IETA Response: Future of UK Carbon Pricing

July 2019

This document forms the response from the International Emissions Trading Association (IETA) to the UK Government's and the Devolved Administrations' public consultation on the Future of UK Carbon Pricing. We welcome the opportunity to respond on this important topic.

Overview

IETA welcomed the recent announcement from the UK Government to adopt a 2050 net zero emissions target. As the first G7 nation to legally commit to a net zero target, the UK is demonstrating global leadership on climate change. IETA is also very pleased that the UK Government and the Devolved Administrations' have expressed a strong preference to put in place a domestic carbon market, that includes aviation and is linked to the EU ETS, at the centre of its climate policy. Cap-and-trade systems have the benefit of being able to guarantee the delivery of internationally agreed climate targets at lowest cost, and linking a UK market to the EU ETS will ensure a level playing field, thereby helping to maintain economic competitiveness of UK installations post Brexit.

IETA is in favour of the development of larger carbon markets and seeks to avoid disruption to UK and EEA operators in the EU ETS, so our response focuses around the need to establish the link to the EU ETS. We believe this is the most important consideration for UK ETS market design and discussions with the European Commission. This is because:

- A link is the only way to ensure carbon prices in the UK remain the same as in Europe, thereby helping to maintain the economic competitiveness of UK installations post-Brexit.
- A stand-alone UK market will not be sufficiently deep or liquid to allow genuine price discovery
- Any delay in the formation of a link will make it harder to establish one in the future.

Further detail on these points is provided in the sections below.

Maintaining economic competitiveness

IETA supports closer collaboration with countries and regions to work together to raise climate ambition, under the umbrella of the Paris Agreement. Ultimately, equal ambition and close cooperation will be the best way to maintain economic competitiveness whilst delivering the Paris Agreement targets. For this reason, IETA strongly supports a UK ETS that:

- Has a market design which is similar to the EU ETS, with alignment on key parameters such as its cap and Monitoring, Reporting & Verification (MRV) requirements; and
- Is linked to the EU ETS.

These two points are clearly related. Ensuring a similar market design to the EU ETS will in turn make it easier to quickly establish a link. These two factors will help ensure carbon prices in the UK remain the same as in the rest of Europe, thereby helping to maintain the economic competitiveness of UK installations post Brexit. In the absence of a link, it will not be possible to create a level playing field as carbon prices will differ. This will create competitive distortions which will ultimately increase costs. It will also put at risk the ability of the UK energy market to transition smoothly into a close post Brexit energy relationship with the European Union.

Market depth and liquidity

IETA also has concerns that in a stand-alone system, the market would not be sufficiently liquid or deep to enable genuine price discovery. In a UK ETS, the majority of trading is expected to take place amongst the power sector as it would receive no free allocation and would need to purchase all of its allowances. This is how the EU ETS currently operates and it means that the industrial sectors are far less active in the market.

During the 2020s, emissions from UK power generation are expected to continue declining rapidly, due in part to developments such as a coal phase out by 2025 and the completion of several GW scale low carbon installations such as Hinckley Point C and the UK's offshore wind pipeline. This would mean that over the course of the 2020s, the number of participants active in the market, and the volumes of allowances being purchased, may not be sufficient to maintain a deep and liquid market that enables genuine price discovery. It is important to take these developments into account as the market design will need to be appropriate for the coming decade and not just the immediate period post Brexit.

Consequently, IETA strongly supports linking a UK ETS to the EU ETS. In 2018, 7.8 billion allowances were transacted in the EU ETS[1], making it – by some distance – the largest and most liquid carbon market in the world. It is vital that UK installations have access to this market in order to drive decarbonisation in a cost-efficient manner that maintains the economic competitiveness of the UK economy post Brexit.

Sequencing of linking negotiations and market design

Given the importance of linking to the EU ETS, IETA feels that this must be the Government's number one priority in the development of the UK ETS and in discussions with the European Commission. Our members are concerned that if linking is not the priority there will inevitably be a period of time before negotiations start. This will mean that:

- It will become harder to establish the link as the European Commission will have other priorities to focus on, such as the MSR review, implementation of CORSIA and a potential EU ETS review after the first Paris Agreement global stocktake. Any delay in commencing the negotiations will make the link harder to secure.
- The market designs of both the EU ETS and a UK ETS could diverge. Again, this would make linking harder as there will need to be alignment on key market design parameters. Given that the UK is starting from a position of total alignment (being a current member of the EU ETS), it will be considerably easier to establish the link at the earliest possible opportunity.

IETA also feels that both the UK and European Union are perfectly positioned to establish a link quickly as the groundwork has been laid by the process of creating the link to the Swiss ETS. This

[1] Carbon Market Year in Review. Refintiv, January 2019

is at the final stage of completion, with both Parties expected to deposit instruments of ratification in the coming months, before the link starts in 2020. The knowledge gained from this process will make the establishment of subsequent links quicker and easier.

IETA also notes that delays to the establishment of the Swiss link have been caused by a variety of non-climate policy issues and the need to align the Swiss ETS with the design of the EU ETS. Neither of these issues will apply to the UK's situation and in terms of carbon market design, the UK is already perfectly aligned as it is still a member of the EU ETS and the UK ETS design proposals do not propose to significantly diverge from this.

Therefore, the time taken to establish the Swiss link is not reflective of how long it should take to establish a UK link. Instead, IETA is confident that it can be ready in time for a potential start of a UK ETS in January 2021. IETA views that any delay to linking negotiations should see the UK continue in the EU ETS, rather than the sub-optimal introduction of a stand-alone UK ETS or Carbon Emissions Tax (CET).

Conclusions

IETA is very pleased that the UK is looking to continue its support of carbon market mechanisms by placing an ETS at the centre of its climate policy. Cap-and-trade systems have the benefit of being the most cost-efficient, equitable and effective of the various policy tools available to deliver widescale decarbonisation across economies.

However, many of these benefits might be strongly diluted in a stand-alone UK carbon market. For these reasons, IETA believes establishing the link to the EU ETS must be the top priority in the development of the UK ETS and in discussions with the European Commission. We stand ready to assist the UK Government, Devolved Administrations and European institutions in delivering this.