction for less than 1,000 allowances would not be cost-effective. In order to mimic prevailing market practice, the Regulation could fix a lot size of 1,000 EU allowances for the auctions in the EU ETS.

Question 17	Is 1,000 allowances the most appropriate lot size? If not, why not?
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3. Auction design

Auctions will concern millions of EU allowances. Such auctions are characterised by the number of rounds of bidding (section 3.1.2) and the rules for determining the price paid by winning bidders (section 3.2); how to allocate **tied bids** in an auction (section 3.2.2); the potential use of a **reserve price** (section 3.3); and the overall need for harmonising auction design across the EU. Some of the views solicited in this section may depend on whether access to the auctions is direct or indirect, and whether exchanges are involved. However, these issues are dealt with in section 4.

3.1 Auction type

3.1.1 Different auction formats

Multiple-round auctions allow bidders to adjust their bids in response to information learnt after each round. In single-round auctions (also referred to as static or sealed-bid auctions); bidders submit several bids at once without any interaction amongst themselves. These multiple bids will typically follow the bidders' demand curve for allowances, i.e. the volume of allowances they are willing to buy at a given price. The option of a single-round auction with only one bid is not relevant in the context of the EUA auctions.

Multiple-round auctions can be ascending or descending. For an ascending auction, the auctioneer will fix the auction price for the round, and bidders must submit the quantity they are willing to buy at the given price. Until total demand is below or equal to total supply, a new round is launched with an increased auctioneer's price and revised quantity by bidder willing to stay in the auction. These revised quantities cannot increase compared to the previous rounds' bids. This activity rule prevents a bidder from hiding their true interests in early rounds. Descending auctions have symmetric characteristics, i.e. the auctioneer's price decreases and the volume of bids increases until demand matches supply.

In addition to the formats described above, auction literature provides numerous innovative auction formats. Although elaborate design may provide marginal benefits to (some) auctioneer(s) and/or bidders, their implementation is complex and only a few of these alternative formats have been implemented on a large scale. The objectives of simplicity, transparency and openness suggest favouring the 'classical' auction formats identified above.

3.1.2 Number of rounds

Compared to single-round sealed-bid auctions, multi-round auctions allow for better **price discovery** during the auction as bidders can learn from the bidding process and condition their bids appropriately. However, with a properly functioning secondary market, price discovery is not considered a major concern in the EU ETS. Moreover, multi-round auctions are complex to implement, both for (the) auctioneer(s) and bidders and have higher administrative cost. Sealed-bid auctions are generally deemed to be more resistant to collusion than multi-round auctions due to the lack of repeated signals of price and volume being available to bidders. This is all the more so when participation in the auction is low or less competitive. Single-round sealed-bid auctions offer a much simpler auction process and are easier to organise. For these reasons, single-round sealed-bid auctions have been the favoured approach for the few auctions in the first and second trading period. This auction format is also used by RGGI.

The above considerations suggest the use of **single-round sealed-bid auctions**.

Question 18 Is a single-round sealed-bid auction the most appropriate auction format for auctioning EU allowances?
If not, please comment on your alternative proposal?

3.2 Clearing price

The **clearing price** hereafter refers to the price paid for winning bids.

3.2.1 What price is paid by winning bidders?

For single-round sealed-bid auctions; bidders can either 'pay-as-they-bid' (also referred to as **discriminatory-price auctions**) or they can pay a **uniform-price** regardless of the amount of their individual bids. In the latter case, the clearing price is generally set as the price of the lowest accepted bids.

When auctioning multiple units such as CO₂ allowances, auction theory does not provide for a clear ranking in terms of efficiency between discriminatory and uniform-price auctions. With discriminatory pricing, the additional revenues from bids at higher prices than the one that clears the auction are normally counter-balanced by more cautious bidding strategies.

Participating in pay-as-you-bid auctions requires the participant to be well informed of market price and perspective so as to avoid paying too high a price (the so-called **winner's curse**). The extent to which such winner's curse could arise is probably limited, given the existence of a clear carbon price signal through the already established secondary market. Electricity producers, oil companies and financial institutions might be expected to have the necessary market and trading know how to take part in pay-as-you-bid auctions, without too much difficulty. For SMEs covered by the EU ETS and small emitters trading is not a core activity, and therefore they might shy away from such auctions, lowering participation from them, although major concerns might be overcome by giving them the option of submitting **non-competitive bids** (see section 4.6 below) Moreover, many of them might well not take part directly in auctions, in any event, preferring to service their shortfalls either through intermediaries or through the secondary market.

Both discriminatory and uniform-price auctions are used in the government securities market. Some debt management offices (DMOs) such as the United Kingdom's (UK) DMO use both methods depending on the product offered for sale, whereas the US Treasury only rely on uniform-price auctions.

Discriminatory-price auctions disincentivise attempts at hoarding or cornering the market as compared to uniform-price auctions. The cost of building a strong position *via* auctions is likely to be higher, since it requires the bidder to bid and pay above the competitive price, whereas with uniform-pricing it can bid at high prices and still pay the clearing price. For this reason using discriminatory-prices may also reduce the need for imposing a maximum bid-size which might otherwise be appropriate in uniform-price auctions. It could thus remove a layer of bureaucracy from the whole pre-auction participation process and the post-auction monitoring process thereby reducing administrative costs.

Question 19 What is the most appropriate pricing rule for the auctioning of EU allowances?

- Uniform-pricing.
 - Discriminatory-pricing.
 - Indifferent.
- Please provide arguments to support your case.

3.2.2 How to manage ties in the auctions?

For sealed-bid auctions, it may happen that more than one bid has been proposed at the level of the clearing price, with a total amount exceeding the volume of EU allowances proposed for sale. Different options can be used for managing such ties, including:

- random approach: winning bids are randomly chosen amongst the tying bids; and
- pro-rata re-scaling of bids: all tying bids are proportionally reduced in size so as the total demand equals the offer of EU allowances.

The random approach reduces the incentive for collusion: bidders coordinating their bids are less certain on the quantity they would receive. For this reason, this approach is used in the US RGGI auctions. Under this approach, however, each participant will need to receive individualized results through a robust information disclosure process, possibly by means of a dedicated channel. The pro-rata rescaling of bids does not have the benefit of disincentivising collusion, but is simpler to organise especially with respect to informing bidders of the auction results as it merely requires the public disclosure of the percentage served for bids accepted at the clearing price.

Question 20 Should the rules for solving ties in the Regulation be:

- random selection; or
- pro-rata re-scaling of bids?

Please comment on your choice.

3.3 Reserve price

In an auction, a 'reserve price' is the lowest price the seller is willing to accept for the auctioned product. In EU allowance auctions a reserve price (should there be such a price) would protect the auctioneer from selling its allowances significantly below the prevailing secondary market price. This could occur as a result of unexpectedly weak competition during the auction or any exogenous event that may affect the auction process such as IT-problems that may reduce the number of participants in the auction. A reserve price would also reduce the profitability –and therefore the risk– of collusion amongst bidders that seek to gain from a low clearing price by withholding bids or bidding in a coordinated way at prices significantly below the market price.

Bids for EU allowances submitted at a price lower than the reserve price would not be accepted. Predictability of volumes to be auctioned should, however, not be jeopardised, so if the reserve price is triggered, unsold EU allowances would be rolled-over automatically into a later auction.

The issue of a reserve price should not be confused with setting an absolute price floor in the framework of government interventions into the price setting mechanism. Such intervention is not foreseen in the revised ETS Directive (except for a limited provision on excessive price volatility in Article 29a) and does not form part of this consultation.

Obviously, a reserve price, if any, would apply in the same manner to any auction throughout the EU. The methodology or formula for calculating the reserve price, based on secondary market trends, may be kept secret or not. Whilst transparency pleads in favour of making it public, this could provide an undesirable focal point for bidding strategies.

Question 21 Should a reserve price apply?

Question 22 In case a reserve price would apply, should the methodology/formula for calculating it be kept secret? Please comment on your choice.

3.4 Maximum size of bids allowed from a single entity

Limiting the size of bids accepted from a single entity in an individual auction is used to deter one or more bidders from using auctions for manipulating the market individually or collectively by hoarding allowances thereby acquiring a dominant position. See sections 1.4.7 and 4.9 below for a broader discussion of anti-competitive behaviour and market abuse.

A major question is whether a maximum bid-size could be effective at all. If the secondary market is sufficiently liquid, a participant (or a group of participants) wishing to build up a large position would be able to do so *via* the secondary market. Fixing a maximum bid-size may not, as such, prevent market manipulation, although a maximum bid-size could possibly make it more difficult to achieve.

If a maximum limit were to be fixed by the Regulation, its level should be consistent with the net demand for allowances from the largest individual ETS operators (i.e. emissions minus any allocation for free) as a share of the total quantity to be auctioned. Currently, the share of the largest emitter is about 6-7% of total emissions, which in 2013 roughly corresponds to 13% of the total quantity to be auctioned. These shares may increase through autonomous growth or through acquisitions. Moreover, the largest participants should have some discretion to spread their participation amongst auctions along the year. For these reasons, if a bid-size limit were to be established, it should not be lower than 20%, at least not for the largest emitters. However, for most participants, a maximum bid-size of 20% would have no impact on their possibilities of hoarding at all. At the same time, varying the maximum bid-size according to the type of participant would introduce further complexity and administrative burden.

A maximum bid-size should apply to the aggregate volume of all bids made by the same group of companies. Imposing a maximum bid-size per bidding entity involves an additional administrative effort. It would require bidders to disclose prior to each auction:

- All the companies that they wholly own, or if partially owned, over which they exercise *de jure* or *de facto* a decisive influence.

- The beneficial ownership of the allowances they are seeking to acquire per auction i.e. whether they are bidding on their own account or on the account of some other entity.
- Any corporate association that could allow bidders to act in concert or that prevent them from competing actively against each other e.g. joint ventures, or any other business associations.

To reduce the burden, bidders could make one disclosure at the outset and then notify any changes as they occur. Otherwise, they would just certify that there are no changes prior to each auction. This requires bidders to declare their intention to participate in an auction before they do so. To enforce the maximum bid-size rule the auctioneer must put in place a pre-auction notification, verification and clearance system giving the bidder the green light to participate in the auction and a post-auction monitoring and correction mechanism to detect infringements of the rule and order appropriate remedial action. The effectiveness of such administrative oversight would depend on its level of enforcement which must be capable of acting as a deterrent (see also section 4.10 below).

In a hybrid approach, the bid-size limit (if any) would apply to the aggregate volume of allowances being auctioned. As bidders should be allowed to participate through the auction process(es) of their choice, this would require a oversight mechanism.

The need for a maximum bid-size, if it can be made effective at all, must be evaluated in the light of the risk of collusion and alternative measures to mitigate such risk, e.g. the use of discriminatory-pricing (see section 3.2 above) or higher frequency with a larger number of individual auctions (see section 2.2.1 above).

Question 23 Is a maximum bid-size per single entity desirable in a Uniform-price auction?
Is a maximum bid-size per single entity desirable in a discriminatory-price auction?
Please comment on your choice.

Question 24 If so, what is the desirable bid-size limit (as a percentage of the volume of allowances auctioned per auction – only one choice is possible):
10%: [] 15%: [] 20%: []
25%: [] 30%: [] More than 30%: [] Please specify.
Please comment on your choice.

Question 25

In case only one of the two following options would be chosen, to limit the risk of market manipulation or collusion, which one would be preferable?

- A discriminatory-price auction format?
- A maximum bid-size per single entity?

Please comment on your choice.

4. How will the auction(s) be implemented?

Sections 2 and 3 dealt with auction design which primarily encompasses the various parameters of the auction format and calendar as well as the products to be auctions. This section deals with auction process which consists of the:

- pre-registration of bidders;
- pre- and post- auction information disclosure;
- collection of bids, running of the auctions, calculation and announcement of the results;
- auction infrastructure and IT tools;
- collateral management;
- payment and delivery; and
- auction monitoring.

The issues raised in the third bullet above are dealt with wherever relevant throughout this consultation paper. The issues relating to auction infrastructure and IT tools are considered in section 5.2 below. The remaining bullets are covered in this section.

4.1 Pre-registration of auction participants

Pre-registration is important for ensuring an efficient, stable, and reliable auction process. Carrying out adequate know-your-customer (KYC) checks prior to the admittance of bidders entails, however, costs for (the) auctioneer(s) and bidders alike. The Regulation will need to contain rules for minimising such costs and safeguarding the openness of each auction in line with the requirements of Article 10(4) of the revised ETS Directive. Openness implies access to all prospective bidders from all Member States, regardless of their nationality, place of business, type of business, or size. Open participation is essential for ensuring competitive auctions, thereby reducing the risk of collusion.

4.1.1 The obligation to know one's customer

It is a pre-requisite for the establishment of any business or trading relationship for the entity concerned to know its customer by having carried out adequate KYC checks. Such KYC checks are common place in the Community's financial system. They are derived from the need to ensure the soundness, integrity, stability, and credibility of that system. In addition, they are aimed at mitigating the risks associated with using the financial system for the purposes of money laundering and financing terrorism. Moreover, robust KYC checks are often necessary to assess the commercial risks associated with setting up the trading relationship. They help ensure that systems are put in place to address such risks.

(i) The anti-money laundering rules

The main rules governing KYC within the Community are set out in Directive (EC) 2005/60/EC on money laundering and terrorist financing³³ (lastly amended by Directive (EC) 2008/20/EC)³⁴ (AML) and Commission Directive (EC) 2006/70/EC (implementing measure).³⁵

³³ Directive 2005/60/EC the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, OJ L 309, 25.11.2005, p.15, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:309:0015:0036:EN:PDF>.

The AML rules rest on rest on four pillars:

- a) Carrying out of customer **due diligence** at the outset of the business relationship.
- b) Monitoring of that relationship and reporting any suspicious activity to a financial intelligence unit (FIUs).
- c) Keeping customer due diligence and transaction records for a period of time after the end of the customer relationship.
- d) Enforcement measures to ensure the existence of: adequate internal policies and procedures to forestall and prevent illegal activity; adequate supervision of the entities entering into the customer relationship; cooperation between FIUs and effective, proportionate and dissuasive penalties in case of infringement

The entity must in addition conduct ongoing monitoring of the trading relationship and keep records of the due diligence carried out on each customer as well as that customer's transactions for five years after the end of the customer relationship.³⁶ Member States must put in place enforcement measures to ensure the existence of: adequate internal policies and procedures to forestall and prevent illegal activity; adequate supervision of the entities entering into the customer relationship; cooperation between financial intelligence units (to which any suspicious activities must be reported) and effective, proportionate and dissuasive penalties in case of infringement. The extent of such KYC checks depends on the risks associated with the setting up of the business relationship (so-called risk-based approach). The entity responsible for setting up the trading relationship is liable under national civil and/or criminal law.

The rules apply where the entity establishing the business relationship is *inter alia*:

- a credit or financial institution;³⁷
- a legal or natural person acting in the exercise of certain professions such as, auditing, accounting, tax advisor, notary, lawyer; as well as
- other natural or legal persons trading in goods, whether the transaction is executed in a single operation or in several operations which appear to be linked.³⁸

In the context of EUA auctions, all of these institutions/persons may be involved in setting up the trading relationship with prospective bidders. Credit or financial institutions were involved as bid aggregators from indirect bidders in the 'primary participant' model used by the UK DMO in the UK's second trading period auctions (see section 4.5.1 below). Other natural and legal persons may also be involved where third party service providers are selected to act as auctioneer especially when auctioning allowances on a spot basis.

³⁴ Directive 2008/20/EC of the European Parliament and of the Council of 11 March 2008 amending Directive 2005/60/EC on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, as regards the implementing powers conferred on the Commission, OJ L 76, 19.03.2008, p.46, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:076:0046:0047:EN:PDF>.

³⁵ Commission Directive 2006/70/EC of 1 August 2006 laying down implementing measures for Directive 2005/60/EC of the European Parliament and of the Council as regards the definition of 'politically exposed persons' and the technical criteria for simplified customer due diligence procedures and for exemption on grounds of a financial activity conducted on an occasional or very limited basis, OJ L 214, 08.08.2006, p.29, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:214:0029:0034:EN:PDF>.

