UK STEEL – SUBMISSION TO THE UK ETS FUTURE MARKETS POLICY CONSULTATION

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To: ukets.consultationresponses@energysecurity.gov.uk

About UK Steel

UK Steel, a division of Make UK, is the trade association for the UK steel industry. It represents all the country's steelmakers and a large number of downstream steel processors.

Submission to the consultation on UK ETS Future Markets Policy

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

UK Steel welcomes the consultation and the opportunity to provide evidence on the design of the UK Emission Trading Scheme. The UK steel sector is committed to Net Zero and delivering on the Government's target, reducing emissions substantially over an accelerated timeline to mitigate contributions to climate change. UK Steel published our Net Zero Steel report in 2022, outlining potential decarbonisation journeys. A year later, both integrated steel producers have announced investment in electric arc furnaces (EAFs) or plans to switch to EAFs. This would reduce the industry's emissions by 80% by 2035. The steel industry is therefore committed to working with the Government to create a suitable business and policy environment, which will support the sector in decarbonising rapidly.

As the consultation makes many references to the incentive to decarbonise, it should be emphasised that the UK ETS fundamentally does not provide an incentive to decarbonise or reduce emissions for the steel sector. Steel is a global commodity, intensively traded across borders. In 2022, while 22% of all steel produced is traded internationally, this climbs to 39% in markets outside of China, and the UK exports 40% of its steel production and imports 55% of its direct requirements. UK steel import penetration (i.e., the percentage of steel demand supplied by imports) has climbed from around 12% in the 1970s to 55% in 2022 due to a rapid increase in global trade, the removal of tariffs on steel products amongst developed nations, manufacturing supply chain integration across the EU, and a gradual decline in the UK's overall steel production capacity. The UK imports its steel from an increasingly wide range of countries. Whilst the vast majority come from the EU, mainly due to geographic proximity and integrated supply chains, countries such as Turkey, India, South Korea, China, Vietnam, and Taiwan are all major exporters to the UK now – each supplying over 100,000 tonnes a year and with Turkey providing as much as 680,000 tonnes in 2022 – 12% of imports and 6% of total demand.

With such high levels of international trade in steel, simple mechanisms such as the UK ETS create an uneven playing field when those countries exporting to the UK have not applied comparable policies. Recouping carbon prices from customers is highly challenging, and almost without exception, customers will instead turn to imported products to keep their costs to a minimum. Without a CBAM, national carbon pricing would be better suited for sectors with no real alternative but to produce the product domestically, where consumers cannot readily turn to imported alternatives.

However, even with a UK CBAM, the UK ETS does not provide an effective incentive to decarbonise integrated steelmaking. When Tata Steel and British Steel switch from integrated production to electric arc furnaces, substantially reducing their emissions, they will not continue to receive similar levels of free allowances, which they can sell as part of the investment financing. Instead, the free allocation would be substantially cut as their new free allocations will be based on the EAF benchmarks. The steel industry cannot pass on the cost of carbon to their customers, nor the cost of decarbonisation due to the high trade intensity of the sector, and the UK ETS does not reward them for a switch to electric arc furnaces. It is, therefore, important to keep in mind that the UK ETS fundamentally does not provide an incentive to decarbonise or reduce emissions for the steel sector but instead increases the risks of carbon leakage and competitiveness.

Reforming the future market policies must, therefore, take into account that high carbon pricing does not incentivise industry to reduce emissions. Consequently, we do not believe that the key risks have been identified, as they assume that a high carbon price is a strong, sufficient, and essential economic signal for industry to decarbonise.

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.

Yes.

As outlined above, in addition to the risks outlined, the Authority must consider the risk of carbon leakage in designing the future market policies of the UK ETS and that the UK ETS does not incentivise trade-exposed industries, like steel, to reduce their emissions.

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.
No.

We do not believe that the UK ETS needs another mechanism to regulate carbon pricing for the following reasons:

1. Unbalanced mechanism: While we recognise that SAM policy could be activated in cases of both high and low UKA prices, evidence from the EU ETS shows that it will likely only be activated in the case of low carbon prices. As detailed in our response to the questions on the Cost Containment Mechanism, so far, the UK ETS Authority has only shown a willingness to increase UKA prices through the ARP and declined to act when sudden steep price rises triggered the CCM. It has demonstrated that the CCM does not work and cannot be trusted to reduce rising prices, indicating a potential bias of the UK ETS Authority. We would be concerned that the SAM would be one-sided only to increase prices.
2. Acceptable prices: The introduction of a SAM policy would suggest that there are acceptable carbon price ranges. The UK ETS is a cap-and-trade mechanism where the Authority sets the overall cap, and the market sets the price. Defining acceptable price ranges is too interventionist. If the UK ETS Authority wishes to do this, it should replace the UK ETS with a carbon tax.

For these reasons, we do not believe that a SAM policy is advisable and do not believe that the UK ETS Authority should introduce it.

