CARBON MARKET ANALYST

Phase 3 allocation: racing against the clock

RESEARCH 17 January 2012

TO THE POINT

New allocation rules in phase 3 of the EU ETS: auctioning will replace free allowances as the main allocation method. We expect 8754 Mt of allowances to be auctioned and 6067 Mt to be allocated for free over the years 2013-2020. This means auctioning will account for 59 per cent of the overall volume for stationary installations.

The power sector will acquire all their emission allowances through auctioning, with the exception of eight member states which have applied for 700 Mt of free allocation for their utilities.

The industry sector will receive free allowances based on benchmarking. The precise amount given to each installation will depend on how CO2 efficient it is compared to predefined efficiency benchmarks.

The free allocation volume will likely be decided towards the end of 2012 once the European Commission finishes the assessment of the member states' National Implementation Measures. We expect the submission of NIMs to be completed by the end of February 2012 at the earliest.

We expect phase 3 auctions to begin in autumn 2012 (or later) as the process of selecting auctioning platforms is still in a very early phase. Tenders need to be published and submitted, then it will take time to select and test platforms before the auctions can start.

We believe the delays will reduce the supply in 2012, with only 70 of the planned 120 Mt of early auctions coming onto the market. Likewise, lingering uncertainty over the free allocation volumes could induce some industry installations to keep their phase 2 surpluses. Together, this could provide some support for carbon prices in 2012.

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Executive summary

Despite the nearing end of phase 2, the phase 3 allocation process is nowhere near completion. Uncertainty remains over the volume and timing of phase 3 auctions as well as over the amount of free allocation.

The total annual cap in phase 3 will decrease by 1.74% of the average annual phase 2 allocation, starting in 2010. This translates into an annual decrease in total allocation of 36 Mt. The total cap will be 2294 in 2013, declining to 2027 in 2020. This is assuming an emission reduction target of 20 per cent by 2020, a scenario we currently see as most likely. Each sector will be given a portion of the total annual phase 3 caps, equal to its share of phase 1 verified emissions.

Industrial installations will receive most of their allocated allowances for free. This will be determined with a bottom-up approach through the use of benchmarks for sub-installations. Member states will calculate the amount of free allocation for each sub-installation based on the existing benchmarks and historical activity levels. These preliminary allocation volumes will not exceed the total cap of the industrial sector which is determined "top-down" based on the sector's share of phase 1 emissions.

The amount of free allocation in the industry sector will become clear after the Commission assesses the National Implementation Measures (NIMs) which are still being submitted by member states. We expect NIM submission to be completed by the end of February 2012 at the earliest and the assessment process to be finalized towards the end the year.

Auctioning will become the rule in the power sector. Unlike industry, the power sector is not eligible for free allocation, with the notable exception of eight member states that have proposed to allocate 700 Mt to their utilities over 2013-2019 for free.

Putting the necessary infrastructure in place for the planned auctions will be a critical issue throughout 2012. Given the current pace of progress we expect that most auctions will not start before October (possibly later). This leaves less time for a distributed spread of the volumes to be brought to market, and we see it as likely that only approximately 70 of the planned 120 Mt will be sold by the end of December.

Together with lingering uncertainties over the free allocation volumes in industry, these delays could provide some support for European carbon prices in 2012.

Introduction

The third trading period of the EU ETS will see several important changes, not least with regard to the allocation of emission allowances. From 2013 onwards, around 60 percent of the European Union Allowances (EUAs) will be auctioned, as compared to 4 per cent today. The remainder will still be handed out for free, but the allocation methodology will change substantially, from being based on historical emissions to benchmarks. Furthermore, the overall scope of the ETS will expand as new sectors such as aviation, aluminium and petrochemicals are included.

The increased use of auctioning in phase 3 is a bid to restore confidence in the ETS. Free allocation has previously allowed many of the biggest CO2-emitters to collect windfall profits as they passed on the opportunity cost of carbon allowances to their customers.

The process for allocating phase 3 allowances will likely become a key item on the policy agenda in 2012. The ongoing submission of National Implementation Measures (NIMs) and their assessment by the European Commission will determine the amount of free allocation to the industry and heat sectors.

Free allocation wil also be given to electricity producers in eight member states. The European Commission is currently reviewing the submitted applications.

In Phase 3, auctions will be carried out on a common EU wide platform and on "opt-out" platforms that will be set up by Germany, UK, and Poland. Auctioning of 2012 aviation allowances will also take place on the new auctioning exchanges. Whether these platforms will be operational in time for all the planned in 2012 however is open to question.

In this report, we cover all critical stages of the phase 3 allocation processes and discuss the potential for delays. We also give a full overview of the methods for allocating free allowances to industrial installations and electricity producers and estimate the potential amounts of free allocation and auctioning.

Total cap

The 12,800 stationary installations that are currently compliant to the ETS emitted approximately 1.9 billion tonnes of CO_2 equivalents in 2010, close to half of the total European greenhouse gas emissions.