³⁶ Article 8(1)(d) of Directive 2005/60/EC.

³⁷ Article 2(1)(1) and (2) of Directive 2005/60/EC as amended.

³⁸ The AML only applies to cash payments of 15 000 Euros or more. The price for one lot of 1000 allowances will exceed this threshold whenever the carbon price is higher than 15 Euros.

Allowances auctioned spot are a commodity or good. Professional advisors may also be involved where attestations are required by the auctioneer from such advisors regarding the potential bidders' identity, financial health, and the like. The AML rules would not apply where a public authority carries out the auctions.

Entities subject to these requirements, must establish the potential customer's:

- identity, integrity and business profile;
- beneficial ownership of the traded product; and
- purpose and intended nature of the trading relationship.³⁹

There are differences between Member States in their transposition of the AML provisions, due partly to differences in local conditions. Moreover, Member States may adopt or retain in force stricter national AML provisions.⁴⁰

Under Community AML rules, all or specific aspects of the KYC requirements may either be carried out in-house by the institution concerned or may be done by relying on performance by third parties such as a credit or financial institution that is covered by Directive 2005/60/EC as amended.⁴¹ Reliance on third party performance is particularly relevant for the identification of customers in non-face to face transactions. Such customers are subject to the need for applying enhanced customer due diligence or double checking of the information initially provided by the client. The most common ways of carrying out such enhanced customer due diligence appears to be through:

- confirmatory certification by an institution subject to the AML Directive e.g. a bank, a notary, lawyer or accountant with whom the customer has a business relationship; and
- first payment to be carried out through an account opened in the customer's name with a credit institution.⁴²

When relying on third party performance as described above, the responsibility remains with the entity that is entering into the trading relationship in question. It does not shift to the third party being relied upon. Both of these enhanced customer-due-diligence methods would be relevant for the setting up of the trading relationship between the auctioneer and potential bidders in the EU-wide auctions which will largely be non-face to face transactions.

Conversely, the AML rules allow the waiver of customer due diligence requirements (so-called simplified customer due diligence) where the customer is:

- itself a credit or financial institution covered by the AML rules; and
- a publicly listed company whose securities are admitted to trading on a regulated market in one or more Member States or in a third country which has equivalent disclosure safeguards as the Community.

Nevertheless, the entity subject to the AML rules must gather sufficient information to establish that the participant qualifies for the exemption.⁴³ Both of these exemptions would be relevant in the case of EU-wide auctions especially for the larger financial or industrial bidders.

³⁹ Article 8 (1)(a) to (c) of Directive 2005/60/EC as amended.

⁴⁰ Article 5 of Directive 2005/60/EC.

⁴¹ Chapter II, Section 4 of Directive 2005/60/EC.

⁴² Commission Staff Working Document of 19.12.2006, SEC(2006) 1792

http://ec.europa.eu/internal_market/company/docs/financial-crime/non_face_to_face_en.pdf.

⁴³ Article 11(1)-(3) of Directive 2005/60/EC as amended.

(ii) *The MiFID rules*

In addition to the AML, the MiFID KYC rules in Articles 19 to 22 as well as the MiFID rules on the terms of access to regulated markets in Article 42 would also be relevant where investment firms act as bid aggregators on behalf of indirect bidders or where the auctioneer is a regulated market (i.e. a regulated carbon exchange), respectively. The role of carbon exchanges as a potential auctioneer is discussed under section 4.5.2 below. The MiFID rules apply to futures but not to spot. They would not apply to third party service providers or to public authorities acting as auctioneer. The role of such third party service providers and public authorities as a possible auctioneer is discussed under section 4.5.3 below. However, the Regulation could extend MiFID-like provisions to such third party service providers and public authorities, if necessary.

Articles 19 to 22 of MiFID stipulate *inter alia* that:

- investment firms must act honestly, fairly and professionally in accordance with the best interests of their clients. In the context of EU-wide auctions, an auctioneer may be requested to act honestly, fairly and professionally, whilst investment firms that field indirect bids would in any case be required to act in the best interests of their clients;
- all information addressed to clients should be fair, clear and not misleading. It should be provided in a comprehensible manner enabling them to understand the risks involved and to take decisions on an informed basis. It may be provided in a standardised format. Imposing similar obligations on the auctioneer(s) could be foreseen in the Regulation;
- the investment firm must obtain the information necessary from a client regarding the client's knowledge and experience in the investment field relevant to the type of product or service, the client's financial situation, trading objectives. In the context of EU-wide auctions, such requirements would enable the auctioneer to distinguish between bidders submitting competitive or non-competitive bids and to assess the bidder's suitability to trade in futures as opposed to spot, as well as the bidder's credit risk;
- clients' orders must be executed on terms most favourable to the client taking into account price, costs, speed, likelihood of execution, including settlement size and nature or any other consideration relevant to execution. Again in the context of EU-wide auctions the Regulation may require certain minimum standards to be observed by the auctioneer(s) in the execution of the winning bids.

By contrast, to the AML KYC checks which are designed to assess the financial probity and integrity of the customer, the KYC rules under Articles 19 to 22 of MiFID are designed with investor protection in mind. As such, they require the entity setting up the trading relationship to act responsibly *vis-à-vis* the client in question. Similar considerations will be relevant in the relationship between the auctioneer(s) and bidders in EUA auctions, bearing in mind, however, that bidders are not clients of the auctioneer(s) and as such they are not owed the same level of **fiduciary duty of care** owed by investment firms to their clients.

The access requirements in Article 42 of MiFID are intended for very sophisticated large-scale financial or industrial traders that have the requisite know how to become 'members' of or participants in regulated markets.⁴⁴ They require the regulated market to:

- establish and maintain transparent, non-discriminatory rules based on objective criteria governing access to the market. Such principles would almost certainly apply to the terms of accessing EU-wide auctions under the Regulation;
- members or participants must be fit and proper, have sufficient level of trading ability and competence, have adequate organisational arrangements, have sufficient resources for the tasks involved especially for the guaranteeing of the adequate settlement of transactions. In EU-wide auctions, such principles would for instance, enable (the) auctioneer(s) to distinguish between bidders suited for admittance to bid competitively as opposed to non-competitively, those admitted to bid on futures as opposed to spot;
- access rules must provide for direct or remote participation in the regulated market. Again similar provisions would be needed in the Regulation given the EU-wide nature of the auctions; and
- have rules specifying the obligations on members or participants arising from the constitution, administration and operation of the regulated market, including professional rules imposed on staff operating on the market and the rules for the clearing and settlement of transactions. Such rules tend to be very specific to the operation of the regulated market in question but they could provide some inspiration for the Regulation in particular with regard to the rules for the clearing and settlement of transactions.

In practice, the access rules to regulated markets are less suitable for other less sophisticated SMEs covered by the EU ETS or small emitters. Therefore, the Regulation would need to devise special access rules for such participants (see section 4.6 below).

4.1.2 The need for the pre-registration of bidders in EUA auctions

Participation in EUA auctions pre-supposes the establishment of a business or trading relationship between each auctioneer and each bidder prior to bidding taking place. An efficient outcome and a smooth process require that any bidder may be expected to abide by the auction rules. This requires the pre-registration of participants by the auctioneer, irrespective of and/or in addition to the obligation to carry out KYCs under the AML and MiFID rules. This is necessary to ensure comparable access standards across EUA auctions regardless of where they take place, by whom they are conducted, on whose behalf, the nationality or location of the bidder. The participation process must be documented and available for verification by (the) auctioneer(s) and inspection by the auction monitor (see section 4.8 below).

Thus, at the very least, the auctioneer must verify the potential bidder's identity, integrity and business profile; in any event, since it must know with whom it is transacting which is central for the soundness, integrity, stability, and credibility of the EUA auctions. Moreover, the auctioneer must analyse the purpose and intended nature of the trading relationship in

⁴⁴ Article 4(1)(14) of MiFID. Members of a regulated market are referred to in this consultation as clearing members of a regulated carbon exchange whilst participants in a regulated market are referred to as trading or non-clearing members of a regulated carbon exchange.

order to assess the risks involved in entering into such a relationship and mitigate those risks. Risks may vary depending on:

- The means of establishing the trading relationship: face to face registration may be considered as less risky than non-face to face registration in identifying the bidder's identity.
- The type of bidder: credit and financial institutions subject to the AML and publicly listed companies may benefit from simplified customer due diligence, although its extent may be subject to the requirement for enhanced customer due diligence to check identity in non-face to face situations. Natural persons and private companies will most probably be subject to enhanced customer due diligence given the fact that EUA auctions will take place on a non-face to face basis.
- The type of trade: spot transactions may be expected to be more susceptible to money laundering given their immediate nature, whilst futures transactions with longer term maturities may be considered less risky from this point of view but riskier from the viewpoint of credit and market exposure (see section 1.4.5 above). Also, given the non-face to face nature of EU auctions there will be a need to ensure that only bidders registered actually take part in the bidding.
- The size of trade: the larger the size of the trade the higher the risks involved and *vice versa*. Smaller trades may require fewer customer-due-diligence checks and financial guarantees than larger trades. Also, futures auctions will require specific margining mechanisms to militate against the credit and market risk exposures (see section 4.2.2 below).
- The means of payment and delivery: electronic settlement and delivery especially through a central counterparty or clearing house are less risky than bilaterally transacted direct cash transactions and physical delivery. Equally, where payment and delivery takes place without the intermediation of a central counterparty or clearing house, the auctioneer may want to receive payment first before making delivery.

Moreover, the auctioneer may need to verify information to check compliance with specific auction rules, such as:

- rules on beneficial ownership of the traded product, corporate and business affiliations if a maximum bid-size per single entity were adopted (see section 3.4 above);
- rules on types of bidders if distinctions were drawn regarding participation through competitive or non-competitive bidding depending on the bidder's size or emission levels (see section 4.6 below);
- bank account details and EU ETS registry account details for the purposes of executing electronic payment and delivery (see section 4.3 below);
- rules on financial guarantees and other forms of assurances required to ensure that the bidder honours its financial obligations (see section 4.2 below); and
- any other bidder information (e.g. EU ETS profile) for the purposes of monitoring and reporting on EU-wide auctions as required by Articles 10(4) and (5) of the revised ETS Directive.

The auctioneer will in addition have to monitor the evolution of the trading relationship and keep records of the due diligence carried out on each customer as well as that customer's transactions for a certain timeframe.

These bidder pre-registration requirements overlap to a large extent with the AML and MiFID requirements. This is hardly surprising, since the auctioneer will have to ensure the stability, integrity and credibility of the EUA auctions pretty much in the same way as the financial system or the regulated market.

4.1.3 Effective and efficient pre-registration whilst safeguarding openness

As set out in the previous two sections, pre-registration checks need to be carried out in respect of each potential bidder by each auctioneer before they may be admitted to bid in an auction. Such checks must be subject to periodic review to verify the reliability and adequacy of the information originally submitted. Moreover, many KYC checks are likely to have a cross-border nature, as bidders will be based in all Member States and not only the Member State where the auction process is based.

Obviously, the number (and hence overall cost) of these checks depends on the number of auction processes used. Full decentralisation would entail the greatest duplication of these checks and full centralisation the least. The hybrid approach may also avoid duplication, since a bidder needs to participate in only one of the auctioning processes involved to access the joint auctions. The coordinated approach lies somewhere in between.

As set out above, the AML does not rule out the use of third parties and imposes an obligation that third parties permitted pursuant to the AML recognise and accept the outcome of KYC checks carried out by other third parties permitted pursuant to the AML. It would therefore seem that reliance on credit and/or financial institutions as 'reliable third parties' may reduce the administrative costs on the auctioneer. It may be used for all or only for specific aspects of the pre-registration requirements listed in section 4.1.1 (e.g. identity). However, such reliance would not exempt bidders from the obligation to submit to multiple pre-registrations for each auctioning process in which they would wish to participate, since such checks are required with respect to the establishment of each trading relationship.

An approach based on a 'single auctioning passport' or on 'mutual recognition' where bidders admitted to one auction process are admitted to another auction process either automatically or *quasi* automatically is not possible under the current AML and MiFID rules. As for the financial system, it is important for the integrity and credibility of the auction processes for each auctioneer to be fully responsible for access to its own process. This responsibility is mandatory under the AML and MiFID rules, which cannot be discarded or overruled by the Regulation, and failure to comply carries criminal and/or civil penalties under national law. As in the AML rules, the Regulation could allow (the) auctioneer(s) to rely on pre-registration checks carried out by reliable third parties (including other auctioneers), but could not mandate them to do so.

Furthermore, the AML and MiFID rules are minimum requirements adopted through Directives which are only binding as to the results to be achieved but leave the choice of means to the Member States. The same is not true of a harmonised Regulation based on the principle of non-discrimination, which is binding in its entirety and directly applicable in all Member States. Therefore, it may be necessary to have the pre-registration requirements for accessing EUA auctions spelled out in greater detail in the Regulation with operational guidance given in guidelines adopted by the Commission. This would facilitate (the) auctioneer(s) relying on KYC checks carried out by reliable third parties.

Therefore, it is submitted that the Regulation should:

- harmonise pre-registration requirements for admittance to EU-wide auctions to create a level playing field for all bidders throughout the Community irrespective of the number of auction processes;
- allow different auctioneers (if more than one) to rely on each others' pre-registration checks in case of full decentralisation or in case the coordinated approach were adopted;
- allow (the) auctioneer(s) to outsource pre-registration requirements to reliable third party service providers in the Member States so as to allow bidders to pre-register in their home country, provided that the auctioneer retains ultimate responsibility. It could involve using the capabilities and network reach of for example credit and/or financial institutions to facilitate the registration of all bidders to take part in EU-wide auctions; and
- prohibit the multiplicity of pre-registration checks in the case of Member States auctioning jointly as unjustified by the need to establish multiple independent trading relationships.

Question 26

Are the following pre-registration requirements appropriate and adequate?

Identity:

- Natural or legal person;
- Name, address, whether publicly listed, whether licensed and supervised under the AML rules; membership of a professional association; membership of a chamber of commerce; VAT and/or tax number;
- Contact details of authorised representatives and proof of authorisation; and
- CITL-Registry account details.
- Anything else? Please specify.

Declarations with respect to the past 5 years on absence of:

- Indictment or conviction of serious crimes: check corporate officers, directors, principals, members or partners;
- Infringement of the rules of any regulated or unregulated market;
- Permits to conduct business being revoked or suspended;
- Infringement of procurement rules; and
- Infringement of disclosure of confidential information.
- Anything else? Please specify.

Declarations and submission of documentation relating to:

- Proof of identity;
- Type of business;
- Participation in EU ETS or not;
- EU ETS registered installations, if any;
- Bank account contact details;
- Intended auctioning activity;
- Whether bidding on own account or on behalf of another beneficial owner;
- Corporate and business affiliations;
- Creditworthiness;
- Collateral; and
- Whether it carries out transactions subject to VAT or transactions exempted from VAT.
- Anything else? Please specify.

Question 27 Do you agree that the pre-registration requirements for admittance to EU auctions should be harmonised throughout the EU?
Yes [] No []
Please comment on your choice.

Question 28 Should the amount of information to be supplied in order to satisfy the pre-registration requirements for admittance to EU auctions depend on the:

- means of establishing the trading relationship;
- identity of bidder;
- whether auctioning spot or futures;
- size of bid;
- means of payment and delivery;
- anything else? Please specify.

If so, what should the differences be?

Question 29 Should the bidder pre-registration requirements under the Regulation apply in the same manner irrespective of whether or not the auctioneer is covered by the MiFID or AML rules?
If not, why not?
Please provide arguments to support your case.

Question 30 Do you agree that the auctioneer(s) should be allowed to rely on pre-registration checks carried out by reliable third parties including:

- Other auctioneers?
- Credit and/or financial institutions?
- Other? Please specify.

Please comment on your choice.

