
REGI Inc.



**REPORT ON THE SECONDARY MARKET
FOR REGI CO₂ ALLOWANCES: THIRD QUARTER 2019**

Prepared for:

REGI, Inc., on behalf of the REGI Participating States

Prepared By:

**POTOMAC
ECONOMICS**

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The Regional Greenhouse Gas Initiative (RGGI) is a cooperative effort of New England and Mid-Atlantic states to reduce emissions of carbon dioxide (CO₂) from the power sector.

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

A. INTRODUCTION AND SUMMARY

The primary market for RGGI CO₂ allowances consists mainly of the auctions where allowances are initially sold. Once a CO₂ allowance is purchased in the primary market, it can then be resold in the secondary market. The secondary market for RGGI CO₂ 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 CO₂ 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 third quarter of 2019 and discusses the results of our market power screens.

- CO₂ Allowance Prices – CO₂ allowance futures prices averaged \$5.32, down from the previous quarter but up from the third quarter of 2018.
 - ✓ Futures prices opened the quarter near \$5.40 and rose slightly in late July before declining to \$5.10 in August. Prices began rising in late August and ultimately closed the quarter near \$5.40.
 - ✓ Auction 45 cleared at \$5.20, consistent with secondary market prices in early September.
- Secondary Market Activity – Allowance transfers in COATS and futures trading volumes increased from the second quarter.
 - ✓ The volume of trading of RGGI futures was 58.9 million CO₂ allowances in the third quarter of 2019, up 22 percent from the previous quarter but down 7 percent from the third quarter of 2018.
 - ✓ The total volume of CO₂ allowance transfers between unaffiliated firms was 9.5 million, up 5 percent from the second quarter.
- CO₂ Allowance Holdings – At the end of the third quarter of 2019:
 - ✓ There were 178 million CO₂ allowances in circulation.
 - ✓ Compliance-oriented entities held approximately 87 million of the allowances in circulation (49 percent).
 - ✓ Approximately 99 million of the allowances in circulation (56 percent) are believed to be held for compliance purposes.

We evaluate information on the holdings of CO₂ allowances and allowance derivatives as well as the demand for allowances to identify firms that may have acquired a position that raises competitive concerns. In the current study period, we find no evidence of anticompetitive conduct.

B. BACKGROUND

The secondary market for RGGI CO₂ 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 CO₂ 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 CO₂ 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 CO₂ 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 CO₂ allowances must be physically transferred to the buyer's account in the COATS registry and funds must be transferred to the seller. Allowances transferred must be usable for compliance in the vintage year of the futures contract. One standard futures contract equals 1,000 RGGI allowances.¹ These contracts are listed by an exchange with simple standardized terms to promote liquidity.
- *Forwards* – These are like futures contracts, but a forward contract typically requires that all financial settlement occur at expiration. These contracts can be made off an exchange between two parties, allowing the parties to agree to less standardized terms.
- *Call Options* – Call options give the purchaser the option to buy a fixed number of CO₂ allowances of a certain vintage year at a particular strike price at the expiration date. For example, suppose a firm holds a call option with \$5 strike price, and December 2019 expiration date. If the price of the corresponding forward contract rose to \$5.75, the firm could exercise the option to buy CO₂ 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

¹ 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.

option expire without exercising it. One standard options contract can be exercised for 1,000 RGGI allowances. Currently, call option contracts listed on ICE are European style, meaning that they cannot be exercised before the expiration date.

- *Put Options* – Put options are similar to call options but they give the purchaser the option to *sell* a certain number of CO₂ allowances of a particular vintage year at a specified strike price any time prior to the expiration date. Currently, put option contracts listed on ICE are European style, meaning that they cannot be exercised before 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 forward contracts, they generally require less financial security since they do not obligate the holder to exercise the contract if its value declines, which could make 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.

