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**RGGI Inc.**



**REPORT ON THE SECONDARY MARKET  
FOR RGGI CO<sub>2</sub> ALLOWANCES: FIRST QUARTER 2012**

**Prepared for:**

**RGGI, Inc., on behalf of the RGGI Participating States**

**Prepared By:**

**POTOMAC  
ECONOMICS**

July 2012

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The Regional Greenhouse Gas Initiative (RGGI) is a cooperative effort of Northeast and Mid-Atlantic states to reduce emissions of carbon dioxide (CO<sub>2</sub>) from the power sector.

RGGI, Inc. is a non-profit corporation created to provide technical and administrative services to the states participating the Regional Greenhouse Gas Initiative.

## A. INTRODUCTION

The primary market for RGGI CO<sub>2</sub> allowances consists mainly of the auctions where allowances are initially sold. Once a CO<sub>2</sub> allowance is purchased in the primary market, it can then be resold in the secondary market. The secondary market for RGGI CO<sub>2</sub> allowances comprises the trading of physical allowances and financial derivatives, such as futures and options contracts.

The secondary market is important for several reasons. First, it gives firms an ability to obtain CO<sub>2</sub> allowances at any time during the three months between the RGGI auctions. Second, it provides firms a way to protect themselves against the potential volatility of future auction clearing prices. Third, it provides price signals that assist firms in making investment decisions in markets affected by the cost of RGGI compliance.

This report provides a summary of activity in the secondary market in the first quarter of 2012 and discusses the results of our market power screens. Several patterns have emerged in this period in the secondary market:

- *CO<sub>2</sub> Allowance Transfers* – Nearly 20 million CO<sub>2</sub> allowances were transferred between unaffiliated firms in the COATS registry. Ninety-eight percent of these transactions were for first control period allowances and occurred before the March 1<sup>st</sup> compliance deadline for the first control period.
- *CO<sub>2</sub> Allowance Prices (First Control Period)* – First control period CO<sub>2</sub> allowance prices ranged from \$1.92 to \$3.75 in COATS transactions (i.e., allowance transfers between unaffiliated firms that were recorded in the COATS registry). This range was much larger than in recent quarters as some compliance entities paid a premium to acquire allowances shortly before the March 1<sup>st</sup> compliance deadline. Although the range of COATS transaction prices was broad, 96 percent of the volume traded between \$1.85 and \$2.10, and the volume-weighted average price was \$2.00.
- *CO<sub>2</sub> Allowance Prices (Second Control Period)* – Second control period CO<sub>2</sub> allowances traded at a discount to first control period allowances, averaging \$1.93 in COATS transactions. This was consistent with the March 14<sup>th</sup> auction in which second control period CO<sub>2</sub> allowances were sold for \$1.93.
- *CO<sub>2</sub> Allowance Holdings* – The share of CO<sub>2</sub> allowances that were held by compliance entities and their affiliates was 98 percent at the end of the first quarter of 2012. Excluding CO<sub>2</sub> allowances that are needed for first control period compliance, the share

of CO<sub>2</sub> allowances held by compliance entities and their affiliates was 90 percent at the end of the first quarter of 2012.

We evaluate information on the holdings of CO<sub>2</sub> allowances and allowance derivatives as well as the demand for allowances to identify firms that may have acquired a position that raises competitive concerns. We find no evidence of anticompetitive conduct; however, we will continue to evaluate the competitiveness of the market.

## B. BACKGROUND

The secondary market for RGGI CO<sub>2</sub> allowances comprises the trading of physical allowances and financial derivatives, such as futures, forward, and option contracts. A physical allowance trade occurs when the parties to the transaction register the transfer of ownership in RGGI's CO<sub>2</sub> Allowance Tracking System ("COATS"). Financial derivatives include any contracts whereby parties agree to exchange funds and/or allowances at some future date, depending in many cases on factors such as the price of allowances at some future date. Many financial derivatives eventually result in the transfer of physical CO<sub>2</sub> allowances (i.e., the transfer is registered in COATS), but this may occur months or years after the parties enter into a financial transaction. These include the following types of transactions:

