

UK Emissions Trading Scheme: Future Markets Policy

March 2024

Background

The Aldersgate Group is an alliance of major businesses, academic institutions, professional institutes and civil society organisations driving action for a sustainable and competitive economy. Our corporate members believe that ambitions and stable low carbon and environmental policies make clear economic sense for the UK. Our members have operations across the UK economy and include companies such as Associated British Ports, CEMEX, Johnson Matthey, National Grid, Suez, Scottish Power, and Siemens.

We develop independent policy solutions based on research and the expertise and diversity of our members. Through our broad membership, we advocate change that delivers benefits to an every-growing spectrum of the economy. The response to this consultation draws on previous Aldersgate Group responses and input from members.

Supply adjustment mechanism

3) Do you believe that the UK ETS would benefit from the introduction of a supply adjustment mechanism to address demand shift with long-term impact risk? (Yes/No). Please explain the reasons for your response.

No. The Aldersgate Group does not recommend introducing a supply adjustment mechanism. The landscape has evolved with the announcement of the Carbon Border Adjustment Mechanism (CBAM) and the Authority being minded to retain the ARP. The Auction Reserve Price (ARP) and Cost Containment Mechanism (CCM) are mechanisms that support market stability, and focus should be placed on ensuring these mechanisms are effective.

A SAM would add an additional layer of complexity and intervention in the UK ETS that we do not view as necessary or appropriate to ensure market stability. By providing robust fluctuation controls with the ARP and CCM, the Authority can create a 'floor and ceiling' on the carbon price that allows for price discovery and market-based decarbonisation where it most affordable, while providing confidence against the effects of extreme price fluctuations in either direction.

The Aldersgate Group and its members support greater linkage with the EU ETS. Linkage with the EU ETS can support liquidity, reduce the burden of participating in multiple carbon markets, and ease the liquidity challenges the UK faces due to the relatively small size of its carbon market. It remains important to consider how changes to the UK ETS may affect future linkage and interoperability with the EU ETS, ensuring that linkage remains a viable and straightforward option.

4) If so, do you have a preference for a) a quantity-triggered supply adjustment mechanism or b) a price-triggered supply adjustment mechanism, as the best means of addressing this risk? Please give your reasons for your preference and response.

If the Authority remains minded to introduce a SAM, we encourage the Authority to ensure that a new SAM remains consistent for future linkage and ensures a trajectory similar in

ambition to the EU's ETS, such as the innovation fund. Adopting a quantity triggered SAM consistent with the EU MSR may help remove a potential future barrier to linkage. However we note that the EU is the only ETS with a quantity triggered SAM and the EU ETS' Market Stability Reserve (MSR) was developed in response to a particular set of circumstances that are unlikely to occur in the UK ETS. The potential challenge of linking of the EU ETS with other international ETSs due to differences between a quantity triggered SAM and the more widely used price triggered SAM has been raised as a concern in the EU.¹²

Auction Reserve Price

23) Do you agree with the Authority's minded to position to retain the ARP? (Yes/No) Please provide any evidence in support of your answer.

Yes. The Aldersgate Group supports the retention of the Auction Reserve Price (ARP). A clear ARP is needed to provide certainty against sudden price drops. Although the price of emissions allowances is well above the level set by the ARP, a carbon price floor is a good way of signalling to investors and participants that the price of emissions allowances will have a minimum level. By providing a robust minimum price, the ARP can also ensure that the UK ETS is less vulnerable to price fluctuations and/or a sudden decrease in the price of allowances.

26) Do you think the ARP trigger level should remain static or should it evolve over time? If you think it should evolve, how do you think the Authority should design this evolution? Please provide a rationale for your answer.

In addition to the ARP's role for market stability, the Authority should look to ensure that the ARP increases over time to provide an effective 'floor' with a clearly defined future escalation. At a minimum, the ARP should increase with inflation or a set percentage plus inflation, or the ARP would effectively decrease in real terms. For example, the California ETS's ARP rises by 5% plus inflation every year.³ Any inflation indexation should take the date of the introduction of the ARP as its base period for inflation indexation, ensuring that the original level is at least maintained in real terms.

The trajectory of the ARP should be clearly set out to enable businesses to plan and invest in decarbonisation. The IMF states that the global carbon price needs to reach \$75 per ton or more by 2030 for decarbonisation in line with our ambitions.⁴ Under a robust ETS, through the 2020s carbon prices should increase at a rate that promotes learning, investment and change; in the 2030s, the price of carbon should be high enough to provide even stronger incentive; and by the 2040s, the incurred cost of carbon emissions should be high enough to initiate the retirement of emitting installations in line with net zero. In this context, an increasing floor will not affect price discovery as the mechanism provides an appropriate minimum price that corrects supply imbalances if they emerge. The Netherlands and Norway have set out the minimum prices that will be reached by 2030, €125/t and €200/t

¹ <https://www.annualreviews.org/doi/pdf/10.1146/annurev-resource-111820-030145>

² <https://www.cen.uni-hamburg.de/research/policy-briefs/bilder-docs/msr-policy-brief-eu-ets.pdf>

³ <https://network.bellona.org/content/uploads/sites/3/2022/10/BENEFITS-OF-A-LONG-TERM-FLOOR-PRICE-FOR-UKETS-2.pdf>

⁴ <https://www.imf.org/en/Blogs/Articles/2021/06/18/blog-a-proposal-to-scale-up-global-carbon-pricing>

respectively, achieved by applying complementary carbon taxes to the EU ETS.⁵⁶ The trajectory of the ARP should be clearly set out to enable businesses to plan and invest in decarbonisation.

Cost Containment Reserve

36) Do you believe that the CCM should retain discretion in its decision-making process? (Yes/No). Please provide any supporting evidence.

The Cost Containment Mechanism (CCM) should be more clearly outlined to provide an effective mitigation mechanism against extreme price spikes. This will provide ETS participants with more confidence on the role of the CCM and what the conditions for government intervention are. In recent months this has been unclear, with the CCM being triggered but no government intervention following. The most important factor of the CCM is a clear outline for which threshold will not just trigger the CCM but trigger intervention. The confidence in the mechanism has been undermined in recent months as it has not always initiated intervention as expected by participants based on its definition.

The Authority should restate the conditions for government intervention (in the form of releasing allowances) so that it is clear when a CCM would be triggered. Greater transparency with regards to the principles or conditions informing the Authority's action (or not) upon the trigger would be beneficial. This would provide ETS participants with more confidence whilst the Authority retains discretion for decision making.

Automation should be carefully considered and only implemented where there is a clear case in favour. The Authority highlights the benefits of retaining discretion, and where automation is introduced this must ensure that intervention only occurs when strictly necessary and remain consistent longer term with a net zero aligned cap.

⁵ <https://www.oecd-ilibrary.org/docserver/6813bf38-en.pdf?expires=1706784335&id=id&accname=guest&checksum=B825E0D09F366F8B2B9EEF4115848331>

⁶ <https://bellona.org/news/carbon-accounting/2021-02-norway-proposes-e200-per-ton-co2-tax-by-2030>