Separately, it is not true that "decarbonisation investments are made based on long-term expectations of allowance prices and are therefore unlikely to be affected by any one year", as detailed in the response to question 1. It is concerning that the Authority is making such a stark assumption, which does not stand up to scrutiny. Decarbonising industrial manufacturing requires several policies in place and as evidenced earlier, carbon pricing alone does not incentivise reducing emissions. This is due to the steel industry's trade intensity, lack of ability to pass on costs to customers, and the nature of UK ETS benchmarks. For the steel sector, carbon pricing only reduces available capex for investment and generates revenue for the Government. The recent investment in EAF announced by Tata Steel has only materialised after direct co-financing, action to reduce electricity prices, and the commitment to introduce a CBAM. This is also the case wherever steelmakers invest in EAF, H2-DRI or CCUS in North America and Europe, where co-financing is the key policy mechanism to attract green investment rather than carbon pricing. We could encourage the UK ETS Authority to reassess its assumptions and analysis, as the above statement is not correct for trade-intensive industries like steel.

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 do not believe either option is preferable, as both have clear disadvantages. A price-based SAM would cement an acceptable price range for the UK ETS price to fluctuate between and remove the advantages of a market-based approach to carbon pricing. Furthermore, it would also duplicate the other price-based instruments, such as the CCM and ARP.

A quantity-based SAM will reduce liquidity and increase volatility, as it will be activated when the total number of allowances in circulation increases or decreases above the defined thresholds. Low liquidity is already a known issue for the UK ETS, and a quantity-based SAM would only exacerbate this. Furthermore, it will be a de facto price regulator, which defines acceptable price ranges.

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.
No.
See our answer to question 3.

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

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We are concerned that this will lower liquidity further in the UKA market, which is already too low due to its small size. Furthermore, introducing a quantity-based SAM would open the market up to manipulation and speculation. If the trigger mechanism is based on TNAC, then market participants could affect this to trigger the mechanism by buying/selling UKAs to reduce or increase the TNAC. This risk will be intensified as the overall allowances are reduced towards 2030, with the latter years having substantially fewer allowances up for auction and issued as free allocations.

7. If you disagree with the proposed approach, please suggest an alternative approach and your rationale for this?
We do not believe that the Government should proceed with the SAM and the quantity-triggered approach.

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.
Again, we would be concerned that this approach would reduce and limit liquidity and be prone to manipulation. The market should be able to function freely, and restricting market activity through a SAM policy would be inappropriate.

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.
No. We do not support the SAM policy.

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.
If the Government still introduces a UK ETS SAM, then it should be the least reactive possible to minimise the risk of market manipulation and illiquidity. The mechanisms (CCM and ARP) should be able to step in in cases of very high or very low UKA prices.

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.

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.
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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 do not support the introduction of a UK ETS SAM. However, if one is introduced, its triggers must be relative, as absolute triggers would significantly increase the risk of manipulation and market illiquidity as the annual cap number and auction volume substantially decline towards 2030.

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.
These should be minimal, considering the low liquidity in the UKA market, and incremental steps must be taken.

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

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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.

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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.

We do not support a UK ETS SAM. But should one be introduced, it would be appropriate to introduce it in 2027 alongside the UK CBAM. We believe that all these policies must be coordinated and adopted in parallel.

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.

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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.
No.

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.

We believe that the current ARP is the right tool to ensure a minimum price in the auctions while also providing the necessary flexibility around auctions and allowances.

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.

It would not be appropriate to introduce further policies to protect against low prices, and this would change the balance of policy interventions in the market. The two existing policies (CCM and ARP) have ensured that prices have remained above the minimum price level of £22/UKA as set out by the Government.

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.
No.

We do not believe it would be appropriate to change the ARP, as this would interfere with the market operation and efficient price discovery, as laid out in the consultation document. The Government has consulted upon the overall cap of the UK ETS and should let the market find the appropriate carbon price, apart from the existing ARP level and CCM mechanism.

If the Government wishes to change the ARP, we would question why the Government introduced a UK ETS over a carbon tax. A market-based approach allows the market to determine the carbon price over the Government, and the Government decided that this was the best approach to carbon pricing. Increasing the ARP further would suggest that the Government would be more comfortable with a politically determined carbon price, which has its own advantages and disadvantages.

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.
It should remain static, as it is a reserve price. It is the minimum expected price and is sufficient to provide a long-term signal.

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.
No.

28. Are there any other ways the Authority could alter an ARP to make it more effective? If so, please explain these alterations.
No.

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

In its current form, the CCM has lost credibility and is not viewed as an effective or reliable mechanism due to the decision not to take any action in December 2021 and January 2022. The two events occurred after substantial price increases, where UKA prices eventually reached £90/UKA, significantly higher than previous price levels. Despite such high prices, the UK ETS Authority declined to intervene, causing great uncertainty around the effectiveness of the CCM. It also created an appearance of bias of the Authority in support of higher prices, despite the Authority insisting that it did not wish to determine the UKA price. Considering the intention to retain the ARP in its current form, where no discretion and a fixed price floor is applied, it would only be appropriate to reform the CCM to remove the discretion in its current form.

