

## The future of UK carbon pricing: an Aldersgate Group position paper

OCTOBER 2020

### ABOUT US

The Aldersgate Group is an alliance of major businesses, academic institutions and civil society organisations, which drives action for a competitive and environmentally sustainable UK economy. Our corporate members have a collective global turnover of over £550bn and include companies with operations across the UK economy such as Associated British Ports, Aviva Investors, BT, CEMEX, the John Lewis Partnership, Johnson Matthey, Michelin, Siemens, SUEZ, Tesco and Willmott Dixon. They believe that ambitious environmental policies make clear economic sense for the UK, and we work closely with our members when developing our independent policy positions.<sup>1</sup>

### SUMMARY

This paper briefly summarises the Aldersgate Group's position on the future design of the carbon emissions pricing regime in the UK following the end of the Transition Period. We believe that, irrespective of the pricing instrument used, the UK Government must use the current context to set an ambitious and predictable trajectory for its carbon pricing regime, which is in line with its net zero emissions target and is carefully designed to ensure that domestic industry is adequately supported in the transition to a net zero emissions economy.

In practice, the UK Government faces a choice between going down the route of a UK Emissions Trading Scheme (ETS) – which it has recently published its proposals on<sup>2</sup> – or put in place a Carbon Emissions Tax (CET). **On balance, the Aldersgate Group believes that an ETS with a trajectory aligned with the net zero target and equipped with a gradually increasing carbon price floor is the most effective option.** It is likely to be seen by businesses and investors as a more reliable investment signal and it would provide greater continuity to businesses, based on their experience of the European ETS, which can reduce the costs of compliance. As we approach 2050, a UK ETS with an emissions cap that is aligned with the net zero target is also likely to be better suited at creating a market for negative emissions as the supply of available allowances under the scheme gradually reduces. We point out however that there could be a potential role for a CET as a back-up/interim option as a UK ETS is set up and extended in scope over time.

Whichever route the UK goes down, it will be important for the new carbon pricing regime to abide by three key principles:

1. It is essential that there be **clarity for businesses as soon as possible** on any future carbon pricing mechanism. Businesses will need time to plan in order to ensure compliance with a new scheme.
2. Clarity on the details of a new scheme must also be accompanied by **a predictable and rising carbon price throughout the 2020s**, aligning it with the rate of emissions reductions required to deliver the UK's net zero target.
3. It would be advantageous for a new scheme to provide as **much continuity as possible** with the arrangements that UK businesses are familiar dealing with under

---

<sup>1</sup> Individual recommendations cannot be attributed to any single member and the Aldersgate Group takes full responsibility for the views expressed.

<sup>2</sup> BEIS (June 2020) Response to UK ETS Consultation: <https://www.gov.uk/government/news/new-emissions-trading-system-proposal-would-see-uk-go-further-in-tackling-climate-change>

the EU ETS. This will be particularly important for international companies operating in the UK, as disruption will increase complexity and the cost of doing business.

## FURTHER DETAILS ON ALDERSGATE GROUP'S VIEW

### *Learning from the EU ETS and the two options facing the UK Government*

A well-designed ETS is a cost-effective way of combating climate change and encouraging large emitters to reduce their carbon emissions footprint. The EU ETS was the first one of its kind and following initial design flaws, it has been improved over time through a tightening of the emissions reduction trajectory and the introduction of measures, such as the Market Stability Reserve, to reduce the amount of excess emissions allowances which have often depressed the price of allowances in the past. To date, the EU ETS has helped drive a reduction in emissions from sectors covered by the system by 21% in 2020 compared to 2005. In 2030, it is currently estimated that emissions from sectors covered by the EU ETS will be cut by 43% from 2005 levels.<sup>3</sup> However, the EU ETS is likely to undergo further changes and deliver greater emission reductions should European Commission President von der Leyen's proposal for a target of 55% emissions cut by 2030 be approved by the European Council.

**With its departure from the EU ETS, the UK has the opportunity to develop a carbon pricing mechanism which is more robust and effective than the EU ETS.** For example, flaws in the design of the EU ETS and the lack of dynamic allocations have created significant fluctuations in carbon pricing, which has limited forward visibility for businesses and investors, and has undermined its ability to act as a reliable investment signal.

It is important that the future UK carbon pricing regime deals with these issues and sets a more ambitious, predictable and reliable trajectory. The main, immediate priority for businesses will be to have clarity on the future design of this mechanism as soon as possible, as any changes in the system will need to be analysed and businesses will need to plan and adjust to ensure compliance.