The EU has decided that in order to reach the 20 per cent reduction target by 2020, EU ETS emissions will have to decrease every year by 1.74 per cent of the average annual cap in phase 2 starting from 2010. This declining trajectory is what determines the annual phase 3 caps.

We currently estimate that the cap will be 2294 $MtCO_2$ in 2013 and gradually decrease to 2027 in 2020 (see Table 1). The exact phase 3 allocation will be known once the total amount of cancelled allowances from countries' NERs and JI reserves in phase 2 are known.

Free allowances will be allocated to the industry and heating sectors EU-wide, and some will also be given to electricity producers in certain eligible countries.

The industry sector will be allocated a share of the phase 3 total cap, based on its share of verified emissions in phase 1. Most of the sector's cap will be allocated for free. The volume of free allocation will be determined based on benchmarking. Industrial operators will receive free allowances based on how CO_2 efficient they are compared to a predefined efficiency benchmark adopted by the Commission.

Table 1: Annual Phase 3 caps
Volumes include allocation to existing sectors, aviation, new industry and Norway.

Year	Total Allocation
2013	2294
2014	2256
2015	2218
2016	2180
2017	2141
2018	2103
2019	2065
2020	2027

All of the allowances that are not allocated for free will be auctioned on specially designated platforms, which will be selected through tender processes in 2012.

Free allocation to industrial installations

Industrial installations will receive free allowances based on benchmarks for CO_2 efficiency. Through benchmarking, installations will receive a certain amount of allowances for each unit of output, to cover emissions from the manufacturing of a certain product. This amount of free allowances is specified by the benchmarks adopted for that product.

The Commission has set 52 such product benchmarks based on the average efficiency of the 10 per cent most CO_2 efficient installations that manufacture each product. If installations produce more than one product, they will be allocated allowances based on more than one benchmark. The product benchmarks will cover 75 per cent of all emissions in the industry sector.

Installations can additionally be covered by benchmarks based on the units of heat and/or fuel consumed or exported, for emissions which are not covered by the product benchmarks. The heat benchmark will be more prevalent and apply to 20 per cent of industrial emissions, while the one for fuel will cover 5 per cent (see Table 2 for the values of these benchmarks adopted by the Commission).

For industrial emissions not covered by the previous three allocation approaches (less than 1 per cent of the sector's emissions) free allocation will be based on historical emissions.

The amount of free allowances received will also depend on the installations' risk of carbon leakage. Those not vulnerable to carbon leakage will receive only 80 per cent of their allocation for free in 2013. This percentage will decrease linearly to reach 30 per cent in 2020. Plants which are exposed to international competition will receive their allocated allowances for free. Whether the free allocation will cover their actual emissions, however, will still depend on their efficiency compared to the relevant benchmarks.

Allocation at the installation level

Different allocation methods can apply to the same installation. Member states will split plants into sub-installations, which will be defined according to the benchmark that applies to them. The final allocation to each sub-installation will be equal to the product of the relevant benchmark, the historical activity level, the carbon leakage factor, and a cross-sectional correction factor. See Table 2 below for how these factors will be calculated for each sub-installation depending on the benchmark used.

The allocation for each installation will then be determined according to the sum of the allocation volumes for all of its sub-installations.

Table 2: Allocation factors in phase 3
Factors for calculating the amount of free allocation to each sub-installation in the industry sector.

Sub-installation	Benchmark	Historical Activity Level (over 2005-2008 or 2009-2010, whichever is higher)	Carbon Leakage Factor (in 2013)
Product benchmark	52 product benchmarks (EUAs/ton product)	Median annual production level (tons of product)	Exposed = 1, Non exposed = 0.8
Heat benchmark	62.3 EUAs/TJ	Median annual heat consumption or export (TJ)	Exposed = 1, Non exposed = 0.8
Fuel benchmark	56.1 EUAs/TJ	Median annual fuel consumption (TJ)	Exposed = 1, Non exposed = 0.8
Historical emissions	97% of historical emissions	Median annual emissions (tCO2)	Exposed = 1, Non exposed = 0.8

Determining the total free allocation volume

In the NIMs that member states submit to the Commission, they will propose a preliminary allocation amount for each sub-installation. This will be equal to the product of the benchmark and the historical activity level. The total allocation determined through this bottom-up approach cannot exceed the total cap for the industry sector. Thus, the Commission could apply a cross-sectional correction factor if the preliminary allocation is higher than the total cap. This factor will be the same for all installations in the industry sector.

The amount of free allocation will depend on when the correction factor is applied. There are three possible scenarios:

1) In all years in phase 3

2) After a certain point in phase 3

3) Not at all

This will depend on how the preliminary allocation amount compares to the total cap. We expect that, as a result of the benchmarks, the preliminary allocation will be less than the total cap in the first years of phase 3. Thus, we see scenario 2 as the most likely and illustrate it in Figure 1. In this case, the constant preliminary allocation in the NIMs starts to exceed the total cap at some point in phase 3. At that point in time, the correction factor is applied and effectively "cuts off" the free allocation amount, which starts decreasing linearly thereafter.

