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To:
The Rt Hon Alok Sharma MP
Secretary of State, Department for Energy, Business, & Industrial Strategy

22 June 2020

Subject: The future of carbon pricing and emissions trading in the UK

We would like to thank the Department for Business, Energy and Industrial Strategy (BEIS) for sharing with us the Government and Devolved Administrations' response to last year's consultation on the future of carbon pricing and emissions trading in the UK.

We welcome this policy proposal, and we support the Government's efforts to ensure that the UK ETS cap is in alignment with 'Net Zero'.

However, we are concerned that there remains a lack of clarity as to the UK's future approach to carbon pricing and emissions trading come the end of the transitional arrangement.

The basic principles of continuity and predictability of carbon pricing are key for preserving well-functioning electricity, gas and emissions markets in the UK. The prevailing uncertainty about the future of carbon pricing and emissions trading in the UK post Brexit has been having a negative impact on the supply and demand balance in the market and on the ability of firms to hedge their risks.

The terms of the Withdrawal Agreement made clear that the UK will remain in the EU ETS market until the end of 2020, in addition to the Government's intention to establish a UK ETS with Phase I running from 2021-2030. The recently published proposals on the Future of UK Carbon Pricing go one step further, yet there remain significant issues which warrant discussion.

We note that in the recently published proposals the UK Government announces that it will publish a separate consultation on the design of a Carbon Emission Tax as an alternative to a UK ETS, "to ensure a carbon price remains in place in all scenarios."[1]

It is therefore unclear to us whether A: The Government is deciding between an ETS or Tax, B: The Government is proposing this as a back-up in case of issues with an ETS, C: The Government believes that an ETS will not be ready by 2021, and therefore an interim Tax is required.

We firmly believe that **a well-functioning UK ETS closely linked with the EU ETS from the outset constitutes the most cost-effective means of achieving the UK's target for net zero carbon emissions by 2050**.

A UK-EU ETS link is therefore a necessity, not just an option. It will give companies long-term visibility, clarity, and predictability, which is especially relevant for energy-intensive industries and power generators.

[1] The future of UK carbon pricing, UK Government and Devolved Administrations' response, June 2020, p.5

The market needs long-term regulatory predictability and visibility of carbon pricing beyond 2020, as companies trade forward on the curve up to three years and beyond with maturities for the next eight years available. Currently, participants to the UK energy market lack visibility of carbon pricing as of 1 January 2021 and are therefore unable to properly hedge their carbon risk in the longer term.

We therefore urge the UK Government to provide clarity on the following matters as soon as possible:

1. The approach to carbon pricing in the UK post-Brexit and a timeline indicating the main actions foreseen for the development and implementation of the given approach. Should a linked UK ETS be the chosen option for the future, what would be the milestones to have it established by 1 January 2021?
2. The approach to Carbon Price Support in the UK beyond 31 March 2022.
3. The Carbon Emissions Tax rate for 2021, and the methodology to set it for the coming year as well as future rates in the event that it is introduced.

In order to ensure a cost-effective transition to net zero carbon emissions in the UK by 2050, we believe that the Government's approach to carbon pricing and emissions trading post-Brexit should rest on the following key policy principles.

Key policy principles to underpin the UK's approach to carbon pricing and emissions trading post-Brexit:

1. Establishing a UK ETS closely and immediately linked with the EU ETS
2. Securing the UK's continued participation in the EU ETS, until a linked UK ETS is established.
3. Recognising that neither a standalone UK ETS nor a carbon tax can constitute an optimal option/ transition mechanism for carbon pricing in the UK.

Please find the detailed description of the three key policy principles in the Annex to the present letter.

ANNEX

Key policy principles to underpin the UK's approach to carbon pricing and emissions trading post-Brexit

1. No-regret option: establishing a UK ETS closely and immediately linked with the EU ETS

In order to deliver on the UK's target for net zero carbon emissions by 2050 in a cost-effective way, the UK post-Brexit should rely on a market-based mechanism for carbon abatement, through **a UK ETS closely and immediately linked with the EU ETS**.

It is clear that any Linking Agreement between the EU ETS and UK ETS will require complex negotiation. Whilst this should be possible in a far shorter time than the negotiations to create the EU-Swiss linkage (which was delayed due to non-market reasons), there may still be uncertainty for market participants if this takes too long.

We therefore believe that a Linking Agreement between the EU ETS and the UK ETS must be given a high priority in the discussions on the future relationship due to be completed by 31 December.