- *Futures* – Under these contracts, two parties agree to exchange a fixed number of CO<sub>2</sub> allowances of a certain vintage year at a particular price at a specific point in the future (called the "delivery month"). At the end of the delivery month, the contracted number of CO<sub>2</sub> allowances must be physically transferred to the buyer's account in the COATS registry and funds must be transferred to the seller. The vintage year refers to the compliance year of the CO<sub>2</sub> allowance that is to be transferred. One standard futures contract equals 1,000 RGGI allowances.<sup>1</sup>
- *Forwards* – These are like futures contracts, but a forward contract typically requires that all financial settlement occur at expiration.
- *Call Options* – Call options give the purchaser the option to buy a fixed number of CO<sub>2</sub> allowances of a certain vintage year at a particular strike price at any time prior to the expiration date. For example, suppose a firm holds a call option with a 2009 vintage year, \$5 strike price, and December 2012 expiration date. If the price of the corresponding forward contract rose to \$5.75, the firm could exercise the option to buy CO<sub>2</sub> allowances at \$5 and immediately sell them at \$5.75. Alternatively, if the price of the forward contract stayed below \$5, the firm would let the option expire without

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<sup>1</sup> More precisely, a futures contract requires parties with an open interest to post financial assurance in an account with the exchange until the contract reaches expiration. The exchange continually withdraws and deposits funds according to changes in the prices of the contracts in which the party has interest. For example, if a firm buys a contract for 1,000 allowances at \$3.50/allowance, the purchasing firm (firm with a long position) must put \$3,500 in an account (or whatever share of the entire liability the exchange requires). If the futures price declines to \$3/allowance, the exchange transfers \$500 from the account of a firm with a long position to the account of a firm with a short position (firm that sold a contract), and the firm with a long position is only required to keep \$3,000 in the account. At the end of the delivery month, allowances are exchanged for funds according to the closing price on the last day of the month.

exercising it. One standard options contract can be exercised for 1,000 RGGI allowances.

- *Put Options* – Put options are similar to call options but they give the purchaser the option to *sell* a certain number of CO<sub>2</sub> allowances of a particular vintage year at a specified strike price any time prior to the expiration date.

Futures, forward, and option contracts allow firms to manage risks associated with unforeseen swings in commodity prices. Futures and forwards allow firms to lock-in the prices of future purchases or sales. Options allow firms to limit their exposure to price volatility. Call options protect the purchaser if the price of the commodity increases, while put options protect the purchaser if the price of the commodity decreases. Although options provide less certainty than futures and forwards, they usually require less financial security, making them more attractive to some firms.

The terms of futures, forward, and option contracts vary in the degree to which they are standardized. “Exchange-traded” contracts typically have the most standardized provisions, while the term “over-the-counter” (“OTC”) is applied to contracts with less standardized provisions. However, OTC contracts, once entered into, are often settled through a clearinghouse in order to protect the parties from the risk that the counterparty defaults.

The amount of *open interest* is the net amount of futures, forwards, or options that have been traded for a contract with a particular set of specifications (i.e., vintage year, delivery month, etc.), but have not reached the time of delivery, expired, or been exercised. For example, if Firm A sells 100 contracts of a particular type to Firm B, Firm A will have a short position of 100 contracts, Firm B will have a long position of 100 contracts, and the total open interest for the particular type of contract will be 100 contracts. Hence, the total open interest can be determined by summing across all of the long positions of market participants or by summing across all of the short positions.

### C. SUMMARY OF PRICES

This section of the report summarizes prices in the secondary market for RGGI CO<sub>2</sub> allowances during the first quarter of 2012. Figure 1 shows the transaction prices in the secondary market for CO<sub>2</sub> allowances, including the prices of allowance transfers registered in COATS,<sup>2</sup> of futures trades on the Chicago Climate Futures Exchange (“CCFE”), and of forward trades on the Intercontinental Exchange (“ICE”). The figure also shows volume-weighted average prices in the first quarter of 2012 compared to the previous quarter and to the first quarter of the previous year. This section also discusses the prices of option contracts.

