The first UK emissions trading system?

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Environment analysis: The UK government and devolved administrations of Scotland, Northern Ireland and Wales have indicated that they are in favour of developing the first UK emissions trading system (ETS) to uphold its carbon pricing obligations after Brexit. Simon Tilling, partner, and Stephen Lavington, senior associate at Burges Salmon, discuss how a UK ETS would operate, interact with the EU ETS and other suggestions in 'The Future of UK Carbon Pricing' consultation.

Original news

'UK and devolved administrations to implement emissions trading proposals', LNB News 01/11/2019 34

The UK government and devolved administrations of Scotland, Northern Ireland and Wales have published a summary of responses and their own response to chapter four of 'The Future of UK Carbon Pricing' consultation which sought views on possible options post-Brexit. The consultation outlined the government's and the devolved administrations' preference to establish a UK ETS that is linked to the EU ETS but also considered options should this not be possible. The majority of respondents were in favour of every proposal in chapter four and the UK government and devolved administrations have confirmed that all the proposals, except the proposal for regulatory responsibility across all devolved administrations for carbon capture and storage, will be implemented into domestic legislation.

What is the background leading up to the consultation on the future of UK carbon pricing?

The EU ETS was the world's first international emissions trading system, and remains the largest one, accounting for over three-quarters of international carbon trading. By putting a price on carbon (and other) emissions, it plays an important part in the EU's climate strategy and, by extension, the climate strategy of the UK—for as long as the UK remains a Member State.

The UK will leave the EU ETS at the point at which it leaves the EU. This will either be immediately in event of a 'no deal' Brexit or in accordance with the timetable of a negotiated Brexit.

To date, UK governments and the devolved administrations have been committed to carbon pricing—notwithstanding any exit from EU ETS—and have intended for the UK's future approach to carbon pricing be at least as ambitious as EU ETS. This is made clear in the first paragraphs of the consultation on the Future of UK Carbon Pricing (which closed in July 2019) and, given the level of public concern and the positions of the major parties, we would expect this to remain the case after the 12 December 2019 election.

The consultation goes on to consider the carbon pricing path that the UK should take in order to ensure that appropriate alternative structures are in place.

How does the question of carbon pricing relate to the UK's goal of reaching net-zero by 2050?

The challenge of reaching net-zero emissions by 2050 is significant, and while reduction of emissions from carbon-intensive installations will not achieve this alone, without such reduction it is difficult to see how the UK will meet an already ambitious target.

To date, the tone of communication from government has been clear—leaving the EU must not change these ambitions and goals. This is a further reason why the consultation has placed such importance on having suitable replacement structures in place.

What does the consultation propose by way of a post–Brexit, post EU ETS carbon pricing scheme and what are the challenges and benefits of the various options?

The consultation primarily considers competing options for a domestic UK ETS (to replace EU ETS) functioning either on a standalone basis or linked to the EU ETS.

The effect of linking a UK ETS with EU ETS would be to create a larger carbon market, making emission reduction opportunities for UK businesses more cost effective.

This is the most prominent difference between the two structures. In contrast to a standalone ETS, this would mean that the UK would not be able to trade on the EU carbon market—it could prove costly for UK companies if they are only able to trade emissions allowances with each other. It might be possible for a standalone UK ETS to form links with carbon markets other than EU ETS, but such proposals are not explored in the consultation (and in any event, the size of such an alternative market would, at this time, still be smaller than that offered by linkage with EU ETS).

At the time of the consultation, it was the preferred approach of the then UK government and the devolved administrations to establish a UK ETS linked to EU ETS. This could take a number of different forms, broadly dependent on whether the linkage would be 'one way' (ie use of EU ETS allowances in some form in the new UK ETS) or 'two way' (ie mutual recognition of allowances between the two systems, as is the case between EU ETS and the Swiss system).

However, a key challenge that the UK will need to resolve if it wishes to implement a linked UK ETS (in common with many other challenges that must be faced in forging post-Brexit relationships with Europe) will be reaching agreement with the EU as to the nature of the linkage. For reference, equivalent negotiations between the EU and Switzerland were proposed in 2010, concluded in 2016 with the link expected to become active in 2020.

Does the consultation consider any options other than a new UK ETS?

The consultation also considers a tax on carbon but primarily sees this as a stop-gap measure.

Indeed, legislation has already deployed the Carbon Emissions Tax (CET) as a contingency in the event of a no–deal Brexit, replacing EU ETS with a tax of £16 per tonne of CO_2 equivalent (this compares with a price of around €24 per tonne in EU ETS at the time of writing). Participants would pay CET on annual emissions and would also be required to continue to comply with existing monitoring, reporting and verification processes relating to greenhouse gas emissions.

The consultation notes that consideration could be given to the potential of a carbon tax as a longer term replacement for EU ETS, however this is not addressed in detail and further consultation would follow if this become a preferred option.

What responses to the consultation have the government issued to date?

In October 2019 the UK government and devolved administrations published their first response to the consultation, specifically addressing chapter 4, which deals with continued UK membership of EU ETS.

The current phase of EU ETS (Phase III) is itself due to end on 31 December 2020, with Phase IV requiring implementation of EU directives by Member States in preparation. The deadline for such implementation was 9 October 2019. In order to comply with its obligations as a current Member State, the UK is obliged to implement this EU legislation—chapter 4 of the consultation reflects this obligation.

There are other considerations. The current withdrawal proposal envisages that the UK will leave the EU at the end of 2020, following negotiation as to the wider post-Brexit relationship between the UK and EU. However, there is a chance that the UK could remain in the EU after this point, either due to extension to the negotiation timetable or if the decision is made not to leave the EU at all. The consultation also acknowledges (in passing) that, in the course of exit negotiations the EU and UK might agree for the UK would continue to participate in EU ETS. In this general context it is prudent to have the necessary legal basis in place to implement Phase IV in the UK.

To that end, and in line with the response to chapter 4, steps are underway to transpose the EU's Phase IV directive (to this end, The Greenhouse Gas Emissions Trading Scheme (Amendment) (No.3) Regulations, SI 2019/1440 were brought into force on 30 October 2019). The response also endorses some technical changes to the current UK regulations and various discretionary provisions for Phase IV proposed in the consultation, primarily around the continued UK opt-out for small emitters and an increase to penalties for non-compliance with UK regulations.

When can the outcomes of chapters 1–3 of the consultation be expected and what are the next steps and timings?

We will now certainly not see a response to chapters 1–3 of the consultation, which address some of the finer points of detail of a UK ETS, until after 12 December 2019.

While it might be premature to assume that the outcome of the election will bring certainty to the UK's future relationship with the EU we can expect that it will bring greater clarity and that the decisions made by the new government will set the scene for the future of carbon pricing in the UK and of a UK ETS.

Until that time, companies should carefully consider their carbon strategy, particularly with regard to preserving the value of any carbon surplus they hold in EU ETS accounts—we have advised business on this very topic in the run-up to the narrowly postponed no-deal Brexit at the end of October 2019.

The UK could still take one of a number of different paths, as referred to in the consultation and as summarised above, and those affected by carbon pricing should seek advice accordingly.

Interviewed by Samantha Gilbert.

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