EnvC 80/19

# Response to the UK Government and Devolved Administrations consultation on the Future of UK Carbon Pricing

**12 July 2019**

**About Energy UK**

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

Our members turn energy sources into electricity for over 27 million homes and every business in Britain. Over 680,000 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 invests over £12.5bn annually, delivers around £84bn in economic activity through its supply chain and interaction with other sectors, and pays £6bn in tax to HM Treasury.

**Executive Summary**

Energy UK welcomes the opportunity to provide this submission to the UK Government's and Devolved Administrations' consultation on the future of UK carbon pricing following the UK's exit from the European Union. We welcome the opportunity for stakeholders to help shape the future direction of carbon pricing across the UK.

The uncertainties around the future carbon price undermine steps to drive decarbonisation in the power sector in the most cost-effective way, at a time when investment needs to be ramped up to meet ambitious long-term targets.

Energy UK members consider carbon pricing to play a pivotal role in delivering cost-effective decarbonisation and is an important mechanism for achieving Net Zero by 2050. It will therefore be important to maintain a clear, stable and robust carbon price leading up to and following the UK's departure from the European Union.

Energy UK's preferred option would be for the UK to continue participating in the EU ETS, however given that this is not a realistic option, we support the proposal of establishing of a UK ETS linked immediately to the EU ETS as set out in the consultation document, as this should ensure a smooth transition and provide continuity around the carbon price for UK operators.

We consider emissions trading to be the most cost-efficient approach to drive greenhouse gas emission reductions across the traded sectors in a way that avoids cross-border distortions, enabling the delivery of affordable, reliable, and sustainable electricity across Europe. It gives energy companies the opportunity to manage price risk by purchasing carbon allowances alongside their fuel requirements to match their forward sales of electricity and fuel purchases, thereby reducing commercial risk, and costs for consumers.

**Response to Questions**

**CHAPTER 1: Design of a UK Emissions Trading System**

**Question 1. Are you a current participant of the EU ETS? If you are a participant or a representative of a sector, which sector do you belong to?**
Yes, Energy UK represents electricity generators in the power sector.

**Question 2. Does your interest in the ETS relate to the operation of the system in a particular geographical area?**
UK-wide

**Question 3. Do you agree with the proposed scope of a UK ETS?**
Yes, Energy UK agrees that the scope of a UK ETS should mirror as closely as possible that of the EU ETS and be linked immediately on its establishment. To facilitate a quick and easy linkage agreement, Energy UK considers that any amendments to the design elements of the EU ETS should only be made on a "by exception" basis and supports the approach of making a UK ETS which is at least as ambitious as the EU ETS.

Energy UK's first preference for carbon pricing post-exit from the European Union would be to stay in the EU ETS, whilst retaining influence over its future development so as to deliver a robust carbon price signal.

Energy UK supports the UK's continued participation in the EU ETS for the following reasons:

- Emissions trading is the most cost-efficient approach to drive greenhouse gas emission reductions across the traded sectors in a way that avoids cross-border distortions. This enables the delivery of affordable, reliable, and sustainable electricity across Europe.
- It gives energy companies the opportunity to hedge the price for carbon emissions alongside their forward sales of electricity and fuel purchases, thereby reducing commercial risk, and costs for consumers. Hedging is not possible with a carbon tax.
- It facilitates an equitable trading relationship with the EU's Internal Electricity Market (IEM) and performs a similar function for the Single Electricity Market (SEM) in Ireland.
- The EU ETS is the largest greenhouse gas emissions trading scheme in the world. A UK-only scheme along similar lines would be only one tenth of the size and less efficient.
- The EU ETS is working. Recent amendments to the design of the scheme (such as the introduction of a Market Stability Reserve to manage the oversupply of allowances) have caused the price of EU Allowances to rise above €25/$tCO_2$.
- It has a clear environmental outcome. In 2020, emissions from sectors covered by the system will be 21% lower than in 2005. In 2030, under the revised system, they will be 43% lower.
- The main administrative costs for participants are related to the monitoring, reporting and verification of emissions. These costs would still be incurred under a UK-only trading scheme or a tax on greenhouse gas emissions.

Our second preference is to create a standalone UK Emissions Trading System (UK ETS) and link this immediately to the EU ETS on exit from the EU ETS. This would allow the UK to still benefit from the favourable features of the trading scheme listed above, if there is no possibility or political will to remain fully in the EU ETS. If neither of these options is possible, then a carbon tax would be preferred to a standalone UK ETS with no linkage.

