

# Energy UK response: UK ETS Future Markets policy consultation

11 March 2024

## About Energy UK

Energy UK is the trade association for the energy industry with over 100 members - from established FTSE 100 companies through to new, growing suppliers, generators and service providers across energy, transport, heat and technology. Our members deliver nearly 80% of the UK's power generation and over 95% of the energy supply for 28 million UK homes as well as businesses.

The sector invests £13bn annually and delivers nearly £30bn in gross value - on top of the nearly £100bn in economic activity through its supply chain and interaction with other sectors. The energy industry is key to delivering growth and plans to invest £100bn over the course of this decade in new energy sources. The energy sector supports 700,000 jobs in every corner of the country. Energy UK plays a key role in ensuring we attract and retain a diverse workforce. In addition to our Young Energy Professionals Forum, which has over 2,000 members representing over 350 organisations, we are a founding member of TIDE, an industry-wide taskforce to tackle Inclusion and Diversity across energy.

## Executive Summary

Energy UK welcomes the opportunity to engage with the UK ETS Authority on the future of the UK Emissions Trading System (ETS). We are supportive of efforts to decarbonise the UK electricity system and view a robust carbon price as a key mechanism for achieving Net Zero in the UK.

Our members are supportive of the proposal to introduce a quantity-based Supply Adjustment Mechanism (SAM) to combat long-term demand shift in the UK ETS and agree in principle with the introduction of relative trigger thresholds. A quantity-based SAM will protect the UK ETS against demand shocks and preserve the carbon price, whilst remaining predictable and providing much-needed stability to industry. The ETS Authority must additionally consider how engineered Greenhouse Gas Removals (GGRs) would impact the market given the stated intent to include them in the scope of the UK ETS.

In principle, members support the retention of the Auction Reserve Price (ARP) to ensure a robust UK carbon price. This should evolve over time to ensure that the ARP responds to price signals in the UK ETS. Members also support the retention of the Cost Containment Mechanism to protect against high prices.

A solution to all of the risks noted in this consultation would be resolved by linking the UK ETS with the EU's carbon market. Linkage would ensure that the UK retains a robust carbon price that effectively incentivises decarbonisation. The UK Government gives 'serious consideration to' linkage in the Trade and Cooperation Agreement between the UK and EU. Any actions taken by the ETS Authority must not, therefore, create significant divergence with the EU carbon market that undermine prospects for linkage.

## Contact

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**1. Do you agree with the key risks we have identified? (Yes/No). Please provide any supporting evidence in your response.**

Yes. Energy UK supports a UK Emissions Trading Scheme (ETS) with a robust carbon price that incentivises the decarbonisation of the electricity system. Energy UK members agree that the risks to the effective functioning of the UK ETS are those discussed in this consultation: a demand shift with long-term impacts, and both sudden, significant, sustained price increases and decreases.

Energy UK notes that there has been a sustained price decrease in the UK ETS from Spring 2023 onwards, which could create further price volatility in the future as the market tightens. This volatility, and other issues related to the relative size of the UK ETS, will increase in the future. A weak and volatile carbon price has a detrimental impact on low carbon investment in the UK, whilst also leading to significantly reduced revenues for the Exchequer – Energy UK analysis conducted in October 2023 notes that between April and October 2023, UK ETS auctions raised £1bn less than had prices remained at the level they were in 2022-23, and that should these prices continue, HM Treasury would lose out on almost £3bn in revenues annually<sup>1</sup>. A robust carbon price must also be paired with appropriate and robust measures to minimise the risk of carbon leakage and support for industry in the move towards decarbonised fuel sources.

In line with the Energy UK publication ‘Energy Matters’<sup>2</sup>, Energy UK calls for the UK Government to continue to work closely with international partners to deliver on the UK’s Net Zero ambitions. Specifically, Energy UK members note that the risks identified by the UK ETS Authority in this consultation, including market liquidity and volatility, would be resolved through linking the UK ETS with the EU Emissions Trading System (EU ETS). Given the UK Government’s commitment to ‘serious consideration’ of ETS linkage as part of the TCA, any new mechanism within the UK ETS must not undermine the prospects of linkage.