Question 31 In order to facilitate bidder pre-registration in their home country, should the auctioneer(s) be allowed to provide for pre-registration by potential bidders in other (or all) Member States than the auctioneer's home country e.g. by outsourcing this to a reliable third party?
Yes [] No []

Please comment on your choice.

If so, should such entities be:

- Covered by the AML rules?
- Covered by MiFID?
- Covered by both?
- Other? Please specify.

Please comment on your choice.

Question 32

Should the Regulation prohibit the multiplicity of pre-registration checks in the case of Member States auctioning jointly?

Yes []

No []

Please comment on your choice.

4.2 Guarantees and financial assurances – so-called collateral

4.2.1 The need for harmonisation of collateral measures

Equivalent collateral terms would be necessary across auctioning processes to avoid the auctioneer(s) *de facto* discriminating between bidders, for instance on grounds of nationality. As auctions must be open on a non-discriminatory basis, there appears to be no objective justification for variation in collateral terms across auction processes.⁴⁵

The level of collateral ought to be commensurate to the risks associated with the type of trade, namely spot versus futures. Moreover, collateral terms must be grounded in commercial reality and therefore the present consultation has taken the secondary market rules on collateral as its benchmark.

The Regulation must take into account the collateral provisions of the Financial Collateral Arrangements Directive 2002/47/EC (FCD),⁴⁶ and the Settlement Finality Directive 98/26/EC (SFD).⁴⁷

The FCD removes all major obstacles to the cross-border use of collateral (cash, financial instruments and also credit claims). It also provides a wide-ranging protection against the effects of insolvency proceedings opened against any of the parties to the collateral agreement. This protection includes the continuing validity of the collateral arrangements even when insolvency proceedings are initiated against one of the parties to the transaction. The FCD has however a somewhat restricted scope of application in the sense that it applies

⁴⁵ Divergent collateral terms could amount to State aid incompatible with the EC State aid rules.

⁴⁶ Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, OJ L 168, 27.06.2002, p.43, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:168:0043:0050:EN:PDF>.

⁴⁷ Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems, OJ L 166, 11.06.1998, p.45, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1998:166:0045:0050:EN:PDF>.

only to parties to a collateral transaction belonging to certain categories.⁴⁸ Depending on the particular legal set-up (e.g. who will be the counterparty to a collateral transaction), the FCD may not be applicable. This could for instance be the case when the auctioneer outsources the management of collateral to a third party service provider.

The SFD on the other hand may also be relevant to the extent that the Regulation would involve the operation of clearing and settlement systems designated under the SFD. For systems covered by it, the SFD establishes a regime under which the finality of transfer orders and netting, as well as the enforceability of collateral security provided in connection with the system are ensured *vis-à-vis* both domestic and foreign participants. The SFD has however a limited scope since it only applies to qualified payment and securities settlement systems notified by the Member States to the Commission. A further limitation consists in the definition of participants in those systems.⁴⁹

In order to harmonise collateral provisions, the Regulation could:

- provide the same protections established by the FCD to transactions not covered by it (e.g. when collateral management is outsourced to third parties and the whole set-up combined with the nature of the counterparties are not within the scope of the FCD);
- provide the same protections as established by the SFD to transfer orders and netting operations in all EUA auctions not covered by the SFD;
- stipulate that EUA auctions may use only clearing and settlement systems notified under the SFD in which case the SFD would apply automatically; and/or
- simply restrict collateral accepted in EUA auctions to collateral deposited with a central counterparty or clearing house covered by the FCD.

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?

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?

4.2.2 Collateral in spot auctions

(An) auctioneer(s) need(s) to manage the risk of a winning bidder in a spot auction failing to honour its bid. Common practices to tackle this risk include both the carrying out of customer due diligence through a pre-registration process (as discussed in section 4.1 above) and the submission of collateral.

⁴⁸ Article 1(2) of the FCD.

⁴⁹ Article 2(f) of the SFD.

The necessary guarantees and financial assurances for spot auctions in the EU ETS should be based on up-to-date market practices. Typically, in the secondary market this is the full cash price for spot contracts in view of the fact that payment is being put up in anticipation of immediate or near immediate delivery.⁵⁰ For non-competitive bids (see section 4.6 below), 100% collateral may also be required as bidders are likely to win their bids so that no extra burden is created.

Accepted collateral should be based on best market practices, including: electronic money transfers, certified cheques, bank guarantees and blocked accounts. Electronic money transfer is the most common practice on the secondary market, although RGGI accepts bank surety or escrow accounts.

The Regulation would provide for un-used collateral provided by losing bidders to be released. Frequent auction participants may re-use the same collateral for all the auctions they participate in if they so wished (although, even collateral from frequent bidders should be freed up if their bids are unsuccessful).

It is therefore submitted that 100% cash collateral ought to be provided up-front to access spot auctions. It could be deposited either with a central counterparty or a credit institution. It could be used to settle payment against delivery for the winning bidders. It would be released in full to losing bidders following announcement of the results of the auction or in part to tied bidders whose bids are reduced to bring them in line with supply. Frequent bidders that may wish to re-use their collateral in another EU auction may do so.

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.

4.2.3 Collateral in futures auctions

If futures are auctioned, collateral should cover the entire life-time of the transaction. Collateral is required to cover two types of risk:

- credit risk, i.e. the risk due to uncertainty in the bidder's ability to meet its obligations upon maturity of the futures e.g. due to bankruptcy; and
- market risk, i.e. the risk associated with the variation of the market value of the auctioned futures pending maturity of the transaction.

In the secondary market, mitigating such risks involves a clearing house which acts as counterparty to both the seller and the buyer. It guarantees payment to the seller in case of default of the buyer and delivery to the buyer in the case of default of the seller. To mitigate

⁵⁰ This seems to be common in the European spot market. Moreover, RGGI auctions which are done on a spot basis require 100% collateral and the electronic auction platform automatically limits bids to the deposited amount. By contrast, in the UK DMO's primary participant model, no collateral was required from the primary participants themselves whilst primary participants were free to require up-front collateral from indirect bidders bidding through them.

its risks, it imposes significant membership criteria on its members and operates a margining system where the buyer and seller deposit an initial margin (normally 10% each of the value of the transaction) and variation margins (i.e. the daily difference between the transaction value and the market value of the allowance at the end of the trading day not covered by the 10% initial margin).⁵¹

This type of clearing mechanism is commonly used by futures carbon exchanges in the EU. Consequently, in the case of a futures auction a similar mechanism ought to be adopted involving a clearing house. However, (the) auctioneer(s) may conceivably deliver allowances into a blocked EU registry account after the auction for release upon maturity of the futures contract instead of bearing margin costs. For the avoidance of doubt, such margining is normally done through electronic money transfers as in a bank account. It is submitted that such a clearing mechanism ought to be used in futures auctions.

However, not all EU ETS market participants can be a clearing house member as it requires *inter alia* a high level of credit worthiness, capital reserves, in-house expertise, technical capacity, and appropriate IT infrastructure to handle daily margin calls and participation in the daily settlement of transactions. Accordingly, in the European carbon market, primarily financial institutions and the trading desks of large energy companies are members of clearing houses that are linked to the exchanges trading EUA futures. Even if membership may increase, the reliance on these clearing houses for futures auctions would limit the direct participation in futures auctions. However, clearing house members do act as intermediaries, clearing transactions on behalf of other participants in the carbon exchanges and assuming responsibility for successful bids *vis-à-vis* the clearing house.

Nevertheless, it is expected that futures auctions, if such auctions were offered, will in any event be used mainly by the more sophisticated EU carbon market players with substantial hedging needs. Such players are already by and large established members of EUA futures exchanges (be they clearing or trading members) and have the capabilities to handle margining. Therefore, such pre-existing market mechanisms could be used for the auctioning of futures.

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?

If you have answered yes, please justify and elaborate on the rules that should apply and the mechanisms to implement them.

4.3 Payment and delivery

Ensuring effective and timely payment and delivery is of fundamental importance for the proper functioning of the auctions. Payment and delivery rules should be based on best-

⁵¹ This process is known as marking to market.

market practices. They must be well known by auction participants as well as by the public before any auctions are conducted.

4.3.1 Settlement modalities

Two different routes for settlement can be followed:

(i) Payment before delivery

Once auction results are known, winning bidders credit the auctioneer's account with their payment for the EU allowances. Once the transfer has been verified, the auctioneer sends delivery instructions to the relevant registries concerned by the transactions asking them to deliver the allowances into the bidder's registry account. Using this route, payment delay should not exceed two working days, whereas effective delivery should physically happen within two further working days or so. This is common practice in auctions of EUAs in the second trading period.

(ii) Delivery-versus-payment

This approach requires both the bidder and the auctioneer to be members of a central counterparty or clearing house, or to use the services provided by a member of such a central counterparty or clearing house. Once auction results are published, cash payment from one side and delivery of allowances from the other are transferred to the central counterparty's or the clearing house's accounts or their members' accounts. The central counterparty or clearing house will then proceed to the exchange of payment versus allowances that will be transferred to the auctioneer(s) and bidders respectively. The full settlement and delivery process should not exceed four working days either. If futures contracts are auctioned, the settlement and delivery process will be similar, but will take place at the maturity date of the contract with a margining system being applied pending such maturity.

Whatever the route chosen, transactions should be settled in accordance with the same commonly accepted rules throughout the EU. Payment and delivery conditions, including timing and currency should be regulated in a harmonised manner through the Regulation. In effect, any auction participant should know that it can benefit from the same payment and delivery conditions wherever it wishes to bid.

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

- Payment before delivery.
- Delivery versus payment.
- Both.

Please comment on your choice.

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.

4.3.2 Handling of payment and delivery failures

For similar reasons of transparency and efficiency, it appears desirable for the Regulation to specify rules for events of default.

The case of non-payment on the bidder's side has been discussed above in section 4.2. In essence, if the provisions of the FCD and the SFD are extended to cover all collateral and transfer orders or netting relating to EUA auctions, then such instructions, which would necessarily have to have been given before the bidder may be admitted to take part in the auction, will be protected from any subsequent insolvency proceedings.

The most relevant other situation arises where the auctioneer cannot carry out the delivery of the allowances sold in the auction, for example following a dysfunction of the CITL, or any lack of availability of a communication system. This is of particular importance if delivery takes place close to: the surrendering date for allowances (i.e. April of each year), as winning bidders would face the risk of not being able to surrender a sufficient number of allowances for their compliance; or the maturity dates for futures on the secondary market (i.e. December of each year), as winning bidders may face delays due to the accumulation of a backlog of deliveries. Such risk may be mitigated by avoiding auctions taking place shortly before the surrendering date or the current futures maturity dates. Moreover, EUAs may be delivered into a blocked central counterparty or clearing house account prior to the EU auction taking place, to reduce the number of potential failure points.

Notwithstanding these precautions, should a delivery failure occur, the related transactions could either be cancelled and any collateral deposited by bidders released forthwith or payment and delivery may be postponed to a later date at the bidder's choice.

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?

4.4 Transaction rules under the Regulation

The Regulation will have to deal with matters that are central to the very creation, existence and termination or frustration of the transaction arising from the EUA auctions. These include without limitation:

- the designation of the parties' to the trade;
- the characteristics of the auctioned product enumerated in section 2.1 above;
- events of 'force majeure' and resulting consequences;
- events of default by the auctioneer and/or the bidder and their consequences;
- applicable remedies or penalties; and
- the regime governing the judicial review of claims across the EU as discussed above.

In the interests of efficiency and tradability into the secondary market, such modalities ought to remain as simple and transparent as possible. They ought to be whilst inspired by existing best practices for similar transactions on the secondary market. They should also be such as not to compromise the openness of the EUA auctions to all EU ETS participants.

The auctioneer will have to issue a 'notice to auction' which sets out all the terms of the auction. In turn, bidders intending to bid in the auction will be invited to return an 'intention to bid' which accepts the terms set out in the notice to auction.

The terms of the notice to auction and intention to bid would derive from the Regulation (i.e. their terms would be directly applicable throughout the EU). This means that the national courts of each Member State would have concurrent jurisdiction in respect of any action brought by an aggrieved bidder. National courts could refer questions of interpretation of the Regulation to the European Court of Justice (ECJ) for a preliminary ruling pursuant to Article 234 of the EC Treaty, which would be binding throughout the EU.

The application of concurrent jurisdiction does have disadvantages, however. If unchecked, it can lead to a multiplicity of proceedings in several Member States on the same claim or to forum shopping for the most advantageous jurisdiction to bring a claim even if the jurisdiction in question has no nexus with the claim. To mitigate such an outcome, it would be desirable for the Regulation to provide for rules on jurisdiction. Equally, the Regulation would have to provide rules for the mutual recognition and enforcement of judgments. This may be done in one of three ways:

- simply by reference to the same rules already agreed in the **Brussels I Regulation** for cross-border disputes on civil or commercial matters of whatever kind;⁵²
- by special rules specific to the Regulation. Though this might involve duplication of some of the provisions of the **Brussels I Regulation**; or

⁵² Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, OJ L 12/1, 16.01.2001, p.1, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2001:012:0001:0023:EN:PDF>.

- by making the **Brussels I Regulation** applicable, whilst providing for any exceptions or additions. This would avoid the aforementioned duplication.

In case the above would not suffice, there could be a risk of having multiple proceedings in several Member States on the same claim or forum shopping for the most advantageous jurisdiction to bring a claim even if the jurisdiction in question has no nexus with the claim. To mitigate such an outcome, the Regulation could provide special rules to apply in addition to the Brussels I Regulation.

Despite the various design and implementation features discussed in this consultation paper to guarantee a smooth running of the auction, there may still be unforeseen gaps in the Regulation. For any unexpected matters not specifically covered by it, the Regulation would have to provide for the applicable law (e.g. on any residual matters of contractual and non-contractual liability), jurisdiction, and for the mutual recognition and enforcement of judgments throughout the EU.

The aforementioned considerations are particularly relevant in the event of full decentralisation or if a coordinated approach were to emerge but they are less problematic in case of full centralisation or if the hybrid approach were adopted.

Question 40 Should the Regulation provide for all matters that are central to the very creation, existence and termination or frustration of the transaction arising from the EUA auctions? If not, why not?

If so, are the matters enumerated below complete?

- The designation of the parties' to the trade.
- The characteristics of the auctioned product:
 - Nature: EUAs or EUAAs, trading period concerned.
 - Date of delivery: date at which winning bidders will receive the allowances on their registry account.
 - Date of payment: date at which payment will be required from winning bidders.
 - Lot size: number of allowances associated with one unit of the auctioned good.
- Events of 'force majeure' and resulting consequences.
- Events of default by the auctioneer and/or the bidder and their consequences.
- Applicable remedies or penalties.
- The regime governing the judicial review of claims across the EU.

If not, what additional matters should be foreseen in the Regulation and why?

Question 41 Should the Regulation provide for rules on jurisdiction and the mutual recognition and enforcement of judgments?

If so, should these be:

- specific to the Regulation;
- by reference to the Brussels I Regulation;
- by citing exceptions from the Brussels I Regulation;
- by citing additions to the Brussels I Regulation?

Please comment on your choice.

If not, why not?

4.5 Facilitating cost effective participation in EU auctions

Although setting up a specific auction process that any pre-registered entity can participate in gives best guarantees for openness and access, alternative approaches may be envisaged by the auctioneer(s) to reduce the financial and administrative burdens as well as the lead time needed for set-up. One way would be to rely on a small group of intermediaries. Another potential approach would be to use existing market infrastructures, most notably existing membership-based organisations (e.g. exchanges). Yet another approach might be

to outsource the organisation of the auction to third party service providers or a public authority.

4.5.1 Intermediaries

The UK DMO used primary participants (i.e. financial institutions that are exclusively mandated to participate directly in EUA auctions in the second trading period) to act as intermediaries in spot auctions.⁵³ They assume the administrative and operational burden of carrying out the KYC checks, and credit risk management *vis-à-vis* indirect bidders. The UK authorities conduct an open process for the pre-qualification of primary participants. They act as principals on their own account or on behalf of their clients. They are not agents, nor are they sub-contractors of the UK DMO.⁵⁴ Initially, primary participants were not remunerated for their intermediation role, although more recently, the UK government has introduced a performance-based fee structure designed to incentivise primary participants to gather bids from indirect bidders. Bidders in the auction process are not charged a fee to take part be they direct or indirect. The costs for the auctioneer may be expected to be a fraction of what would be involved in organising an open process for all bidders to bid directly.