**The UK essentially has two key options to develop its carbon pricing regime. It could either go down the route of developing a UK ETS (which could link up with the EU ETS) or putting in place a Carbon Emissions Tax (CET). Whichever route the UK goes down, the most important features that will determine the effectiveness of the new regime will be the clarity, perceived reliability, and ambition of the carbon price trajectory it provides.**

On balance, we believe that a UK ETS with some added attributes (compared to the EU ETS) would be the most effective of the two schemes. A CET underpinned by a carbon price escalator – not dissimilar to what has been done with the Landfill Tax – could in theory provide a clear carbon price. However, carbon pricing introduced as a tax instrument is likely to be seen as the one that is more vulnerable to future political changes, which could undermine the multi-year investment signal that the new carbon pricing regime must provide. It would also provide less continuity with the carbon pricing regime which businesses covered by the EU ETS have been dealing with to date.

In addition, if a UK ETS has a trajectory that is aligned with the net zero target, then the supply of available allowances under the scheme would automatically tighten as 2050 approaches, thereby gradually creating a market and providing a price signal for negative emission

---

<sup>3</sup> European Commission (2020) EU Emissions Trading System [https://ec.europa.eu/clima/policies/ets\\_en](https://ec.europa.eu/clima/policies/ets_en)

solutions. Creating new streams of revenue for developers of Negative Emissions Technologies is more easily done through a cap and trade system rather than through the tax system and the greater degree of government intervention this requires.

### **Key features for an effective UK ETS**

Should the UK establish its own ETS, the Government should implement **gradually reducing caps in line with the Committee on Climate Change’s cost-effective pathway to net zero emissions**, which will have the effect of aligning carbon pricing trajectory with the UK’s domestic policy objectives. This will help the new ETS support the UK’s net zero ambitions and it would put in place a framework which will drive continuous reductions in greenhouse gas emissions. Carbon prices can also be an important part of wider fiscal reforms that help boost public finances and set clear expectations on the long-term direction of structural change in the economy.<sup>4</sup> We welcome the Government’s commitment in its response to the recent UK ETS consultation that it would seek to align the scheme with the net zero target and is awaiting the advice of the CCC on this issue.

As argued in *Rebuilding to Last*<sup>5</sup> - a report from Dimitri Zenghelis and James Rydge at the London School of Economics commissioned by the Aldersgate Group - a UK ETS should **set a predictable and rising carbon price, starting at around £40 per tCO<sub>2</sub> in 2020 and rising to £100 per tCO<sub>2</sub>, or more, in 2050**. This trajectory should be aligned with the net zero target, be underpinned by a price floor, and the initial cap should be set at a level consistent with future advice from the Committee on Climate Change. The Zero Carbon Commission – which drew on the advice of many UK climate policy and business experts - has estimated that a net zero consistent carbon price trajectory could generate £27 billion in revenue in 2030<sup>6</sup>, which could then be redirected to help fund low carbon innovation in ‘hard to treat’ sectors, support a green economic recovery, and support investment in nature-based solutions. It would also reflect the likely cost of negative emissions technology and can serve as the new anchor of the shadow price trajectory.<sup>7</sup>

Furthermore, a steadily rising carbon floor price will be vital to drive cost-effective decarbonisation across industries. **The revenue raised can be consolidated in a set of funds used to leverage additional private finance in industrial decarbonisation projects** through (i) co-investing with the private sector at the development stage to crowd in other funding, (ii) direct government funding of development costs to be refinanced by the private sector on successful completion of a project, or (iii) Government guarantees to repay early-stage development funding from the private sector in the event of a failure to complete an innovative project.<sup>8</sup>

Increasing the ambition of a UK ETS should also involve designing it to include sectors that are currently not covered by the EU ETS or the proposed UK cap and trade scheme. For example, emissions from the incineration of hazardous or municipal waste are not yet covered by the EU ETS nor by the proposed UK ETS. Having a form of carbon pricing for this sector

---

<sup>4</sup> Zenghelis, D. and Rydge, J. (2020) *Rebuilding to Last: how to design an inclusive, resilient and sustainable growth strategy after COVID-19* (Commissioned by Aldersgate Group)

<sup>5</sup> Zenghelis, D. and Rydge, J. (2020) *Rebuilding to Last: how to design an inclusive, resilient and sustainable growth strategy after COVID-19* (Commissioned by Aldersgate Group)

<sup>6</sup> Zero Carbon Commission (2020) *How carbon pricing can help Britain achieve net zero by 2050*

<sup>7</sup> Grantham Research Institute on Climate Change and the Environment and Centre for Climate Change Economics and Policy (May 2019) *How to price carbon to reach net-zero emissions in the UK*

<sup>8</sup> Aldersgate Group (February 2019) private briefing *Directing green finance towards infrastructure* – available on request

could not only drive down the significant share of emissions it is responsible for, but also encourage businesses to invest in more innovative waste treatment options. Likewise, smaller emitters, with emissions lower than 25,000 tCO<sub>2</sub>e<sup>9</sup> are not yet set to be covered by the proposed UK ETS.