After the correction factor is applied, the allocation amount will also be adjusted according to the carbon leakage risk for industrial installations. For installations deemed not to be vulnerable to carbon leakage, the free allocation amounts determined thus far will be discounted by the percentages described above. Due to this, the final free allocation amounts will never actually be constant as in Figure 1.

We estimate that the total amount of free allowances that the Industry and New industry sectors are expected to receive will be 773 Mt in 2013 and decrease to 622 Mt in 2020 (Table 3, next page). There is uncertainty over the point in time when the cut-off takes place. We have assumed that the correction factor will be applied in 2016.

Benchmark impacts

The method of benchmarking will affect the way allowances are distributed in the ETS. As emitters no longer receive allowances based on historical emissions, less efficient installations could face shortages on a year-by-year basis. This is not to suggest that these installations will necessarily assume buying positions

Figure 1: Time for a correction?
Illustrates how the Commission will determine the need and timing of a correction factor. Annual max allocation is the total annual cap for the industry sector. Preliminary allocation is the amount proposed by member states in the NIMs.

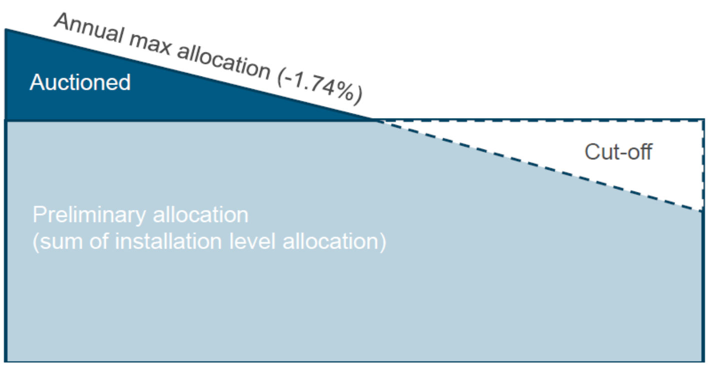


Table 3: Estimated free allocation volumes to each industry sector
Values in million tons.

	Pulp and Paper	Metals	Oil and Gas	Cement, Lime and Glass	Other	New Industry	Total
2013	33	167	156	192	123	102	773
2014	33	165	153	189	121	98	758
2015	32	162	150	185	118	95	743
2016	32	159	148	182	116	91	728
2017	31	153	142	175	112	88	701
2018	29	147	137	169	108	85	674
2019	28	141	131	162	104	81	648
2020	27	136	126	156	100	78	623
Total	246	1230	1143	1410	901	719	5649

in the market. Many industrial installations are sitting on large phase 2 surpluses, which can cover future shortages. What it does imply is that less efficient industrials might hold on to their phase 2 surpluses to cover phase 3 shortages caused by the benchmarks.

How installations compare to their benchmarks will be an important factor in how long or short they end up. The benchmarks are based on intensity data from 2007 and 2008 and the technologies which existed at the time. The Commission thus argues that the benchmarks should be achievable.

However, the benchmarks could have a significant impact on the amount of free allowances the installations will receive. For the steel sector for instance, Eurofer has announced that the CO2 efficiency of the average blast furnace plant is 1.59 tCO2/t (for a tonne of steel produced). In comparison, the product benchmark for hot metal determined by the Commission is 1.33 tCO2/t. Given historical production data, we estimate that the steel sector will receive 30Mt less per year in phase 3 than if the average efficiency was equal to the Commission's benchmark.

See textbox for the current status of two court cases raised against benchmarks.

Benchmarks upheld in court

The adopted benchmarks have been the subject of two court cases brought against the Commission, one by steel industry group Eurofer and the other by Poland. The rules surrounding waste gases used as a heat source in production processes have proven particularly contentious for both cases

Both plaintiffs have raised issue with the Commission's decision to reduce the amount of allowances given out for such use of waste gases. According to the community wide implementation measures (CIMs), these allowances are discounted by the amount of emissions from producing an equivalent amount of heat from natural gas. Eurofer applied for the annulment of this decision, but also for the suspension of its execution until the Court reaches its final verdict. The latter plea was rejected by the Court in September 2011.

The case filed by Poland also calls for the annulment of the benchmarking decision. In addition to contesting the rule on waste gases, Poland pleaded that the Commission had not sufficiently taken into account the unique situation of the fossil fuel dependent country. The court has yet to issue a judgment.

Currently, the Commission has green light to implement the benchmarks. The court cases, which could last between one and two years, could mean some changes to benchmarks down the road, but they will not delay the phase 3 allocation process.

Any future changes to the benchmarking rule will not affect the total supply of allowances in the EU ETS because the share of the cap to be allocated to industry is already determined as their share of total emissions during phase 1.

NIM submission status

The NIM submission process has so far seen a significant delay. The formal submission deadline of 30 September 2011 was missed by most member states. By 3 January 2012 only ten states had turned in their allocation plans: Cyprus, Great Britain, Estonia, Ireland, Latvia, Lithuania, Malta, Poland, Romania, and Slovakia.

