

Emissions Trading Scheme – auctions and how they work

After the third Emissions Trading Scheme auction saw the \$50 price ceiling exceeded, the Government released additional credits into the market. We revisit how the auction process works and what happened at the latest auction on 1 September.

Background

Auctions were introduced as part of the package of reforms to the Emissions Trading Scheme (ETS) that the Government made last year. The reforms – particularly the cap on emissions, which limits the number of units available to offset emissions – were designed to make the ETS a more effective tool for incentivising participants to actually reduce their emissions.

Prior to the cap being introduced, emitters could purchase an unlimited number of units for a fixed price of \$25 per unit. This was an arbitrary figure and was increased to \$35 per unit last year until the first auction in March of this year.

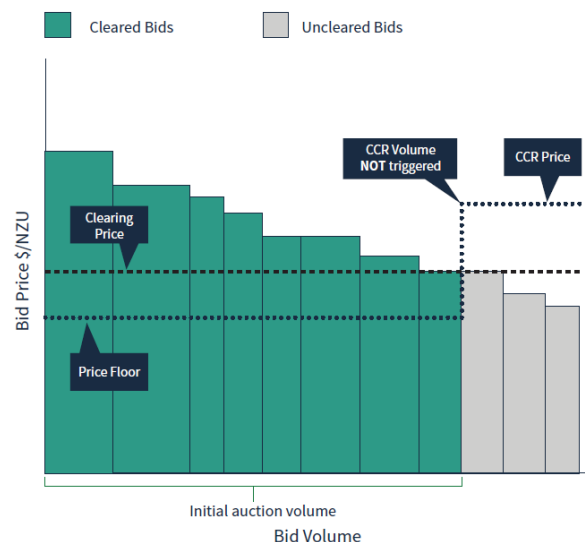
Last year the Government set a provisional emissions budget for 2021 to 2025. For 2021, the budget is 71.8 million tonnes. After removing the emissions from outside the ETS (e.g. agricultural emissions), free allocations to trade exposed firms, and an allocated amount of stockpiled units, this leaves 19 million of units available to be purchased at auctions during 2021.

Auctions – how they work

For the auctions taking place in 2021, they work as follows:

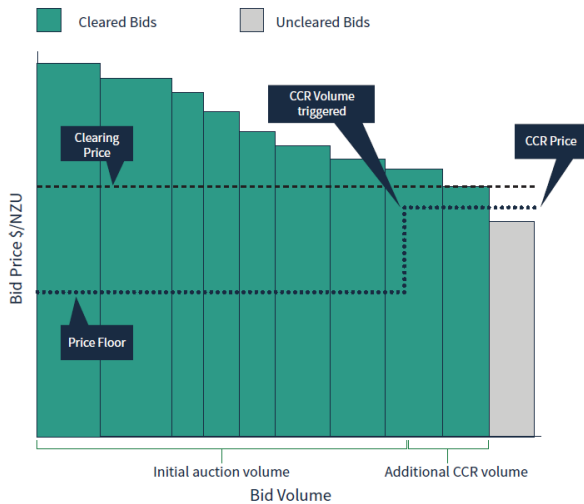
- they take place every 3 months – the schedule is 17 March, 23 June, 1 September, and 1 December.

- each auction will have a fixed amount of 4.75 million units that can be purchased.
- there is a price floor of \$20 per unit – they cannot be sold for less than this amount.
- there is a cost containment reserve trigger price of \$50 – if the bidding reaches \$50 per unit, an additional reserve of up to 7 million units (called the cost containment reserve) can be released, which is designed to meet the extra demand and reduce the price pressure.
- the clearing price is the price at which all of the units are sold. After bids are ordered from highest to lowest price, the clearing price is determined by the point at which the available auction volume is met by the quantity demanded bid volume (see figure below, source Ministry for Environment). If the auction volume exceeds the bid volume, the clearing price is the lowest bid price.



If, however, the cost containment reserve is triggered, then the clearing price is set by the last bid above the trigger price (see figure below, source Ministry for Environment).

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- collateral must be lodged at least 5 business days prior to the auction. Either cash or letters of credit (issued by an organisation with a credit rating of BBB+ or higher) can be lodged as collateral. A participant's maximum bid is 4x their eligible collateral and the minimum collateral required to participate is 500 x the price floor x 25% (being \$2,500 for 2021).
- confidential reserve price – in between the price floor and cost containment reserve price, the bid price must reach the confidential reserve price in order for the units to be sold. Similar to when you sell your house at auction, only the Government (the seller of the units) knows this price, which is intended to prevent any market manipulation. While there may be a number of factors determining the confidential reserve price, we can probably assume that it will be influenced by reference to the prevailing price on the secondary market.

For auctions taking place in 2022 and until the end of 2025, it is currently anticipated that they will work in largely the same way, with the cost containment reserve price currently being scheduled to increase by 2% each year or from \$51 in 2022 to \$54.12 in

2025 (however, this will be changed as per the Climate Change Minister's comments below).

Results of the 1 September 2021 auction

The latest auction saw strong demand from participants which resulted in the cost containment reserve price (**CCR Price**) being triggered, and all of the 7 million units budgeted for 2021 in the cost containment reserve (**CCR**) being sold. Approximately 18.5 million units were bid by 43 participants, with 31 participants successfully acquiring 11.75 million units in total. The clearing price was \$53.85, up from \$46 at the June auction and \$36 at the March auction. So what does this mean?

First, the CCR has been emptied for 2021, meaning that there are no additional units allocated for the December 2021 auction. Units sold from the CCR comprise:

- stockpiled units that are already included in the emissions budgets; and
- additional units not included in the emissions budgets, which therefore have to be "backed" by an equivalent tonne of removals or reductions by the Government to maintain their integrity (for example by purchasing international units or funding activities that reduce emissions domestically).

Therefore, given that the CCR has been emptied, and that we have a fixed emissions budget for 2021 of 71.8 million tonnes, the Government will need to either purchase units from overseas or source extra reductions to account for some of the 7.5 million units sold at the September auction, as well as any additional units it chooses to make available at the December auction.

There is likely to be an even greater amount of pressure on the clearing price at the December auction. The Climate Change Minister James Shaw has publicly stated that the Government cannot raise

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the \$50 CCR Price this year, but will be raising it to \$70 for 2022 and will increase it again each year. This follows the Climate Change Commission's advice to the Government that it should raise the CCR Price to \$70, with an annual increase of 10% plus inflation. The Commission went on to say that the carbon price could reach \$140 per unit by 2030.

With public statements such as these from the Minister and Climate Change Commission, we can understand why there have been comments in the media that the strong demand at the recent auction was driven by speculators (without obligations to surrender units) looking for a financial return based on a predicted rise in the carbon price. Anyone can participate in auctions (provided sufficient collateral is lodged) and there is no requirements to surrender units in any particular year (if at all). They can be held and traded like any other asset, and the spot price on the secondary market is (at the time of writing) around \$60 per unit.

However, the strong demand could also have been driven by mandatory participants in the ETS looking to acquire units at comparatively low prices to meet surrender obligations in future years. If the Climate Change Commission is predicting a price rise to \$140 per unit by 2030, then mandatory participants will want to be acquiring all the units they can get for \$53.85 per unit.

Want to know more?

If you would like further information or want to discuss the Government's proposals, please contact Anderson Lloyds's specialist [Carbon Trading and ETS Team](#).