Paul Dawson

UK ETS Authority
1 Victoria Street
London SW1H 0ET

ETG Secretariat
Golden Cross House
8 Duncannon Street
London WC2N 4JF

Tel: 020 7484 5274

Email: john.craven@etg.uk.com
Web Site: www.etg.uk.com

16 June 2022
By email

Could you please reply by email to the ETG Secretariat at john.craven@etg.uk.com

Dear UK ETS Authority,

Response from the UK Emissions Trading Group to the UK ETS Authority consultation on Developing the UK Emissions Trading Scheme[1], 17th June 2022

The Emissions Trading Group's (ETG) members represent a high proportion of the businesses covered by the UK emissions trading system and, until 2020, the EU Emissions Trading System. ETG provides a forum for discussion and resolution of all aspects of emissions trading and uniquely it provides a regular forum for communication to take place between commerce and industry, the UK Government, Devolved Authorities, and regulators.

The sectors and businesses represented in ETG are important elements of the UK energy, manufacturing, energy-intensive industries and supporting services such as verification, participants in traded markets and a wide range of advisory functions. They all have a key role in the transformation towards the objective of a zero-carbon economy and society.

ETG has a broad membership and the views expressed here do not necessarily reflect the views of every individual member.

Our members have raised a number of concerns regarding the proposals set out in the UK ETS consultation which we wish to bring to your attention. These concerns are set out below but in summary;

1. There is an ongoing lack of clarity on progress to link UK ETS with EU ETS and to introduce Paris Agreement Article 6 mechanisms, which could aid liquidity in the small UK ETS market
2. The timing of the cap reduction seems out of step with wider policy development including CCUS cluster sequencing, the size and scope of policy measures such as IETF, and the technical ability of sectors to decarbonise
3. It is disappointing that the current consultation only provides part of the overall picture of UK ETS, and without further information on carbon leakage mitigation and the treatment of free allocation, it is difficult to assess the impact on industry

[1] Developing the UK Emissions Trading Scheme (UK ETS) - GOV.UK (www.gov.uk)

4. The lack of an impact assessment makes it impossible to analyse what the proposals mean for the carbon price trajectory and the potential cost and competitiveness impact on industry and how this compares to proposals in the EU ETS
5. Five objectives are set out for future markets policy - more policy direction is required to ensure these objectives are not undermined.

Linking and Article 6

There is significant concern regarding the apparent lack of progress around linking and the introduction of Paris Agreement Article 6 mechanisms. ETG has previously written to Ministers noting that progress in linking UK ETS to EU ETS is required to increase liquidity and enable the UK to avoid the significant administrative hurdles from the EU CBAM when exporting to the EU, including to Northern Ireland. Although linking and Article 6 are mentioned in the consultation there are no proposals to progress this and divergence of the scheme from that of EU ETS will only make linking more difficult in future. Urgent progress is required so that the carbon price faced by industry in the UK is aligned with that faced by our closest neighbours and competitors as soon as possible.

Having led the successful negotiations at COP26, ETG believe the UK ETS Authority should consider how international credits ("ITMOs") can be recognised in UK ETS under Article 6 of the Paris Agreement as modified at Glasgow. A start point would be to provide a single well publicised contact point within government so it is clear who is leading on this issue. Recognition of ITMOs could allow UK entities to benefit from cheaper abatement costs that exist elsewhere in the world, and bring forward investment in genuine emissions reductions in territories where a carbon price signal does not yet exist. This could help spur progress towards establishing an international carbon market as well as allowing these countries to make progress towards their NDC aspirations. However, ETG would prioritise linking with EU ETS over recognition of ITMOs if their recognition put linkage at risk.

Timing of the Cap Reduction

ETG members are committed to decarbonising in line with the UK ambition for net zero and in 2021 ETG formed a Net Zero Industry working group. Six meetings have been held where different sectors have presented their roadmaps to net zero (see Annex for a brief summary) and the opportunities and barriers associated with the various pathways. The HM Treasury Net Zero Review[2] and BEIS Net Zero Strategy[3] were also presented and discussed. The meetings have shown how all sectors are committed to meeting the UK net zero ambition, and while we agree that the cap needs to align with a net zero trajectory, there are a number of technological and economic barriers that are common across many sectors that must be overcome before deep decarbonisation can be achieved. The timing of the cap reduction is therefore important, as well as its end point.

For some sectors, the majority of plants are in dispersed locations which presents challenges for: increasing grid capacity to switch from fossil fuels to electrification, accessing low carbon hydrogen, and connecting to CO_2 transport and storage networks. Whatever the location of the plants, access to secure and competitively priced supplies of low carbon hydrogen in the quantity required for industrial consumption is not available yet and CO_2 pipelines and non-pipeline transport and storage are also missing. These are considerable and fundamental infrastructure requirements that are outside the control of industry alone to build, with government policy support for these still being finalised. For all plants looking to electrify, electricity prices are

[2] Net Zero Review Final Report - GOV.UK (www.gov.uk)
[3] Net Zero Strategy: Build Back Greener - GOV.UK (www.gov.uk)

prohibitively high and action must be taken to reduce them so they are more aligned with those faced by competitors outside of the UK.

The UK ETS Authority proposal to make a step change reduction in the level of the cap in 2024, and to expect this to be factored into the decarbonisation plans of industry, entirely misses the point that this is unlikely to be possible for the vast majority of sites. Even sites in Track 1 clusters, who may have earlier access to CO_2 networks, are not expected to have capture plants up and running before 2027.