**To ensure that the whole of the economy is subject to a form of carbon pricing, and that a system is in place immediately after the end of the transition period, carbon taxation could be considered as a back-up / interim option for some sectors, given that a robust UK ETS could take longer to set up.** We recognise that a robust carbon tax, accompanied by a price floor and predictable escalator could send a more immediate signal about the need to decarbonise sectors like domestic heating or agriculture, which could be more difficult to tackle under a cap and trade system. It would also be easier to implement initially. However, any form of carbon pricing will only be effective if businesses perceive it to be in place for the long term. Policy makers would need to address the fact that any form of carbon taxation is likely to be perceived as more vulnerable to short-term policy changes, which makes it more likely for investors to discount when making decisions about investing in early-stage low carbon technologies.

Learning from the flaws of the EU ETS, a UK ETS should implement a fully dynamic allocation which allots free allocations closely to the most recent verified emissions.

***An effective carbon pricing regime must operate in conjunction with other policy levers***

**A carbon price mechanism cannot single-handedly put the UK economy on a credible pathway towards net zero emissions. An effective carbon pricing scheme needs to be accompanied by strong regulations, innovation support measures and market mechanisms to bring new technologies and business models to market.** Innovation needs to focus on large scale trials of technologies and business models that will be essential to cut emissions in ‘hard to treat’ sectors, such as heavy industry, agriculture and aviation. These include at scale trials of Carbon Capture and Storage, hydrogen production and use, investment in battery technology and sustainable biofuels and trialling more resource efficient business models.<sup>10</sup>

The UK should also adopt targeted measures to prevent carbon leakage and support the competitiveness of UK industries as they decarbonise. For example, product standards, which take into account the whole product lifecycle and circular economy considerations, such as reuse and recyclability, can incentivise greater resource efficiency in production processes. It can also drive down embodied carbon in building materials, such as steel and cement, whilst growing the market for ultra-low carbon industrial goods and protecting UK businesses from high carbon imports. As an example, the EU’s highly successful Ecodesign Directive set energy efficiency criteria for a range of products, achieving an 18% reduction in average energy consumption by 2020 against business as usual, and saving consumers \$3 for every \$1 spent on average.<sup>11</sup>

Finally, if the UK establishes its own, ambitious ETS, it should seek to **cooperate with the EU on the design and implementation of the new scheme.** Businesses would benefit from a degree of continuity in the immediate term. It could also help reduce costs by, for example, linking the new UK ETS with the EU ETS, and co-ordinating low carbon stimulus and innovation investments - thereby amplifying the potential growth benefits of the net zero

<sup>9</sup> <https://www.pinsentmasons.com/out-law/guides/uk-emissions-trading-scheme-2021>

<sup>10</sup> Aldersgate Group (2020) *Building a net zero emissions economy: next steps for Government and businesses*

<sup>11</sup> The Economist (October 2016) ‘The EU is reviewing the policy that makes its appliances so energy efficient’

transition<sup>12</sup>. It is vital for companies operating across the EU as well as the UK to have the ability to decide on any proposed investments in an efficient way, thereby maximising the value of CapEx in all operating units on the same basis.

If the UK sets up a linked ETS, it could switch to a 'gross' accounting system for emissions. This would require the Government to report actual domestic emissions for ETS facilities against the UK carbon budgets, which would ensure greater accountability for Government and a clearer direction of travel. This would not prevent ETS facilities from trading allowances across borders to achieve decarbonisation as cost-effectively as possible.<sup>13</sup>

---

<sup>12</sup> Zenghelis, D. and Rydge, J. (2020) *Rebuilding to Last: how to design an inclusive, resilient and sustainable growth strategy after COVID-19* (Commissioned by Aldersgate Group)

<sup>13</sup> WWF (2019 unpublished report) *Forging a new path: Preparing UK carbon budgets for Brexit*