The voice of the energy industry

EnvC WGEUETS 73/17

Considerations for continued UK participation in the EU Emissions Trading System (EU ETS) – long-term issues

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Introduction and summary

Energy UK is the trade association for the GB energy industry with a membership of over 90 suppliers, generators, and stakeholders with a business interest in the production and supply of electricity and gas for domestic and business consumers. Our membership encompasses the truly diverse nature of the UK's energy industry – from established FTSE 100 companies right through to new, growing suppliers and generators, which now make up over half of our membership.

Our members turn renewable energy sources as well as nuclear, gas and coal into electricity for over 26 million homes and every business in Britain. Over 619,000 people in every corner of the country rely on the sector for their jobs with many of our members providing long-term employment as well as quality apprenticeships and training for those starting their careers. The energy industry adds £83bn to the British economy, equivalent to 5% of GDP, and pays over £6bn in tax annually to HM Treasury.

This discussion paper builds on the Energy UK position paper on "Brexit and the EU ETS"[1] and focuses on the long-term issues arising from UK participation in the EU ETS.

Energy UK's preference is for the UK to remain within the EU ETS whilst retaining influence over its future development so as to deliver a robust carbon price signal. With the upcoming conclusion of the latest revision of the EU ETS Directive, which the UK Government has engaged in, the main governance of the EU ETS is likely to be established until the end of the Phase IV trading period (2021-30).

However, if the UK is unable to influence the development of the EU ETS for the period beyond Phase IV to deliver a credible carbon price signal, then alternative options should be explored.

The reasoning behind Energy UK's position on participation in the EU ETS has been described in more detail in the previous paper, and it is driven by the need to ensure an equitable trading relationship with the EU's Internal Electricity Market (IEM). This paper provides more information on two long-term issues that have arisen from discussions on the Energy UK position paper:

- The UK's influence on the design of the EU ETS – during Phase IV (2021-30) and beyond, and
- The EU ETS funds – access to innovation funding and political commitments.

[1] Energy UK "Position on Brexit and the EU Emissions Trading System (EU ETS)", February 2017, EnvC WGEUETS 15/17.

1) The UK's influence on the design of the EU ETS – will the UK be a "rule-taker"?

Energy UK understands that one of the major concerns for the UK Government and UK Parliament over continued long-term participation in the EU ETS is that the UK would remain subject to EU rules over which it had little or no influence.

However, in headline terms, whilst the UK will technically be a "rule-taker" if it participates in Phase IV of the EU ETS (2021-30), in practice it is not likely to be a rule-taker as the architecture for Phase IV has now broadly been set. Furthermore, the UK Government has engaged significantly on the latest revision of the EU ETS Directive, which includes the most controversial elements of ETS design, namely provisions to mitigate carbon leakage, which will continue to be so as the provisions are finalised (whilst the UK is still an EU Member State). Without the support of the UK Government in the Council and the UK MEPs in the European Parliament, it is very unlikely that the EU ETS Directive revision would have included its most important strengthening element i.e. the doubling of the Market Stability Reserve (MSR) outtake rate.

This is in addition to significant UK influence over the original design of the EU ETS for Phases I (2005-07), II (2008-12) and III (2013-2020) and, more recently, the back-loading decision agreed in 2014 and the introduction of the MSR agreed in 2015. Up until the end of Phase IV therefore, if the EU ETS does not develop during the course of Phase IV, the UK will have had the same level of influence on the main design elements of the EU ETS as any other EU Member State proportionate to its size, if not more.

As such, Energy UK considers that participation in Phase IV of the EU ETS is desirable so long as participation can be secured in such a way that the UK has sufficient influence over the development of the system throughout the trading phase.

The views of other UK sectors in the EU ETS are likely to be defined by their access to the EU Single Market. Since EU ETS participation, or a directly tradable mechanism, would be an obvious prerequisite for equitable trade with the equivalent industries in the EU, continued EU ETS participation is likely to be a preference for many UK sectors wanting continued access to the EU's Single Market. EEF, the trade association for the UK manufacturing industry, has called for tariff-free access to the EU Single Market, and would be aware that this would likely require equivalent carbon costs[2].

A concern raised by some UK stakeholders is the EU ETS compliance costs for small emitters, but this would likely be the same for any robust ETS or other carbon reduction mechanism, whether UK or EU-wide in scope. Indeed an expanded opt-out for small emitters is expected to be agreed in the EU ETS Directive revision for Phase IV.

There are some other technical elements of the EU ETS which the Commission will adopt at a later stage through delegated legislation, such as the use of the funds, benchmarks for free allocations and auctioning timetables. However, as these are delegated acts, the UK would have less direct influence over these elements in any case. The UK can largely mitigate any loss of influence here by continued dialogue with the Commission and other stakeholders over the technical details of these regulations.

