Incentivising net zero—an analysis of the government's carbon emissions tax consultation

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Environment analysis: Simon Tilling and Stephen Lavington, partner and senior associate respectively in Burges Salmon's environment and climate change team, discuss the government's recent carbon emissions tax consultation

What is the background leading up to this consultation?

The Carbon Emissions Tax (CET) was first announced in the 2018 budget as a contingency measure in the event of a no-deal Brexit. Had the UK left the EU with no deal it would have immediately ceased participation in the EU Emissions Trading Scheme (EU ETS). In those circumstances, the UK government would have implemented CET to ensure the continuity of carbon pricing across the UK.

In accordance with the EU-UK Withdrawal Agreement, the UK will remain part of EU ETS until the transition period for leaving the EU ends on 31 December 2020. The government has already stated its intention to continue carbon pricing (which forms an essential part of meeting its ambitious 2050 net-zero target) and so will need to implement a replacement regime.

As outlined in the 2019 consultation, on 'The Future of UK Carbon Pricing' and the government response document published on 1 June 2020, the preferred alternative to the EU ETS is a UK emissions trading scheme (UK ETS).

If it is not possible to put a UK ETS in place (either on a standalone basis or linked with the EU), the current intention of the government is to implement CET. This consultation paper details the government's proposals for the operation of CET, building on the legislative framework for the tax already contained in the Finance Act 2019 (FA 2019).

What provisions have already been made in FA 2019 with regard to the carbon emissions tax?

FA 2019, Pt 3 sets out the scope, rate and basic structure of the CET. It provides for most of the operational detail for the tax to be set out in secondary legislation.

Under FA 2019, s 70, regulated installations would be required to pay tax, at a rate of £16 per tonne of carbon dioxide equivalent, on reported carbon emissions in excess of the emissions allowance given to the particular installation for the relevant period.

Assessment of emissions for the purposes of FA 2019 is linked back to the monitoring and reporting conditions implemented in the UK in respect of EU ETS by the Greenhouse Gas Emissions Trading Scheme Regulations 2012, SI 2012/3038. Effectively, therefore, administration of the CET would be based upon the infrastructure built for EU ETS. This is consistent with the UK government's intention in respect of carbon pricing after Brexit to provide continuity for business in terms of the obligations imposed.

What are HMRC's new proposals for operation of the tax as set out in the consultation?

The consultation recognises that numerous key elements of the proposed CET are already provided for in legislation because they are adopted wholesale from existing UK legislation relating to EU ETS (eg SI 2012/3038). This includes elements to be introduced in Phase IV of EU ETS, such as an exemption for ultra-small emitters (those with greenhouse gas (GHG) emissions of less than 2,500 tonnes of CO2 per year and reserve/backup units that do not operate for more than 300 hours a year). As matters stand at present (and subject to a UK-EU deal to the contrary) the UK will not participate in Phase IV, which commences on the same day as the transition period ends. However, Phase IV measures have previously been implemented into existing UK GHG legislation.

The consultation also contains proposals for the aspects of the tax yet to be legislated. These include:

• setting tax emission allowance levels (equivalent to the free allowances allocated to certain installations under EU ETS)

• payments to reward decarbonisation measures that bring emissions below the tax emissions allowance level (as affected installations will no longer receive free allowances that they will be able to trade, as was the case in EU ETS)

• changes to the tax rate in the first few years of the CET scheme, with the aim of maintaining an ambitious carbon price

What does the consultation say as to how the tax might evolve in the future?

The consultation recognises that in order to deliver the UK's net zero commitment by 2050, the tax would need to evolve. Indeed, only one-third of UK emissions would be covered by the proposed tax. The shipping and aviation sectors are identified as potential areas for expansion—applying a carbon tax to domestic shipping may incentivise a shift to lower carbon fuels, and aviation emissions are already subject to a carbon price within an aviation EU ETS (albeit with significant free allowances).

In addition to potentially expanding the scope of the tax, HMRC also propose incentivising the use of negative emissions technologies. The Committee on Climate Change suggests that these technologies, such as direct air capture or bioenergy production with carbon capture and storage, will be needed to offset emissions from sectors, like aviation, that may not decarbonise completely by 2050. The consultation welcomes any stakeholder views on broadening the scope of the tax or incentivising negative emissions.

When will we know if the Carbon Emissions tax will proceed as opposed to a UK emissions trading system (either linked or stand-alone)?

Everything we have seen so far indicates that the government's preferred replacement for the EU ETS is a UK ETS, with the CET being a contingency measure in the event that a UK ETS cannot be implemented from 1 January 2021. In its response to the consultation on the future of UK carbon pricing, the government acknowledges that the tax is a 'fallback carbon pricing option'—a prudent measure given the 'inherent uncertainty' around the UK ETS. Therefore, while the government has not given us a date by which it will decide its approach to carbon pricing post-Brexit, we can expect to gain some clarity on the future of the tax as negotiations with the EU progress this year.

What are the timings and next steps?

The consultation closes on 29 September 2020, with a response from HMRC following later in the year. The government will then need to introduce secondary legislation to provide for the detailed operation of the tax as outlined in this consultation. The intention is to put legislation before Parliament in late 2020 with more following in 2021 or 2022. Additionally, it is intended that a Finance Bill in autumn 2020 will update FA 2019 to set the tax rate for 2021 and to provide for that rate to be adjusted.

Interviewed by Tom Inchley.