THE INVESTMENT ASSOCIATION

Response to the UK ETS Authority consultation on future markets policy

MARCH 2024

We welcome the opportunity to respond to the UK ETS Authority's consultation on future markets policy.

The Investment Association is the trade body that represents UK investment managers. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £8.8 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 48% of this is for overseas clients. The UK investment management industry is the largest in Europe and the second largest globally.

As investors, IA members recognise that climate change poses significant risks and opportunities for clients, investee companies, and the wider economy and society. Considering climate risk in investment is a fiduciary responsibility and a potential driver of long-term value creation. Climate risk can affect the performance and prospects of companies across sectors and regions.

Carbon markets are a key instrument to enable the transition to a low-carbon economy. They provide a mechanism to put a price on carbon emissions and incentivise the reduction of greenhouse gas emissions across sectors and geographies. Carbon markets can also mobilise finance for climate action and support innovation in low-carbon technologies and practices. By establishing mechanisms to adequately and appropriately price climate risk, investors can allocate capital more efficiently and effectively towards activities that reduce carbon emissions and increase climate resilience and assess and manage their exposure to physical and transition risks arising from climate change.

As a founding member of the EU ETS, the UK has played an important role in the development and implementation of the world's largest carbon market. The UK has contributed to the design and reform of the EU ETS, including the introduction of the Market Stability Reserve (MSR). The decision to introduce the UK ETS on leaving the EU reflects the UK's continued commitment to carbon pricing as a policy instrument to achieve its net zero goal by 2050. We support the UK's efforts to maintain a strong and credible carbon pricing regime that can incentivise emission reductions across the economy and has the potential to foster collaboration and cooperation with other jurisdictions.

As the UK ETS Authority refines the operation of the market for emissions trading in the UK, we encourage you to consider the following matters:

- Investors regard a carbon market that is stable and reliable and without excessive price fluctuations as an essential policy tool for the mobilisation of private capital at the scale and speed required to

The Investment Association

Camomile Court, 23 Camomile Street, London, EC3A 7LL
www.theia.org

paul.scaping@theia.org

achieve a shift to a low-carbon economy in line with the UK's climate goals. **As a policy tool, carbon markets are exposed to any regulatory and policy uncertainty which might exist in the same jurisdiction**, and this uncertainty can lower investment. Investors report a lack of confidence and low participation in the UK ETS as contributing to a failure to set an adequate price signal to encourage investment aligned with the UK's decarbonisation targets. In 2021, a BEIS policy paper sought to identify a carbon value for policy appraisal purposes which would be consistent with the UK's domestic and international climate targets. This paper suggested a carbon value in 2024 of £128-384 per tonne of CO2 (in 2020 prices), a value well above the current UK ETS price.[1]

- It therefore appears **necessary for the UK ETS to enhance its market management features if the UK Government wishes to avoid an excessively low price and ensure a consistent long-term price signal aligned with the UK's decarbonisation targets**. As such, we welcome the UK ETS Authority's intent to bolster the market management features of the UK ETS, including through the auction reserve price, supply adjustment and cost containment mechanisms.
- Currently, there is a significant divergence between the UK ETS and the EU ETS prices, which reflects different levels of supply and demand in each market, but also different expectations and uncertainties about their future trajectories. **It is important to monitor and analyse the drivers and implications of the price divergence between the UK ETS and the EU ETS, and to consider the potential benefits of convergence between the two markets in the future.** While the stated intent of this consultation is not to achieve such convergence, we welcome the consultation's recognition of effective features of the EU ETS and willingness to learn from them.
- **Greater alignment between UK and EU ETS prices should reduce the risk of carbon leakage and support the competitiveness of the low-carbon sectors across Europe.** Cooperation between neighbouring markets and major trading partners could send a consistent carbon price signal to support the integration of energy markets and the development of cross-border infrastructure projects, increase opportunities for innovation, and improve the efficiency and security of the energy supply.
- **Alignment between UK and EU ETS prices could ultimately strengthen the credibility and stability of the carbon market and increase its resilience to external shocks.** By having a larger and more liquid market, the price volatility and uncertainty would be reduced, and the long-term investment signals would be clearer.
- **Any approach which is developed to allow the Government to intervene in the UK ETS markets must be rules-based**, rather than relying on discretionary decisions that may create uncertainty and instability for market participants. A rules-based approach would specify in advance the conditions under which the Government would adjust the supply of allowances, such as the price level, the volatility, or the deviation from the emissions reduction trajectory. This would enhance the credibility and predictability of the UK ETS.
- It is important to remember that the UK ETS is intended to be a market-based mechanism that aims to provide a transparent and efficient way of pricing carbon emissions and incentivising emission reductions. While it is important to have some interventions to ensure the smooth functioning and stability of the market, including the cost containment mechanisms and the auction reserve price, **it is also crucial to preserve the market dynamics and allow the price discovery process to reflect the supply and demand of allowances**. Excessive or arbitrary interference with the market could undermine the credibility and effectiveness of the UK ETS and distort the price signal for low-carbon investment and innovation. As above, any approach to adjust the supply of allowances should be based on clear and objective criteria and be consistent with the long-term emissions reduction targets and the net zero goal.