The only reason that Energy UK can see for creating a standalone UK ETS would be for the express intention of linking it to the EU ETS as soon as is feasible. If there is no realistic prospect for that in the immediate future, then a permanent standalone UK ETS has many potential drawbacks that need to be considered, including:

- A potential lack of liquidity, due to the smaller number of participants.
- Linked to this, a higher risk of price volatility and greater market uncertainty.

- This in turn will make it more difficult to ensure consistency with the EU ETS, which is likely to be a condition for the closest possible future participation in the IEM, another priority for Energy UK members.

It will be much easier to deliver a linked UK ETS if we minimise divergences between the UK ETS and the EU ETS. Consequently, securing an agreement for linking must take absolute priority over any UK divergences for flexibility. The potential cost implications of not securing a linking agreement and being forced into a standalone UK ETS are orders of magnitude greater than the benefits of the proposed divergences in the UK ETS.

From the experience of Switzerland in linking its ETS to the EU's (which has so far taken 7 years to negotiate) it would appear that the closer an ETS is to the EU geographically/economically, the closer its architecture will need to be to that of the EU ETS before the Commission will agree linkage. In the same vein, the more similar the architecture of the candidate ETS is to the EU ETS, the quicker the process of linkage will be.

This means that divergences in the design of the UK ETS from the EU ETS must be kept to an absolute minimum and any proposed divergence must be avoided entirely if it would present a significant risk to the linking of the UK ETS. All scoping and design aspects of the UK ETS must be tested against this principle of "no divergence".

In general, the proposed scope of the UK ETS follows the scope of the EU ETS and is consistent with the principle of "no divergence". For this reason, in general we support the proposed scope of the UK ETS. However, there are several proposals for specific divergences from the EU ETS in the design of the UK ETS. Only a few of these are unavoidable (e.g. the use of a UK registry), and therefore most are optional.

For any divergence from the EU ETS, before proceeding, confirmation should be obtained from the EU that there is no objection to this divergence if the EU ETS were to be linked to the UK ETS. If there is any doubt, the divergence should not be implemented.

**Question 4. Do you have any suggestions for which sectors might be included in scope in the future?**

Energy UK requests that Government seriously considers the widening of carbon pricing to include other sectors that have not been subject to this so far. An appropriate mechanism for this could be a widening of the scope of the UK ETS, once a link with the EU ETS has been secured and well-established, or through a different mechanism (such as a tax) if this is more appropriate to the scale of the other sectors. With the implementation of the net zero emission target for 2050, how to deliver negative emissions to cover any residual emissions in the economy will need be considered. To reflect and incentivise the growth of Greenhouse Gas Removal (GGR) technologies, we would also support the rewarding of negative emissions through carbon pricing or other mechanisms.

However, whilst non-ETS emissions and negative emissions are areas which need to be explored in the context of the UK's commitment to net zero emissions by 2050, the priority for a UK ETS must be that it can be linked to the EU ETS. This means that divergences in the design of the UK ETS from the EU ETS must be kept to an absolute minimum. Any proposed divergence must be avoided entirely if it would present a significant risk to the linking of the UK ETS. All design aspects of the UK ETS must be tested against this principle of "no divergence".

After a linking agreement is reached with the EU ETS, the UK can maintain influence in EU ETS design through continued thought leadership in areas such as non-ETS emissions and negative emissions using the technical, analytical and diplomatic capability of the UK government as well as UK stakeholders. The UK has the potential to develop negative emissions at scale in the mid-2020s and therefore a system of negative emissions reward should be considered as soon as possible.

**Question 5. Do you agree that costs to business alongside climate ambition are the appropriate ones to be considered for the final decision on setting the cap and trajectory? What other factors should be prioritised in the setting of the cap and trajectory?**
Energy UK agrees that the considerations outlined are appropriate. However, costs to business are not the only additional factor and further ones must be considered.

One of the ways in which a carbon price delivers enduring reductions in carbon emissions is by supporting investment in low carbon generation and other infrastructure. To maximise confidence in low carbon investment, a stable and enduring carbon price signal is required. Consequently, it is essential that a UK ETS delivers continuity and stability in carbon pricing, starting from the changeover from the EU ETS. To deliver price continuity, the initial carbon price of the UK ETS should fall within the range of recent EU ETS carbon prices (for example, the average EU ETS price for the preceding 6 months).

