IETA
CLIMATE CHALLENGES
MARKET SOLUTIONS

Carbon pricing options for the UK following EU Exit

December 2018

Summary

Ahead of the UK's exit from the European Union in March 2019, the Government is considering four options for future carbon pricing in the UK:

1. The UK remains in the EU ETS
2. The UK creates a domestic carbon market that links to the EU ETS
3. The UK creates a standalone domestic carbon market
4. The UK transfers its carbon pricing commitment to the tax regime

The members of the International Emissions Trading Association (IETA) strongly support retention of a carbon market with a preference for options 1 or 2 listed above. A carbon market mechanism has the benefit of being able to guarantee the delivery of internationally agreed climate targets at lowest cost. In contrast, a carbon tax will introduce competitive distortions, will not provide certainty over future pricing levels and will not guarantee that the correct amount of emission reductions take place for the UK to meet its carbon targets.

IETA also supports the view of both the UK Government[1] and European Commission[2] that the UK's 2019 auctions and free allocation to industry should be postponed in the event that there is still uncertainty by the start of 2019. Having marked UK issued allowances in circulation, which could be invalidated under a no deal EU exit, risks creating a two-tiered market with associated distortions.

We call on the UK Government to complete all necessary preparations, both internally and with European partners, to ensure any carbon market disruption associated with EU exit is minimised.

The benefits of a market-based approach to carbon pricing

Cap-and-trade is the best method of implementing a carbon price because it meets two key requirements for any government policy; it is capable of delivering its objective and it is highly cost-efficient. It is also currently in place, has an excellent compliance record[3] and is well understood by industry, competent authorities, traders and independent verifiers.

A cap-and-trade system guarantees the delivery of the climate objective because the supply of allowances into the market is determined by the cap, which is calibrated to the climate target. Policy

1 Consultation on bringing forward EU ETS 2018 compliance deadlines in the UK. BEIS, November 2017
2 Preparing for the withdrawal of the United Kingdom from the European Union on 30 March 2019: A Contingency Action Plan. European Commission, November 2018
3 For 2016, the application of excess emissions penalty was reported for only 14 installations across the whole market. Report on the functioning of the European carbon market, European Commission, November 2017

makers therefore have certainty that the environmental targets they have agreed to will be achieved. This approach also means that emission reductions will occur at least-cost. The market establishes a price that reflects the marginal cost of abatement needed to deliver the carbon target. Installations that have abatement costs below the market price are incentivised to reduce emissions, and those that have abatement costs above it will buy allowances. Ultimately, this will reduce emissions in the most economically efficient manner, thereby lowering the overall cost of decarbonisation.

Cap-and-trade is also the best approach for the companies that are part of the market. Firstly, it creates a uniform price, meaning that all companies in the market operate on a level playing field. Secondly, it establishes a set of harmonised rules to mitigate the risk of carbon leakage and maintain economic competitiveness. Thirdly, it integrates easily into the business models of the companies in the market. As an example, power companies sell electricity on a forward basis for delivery in the future. At the same point in time, they also buy input fuels and emission allowances on a forward basis to lock in a profit margin and provide certainty over future cash flow. This means they can manage and hedge future market risks – directly as a result of being able to access a market as liquid as the EU ETS. Therefore, a market-based carbon price efficiently integrates into the way they operate their business because it is similar to the markets in which they buy and sell their inputs and outputs.

Maintaining a market-mechanism in the UK following EU Exit

The Government has various options to maintain a market-based carbon price in the UK following EU exit. If an exit deal is agreed, the UK has already stated that it will remain in the EU ETS until the end of 2020. IETA would support a continuation of the UK's participation in the market beyond this date. We note that a coalition[4] of 10 leading energy companies (some of whom are IETA members) and trade associations have called for the UK to remain in the market until at least the end of Phase 4. This approach would be similar to Norway, Lichtenstein and Iceland who are not EU Member States but participate in the market.

One challenge with remaining in the EU ETS following EU exit is the legal oversight of the market. The majority of participating countries fall under the jurisdiction of the European Court of Justice (ECJ). However, we note that non-EU countries defer to the European Free Trade Agreement court on EU ETS matters. Therefore, recognition of the ECJ is not a requirement for participating in the market – with this information the UK Government should consider its options for EU ETS participation that are available to them.

An alternative to remaining in the EU ETS is to set up a linkable domestic UK market. This option would be similar to the Swiss approach, who have a domestic carbon market and are currently undertaking modifications to link to the EU ETS in 2020. This process should lay the groundwork for other markets to link to the EU ETS in the future and will make it easier should the UK choose this option following EU exit. Another simplifying feature of this option is that the Secretary of State already has the powers to create a UK carbon market under both the 1999 Pollution Prevention &

4 https://www.euractiv.com/section/climate-environment/news/uk-eu-urged-to-continue-energy-and-climate-cooperation-after-brexit/

Control Act and the 2008 Climate Change Act. This means that no primary legislation would be needed to set up a UK carbon market.