Key observations regarding RGGI CO<sub>2</sub> allowance prices:

- First control period CO<sub>2</sub> allowance prices ranged from \$1.92 to \$3.75 in COATS transactions (i.e., allowance transfers between unaffiliated firms that were recorded in COATS). This range was much larger than in recent quarters as some compliance entities still needed to acquire allowances shortly before the deadline for the first control period on March 1, 2012. Although the range of COATS transaction prices was broad, 96 percent of the volume traded between \$1.85 and \$2.10, and the volume-weighted average price was \$2.00.
- Second control period CO<sub>2</sub> allowances traded at a discount to first control period allowances, averaging \$1.93 in COATS transactions.
- The prices of first and second control period CO<sub>2</sub> allowances in COATS transactions each rose five percent from the fourth quarter of 2011.
- The clearing price in the March auction for second control period CO<sub>2</sub> allowances was consistent with the prices of COATS transactions for second control period allowances.
- The prices of CCFE futures trades and ICE forward trades were consistent with contemporaneous COATS transaction prices during the quarter. The CCFE delisted RGGI futures and options on February 14 in accordance with its intention to wind-down its operations.<sup>3</sup>

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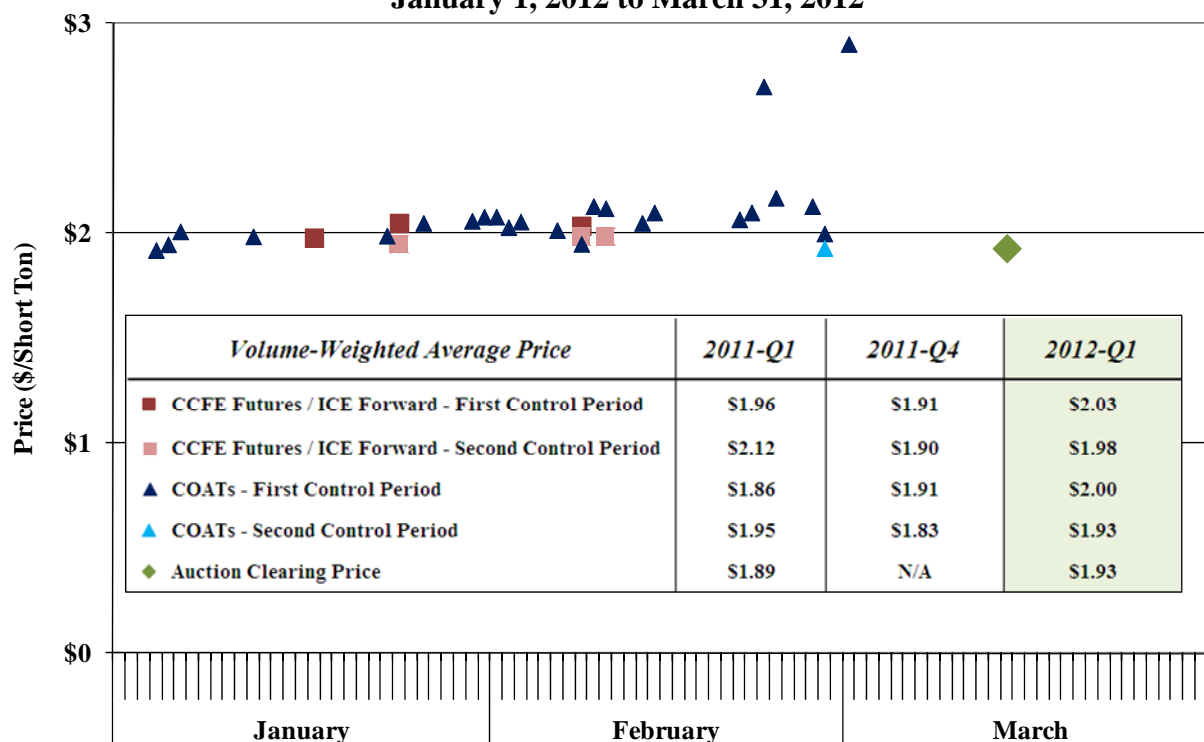
<sup>2</sup> Parties are required to report the transaction price if there is an underlying financial transaction related to the transfer of allowances between accounts.

<sup>3</sup> See press release at “[http://www.ccfе.com/membership\\_ccfe/advisories/2012/021312CFTC.pdf](http://www.ccfе.com/membership_ccfe/advisories/2012/021312CFTC.pdf).”

*Prices of CO<sub>2</sub> Allowances and Allowance Derivatives*

Figure 1 summarizes prices in the secondary market during the period. The red squares show the closing prices of the CCFE futures and ICE forwards on days with trading volume for the first and second control period. Prices are shown for the prompt month contract. The blue triangles show the volume-weighted average prices of physical deliveries registered in COATS for first and second control period CO<sub>2</sub> allowances on days with transactions when the price was recorded. The green diamond shows the clearing price of the second control period CO<sub>2</sub> allowances that were sold in the RGGI auction held on March 14. Figure 1 also shows volume-weighted average prices for each category in the first quarter of 2012 compared to the previous quarter and the first quarter of the previous year.