> “NIM submission still far from completion

In response, the Commission has threatened to launch infringement proceedings against the other 17 member states. The countries have to provide information on their progress to the Commission by 1 March 2012, when the Commission will consider any further legal proceedings.

The delay can be explained by the complicated process for NIM preparation. A member state has to collect verified historical activity data for each sub-installation that falls under the ETS. Installations within some member states missed these deadlines. In Germany, industrial operators were given until 23 January 2012 to submit data. Thus, Germany will not be able to submit its NIM until the end of February 2012.

Italy is currently processing its collected data, and could probably submit its national plan by the end of January 2012. Sweden could submit soon, as its official plan was to submit in December last year. In addition, Finland has announced that it will turn in its plan in early February 2012.

> “Eight countries to give away EUAs to their power sectors

Overall, we expect that the latest NIM will be submitted towards the end of February 2012 at the earliest, given the progress seen from nations so far.

Upon submission, the Commission will assess the NIMs to determine whether member states have calculated the preliminary allocation amounts correctly. It will also determine whether to apply the cross-sectional correction factor and how large that will be. It is important to note that the Commission will not be able to determine the final allocation to each installation before it has received the NIMs of all member states.

In conclusion, we expect that the allocation figures will be complete towards the end of 2012. There is a risk that the process could be postponed even further if the Commission rejects any preliminary allocation amounts. That will result in a back-and-forth process between the Commission and a member state, much too reminiscent of the NAP process which saw many delays.

Free allocation to power installations

The revised ETS directive includes a derogation rule under which ten member states were eligible to allocate a certain number of allowances for free to electricity producers. Allowances could be allocated for free to power producers on the condition that they invest the corresponding value of the received free allowances in green technology.

To apply for this type of free allocation, the eligible member states had to submit national plans to the Comission by 30 September 2011. This process is separate than the NIM submission. In their applications, member state had to list all eligible power plants and the investments they will make to qualify for free allocation.

Eight out of the ten eligible countries decided to apply for free allocation to electricity producers. Table 4 shows the total free allocation proposed by each country, as seen in submitted documents or in pre-submission drafts published on national authorities' websites.

The proposed volumes for free allocation fall far below the maximum amount of free allocation allowed under the derogation rule. On average, the eight countries have chosen to allocate no more than 64 per cent of the maximum available allowances for free. Poland took the biggest advantage of the derogation possibility (75 per cent), whereas Lithuania on the other end, proposed to allocate only 31 per cent for free.

We have estimated the maximum amount of free allocation based on the "derogation package" adopted by the Commission on 29 March 2011. These rules stipulate that the free allocation in 2013 can be no more than 70 per cent of the total power sector emissions over the period 2005-2007. After 2013, the percentage has to decrease gradually to reach zero in 2020.

This decline could either be linear or non-linear. A non-linear trajectory cannot deviate more than 50 per cent from the average decline necessary in any given year to reach zero per cent by 2020. Based on such an "optimizing" approach, we estimate the total maximum

Table 4: Proposed free allocation to power sector in eligible countries
Values in million tonnes.

Member state	Proposed free allocation	Total allowed	Proposed allocation as % of total allowed
Bulgaria	58	104	56%
Cyprus	9	14	64%
Czech Republic	108	199	54%
Estonia	19	40	48%
Hungary	24	54	44%
Lithuania	2	8	31%
Poland	405	537	75%
Romania	75	140	54%
Overall	701	1096	64%

number of allowances that can be allocated for free in each of the eight member states in Table 4. Overall, the maximum amount of allowances they could receive is 1096 Mt.

Table 5: Income lost
Revenue foregone from the proposed free allocation to the power sector.

Member state	Revenue forgone (Million EUR)
Bulgaria	548
Cyprus	60
Czech Republic	1095
Estonia	250
Hungary	363
Lithuania	63
Poland	1584
Romania	777
Total	4740

Choosing to allocate allowances for free, the eight member states would forgo some potential revenues in a time of strapped public budgets. Given our forecasted average price for phase 3 of EUR 12/tCO_2, we estimate the amount of revenues that governments will forgo if they were to allocate free allowances based on their proposals (see Table 5). The values range from 1.6 billion for Poland to €60 million in Cyprus, for a total of €4.7 billion.

Commission assessment of optional allocation

The European Commission has until 30 March 2012 to assess the applications. During this period, it will make sure that the total allocation in each country does not exceed the average electricity emissions over 2005-2007, and apply a cross sectional correction factor if they do. More importantly, the Commission will determine whether the installations included in the application are eligible for partial free allocation.

Eligible installations are those that have started to generate electricity before 31 December 2008 or for which the investment was "physically initiated" by that date. The latter can be demonstrated by a contract for the construction of the plant, signed before 31 December 2008, an authorizing document from a national authority approving the construction, or any other evidence proving the investment decision was not influenced by the option to receive free allowances.

There is a possibility that the Commission will contest Poland's proposed allocation that includes thirteen yet-to-be-built power plants which did not have a building permit by 31 December 2008. According to Polish law, a building permit is required before construction commences. Polish authorities will have to provide other evidence that the plants were "physically initiated" if challenged by the Commission, but their plan is currently not clear.