Challenges and disadvantages of a UK carbon tax

Alongside recognising all the benefits of a market based approached described above, IETA members have significant concerns about a UK carbon emissions tax which will be implemented from April 2019 should no EU exit deal be negotiated.

Firstly, there is a risk that a tax will not deliver the correct amount of emission reductions necessary to reach UK carbon targets. Setting the tax at the right level to ensure that the UK does not over or under achieve against its targets is very difficult. IETA notes the example of the Swiss carbon tax which was introduced in 2008 at CHF 12/tCO2 and is automatically adjusted higher if climate targets are not reached. The tax has consistently had to be raised as targets have not been met, and it currently stands at CHF 96/tCO2. This represents a 14% increase from the previous year.

Secondly, a tax will not provide industry with certainty over future pricing levels. One of the aims of the UK Carbon Price Support was to deliver Total Carbon Prices in a predictable trajectory to reach £70/tCO2 in 2030[5]. Within one year of being implemented the Government announced a deviation from this long-term trajectory to limit competitive disadvantage. Experience shows that, because taxes are highly politicised, no Government can provide long-term certainty over their future levels. This contrasts sharply with a market approach to carbon pricing. Whilst a market price may fluctuate, the ability to buy allowances on a forward basis from a liquid market such as the EU ETS means that companies can lock in future costs and manage their market risks on a continuous basis.

Finally, implementing a carbon tax will introduce competitive distortions in many markets which will ultimately increase costs. As the EU ETS is a market its price is variable, and it has fluctuated significantly during 2018 as participants prepare for the Phase 4 reforms, notably the start of the Market Stability Reserve. If a UK carbon tax is implemented, IETA would support measures to try to align the tax level with the EU ETS. However, it is still very likely that it will differ from the EU ETS price most of the time, potentially by £10 or more. This will create significant distortions in several areas. For instance, UK industrial installations whose emissions exceed their free allocation will need to pay the tax. Depending on the whether the tax is higher or lower than the EU ETS price will lead to unpredictable benefits or disadvantages to UK industry. Ultimately though it will create competitive distortions which will increase costs.

UK issued allowances in 2019

IETA also supports the view of both the UK Government and European Commission that the UK's 2019 auctions and free allocation should be postponed if there is still uncertainty over the UK's participation in the EU ETS by the start of 2019.

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[5] Carbon price floor: support and certainty for low carbon investment. HM Treasury, December 2010

If there is still uncertainty by this time, and UK auctions and free allocation go ahead in Q1 2019, any allowances issued by the UK will be marked so that they can be invalidated in the event of a no-deal exit from the EU. IETA members would be very concerned by this potential development as it would lead to a two-tiered market which would create distortions. For instance, UK issued allowances may trade at a significant discount on the secondary market, and there may be a high risk of UK auctions failing as stakeholders choose not to participate in them.

We also believe a temporary pause such as this would not cause significant disruption to the market; free allocation to industry only needs to occur by February of each year and delays have occurred in the past, and a pause in auctioning is not unprecedented. For example, German auctions scheduled for the end of 2018 have been postponed until Q1 2019.

IETA calls on both the UK Government and European Commission to confirm that UK auctions and free allocation will be postponed if there is still uncertainty regarding the UK's participation in the market by the start of 2019.

Conclusions

The EU ETS currently provides many benefits to both the UK Government and UK industry, namely:

- It guarantees the delivery of internationally agreed climate targets;
- It delivers emission reductions at least-cost, and;
- It establishes a uniform carbon price across Europe, thereby creating a level playing for all participants and helping to maintain economic competitiveness.

The UK can choose to maintain all these benefits following its exit from the EU in March 2019. For these reasons, IETA and our members strongly support the UK either continuing to participate in the EU ETS or creating a linkable domestic UK carbon market.

IETA also supports the preference of both the UK Government and European Commission to postpone its 2019 auctions and free allocation to industry until there is further clarity on the UK's situation. Having marked UK issued allowances in circulation, which could be invalidated under a no deal EU exit, risks creating a two-tiered market with associated distortions. IETA calls on both the UK Government and European Commission to confirm that UK auctions and free allocation will be postponed if there is still uncertainty regarding the UK's participation in the market by the start of 2019.

IETA stands ready to assist the UK Government and European institutions in ensuring any carbon market disruption associated with the UK's exit from the EU is minimised.