**2. Are there any alternative risks to those listed above that the Authority should consider? (Yes/No). Please provide any supporting evidence in your response.**

No.

**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 impacts risk? (Yes/No). Please explain the reasons for your response.**

Yes. Energy UK members agree that a quantity-based Supply Adjustment Mechanism (SAM) would help address this future risk, whilst also providing long-term certainty on the future of the UK ETS to help address uncertainty in the market today.

**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.**

Energy UK members agree that a quantity-based SAM is preferable to a price-triggered SAM due to the longer-term political risk associated with price-based mechanisms. The similarity of this mechanism to the EU ETS Market Stability Reserve (MSR) means that the UK ETS SAM is better understood by market participants, giving greater stability to the market.

However, unlike when the EU ETS introduced the MSR in 2019, the UK ETS does not have a structural oversupply of allowances with a historical surplus. The challenges faced by a UK ETS SAM will therefore be different and this needs to be considered in SAM design.

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<sup>1</sup> [Energy UK \(2023\) Without linking emissions trading systems, UK companies face higher bills and red tape.](#)

<sup>2</sup> [Energy UK \(2023\) Energy Matters.](#)

**5. Do you agree with the Authority's minded-to position on the introduction of a quantity-triggered SAM? (Yes/ No). Please give your reasons for your response.**

Yes. Energy UK members welcome the Authority's minded-to position and note that this is in line with Energy UK's previous submission to the Authority's 'Developing the UK ETS' consultation<sup>3</sup>.

The size of the UK ETS market and level of diversity, both between and within sectors, means that the balance of demand and supply (and therefore carbon price) has been significantly more volatile in the UK than in the EU. This has led to a lower carbon price in the UK ETS compared to the EU. A lower carbon price will reduce the incentive to decarbonise for UK businesses and will also lead to higher payments for exports under the EU CBAM when this is implemented in 2026. A quantity-based SAM will protect the UK ETS against demand shocks and preserve the carbon price, whilst remaining predictable and providing much-needed stability to industry.

There is also a need to ensure that the threshold for the activation of the SAM is set according to modelling based on the UK ETS alone to ensure the more effective functioning of this system.

**6. Do you agree with the proposed approach for calculating the UK ETS TNAC? (Yes/ No) Please give your reasons for your response.**

Yes. Energy UK members believe that the proposed approach for calculating the UK ETS TNAC is appropriate. This approach will provide the greatest amount of transparency and predictability to industry. In addition to the proposed approach, some members suggest that the Authority could consider the publication of a rolling TNAC published online, giving greater predictability to the market compared to an annual publication of the TNAC. This would require further investigation of whether this is feasible given existing reporting requirements.

**7. If you disagree with the proposed approach, please suggest an alternative approach and your rationale for this?**

n/a

**8. What is your view on what level of surplus constitutes a) an optimum level of surplus in the scheme, that would allow for effective functioning of the market and b) how could this be assessed including in terms of methodology? Please give your reasons and evidence you may have for your response.**

It is difficult to state an exact surplus level for the UK ETS. The surplus level should be kept carefully under review as this will need to evolve as the number of ETS allowances declines. The methodology used to calculate this should reflect the principles the ETS Authority has outlined in this consultation (p.24) – that the surplus level should not be insufficient or excessive. This will provide a robust and stable carbon price and also allow for the day-to-day functioning of the market.

Members believe that, in principle, the SAM would need to remove allowances from the market in the first instance to address near-term oversupply. The ETS Authority will need to think carefully about when any return of allowances to the market would occur, to prevent the SAM from adding to current market uncertainty. Some members think that allowances should not be returned to the market before 2030; this would need to be subject to further analysis. Energy UK would suggest that analysis should also be undertaken by the ETS Authority to consider the parameters of the SAM.