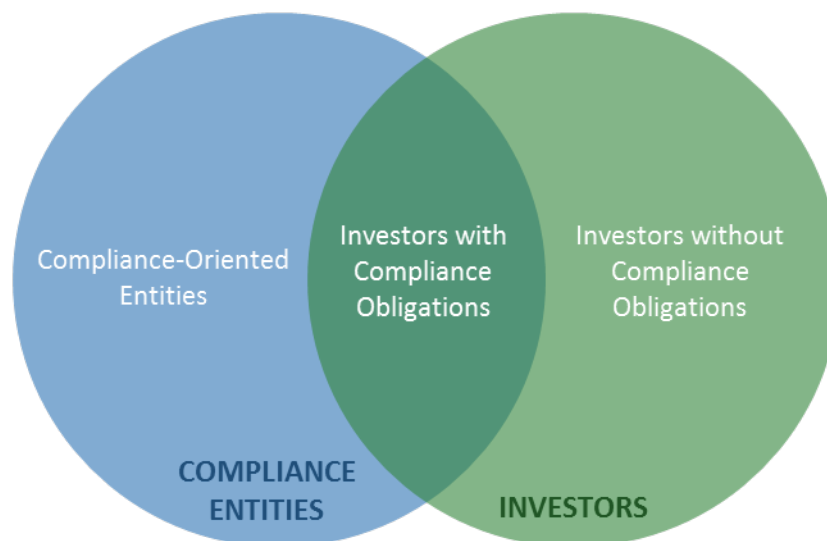
The volatility of a CO₂ allowance refers to the expected standard deviation of the distribution of allowance prices one year in the future. For example, if the expected value of the price one year

in the future is \$1 and the option-implied volatility is 25 percent, this implies that the probability that the price will be within 25 percent of \$1 (i.e., between \$0.75 and \$1.25) is 68.2 percent assuming that the price is distributed log-normally. Option-implied volatility refers to volatility estimates that are derived by analyzing the price and other terms of an option contract compared with the price of CO₂ allowances.

Categories of Firms Participating in the RGGI Market

Participation in the RGGI market involves many different firms with various interests in RGGI allowances. Some participate in order to satisfy compliance obligations, others have investment interests, and still others participate for both purposes. To more effectively track the activity of different participants, we use several classifications for participant firms. Figure 1 summarizes the relationship between these classifications.

Figure 1: Classifications of Participant Firms in the RGGI Marketplace



- *Compliance-oriented entities* are compliance entities that appear to acquire and hold allowances primarily to satisfy their compliance obligations.
- *Investors with Compliance Obligations* are firms that have compliance obligations, but which hold a number of allowances that exceeds their estimated compliance obligations

by a margin suggesting they also buy for re-sale or some other investment purpose.

These firms often transfer significant quantities of allowances to unaffiliated firms.

- *Investors without Compliance Obligations* are firms without any compliance obligations.

These three categories form the basis for two overlapping groups.

- *Compliance Entities* – All firms with compliance obligations,² and their affiliates.³
Combines the first and second of the above categories.
- *Investors* – All firms which are assessed to be purchasing primarily for investment rather than compliance purposes. Combines the second and third of the above categories.

The assessment of whether a compliance entity holds a number of allowances that exceeds its compliance obligations by a margin that suggests they are also buying for re-sale or some other investment purpose is based on: (a) the entity's forecasted share of the total compliance obligations for the entire RGGI footprint through 2026, (b) the total number of allowances in circulation, and (c) consideration of the pattern of the entity's allowance transfers to unaffiliated firms versus affiliated firms. Since the designation of a compliance entity as an investor is based on a review of its transactions and holdings, the designation of a particular firm may change over time as more information becomes available. Therefore, some of the quantities in this report may not match previous reports because of changes in the classification of particular firms.

The number of allowances that are believed to be held for compliance purposes includes 100 percent of the allowances held by compliance-oriented entities and a portion of allowances held

² Before New Jersey announced on June 17, 2019 that it would participate in RGGI beginning in January 2020, firms owning Budget Sources in New Jersey but not in currently Participating States were not treated as compliance entities. However, since the announcement, such firms are treated as compliance entities in our reports.

³ Affiliates are firms that: (i) have a parent-subsidiary relationship with a compliance entity, (ii) are subsidiaries of a parent company that has a large interest in a compliance entity, (iii) have substantial control over the operation of a budget source and/or responsibility for acquiring RGGI allowances to satisfy its compliance obligations.

by other compliance entities (i.e., entities with compliance obligations that are not included in the compliance-oriented category).

C. SUMMARY OF PRICES

This section summarizes prices in the secondary market for RGGI CO₂ allowances in the third quarter of 2019. Figure 2 summarizes transaction prices in the secondary market for CO₂ allowances, including the prices of allowance transfers registered in COATS⁴ and the prices of futures contract trades on the Intercontinental Exchange (“ICE”).