We would also note that the CCM in its current form does not follow the principles set out at the beginning of the UK ETS consultation, where the UK ETS Authority states that the scheme should "Provide long-term reassurance to participants with a rules-based approach to any Authority intervention". The CCM does not follow this principle, as the discretion built in and the decision to not take any actions the two times it was triggered suggest that the CCM is instead politically driven, rather than explicit rules and transparency of decision-making. Instead of instilling confidence in the Authority and the ETS market, the discretion creates uncertainty and a lack of trust.

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

As stated in the consultation document, the current trigger threshold will be harder and harder to trigger despite substantial price increases. For example, a price increase from the current £40/UKA to £110/UKA within six months would not trigger the CCM despite representing the biggest absolute price increase in the scheme's history or carbon pricing in the UK. At current price levels, the CCM is already largely redundant and unlikely to be triggered.

Furthermore, the CCM is much less reactive than the other proposed market mechanisms. The CCM triggers are very high, i.e. three times the average price in the preceding two-year period for six consecutive months, whereas the ARP is fixed, without equivalent low trigger points. The CCM is also a relative mechanism, where the triggers change, unlike the ARP, which is an absolute. This again creates an unbalanced approach to market interventions, where the mechanism to prevent low prices is absolute and without discretion, whereas the mechanism to avoid sudden, steep price increases is relative, with moving triggers and discretion not to intervene if the Authority decides.

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 recommend changing the multiplier from three to two times the average price, making the mechanism more reactive to sudden price increases. In the example above, where the UKA price increased from the current £40/UKA to £110/UKA within six months, the CCM would be triggered, and the Authority could increase the supply of UKAs to impact the price indirectly. However, we do note that this would still leave the CCM based on relative triggers with Authority discretion, unlike the ARP, and retain the unbalanced approach to market intervention.

We do not have an opinion on whether the length of the trigger periods or reference period should be changed.

34. Do you believe the CCM trigger methodology should be based on historical comparisons or a fixed price? Please provide any supporting evidence.
To provide a balanced approach to market intervention, the CCM trigger methodology should be based on fixed prices, like the ARP. The current unbalanced approach, where one mechanism has a fixed price and no authority discretion and the other relative triggers and Authority discretion, leaves a clear message of bias of the Authority in support of high carbon prices.

If carbon prices increase, a historical comparison will, in effect, leave the CCM redundant and ultimately ineffective, even if the multiplier was changed. In a case where UKA prices rose from £100/UKA to £190/UKA, the CCM would not be triggered, despite the substantial price increase. Not changing the triggers now is designing it to be obsolete. We strongly encourage the Authority to change the methodology.

35. Are there alternative methods we should consider when setting the CCM trigger price? Please provide any supporting evidence.
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36. Do you believe that the CCM should retain discretion in its decision-making process? (Yes/No). Please provide any supporting evidence.
No.

In accordance with the UK ETS principles, the UK ETS should "Provide long-term reassurance to participants with a rules-based approach to any Authority intervention". The CCM discretion does not provide this and is inappropriate. Market participants need certainty and transparency, two critical values of good Governance.

As stated earlier, the CCM in its current form has lost credibility and is not viewed as an effective or reliable mechanism due to the decision not to take any action in December 2021 and January 2022. The two events occurred after substantial price increases, where UKA prices eventually reached £90/UKA, significantly higher than previous price levels. Despite such high prices, the UK ETS Authority declined to intervene, causing great uncertainty around the effectiveness of the CCM. It also created an appearance of bias of the Authority in support of higher prices, despite the Authority insisting that it did not wish to determine the UKA price. The Authority did not lay out its assessment, the evidence behind the lack of action, and how it arrived at this conclusion, creating further distrust in the Authority and uncertainty in the market. Considering the intention to retain the ARP in its current form, where no discretion and a fixed price floor is applied, it would only be appropriate to reform the CCM to remove the discretion in its current form. As no discretion is deemed necessary for the ARP, why is it deemed necessary for the CCM?

Creating clear, rule-based, transparent triggers without discretion will reestablish trust in the CCM and create a balanced approach to the UK ETS market.

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.
It should have a fully automated response, as this would create clarity of the outcomes following a CCM trigger, allowing participants to plan, better internalise the supply implications of a potential trigger, and make investment decisions on that basis.

38. Are there any other design changes not listed above that would improve the effectiveness of the CCM?
If the Authority still intends to retain its discretion, despite industry recommendations against this, it should, as a minimum, be forced to outline in detail its assessment of why it took (or did not take) the action it did, evidence this decision, and how it arrived at this conclusion. This would help recreate some trust in the CCM and the Authority's decision-making process. Of course, a rule-based approach with automatic triggers and actions is considerably more preferable.

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?
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For further information, contact:
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