Special Report: UK ETS Authority provides response to UK ETS reform consultation

July 2023

UK ETS consultation response released

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UK ETS reform consultation finally concludes, setting out a pathway to net zero

Need to know

- The UK ETS cap will be reduced to put the UK ETS on a pathway to net zero by 2050:
    - the total number of Phase I allowances will now be 936Mt, down from 1,365Mt
    - the 2030 cap will become c. 50Mt vs 118Mt under current legislation
    - as a guide: 2022 verified emissions stood at 110Mt
- A 53.5Mt reserve of unallocated allowances will be created and utilised to:
    - avoid the need for a Cross Sectoral Correction Factor (CSCF) cut to free allocations in 2024 and 2025
    - protect against liquidity issues 2024 and 2025 due to the steep cap drop
- Industry’s share of the cap will increase to 40%, up from 37% to protect against carbon leakage
- Domestic shipping will be included from 2026 with Electricity from Waste and Waste Incineration also phased in from 2026-2028
- Free allocation to the aviation sector will be removed entirely by 2026
- New sectors will be included in the UK ETS, potentially squeezing available supply
- Potential for the inclusion of Greenhouse Gas Removals (GGRs) to be submitted in place of UKAs, subject to further consultation

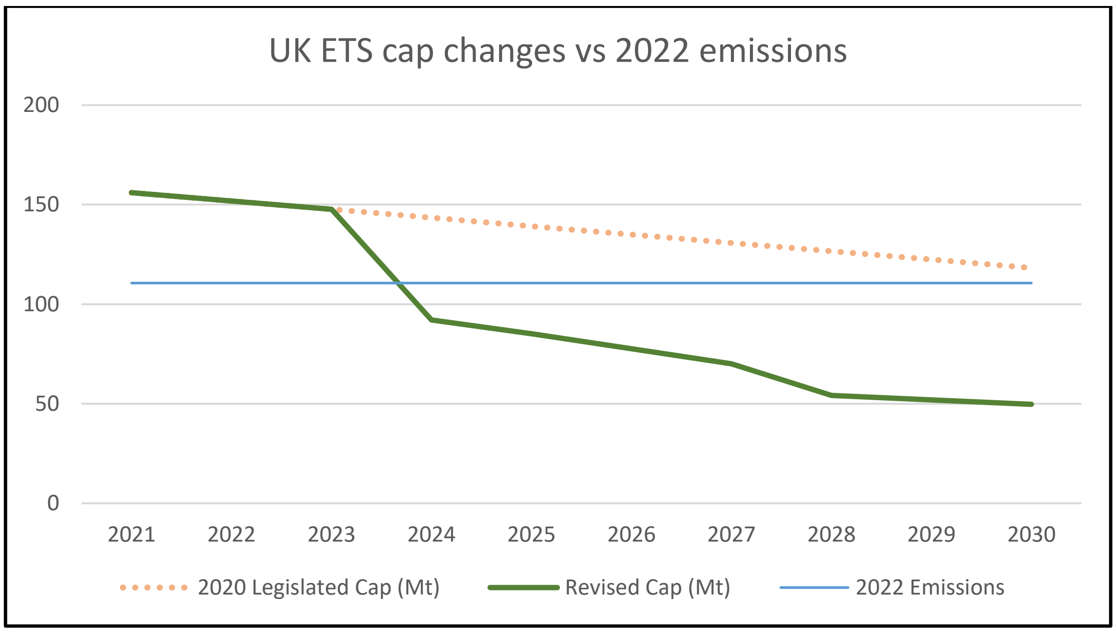
The UK ETS Authority, created by the government to manage the functioning of the UK ETS, have provided a response to the consultation they had started on the reform of the UK ETS. The consultation was opened in 2022 when the UK ETS Authority put forward a number of proposals for comment. Following responses from a wide variety of stakeholders, the UK ETS Authority has now decided on the amendments to be made to the system. Reform of the UK ETS is required to help put the UK on a net zero pathway and ensure that the UK remains at the forefront of the fight against climate change. The response provides details on the changes that will be made to the UK ETS and we summarise the most important changes for you below.