The cap and trajectory will be primary factors in determining the carbon price in the UK ETS, so the design of these will be critical in delivering carbon price continuity and stability. The UK ETS is very likely to be more volatile than the EU ETS, so the design of stability mechanisms, including the Supply Adjustment Mechanism (SAM) and Auction Reserve Price (ARP) included in the consultation proposals, will also be a key consideration alongside the cap and trajectory.

The design of the standalone UK ETS "package" of cap and trajectory and stability mechanisms needs to anticipate, and be ready to deal with, a greater volatility in the UK ETS supply-demand balance and consequent price so as to provide the continuity and stability in carbon price that operators and investors require.

A standalone UK ETS will be about one-tenth the size of the EU ETS and participants will be located solely in the UK, resulting in a much greater geographical concentration. In addition, the level of diversity between and within sectors is lower than the EU as a whole. The combination of these characteristics means that the supply-demand balance in the UK ETS (and resulting carbon price) is likely to be more volatile than the EU ETS. For example:

- Annual output of wind generation in the UK can fluctuate significantly, due to wind turbines in the UK being located in a more concentrated geographical region (unlike the EU ETS). This results in significant fluctuations in gas generation output in the UK, which in turn creates fluctuations in the power sector's demand for carbon allowances.
- Demand from the largest individual UK ETS operators represents a much more significant portion of the UK ETS total than the EU ETS. Decisions on trading of allowances by a few of the largest operators can have a much greater effect on the overall market than in the EU ETS.
- Reduced diversity within and between sectors means that a short-term decrease in demand from one is less likely to be balanced by an increase in demand elsewhere in the scheme.

**Question 6. What would the implications be for your business if the cap for a standalone UKETS was set at a tighter level than the UK's anticipated notional share of the EU ETS cap?**
It is essential that the design of a standalone UK ETS delivers continuity in the carbon price, through measures that provide a high level of confidence of this outcome. Continuity in carbon pricing is a key requirement for a standalone UK ETS for our members.

As the consultation document notes, it is likely that, in order to ensure continuity in the carbon price applied by the EU ETS, the cap for a standalone UK ETS will need to be set at a tighter level than the UK's anticipated notional share of the EU ETS cap. If it is necessary for a standalone UK ETS cap to be set at a level below the UK's share of the EU ETS, in order for the UK ETS to be fully effective and most efficient, then this should be implemented. Detailed analysis should be carried out to inform this decision and such analysis should be shared with all stakeholders to ensure transparency in the detailed design of the UK ETS.

**Question 7. Do you agree with using the EU ETS Phase IV Carbon Leakage List and Benchmarks for determining UK ETS free allocation?**

The priority for a UK ETS must be that it can be linked to the EU ETS. This means that divergences in the design of the UK ETS from the EU ETS must be kept to an absolute minimum. Any proposed divergence must be avoided entirely if it would present a significant risk to the linking of the UK ETS. All design aspects of the UK ETS must be tested against this principle of "no divergence".

Using the EU ETS Phase IV Carbon Leakage List and Benchmarks for determining UK ETS free allocation follows the arrangements for the EU ETS and is consistent with the principle of "no divergence".

**Question 8. Do you agree with using the Phase IV approach to the Carbon Leakage Exposure Factor for a UK ETS?**

The priority for a UK ETS must be that it can be linked to the EU ETS. This means that divergences in the design of the UK ETS from the EU ETS must be kept to an absolute minimum. Any proposed divergence must be avoided entirely if it would present a significant risk to the linking of the UK ETS. All design aspects of the UK ETS must be tested against this principle of "no divergence".

Using the Phase IV approach to the Carbon Leakage Exposure Factor for a UK ETS follows the arrangements for the EU ETS and is consistent with the principle of "no divergence".

**Question 12. Do you agree with the concept of introducing a SAM, similar in function to the EU ETS MSR, for a UK ETS? (Noting that a SAM cannot be operational immediately and we will consult on the specific details at a later date.)**

Energy UK agrees that it is essential that the UK ETS design delivers continuity and stability in the carbon price (whichever version of the UK ETS is implemented) through measures that provide a high level of confidence of this. This continuity in carbon pricing is a critical requirement for a standalone UK ETS for our members.