**Figure 1: Prices in the Secondary Market for RGGI CO<sub>2</sub> Allowances<sup>4</sup>  
January 1, 2012 to March 31, 2012**



<sup>4</sup> Sources: Auction clearing prices are available at [www.rggi.org/market/co2\\_auctions/results](http://www.rggi.org/market/co2_auctions/results), CCFE futures contract prices are available at [www.ccfе.com](http://www.ccfе.com), ICE forward prices are based on information from ICE, and the prices of physical deliveries in COATS are based on information in COATS.



Key observations regarding CO<sub>2</sub> allowance prices:

- First control period CO<sub>2</sub> allowance prices ranged from \$1.92 to \$3.75 in COATS transactions. This range was much larger than in recent quarters as some compliance entities still needed to acquire allowances shortly before the deadline for the first control period on March 1, 2012. Although the range of COATS transaction prices was broad, 96 percent of the volume traded between \$1.85 and \$2.10, and the volume-weighted average price was \$2.00.
- The prices of first control period CCFE futures and ICE forwards ranged from a low of \$1.98 to a high of \$2.05 and averaged \$2.03, which is an increase of six percent over the prior quarter and four percent over the first quarter of 2011.
- Second control period CO<sub>2</sub> allowances traded at a discount to first control period allowances, averaging \$1.93 in COATS transactions.
- The prices of second control period CCFE futures and ICE forwards ranged from a low of \$1.95 to a high of \$1.99 and averaged \$1.98, which is an increase of four percent over the prior quarter and a decrease of seven percent from the first quarter of 2011.
- The prices of first and second control period CO<sub>2</sub> allowances in COATS transactions each rose five percent from the fourth quarter of 2011.
- The clearing price in the March auction for second control period CO<sub>2</sub> allowances was consistent with the prices of COATS transactions for second control period allowances.
- The prices of CCFE futures trades and ICE forward trades were consistent with contemporaneous COATS transaction prices during the quarter.

### *Prices of Options for CO<sub>2</sub> Allowances*

The clearing prices of option contracts provide insight about how the market expects the price of the underlying commodity to behave. The price of an option depends on two factors: (i) the expected value of the underlying commodity relative to the strike price of the option, and (ii) the expected volatility of the underlying commodity over the period before the expiration date. When call option price decreases coincide with put option price increases, it signals a decrease in the expected price of the underlying commodity. Conversely, when call option prices and put option prices move in the same direction, it signals a change in the expected volatility of the underlying commodity price.

Key observations regarding prices of options for CO<sub>2</sub> allowances in the first quarter of 2012:

- There was just one small option trade during the quarter. The low volume of options trading may reflect that firms perceive little risk from variations in future CO<sub>2</sub> allowance prices. Since the auction reserve price of \$1.93 is indexed to inflation, compliance entities are unlikely to be able to obtain CO<sub>2</sub> allowances at a lower price in the future. Prices in the futures market have remained very close to the auction reserve price, suggesting that firms perceive little risk that CO<sub>2</sub> allowances will fall below this level.

## D. VOLUMES AND OPEN INTEREST

This section evaluates the volume of trading and the open interest in exchange-traded futures, forwards, and options and the volume of COATS transactions (i.e., transfers of CO<sub>2</sub> allowances between unaffiliated parties as recorded in COATS). Figure 2 examines the volume of COATS transactions recorded in COATS.

Key observations regarding trading volumes and open interest:

- Trading of futures, forwards, and options has declined from prior quarters. The total volume of futures and forward trading was 1.6 million CO<sub>2</sub> allowances in the first quarter of 2012. The open interest in RGGI forwards listed on ICE at the end of the quarter was for less than one million allowances.
- In the first quarter of 2012, 19.8 million CO<sub>2</sub> allowances were transferred between unaffiliated firms in COATS. Almost all of these COATS transactions were for first control period allowances and occurred before the March 1 compliance deadline.
- The volume of CO<sub>2</sub> allowance transfers increased from 4.2 million in the fourth quarter and decreased from 23.1 million in the first quarter of 2011.
- The share of CO<sub>2</sub> allowances that were held by compliance entities and their affiliates was 98 percent at the end of the first quarter of 2012.
- Excluding CO<sub>2</sub> allowances that are needed for first control period compliance, the share of CO<sub>2</sub> allowances held by compliance entities and their affiliates was 90 percent at the end of the first quarter of 2012.