Key observations regarding RGGI CO₂ allowance prices:

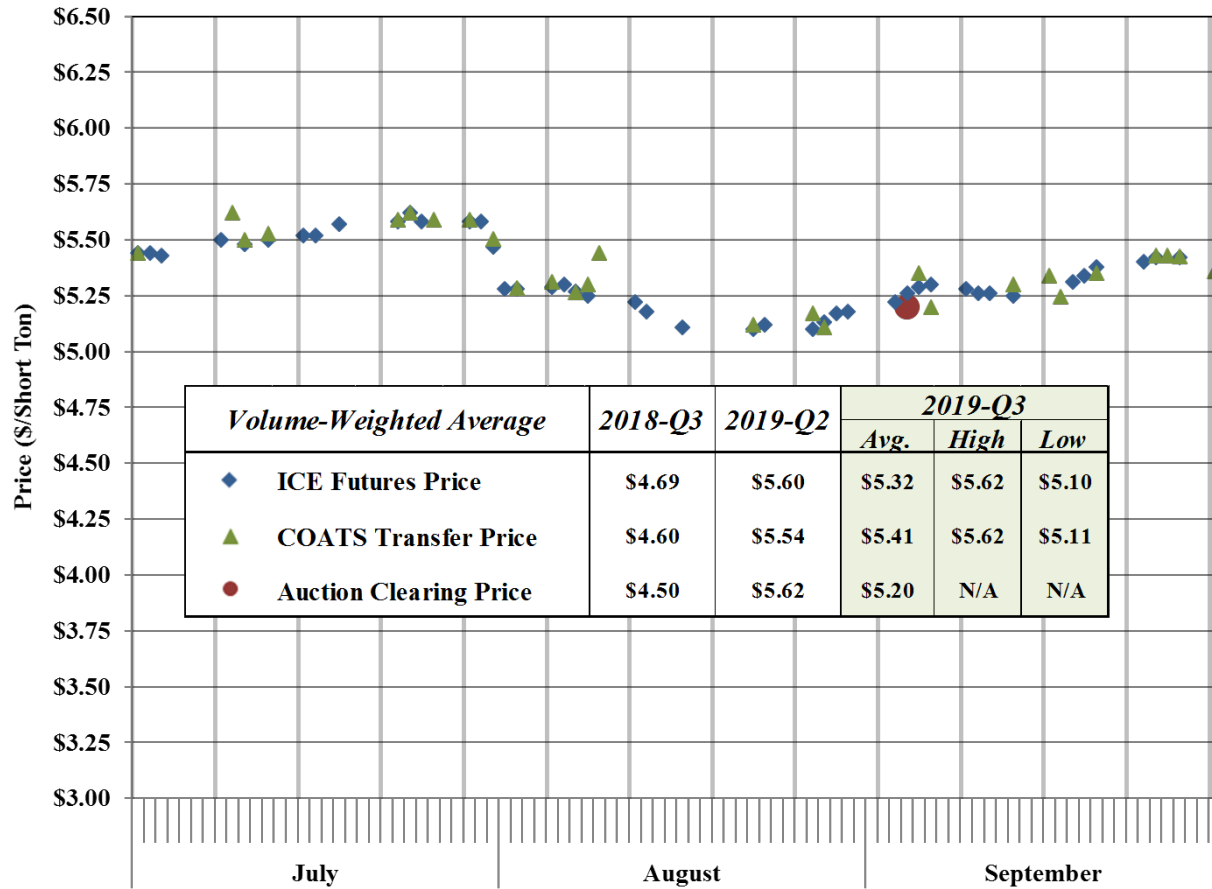
- Futures prices opened the quarter near \$5.40 and rose slightly in late July before declining to \$5.10 in August. Prices recovered somewhat in late August and following Auction 45 in early September, closing the quarter near \$5.40.
- The prices of COATS transfers were generally consistent with futures prices throughout the quarter.
- The clearing price in Auction 45, which was held on September 4, was \$5.20, consistent with futures prices at the time.
- Options trading remained sparse relative to activity before 2017.

Prices of CO₂ Allowances and Allowance Derivatives

Figure 2 summarizes prices in the secondary market during the period. The blue diamonds show the price of ICE futures on days with trading volume. The green triangles show the volume-weighted average prices of physical deliveries registered in COATS on days with transactions when the price was recorded (“COATS transactions”). The red circle shows the clearing price of the CO₂ allowances that were sold in RGGI Auction 45, which was held on September 4. Figure 2 also shows volume-weighted average prices for each category in the third quarter of 2019 compared to the previous quarter and the second quarter of the previous year. Additionally, high and low values are presented for the daily volume-weighted average values. Volume-weighted average prices for the first, second, third, and fourth control period CO₂ allowances are shown together.

