

## CONSULTATION RESPONSE

### Energy Traders Europe response to the UK ETS consultation on possible reform

**Brussels, 11 March 2024**

#### General remarks

We welcome this consultation on the design of the UK Emissions Trading System (ETS) and support design changes that would facilitate linking the UK ETS with the EU ETS at the earliest feasible occasion. Indeed, linking the two schemes would:

- Improve liquidity, price discovery and the ability to attract abatement across a larger area;
- Exempt UK imports of electricity into the EU from the application of EU CBAM;
- Incentivize the uptake of CCS and allow cross-border CO<sub>2</sub> flows, ultimately promoting the development of an international market for CO<sub>2</sub> storage services;<sup>1</sup>
- Show commitment to the Paris Agreement and net zero emissions target.

The similarities between the UK and the EU carbon trading regimes until now make them particularly good candidates for linking. Keeping the design of the two schemes close is essential to keeping the door open for a decision to link them, and to implementing this decision rapidly.

If the market design of the UK ETS were to start differing significantly from the EU ETS, the prospects of linking it with the EU ETS will diminish – or its implementation be more complex and lengthy. Overall, it may lead to competitive distortions between the two markets and disadvantages for British businesses as participants in the smaller market.

Last but not least, the EU has already developed creative arrangements to facilitate the linkage of their ETS with that of other jurisdictions. In particular, the linking agreement of the EU ETS and the Swiss ETS could provide a broad framework for similar negotiations between the UK and the EU.

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<sup>1</sup> Currently, as the EU ETS Directive, UK ETS regulations and domestic CCS legislation stand, CO<sub>2</sub> that is transferred out of one installation to another installation that does not fall under the same jurisdiction as the first installation, that CO<sub>2</sub> is treated as 'emitted'. This disincentivises EU and UK ETS operators from sending captured CO<sub>2</sub> across borders and ultimately disincentivises the uptake of CCS.

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## Questions

### Risks to Market Stability

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

Yes, we agree with the identified risks. Demand shifts with long-term impacts and sudden, significant and sustained price decreases/ increases are the key risks to the stability of the UK ETS. To address these risks, we agree that a Supply Adjustment Mechanism should be introduced, and the Cost Containment Mechanism and the Auction Reserve Price should be maintained.

In addition, low liquidity increases costs and reduces the efficiency of the carbon market.

We would therefore recommend linking the UK ETS with the much larger and more liquid EU ETS. Linking would benefit decarbonisation efforts in both the UK and in the EU and help to address any issues related to the implementation of carbon border adjustment mechanisms.

**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.**

We see risk of unstable regulatory framework due to sudden policy changes in the UK. We underline the importance to follow set consultation processes with the market and we encourage better communication on policy targets.

### Risk 1: Demand shift with long-term impacts

#### Policy options

**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, we support the introduction of a Supply Adjustment Mechanism. We believe the UK ETS would benefit from a SAM so long as it is designed correctly. In particular, we flag the absence of an invalidation rule from the SAM.

*Invalidation rule - The EU ETS, since last year, has implemented a new rule stipulating that if allowances in the reserve exceed the number of allowances that were auctioned off the previous year, the difference is invalidated. The rule ensures that past market surpluses are never returned to the market and helps to maintain scarcity in the market. The invalidation rule does this by ensuring that as the overall cap on emissions decreases over time, the reserve account also shrinks accordingly.*

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Introducing a SAM would also ensure alignment with the EU ETS (which features a comparable quantitative adjustment mechanism - the Market Stability Reserve) and facilitate future linking between the two emission trading schemes.

**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.**

We think a quantity-triggered supply adjustment mechanism offers more predictability and avoids impacting price discovery, compared to a price-triggered SAM. A quantity-triggered design would ensure alignment with the EU ETS where the Market Stability Reserve is quantity-triggered.

**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, we support the introduction of a quantity-triggered SAM in emulation of the EU ETS Market Stability Reserve (MSR) in its design while considering underlying differences (e.g. different overhang of surplus allowances at the start).

## Calculating the UK ETS TNAC

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

We agree with the approach.

However, we recommend including the allowances in the SAM to ensure additional transparency and clarity as outlined below.

$$TNAC = Supply - (Demand + allowances in the SAM)$$

*Where supply includes all allowances added to the SAM to date (in each TNAC year)*

The net effect of adding the SAM component to this calculation is zero, but it provides additional detail for transparency and completeness. This approach aligns with the TNAC calculation under the EU ETS.

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

Please see our response to question 6 above.

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## The appropriate level of an upper and lower quantity trigger threshold

**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.**

The surplus should be at a level that allows utilities to hedge effectively. It should be dynamic and defined via the SAM upper threshold.

**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.**

The thresholds should be dynamic and reactive. This reflects the decline of emissions over time and the associated decline in hedging potential in the ETS over time.

**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.**

We would be fine for a sliding scale to be implemented on the upper threshold, such as in the EU ETS.

