UK Emissions Trading Scheme (UK ETS)

Maintaining Market Stability

Tuesday 17 October

Department for Energy Security & Net Zero

Agenda: What will we cover today?

1. Overview of UK ETS
2. UK ETS Market
3. Maintaining Market Stability
4. Lessons learned and future markets policy
5. Questions

Overview of UK ETS

On **1st January 2021**, we launched the **UK Emissions Trading Scheme**, to replace the UK's participation in the EU ETS.

The UK ETS is a **cap-and-trade scheme**, where a cap is set on the total amount of certain greenhouse gases that can be emitted by sectors covered by the scheme.

Scheme participants must **surrender 1 UK Allowance (UKA) per tonne** of emitted CO2 equivalent (CO2e) each year.

- Covers a **quarter of UK emissions (108 MtCO2e in 2021).**
- **Sectors** covered are power, energy-intensive industries, and aviation (UK domestic and UK to European Economic Area countries).
- **Gases** covered are carbon dioxide, nitrous oxide and perfluorocarbons (PFCs).
- In 2019, the UK legislated for **net-zero emissions**, with a **target of 2050**. The UK ETS will play a key role in achieving this.
- In **July 2023,** the UK ETS Authority outlined a range of **policy developments to the ETS** including:
  - aligning the UK ETS cap to the UK's Net Zero target,
  - expanding the scope of the scheme,
  - developing our free allocation and aviation policies in future.

Overview of UK ETS: Key features

Cap: Total amount of greenhouse gases, sectors included in the scheme, can emit each year. The cap decreases over time, meaning a decreased availability of allowances in future.

Auctioning: Auctioning is the primary means of introducing allowances into the market. Participants are also able to trade UK ETS allowances on a secondary market.

Free allocation: Some allowances are received by industry for free to protect against carbon leakage. This is based on benchmarks, and targets sectors most at risk of carbon leakage.

Market stability mechanisms: are in place to support orderly and healthy UK ETS markets, including the Auction Reserve Price, the Cost Containment Mechanism and protections against disorderly market behaviour and abuse.

Scope: A quarter of UK emissions are covered by the UK ETS. Sectors covered are power, energy-intensive industries and aviation (UK domestic and UK to European Economic Area countries).