⁴ Parties are required to report the transaction price if there is an underlying financial transaction related to the transfer of allowances between accounts.

**Figure 2: Prices in the Secondary Market for RGGI CO₂ Allowances⁵
July 1 to September 30, 2019**



Key observations regarding CO₂ allowance prices:

- Futures contracts opened the quarter near \$5.40 and rose slightly in late July before declining to \$5.10 in August. Prices recovered somewhat in late August and following Auction 45 in early September, closing the quarter near \$5.40.
- COATS prices opened the quarter near \$5.45 and rose to around \$5.60 in mid-July. Prices then declined to nearly \$5.10, where they remained until the end of August when prices began to rise, reaching \$5.40 in late September.

⁵ Sources: Auction clearing prices are available at <https://www.rggi.org/auctions/auction-results>, ICE futures prices are available at www.theice.com, and the prices of physical deliveries are based on information in COATS. Futures prices are shown for the prompt month contract settlement price even if the volume traded was for another contract. Average COATS Transfer Prices for previous quarters have been updated to reflect transactions reported after the compilation of data for previous quarterly reports.

- COATS transfer prices were broadly consistent with futures prices, albeit with a small number of outliers. This reflects that some of the COATS transfers settled at prices that were determined at an earlier date or resulted from a contract with less standard provisions.
- The clearing price in Auction 45 was \$5.20, which was in line with the secondary market price trend leading up to the auction. The auction clearing price decreased \$0.42 from Auction 44 (which was held in June 2019).

Prices of Options for CO₂ Allowances

The clearing prices of option contracts provide insight about how the market expects the price of the underlying commodity to move in the future. 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 the pricing of options for CO₂ allowances in the third quarter of 2019:

- Two option trades were recorded on ICE in the third quarter, up from the previous quarter.
- One trade was a call option with a strike price of \$7.00 for December 2020 settlement, while the other was a put option with a strike price of \$5.00 for December 2019.

Volatility of CO₂ Allowance Prices

Market-based emissions reduction programs such as RGGI are designed to give firms efficient incentives to reduce or offset emissions. In the short-term, high-emitting generators will operate less frequently in favor of low-emitting generators. In the long-term, the market will affect the decisions of firms to develop offset projects, retire older inefficient generation, and perform maintenance that increases fuel efficiency and lowers carbon-intensity. Predictable CO₂ allowance prices decrease the risks associated with making long-term investments in reducing CO₂ emissions. Since CO₂ allowance prices can be volatile, the availability of futures and options contracts allows firms to protect themselves from the risks of such investments.

Expected price volatility is affected by elements of the RGGI program that promote allowance price stability. Potential upward price movements are limited by the Cost Containment Reserve (“CCR”), which allows for the sale of a fixed number of allowances in addition to the cap if the auction clearing price reaches the CCR Trigger Price.⁶ Potential downward price movements are limited by the Reserve Price, which currently prevents allowances from being sold in the auction at a price below \$2.26 (and is indexed to inflation), and the Emissions Containment Reserve (“ECR”), which will withhold allowances from circulation if prices fall below established trigger prices starting in 2021.⁷

One measure of the volatility of CO₂ allowance prices is known as option-implied volatility, which measures the volatility that is implied by the trading of option contracts for CO₂ allowances. If a firm perceives that CO₂ allowance prices are volatile, the firm may be willing to pay a high price for an option contract that protects it from unforeseen allowance price fluctuations. Likewise, if a firm perceives that CO₂ allowance prices are relatively stable, the firm will be willing to pay relatively little for the same option contract.

Very few options trades in total have been recorded over the past two quarters, therefore the options-implied volatility figure has been omitted from this report. For analysis of historical options trading refer to the Secondary Market Reports from previous quarters.

⁶ From 2015 to 2020, the annual withdrawal limit is ten million allowances. The CCR trigger price was \$10.00 in 2017, rose to \$10.51 in 2019, and it will rise 2.5 percent in 2020. After 2020, the size of the CCR and the CCR trigger price will be set in accordance with the 2017 Model Rule. Details are provided at <http://www.rggi.org/program-overview-and-design/elements>.

⁷ Beginning in 2021, the size of the ECR will be equal to 10 percent of the budgets of states implementing the ECR. The ECR trigger price for 2021 will be \$6.00 and will rise 7 percent each year thereafter. Details are provided at <http://www.rggi.org/program-overview-and-design/elements>.