The use of a primary participants model reduces overall administrative cost only if they can deal with the EU-wide pre-registration of indirect bidders more efficiently than public authorities. The model's main disadvantage is, however, that key EU ETS compliance participants could not participate in the auctions directly to trade on their own account only. This may be a concern in particular for emitters with larger net demand, such as the power companies. Participating in the auction through primary participants will require such utilities to share commercially sensitive information on their demand for allowances, although such information may be spread across several primary participants. The model therefore requires clear rules, in particular, to protect the information which resides in indirect bids. Participation in the auctions on behalf of clients is therefore strictly separated from participation on the primary participant's own account as well as from any other commercial activities the primary participant may have particularly on the secondary market, e.g. through 'Chinese walls'. Monitoring the effectiveness of such 'Chinese walls' may be an issue.

There may be a number of ways of mitigating these disadvantages such as:

- allowing direct access to the auctions to the largest ETS operators trading on their own account only alongside the primary participants – this could however reduce the incentives for (and increase the costs of) becoming a primary participant if large volumes are bid directly; and
- excluding primary participants from bidding on their own account, or imposing requirements for the supervision and enforcement of 'Chinese walls' to mitigate conflicts of interest effectively. Again exclusion of own-account bidding could reduce the incentives for (and increase the costs of) becoming a primary participant.

When considering the primary participants option, it is important to keep in mind that most SMEs covered by the EU ETS and small emitters are likely to rely on intermediaries in any event, for the expertise needed to access competitive auctions (see section 1.5.2 above).

⁵³ This model is used by most Member States when auctioning government bonds.

⁵⁴ The services of primary participants could also be secured under contract to the Member State concerned through a tender procedure in line with EU public procurement rules.

Within the context of open, transparent and non-discriminatory EU-wide auctions, selected primary participants ought to be able to demonstrate the required depth of reach in terms of the types of clients they could or would handle as indirect bidders as well as their breadth of reach in terms of their geographical coverage throughout the EU. This could be done through reciprocal arrangements with financial institutions in other jurisdictions.

Moreover, primary participants ought to play an active **market maker** role both with regard to spot and futures by gathering and submitting bids from indirect participants and by providing continuous two-way bid/offer quotes to all other market participants throughout the EU.

The Regulation could provide for pre-qualification requirements for primary participants taking part in EU-wide auctions.

4.5.2 Exchanges

The second approach for reducing the burden and time needed for setting up an auctioning process would be to rely on existing market infrastructure such as exchanges. There are currently at least six carbon exchanges in the EU, some are regulated whilst others are not, some specialise in futures whilst others do spot only, others still sell energy products alongside carbon. Where an exchange is appointed, KYC checks and financial risk management can be taken care of by the exchange. Auctioning through existing exchanges may be particularly attractive with respect to futures auctions, since it avoids the need to set up the necessary settlement and clearing infrastructure for managing the risks associated with such transactions. This is all the more so, since potential bidders interested in futures auctions may already be expected to be current members (both as clearing and non-clearing (or trading) members)⁵⁵ of exchanges since all EUA futures are transacted through exchanges. In any event, auctions conducted through exchanges may not be done anonymously, save for the identity of the bidders. This distinguishes it from 'selling' EUAs on an exchange.

Exchanges are advantageous, if they are able to deal with the administrative and financial burdens associated with the auction process, more efficiently than a public auctioneer. However, as compared to the primary participants model discussed under section 4.5.1, exchanges do not raise the same conflict of interest issues because they provide the marketplace or auction process but do not actively participate in that market or auction as bidders alongside other market participants.

Selecting exchanges to organize EUA auctions should follow open and competitive procedures based on objective and transparent criteria that ensure value for money. These could either be subject to pre-qualification requirements provided for in the Regulation as well as a public procurement process compatible with the applicable EU rules. The selection criteria could be based on the exchange's existing membership rules. If so, participation in the auctions would effectively be limited to members of the exchange and the costs of such participation would be split between the Member State and the bidding exchange members. Alternatively, exchanges might be required to develop the capability to process direct and/or indirect bids from bidders throughout the EU particularly in the case of spot auctions; to

⁵⁵ Exchanges have two types of members: trading members and clearing members. A clearing member will be responsible for the clearing of trades executed by trading members. It so happens that one company – most often banks – can be both a trading and clearing member. But the two activities are clearly separated, notably by having different teams, Chinese walls, etc.

provide for full, fair and equitable access to SMEs covered by the EU ETS and small emitters bidding non-competitively; to ensure transparent and equal access to both pre- and post-auction information; and to ensure non-discriminatory cost-effective conditions of access by type of bidder throughout the EU. Clearly, requiring the exchanges to change their existing membership rules for the purposes of EU-wide auctions would have cost implications, although it would also carry rewards in terms of substantially increased volumes being transacted on that exchange post-auction.

4.5.3 Third party service providers or public authorities

Another way of organising EU auctions could be to engage the services of a third party service provider to organise the auction process, including the pre-registration of bidders. This is the route taken by RGGI Inc a private company mandated by the RGGI states to organise the auctioning of allowances on their behalf. The third party service provider was selected following a tendering procedure. RGGI auctions are open access, available to anyone that is pre-registered through a web-based interface. This has meant, however, limiting the number of auctions carried out per annum to quarterly events. The three-months between auctions are needed to ensure that bidders intending to bid are properly vetted. The scope of RGGI auctions are a fraction of the forthcoming EU-wide auctions under the revised ETS Directive. A pre-registration process that has to pass through a single entity could lead to a bottleneck, at least in the beginning. If added to this, EU auctions were required to be conducted more frequently than three-monthly intervals (e.g. weekly) then, this may become unmanageable. On the other hand, the frequency of the auctions could mean that if a bidder misses to qualify for one weekly auction they could take part the following week rather than wait for three months. Moreover, more than one third party service provider may be selected through a public tender procedure. Such third party service providers would have to be able to offer their services on a competitive basis. They could be appointed by a public authority mandated by one or more Member states to act on their behalf.

Question 42 Which auction model is preferable?

- Direct bidding?
- Indirect bidding?
- Both?

Please comment on your choice.

Question 43 If an indirect model is used, what share of the total volume of EU allowances could be auctioned through indirect bidding?

Please provide arguments to support your case.

Question 44 If the primary participants model is used, what provisions would be desirable for mitigating disadvantages of restricting direct access (more than one answer is possible):

- Allow direct access to largest emitters, even if they trade only on their own account?
If so, who should have direct access and what thresholds should apply?
- Disallow primary participants trading on their own account?
- Impose strict separation of own-account trading from trading on behalf of indirect bidders?
- Other? Please specify.

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.
- Separation of anything else, please specify.

Question 46 What obligations should apply to primary participants acting in EU-wide auctions as:

- Intermediaries?
- Market makers?

Please provide arguments to support your case.

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

- Only for futures auctions open to established members of the exchange?
- Also for spot auctions open to established members of the exchange?
- Only when the exchange-based auction is open to non-established members on a non-discriminatory cost-effective basis?
- Other? Please specify.

Please provide arguments to support your case.

Question 48 Should direct auctions through:

- third party service providers; or
- public authorities be allowed?

If not, why not?

4.6 Ensuring full, fair and equitable access to SMEs and small emitters

The options put forward for many of the issues discussed throughout this consultation paper, already bear in mind the requirement to ensure full, fair and equitable access to EUA auctions for SMEs covered by the EU ETS and small emitters. In case the general rules would not suffice to meet this objective, specific measures may be considered.

Allowing for non-competitive bids is often mentioned as a means of providing fair and open access to the EU-wide allowance auctions for SMEs covered by the EU ETS and small emitters since it does not require much trading expertise to take part. Non-competitive bids allow auction participants to bid on volume without the need to quote a price. Non-competitive bids are given priority and are awarded at the clearing price. Non-competitive bidding is most relevant for SMEs covered by the EU ETS and small emitters in discriminatory-price auctions as it allows them to avoid the risk of paying (significantly) above the clearing price. Non-competitive bidding does not appear to be relevant in uniform-price auctions as any bidder could submit a bid at a 'high' price to secure that it will get the bid. Non-competitive bidding does not appear relevant for futures auctions, since these auctions would by definition involve sophisticated bidders.

The very small share of emissions from SMEs and small emitters in combination with the rules for free allocation suggest limiting the share of allowances to be sold through non-competitive bids, if any, between 5% and 10% of the total volume of allowances to be auctioned.

Different rules could be envisaged for submitting non-competitive bids:

- Bidders could be allowed to use only one of the two bidding routes (competitive or non-competitive).
- Non-competitive bids could be restricted to a specific category of ETS operators, namely SMEs covered by the EU ETS and small emitters. The definition used should be as clear as possible to minimise administrative burden.⁵⁶

If non-competitive bids were used, and if the demand for non-competitive bids were to exceed the maximum volume of EU allowances offered for sale through this route, all bids could simply be scaled down proportionally.

Question 49 Do the general rules for auctioning EUAs suffice for ensuring full, fair and equitable access to allowances to SMEs covered by the EU ETS and small emitters? If not, why not?

Question 50 Is allowing non-competitive bids necessary for ensuring access to allowances to SMEs covered by the EU ETS and small emitters in case of:

- discriminatory-price auctions?
- uniform-price auctions?

Question 51 If non-competitive bids are provided for in spot auctions, what maximum share of allowances could be allocated through this route?

- 5% []
- 10% []
- Other? Please specify.

Please comment on your choice.

Question 52 What rule should apply for accessing non-competitive bids (more than one answer possible):

- Participants should only be allowed to use one of the two bidding routes?
- Non-competitive bids should be restricted to SMEs covered by the EU ETS and small emitters only?
- Other? Please specify.

Please comment on your choice.

⁵⁶ Alternatively, every auction participant could be allowed to use this option up to a maximum bid-size, although participants that are not submitting competitive bids would have priority in being served. This would also allow large participants to make use of the provision, which would only be justified if administrative costs of checking the bid-size limitation is substantially lower than checking whether bidders are SMEs covered by the EU ETS and small emitters.

- Question 53** What should be the maximum bid-size allowed for SMEs covered by the EU ETS and small emitters submitting non-competitive bids?
- 5 000 EUAs
 - 10 000 EUAs
 - 25 000 EUAs
 - Over 25 000 EUAs, please specify exact size and give reasons for your answer.

- Question 54** Are there any other specific measures not mentioned in this consultation that may be necessary for ensuring full, fair and equitable access to allowances for SMEs covered by the EU ETS and small emitters?
- If so, please specify.

4.7 Auction information disclosure

4.7.1 Pre-auction information disclosure

The auction calendar (discussed in sections 2.1 and 2.2 above) will have already determined and disclosed essential information on individual auctions. For reasons of legal certainty and for the purpose of establishing legally binding, individual trading relationships between each auctioneer and bidder, the auctioneer will need to publish a notice to auction. The notice:

- announces what will be auctioned, when it will be auctioned, how it will be auctioned as well as auction design rules that bidders need to know in advance of the auctions; and
- invites bidders to pre-register by a given date sufficiently in advance for the auctioneer to carry out its pre-registration checks. If bidders have already pre-registered, the auctioneer will ask for confirmation of no material changes to the information in the pre-registration.

Bidders intending to bid will need to submit an intention to bid by a given date whereby they will confirm that they intend to take part in the announced auction and that they agree to abide by the terms of the notice to auction.

The Regulation will need to contain rules that ensure that non-publicly known pre-auction information for each EU auction is released to the EU public at the same time. In particular, this means that pre-auction information will need to be kept confidential until such public release occurs. Moreover, the timing and means of such release must not discriminate between potential bidders from different Member States, by allowing some bidders e.g. national bidders, to gain prior notice before other market participants. Otherwise, companies with prior notice may be able to capitalise on such market sensitive information disrupting bidder confidence. If this were to occur, it would undermine the integrity and credibility of the primary market and may become a vehicle for **insider dealing**. The Regulation must

therefore provide for adequate provisions to ensure equal access in all circumstances to avoid insider dealing from occurring. It should also provide for prompt EU-wide public disclosure of all leaked information should such a leak occur inadvertently as required by the Market Abuse Directive (MAD).⁵⁷ It would also have to provide rules to guide potential bidders to whom such information has been leaked accidentally on how to conduct themselves. Such obligations on the auctioneer(s) and potential bidders will have to be backed by effective, proportionate and dissuasive sanctions. There would have to be equivalent guarantees for spot and futures auctions, in this respect.

Question 55 What should be the minimum period of time before the auction date for the release of the notice to auction?

2 weeks [] 1 month [] 2 months []

Other [] Please specify.

Please comment on your proposal.

Question 56 What should be the minimum period of time before the auction date for the submission of the intention to bid?

1 week [] 2 weeks [] 1 month []

Other [] Please specify.

Please comment on your proposal.

Question 57 Are there any specific provisions that need to be highlighted in:

- The notice to auction?
- The intention to bid?
- Both?

Please specify what they are.

4.7.2 Post-auction information disclosure

The disclosure of post-auction information falls into two categories. First, there are the auction results which need to be disclosed as soon as possible following the auction. Second, there is the more detailed auction information that needs to be collated and published for the purposes of monitoring the conduct of the auctions. This section deals with the former. The latter is dealt with under sections 4.8 and 4.9.5 below.

The announcement of auction results includes issues such as the:

- clearing price (if allowances are awarded on a uniform-price basis or in the case of non-competitive bids being allowed);

⁵⁷ Article 6(3) of MAD.

- average price (if allowances are awarded on a discriminatory-price basis);
- any relevant information to solve tied bids;
- total volume of EUAs auctioned;
- total volume of bids submitted distinguishing between competitive and non-competitive bids (if applicable); and
- total volume of allowances allocated.

The delay between the end of an auction and the disclosure of the auction results should be reduced to a minimum as bidders will need this information, and the status of their bids, to interact with the secondary market. In government securities markets, some countries are committed to disclosing auctions results within minutes of the auction closing. For EUA auctions, the Regulation could set a maximum acceptable delay for publishing auction results.

Auction information disclosure should be made so as to ensure fairness and transparency. Auction results should be made public through fully accessible public information channels – such as a dedicated public website, for example. Specialised information channels should not have access to the information prior to the public channels.

(An) auctioneer(s) should be fully responsible for information disclosure. Complementing this, the Commission has already created a dedicated EU ETS auctioning website which can be further developed so EU ETS and EUA auction participants will be able to find:

- the information on every planned auction in accordance with the auction calendar;
- practical information for participating in any of the EU allowance auctions; and
- the results of past auctions for EU allowances.

The above is not meant to be an exhaustive list.

Question 58 What information should be disclosed after the auction:

- Clearing price (if allowances are awarded on a uniform-price basis or in the case of non-competitive bids being allowed)?
- Average price (if allowances are awarded on a discriminatory-price basis)?
- Any relevant information to solve tied bids?
- Total volume of EUAs auctioned?
- Total volume of bids submitted distinguishing between competitive and non-competitive bids (if applicable)?
- Total volume of allowances allocated?
- Anything else? Please specify.

Question 59 What should be the maximum delay for the announcement of auction results?

5 minutes [] 15 minutes [] 30 minutes []

1 hour []

Other [] Please specify.

Please comment on your proposal.

Question 60 Do you feel that any specific additional provisions should be adopted in the Regulation for the granting of fair and equal access to auction information?

If so, what may they be?