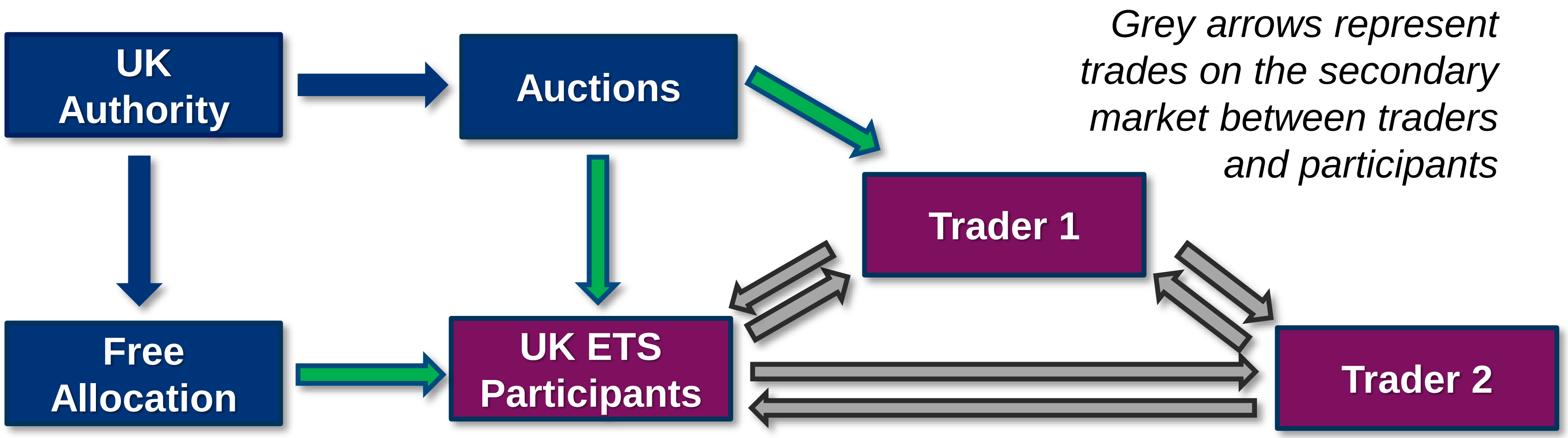
UK ETS Market

- Auctions started on 19 May 2021 and are one of the **main routes to market** for UK allowances. They are hosted **fortnightly** by ICE Futures Europe.

- **Auction eligibility is wide,** to support market delivery. Scheme participants, their affiliated companies and credit institutions/investment firms with relevant permissions can participate.

- Companies can purchase allowances to meet their UK ETS obligations through **auctions**, or through the **secondary market,** from traders or other companies who have reduced their own emissions and have spare allowances.

- **Indicative diagram of ETS market:**

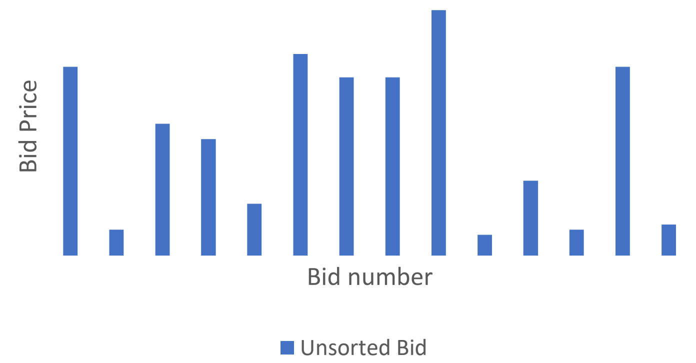


UK ETS Market: Auctions

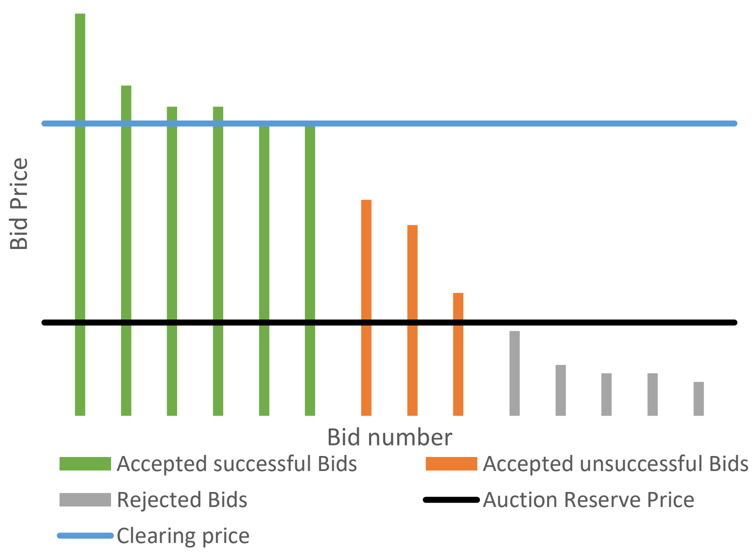
Auction rules:

- Bids are submitted between 12:00 and 14:00. At 14:00 the bids are automatically stacked from highest to lowest.
- The **Auction Clearing Price (ACP)** is the price at which the sum of volumes bid exceeds the number of allowances auctioned.
- Where this price is significantly below the prevailing secondary market price, the ACP becomes the price of the lowest bid that is not significantly below the prevailing secondary market price (methodology determined by the auction platform).
- All successful bidders pay the ACP and all bids under the ACP are unsuccessful.
- There is also an **Auction Reserve Price**, currently set at £22, below which bids will not be accepted.
- **UK ETS auctions can partially clear.** In this scenario, unsold allowances are allocated across the next four auctions or, if criteria are met, added to the market stability mechanism account.