D. VOLUMES AND OPEN INTEREST

This section evaluates the volume of COATS transactions (i.e., transfers of CO₂ allowances between unaffiliated parties as recorded in COATS) as well as the volume of trading and the level of open interest in exchange-traded futures and options. Figure 3 examines the volumes of transactions recorded in COATS and of futures trading. Figure 4 summarizes the level of open interest in exchange-traded RGGI futures and option contracts. Figure 5 evaluates the concentration of firms with open interest in exchange-traded RGGI futures and option contracts.

Key observations regarding trading volumes and open interest in the third quarter of 2019:

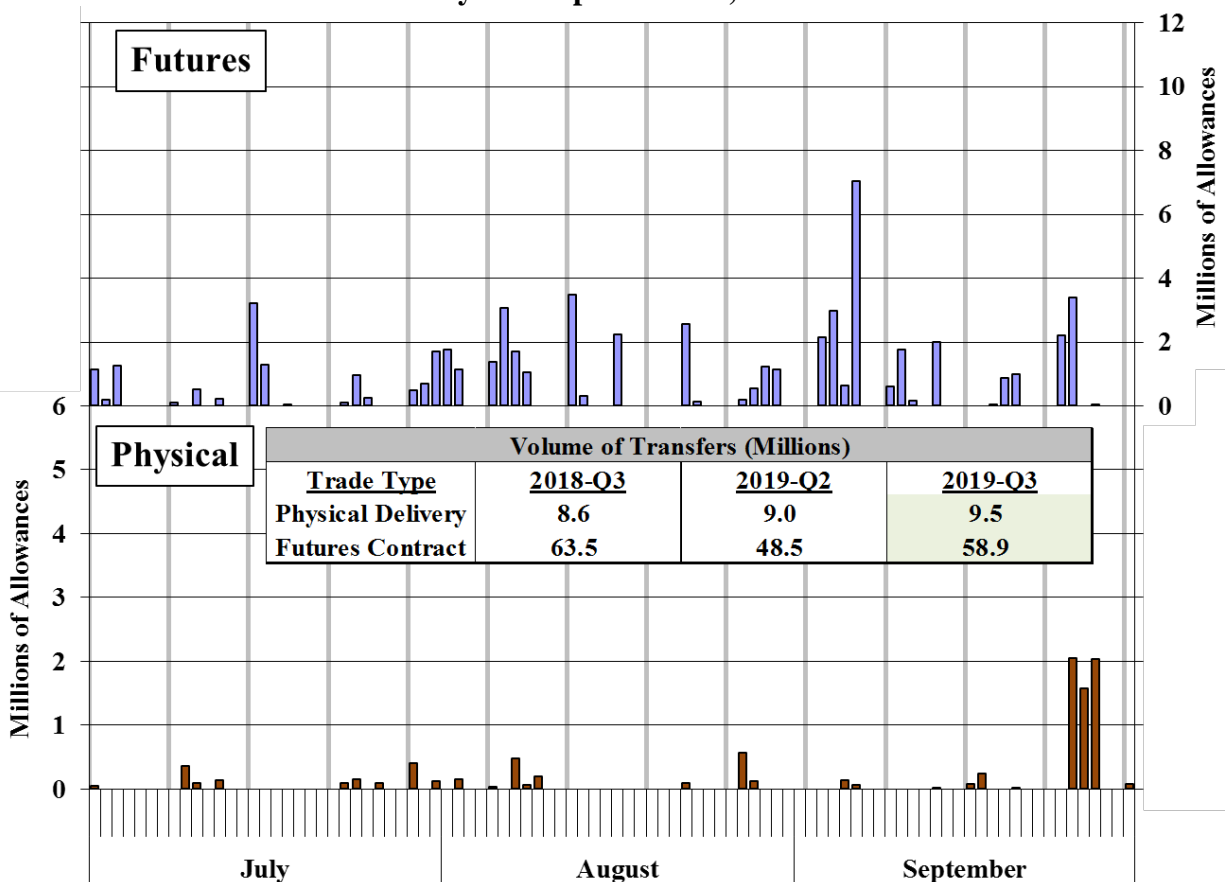
- The volume of trading of RGGI futures was 58.9 million CO₂ allowances in the third quarter of 2019, up 22 percent from the previous quarter but down 7 percent from the third quarter of 2018.
- Physical allowance transfers between unaffiliated firms increased by 5 percent from the second quarter.
- There were 178 million CO₂ allowances in circulation at the end of the quarter.
 - ✓ Compliance-oriented entities held approximately 87 million of the allowances in circulation (49 percent).
 - ✓ Approximately 99 million of the allowances in circulation (56 percent) are believed to be held for compliance purposes.