Total Free Allocation Volumes

The amount of free allocation for each year is comprised of the free allocation to the power, industry and new industry sectors. For the power sector we have aggregated the volumes proposed by member states under the derogation rule.

However, Romania and Estonia have only announced the total proposed free allocation for the whole period 2013-2019. Thus, we have estimated the potential amount of allowances they could allocate for free for each year according to their total proposed volume. To do this, we assumed that the percentages in Table 4 are constant for all years 2013-2019. We have multiplied this percentage by the estimated maximum allowed allocation for each year to calculate the potential annual amounts.

Auctioning

The increased use of auctioning for allocating allowances will be one of the most important changes in the EU ETS as we pass from phase 2 to phase 3. Overall, in the years 2013-2020, around 59 per cent of the total allocation will be auctioned (see Table 6). In the ongoing second trading period, only 4 per cent of the EUAs have been auctioned.

Table 6: Free allocation and auctioning
The 300 million allowances set to be allocated from the NER 300 in 2012 have been subtracted from the phase 3 allocation. The early auction volumes of 120 million allowances are included in phase 3.

	Total free allocation ($MtCO_2$)	Total auctioning ($MtCO_2$)	Auctioning % of total allocation
2013	881	1099	55%
2014	853	1091	56%
2015	824	1083	57%
2016	794	1076	58%
2017	752	1083	59%
2018	708	1090	61%
2019	663	1099	62%
2020	592	1134	66%
Total	6067	8754	59%

Total Auctioning Volumes

In phase 3, auctioning volumes will be equal to the cap minus the free allocation. We estimate that the amount of auctioned allowances will be 1099 in 2013 and gradually increase to 1134 in 2020 (Table 6).

The exact auctioning volumes will be known once the Commission decides how many free allowances will be given out, which we expect to happen towards the end of 2012.

Distribution among member states

The total auctioning volumes are divided among the member states following a rather complex calculation in the ETS directive. Essentially, each country will receive allowances more or less proportionally to its share of historical emissions, except that 12 per cent of the annual volumes will be deducted before the initial distributions, to be added to the shares of certain eligible countries.

The various governments will then offer their allowances to the market on one of four auctioning platforms that will be created for this purpose. 24 member states will set up a common platform together with the European Commission. The top three CO2 emitters Germany, Poland and UK have decided to launch their own national platforms.

Volumes shall be spread throughout the year, in regularly recurring "bidding windows", in order to minimize the impact on secondary trading. The technical details will be decided by the platform operators, but questions of substance, such as possible revision of volumes, will be deicided by the Commission. The exact dates and times of the auctions will be published in auction calendars in February the preceding year.

Auction format

The auctioned product will be daily futures (two day delivery delay). The sales will take place as single-round, sealed bid, uniform price auctions. This is a simple format that has been chosen deliberately to ease the access for a maximum number of bidders, including small and medium sized enterprises. Directly following the closure of the bidding window (minimum two hours), the auction platform will determine and publish the clearing price at which demand for allowances equals the number of allowances offered for sale in the auction concerned.

Successful bidders will be the ones who have placed bids for allowances at or above the clearing price. They will all pay the same price, regardless of the price they specified in their bids.

The auction handling will entail significant costs for the platform operators, especially linked to due diligence (of buyers and sellers) and clearing. This will be covered by a fee, consisting of a fixed and a variable part, which the bidders will have to pay to participate in the auctions.

In today's market (phase 2), fees on the major exchanges typically range from 2-4 euro per 1000 tonnes. The higher supervision standards in phase 3, could justify the fees to rise, but given the exchanges' eagerness to handle the EUA auctions, we expect they will likely bid to host them at substantially discounted fees.

Only regulated markets can auction in phase 3

A key difference in phase 3 will be that only "regulated markets" will be allowed to operate auction platforms. This typically means fully regulated commodity exchanges (such as ICE ECX, GreenX, NASDAQ and EEX), which already conduct much of the EUA trading in phase 2. Other currently operating platforms which are not considered regulated markets will either have to upgrade their legal statuses, a long and cumbersome process, or be excluded from selling primary EUAs.

Two main groups of buyers will be admitted to the auctions: installation operators that are compliant under the ETS (those who need to surrender EUAs every year) and investment firms and credit institutions that are authorised and regulated under EU law. In addition, a special provision allows for fuel traders to take part.

> “Much remains to be done regarding auction platforms

Financial market exchanges can compete in the tenders, as can newly set up entities, as long as they get the status of regulated market. Given the complexities involved, the likelihood of a new operator winning a tender seems very slim.

The platform selection will be based on price (cost to participants), as well as technical and financial capacity to perform the contract. The draft version of the tender indicates a comprehensive list of precise aspects that will be assessed, including web interface, training courses, etc.

A common auction monitor will scrutinize all four platforms to guarantee non-discriminatory access for all admitted participants, avoid market manipulation, etc.

