

Independent Observer's Report on the conduct of the EU ETS Carbon Emissions Allowances Auction on 19 November 2008

Role of the Independent Observer

The Independent Observer is David Steeds, a senior partner of Evolve Business Consultancy, who was appointed by HM Treasury through an open competition. His role under Regulation 12 of the Community Emissions Trading Scheme (Allocation of Allowances for Payment) Regulations and Scheme 2008 is to oversee an auction and to provide a report to HM Treasury on the conduct of an auction as soon as reasonably practicable after the auction has taken place. HM Treasury and the Independent Observer take the view that his role is essentially to monitor the conduct of the auctions to provide assurance that the published procedures have been followed and that all Primary Participants have been treated fairly and equally in accordance with the Regulations and the Scheme.

Primary Participants are parties who are approved to bid both on their own account and on behalf of other parties (who are known as Indirect Bidders). Primary Participants must have an office in an EEA state, have the ability to meet their financial commitments, the ability to participate effectively in an auction on behalf of others and systems to prevent the disclosure of confidential information.

Before the Auction

Before the auction the Independent Observer reviewed the Community Emissions Trading Scheme (Allocation of Allowances for Payment) Regulations 2008 and the Community Emissions Trading Scheme (Allocation of Allowances for Payment) Scheme 2008 and discussed the proposed procedures with officials from HM Treasury, the UK Debt Management Office ('DMO') and Department of Energy and Climate Change ('DECC'). The Independent Observer noted that HM Treasury has appointed DECC to conduct auctions of EU ETS allowances and the Secretary of State for DECC is now responsible for the conduct of auctions. It was also noted that DECC has engaged the DMO to act as its agent for administrative purposes. The Independent Observer noted that many of the auction procedures are based on DMO's procedures for gilt auctions using Bloomberg's Auction System which have a long history and are widely accepted by all the market participants. He is satisfied that the adopted procedures are appropriate for the EU ETS auctions.

The Independent Observer also reviewed the information published for Primary Participants and for Indirect Bidders. The Independent Observer noted that Bloomberg, on behalf of the DMO, had provided training for the Primary Participants' dealing and sales teams at their offices.

Four Primary Participants had been approved before the auction by DECC on advice from the DMO and their contact details were published on the DMO website. All 4 took part in the auction. The Independent Observer was informed that one other Primary Participant application was rejected because the requirements for separation of own-account dealing and indirect bidder dealing were not met.

The Independent Observer was present at and observed one of the simulated auctions at the DMO's offices on 11 November. During the mock auction the approved Primary Participants also simulated their role. The mock auction ran smoothly with no indication of hardware or software problems.

During the Auction

The Independent Observer was present at and observed the auction at the DMO's offices on 19 November 2008 from 8am to 10am.

There were 55 winning bids for 4million EUA's (EU carbon allowances) at or above a clearing price of €16.15. The total number allowances for which bids were received was 16,586,000 so the bid cover ratio was 4.15. Each allowance covers the emission of one tonne of carbon. The clearing price is the lowest bid price, above a Reserve Price set by HM Treasury, at which all allowances for sale would be allocated. The Reserve Price is not disclosed.

The scaling ratio applied to bids at the clearing price (where there are not enough allowances being auctioned to meet all the bids made at the clearing price) was 17.5%.

The total proceeds from the auction were €64,597,981 (£54.4 million @ €1= £0.8428) before VAT.

The ECX ICE futures market is currently the most liquid secondary market in carbon trading. The prices of secondary trades (DEC-08 contract) on this market at the time of the auction are shown below together with the futures prices adjusted to spot prices by discounting using the nearest Euribor interest rate.

	Dec 08 Futures	Adjusted to spot price
Before the start of the auction (08:00am)	€16.70	€16.66
Approximate weighted average of trades during auction bidding window	€16.60	€16.56
After the end of the auction (10:00am)	€16.68	€16.64
Auction clearing price as a discount to weighted average of trades during auction		2.5%

A small discount to the secondary market is to be expected. A discount of 2.5% to average secondary prices would appear quite acceptable.

No telephone bids were received, although the facility to make bids by telephone was available to bidders. The DMO provided some minor practical assistance to two bidders in respect of the arrangements for submitting bids.

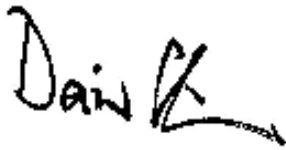
Conclusions

Based on his observation of the conduct of the auction, it is the Independent Observer's view that:

- The auction was conducted in a fair and transparent manner in accordance with the published procedures
- The auction results were consistent with the published procedures and the bids received;
- Sensitive information was treated appropriately by the auction administrator.

- There were no indications of hardware or software problems, communications issues, security breaches, or other problems with the auction platform;
- All the information that he requested had been provided to him.

In summary, the Independent Observer confirms that the results of his monitoring of the first EU ETS auction raise no material concerns about the conduct of the auction in terms of either the process or its results.



David Steeds

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The Independent Observer of EU ETS Carbon Emissions Allowances Auctions
19 November 2008