Volume of CO₂ Allowance Transfers, Futures, and Options

Figure 3 summarizes the volume of transfers of CO₂ allowances between the COATS accounts of unaffiliated firms and the volume of trading of RGGI futures listed on ICE. The figure also shows the volume of transfers in the third quarter of 2019 compared to the previous quarter and to the third quarter of 2018.⁸ The volume of futures trading and transfers of CO₂ allowances for each control period are shown together because all CO₂ allowances are interchangeable for compliance purposes.

⁸ Firms are categorized as affiliated based on available information. As a result, calculations provided in previous reports may be inconsistent with results in this report when new information becomes available.

**Figure 3: Volume of CO₂ Allowance Transfers Between Unaffiliated Parties⁹
July 1 to September 30, 2019**



Key observations regarding physical CO₂ allowance transfers between unaffiliated firms:

- The total volume of CO₂ allowance transfers between unaffiliated firms was 9.5 million, up 5 percent from the second quarter and 10 percent from the third quarter of 2018.¹⁰
- The majority of CO₂ allowance transfers occurred in the last three business days of the month when ICE futures contracts are settled, reflecting that most allowance transfers result from settlement of futures contracts.

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

⁹ Source: CO₂ allowance transfers are based on information in COATS.

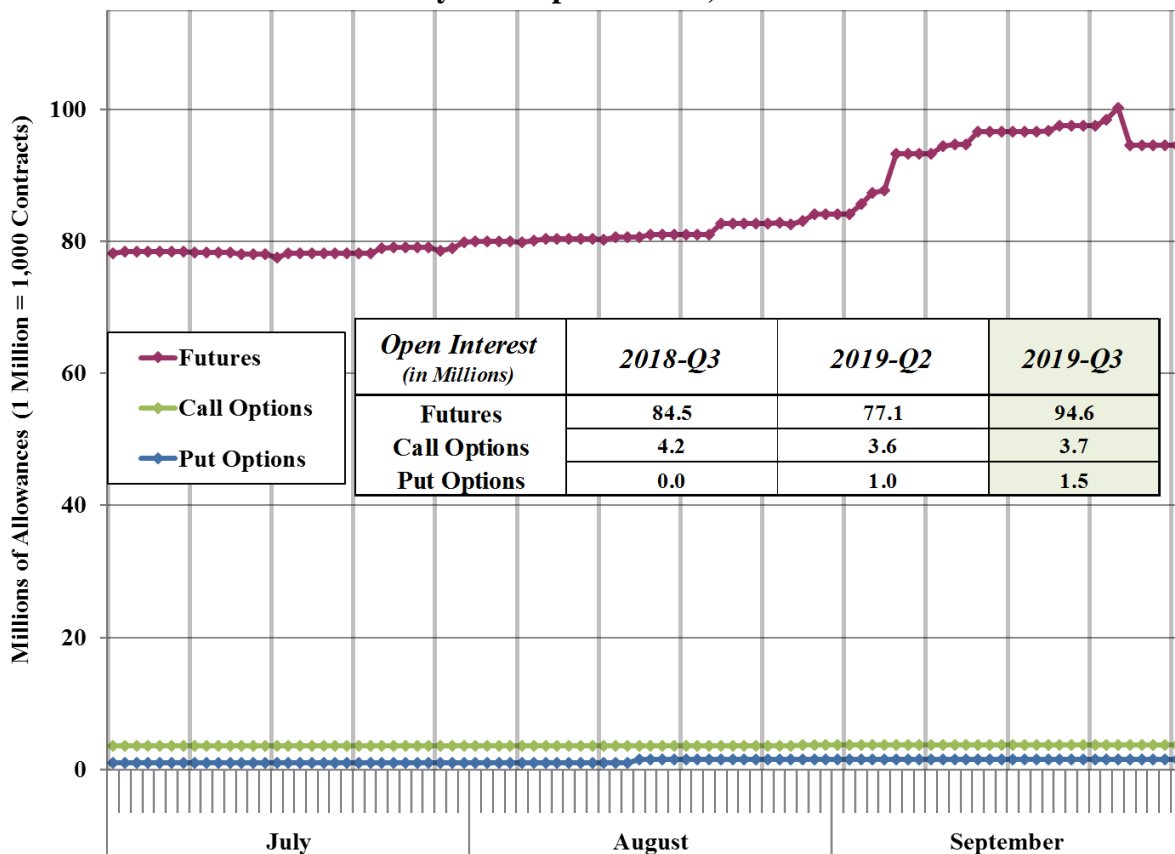
¹⁰ The COATS transfer totals from previous quarters have been revised upwards from previous reports to reflect late-reported transactions.