[1] BEIS, 'Valuation of greenhouse gas emissions: for policy appraisal and evaluation', September 2021.

- While carbon pricing can be a useful tool to support climate transition, it will generate a need for ambitious and immediate emission reductions across sectors and regions. **Companies will need to prioritise reducing their own emissions and investors must consider how they align their strategies and portfolios with the net zero trajectory**, as well as supporting and engaging with companies that are committed to broad and systematic emissions reduction. Carbon markets will provide an incentive to pursue science-based emissions reduction efforts on the path to net zero, and not to avoid or delay the necessary transformation of the global economy towards low-carbon transition.
- Policymakers across all administrations which form the UK ETS Authority must not regard the creation of compliance carbon markets as an alternative to the broader work required to create incentives and support innovation and investment in low-carbon solutions, including the blending of public and private sources of capital. Indeed, such policy interventions can help to develop outlets for investment where the UK ETS has disincentivised activity with high emissions. It is essential for policymakers to **provide clear and predictable policy roadmaps that indicate the course and pace of change** that will be followed in the transition of the global economy towards net zero.
- We wish to highlight a recent report produced by the thinktank IPPR with contributions from the Green Finance Institute. The report, **'Making Markets: the City's role in industrial strategy', sought to identify what factors might be limiting private sector growth and decarbonisation**. Through interviews with market participants, the report identified a clear sense of a lack of direction or coordination from government in addressing cross-sector challenges and a need for long-term clarity on policy pathways to build investor confidence.[2] The report made recommendations to address these concerns which fall outside of the scope of this consultation, but which should be considered by UK ETS Authority members.
- In designing and implementing an effective carbon pricing scheme it is important to consider the impact of the policy on people, especially those who are employed in the sectors that are most affected by the transition to a low-carbon economy. **Carbon pricing can create winners and losers, depending on how the revenues from the scheme are used and how the costs are distributed across different groups of society.** Policymakers should have mechanisms to assess the potential social and economic consequences of carbon pricing, such as the effects on employment, income, poverty, inequality, and regional disparities.
- **It will be necessary to design measures outside of the UK ETS to mitigate the negative societal impacts** and enhance the positive ones, such as providing support for workers who need to reskill or relocate, compensating low-income households for higher energy prices, and investing in green infrastructure and innovation. These measures can not only improve the efficiency and fairness of the carbon pricing scheme, but also increase its public acceptability and political feasibility.
- **The enhancement of the UK ETS, alongside the introduction of a Carbon Border Adjustment Mechanism, will impact on other countries, including those outside of Europe that are important partners for the UK in the global transition to a low-carbon economy.** Policymakers should have mechanisms to assess the potential cross-border effects of carbon pricing, such as the effects on trade flows, investment patterns and environmental integrity. It may be necessary to provide support for low-carbon development and cooperation in emerging markets, facilitating technology transfer, and aligning standards and regulations across countries. These measures can not only improve the efficiency and fairness of the carbon pricing scheme, but also increase its international legitimacy and compatibility. The UK should seek to engage with these countries in constructive dialogue and collaboration and consider supporting these countries in developing their own domestic carbon pricing schemes and integrating them into regional and global carbon markets.

[2] IPPR, 'Making Markets: the City's role in industrial strategy', February 2024.