The consultation even acknowledges that such a step change is problematic and proposes to use unallocated allowances from earlier years to smooth the transition. However, this comes with the trade-off that these allowances wouldn't then be available later in the phase to mitigate the cross sectoral correction factor (CSCF) or potentially be drawn from a market stability mechanism in the event that action is required to address high and sustained carbon prices. With such a significant reduction in the overall cap, these allowances may well be required later in the phase to avoid the CSCF and ensure carbon leakage vulnerable sectors receive the level of free allowances they require. ETG strongly advises the UK ETS Authority to reconsider the cap trajectory to ensure it more closely aligns with the ability of sectors to decarbonise.

One of the issues with meeting the trajectory of the cap proposed is that many of the technologies that will enable deep decarbonisation are only now being developed at a commercial scale. The cost and risk associated with such investment means greater support is needed from Government to accelerate their deployment, not just for the initial capex but for ongoing operational support too. The UK Government is on track to receive GBP 6.6 billion in UK ETS allowance auction revenues in 2022 alone[4] but the level of support flowing back to industry for both the development of transformational technologies and also the ongoing operational support is barely a fraction of this. Far more support is required, and urgently. Under the existing EU ETS, Member States are required to spend at least half of their auction revenues to support greenhouse gas emissions reductions, to deploy renewables and carbon capture and storage, and to improve energy efficiency and district heating.

Future of free allocation

Carbon leakage mitigation is another concern of ETG members. The document implies that the number of allowances issued for free will be reduced from 2026 onwards, and the UK ETS Authority plan to consult on the methodology to target free allocation at the most vulnerable sectors before the end of 2023. On 16th May 2022, Lucy Frazer, Financial Secretary to the Treasury announced the "*intention to consult later in the year on a range of carbon leakage mitigation options, including on … measures such as product standards and a carbon border adjustment mechanism (CBAM)*"[5].
ETG understands that this consultation is being run separately to the free allocation review and the consultation expected on free allocation in 2023. ETG is disappointed at this disjointed approach to policy making, which makes it impossible for sectors and businesses to understand the policy landscape that would give them, and their investors, the confidence that the UK is the place to invest in decarbonisation. This is affecting investment decisions now.

BEIS themselves noted in the ETG meeting on 10th May that it's not possible to calculate the impact of the cap reductions on sectors without knowing and understanding the changes to free allocation. If this calculation cannot be done, then how does the UK ETS Authority know that the proposed cap and the level of the industry cap is enough to fully mitigate carbon leakage? The cap reduction and carbon leakage mitigation must be considered together otherwise

[4] UK 2022 published auction timetable envisages 25 auctions each of 3,221,000 UKA. Current UKA price is GBP 82.37 (Fri 19 May 2022 DEC contract) = GBP 6.6bn per annum
[5] Written statements - Written questions, answers and statements - UK Parliament

decarbonisation will be through deindustrialisation and the loss of GVA and jobs from the UK economy.

Another important aspect of carbon leakage mitigation is indirect compensation for energy intensive industries. ETG is concerned that the data used in the recent eligibility assessment for this vital compensation was several years old (2016-2018 data was used) and may not be fit for purpose. Only a fraction of the sectors deemed vulnerable to carbon leakage under UK ETS are being compensated for indirect costs, despite UK energy costs being far higher than those faced by competitors in the EU. Whatever carbon leakage mitigation is in place from 2026 onwards, it must mitigate carbon leakage from both direct and indirect costs.

Impact Assessment

In terms of impact assessment, ETG members have noted the significant omission of any such assessment accompanying the proposals in the consultation. Given that the potential impact on carbon price, industry and competitiveness could be significant, the lack of an impact assessment is a worrying omission that should be addressed as soon as possible. ETG would expect a full impact assessment to accompany changes in legislation, consistent with Better Regulation principles.

Market development and oversight

Chapter 4 of the document sets out a call for evidence on future markets policy and sets out five overarching objectives namely: (i) a rules based approach, (ii) avoiding gaming of regulatory decisions, (iii) avoiding excessive shocks, (iv) supporting liquidity, (v) market integrity. In themselves these are all sensible overall objectives.

However, many of the means of achieving these objectives lie in policy choices that are not covered in the current Call for Evidence set out in Chapter 4, or only referred to in passing. Without more policy direction in terms of potential linkage to EU ETS or the role of ITMOs in international markets, prices will continue to be driven by relatively small changes in perception and hence be potentially volatile. This will continue to undermine the above objectives.

As far as specific improvements are concerned, ETG members would advise that the Auction Reserve Price should be withdrawn and implementation of a Supply Adjustment Mechanism should be accelerated to safeguard market stability. Meanwhile there is a broad consensus that the CCM should be used to avoid excessive deviation of UK ETS prices from those in the EU, until such time as the two schemes are linked.

Yours sincerely,

Chair, UK Emissions Trading Group

ANNEX

INDICATIVE TECHNICAL SOLUTIONS BEING CONSIDERED BY UK INDUSTRY TO REACH NET ZERO BY SECTOR

	Electrific-ation	Hydrogen	CO2 usage	CO2 storage	Biofuels \synthetic fuels	Nature based
Mineral products	✓	✓	✓ in products	✓✓	✓	✓
Steel	✓✓	✓	✓	✓✓		
Glass	✓✓	✓				
Aviation	✓				✓✓	
Food and drink	✓	✓			✓	✓
Vehicle manufacture	✓	✓			✓	
Oil and gas extraction	✓✓	✓ providing		✓✓	✓	
Fuel processing\ refining	✓	✓ providing	✓ in products	✓	✓ providing	
Paper	✓✓				✓	
Power generation	✓✓ providing	✓✓ user and provider		✓✓	✓	
Chemicals	✓	✓✓	✓	✓	✓	
Building materials (e.g. wood panels)	✓				✓✓	
Ceramics	✓	✓✓	✓	✓	✓	✓