The Authority needs to further consider how engineered Greenhouse Gas Removals (GGRs) would impact the market given the stated intent to include them in the scope of the UK ETS. This could impact the availability of allowances and therefore must be considered when designing appropriate thresholds for the SAM. In the longer term, the UK ETS will need to transition to a negative emissions market, and GGRs could be a tool to protect against the risk of price spikes in the 2030s through both

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<sup>3</sup> [Energy UK \(2022\) Energy UK response to Developing the UK ETS Consultation.](#)

the Cost Containment Mechanism (CCM) and the SAM. Due consideration must be given to the timing of the inclusion of GGRs within the UK ETS.

**9. Do you have a view on what level a) the upper quantity trigger threshold and b) the lower quantity trigger threshold should be in a UK ETS SAM? (Yes/ No). Please give your reasons and any evidence to support your response.**

Thresholds should be decided based on modelling from DESNZ taking into account activity under the UK ETS so far, including both compliance and hedging needs for market participants. The threshold needs to be reactive enough (i.e. kept under review) to ensure that there is enough tightness in the market to ensure that businesses within the scope of the UK ETS have an incentive to decarbonise, whilst also preventing the risk of carbon leakage.

Energy UK members note that any threshold should adapt as demand for allowances falls as businesses decarbonise over the lifetime of the UK ETS. Energy UK members stress the need for predictability in any system, including about how any threshold is set and amended.

**10. How reactive should the upper and lower thresholds be, for example should each threshold have a sliding scale of supply adjustment? Please give your reasons and any evidence to support your response.**

n/a

**11. Has the Authority identified all types of triggers that should be considered; or are there any other types of trigger thresholds that should be considered? Please give your reasons for your response.**

Yes, the Authority has considered all types of trigger thresholds.

**12. Do you agree that relative trigger thresholds would be more appropriate than absolute static thresholds? (Yes/No). Please give your reasons for your response.**

Energy UK members agree in principle with the introduction of relative trigger thresholds. In the implementation of any relative threshold, the Authority must ensure that any action is predictable and frequently reviewed to take into account the evolution of UK ETS prices as the supply of allowances declines. There is a risk that, should allowances be reintroduced too fast, this could undermine the incentive for businesses to decarbonise as a result of a low carbon price.

The introduction of GGRs into the UK ETS must also be considered in designing any trigger threshold.

**13. If you agree, what is your preference – relative trigger threshold values a) as a proportion of the annual UK ETS cap or b) relative to annual auction volume.**

There are a variety of views expressed by members regarding how this threshold should be calculated:

- Some members believe that relative trigger thresholds should be set as a proportion of both annual auction volumes and free allocation combined, as this constitutes the same methodology as the TNAC.
- Some members prefer the threshold to be calculated relative to auction volumes, as free allocation does not need to be hedged.
- Some members suggest that calculating thresholds less frequently than on an annual basis, for example every two years using three-year aggregated auction volumes, would provide greater market certainty.
- Some members would also suggest that trigger thresholds are relative to the annual UK ETS cap, given the current annual auction volume is higher than anticipated due to additional

allowances announced by the ETS Authority in their response to the 'Developing the UK ETS' consultation<sup>4</sup>.

**14. What is your view on what the appropriate level of auction volume adjustment should be? Please give your reasons and any evidence for your response.**

The UK ETS Authority should model how to set volume adjustments. Any adjustment should be of sufficient size to address the issue at hand, i.e. whether the surplus is too large or too small. Any adjustment should return the surplus to a desirable level within the 12-month period when auctions are adjusted, or if there is a particularly large or small surplus that may take longer to correct, the SAM should at least be making a significant adjustment to supply within the 12 months.

Some members additionally believe that the auction volume adjustment could be aligned with that of the EU ETS, for example by having a sliding scale above the upper threshold and a fixed volume below the lower threshold.

**15. Do you have a preference for this adjustment to be a percentage of annual auction volume, or other fixed amount, a combination of both or any other metric? Please give your reasons for your response.**

There is no consensus on this amongst membership, however some members have expressed a preference for a percentage of the TNAC in the case of exceeding the upper threshold.

**16. Do you agree with the proposed TNAC publication timing of post compliance in spring? (Yes/ No). If not, please explain your reasons.**

Yes. Energy UK members think that spring would be an acceptable time to publish TNAC data.

