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CARBON MARKET BUSINESS BRIEF

UK

UK ETS AT A GLANCE

Years in operation	Phase I: 2021-30, with reviews planned in 2023 and 2028
Overall cap & trajectory	The cap is set at 5% less than the UK's notional share of the EU ETS cap for Phase 4 (2021-2030). It started around 156 million allowances in 2021 and 1365 million allowances from 2022 to 2030. Currently a public consultation is being held on proposals to revise the UK ETS, including the cap. The UK ETS Authority considers a total cap for Phase I (2021-2030) of between 887 and 936 million allowances. Any revisions to the cap would take effect from 2024. Compared to the current cap for the whole phase, this would equate to a reduction of between around 30-35% over the course of the phase. The UK ETS Authority is inclined to set the cap towards the higher end of the range.
Target(s)	A 68% reduction in economy-wide GHG emissions by 2030 as part of its NDC. As part of the UK ETS review, the UK is planning to align the UK ETS cap and trajectory with its 2050 net zero target.
Emissions Reduced to date	Emissions within the current scope of the UK ETS have fallen from around 223 million tCO2e in 2013 to around 108 MtCO2e in 2021. The UK ETS only launched in 2021and so no assessment has yet been made of its performance in reducing emissions.
Sectors covered	• Power and heat generation • Industrial processes, including oil refining, steel works and production of iron, aluminium, metals, cement, lime, glass, ceramics, pulp, paper, cardboard, acids and bulk organic chemicals • Aviation
GHGs covered	CO_2, N_2O, PFCs
# of covered entities	1,008 installations
Allocation method	Auctioning is the default method, with free allocation to industrial sectors based on harmonised rules. In 2022, the UK is scheduled to auction 81 million UK allowances and distribute 42 million for free. The initial approach to free allocation (including benchmarks) closely resembles the EU's approach for the EU ETS Phase 4. Under the planned revision of the UK ETS, the industry cap will be based on a percentage of the total cap, instead of a fixed number.
Trading rules	N/A

Use of offsets and linking	The use of international credits for compliance is not permitted. The UK Government says it is ‘open’ to linking the UK ETS but so far no linking negotiations have been initiated.
Other features	Allowances can be banked indefinitely, meaning any historic vintage can be used for future compliance. It is also possible to borrow allowances from one year into the future if this is within a trading phase. It is not possible to borrow allowances between trading phases. The UK ETS auction reserve price sets a minimum bid price at auctions of £22, which establishes a minimum price at which allowances can be sold at auction. The Cost Containment Mechanism provides the option for the regulator to intervene if prices are elevated for a sustained period of time. This mechanism will have lower price and time triggers over the first two years of operation than the EU ETS equivalent. The final decision whether to intervene or not lies with the UK ETS Authority.
Penalties for non-compliance	A fine of £100/t, plus the outstanding allowances must also be surrendered by the next compliance window
Use of revenues	UK ETS revenue is not ring-fenced for climate and energy purposes.

MAJOR DEVELOPMENTS

The first compliance cycle of the UK ETS was completed in April, and preliminary results showed that emissions covered by the market rose 4% year-on-year to nearly 108 million tonnes, compared with a market cap of 155.7 MtCO2e. However, around 30 million UKAs were not issued in 2021, trimming the overhang to about 19 Mt.

In March, the UK ETS Authority launched a public consultation to align the UK ETS cap and trajectory with its net zero target. The Authority is seeking comments in several areas, including free allocation, market stability, unallocated allowances, expanding the scope and inclusion of carbon removal units. The consultation lasts until 17 June.

As to linking, although many have called for linkage of the EU ETS and the UK ETS, the two jurisdictions had not initiated negotiations by the time this briefing was published.

MARKET COMMENTARY

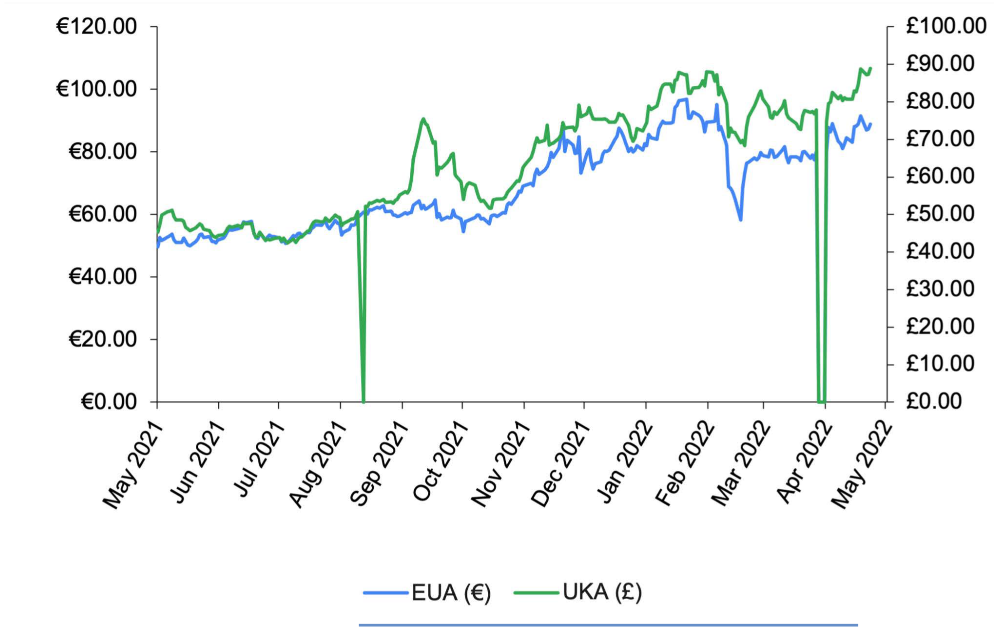

FIGURE 1
Front-December EUA and UKA Prices 2021-22

UK Allowance (UKA) prices traded roughly at parity with EU Allowances (EUAs) at the market's debut in May 2021, but began to develop a premium to the European market as market participants absorbed the UK ETS' inherent tightness of supply compared to its EU counterpart.

The early months of the market have been characterised by strong auction participation, as UK utilities looked to replace previously-acquired EUAs with UKAs. In recent months, a pattern has developed in which the UKA premium to EUAs shrinks in weeks when there is a UKA auction, and widens again in the intervening fortnight. This is thought to reflect the tight market but also the desire of utilities to swap EUAs for UKAs only when new supply is imminent.

As UKA prices rose along with EUA levels throughout 2021, speculation mounted as to whether the CCM would be triggered. This eventually happened in both December 2021 and January 2022 when the average daily settlement price in both months exceeded the government-set CCM "trigger" price.

However, in both instances the market regulator decided that the rising market price did not reflect an excessively tight market, but instead was following the strong trend in EUA prices, so no additional supply was injected to the market. It also said that this decision does not prejudice future decisions.

USEFUL LINKS

[Developing the UK ETS]

[Developing the UK Emissions Trading Scheme (UK ETS)]

[The Greenhouse Gas Emissions Trading Scheme Order 2020]

REFERENCES

UK Energy White Paper BEIS (2020)

The Future of UK Carbon Pricing HMG & Devolved Authorities (2020)

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