[2] EEF (2017) – *UK Trade with the EU: a new trading order for the manufacturing industry* – https://www.eef.org.uk/campaigning/news-blogs-and-publications/blogs/2017/mar/no-deal-is-a-no-go-for-manufacturers

Influencing EU ETS developments during Phase IV – The MSR review and the Paris review process

UK influence may be missed more in Phase IV during the review of the parameters of the MSR (due by 2022) and the Paris Agreement review cycles in 2018/20, 2023/25 and 2028/30. The MSR review will be important to ensure a functioning EU ETS in the latter part of the next decade and the Paris reviews will of course be critical for ensuring that the long-term temperature targets within the Paris Agreement can be met.

The UK could retain influence in these areas through its excellent international climate change diplomacy via the Foreign and Commonwealth Office (FCO) and the Prime Minister's Office as well through the strong analytical capacity of the emissions trading team within the Department for Business, Energy and Industrial Strategy (BEIS).

For the **MSR review** – that is expected to take place in 2021 – the UK Government could use its strong analytical capability to directly aid the development of the review with the European Commission, as well as other key stakeholders in the European institutions, industry associations and the NGO community.

Any change to the MSR will be agreed by Qualified Majority Voting (QMV) in the Council, and by a simple majority in the European Parliament via co-decision, so the UK's votes in these institutions may be missed. Whether the UK would have been a deciding vote in the Council or the Parliament will only be known in hindsight.

For Energy UK, the main outcome for the MSR review to ensure a functioning EU ETS should be to ensure that the hedging band for the MSR – currently 400m and 833m – comes down in line with market participants' hedging requirements as they decarbonise. The European electricity industry association, EURELECTRIC, of which Energy UK is an active member, has already called for the hedging band to be reduced from 400-833m to 300-600m[3] (see Figure 1, overleaf). If the hedging bands are not adjusted downwards to match reduced hedging requirements, this could impact the development of a robust carbon price signal towards the end of Phase IV[4].

For the **Paris review process** that will take place every five years, the UK Government can continue to have significant influence internationally through the continued work of the FCO and the Prime Minister's Office to promote the climate leadership of the UK and advocate increased ambition from other UNFCCC parties.

The main tools for increasing ambition within the EU ETS will be to address the annual Linear Reduction Factor (LRF) and retirements from the MSR. Rebasing is a popular proposal amongst some stakeholders, but it is unlikely that this would be done outside of an ETS Directive revision, which sets the cap for the upcoming phase.

[3] EURELECTRIC (2016) - *EU ETS Reform: EURELECTRIC recommendations on proposals to strengthen the EU ETS* - http://www.eurelectric.org/media/295167/20161130_recommendation_to_strengthen_eu_ets-2016-030-0608-01-e.pdf

[4] ICIS Tschach Solutions/EURELECTRIC (2016) - *Options to Strengthen the EU ETS* - http://www.eurelectric.org/media/295165/icis_study_options_to_strengthen_the_eu_ets_fin-2016-oth-0104-02-e.pdf