## Type of trigger thresholds: absolute, static thresholds or relative thresholds

**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, we think that the Authority has identified all types of triggers that should be considered.

**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.**

Yes, a relative trigger threshold would be more appropriate than absolute static thresholds. A relative trigger reflects best the emissions decline over time and the decline in hedging potential in the ETS over time.

**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.**

We have a preference for a dynamic trigger threshold, linked to annual auction volume.

## Auction volume change following SAM activation

**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 auction volume adjustment should be aligned with the EU ETS (e.g., 24% with a sliding scale above the upper threshold and a fixed volume below the lower threshold. The fixed volume should be scaled to the cap of the UK ETS (vs. EU ETS).

**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.**

We prefer a percentage of the TNAC (in the case of exceeding the upper threshold).

## Operational timings of a SAM if triggered

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

Yes.

**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.**

The auction supply should be adjusted in equal portions over a 12-month period, starting from the September auction (aligned with the EU ETS). We would also recommend 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.

## Timing of introduction of any potential SAM into the UK ETS

**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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In our view, SAM should be implemented as soon as possible, preferably in 2025 – against the 2024 TNAC.

## Interaction with wider markets policy

**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.**

We do not think that a quantity-triggered SAM has to interact with the ARP or the CCM. They address different risks – under/over-supply in the case of the former, and price shocks (sudden increases or decreases), in case of the latter.

## Risk 2: Sudden, significant and sustained price decreases

### Policy options

**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, and we do not think that any alternative policy options from this section, besides the existing Auction Reserve Price, should be considered.

**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.**

No.

### The Authority's assessment

**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.

**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, we do not think that any alternative policy options should be implemented. Instead, we would recommend an adjustment to the ARP – increasing the price with inflation.

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## ARP trigger level

**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.**

We do not have a view on the actual level, but the trigger should increase with inflation (e.g., CPI from 2025).

**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 evolution of the ARP trigger levels should consider recent UK and EU ETS prices, the carbon price needed for decarbonization as well as inflation.

## Adjust intervention approach

**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.**

Unsold allowances should not be reallocated to subsequent auctions.

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

We do not think that further alterations beyond what we've mentioned above (increasing the trigger with inflation and no reallocation of unsold allowances to subsequent auctions) are necessary.

## Risk 3: Sudden, significant and sustained price increase

### Policy options

**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, we agree with the assessment. In our view, it is not necessary to consider any other policy options besides retaining the Cost Containment Mechanism (CCM).

**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.**



In our view, it is not necessary to consider any other policy options besides retaining the Cost Containment Mechanism (CCM).

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

We believe the CCM should be retained with some adjustments, as described in our answers to the questions below.

### CCM trigger thresholds

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

Yes, we agree with retaining the current trigger threshold.

**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.**

We do not think that such adjustments are necessary.

### CCM trigger methodology

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

We think that the trigger methodology should be based on historical comparisons, as that would ensure that the mechanism evolves with the changing market conditions. We agree that an absolute trigger price would be significantly more interventionist and may impact price discovery and maintaining an effective carbon price signal.

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

No.

### Authority discretion and automation

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

The element of discretion, as currently introduced and implemented, creates considerable uncertainty regarding the CCM, which has a negative market impact as it is difficult for



market participants to factor in potential changes into their decisions. We would support retaining the element of discretion, provided that all decisions are properly explained and reasoned. Furthermore, the assessment criteria should be published to give market participants greater predictability.

Any decision to intervene must ensure a neutral impact on the cap via frontloading, preferably within the same year (bringing forward auctioned allowances from future years would also be acceptable, but it would be less desirable). We propose to discard other options, including auctioning allowances from the market stability mechanism account (as this would undermine the mechanism), the New Entrants Reserve (NER), the flexible share, or unallocated allowances from the Industry Cap.

**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.**

We encourage the alignment of the CCM rules with the EU ETS. We are also in favour of a partial automation in the process of releasing allowances (see [Article 29a](#)) while retaining a discretionary process in parallel (as in the EU).

A partially automated response in the form of a fixed amount of allowances with a small +/- percentage discretion would be helpful, as it would provide more predictability and reduce uncertainty.

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

Once the trigger threshold is reached, there should be a time limit for making a decision on whether to release additional allowances. Once again, this would give the market more visibility and predictability.

## The Reserve

**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?**

In our view, the Reserve should not be used for the CCM. In case the CCM is triggered, and a decision is made to release additional allowances, that should be done only in a cap-neutral manner, i.e., through the frontloading of allowances, preferably within the same year. Any action that may lead to an increase in the cap would undermine the system and market participants' confidence in the abatement signal provided by the UK ETS.

The Reserve should not be used for the SAM either, as the mechanism should be supplied from the allowances in circulation, depending on the activation of the trigger thresholds.

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The only possible use for the Reserve could be for mitigating the application of a Cross-Sectoral Correction Factor (CSCF) to support levels of free allocation. Otherwise, these allowances should be permanently cancelled to avoid the risk of them being used in the future to undermine the absolute cap.

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