The SAM will play a key role in ensuring continuity in the carbon price applied by the UK ETS. As explained above, due to high volatility, a UK ETS will have a high risk of periods of sustained low carbon price, which would fail to deliver the continuity and stability in carbon pricing that low carbon operators and investors require.

The SAM will provide a degree of protection against a sustained low carbon price and it is essential that the SAM is included in a standalone UK ETS.

**Question 13. What factors should be considered when setting the thresholds for a standalone UK ETS SAM?**

It is essential that the outcome of the SAM is to maintain the required level of continuity and stability in carbon price. The thresholds of the SAM should be based on modelling of the supply-demand balance in the standalone UK ETS, so that allowances are removed at early stage of over-supply (and added back at an early stage of under-supply).

**Question 14. What factors should be considered in determining at what point in Phase I of a standalone UK ETS a SAM should be introduced?**

To be most effective, the modelling of the SAM should include data from the operation of the UK ETS in the initial years of operation, to understand the actual patterns of supply and demand that emerge. At least two years of practical experience are needed, keeping in mind that the EU ETS MSR was introduced based after two phases of operation had already been completed.

**Question 15. Do you agree that the proposed CCM strikes the appropriate balance between effectively addressing in-year price spikes without responding too frequently to shorter term upward price fluctuations, thereby avoiding market disruption?**

Energy UK agrees that the proposed CCM is an appropriate balance between effectively addressing in-year price spikes without responding too frequently to shorter term upward price fluctuations. These proposals are based on the EU ETS CCM and therefore meets the important "no divergence" principle. The EU ETS CCM design was based on detailed analysis of potential price spikes and their

consequences. In our view, the EU ETS CCM design will provide the appropriate balance for the UK ETS as well.

**Question 16. Should a transitional Auction Reserve Price be implemented to provide minimum price continuity during the transition from the EU ETS to a UK ETS?**
We agree that a transitional ARP should be implemented to provide a minimum price during a transition period. It is essential that the standalone UK ETS design delivers continuity and stability in the carbon price through measures that provide a high level of confidence of this. This continuity in carbon pricing is a critical requirement for a standalone UK ETS for our members.

The ARP will play a key role in ensuring continuity in the carbon price applied by the UK ETS. As explained above, due to high volatility, a UK ETS will have a high risk of periods of sustained low carbon price, which would fail to deliver the continuity and stability in carbon pricing that low carbon operators and investors require.

The ARP will provide a degree of protection against a sustained low carbon price and it is essential that the ARP is included in a standalone UK ETS. It is also essential that the level of the ARP is set sufficiently high to maintain the required level of continuity and stability in price. For the same reason, the future level of the ARP should be confirmed several years in advance, to provide a pre-determined floor that increases with time and inflation.

We note the following discussion in the consultation document of possible factors to be taken into account in setting the level of the ARP:
*"…The price of allowances in the EU ETS has historically remained low for a number of reasons. Overlapping policies, the availability of offsets, and the 2008 economic crisis all contributed towards reduced demand for allowances and a downward pressure on price, resulting in a 2013-14 average price of £4.70 for an EU ETS allowance.*
*77. More recently, EU ETS prices have been rising in part due to the anticipated impact of the MSR becoming operational and removing allowances from 2019, with an average 2018 price of £13.70. In setting the ARP for a standalone UK ETS we will take this range into consideration, in addition to more recent price trends."*

We support the principle that recent EU ETS prices should be taken into consideration in setting the level of the ARP. For continuity, the appropriate benchmark for the ARP level will be the most recent price trends, rather than the range of prices in preceding years quoted in the consultation. This is because:

- In all scenarios, there will be a transition from the EU ETS to the UK ETS and this will be direct, except for the case of a "No Deal" exit from the EU
- Even if the UK ETS is initially standalone, the objective should still be to link to the EU ETS as soon as possible and price consistency with the EU ETS will facilitate this.

During 2019 the EU ETS price has been significantly higher than the upper level of £13.70 quoted in the consultation document. We believe this figure would be too low for the level of the ARP, as it would not provide continuity or stability in carbon price during the transition to a standalone UK ETS.

In particular this presents a challenge for the ETS component of the Total Carbon Price (TCP) for electricity generation in Great Britain. The Carbon Price Support (CPS) which is a top up to the ETS component of the TCP, is set in legislation within the Finance Act. For Financial Year (FY) 2020/21 the CPS has been set at £18, and for FY2021/22 it is expected to be set out in the 2019 Autumn Budget. If the UK ETS drops significantly from the EU ETS price this could impact the TCP with implications for the relative profitability of coal and gas plant, and thus UK emissions.