### *Volume and Open Interest in Futures, Forwards, and Options*

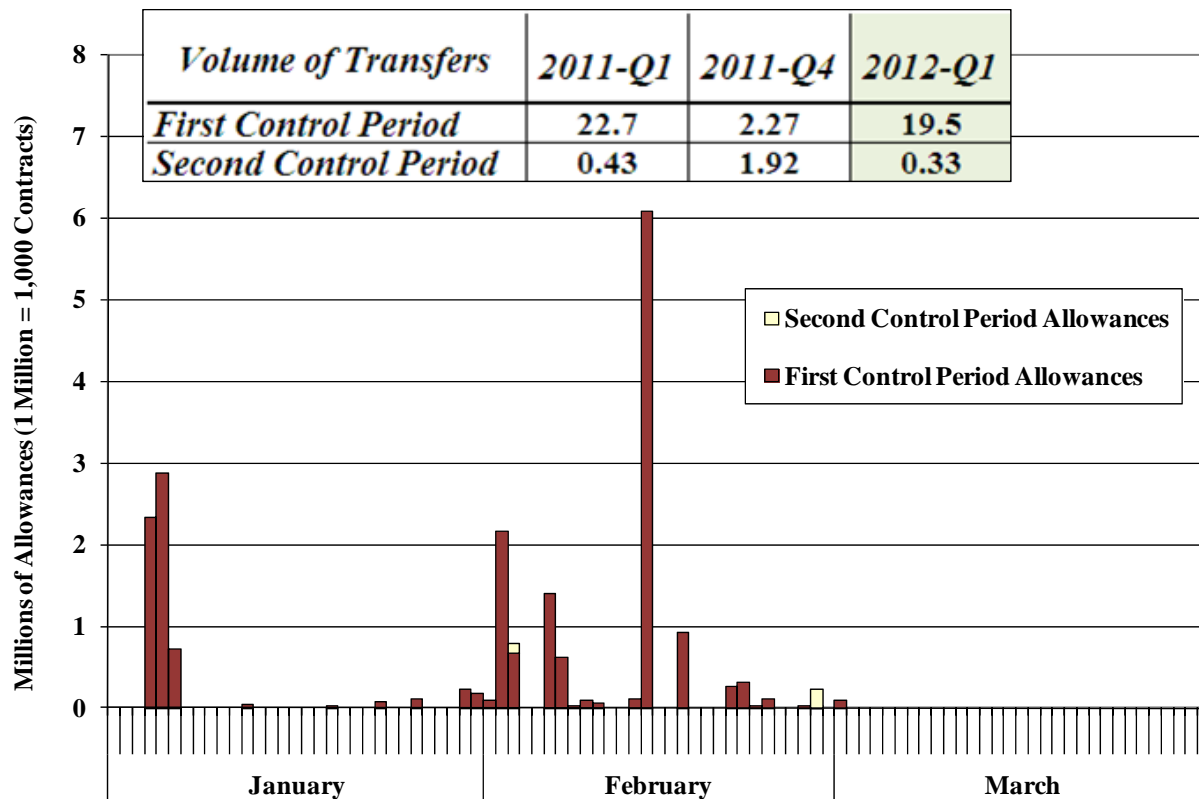
Key observations regarding the volume of trading of futures, forward, and options contracts:

- The volume of futures trading on the CCFE was just 0.92 million CO<sub>2</sub> allowances in the first quarter of 2012. The remaining open interest in RGGI futures and options was closed out and the contracts were delisted by the CCFE on February 14.
- The volume of forward trading on ICE was 0.68 million from two trades during the period, both matching up with trades on the CCFE. No trades of RGGI forwards or options were reported on ICE after February 10.
- The open interest in RGGI forward contracts listed on ICE at the end of the first quarter of 2012 was for less than one million allowances.

*CO<sub>2</sub> Allowance Transfers Registered in COATS*

Figure 2 summarizes transfers of CO<sub>2</sub> allowances between the COATS accounts of unaffiliated firms during the first quarter of 2012. The red bars in the figure represent first control period CO<sub>2</sub> allowances, while the yellow bars represent second control period CO<sub>2</sub> allowances. The figure also shows the volume of transfers in the first quarter of 2012 compared to the prior quarter and to the first quarter of the previous year.