The regulatory framework for auctioning

The general regulatory framework for the EU ETS is set by the Emission Trading directive, which determines the total cap. The directive also calls for a regulation to be adopted by the Commission, on the "timing, administration and other aspects of the auctions". This became the Auctioning Regulation, (AR) which specifically governs the auctions of phase 3 allowances.

Originally passed in 2010, the newest version of the AR entered into force 25 Nov 2011, with amendments that set the national volumes for the phase 3 auctions that will take place already in 2012. Like the ETS directive, the AR covers stationary installations (EUAs) as well as aviation (AEUAs). The AR contains several measures to avoid cheating, fraud and favouritism.

Broadly speaking the AR provisions concern two different aspects of the platforms: 1) the procurement procedure to be followed to select them, in order to ensure a non-discriminatory competition among the interested candidates, and 2) the functioning (once they will be operational). The latter point includes the general design: how to spread volumes throughout the year, when to publish the calendars, criteria for access to auctions (who can place bids? who can be refused?), the role of the auctioneer and the auction monitor, etc.

The regulation clearly distinguishes between the common platform and the national ones, although most provisions are applicable to both types. More details on the platform design will appear in the tender that is likely to be published in January 2012.

Infrastructure implementation

Although the regulatory framework is more or less ready on a EU level, the implementation in the member states is far from being finished. The Auctioning Regulation (AR) has direct legal effect, but the fact that it refers to a series of other legislative acts, not yet fully transposed in all member states, means that potential platform operators risk being excluded on the basis of their host country not having up to date national legislation. The Commission is mapping the implementation status, and the latest available update (November 2011) shows that at least ten member states still need to implement provisions pursuant to the directives for market in financial instruments (MiFID) and for market abuse (MAD).

More important in terms of delay risk is the fact that the entire infrastructure still needs to be set up. The joint procurement agreement for the common auction platform was published late November 2011, and the call for tenders seem to be in the last phase of preparation (draft version can be found on the Commission's website). We assume it will likely be published by late January or early February 2012. As it is set to be a very thorough selection process, the platform is not likely to be operational before October at the earliest. The auction monitor will also be selected through a tender process in 2012 (the joint procurement agreement was published in November 2011).

With only one year to go before the start of phase 3 (January 2013), the planned schedule seem to be a race against the clock (se Figure 4 below)

UK started procurement of opt-out platform

The UK, which has opted out of the common platform, launched a tender for its own permanent platform on 22 December 2011, with submission deadline 17 February 2012. ICE Future Europe, Bluenext and EEX have all indicated that they will submit tenders, whereas GreenX is reported to be "reviewing the documents".

Germany and Poland also opted-out of the common facility, and will set up their own national platforms through separate tenders. So far, little news has been revealed about their procurement procedures, it thus seems likely that their permanent platforms will be finalised only some time after the common European and the UK platform.

Once all the four platforms are operational they will share the total auctioning volume between them. Assuming that Germany will auction its EUAs on its own platform, as will UK and Poland on theirs – whereas the rest will enter the market through the common platform – we

Figure 2: Share of early auctions by platform

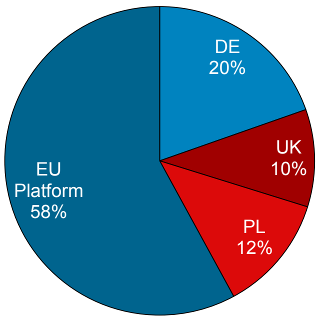
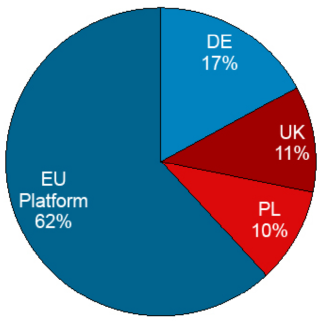


Figure 3: Share of phase 3 auctions by platform



estimate the shares of each in Figure 2 (based on the 2012 early auction volumes decided by the EU in 2011). For the whole period 3, the EU share will slowly increase its part (from 58 to 62 per cent) as the calculations stipulated in the ETS directive comes into play (Figure 3).