We would also like to highlight that the UK will host COP 26 in 2021, where a particular focus will be placed on Article 6, providing for the use of international carbon markets for achieving the emissions reduction targets set by the Parties. A timely establishment of a Linking Agreement between the UK ETS and the EU ETS would evidence and reinforce the UK's commitment to deploying market-based mechanisms to achieve cost-effective decarbonisation of the economy.

<u>UK ETS design: ensuring alignment with the EU ETS is key</u>

The design of the UK ETS should be closely aligned to the EU ETS in order to allow the two systems to link.

We therefore welcome the UK Government's intention to ensure that "elements of the new [UK] ETS will be familiar to operators" and that "it is designed to ensure a seamless transition at the end of the year."[2]

Ensuring harmonisation of the UK ETS and the EU ETS design would facilitate linkage discussions with the European Commission and increase the likelihood of having the two systems linked from the outset. For markets to link, it is important that they align on some key parameters, such as cap trajectory, MRV requirements, carbon leakage protection, and types of unit eligible for compliance.

We firmly believe that this UK-EU ETS link is in the best interest of both parties. However, this will require give and take from both sides to ensure that the design features of the UK ETS

[2] The future of UK carbon pricing, UK Government and Devolved Administrations' response, June 2020, p.5

and the EU ETS are fully aligned. This concerns in particular the phase out of free allocation and other improvements to the functionality of the system (e.g. the rules addressing carbon leakage and the potential expansion of the ETS to the sectors that it currently does not cover) in order **to enable and maintain a robust link between the two systems going forward**. Regarding the EU Market Stability Reserve (MSR), coherence between the proposed UK ETS mechanism and the reformed EU ETS MSR has to be ensured in order to avoid market distortions. Apart from that, the upcoming changes to the design of the EU ETS, such as the extension of the scope of the EU ETS, the review of the Auctioning Regulation or the update of the monitoring, reporting and verification rules, would need to be aligned.

Once the linking of the two systems is established, this would help to ensure a market-based price for carbon emissions in the UK and that the liquidity benefits from the EU ETS can be maintained. Indeed, the deep level of liquidity provided by the high number of active market participants constitutes one of the key benefits of the EU ETS since its creation. Even when the carbon price and volatility were much lower, the level of liquidity in the market held up very well and market participants were able to efficiently manage their risks on a continuous basis.

2. UK's continued participation in the EU ETS until a linked UK ETS is established is essential

In the event that the UK ETS and its link to the EU ETS is not legally established in time for 2021, it is crucial to ensure the UK's continued participation in the EU ETS. The UK and the EU should endeavour to agree a temporary linking arrangement under the terms of the Transition Period in the Withdrawal Agreement.

3. Neither a standalone UK ETS nor a carbon tax constitute an optimal option/ transition mechanism for future carbon pricing in the UK

In the event that the linking of the two systems cannot be agreed and/or implemented initially, the UK should maintain an ETS that is strongly aligned with the EU ETS in order to be able to agree the linking of the two systems in the future.

We strongly believe that a standalone UK carbon trading mechanism would not be able to deliver a sufficient level of liquidity for the market to operate efficiently. Without sufficient liquidity, it is likely that the market will have to face wider bid-offer spreads, leading to increasing compliance costs for market participants and end-consumers. We therefore strongly advise against this option, as well as against a carbon tax as an alternative. It is worth noting that important strengths of the ETS also include the progressive nature of the volume of allowances granted and the flexibility of distributional effects.

We stand ready to provide further input on the future of carbon pricing and emissions trading in the UK and we are keen to ensure a continued dialogue with BEIS in view of the transition period.

About

The **European Federation of Energy Traders** (EFET) promotes competition, transparency and open access in the European energy sector. We build trust in power and gas markets across Europe, so that they may underpin a sustainable and secure energy supply and enable the transition to a carbon neutral economy. We currently represent more than 100 energy trading companies, active in over 27 European countries. For more information: www.efet.org.

Europex, the Association of European Energy Exchanges, is a not-for-profit association of European energy exchanges with 29 members. It represents the interests of exchange-based wholesale electricity, gas and environmental markets, focuses on developments of the European regulatory framework for wholesale energy trading and provides a discussion platform at European level. For more information: www.europex.org

The **International Emissions Trading Association** (IETA) is a global organisation which promotes market solutions to climate challenges. With membership from across the carbon trading value chain, IETA seeks to develop an emissions trading regime that results in real and verifiable emissions reductions, consistent with the Paris Climate Agreement, while balancing economic efficiency, environmental integrity, and social equity.

Eurogas is an association representing the European gas wholesale, retail and distribution sectors towards the EU institutions. Founded in 1990, Eurogas currently comprises 49 companies and associations from 23 countries.