The next fiscal event after the introduction of a UK ETS where a smooth change to the CPS (to reflect changes to the ETS component) could be implemented would be at the 2021 Budget in Autumn 2021, with changes taking effect in April 2022 and meaning a risk to emission for 15 months. To mitigate this risk to electricity system emissions, the ARP should at least be set at a level to reflect the EU ETS when

the CPS was set in FY2020/21 and FY2021/22. Likewise, the upcoming considerations for the CPS for FY2021/22 should bear this in mind.

Therefore, in order to prevent the UK ETS price slipping significantly below that of the EU ETS price at present, and to ensure that the ARP operates as a reserve measure, it would be appropriate to apply a discount to the prevailing EU ETS allowance price that is used as a reference. In selecting the level of the discount, a balance will need to be struck between:

- the need to avoid triggering the ARP too readily and
- ensuring that the ARP does deliver carbon price continuity and stability in practice.

**Question 17. Do you agree with the proposed approach to phases?**
Energy UK supports using phases for a standalone UKETS which mirror those of the EU ETS for clarity and to avoid limiting the prospect of linkage to the EUETS.

**Question 18. Do you agree with the proposed approach to reviews?**
To some extent we agree, however we would make the case that despite spanning 10 years, there is one too many reviews during the first Phase, and in order to maintain stability, two review points would suffice. Perhaps more importantly, any proposed review points should be subject to advance agreement by the EU that this would not affect linkage to the EU ETS.

**Question 19. Do you support the implementation of a Small Emitter and Hospitals Opt-Out Scheme in a UK ETS for installations emitting less than 25,000t CO2eq p.a. and having a thermal input less than 35MW with the same design as the Article 27 Scheme proposed by the UK under the EU ETS for Phase IV?**
Energy UK members have diverging, more detailed, views on this point and will submit them on an individual company basis. However, in principle, we would support the proposed opt-out scheme, subject to:

- an advance agreement by the EU that this would not affect linkage to the EU ETS.
- there being a replacement carbon price signal applying to these opt-out installations of an equivalent value to the UK ETS.
- a recommendation that installations (of any size and level of emissions) that generate electricity are not eligible for this opt-out, taking into account concerns about disproportionate regulation and costs relating to MRV, and imposition of requirements for small companies to comply with MIFID legislation relating to trade in financial products.

**Question 20. Do you have any other comments on our proposals for a Small Emitter and Hospitals Opt-Out Scheme in a UK ETS, not covered by your responses to questions in Chapter 4?**
It is important that all electricity generators are subject to equivalent policy costs, or electricity market distortions could arise. If electricity generators were to be eligible for this opt-out scheme then this could lead to perverse incentives to install plants with lower capacity to avoid the UK ETS carbon price. That in turn could lead to an increase in overall carbon emissions from electricity generation. For this reason, this opt-out should include a condition that installations (of any size and level of emissions) that generate electricity are not eligible for this opt-out.

**Question 21. Do you support an Ultra-Small Emitters Exemption for installations emitting less than 2,500t CO2eq per annum?**
The same principles outlined in our response to Question 19 apply here.

**Question 22. Do you have any other comments on our proposals for an Ultra-Small Emitters Exemption in a UK ETS?**
The same principles outlined in our response to Question 20 apply here.

**Question 23. Do you agree with the proposed mechanism for recalculating the system-wide number of allowances to be issued at the start of the phase and at the midpoint of the phase?**
Yes, subject to advance agreement by the EU that this would not affect linkage to the EU ETS.

**Question 25. Do you consider that we should create a fund for industrial decarbonisation under a linked or a standalone UK ETS?**
Yes, subject to advance agreement by the EU that this would not affect linkage to the EU ETS.

**CHAPTER 2: Operation of a UK ETS**

**Question 34. Do you agree with any (or all) of the proposals for MRV simplification in a UK ETS? Do you agree with those proposals that would also apply to a Carbon Tax?**
Yes, subject to advance agreement by the EU that this would not affect linkage to the EU ETS.

**Question 36. Do you agree with the proposals that the auction success criteria in a standalone UK ETS should be changed as described above? Do you agree with the proposed method of redistributing unsold allowances across future auctions and a reserve?**
Yes, subject to advance agreement by the EU that this would not affect linkage to the EU ETS.

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