4.7.3 Language regime

EUA auctions in the third trading period will consist of the offering of EUAs to bidders across the EU in an open, transparent and non-discriminatory manner. This raises the issue of what language regime should apply to pre- and post- auction information released in connection with such cross-border offerings. The Regulation could stipulate that the auctioneer should disseminate information not only in the official language(s) of the relevant Member State(s) but also either in all official languages of the EU or in a language customary in the sphere of international finance. Such an approach would be in line with the approach already developed in the Prospectuses Directive⁵⁸ for the dissemination of similar information in

⁵⁸ Article 19 of Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003, on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, OJ L 345, 31.12.2003, p.64, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003L0071:EN:NOT>.

financial securities markets. Dissemination in all languages should occur simultaneously. Given the diversity of official EU languages, developing common standardised information formats (especially for the notice to auction, intention to bid and auction results), will allow for a more timely, open and transparent access to the information on EUA auctions. The Commission may provide such standardised information formats either in the Regulation itself or as part of the guidelines for implementing the EUA auctions.

4.8 Auction monitoring and reporting

Articles 10(4) require Member States to report to the Commission on each auction within one month of the auction "*in particular with respect to fair and open access, transparency, price formation and technical and operational aspects*". Article 10(5), in turn, requires the Commission to monitor the functioning of the European carbon market and report annually to the European Parliament "*including the implementation of the auctions, liquidity and the volumes traded*."

The purposes of auction monitoring are:

- to detect possible non-compliance with the objectives pursued by the revised ETS Directive (openness, transparency, required level of harmonisation and non-discrimination to mention but a few);
- to improve auction design modalities through periodic review; and
- to identify any anti-competitive behaviour and/or market abuse (see further section 4.9 below).

This implies a regular analysis of how auctions are conducted, how the Regulation is implemented and the bids submitted respectively.

Auction monitoring should be consistent with the requirements for the monitoring of the European carbon market by the Commission.⁵⁹

Proper monitoring requires scrutiny of all auctioneers and auction processes. As this requires an analysis of all EUA auctions, such monitoring would be best carried out by a central auction monitor. This is all the more so since, an EU-wide monitor is in any event needed to determine whether auctions are effectively conducted in a harmonised manner in full compliance with the objectives pursued by the revised ETS Directive.

The Regulation should contain general principles on:

- the designation and mandate of the auction monitor; and
- cooperation between the auctioneer(s) and the auction monitor.

This will need to be supplemented by operational guidance, possibly through Commission guidelines.

The auction monitor could either be a private undertaking or a public authority. The reports of the auction monitor ought to be transmitted to the Commission and non-confidential versions ought to be published on the Commission's website.

Auction monitoring will be done without prejudice to the existing framework for the enforcement of EC and national legislation. Indeed, monitoring results may be used to trigger enforcement measures, either those that the Regulation would eventually provide for, or those already provided for under the EC Treaty or other EC legislation. It would have to

⁵⁹ The broader issue of monitoring the European carbon market is not the subject of the present consultation.

be capable of supporting the annual report the Commission is to make on the functioning of the European carbon market.

The Regulation should ensure that auction monitoring is to be undertaken by an entity and/or authority which is independent from the auctioneer. It should have the requisite qualifications and professional experience to carry out its mandate.

Question 61 Should an auction monitor be appointed centrally to monitor all EU auctions?
If not, why not?

Question 62 Do you agree that the Regulation should contain general principles on:

- the designation and mandate of the auction monitor; and
- cooperation between the auctioneer(s) and the auction monitor?

If not, why not?

Should these be supplemented by operational guidance, possibly through Commission guidelines? If not, why not?

4.9 Preventing anti-competitive behaviour and/or market abuse

4.9.1 Anti-competitive behaviour and/or market abuse in primary markets

Some argue that primary markets in general are less prone to the risk of anti-competitive behaviour and/or market abuse given that the auctioneer will have full access to all bidding information and may therefore be expected to detect such conduct rendering it less sustainable. Others point to the fact that in the face of such detection opportunities on primary markets such conduct is more likely to occur on the secondary market where the transparency of trading information may be more opaque to the competent national authorities necessitating the gathering of information across:

- different exchanges located in different jurisdictions;
- exchange-based and OTC transactions; and
- **commodity derivatives** and the underlying commodity trades that are not subject to the same level of transparency, supervision and enforcement.

Nevertheless, this does not mean that primary markets are *ipso facto* always immune from anti-competitive behaviour and/or market abuse, particularly if such conduct is carried out through a scheme designed to camouflage the underlying anti-competitive or manipulative conduct, especially if the scheme were to encompass trading on the secondary market. The proliferation of more than one EUA auction process and/or monitor might further facilitate the sustainability of such conduct by fragmenting bidding information and/or detection across several auctioneers (if more than one) and monitors thereby reducing the transparency of bidding patterns on the overall primary market, rendering it harder to detect anti-competitive behaviour and/or market abuse.

In any event, Member States and/or Community institutions may want to be vigilant against the possibility of anti-competitive behaviour and/or market abuse occurring, even if it were for no other reason than ensuring confidence in the EU-wide auctioning system by the auctioneer(s) and bidders alike.

4.9.2 Anti-competitive behaviour and/or market abuse in EUA auctions

Within the context of EUA auctions, there are large compliance buyers on the market, notably power companies, with needs that exceed 10% of the total volume auctioned, so risks of anti-competitive behaviour and/or market abuse exist at least in theory. Two such risks are hoarding strategies (e.g. by stockpiling more than anticipated compliance needs) cornering strategies (e.g. by stockpiling allowances to create price peaks at given dates such as surrendering dates).

The former risk may actually be reinforced by the fact that large participants that have their production committed through long term contracts will typically buy allowances to cover not only for current compliance needs, but also for future compliance needs. Hence, at a given point in time, such large participants may in principle hold a fraction of the yearly volumes auctioned that significantly exceeds their actual emissions for that year, thereby reducing the volume of allowances available to other installations at surrendering dates.

The latter risk may be exacerbated by the fact that by buying a significant share of EU allowances, low emitting utilities in particular may benefit from an associated rise in their value by:

- raising their higher emitting rivals' compliance costs;
- benefiting from the inclusion of a higher carbon price in the wholesale price of electricity; and/or
- re-selling them for profit during periods of peak demand.

Both risks depend much on the volume of EUAs in the market in excess of the amount that would be needed for surrendering or hedging in the year in question. This will depend in the first place on auctioning sufficient quantities in a timely manner and in accordance with a predictable calendar. Other factors affecting the risks could include the extent to which participants withhold excess EUAs from the secondary market and the responsiveness of the market to latent demand from certain participants that expect (significant) future price rises later on.

The extent to which such conduct may be sustainable over time will depend very much on the **depth** and **breadth** of both the primary and secondary market for EU allowances. Therefore, the rules for EU-wide auctions ought to at least maintain the current liquidity of the secondary market and ought not to reduce or restrict the plurality of sources of supply into that market.

A view sometimes expressed by ETS operators is the need to limit participation in EU-wide EUA auctions so that they are assured access to allowances either to the exclusion of or in priority to participants other than ETS operators. This view is generally founded on the fact that ETS operators currently receive free allocations directly from the Member States into their registry accounts. Others argue that the exclusion or restriction of the financials' participation in the auctions will unnecessarily dampen competition in the auctions by lowering the depth and breadth of participation. Indeed, this is one reason why the revised ETS Directive sets out openness of the auctioning process as an objective. Such openness is necessary since a relatively limited number of EU-wide power companies will almost certainly

be subject to full auctioning in the third trading period with the large industrials probably benefiting from a high degree of free allocation. In these conditions, the participation of the financials in the auctions is seen as a means of injecting competition in the auction process quite apart from their function as demand aggregators and liquidity providers within the secondary market. This is all the more so since the allowances acquired by power companies would in all probability be parked in hedging accounts to meet their in-house forward needs of EUAs rather than being re-sold onto the secondary market.

4.9.3 Existing EC framework dealing with anti-competitive behaviour and/or market abuse

(i) *Anti-competitive behaviour*

Articles 81 and 82 of the EC Treaty⁶⁰ prohibit anti-competitive behaviour such as concerted practices or collusion and the abuse of a dominant position or market power. Moreover, Article 86 of the EC Treaty, prohibits Member States from infringing *inter alia* the EC competition rules.

Article 81 of the EC Treaty prohibits agreements between bidders or decisions by associations of bidders or other concerted practices that may affect trade between Member States and have as their object or effect the prevention, restriction or distortion of competition within the common market. For example, by submitting coordinated bids or by taking part in any other collective bid-rigging or market gaming strategies designed to influence the outcome of the auctions. In particular, price-distorting agreements amongst bidders are prohibited under Article 81 EC.

Article 82 of the EC Treaty prohibits any abuse of a dominant position by one or more undertakings within the common market or any substantial part of it in so far as it may affect trade between Member States. Most importantly, it is the abuse of a dominant position (e.g. by limiting the supply of EUAs on the secondary market for EU allowances without any objective justification) that would be prohibited under Article 82 of the EC Treaty, but not its acquisition (e.g. through hoarding or cornering bidding strategies which does not involve cartel like behaviour contrary to Article 81 of the EC Treaty).

Article 86 of the EC Treaty prohibits Member States from maintaining in force any measures that are contrary to the EC competition rules or to the Community principle of non-discrimination on the grounds of nationality, with regard to public undertakings or undertakings to which Member States grant special or exclusive rights. In addition, undertakings entrusted with services of general economic interest or having the character of a revenue-producing monopoly are also subject to the EC competition rules in so far as the application of such rules does not obstruct them in their performance of the particular tasks assigned to them. The Commission is entrusted with ensuring that Member States apply these provisions and can address Directives or Decisions to the Member States to that effect.

Finally, Articles 87 to 89 of the EC Treaty regulate all manner of aid granted by the Member States. Within the context of EU-wide auctions any auction rules could fall within the definition of State aid in Article 87 if they are left to the discretion of the Member States, if they involve a transfer of selective benefit to bidders in a manner that distorts or threatens to distort competition. This could be the case in particular if Member States were to tailor

⁶⁰ Council Regulation (EC) No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty, OJ L 1, 04.01.2003, p.1, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003R0001:EN:NOT>. This Regulation also defines the scope for enforcement action both at EU and national levels.

auctions so that certain bidders or certain sectors benefit through limited competition or lower prices such as: through informal pre-auction information disclosure; advantageous collateral, payment or delivery terms; or choice of certain dates in the auction calendar. *A priori* it is not clear on what grounds any such aid could be found compatible with the common market.

In accordance with Article 88 EC, Member States must notify the Commission their intentions to grant or alter aid prior to its implementation. If the Commission finds that the aid is incompatible, it will decide that the aid in question may not be granted or may only be granted subject to conditions.

The Commission is empowered to take action under the above-mentioned EC Treaty provisions. National competition authorities have concurrent jurisdiction to apply Articles 81 and 82 of the EC Treaty in their entirety. Moreover, the national courts have concurrent jurisdiction to apply Articles 81 and 82 as well as certain provisions of Articles 86, 87 and 88 of the EC Treaty which have direct effect i.e. they are directly enforceable in the national legal order without the need for Community or national implementing measures. These enforcement powers will continue to co-exist with the Regulation.

(ii) Market Abuse

In general terms, under the Market Abuse Directive 2003/6/EC (MAD), market abuse relates to:

- insider dealing, i.e. using price sensitive market information which is not publicly available to the market at large, so-called insider information; and
- market manipulation, i.e. distorting the normal market price-setting mechanism, e.g. by disseminating false or misleading information, by trading at an abnormal or artificial price, or by acquiring a dominant position.

MAD deals with market abuse in financial markets. The types of market manipulation that it sanctions fall below the thresholds required for the finding of an infringement under the EC competition rules discussed in (i) above. It does not require a finding of explicit collusion as is the case under Article 81 EC for instance. Moreover, it catches the acquisition of a dominant position over supply or demand which is not caught by Article 82 EC.

The need to regulate market abuse stems from the necessity to ensure full and proper market transparency which is a prerequisite for trading for all economic actors in integrated financial markets.⁶¹ Prompt and fair disclosure of information to the public enhances market integrity whereas selective disclosure reduces confidence in the integrity of financial markets.⁶² MAD also seeks to establish a level playing field in Community financial markets i.e. not only within a Member State but also between Member States.⁶³ Economic actors are expected to contribute to financial market integrity by various measures e.g. ring-fencing sensitive categories of personnel, internal codes of conduct, "Chinese walls", designated compliance officers, independent auditors and the like.⁶⁴

MAD's provisions apply primarily to any financial instrument (including commodity derivatives) admitted to trading in a regulated market in at least one Member State or for which a request for admission has been made irrespective of whether or not the transaction

⁶¹ Recital 15 of MAD.

⁶² Recital 24 of MAD.

⁶³ Recital 35 of MAD.

⁶⁴ Recital 24 of MAD.

takes place on that market.⁶⁵ Within the context of this consultation, EUA futures are commodity derivatives within the meaning of MAD. However, MAD would only apply in full if futures auctions took place over a regulated market (e.g. a regulated carbon exchange). MAD's provisions would not apply to spot auctions (unless they were spot futures), nor would they apply to futures auctions carried out on an unregulated market (e.g. an unregulated exchange) or to spot auctions conducted through primary participants, or through unregulated third party service providers for that matter. This would result in an uneven application of legally mandatory standards of supervision of market abuse across EC-wide EUA auctions depending on the type of product being auctioned and the type of auctioneer chosen. The question arises therefore, as to whether such disparity may be tolerated or whether there is a need for harmonised market abuse rules applicable to all EUA auctions.

For EUA auctions falling under MAD, namely the auctioning of futures on a regulated carbon exchange, the enforcement mechanisms foreseen in MAD would apply. These are: the appointment of a competent national authority with supervisory and investigative powers; reporting obligations; imposition of sanctions; and cooperation between national competent authorities. The question arises of whether such supervision and enforcement is needed within the context of EUA spot auctions not covered by MAD, regardless of the identity of the auctioneer. If MAD-like supervision and enforcement were deemed desirable, a number of ancillary questions would arise as to whether such an infrastructure should be:

- at national or EU level or both;
- limited to overseeing the primary carbon market or both primary and secondary carbon market;
- overseeing trade in commodity derivatives alone or also in spot carbon; and
- a securities regulator, an energy regulator, or both and/or some other authority.

These issues have to be examined by the Commission within the context of the follow-up to be given to Article 12 of the revised ETS Directive which states:

"The Commission shall, by 31 December 2010, examine whether the market for emissions allowances is sufficiently protected from insider dealing or market manipulation and, if appropriate, shall bring forward proposals to ensure such protection. The relevant provisions of Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) may be used with any appropriate adjustments needed to apply them to trade in commodities."

The current consultation paper focuses on what provisions could be included in the Regulation to deter collusion and/or market abuse from arising in the first place and to protect the integrity of the EUA auctions (see sections 4.9.4 and 4.9.5 below).

4.9.4 Preventing anti-competitive behaviour and market abuse in the Regulation

Throughout the preceding discussion on auction design (sections 2 and 3) and auction process (see the preceding sections of this section 4), particular emphasis has been placed on design and implementation features which would tend to promote competition in EU-wide auctions. Auction design and process features intended to enhance participation and competition in the EUA auctions include:

⁶⁵ Article 9 1st paragraph of MAD.

- timing, size and frequency of the auctions (sections 2.1.1 and 2.1.3, 2.2.1-2.2.4);
- product mix (section 2.1.2);
- lot size (section 2.3);
- simplified pre-registration KYC checks wherever possible (section 4.1);
- non-competitive bids for SMEs covered by the EU ETS and small emitters (section 4.6);
- equal access to pre- and post- auction information (section 4.7); and
- regulating administrative fees paid by bidders (section 5.3).

All these features improve participation in the EUA auctions. Additional auction design and process features intended to mitigate risks of collusion and/or market abuse include:

- discriminatory clearing price (section 3.2.1);
- random approach for managing ties in auctions (section 3.2.2);
- reserve price (section 3.3);
- maximum size of bids allowed from a single entity (section 3.4);
- provisions for 100% cash collateral being put up in spot auctions and for marking to market in futures auctions (section 4.2);
- rules on conflicts of interest in the primary participants model (section 4.5.1)
- auction monitoring and reporting (section 4.8); and
- transparency and confidentiality requirements (section 4.9.5).