Example selection of unsorted bids



Example completed bidding process



UK ETS Market: Secondary Market

- **Secondary markets** also started on 19 May 2021 and **they are a crucial forum for trading** in UK allowances. They are hosted by ICE Futures Europe as part of the conditions of the auction contract.

- **December futures contracts are the main product traded**, giving participants the ability to lock in carbon prices ahead of time for future emissions (hedging).

- We use **end of current year futures contracts as our main measure of price** in the UK ETS. This is used for triggering the Cost Containment Mechanism as well as calculating penalties for non-compliance.

- **Trading is monitored by ICE Futures Europe and the Financial Conduct Authority** to ensure that trading complies with UK market oversight rules.

UK ETS Market: Key Market Stability Mechanisms

- The UK ETS is a market mechanism, and it is the **market that sets the carbon price.**

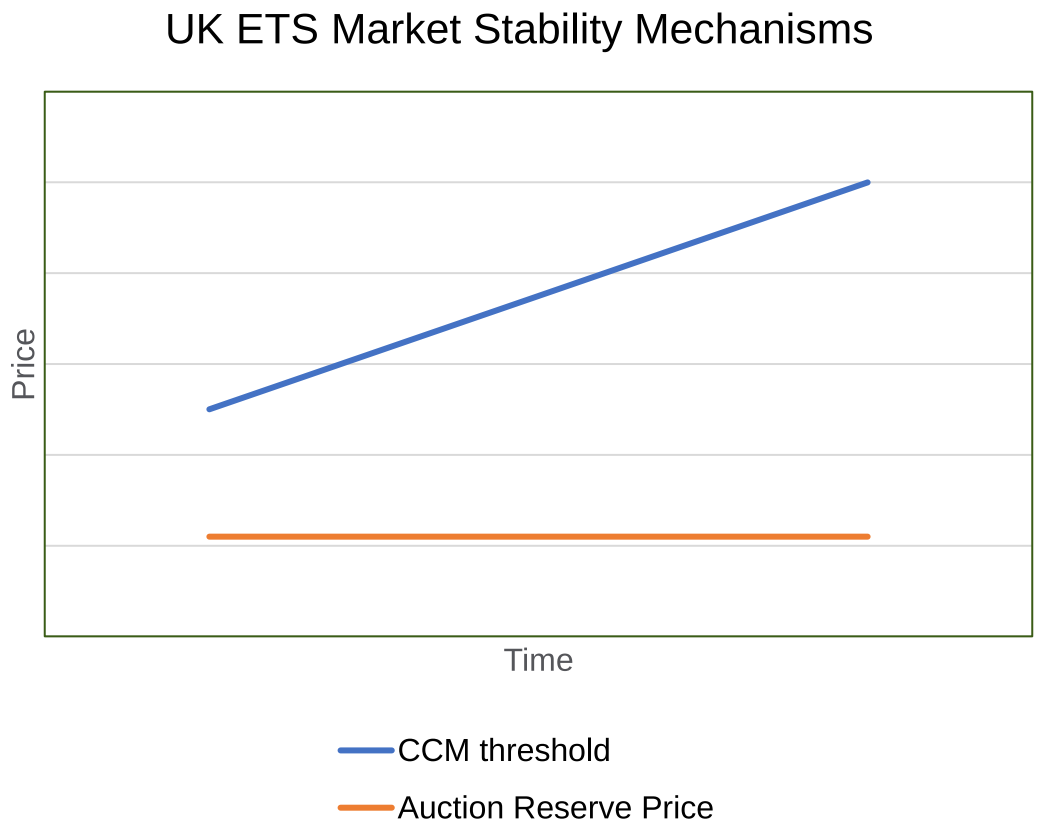
- The purpose of the UK ETS is to **incentivise abatement in the most cost-effective manner.** For the success of the UK ETS, it is important for us to have an **effectively functioning market.**

- The UK Authority aims to **provide confidence** in the market, ensuring it has stability and liquidity, whilst mitigating against excessive market volatility.