**Figure 2: Volume of CO<sub>2</sub> Allowance Transfers<sup>5</sup>  
January 1, 2012 to March 31, 2012**



Key observations regarding the transfer of CO<sub>2</sub> allowances in COATS between unaffiliated firms:

<sup>5</sup> Source: CO<sub>2</sub> allowance transfers are based on information in COATS.

- In the first quarter of 2012, 19.8 million CO<sub>2</sub> allowances were transferred between unaffiliated firms. Approximately six million COATS transactions occurred in the first week of January as a result of the delivery of December 2011 contracts. The rest of the COATS transactions occurred in the weeks leading up to the compliance deadline on March 1.
- The volume of CO<sub>2</sub> allowance transfers between unaffiliated firms increased from 4.2 million in the fourth quarter.
- The volume of CO<sub>2</sub> allowance transfers between unaffiliated firms decreased from 23.1 million in the first quarter of 2011 when a large number of COATS transactions occurred as a result of the delivery of December 2010 contracts.

### *Commitments of Traders Reports*

Additional information about the trading of futures, forwards, and options is available in the weekly Commitments of Traders (“COT”) reports, which are published by the Commodity Futures Trading Commission (“CFTC”).<sup>6</sup> Participation in the market for RGGI CO<sub>2</sub> allowance derivatives remained low as the numbers of firms maintaining significant positions in each vintage listed on the ICE continued to be lower than 20 throughout the first quarter of 2012. The CFTC does not publish information from the COT reports for a particular vintage at times when fewer than 20 firms have reportable positions, so no specific information was published during the quarter.

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<sup>6</sup> Each day, firms with an open interest of 25 contracts or more are required to report their positions to the CFTC. The CFTC categorizes each firm as Commercial if it engages in trading primarily to supply its own need for allowances or Non-Commercial if it trades for another purpose. Hence, compliance entities are generally designated as Commercial and non-compliance entities are frequently designated as Non-Commercial. Each Tuesday, the CFTC publishes the COT report, which is a summary of the long and short positions of participants in the market.

## E. DISCUSSION OF MARKET MONITORING

As the RGGI Market Monitor, we monitor trading in the secondary CO<sub>2</sub> allowance market in order to identify anticompetitive conduct. Additionally, the Commodity Futures Trading Commission (“CFTC”) evaluates trading in the secondary CO<sub>2</sub> allowance market consistent with its role as the regulator of derivative markets in the U.S. This section discusses two types of anti-competitive conduct for which we monitor. As in previous reports on the secondary market, we find no evidence of anti-competitive conduct.

In any commodity market, one potential concern is that a firm could hoard a substantial share of the supply of a commodity to influence prices or to prevent a competitor from obtaining CO<sub>2</sub> allowances. Hence, we screen information on the holdings of CO<sub>2</sub> allowances and allowance-derivatives and the demand for allowances to identify firms that might acquire a position that raises competitive concerns. During the first control period, hoarding was not a significant concern for the RGGI CO<sub>2</sub> allowance market because the amount of allowances that were available through the auctions was more than sufficient to satisfy the demand for allowances. During the second control period, which began in January 2012, the ability of an individual firm to hoard will be limited by the market rules, particularly the auction rules that limit the amount of allowances that can be purchased by a single party or group of affiliated parties in a single offering to 25 percent.

Another potential concern is that a firm expecting to purchase CO<sub>2</sub> allowances in the auction might sell a large number of futures contracts in an effort to push the futures price below the competitive level. Such a firm might profit from buying a large number of CO<sub>2</sub> allowances in the auction at a discount if the bidding in the auction were influenced by the depressed futures price. For this to be a profitable strategy, the firm would need to be able to substantially depress the futures price with a relatively small amount of sales—an amount smaller than the amount of CO<sub>2</sub> allowances it planned to buy in the auction. The best protection against this strategy is a market where other firms respond by making additional purchases. Firms that are looking for an opportunity to reduce their short positions or to purchase CO<sub>2</sub> allowances for their future

compliance needs help limit the effectiveness of a strategy to depress prices below the competitive level. Given current price levels relative to the floor price for CO<sub>2</sub> allowances, firms would have a strong incentive to make additional purchases if a firm deliberately attempted to depress the futures price. Nevertheless, the CFTC has access to confidential transaction data, which allows it to monitor for evidence of manipulative conduct.