At a higher level, by keeping auction design and implementation simple for all to follow, openly accessible (including to financial institutions), cost effective to attract wide participation, predictable to avoid hoarding tendencies, non-discriminatory to ensure a level playing field and efficient for instance by reducing the multiplicity of auction processes, the Regulation ought to contribute towards preventing anti-competitive behaviour and/or market abuse situations from arising in the first place. Moreover, the requirement of equal access to pre- and post- auction information and rigorous auction monitoring and reporting ought to contribute towards detecting such behaviour and/or abuse.

4.9.5 Transparency and confidentiality requirements

Article 10(4) of the revised ETS Directive specifically calls for all auction participants to have access to the same information at the same time. It is therefore essential for the financial integrity of the system that no bidder receives advance notice of information concerning the organisation and results of auctions that has not been announced publicly across the EU.

Transparency is particularly important to avoid discriminating between nationals of the Member State concerned and those of other Member States. Should Member States organise their own auctions there will be a further need for harmonising and synchronising the release of auction information both in terms of format and timing.

Yet, too much transparency regarding confidential information on individual bids and bidders might dampen competition by facilitating market manipulation and/or collusion in auctions and possibly even in down-stream markets. The risk of such an outcome increases with decreased participation both in terms of the numbers and types of bidders. A balance will have to be struck therefore between the twin needs for transparency and confidentiality.

The need for transparency, equal access and confidentiality is also reiterated in Article 15a of the revised ETS Directive which states:

"Member States and the Commission shall ensure that all decisions and reports relating to the quantity and allocation of allowances and to the monitoring, reporting and verification of emissions are immediately disclosed in an orderly manner ensuring non-discriminatory access.

Information covered by professional secrecy may not be disclosed to any other person or authority except by virtue of the applicable laws, regulations or administrative provisions." (Emphasis added)

In any event, transparency will derive from the publication of:

- The total cap on emissions, the amounts to be auctioned (in total and by Member State) and allocated for free (at the level of individual operators and installations) under the revised ETS Directive.
- The auction calendar under the Regulation (see sections 2.1 and 2.2).
- The auction results under the Regulation (see section 4.7.2).

The key question for the Regulation is what additional information ought to be disclosed regarding the EUA auctions. One option might be for the Commission to publish annually the aggregate amounts won in all EUA auctions carried out in the preceding year, by bidders at the level of the final beneficial owner. Such information could be reported to, collated, verified, and validated by the auction monitor for all EU-wide auctions prior to their publication by the Commission. In addition, more enhanced information disclosure may be particularly relevant during the period just before the surrendering date (i.e. between January and April of each year). The role and effectiveness of such disclosure needs to be assessed in the light of the work on protecting the market for emissions allowances from market abuse, which is being carried out by the Commission pursuant to Article 12 of the revised ETS Directive (see section 4.9.3(ii)).

Question 63

Is there a need for harmonised market abuse provisions in the Regulation to prevent insider dealing and market manipulation? If not, why not?

Please comment on your choice outlining the provisions you deem necessary and stating the reasons why.

4.10 Enforcement of the provisions of the Regulation

The mere possibility of detection could act as a deterrent from engaging in anti-competitive or market manipulative conduct, particularly if it is accompanied by effective, proportionate and dissuasive, enforcement mechanisms. Such enforcement measures ought not to duplicate enforcement measures already available in the existing EC framework for dealing with anti-competitive behaviour and/or market abuse situations discussed under section 4.9.3.

Nevertheless, the Regulation would have to fill in the gaps with regard to conduct that could potentially undermine the soundness, stability, integrity or credibility of the EU auctions but which is not adequately covered by the existing EC framework for dealing with anti-

competitive behaviour and/or market abuse, as already discussed in section 4.9.3 above. More specifically, a number of enforcement measures under the existing EC framework require time consuming investigation and enforcement either by the Commission or by competent national authorities before the anti-competitive conduct or market abuse may be terminated and/or sanctioned. Such delay may well be incompatible with the proper functioning of an on-going primary market in the auctioning of EUAs which is intended to put allowances in the hands of ETS operators for the purposes of surrendering them annually against their verified carbon emissions.

Quite apart from the need for enforcement measures to deter anti-competitive conduct and/or market abuse, the Regulation will have to contain enforcement measures designed to ensure that both the auctioneer(s) and bidders adhere to the auction design and process rules mandated by the Regulation. Provision should be made for swift action in case of non-adherence, particularly where such failures threaten the smooth running, integrity and credibility of the EU-wide EUA auctions.

Therefore, it is submitted that the Regulation ought to employ the following hierarchy of norms to ensure effective enforcement of its provisions generally and more particularly with respect to any anti-competitive conduct and/or market abuse, be it by the auctioneer(s) or bidders alike.

- Strict non-fault based liability ought to be preferred to fault based liability which requires onerous and potentially time consuming investigation i.e. certain conduct may be prohibited under the Regulation by virtue of its form alone or on the basis of its actual or potential effects regardless of any fault or bad faith on the part of any participant.
- Remedial action to reverse the effects of the detrimental conduct ought to be preferred to punitive action, e.g. in the case of hoarding, the Regulation could provide for undertakings that acquire beyond a certain threshold of allowances to divest themselves of excess holdings by means and through channels designed to ensure that there are no adverse effects on the secondary market.
- Structural remedies that are self-executing and may be implemented in a clean-cut manner ought to be preferred to behavioural remedies that require follow-up and monitoring for their proper implementation, wherever possible. Thus, breach of the provisions of the Regulation may result in suspension from the EUA auctioning system for a certain timeframe or until the breach is remedied.
- Punitive remedies ought to be reserved for situations where participants have intentionally, negligently or recklessly flouted the provisions of the Regulation. In which case, they should be primarily civil in nature (although criminal sanctions may not necessarily be excluded) attaching to both natural and legal persons depending on the gravity of the infringement.
- Either the Commission and/or the auction monitor could have the power to address binding interim decisions to the auctioneer(s) and/or bidders alike to avert any urgent, imminent threat of breach of the Regulation with likely irreversible adverse consequences.

Finally, there are issues around the:

- level(s) at which enforcement should apply; and
- desirable level of harmonisation of enforcement measures so as to avoid forum shopping for the least stringent auction.

Question 64 Should the Regulation provide for harmonised enforcement measures to sanction:

- Non-compliance with its provisions?
- Market abuse?

Please provide arguments to support your case.

Question 65 Should the enforcement measures include:

- The suspension of the auctioneer(s) and/or bidders from the EU-wide auctions?
If so, for how long should such suspension last?
- Financial penalties?
If so, at what level should such penalties be fixed?
- The power to address binding interim decisions to the auctioneer(s) and/or bidders to avert any urgent, imminent threat of breach of the Regulation with likely irreversible adverse consequences?
- Anything else? Please specify.

Please provide arguments to support your case.

Question 66 Should such enforcement measures apply at:

- EU level?
- National level?
- Both?

Please comment on your choice.

Question 67 Who should enforce compliance with the Regulation (more than one answer is possible):

- The auction monitor?
- The auctioneer?
- A competent authority at EU level?
- A competent authority at national level?
- Other? Please specify

Please provide evidence to support your case.

5. Who auctions? Auction processes and auctioneer(s)

5.1 Overall model for EU ETS auctioning system

The EU ETS is an EU-wide policy instrument constituting an EU-wide allowance market. Whatever the number of auction processes to be used, the Regulation must ensure an overall process that suits the system and meets the objectives and requirements of Article 10(4) of the revised ETS Directive.⁶⁶

The revised ETS Directive does not lay down the number of auction processes to be used. Section 1.5.6 already referred to different approaches: full decentralisation with 27 or more auction processes, full centralisation based on a single EU-wide auction process, an intermediate approach consisting of a limited number of coordinated auction processes and a hybrid approach where a central auction platform resolves the clearing price on the basis of bids received *via* various auctioneers. This section looks in more detail at the different approaches, bearing in mind the different parts of the auction process.

The need for harmonisation and centralisation of each part of the auction calendar, design and process is to be determined after the present consultation, taking into account stakeholders' responses. At least in theory, the above tasks may be assigned to different entities and at different levels of centralisation, under a variety of possible combinations. For instance, a system with multiple auction processes could still make use of a common auction monitor or a common clearing platform.

At a general level, the four approaches have the following advantages and disadvantages.

Full decentralisation with 27 or more auction processes clearly poses problems with respect to the auction calendar and risks major inefficiencies. Large participants would be forced to cope with a multitude of different auction processes, which multiplies the administrative burden and risk of errors. Some emitters may find it easier to deal with a local auctioneer rather than one located in another country, but this could easily be outweighed if the local platform can give access only to a limited number of EUAs, in particular if it is more difficult to access auctions in other Member States. Should each auction process and platform target its 'own' sub-set of stakeholders, overall accessibility to auctions would be very limited. Smaller auction processes where only very few and/or relatively small auctions are carried out risk to be unattractive and non-competitive. Inefficiency would, furthermore, reduce revenues, so it is difficult to identify any advantages of this option.

A system of a limited number of coordinated auction processes can overcome some of the disadvantages of the previous option. With 2 to 5 processes, an auction calendar with appropriate frequency and size of auctions may be feasible, even when auctioning both spot and futures. The efficiency of this approach depends to a great extent on the degree of variation and harmonisation of the rules of the various auction processes. An advantage may consist in the possibility of using existing auction infrastructure, such as established intermediaries and carbon exchanges. There are, however, risks of complexity and lack of transparency (e.g. coordination between the different operators responsible for the auction processes, criteria for Member States to decide on possible distribution of allowances auctioned between different processes, timing and consistency of information disclosure). The greater the variation, the greater the need for coordination. The greater the harmonisation, the lesser the need for coordination.

⁶⁶ The experience with highly diverse and distortive allocation rules in NAPs is not to be repeated.

One single centralised EU-wide auction process by definition allows for setting the auction calendar as preferred. Common rules for auction design and process will also generate efficiency, transparency, simplicity and thereby the highest degree of accessibility of auctions. Of course, like for any auction process still to be established, "the proof of the pudding is in the eating", but a centralised process offers the highest potential for open, transparent, competitive and accessible auctions. The KYC checks and collateral management will, however, represent a challenge and may constitute a bottleneck for the first auction to be implemented on-time. Disadvantage related to a potentially perceived "distance between bidders and the auctioneer" could be limited by setting up relevant web-based IT tools and infrastructure coupled with targeted training for potential bidders.

Finally, there is the hybrid approach where several auction processes are coordinated by one centralised clearing platform taking into account aggregated demand (all bids collected by the auctioneers) and aggregated supply (all EUAs auctioned by all auctioneers). So calculating the clearing price, resolving ties and managing the corresponding software would be carried out at a central level, whereas registering participants and collecting bids would be taken care of by several institutions at a decentralised level, in the same way as in the coordinated auction processes approach. This approach has the same advantage as the centralised process in that it also allows setting the auction calendar as preferred. It may also allow greater use of existing infrastructure able to collect bids. In this approach, the need for harmonisation and/or coordination of auction rules for tasks at decentralised level may be limited compared to the other approaches, precisely because bidders can obtain the EUAs they wish through any one or more decentralised processes of their choice.

The different approaches briefly described above are not mutually exclusive: a centralised clearing platform could co-exist with 2 or 3 independent auction processes. A single Member State could also participate in different platforms, either to auction different types of products (e.g. spot and futures), to spread risks, or as a means of fostering innovation and competition amongst platforms.

Question 68 Which of the three approaches for an overall EU auction model do you prefer? Please rate the options below (1 being the most preferable, 3 being the least preferable)

- Limited number of coordinated auction processes. []
- Full centralisation based on a single EU-wide auction process. []
- The hybrid approach where different auction processes are cleared through a centralised system. []

Please give arguments to support your case.

Question 69 If a limited number of coordinated auction processes develops, what should be the maximum number?

- 2
- 3
- 5
- 7
- more than 7, please specify.

Please give arguments to support your case.

Question 70 Is there a need for a transitional phase in order to develop gradually the optimal auction infrastructure? If so, what kind of transitional arrangements would you recommend?

5.2 Key requirements for the auctioneer(s) and auction processes

Typical governmental institutions that might be involved in the auction process include the Ministries of Environment, Finance and Industry, DMOs or other official agencies. Member States may also mandate a designated auctioneer bringing additional expertise, capacity and resources. Indeed, various commercial companies are available to provide services of organising the entire auction process or parts of it, such as the development and operation of electronic trading platforms or carrying out KYC checks.

Selection of auctioneers should be open and transparent. The Regulation ought to provide for appropriate quality standards. It could also provide for a pre-qualification procedure to establish a non-exclusive list of potential auctioneers. The auctioneer(s) may wish to sub-contract parts of the process to other entities.

To ensure a smooth and reliable auction process, the Regulation could impose the following requirements.

1) Technical capabilities:

- a) the auctioneer(s) need(s) to have the capacity and experience to conduct auctions (or a specific part of the auction process) in an open, fair, transparent, cost-effective and non-discriminatory manner;

- b) the auctioneer(s) also need(s) to make appropriate investment in keeping the system up-to-date and in line with ongoing market and technological developments; and
 - c) the auctioneer(s) need(s) to dispose of any relevant professional licences, high ethical and quality control standards, and be in compliance with financial and market integrity rules.
- 2) Integrity:
- a) the institution must guarantee confidentiality of bids and be able to manage market sensitive information in an appropriate manner;
 - b) electronic systems must be duly protected and appropriate security procedures with regards to identification and data transmission should be designed and implemented;
 - c) appropriate rules on avoiding conflicts of interest need to be in place and enforced. The absence of conflicts of interest and abidance by such rules should be duly monitored by the auction monitor; and
 - d) full cooperation with the auction monitor must be ensured.
- 3) Reliability: the organisation and systems need to be robust with adequate fallback measures in case of unexpected events. The risk of cancelling an individual auction once announced and the risk of failing functionalities (e.g. access to the bidding platform for certain potential bidders) should be strictly minimised. In case of IT problems on the bidder side, a fallback system could consist in telephone, fax or e-mail orders being sent to the auctioneer. Larger participants could have the option of using secured lines.
- 4) Accessibility and user friendliness:
- a) information on how to participate in auctions should be fair, concise, comprehensible and easily accessible;
 - b) pre-registration forms should be as short and simple as possible;
 - c) electronic tools should be clear and simple, designed to minimise the risk of errors. Each platform may have to be accessible through a dedicated internet interface;
 - d) proprietary trading systems used by active market participants should be able to connect to and communicate with the auction platform; and
 - e) adequate and regular training (including mock auctions) should be provided since a large number of expected bidders may have little familiarity with auctioning and trading systems. The auctioneer(s) should provide for detailed user guidance on how to participate in the auction. They should allow each bidder to test identification and access to the auction.
- 5) Non-discrimination must be ensured both *de jure* and *de facto*. Technical aspects of the auctions should not undermine competition and the efficiency of each auction and may not lead to an uneven level-playing-field across the EU.
- 6) Flexibility is required to accommodate possible changes in the key auction design elements resulting from periodic reviews.

For all of these aspects, the Regulation could list requirements, regardless of the identity of the auctioneer and location of the auction process. This would underpin the credibility of the auctioning system throughout the EU and help to ensure a proper auction process throughout the EU ETS. The requirements may be referred to when drawing up a tender in case a public procurement procedure has to be carried out.

Question 71

Should the Regulation impose the following requirements for the auctioneer(s) and auction processes?

Technical capabilities of auctioneers:

- capacity and experience to conduct auctions (or a specific part of the auction process) in an open, fair, transparent, cost-effective and non-discriminatory manner;
- appropriate investment in keeping the system up-to-date and in line with ongoing market and technological developments; and
- relevant professional licences, high ethical and quality control standards, compliance with financial and market integrity rules.

Integrity:

- guarantee confidentiality of bids, ability to manage market sensitive information in an appropriate manner;
- duly protected electronic systems and appropriate security procedures with regards to identification and data transmission;
- appropriate rules on avoiding and monitoring conflicts of interest; and
- full cooperation with the auction monitor.