Furthermore, as noted in our response to Q.6, some members believe that the Authority could consider a rolling TNAC subject to the feasibility of implementation. This would preclude the need for an exact publication date for the TNAC.

**17. What is your view on auction supply adjustment timings if the SAM is activated? Please give details of your preferred timings and rationale for this.**

Energy UK supports in principle the suggestion made by the UK ETS Authority that auctions are adjusted from July to June. However, some members have noted that:

- The specific timing may not be critical to market functioning and there may be benefits for market simplicity in having the auctions adjusted from January the following year.
- The auction supply could be adjusted in equal portions over a 12-month period, starting from the September auction (aligned with the EU ETS). This could include the cancellation of allowances above one year of auction volumes, as with EU ETS 'invalidation'.

**18. Should auction volume require adjustment due to SAM activation, do you agree that the Authority should endeavour to preserve approximate equal auction volume distribution in the time period affected by this adjustment? (Yes/ No). Please give your reasons for your response.**

Yes.

**19. In your view, when, in terms of scheme year, should any quantity-triggered SAM be implemented into the UK ETS, meaning the SAM would begin operating the following year post compliance period? Please explain your reasons for your response.**

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<sup>4</sup> [UK ETS Authority \(2023\) Developing the UK Emissions Trading Scheme: main government response.](#)

Energy UK members note the need to ensure that early clarity on the implementation of a quantity-based SAM is vital to provide predictability to the market, however this should be balanced with the need to ensure that enough time is spent designing the SAM to ensure that it is effective when introduced.

**20. Do you have any views on the interactions between any quantity-triggered SAM and the ARP and CCM? Please give your reasons and any evidence for your response.**

Energy UK believes a quantity-based SAM should function well alongside existing market mechanisms in the UK ETS; the EU ETS MSR and Cost Containment Mechanism (CCM) already demonstrate that these mechanisms can function alongside each other.

**21. Do you agree with the Authority's assessment of each of the options considered? (Yes/No). Please provide any evidence in support of your answer.**

Yes.

**22. Are there any alternative options to those listed above that could be implemented by the Authority to address the risk of a sudden, sustained and significant price decrease in the UK ETS market? If so, please describe how the mechanism functions.**

n/a

**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. As noted in Q.1, Energy UK members support a robust carbon price. In principle, members believe that retaining an ARP will ensure that this will be the case in the event of sudden price decreases.

**24. Do you think that an alternative policy option, such as any of the options previously discussed in this chapter, should be implemented in conjunction with the ARP? (Yes/No). If so, please elaborate.**

No. Beyond the introduction of a SAM, Energy UK members would caution against the introduction of further mechanisms to avoid overcomplicating the UK ETS.

**25. Do you think the ARP trigger level should be changed? (Yes/No). What level do you think the ARP should be set at? Please provide a rationale for your answer.**

There are a variety of views expressed by Energy UK members regarding the ARP. Most Energy UK members believe that the ARP should be retained, with a value set at least at the current ARP trigger level. Energy UK believes the ARP should support a robust carbon price.

Some members suggest that the ARP could be raised to:

- Provide stability to the UK carbon market (which has been below the EU ETS since Spring 2023);
- Provide certainty of UK ETS revenue to HM Treasury;
- Support the deployment of all low carbon technologies to support industrial decarbonisation; and
- Mitigate the impact of an EU CBAM by levelling out carbon prices between the UK and EU.

The level of the ARP should be evidence-based and could be set based on historical factors, for example an average of previous years, to ensure that the ARP reflects market conditions and is not set at arbitrary levels. The trigger level could also be adjusted annually for inflation.

**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.**

The ARP should evolve to ensure that this evolves with price signals in the UK ETS. As noted in our response to Q.25, the level of the ARP could be set based on historical levels. Members stress that any changes to either the ARP trigger level or the methodology by which this is calculated should be predictable, with a clear methodology, and be clearly communicated in advance. This will ensure transparency for market actors.

**27. Do you think the Authority should alter the way an ARP trigger affects auction supply? If so, please explain how you think this should be changed.**

Yes. Most Energy UK members believe that there should be no reallocation of unsold allowances into the next four auctions; these should be automatically transferred into the market stability mechanism account.