Set-up of platforms to go on throughout 2012

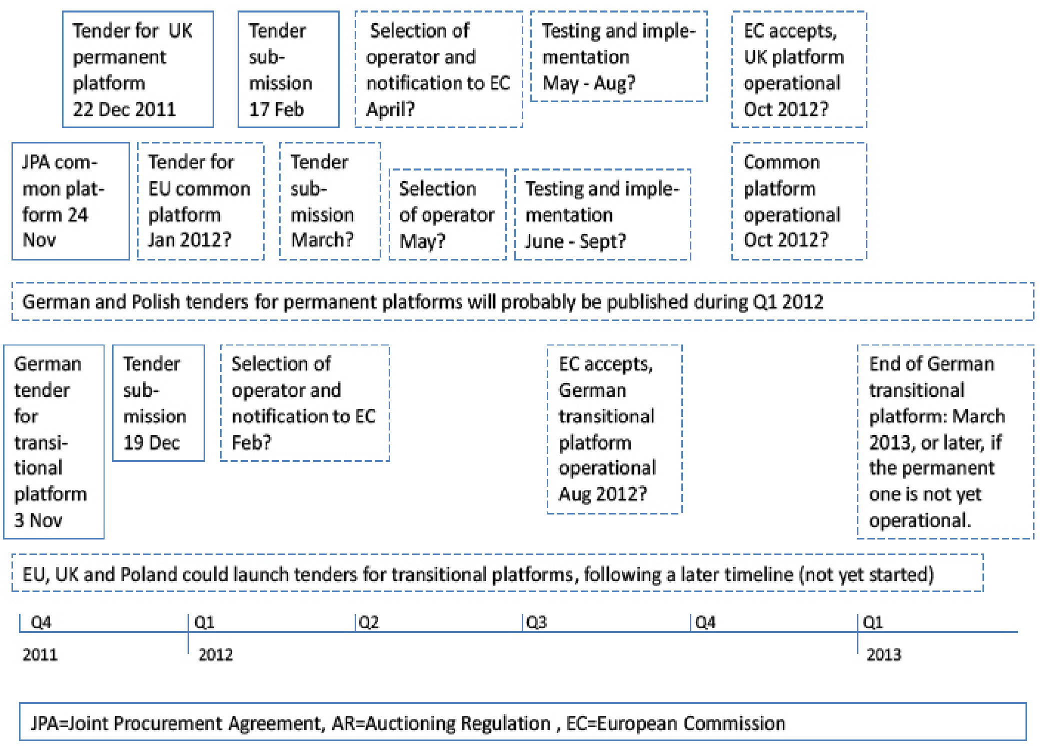
If the tender for the permanent common platform is published by the end ofJanuary, candidates will probably have until March to present their offers. Then it will take a minimum of two months to conclude the selection of operators, and then potentially several months more to test the platforms before they are ready for commercial operations.

The UK already published its tender, and could thus enjoy a head start for its platform. However, the Commission will still need to assess the chosen UK platform; to be sure that all eligible bidders are given equal access to the auctions, and that no preference is given to companies registered in any particular member state. If satisfied, the Commission will then put forward a draft amendment of the Auctioning Regulation in order to list the opt-out platform in the regulation annex.

This amendment follows the same procedure as the adaptation of the AR itself, including a vote by the Climate Change Committee followed by a three-month scrutiny period in the European Parliament. The opt-out platform can start conducting auctions only when the amendment to list it in the annex to the AR has entered into force. This legislative process will take 4-6 months.

In a fast track scenario, we believe both the UK and the common platforms can be ready to host their first phase 3 EUA auctions in October 2012. Germany and Poland have not yet started the procurement of permanent platforms, and unless they publish calls for tenders by the end of the first quarter of 2012, we see a very limited probability for their permanent platforms to be operational by the end of 2012. Figure 4 shows a step-by-step illustration of what we consider a likely timeline.

Figure 4: Tentative timeline for set-up of phase 3 auction platforms



Delayed early auctions

The result of all this is that no auction for phase 3 allowances is likely to take place before autumn 2012, at least not on a permanent platform. Although the next trading period does not start until 2013, the AR clearly stipulates that 120 million phase 3 EUAs shall enter the market already in 2012, in the form of so-called early auctions. The allowances are meant to enter the market in small portions throughout the year, in order to "limit the impact on the secondary market".

As the necessary infrastructure for auctioning is not likely to be in place before October, this concern will be hard to accommodate unless the early auction volumes are reduced. If only three months will be available for auctions – instead of six as originally planned – member states will face a choice of pumping out huge volumes, or keeping significant amount of phase 3 allowances till the phase 3 actually starts.

There is also a question of EU policy makers' willingness to push forth the early auctions. In a market where prices are low and the dominant ongoing debate is about possible set-asides (withholding allowances), there might to be little enthusiasm to rush the early auctions.

German transitional platform

The AR does in fact foresee a need for a temporary solution in the form of "transitional platforms". These can be established more quickly as they are not subject to all the strict rules applying to the permanent ones, but can be "aligned to services already existing in the market". They do need to be "regulated markets", in order to prevent market abuse.

So far, only Germany has launched a tender for a transitional platform, with submission deadline 19 December. Given the less onerous tender procedure, and assuming the choice of a platform that a) has experience in EUA auctions, and b) qualifies as a regulated market, Germany could possibly have it up and running by summer 2012.

The German tender specifies that the platform shall auction the 24 Mt of German third phase EUAs (early auction) and the estimated 7 Mt of German aviation EUAs. It also states explicitly that a candidate must be prepared to continue operations at least till the end of March 2013, or later, if the permanent platform is not operational by then.

> "Are policy makers willing to push early auctions?

The tender asks the candidate operators to submit a detailed list of information, of which the most important are fees to be charged on the auction participants, trade volumes on operator's existing market and number of traders on the operator's existing market. The candidates must also specify their planned start of auctioning EUAs (both aviation and third phase), and a description of their platform's Internet interface and customer support system.

The award of the German contract will be based on three aspects: price, quality of service and quality of monitoring (detection of market abuse).

