

IPE CIRCULAR 05/99

23 September 2005

To: All Members

Copy to: The Financial Services Authority
LCH.Clearnet Limited
European Climate Exchange

Dear Member

The IPE ECX Carbon Financial Instruments futures Contract – Guidance on the use of the Exchange for Physicals ('EFPs') facility during December 2005

The Exchange issued specific guidance on the registration of EFP and EFS transactions in relation to the IPE ECX Carbon Financial Instruments futures Contract in Circular 05/87 dated 27 July 2005. In response to queries from Members, the purpose of the attached document is to explain how the EFP facility might be used during December 2005 prior to the expiry of the December 2005 contract month and may be of interest to some Members and their clients.

Any questions concerning the use of the EFP facility in relation to the IPE ECX Carbon Financial Instruments futures Contract should be directed to Mark Woodward (+44 (0)20 7265 5729 or mark.woodward@theipe.com) or Jason Labrooy (+44 (0)20 7365 5737 or jason.labrooy@theipe.com).

Yours sincerely

Patrick Davis
Company Secretary

It is suggested that this Circular is passed to the member of your staff in charge of:

Compliance	✓	Deliveries	✓
Back Office	✓	Technology	✓
IPE ETS	✓	Finance	✓

Thank you for your co-operation.

Guidance on the use of the Exchange for Physical (EFP) facility during December 2005

The Exchange offers an EFP facility for participants in the emissions markets to use the IPE ECX Carbon Financial Instruments futures Contract (ECX CFI futures) to mitigate their OTC risk exposures by registering their positions with the Exchange for clearing by LCH.Clearnet Ltd (LCH). The expiry of a large number of forward trades on or around 01 December 2005 (irrespective of whether they are based on EFET, IETA or ISDA documentation) and prior to the expiry of the ECX CFI futures contract on 19 December 2005 ("the December '05 expiry window") could cause issues for a number of market participants who are dependent on the receipt of allowances from one counterparty in order to fulfil their obligations to another counterparty.

The purpose of this document is to explain how participants may be able to use the EFP mechanism in order to help to manage their counterparty risk exposures, alleviate some of the possible difficulties around the December '05 expiry window, and benefit from the security provided by the Exchange's delivery mechanism and LCH's financial guarantee.

What are EFPs?

EFPs work on the basis that the counterparties agree that they wish to complement or transfer a natural physical or OTC position with an on-exchange futures position. If the counterparties are Exchange Members, they can advise the Exchange directly, or if not, they will ask their Clearing Member or brokers to arrange for the registration of the transactions with the Exchange on their behalf.

What are the benefits of using the EFP facility during the December '05 expiry window?

Using the EFP facility could allow you to:

- net exposures from a number of OTC counterparties in one position with LCH;
- consolidate OTC and exchange-traded positions in one place;
- close-out open positions by taking the equal and opposite position in ECX CFI futures;
- maintain positions by rolling-forward a futures position into the March 2006 or December 2006 contract months; and
- utilise the Exchange's delivery mechanism for ECX CFI futures to simplify the delivery process and reduce the pressure on your Back Office.

Step-by-step approach to EFPs

If you wish to utilise the EFP facility you will need to go through the following steps:

Step 1 – Agree to EFP the contract and close-out your OTC position. Contact your counterparty and agree to register the position as an EFP;

Step 2 – Register the EFP with the Exchange. If you are a General Participant of the Exchange, complete the IPE ECX CFI Futures Contract EFP/EFS/Block trade Entry Form and fax it to the Exchange. If you are not an Exchange Member, you will need to ask your Clearing Member or broker to complete and arrange for the return of the form on your behalf. Your Counterparty will need to do the same.

Step 3 – Determine your trading strategy for your ECX CFI futures position. Determine whether to close-out the futures position (by taking an equal and opposite ECX CFI futures position) or take the position to expiry. In the latter case, you will need to ensure that you have put in place the relevant arrangements to take or make delivery under the Exchange Contract Rules.

Fees

The Exchange transaction fee is **€2.00 per lot for Members' proprietary business and €2.50 per lot for non-proprietary business**. LCH also charges a Clearing registration fee of **€1.00 per lot**.

Example – Using an EFP to bring an OTC physical position on-exchange

On 14 January 2005 an oil producer entered into a December 2005 forward contract to sell 200,000 tonnes of CO₂ (i.e. 200,000 emissions allowances) to a utility company.

On 21 November 2005, the counterparties agree that they will bring their OTC position onto the Exchange using the EFP facility and ask their brokers to arrange an EFP such that a position in the ECX CFI futures Contract is created which is equivalent to the OTC position – i.e. the major oil producer will open a 200 lot short position in ECX CFI futures (the lot size is 1,000 emissions allowances) and the utility company will take an equivalent long position. This leg may be registered at the same price as the OTC transaction.

The two parties also agree to reverse out their OTC position.

Positions after the EFP

Oil producer

Short 200,000 tonnes CO₂
Long 200,000 tonnes CO₂ (i.e. reverse OTC contract)
Short 200 lots Dec 05 ECX CFI futures Contract

Utility

Long 200,000 tonnes CO₂
Short 200,000 tonnes CO₂
Long 200 lots Dec 05 ECX CFI futures Contract

Therefore once the EFP is executed, the oil producer will be short 200 lots Dec 05 ECX CFI futures Contract and the utility company long 200 lots Dec 05 ECX CFI futures Contract. The OTC position is closed. If the futures position is held to expiry, the oil producer will need to deliver 200,000 emission allowances to its Clearing Member on 19 December 2005 (the last trading day) with the utility company receiving the allowances four days later from its Clearing Member. Alternatively, if either party, for whatever reason does not wish to take the position to expiry, it can independently close out its position by taking a short (long) position of 200 lots Dec '05 ECX CFI futures.

Key points to note about EFPs

The Exchange Rules contain a number of requirements in relation to EFPs, most notably that:

- all EFPs should be underpinned by an underlying physical transaction – the Exchange may request evidence to support the underlying transaction;
- EFPs may be reported in respect of any contract month during trading hours and up to 30 minutes after the close of trading (including last trading day);
- EFPs must be reported to the designated Exchange official by fax on the prescribed Exchange form;
- details of all EFP registrations (**except for transaction price**) for the current day are recorded by Exchange staff and published on IPE ETS;
- if the price is not at the current market price or is outside those parameters announced by the Exchange from time-to-time, the Exchange must be satisfied that the transaction is a legitimate use of the facility before registration can take place. The Exchange may request evidence to support the underlying transaction;
- EFPs are not included in the settlement price calculation.

Further information

These Rules are set out in Section F.5 of the Exchange Regulations. Further information about the use of EFPs in relation to the ECX CFI futures Contract was provided in IPE Circular 05/87 dated 27 July 2005. Further information about the Exchange's delivery mechanism can be found in the "IPE ECX Carbon Financial futures Contract: User Guide" which is available on the Exchange's website at www.theipe.com/emissions.

For more information about EFPs or the IPE ECX CFI futures Contract, please contact Mark Woodward (+44 (0) 20 7265 5729 mark.woodward@theipe.com) or Jason Labrooy (+44 (0) 20 7265 5737 or jason.labrooy@theipe.com) at the IPE or Phil Brown (+44 (0) 20 7382 7804 or phil.brown@ecxeurope.com) or Albert de Haan (+31 20 799 7990 or albert.dehaan@ecxeurope.com) at ECX.