Reliability:

- robust organisation and IT systems;
- adequate fallback measures in case of unexpected events;
- minimisation of the risk of cancelling an individual auction once announced;
- minimisation of the risk of failing functionalities (e.g. access to the bidding platform for certain potential bidders); and
- fallback system in case of IT problems on the bidder side.

Accessibility and user friendliness:

- fair, concise, comprehensible and easily accessible information on how to participate in auctions;
- short and simple pre-registration forms;
- clear and simple electronic tools;
- (option of) accessibility of platforms through a dedicated internet interface;
- ability of the auction platform to connect to and communicate with proprietary trading systems used by bidders;
- adequate and regular training (including mock auctions);
- detailed user guidance on how to participate in the auction; and
- ability to test identification and access to the auction.

Please elaborate if any of these requirements need not be included.

Please elaborate what additional requirements would be desirable.

5.3 Administrative fees

Bidders can be expected to take eventual fees into account in their bids and, at the margin, an auction with higher administrative fees can be expected to generate correspondingly lower revenues. Fees may consist in a fixed amount and/or a percentage of the winning bids. Any fee ought to be commensurate to the actual cost borne by the auctioneer. Situations may differ from one auction process to the other.

The Regulation should include adequate rules to ensure respect of the general principles of proportionality, fairness, non-discrimination and legal certainty with respect to administrative fees. Excessive fees ought to be avoided. The Regulation should also provide rules to avoid administrative fees becoming an undue barrier to access in particular for SMEs covered by the EU ETS and small emitters. All this would entail harmonised rules on fee structure and levels.

Question 72 What provisions on administrative fees should the Regulation include (more than one answer is possible)?

- General principles on proportionality, fairness and non-discrimination.
- Rules on fee structure.
- Rules on the amount of admissible fees.
- Other, please specify.

Please provide arguments to support your case.

5.4 How to ensure appropriate and timely preparation of auctions?

The Regulation is important to protect confidence both in the primary and secondary carbon market, hence the need of a credible auction calendar. The calendar, however, can only be credible if there is sufficient certainty that the auction processes and the auctioneer(s) will be ready in time. The following time-schedule for introducing new (or adapted) auction processes appears appropriate:

- 18 months in advance of the first auction to be carried out by means of the new (or adapted) auction process:
 - Selection of auctioneer and auction process.
- 6 to 12 months in advance:
 - Pre-registration should commence.
 - Auction platform and related IT tools should be ready and tested.
- 3 months in advance:
 - Training and mock auctions should commence.

The Regulation could require any Member State wishing to introduce a new (or adapted) auction process to make its intention public in good time (e.g. 18 months in advance of its start date). This would create transparency and guide expectations from market participants.

Subsequent material steps in the process should also be subject to public disclosure requirements.

A procedure for notification to and authorisation by the Commission of the selected auctioneer, auction design and auction process would help to ensure compliance with the objectives laid down in Article 10(4) of the revised ETS Directive as implemented by the Regulation.

If a Member State does not hold auctions it is responsible for on time, the proper functioning of the carbon market and the integrity of the EU ETS may be at risk. The Regulation should therefore contain a fallback provision to ensure that allowances retained by the Member State in question will be brought to market. Two potential fallback provisions may be envisaged.

- The Commission could authorise another auctioneer to auction the allowances on behalf of the Member State concerned (allowing the auctioneer to recover its administrative costs from the proceeds).
- The allowances are automatically added to the quantities scheduled for the two or three next auctions (the number may depend on the size and frequency of auctions).

In both situations, the revenues would still belong to the Member State that was originally responsible for auctioning them.

However, the Regulation could sanction Member States that do not live up to the timetable they are committed to. This could take the form of 0.1 - 0.25% of the delayed quantity being redistributed amongst Member States on the basis of the shares laid down in Article 10(2) of the revised ETS Directive, or by adding the same amount to the NER.

Question 73 Should there be provisions for public disclosure of material steps when introducing new (or adapted) auction processes?

Should new (or adapted) auction process be notified to and authorised by the Commission before inclusion in the auction calendar?

Question 74 Which one of the following options is the most appropriate in case a Member State does not hold auctions (on time)?

- Auctions by an auctioneer authorised by the Commission.
- Automatic addition of the delayed quantities to those foreseen for the next two or three auctions.

What other option would you envisage? Please specify.

Question 75 Should a sanction apply to a Member State that does not auction allowances in line with its commitments? If so, what form should that sanction take?

6. How to organise auctions of EU aviation allowances?

The Regulation needs to set the modalities for the auctioning of EUAAs to aircraft operators that will be included in the EU ETS starting 2012 (i.e. one year in advance of the third trading period). As explained in section 1.4.3, around 30 million EUAAs will be auctioned each year, which corresponds to 15% of the total quantity of EUAAs. This section explores the specifics of EUAA auctions, in particular insofar as they may be different to EUA auctions as examined in sections 2 to 5.

While aircraft operators will be able to use EUAs for compliance, non-aviation ETS operators will not be able to surrender EUAAs to cover their emissions. Accordingly, EUAAs require a separate auction process.

Potentially more than 2,000 aviation operators will be regulated under the EU ETS, ranging from large commercial carriers to private business jets. The 15 largest operators are expected to represent around 50% of aviation emissions regulated under the EU ETS. Less than 200 should have emissions over 100,000 tCO₂ in 2012, of which around 50 will emit more than 1 million tCO₂.⁶⁷ The distribution of EUAA allowances for auctioning over Member States is based on the emissions attributed to that Member State on the basis of departing flights and flights arriving from non-EU countries. This implies that a small number of Member States with the largest hub airports will account for a relatively large number of EUAAs to be auctioned. As aviation is expected to grow significantly, emissions in the sector are expected to exceed the cap on EUAAs and the sector is expected to buy additional EUAs for compliance needs. Under this scenario, one can expect that EUAA prices will closely follow EUA prices. This also implies that access to EUAAs for SMEs covered by the EU ETS and small emitters would not be a real issue as long as access to EUAs is adequately ensured and as long as EUAAs are not auctioned at a discount below the price of EUAs. However, because of the relative scarcity of EUAAs and because of the generally smaller amounts involved, liquidity of the secondary market for EUAAs may be lower than for EUAs.

6.1 What and when to auction?

Larger aircraft operators generally hedge (part of) their fuel needs some time in advance. Carbon hedging, to the extent required in addition to free allocation, may become a widespread practice in the industry, though companies' hedging strategies may vary significantly.

Given the relatively small number of EUAAs to be auctioned and the potentially lower liquidity of the secondary market for EUAAs, care must be taken not to fragment the market. Hedging solutions will be available to aircraft operators from the EUA secondary market, and possibly from EUA auctions. Hence, auctioning EUAA futures may carry only limited benefits to fulfil hedging needs.

As regards size and frequency of EUAA auctions, similar considerations as for EUA auctions apply. There may not be a need for a high number of auctions per year, given the possibility of using EUAs and accessing such allowances through EUA auctions. By contrast, the smaller group of large aviation operators suggests a need for relatively large EUAA auctions in order to ensure effective competition.

⁶⁷ ICF estimates based on the preliminary list of operators and their administering Member States published by the Commission, which can be found at http://ec.europa.eu/environment/climat/pdf/aviation/alloc_operators_110209.pdf.

In order to avoid bidding dilemmas, EUAA auctions should not coincide with EUA auctions. In case of a low number of EUA auctions, it may be desirable to have EUAA auctions following EUA auctions without too much delay, so as to benefit from the price signal from the EUA auctions. However, with a properly functioning secondary market for EUAs providing a clear carbon price signal at any time, this would be less of a concern.

In case of a relatively large number of EUAA auctions per year, it seems simplest to spread them equally over the year. In case of holding only 2 or 3 EUAA auctions per year, it may be desirable to hold these auctions in the months preceding the surrendering date, rather than shortly after the surrendering date.

Question 76 As a general rule throughout the trading period, in your opinion, are early auctions necessary? If so, what should the profile of EUAA auctions be:

- 5-10% in year n-2, 10-20% in year n-1, remainder in year n
- 10-20% in year n-2, 20-30% in year n-1, remainder in year n
- 20-30% in year n-2, 30-35% in year n-1, remainder in year n

Other? Please specify.

Question 77 Do you think there is a need to auction EUAA futures? If so, why?

Request for potentially confidential information 3 Please send the answer to this question in paper and electronic format, marked on the envelope "Strictly Private and Confidential – Auctioning consultation", directly to the European Commission, DG ENV, Directorate C, Unit C2, to the attention of the Head of Unit, Office BU-5 2/1, 1049 Brussels, Belgium. It will be treated confidentially and will not be disclosed publicly.

For aircraft operators covered by the EU ETS:

Have you determined a corporate hedging strategy for carbon needs?
Yes [] No []

If so, what share of your expected emissions covered by the EU ETS in a given year n do you (intend to) hedge and how much in advance?

- year n : _____%
- year n-1 : _____%
- year n-2 : _____%

Request for potentially confidential information Please send the answer to this question in paper and electronic format, marked on the envelope "Strictly Private and Confidential – Auctioning consultation", directly to the European Commission, DG ENV, Directorate C, Unit C2, to the attention of the Head of Unit, Office BU-5

information 4 2/1, 1049 Brussels, Belgium. It will be treated confidentially and will not be disclosed publicly.

What share of the annual quantity of allowances you intend to purchase *via* auctions would you wish to buy spot or futures respectively?

		SPOT	FUTURES
•	year n	: _____%	_____%
•	year n-1	: _____%	_____%
•	year n-2	: _____%	_____%

Question 78 What should be the optimal frequency and size of EUAA auctions:

- 2 auctions per year of around 15 million EUAAs?
- 3 auctions per year of around 10 million EUAAs?
- More than 3 auctions per year? Please specify.

Please comment on your choice.

Question 79 What would be your preferred timing for EUAA auctions:

- Equally spread throughout the year?
- November – March?
- Other? Please specify.

6.2 Auction design

The smaller volume suggests an even greater need for simplicity. Therefore, a single-round auction appears appropriate. As for EUA auctions, discriminatory-pricing may help to deter anti-competitive behaviour and/or market manipulation.

As liquidity of the secondary market for EUAAs may be lower than for EUAs, a reserve price may be useful. The reserve price could not only be based on the prevailing market price of EUAAs, but also to the prevailing EUA market price. In order to (further) mitigate the risk of anti-competitive behaviour and/or market manipulation, ties could be solved by randomly selecting the winning bids.

As aircraft operators have the possibility to use EUAs instead of and in addition to EUAAs, attempts to drive up the EUAA price are likely to have limited effects. Accordingly, there seems to be no case for a maximum bid-size in EUAA auctions.

Question 80 Should any of the EUAA auction design elements be different compared to EUA auctions (see section 3)?

If so, please specify and comment on your choice.

Question 81 Do you agree there is no need for a maximum bid-size? If not, why not?

6.3 How will EUAA auctions be implemented?

A number of aircraft operators will be SMEs covered by the EU ETS and small emitters. Provisions described in section 4.6 may apply to EUAA auctions thereby ensuring full, fair and equitable access.

It may be noted that the provisions on greenhouse gas emissions permits in Articles 4 to 7 of the revised ETS Directive do not apply to aircraft operators. Of course, any landing in an EU airport requires licences governed by other regulatory requirements. Information regarding aircraft operators made available as part of the regulatory process to the competent authority in each Member State⁶⁸ might facilitate the KYC checks performed by the auctioneer(s).

Some aircraft operators based in third countries may be included in the scheme only due to incidental or only a limited number of flights to the EU. Conditions for registering and participating in the auctions should be open also for these operators and measures targeted at SMEs covered by the EU ETS and small emitters may take their situation into account.

There appears to be no need for specific rules as regards guarantees and financial assurance, payment and delivery and transaction rules that would be different from those for EUA auctions.

For cost efficiency reasons, the smaller total volume of EUAAs to be auctioned may suggest relying on systems developed for EUA-auctions. The role of primary participants, exchanges, third party service providers or public authorities is discussed in section 4.5.

As said, the possibility of using EUAs reduces the need to provide for specific measures to ensure access to SMEs covered by the EU ETS and small emitters amongst the aircraft operators, such as providing for non-competitive bids, in particular in case all winning bids would pay the uniform clearing price. It is important that third-country aircraft operators which are included in the EU ETS only because of a low number of flights are made aware of the possibility of using EUAs for surrendering next to EUAAs.

There appear to be no specific issues for EUAA auctions as regards information disclosure and auction monitoring other than those also applying to EUA auctions.

Question 82 Is there any information regarding aircraft operators made available as part of the regulatory process to the competent authorities that could facilitate the KYC checks performed by the auctioneer(s)?
If so, please describe what information is concerned and whether it should be referred to in the Regulation or any operational guidance published by the Commission.

⁶⁸ Or to Civil Aviation Authorities as part of the Air Operators Certificates.

Question 83 In your opinion, is there a specific need to allow for non-competitive bids in EUAA auctions?
Would this be the case even when applying a uniform clearing price format?
Please provide arguments to support your case.

Question 84 Do you agree that there is no need for any specific provisions for EUAA auctions as regards:

- Involvement of primary participants, exchanges or third party service providers?
- Guarantees and financial assurance?
- Payment and delivery?
- Information disclosure?
- Auction monitoring?
- Preventing anti-competitive behaviour and/or market manipulation?
- Enforcement?

If not, please describe in detail what rules would be needed and why.

6.4 Institutions for auctioning EU aviation allowances

The much smaller volume of EUAAs to be auctioned exacerbates the disadvantages of fully decentralised auctioning of aviation allowances as it would result in a large number of very small auctions. It rather pleads for a coordinated approach with a (very) limited number of auction processes, a fully centralised approach or the hybrid approach. On the one hand, one could argue in favour of specialisation of one or few auction processes. On the other hand, one could seek benefits by minimising the differences between auctions of EUAAs compared to EUAs.

For auctioning EUAAs, there appear to be no specific considerations as regards the requirements applicable to the auctioneer(s) and auction processes, administrative fees and the rules to ensure appropriate and timely preparation of the auctions. Of course, account should be taken of the fact that aviation will be included as from 2012.

Question 85 Taking into account the smaller volume of EUAA allowances to be auctioned compared to EUAs, which of the three approaches for an overall EUAA auctioning model do you prefer? Please rate the options below (1 being the most preferable, 3 being the least preferable)

- Limited number of coordinated auction processes. []

- Full centralisation based on a single EU-wide auction process. []
- Hybrid approach where different auction processes are cleared through a centralised system. []

Does your choice differ from the approach preferred for EUAs? Please provide arguments to support your case.

Question 86

Do you agree that there is no need for any specific provisions for EUAA auctions as regards:

- Requirements for the auctioneer(s) and auction processes?
- Administrative fees?
- Rules to ensure appropriate and timely preparation of the auctions?

If not, please describe in detail what rules would be needed and why.

Appendix 1 – Glossary

Anti-competitive behaviour – Conduct that contravenes Articles 81 and 82, as well as Articles 86 of the Treaty establishing the European Community.

Arbitrageurs – Entities that practice arbitrage, i.e. trading in order to take advantage of a price differential between similar commodities in different markets or different but fungible commodities on the same market.

Auctioneer – A public authority or an agent or sub-contractor who conducts an auction on behalf of one or more Member States.

Auction calendar - covers the annual volume of auctions, the distribution over spot and futures (if any), the dates of individual auctions spot or futures (if any), the auction processes used for individual auctions and the size of individual auctions.

Auction design – For the purposes of this consultation, auction design encompasses the choices on the number of rounds, number of bids that may be submitted, the rules for establishing the clearing price resolving tied bids, the potential use of a reserve price and maximum bid-size.

Auction platform – Refers to the IT system used by an auctioneer to run an auction.

Auction process - Refers to the whole process of organising an auction, encompassing the following functions: setting the date and volume of auctions to take place; registering and pre-qualifying participants; providing an platform and infrastructure; collecting bids, managing collateral, running the auction, calculating the results and resolving eventual ties, ensuring the settlement (payment and delivery) and monitoring.

Banking of allowances - A mechanism whereby participants are able to exchange excess allowances or credits from one trading period for new allowances or credits for use in later trading periods.