Cap changes will govern the net zero pathway

An emissions cap is the most crucial part of any ETS. It governs the number of allowances that are created and therefore creates a limit on emissions. To be effective the cap must decline over time, the speed at which it declines will depend on the start and end points, i.e.

base emissions and the emissions reduction target. The UK ETS Authority has decided to set the UK ETS cap at the highest amount proposed in the consultation of 936 Mt, which equates to a c.30% reduction from the current cap. The original proposal for the Phase I cap was between 887-936Mt, down from the current 1,365Mt. The cap will be adjusted with a one-off step change in 2024 with the cap then falling away over the remainder of the Phase such that by 2030 it will be c.50Mt (vs 118.2Mt under the current legislation). The chart below shows the steep drop in cap that will come as a result of this revision. It also shows 2022 verified emissions to illustrate the switch from long to short the market will soon go through.

Ultimately, a cap reduction will decrease the supply of allowances and almost certainly lead to higher prices.



Protecting UK industry

To protect industry from a sudden shortage of allowances created by the one-off cap reduction, the UK ETS Authority will be releasing 53.5 Mt of unallocated allowances between 2024-2027 to assist in the transition. This cushion will decrease the likelihood of short-term liquidity issues, especially in 2024 when 23.3 Mt of the 53.5 Mt extra allowances will be released to top-up the auction volumes. As part of the protection, the UK ETS Authority will also increase the percentage of the total number of allowances allocated to industry. Currently, the industry cap stands at 37% but this will be increased to 40% to help smooth the transition for UK industrials who otherwise would have extremely limited time to react to the tighter market. These changes will be implemented in 2024. A further protection measure will free up an estimated 2.5 million allowances from the reserve to protect against the possible need for a Cross Sectoral Correction Factor (CSCF) in 2024 and 2025.

There will also be a further consultation on technical changes to free allocation, which should be released by the end of the year. For now, two changes impacting free allocation have been announced:

1. A temporary change to the lime benchmark will be in place for two years which will increase free allocation by 10% from 1st January 2024,
2. Malt extract production will be included in the carbon leakage list, ensuring that producers get a higher and protected free allocation.

Increasing the scope of the UK ETS

As part of the revisions, the UK government also plans to include more of the UK's emissions under the UK ETS. A larger scheme presents many benefits including improved market liquidity, greater emissions reduction cost efficiency and an environmentally certain outcome for more of the emissions the UK produces.

Under the revision, process emissions from CO_2 venting from the upstream oil and gas sector will be included in the UK ETS. The threshold for inclusion of such an installation in the UK ETS will be emissions of 1,000 tonnes of CO_2 per annum. These processes include, but are not limited to, amine units, glycol units, selexol processes, absorption units, acid gas removal units, membrane technology and cryogenic methods. Further guidance is laid out in the consultation response.

The UK ETS will also expand into the domestic maritime sector. The expansion will be implemented from 2026 (in line with full inclusion in the EU ETS) and the UK government are minded to apply the scheme to vessels over 5,000 Gross Tonnage (GT). They will look to set out additional detail and aim to consult on key aspects later in 2023. One of the primary factors influencing the UK government decision on the maritime sector was a report by the Department for Transport which confirmed the current price of conventional marine fuel does not accurately reflect its environmental cost. Current estimates by the UK government suggest that shipping demand for allowances in 2026 will be around 2 million UKAs. The guidelines for the inclusion of the maritime sector are:

> Definition of a journey: Those journeys which start and end at the same port in the UK and those going from one UK port to another UK port. Emissions at sea and at berth in UK ports or at anchor will fall within the scope of the UK ETS.
>
> Point of Obligation: The Authority intends to apply the point of obligation to the vessel owner, or to whichever party has assumed responsibility for the operation of the vessel and the duties imposed by the International Safety Management (ISM) Code.

In addition to the maritime sector, the UK ETS Authority intends to include Energy from Waste (EfW) and waste incineration in the UK ETS fully from 2028 with a two-year phasing in period from 2026 – 2028. Like the maritime sector, they aim to consult on the implications of this position by the end of 2023. The obligation will be on the operators of waste incineration and EfW facilities. The government estimates there to be an initial demand of around 7 million allowances in 2028 from the EfW and waste incineration sector.