- We have **two key market stability mechanisms** in the UK ETS:

  1. **Auction Reserve Price** which sets a minimum bid price at auctions of £22. Bids below this price are not accepted.

  2. **Cost Containment Mechanism** which provides the UK ETS Authority with the option to intervene if prices are elevated for a sustained period of time.



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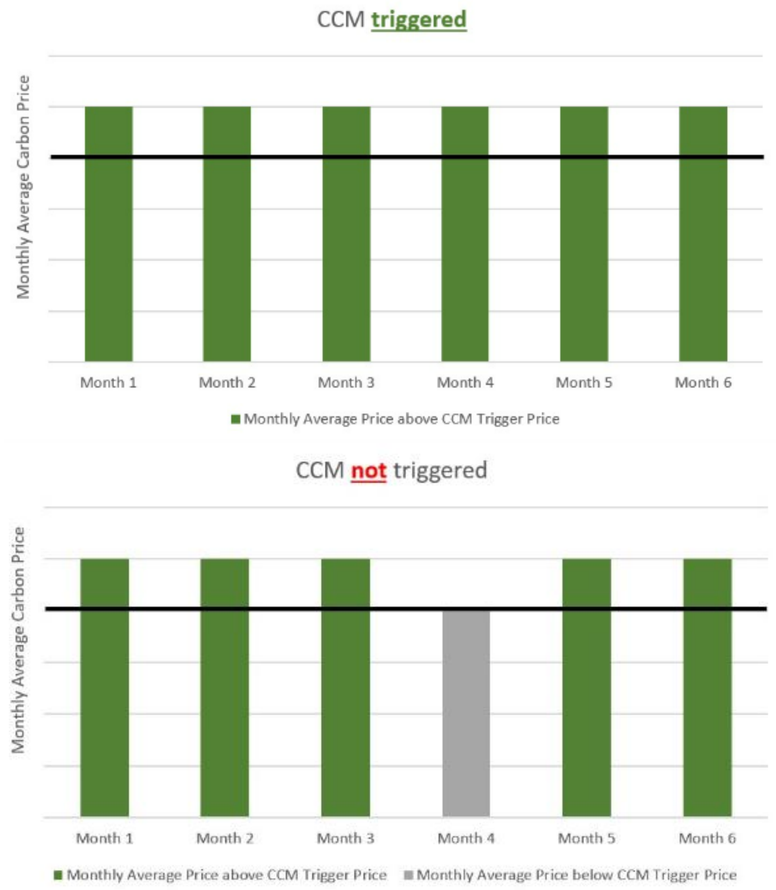
UK ETS Market: Cost Containment Mechanism (CCM)

- The Cost Containment Mechanism provides the UK ETS Authority with the **option to intervene** if prices are elevated for a sustained period of time.
- The Cost Containment Mechanism was designed to be **more responsive in earlier years** of the Scheme.
- From February 2023 onwards, the CCM will be triggered if the relevant UKA* price **is more than three times** the average price for the preceding 2-years, **for six consecutive months.**



**UKA represents the UK Allowance December futures contract*

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UK ETS Market: Cost Containment Mechanism (CCM)

- If the **CCM is triggered**, the UK ETS Authority will consider the most appropriate interventions given the market context and will implement them in a timely manner.

- The interventions the Authority could take include:

  - **Changing distribution of allowances to be auctioned** within the year

  - **Increasing the number of allowances to be auctioned** within the year by **bringing forward allowances** from future years

  - **Releasing allowances from the New Entrants' Reserve**

  - **Releasing allowances from the market stability mechanism account**.

- The Cost Containment Mechanism (CCM) was **triggered in December 2021 and January 2022**. In both cases, the UK ETS Authority **decided not to intervene** after examining a range of relevant evidence.