If anyone else (including the Commission) will go ahead with tenders for transitional platforms, they are most likely to trail behind the German process, and not be ready before the end of 2012, by which time the permanent platform should anyway be operational.

Delays likely to reduce early auctions to 70 Mt

The delays are likely to have a significant impact on the volumes of early auctions brought onto the market in 2012. According to the EU decision in July 2011, 120 Mt should reach the market "in the second half of 2012", but given the reduced time window we do not see this as likely.

In order to quantify the effect of the delays, we have made an estimate based on the assumptions that once the auctions start, volumes will be limited pro rata in order to avoid price impact on the secondary market. 120 Mt spread out from July through December, gives a monthly volume of 20 Mt, and we assume that this will be a good indication of how much that will be sold on a monthly basis in 2012.

With regard to the timing, we assume that the German transitional platform will be ready to host early auctions from August-December (five months). With the country's 20 per cent share of the 120 Mt this gives 24 Mt / 6 x 5 = 20 Mt (see figure 2 on page 9 for the shares of the different platforms).

We assume that the European and UK (transitional) platforms will start in October, and that they will host the remaining 80 per cent, but adjusted down from 6 to 3 months. This gives 96 Mt / 6 x 3 = 48 Mt (in the absence of a Polish exchange we expect the country will auction on the common platform).

In total this would mean about 70 Mt out of the 120 Mt early auctions will come onto the market during 2012. There are obviously several uncertainties attached to all the above assumptions, but given the currently available information, we consider this our best possible estimate.

New Union Registry will replace national registries

In addition to the platforms, there is also the question of the new Union Registry which is set to replace the national carbon registries. It was meant to start receiving EUAs in January 2012, but this has been postponed till June. The transfer from the national to the Union Registry will happen gradually, and is likely to be fully operational by the end of 2012.

Phase 3 EUAs can only be deposited in the Union Registry, meaning that until it is operational, there can be no spot sale of phase 3 allowances (spot contracts are deposited immediately upon acquisition). This means that forward contracts will still be relevant for the early auctions that will take place on the German *transitional* platform (buyers can purchase in 2012 and deposit whenever the Union Registry is ready).

Auctioning aviation allowances

2012 has seen the introduction of aviation into the EU ETS. The ruling of the European Court of Justice on 21 December 2011 has in principle cleared the last legal hurdle for this scheme, which will include all airlines operating to, from and within Europe.

Several international airlines have stated their intention to file a complaint at the International Civil Aviation Organisation, so the final word might not yet have been said. Some of the same airlines (in particular the American ones) have nevertheless started to charge extra ETS fees on the passengers, in a clear sign that they are adapting to the new regulatory framework.

They will receive special aviation allowances (AEUAs), but they can also buy regular EUAs. The stationary compliance buyers on the other hand cannot surrender AEUAs.

The special registry for aviation is set to be operational by February 2012, but whether this deadline will be met remains to be seen. Furthermore, as we have already seen, there will be no platform for the sale of AEUAs before the summer of 2012 at the earliest (if the German transitional platform is open by then).

The aviation sector has separate caps for 2012 and for the 2013-20 period. For 2012, the cap is set at 97% of the sector's emissions in the 2004-06 period, while in phase 3 this percentage is reduced to 95%. For both 2012 and 2013-20, 15% of the aviation cap will be auctioned.

During 2012, the aviation allowances will be auctioned on the transitional platform(s) that will be set up to auction the pre-2013 volume of EUAs. As it is unlikely that these platforms will be in place before the second part of 2012, operators will likely turn to the secondary EUA market.

> Airline operators could seek secondary market EUAs in 2012

Another factor that will encourage operators to buy EUAs is their tendency to hedge future fuel costs, making them likely to cover a need for carbon allowances in advance. Aviation operators usually hedge fuel costs roughly 6-18 months ahead.

A delay in 2012 aviation auctioning is estimated to increase EUA demand from aviation by 32 Mt.

Conclusions

The phase 3 allocation process is still far from completion as many key stages remain to be carried out in 2012. The Commission will begin reviewing the NIMs only after all of them have been submitted, an event we expect around the end of February 2012 at the earliest.

We expect that the free allocation volumes will be determined towards the end of 2012, with the first issuance to take place on 28 February 2013. The result of this delay is increased uncertainty for the industry sector especially, which might prompt installations to hold on to their phase 2 surpluses and limit their selling going forward.

For sectors that will not receive free allocation, the question is how soon they will be able to buy allowances on auctions. Given the current pace of progress, we expect the necessary auctioning platforms to be up by autumn 2012, delaying the early auctioning and calling into question how many phase 3 allowances will actually be auctioned in 2012.

It seems unlikely that the full early auction volume of 120 Mt will be put to market in 2012. The final volume could even be zero, but based on our assumptions for the timeline and for moderate distributed volumes, we expect the volume of early auctioning to be in the order of 70 Mt.

A lower than expected supply of early auction allowances and planned aviation allowances could lend support to carbon prices in 2012. Any support for carbon prices however will come against the backdrop of the oversupplied carbon market and the ongoing sovereign debt crisis in Europe.

Colophon

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