The cap will be adjusted to take into account the addition of sectors such as EfW, waste incineration and maritime into the UK ETS. Any increase to the cap will retain the same ambition in terms of the required emissions reductions.

The consultation response also explores the options for biomass in the UK ETS and is aiming for a full policy design for new UK ETS biomass sustainability criteria as soon as practicably possible, but it should arrive before the end of 2023.

Aviation sector to lose free allocation

In line with the EU ETS, the UK ETS Authority has decided to phase-out free allocation to the aviation sector by 2026. Aviation free allocation entitlements will continue to reduce at the existing fixed amount of 2.2% annually in 2024 and 2025 but will transition to full auctioning in 2026. In addition, from 2024, aircraft operators' free allocation entitlements will be capped at 100% of their verified emissions such that an aircraft operator cannot receive more free allocation than its emissions.

Given the possible impacts of the phase-out, and ultimate removal, of free allocation for the domestic aviation sector, the UK ETS Authority has expressed a plan to further assess and review this policy. They will ensure there is appropriate provision to support airlines and individual routes that are in danger of being lost, thus maintaining vital connectivity across the United Kingdom, especially in remote areas such as the Scottish Highlands. For example, this could include exemptions and policies outside of the UK ETS.

In addition to the free allocation changes, the UK aviation sector will also be subject to a Sustainable Aviation Fuel (SAF) mandate. The mandate will require at least 10% (c.1.2 million tonnes) of jet fuel to come from sustainable sources by 2030. The mandate will begin in 2025 and gradually increase the amount of SAF to be blended into the UK jet fuel mix. As part of the mandate, the UK ETS Authority will continue to consult on the treatment of SAF in the UK ETS. In the short-term, SAF will remain zero-rated in the UK ETS.

Inclusion of Greenhouse Gas Removals (GGRs)

The UK ETS Authority also intends to allow the use of carbon credits issued to engineered Greenhouse Gas Removal (GGR) projects in the UK ETS provided that they meet robust standards set by the Authority in the UK ETS. The consultation response alludes to the inclusion of high-quality nature-based GGRs as well. However, both nature-based GGRs and engineered GGRs will be subject to further consultation, an MRV regime being in place and management of wider impacts.

There are still many questions remaining for the integration of GGRs, such as the ambiguity in defining what a robust, high-quality credit is, the phasing-in schedule, the supply and scalability of removals, the interaction with the VCM and its impact on the UK ETS.

The Authority will aim to carry out the further consultation on the inclusion of engineered and nature-based GGRs in the UK ETS in 2023. This will address the design of the market, what market eligibility requirements need to be set and when inclusion may take place alongside other relevant considerations.

Questions remain

The big question concerning the UK ETS cap appears to have been answered, however, many questions remain such as: the details of EfW inclusion, how SAF will be handled under the UK ETS in the longer term, GGR inclusion and how future market policies might be updated to improve the existing cost containment mechanism, the auction reserve price and whether a supply adjustment mechanism is required. The government aims to provide further guidance on many of these issues by the end of 2023.

Redshaw Advisors' comment

The UK ETS Authority have finally outlined many of their plans for the UK ETS revision. The changes to the cap will dramatically alter the system's supply-demand balance in the coming years. Whilst several measures have been implemented to cushion the impact of expected price rises over the next two years and some surplus has been built up, the market will now switch back to an annual shortfall with it unlikely to ever be long (supply > demand) again on an annual basis. This is likely to have a dramatic impact on prices as the supply cuts bite and decarbonisation fails to keep pace. The small market and lack of liquidity make it particularly vulnerable to price spikes. We wait to see just how bullish the various price forecasting analysts become, and when they think it will impact the market but we are clear in our minds, the cap revision is bullish and we can expect the market to reflect this reality sooner rather than later. Whatever your short to medium term view of prices, current levels will look cheap within the next 2 years.. Action taken now to either decarbonise or hedge future exposure is likely to reap big rewards in the coming years.

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