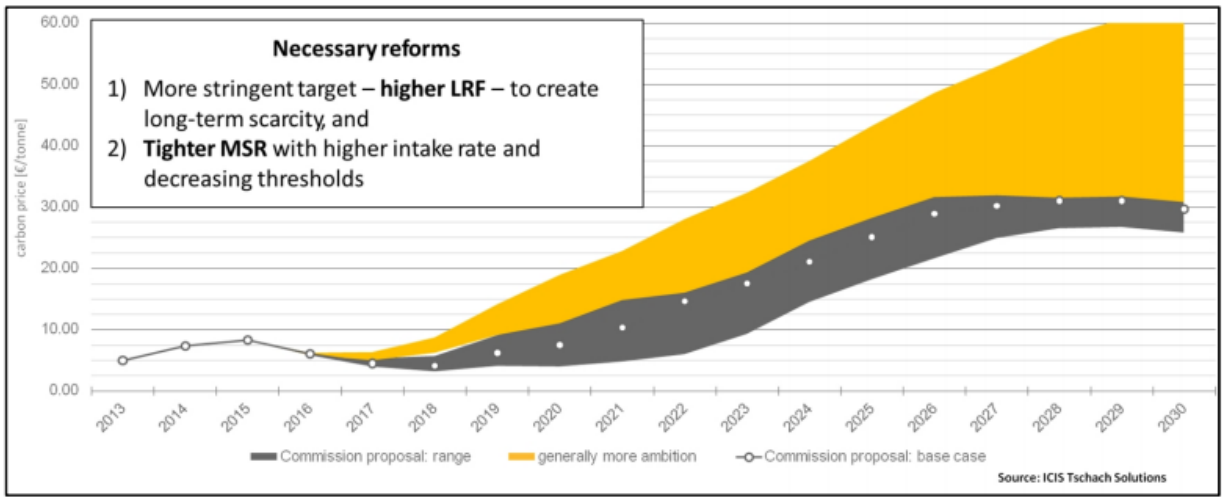

Figure 1. Eurelectric (2016) **-** Impact of 2.4% LRF and lowered MSR hedging band required within Phase IV, on top of MSR outtake rate increase expected to be agreed in EU ETS Directive. From "*EU ETS Reform: EURELECTRIC recommendations on proposals to strengthen the EU ETS*"

Within the current revision of the ETS Directive, one of the policies to increase ambition that has in effect been agreed is the retirement of allowances from the MSR. However, whilst MSR retirements are good for the environmental integrity of the EU ETS, they have a limited market impact as the allowances will only return to the market in relatively small volumes (100m/year) and not for at least another decade.

In this respect, the primary tool to tighten the EU ETS cap and increase ambition to the higher end of the EU's indicative long-term greenhouse gas target of an 80-95% reduction by 2050 on 1990 levels, is the LRF. The LRF is currently set at 1.74%, and due to be increased to 2.2% for Phase IV in the current revision of the EU ETS Directive. Of note is that the European Parliament's position for the ongoing revision includes a review of a 2.4% LRF in 2024. In the revision, Energy UK and EURELECTRIC supported an LRF of at least 2.4%, and would support a within-phase LRF increase to take effect on 1 January 2026.

Whilst the UK will not be involved in Council discussions for decisions on the LRF, there is a political convention that the LRF and high-level climate targets are set by unanimity in the European Council as per 2007 and 2014 European Council Summits for the respective 2020 and 2030 targets. Therefore, the "lowest common denominator" is usually the key decision-maker and consequently the UK's absence in the European Council is unlikely to have a material impact in practice on the outcome of negotiations on the future level of the LRF.

If, towards the end of Phase IV, the UK is unable to influence the development of the EU ETS beyond 2030, then Energy UK would agree that alternative options compatible with equitable trading with the Internal Electricity Market should be explored.

However, if the hedging band can be lowered at the MSR review and the LRF is progressively tightened over time, Energy UK is confident a more robust price signal into the end of the 2020s and 2030s can be delivered through the EU ETS – building on the changes likely to be agreed in the current EU ETS Directive revision that will breathe life into the EU ETS in the coming years.

Influencing EU ETS developments beyond Phase IV?

Beyond 2030, the EU ETS Directive will need to be revised again for Phase V (2031-40). As noted previously, the major controversial elements of ETS design are the carbon leakage provisions covered in the revised EU ETS Directive. The UK Government would then need to consider whether it is comfortable with the rules that would be put in place at the time. A key consideration is that EU ETS participation/linkage would likely be a fundamental component of any equitable trading relationship with the EU Single Market for those sectors covered by the EU ETS.

However, carbon leakage provisions only need to be put in place to maintain international competiveness by mitigating differences in carbon prices globally. It would be hoped that beyond 2030, there would be a focus on minimising carbon leakage concerns through linkage with ETSs elsewhere in the world rather than continued free allocations across a wide range of sectors.

Energy UK is optimistic for the development of carbon trading elsewhere in the world, given that Article 6 of the Paris Agreement encourages the development of emissions trading mechanisms to meet the Nationally Determined Contributions (NDCs). Even now, as highlighted in Figure 2, there is significant ETS development currently ongoing internationally including the creation of the world's largest carbon market in China, which is expected to be introduced by the end of this year. If looking to influence the development of the EU ETS beyond 2030, the UK Government could have more success by focussing its attention on international carbon discussions in collaboration with the EU, rather than on the EU's legislative process itself.