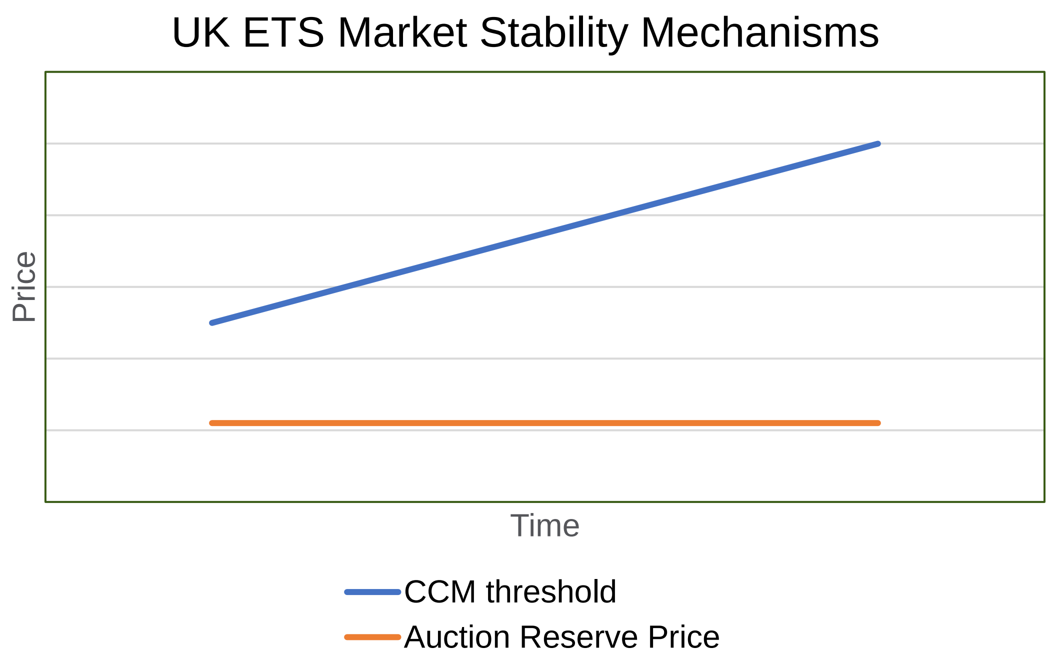
UK ETS Market: Benefits of our Market Stability Mechanisms

Auction Reserve Price

- Provides a **guaranteed minimum price**
- Helps to create **certainty for businesses**
- **Supports climate ambition**, incentivising low carbon investment

Cost Containment Mechanism

- **Addresses stakeholder concerns** around price spikes
- Provides the **opportunity** for the UK ETS Authority to intervene
- Provides **flexibility** in how the UK ETS Authority chooses to intervene, if at all



Market Experiences and Lessons learned

- The UK Authority's **aim** was to introduce a new ETS and keep the market price stable.
- The Cost Containment Mechanism (CCM) was **triggered in December 2021 and January 2022**. In both cases, the UK ETS Authority **decided not to intervene.**
- The methodology for calculating thresholds was **clearly communicated** in advance, and when it triggered, the UK ETS Authority **committed to sharing a decision within two weeks**.
- The UK ETS Authority **monitors UK ETS markets closely**, working with our regulatory and operational partners to ensure we have a complete picture of their operation. This includes tracking of registry holdings, auction outcomes, secondary market reporting, and any impact of the UK ETS on other markets.
- We are currently **reviewing market stability policy** to ensure it is fit for purpose as the scheme continues to develop.

UK ETS Market: Future Markets Policy

In March 2022 **we launched a call for evidence on future markets policy**, to ensure UK ETS markets remain fit for purpose in the long-term. The call for evidence invited views and evidence on our approach.

Key proposals

- We called for evidence on:
  - **Issues** that ETS markets policy can **guard against**;
  - Potential **drivers of evolving market conditions** in the UK ETS in the coming years;
  - **Objectives** for UK ETS markets policy as the scheme matures; and
  - **Existing UK ETS markets policy**, including our intent to withdraw the Auction Reserve Price (ARP).
- Subject to responses, we intend to return with detailed markets policy proposals, as appropriate, in due course.

What did we cover?

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Questions

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