Basel II accords - Recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision with the purpose of creating an international standard that banking regulators can use when creating regulations concerning how much capital banks need to put aside to guard against financial and operational risks.

Breadth of market – The number and variety of market participants in terms of types of participants and geographical scope.

Central counterparty – A central counterparty guarantees execution of the buyer and seller's transfer orders but does not guarantee the performance of the transaction for either side. Moreover, central counterparties do not provide netting services that clearing houses provide.

Certified Emission Reduction (CER) - The unit of the Kyoto Protocol's Clean Development Mechanism (CDM), equivalent to 1 metric tonne of CO₂ equivalent.

Clean Development Mechanism (CDM) - Flexible mechanism under Article 12 of the Kyoto Protocol through which EU companies may finance greenhouse gas emission reduction

or removal projects in developing countries and receive credits (CERs) for doing so. These credits may be used up to a certain limit for compliance purposes within the EU ETS.

Clear the trade – Complete an agreed trade by settling payment and delivering the allowances.

Clearing house - A clearing house acts as guarantor of the transaction in case of default by either the buyer or seller. Moreover, clearing houses provide netting services that central counterparties do not provide such as daily margining services for futures transactions pending their maturity date. Clearing houses are better suited for payment and delivery in futures auctions which require the netting of such margins.

Clearing price – The price at which the quantity of allowances supplied in an individual auction is equal to the quantity demanded in that auction. All bidders who bid at more than the clearing price receive the allowances that they bid for.

Collateral, payment and delivery – Requirements that determine the process for a trade, meaning security to guarantee a trade, the way in which payment is made and the means by which a commodity is delivered, respectively.

Collusion – Market participants acting together to manipulate the price of an asset.

Commodities – A commodity is a homogenous good or product.

Commodity derivative - A financial instrument the value of which depends on the value of an underlying commodity.

Community independent transaction log (CITL) - A log that records the issuance, transfer, cancellation, retirement and banking of allowances that take place in the EU ETS registry.

Coordinated approach – The auctioning of allowances by Member States acting individually or jointly through a limited number of auction processes.

Cornering strategies – A market strategy where an ETS market participant attempts to control a significant proportion of all available supplies of a given commodity by stockpiling allowances to create price peaks at given dates such as surrendering dates, in order to be able to manipulate the price.

Default – The act of failing to meet an obligation, e.g. to pay for or deliver allowances.

Delivery date – The day on which allowances or credits must be delivered to the buyer.

Depth of market - The scale of a market which is key for price stability. If the market is deep, a large order is needed to change the price.

Derivative - A financial instrument the value of which depends on the value of another underlying asset. The main types of derivatives are futures, forwards, options and swaps.

Discriminatory-price auctions – An auction in which the winning bidders pay the amount they bid for the asset.

Due diligence - A process undertaken by potential investors to assess an investment opportunity by researching material facts in relation to the investment.

Early auctions - Auctions held prior to the relevant year in the trading period. An allowance which falls under the cap calculated e.g. for the year 2014 may be auctioned in 2012 or 2013.

Emission Reduction Unit (ERUs) – The unit of the Kyoto Protocol Joint Implementation (JI) flexible mechanism, equivalent to 1 metric tonne of CO₂ equivalent.

Equal treatment – A general principle of Community law according to which similar situation ought to be treated in the same way whilst different situations ought to be treated differently.

EU allowances (EUAs) – The currency used in the EU ETS. One EUA can be surrendered with respect to 1 metric tonne of CO₂ equivalent of verified emissions.

EU Aviation Allowances (EUAAAs) – The currency used in the EU ETS which can only be used with respect to emissions from aircraft operators. One EUAA can be surrendered with respect to 1 metric tonne CO₂ equivalent of verified emissions.

European carbon market – The market encompassing all trading of EU allowances and other carbon currencies such as CERs and ERUs in Europe be it through exchanges or OTC including all associated activities.

Exchanges - Organised markets for the buying and selling of financial instruments and/or commodities.

Fiduciary duty of care – A duty of care involving a high level of trust.

Financial instruments – The Markets in Financial Instruments Directive (MiFID) defines financial instruments to include *inter alia* transferable securities, money-market instruments and certain options, futures, swaps, and other derivatives relating to commodities.

Force majeure clause – A clause that lessens or waives parties' liabilities if an extraordinary event or circumstance beyond their control, arise.

Forwards - A transaction between two parties to exchange a fixed volume of allowances against fixed payment at a future date. It is a direct, 'over-the-counter' (OTC) trade between two counterparties conducted bilaterally or through a broker.

Full centralisation – A single process for auctioning all EU allowances.

Full decentralisation – Auctions arranged by individual Member States, implying a potentially large number of separate auction processes.

Fungibility – The ability of an asset to be freely substituted by another in satisfying an obligation.

Futures – A standardised, exchange-traded transaction to buy or sell allowances or credits at a designated future point in time at a price agreed upon today by the buyer and seller.

Futures auctions - Auctions of allowances in accordance with standardised terms and conditions to be delivered at some future date. Payment is deferred until delivery although buyers and sellers are subject to a margining system in the interim.

Futures position – The holding of futures commitments by an exchange participant.

Hedge - Offset exposure to price risk. An electricity producer that, e.g. commits to supply electricity in two years time will have a need for the corresponding EUAs in two years. It may hedge the price risk in the carbon market by buying carbon futures that will guarantee the delivery of allowances at the time it needs them at a pre-determined price.

Hoarding strategies - A market strategy, whereby an ETS operator attempts to control a significant proportion of all available supplies of a given commodity, by stockpiling more than what is needed to cover its anticipated compliance needs.

Hybrid approach – Where several auction processes are coordinated by one centralised clearing platform taking into account aggregate demand (all bids collected by the auctioneers) and aggregated supply (all EUAs auctioned by all auctioneers). So calculating the clearing price, resolving ties, managing the corresponding software and possibly collateral, payment and delivery would be carried out at a central level, whereas registering participants and collecting bids would be taken care of by several auction processes at a decentralised level

Initial margin call – The initial security payment made to an exchange's clearing house by the buyer and seller of futures in order to guarantee the eventual trade.

Insider dealing – Using price sensitive market information which is not publicly available to the market at large.

Intermediaries – Companies trading in EUAs or other products on behalf of, or in order to satisfy demand from others, in particular ETS operators.

Issuance date – The date by which freely allocated allowances are issued to ETS operators in a given year. The date by which Member States have to issue EU allowances is 28 February of each year.

Joint Implementation (JI) - Flexible mechanism under Article 6 of the Kyoto Protocol through which EU companies may finance greenhouse gas emission reduction or removal projects in other developed countries and receive credits for doing so (ERUs). These credits may be used up to a certain limit for compliance purposes within the EU ETS.

Kyoto credits – Emission reduction credits generated by Clean Development Mechanism or Joint Implementation projects under the Kyoto Protocol.

Legal certainty – A general principle of Community law which entails complete knowledge of one's legal position. The principle of legal certainty militates against the retrospective application of legal acts save for in very exceptional circumstances.

Liquidity - The degree to which an allowance can be bought or sold on the secondary market without affecting the price. Liquidity is characterised by high trading volumes.

Long position – The holder of the position owns a commodity or rights to a commodity under a financial instrument and will stand to profit if the price of that commodity rises.

Lot size - Number of allowances associated with one unit of the auctioned product.

Margining system – A system designed to manage risks pertaining to futures. Under a margining system, the buyer and seller pay an initial margin call of 10% and daily variation margin calls in accordance with changes in the market price of the futures not covered by the 10% initial margin call until maturity of the futures. A margining system is managed by a clearing house.

Market abuse – Consists of insider dealing and market manipulation.

Market maker – A person who holds himself out on the financial market on a continuous basis as being willing to deal on own account by buying and selling financial instruments against its proprietary capital at prices defined by him.

Market manipulation - Distorting the normal market price-setting mechanism, e.g. by disseminating false or misleading information, by trading at an abnormal or artificial price, or by acquiring a dominant position.

Maturity date – The date when a futures expires. The maturity date of futures is the date where settlement and delivery of the allowances is foreseen.

National Allocation Plans (NAPs) - Member State plans with respect to the first or second trading periods determining the quantity of EU allowances to be issued by that Member State and the method of allocation, in particular with respect to free allocations to installations taking part in the EU ETS in that Member State.

New Entrants Reserve (NER) – A quantity of allowances set aside with respect to allocations for free to new installations that are established during the course of a trading period.

Non-competitive bids – Bids for a fixed quantity without specifying a price. Participants submitting and winning such bids pay the clearing price.

Over-the-counter (OTC) – Trading not mediated by an exchange but undertaken directly between the trading parties. OTC-trades are often facilitated by a broker.

Price discovery - The process of determining the price level of an asset based on supply and demand factors.

Primary market – The primary market refers to auctions of EUAs and EUAAs. Primary issuance of allowances takes place in respect of free allocation (which is not a 'market') and in respect of auctioned allowances.

Proportionality – A general principle of Community law whereby the measures employed ought to be commensurate to the desired objective.

Regional Greenhouse Gas Initiative (RGGI) - A regional initiative by states and provinces in the Northeast of the United States to reduce greenhouse gas emissions. RGGI is a cap and trade emissions trading system for greenhouse gas emissions from power plants.

Reserve price - The minimum price the seller will accept at auction.

Secondary market - The market in which carbon units (EU allowances, CERs or ERUs) are traded after they are initially offered in the primary market. In the secondary carbon market an traders transact with each other rather than with an issuing authority.

Settlement date – The date on which a carbon trade is closed out through payment of the amount due.

Short position - The holder of the position owes obligations to deliver a commodity or financial instrument that it does not necessarily own at a future date at a pre-determined price. It stands to gain if the price of the commodity or financial instrument were to fall in the interim.

Single-round sealed-bid model – An auction design where bidders only have one time slot to submit bids which are submitted confidentially and opened simultaneously.

Small and medium sized enterprises (SMEs) – In this consultation document, small and medium sized enterprises generally refers to SMEs covered by the EU ETS.

Small emitters – Installations with low emissions of CO₂ relative to other installations included within the scope of the EU ETS.

Spot futures – A futures trade with a maturity date only a few days after the contract date. Spot futures are regulated as financial instruments in the Markets in Financial Instruments Directive (MiFID), though in practice they have characteristics comparable to spot trades.

Spot - A transaction in which a commodity is bought or sold for immediate delivery or delivery in the very near future.

Spot auctions - Refer to auctions resulting in immediate or near immediate payment and delivery.

Spreads – The price difference between two defined assets.

Subsidiarity – A principle referred to in Article 5 of the Treaty establishing the European Community which states that in areas outside the exclusive competence of the Community, the Community shall take action only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore by the scale or effects of the proposed action be better achieved by the Community.

Surrendering - The annual process whereby ETS operators submit EUAs to the appropriate national registry in order to comply with their obligations arising from emitting greenhouse gases. Verified emissions must be matched by an equal amount of allowances.

Surrendering date – The deadline for ETS operators to surrender allowances with respect to their emissions in a given year. This date is 30 April of the following year.

Tied bids – Two or more bids made at the clearing price in an auction for which the quantity offered does not suffice.

Trading period – EU allowances are valid for a specific multi-annual trading period. As from 2013 onwards, trading periods will last 8 years. The EU ETS does not have an annual 'vintage'. Sometimes, trading periods are also referred to as 'phases'.

Transaction costs – The costs incurred in preparing for and executing a transaction above and beyond the price of the asset itself.

Uniform-price auctions – An auction in which all of the successful bidders pay the same price for the auctioned asset.

Variation margin call – Additional security required by an exchange from the buyer or seller of futures because of changes in the market value of the futures.

Winner's curse – A theory that the winning participant in an auction will typically pay too high a price for the auctioned asset.

Appendix 2 – List of abbreviations

CCS – carbon capture and sequestration
CER – Certified Emission Reduction
CET – Central European Time
CITL – Community Independent Transaction Log
CO₂ – Carbon Dioxide
DMO – Debt Management Office
ECB – European Central Bank
ERU – Emission Reduction Unit
EUA – European Union Allowance
EUAA – European Union Aviation Allowance
EU ETS – European Union Emissions Trading Scheme
FCD – Financial Collateral Arrangement Directive
GHG – Greenhouse gas
IEA – International Energy Agency
IMF – International Monetary Fund
JI – Joint Implementation
MAD – Market Abuse Directive
MiFID – Markets in Financial Instruments Directive
NAP – National Allocation Plan
NER – New Entrant Reserve
OECD – Organisation for Economic Cooperation and Development
OTC – Over-the-counter
RGGI – Regional Greenhouse Gas Initiative
SFD – Settlement Finality Directive
UK – United Kingdom
US – United States

Appendix 3 – List of relevant legislation

Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC; OJ L 275, 25.10.2003, p.32, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003L0087:EN:NOT>.

Directive 2009/29/EC of the European Parliament and of the Council of 22 April 2009 amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading scheme of the Community; adopted on 26 March 2009, not yet published in the Official Journal of the EC, <http://register.consilium.europa.eu/pdf/en/08/st03/st03737.en08.pdf>.

Directive 2008/101/EC of the European Parliament and of the Council of 19 November 2008 amending Directive 2003/87/EC so as to include aviation activities in the scheme for greenhouse gas emission allowance trading within the Community, OJ L 8, 13.01.2009, p.3, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:008:0003:0021:EN:PDF>.

Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L 145, 30.04.2004, p.1, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:145:0001:0044:EN:PDF>.

Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation, OJ L 96, 12.04.2003, p.16, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:081:0042:0044:EN:PDF>.

Council Decision 1999/468/EC of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission, OJ L 184, 17.07.1999, p.23, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1999:184:0023:0026:EN:PDF>, last amended by Council Decision 2006/512/EC, OJ L 200, 22.07.2006, p.11, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:200:0011:0013:EN:PDF>.

Directive 2005/60/EC the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, OJ L 309, 25.11.2005, p. 15, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:309:0015:0036:EN:PDF>.

Directive 2008/20/EC of the European Parliament and of the Council of 11 March 2008 amending Directive 2005/60/EC on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, as regards the implementing powers conferred on the Commission, OJ L 76, 19.03.2008, p.46, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:076:0046:0047:EN:PDF>.

Commission Directive 2006/70/EC of 1 August 2006 laying down implementing measures for Directive 2005/60/EC of the European Parliament and of the Council as regards the definition of 'politically exposed persons' and the technical criteria for simplified customer due diligence

procedures and for exemption on grounds of a financial activity conducted on an occasional or very limited basis, OJ L 214, 08.08.2006, p. 29,

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:214:0029:0034:EN:PDF>.

Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, OJ L 168, 27.06.2002, p.43,

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:168:0043:0050:EN:PDF>.

Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems, OJ L 166, 11.06.1998, p.45,

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1998:166:0045:0050:EN:PDF>.

Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, OJ L 12/1, 16.01.2001, p.1,

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2001:012:0001:0023:EN:PDF>.

Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003, on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, OJ L 345, 31.12.2003, p.64,

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003L0071:EN:NOT>.

Council Regulation (EC) No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty, OJ L 1, 04.01.2003, p.1,

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003R0001:EN:NOT>.

Appendix 4 –Member States' share of auctioned EUAs

The table below provides estimated shares of Member States in the total quantity to be auctioned pursuant to Article 10(2) of the revised ETS Directive.

EU	100,00%
Austria	1,36%
Belgium	2,48%
Bulgaria	2,96%
Cyprus	0,26%
Czech Republic	4,57%
Denmark	1,22%
Estonia	0,89%
Finland	1,63%
France	5,35%
Germany	19,57%
Greece	3,39%
Hungary	1,46%
Ireland	0,92%
Italy	9,42%
Latvia	0,20%
Lithuania	0,53%
Luxemburg	0,17%
Malta	0,10%
The Netherlands	3,28%
Poland	12,21%
Portugal	1,72%
Romania	4,88%
Slovakia	1,50%
Slovenia	0,43%
Spain	8,44%
Sweden	0,87%
United Kingdom	10,20%