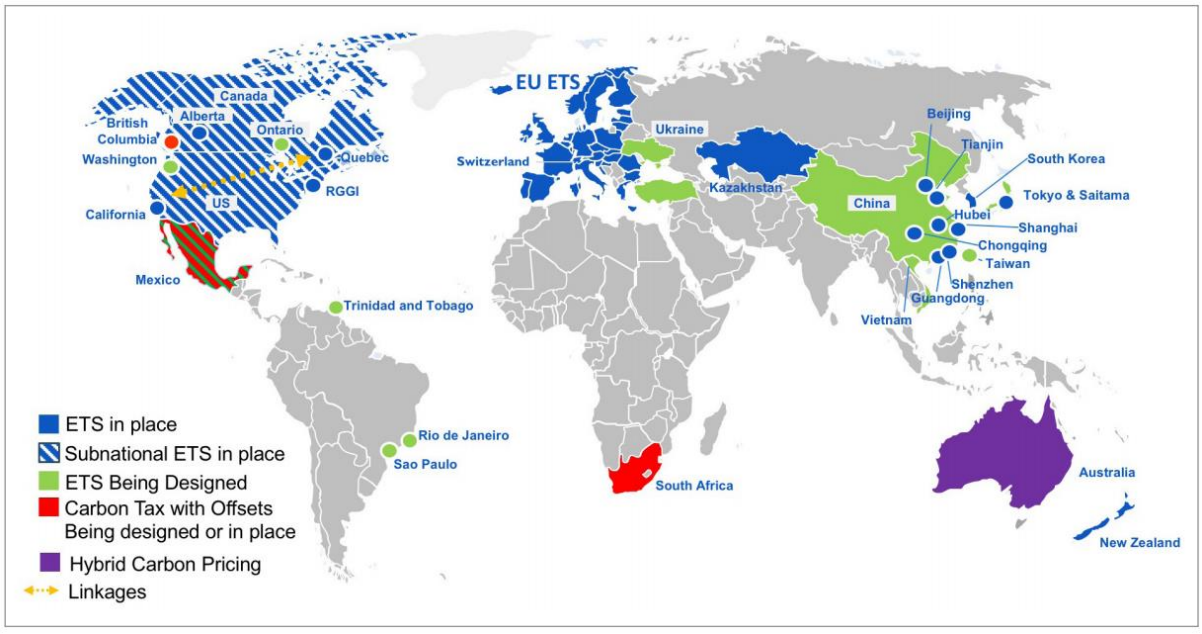

Figure 2. IETA (2015) – From *"The 2015 Paris Agreement, Carbon Pricing and Markets: Connecting the Dots"*

Indeed, it is possible that future revisions to widen the geographic scope of the EU ETS will result in third countries having some direct input in future governance, so that all participants have some influence on the design of the scheme. This could include the European Economic Area (Iceland, Liechtenstein and Norway), which already participates in the EU ETS without direct input into its rules, or even Switzerland, Turkey, Ukraine and the western Balkans which either have, or are developing, ETSs neighbouring the EU ETS.

2) The EU ETS funds – Loss of innovation funding and political implications of commitments made

Firstly, if the UK leaves the EU ETS it will lose access to the **Innovation Fund**, where 400-600m allowances will be auctioned off between 2021-30 to fund low carbon innovation for the energy and industrial sectors. Depending on carbon prices, this could be worth in the region of €10 billion[5] over the period 2021-30. There would be a limited impact on the rest of the EU of a UK exit from the EU ETS, as it could be assumed that the Innovation Fund would be reduced proportionately if the UK lost access. In this event, Energy UK would expect an equivalent level of funding to be put in place for UK stakeholders by the UK Government on a proportionate basis.

The second EU ETS fund is the **Modernisation Fund**, which will provide 2% of all allowances to be auctioned over the period 2021-30 for the modernisation of the energy systems in 10 lower income Member States. This fund was part of the 2030 climate and energy targets that were agreed at the European Council Summit in October 2014, where the UK was a major advocate for a higher 40% greenhouse gas reduction target on 1990 levels, rather than 35%[6].

To secure agreement from the lower income Member States for a higher EU target ahead of the Paris climate change talks in December 2015, the Modernisation Fund was created to compensate them for the increased EU ETS compliance costs.

As part of the 2030 climate and energy targets that were agreed at the European Council Summit in October 2014, it was also agreed that 10% of allowances to be auctioned would be transferred to lower income Member States for the purposes of solidarity, growth and interconnection. The UK is a significant contributor to this transfer through its large share of allowances to be auctioned. As with the Modernisation Fund, the solidarity transfer was important in securing agreement from lower income Member States to accept a higher greenhouse gas reduction target.

There is no precedent for how an adjustment to the ETS cap would be made if the UK were to leave the EU ETS. Even if there were an agreement to cancel the UK allowances, there may be strong opposition to reducing the absolute volume of allowances within the Modernisation Fund, in effect increasing the relative proportion of EU ETS allowances above 2%, which would depress the EU ETS price by negatively impacting the supply-demand balance.

[5] Energy UK calculation - 500 million allowances auctioned at an assumed average EU ETS price of €20.

[6] UK Department for Energy and Climate Change (DECC 2013) - UK analysis of EU 2030 GHG target options - https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253209/UK_Analysis_of_EU_2030_GHG_Targets_FINAL_TO_WEBSITE.pdf

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