- The total volume of trading of RGGI futures was 58.9 million CO₂ allowances in the third quarter of 2019, an increase of 22 percent from the previous quarter and a 7 percent decrease from the third quarter of 2018.
- Approximately 11 percent of the trading volume of futures contracts listed on ICE during the third quarter of 2019 was for contracts that settled during the quarter. Additionally, 48 percent of the total volume of trading was for contracts that settle in December 2019.

Open Interest in Exchange-Traded RGGI Futures and Options

Figure 4 summarizes the level of open interest in exchange-traded futures and options listed on the ICE during the third quarter of 2019. The red line shows the level of open interest in futures contracts. The green line shows the level of open interest in call options. The blue line shows the level of open interest in put options.

**Figure 4: Open Interest in RGGI Futures and Options
July 1 to September 30, 2019**



Key observations regarding the level of open interest in RGGI futures and options:

- The total open interest in RGGI futures increased from 77.1 million allowances at the end of the second quarter of 2019 to 94.6 million allowances by the close of the third quarter of 2019.
- The open interest in RGGI call options increased from 3.6 million recorded at the end of the second quarter to 3.7 million by the close of the third quarter.
- The open interest in put options increased from the 1 million recorded at the end of the second quarter of 2019 to 1.5 million at the end of the third quarter of 2019.
- Overall, the level of open interest across RGGI options and futures products increased from the close of the second quarter of 2019 to the close of the third quarter of 2019.