**28. Are there any other ways the Authority could alter an ARP to make it more effective? If so, please explain these alterations.**

Some Energy UK members suggest that the ARP could be set annually, for example as part of the UK Budget and Finance Bill or set ahead of auctions. Options for how this could be set include being measured against previous UK ETS prices, the EU ETS, levels used within Government policy to support decarbonisation plans, or be set dynamically, for example based on a rolling average of prices over the previous 12 months (or over a longer time period).

As noted in our response to Q.26, any changes to the ARP must be predictable, made according to a clearly defined methodology, and clearly communicated to industry in advance of their introduction.

**29. Do you agree with the Authority's assessment of each of the options considered? (Yes/No). Please provide any evidence in support of your answer.**

Yes.

**30. Are there any alternative options to those listed above that could be implemented by the Authority to address the risk of a sudden, sustained and significant price increase? If so, please describe how the mechanism functions.**

n/a

**31. Do you believe the CCM should be retained with no adjustments? (Yes/No). Please provide any supporting evidence in your response.**

Energy UK believes that the CCM should be retained with no adjustments to ensure stability in the UK ETS. Nevertheless, Energy UK members would welcome any minor adjustments to the functioning of the CCM to improve the reactivity of the mechanism whilst retaining predictability.

**32. Do you believe the current CCM thresholds should remain? (Yes/No). Please provide any supporting evidence.**

Yes. Energy UK believes that the current CCM thresholds should be retained to ensure market stability. However, members note that the CCM may need to be evaluated in the long-term to provide certainty against longer-term price spikes and avoid political risk as the UK ETS tightens.

**33. If no, should the CCM thresholds be made more reactive by changing the multiplier, trigger period and/or reference period? Please provide any supporting evidence.**

n/a

**34. Do you believe the CCM trigger methodology should be based on historical comparisons or a fixed price? Please provide any supporting evidence.**

Energy UK believes the CCM trigger methodology should be based on historical comparisons.

**35. Are there alternative methods we should consider when setting the CCM trigger price? Please provide any supporting evidence**

n/a

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

Energy UK does not have strong views on whether CCM decision-making should remain discretionary or be an automated process. Irrespective of either method, members would welcome greater guidance from the ETS Authority on the decision-making process for activating the CCM. This would enable greater transparency for market actors regarding when the CCM would be implemented. Furthermore, the CCM assessment criteria should be published to give market participants greater predictability.

**37. If no, do you believe the CCM should have a fully or partially automated response following a trigger? If so, please describe how this could function.**

Should automation be introduced into the CCM, some members have suggested that partial automation in the form of a fixed number of allowances with a small percentage discretion on either side could be an option.

**38. Are there any other design changes not listed above that would improve the effectiveness of the CCM?**

Energy UK would welcome further transparency about how the CCM is implemented to give the market further transparency and predictability.

Some members have suggested that once the trigger threshold is reached, there should be a time limit for deciding on whether to release additional allowances.

**39. Do you have any views on the approach to reserve allowances in the UK ETS or anything you would like the Authority to consider when making decisions on its size and structure?**

Carbon budgets and SAM Reserve

Energy UK asks the UK ETS Authority to clarify to industry whether allowances in the SAM reserve would be able to be carried over between Carbon Budgets, depending on the interpretation of existing legislation. Given these allowances would technically be held by Government, carrying them over from one Carbon Budget to another could be perceived to be breaching the Carbon Budget under the Climate Change Act – so at the end of each Carbon Budget the SAM reserve may need to be emptied. This would undermine price stability in the UK ETS, given the SAM could trigger in one Carbon Budget (for example in 2031/32 under CB5), but be potentially unable to return allowances as it could be in the next Carbon Budget (for example 2033 in CB6). A sensible compromise may be a cap on the number of allowances that can be carried over in the SAM reserve.

Transparency on reserve allowances

Energy UK members note a need for clarity regarding the number of reserve allowances in the UK ETS. This is not currently available without a significant administrative and analytical burden on market participants. The UK ETS Authority should communicate clearly with market participants regarding the number of reserve allowances to create greater transparency in the market.