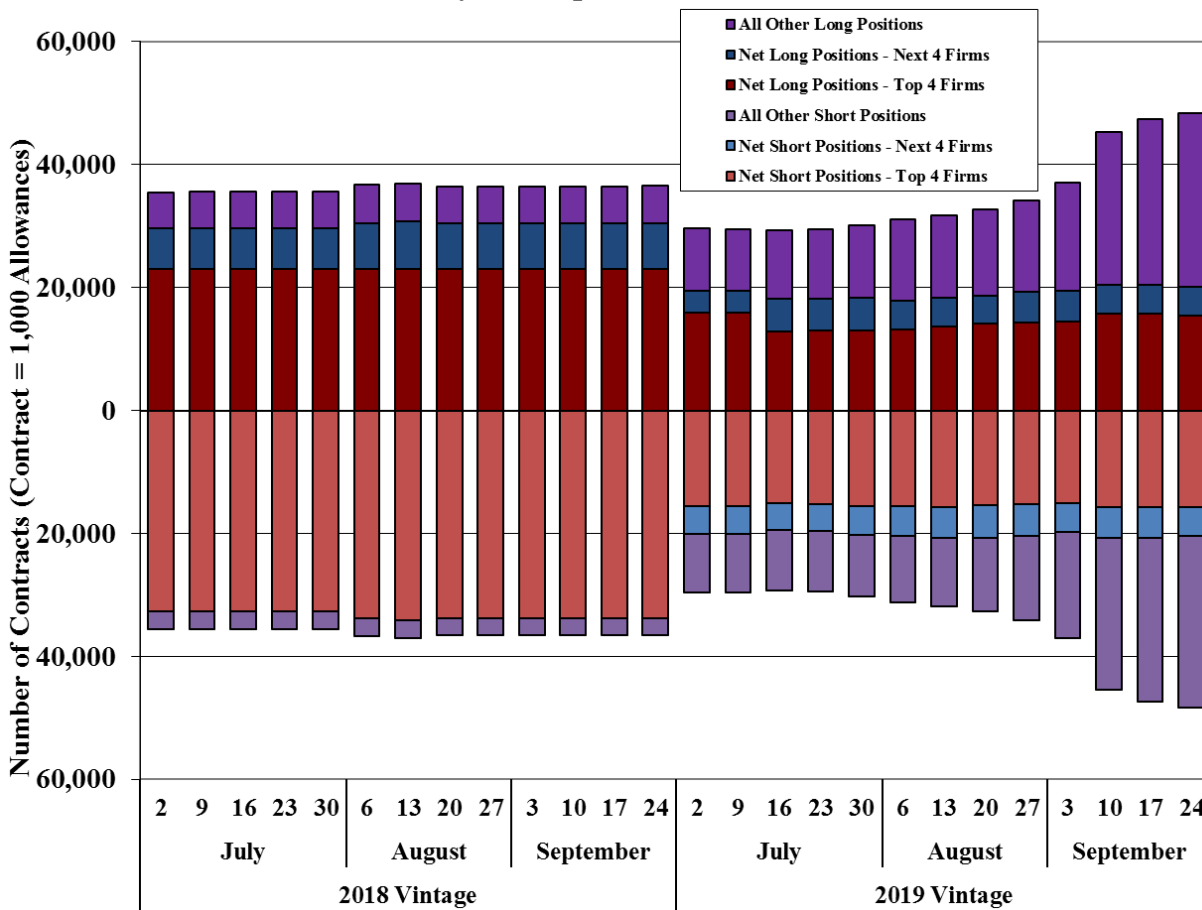
Concentration of Open Interest

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”)¹¹ for each week when greater than 20 firms have reportable positions in a particular product.

Figure 5 summarizes the concentration of open interest in 2018 and 2019 vintage ICE futures and options contracts. The figure reports the net long positions in three categories: (i) the four firms with the largest long positions, (ii) the four firms with the largest long positions not including the Top 4, and (iii) all other long positions. The figure also reports the net short positions in three categories: (i) the four firms with the largest short positions, (ii) the four firms with the largest short positions not including the Top 4, and (iii) all other short positions.

¹¹ 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 other entities are frequently designated as Non-Commercial. Each Tuesday, the CFTC issues the COT report, which is a summary of the long and short positions of participants in the market.

**Figure 5: Concentration of Open Interest in ICE Futures and Options
July 1 to September 30, 2019**



Key observations regarding the concentration of open interest:

- Although many firms have open interest in RGGI CO₂ allowance futures and options, a small number of firms account for large shares of the net long and short positions in 2018 and 2019 Vintage contracts.
- Open interest in Vintage 2019 contracts was steady during July, but then it began to increase in August. Additionally, open interest increased significantly immediately after the September auction.
 - ✓ The “Top Four” Firms’ concentration decreased from 53 percent to 32 percent for net short positions, and decreased from 54 percent to 32 percent for net long positions for the 2019 Vintage contracts over the course of the quarter.
 - ✓ On a weekly basis, the “Top Four” Firms accounted for an average of 42 percent (not weighted by volume) of the total net long positions in 2019 Vintage contracts during the quarter, while 56 percent of the total net long positions were held by eight firms.

- ✓ On a weekly basis, the “Top Four” Firms accounted for an average of 46 percent (not weighted by volume) of the total net short positions in Vintage 2019 contracts during the quarter, while 60 percent of the total net short positions were held by eight firms.
- ✓ The total open interest in 2018 Vintage contracts increased slightly in the quarter.
- ✓ Concentration of both long and short positions for the “Top Four” firms holding 2018 Vintage contracts averaged 64 percent and 92 percent, respectively.
- The CFTC does not publish firm-level information on open interest, although the information they publish provides an indication of the upper limits of the net long and net short positions of individual firms. Combined with firm-specific information about CO₂ allowance holdings from COATS, the information on open interest that is published by the CFTC is useful for evaluating the potential for a firm to hoard RGGI CO₂ allowances, which is discussed further in Section E.

E. DISCUSSION OF MARKET MONITORING

As the RGGI Market Monitor, we monitor trading in the secondary CO₂ allowance market in order to identify anticompetitive conduct. Additionally, the Commodity Futures Trading Commission (“CFTC”) evaluates trading in the secondary CO₂ 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 CO₂ allowances. Hence, we screen information on the holdings of CO₂ allowances and allowance-derivatives and the demand for allowances to identify firms that might acquire a position that raises competitive concerns. The ability of an individual firm to hoard is limited by the substantial private bank of CO₂ allowances that has been accumulated and also 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 CO₂ allowances in the auction might sell a large number of futures contracts in an effort to push the price of the contracts below the competitive level. Such a firm might profit from buying a large number of CO₂ 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 CO₂ 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 CO₂ allowances for their future compliance needs help limit the effectiveness of a strategy to depress prices below the competitive level. Nevertheless, the CFTC has access to confidential transaction data, which allows it to monitor for evidence of manipulative conduct.