Developing the UK Emissions Trading Scheme

February 2023

Introduction

What is the UK ETS?

The UK Emissions Trading Scheme (UK ETS) puts a price on carbon emissions. It began in 2021 after the UK withdrew from the EU, and with it, the EU ETS. Businesses covered by the UK ETS (referred to as 'installations') buy and sell emissions 'allowances' that they must hand over at the end of the year to cover their emissions. The more they emit, the more allowances they will need to buy; but if they decarbonise, perhaps by switching from gas to electricity, they will have leftover allowances to sell for profit. In this sense, the ETS acts as both carrot and stick to incentivise decarbonisation.

The UK ETS covers energy intensive industries like steel and cement, power stations, and aviation.

By capping the overall number of allowances available in the Scheme, the UK ETS can be a great way of limiting territorial emissions from certain sectors, while driving decarbonisation where it is cheapest and most easily achievable. At least in theory.

How has the UK ETS performed so far?

In practice, the UK ETS, like its EU counterpart, has been ineffective in significantly lowering emissions, largely due to a loose cap on the overall number of available allowances, which has allowed emissions from the sectors covered by the Scheme(s) to remain high for years. Meanwhile, 'free allowances' – which are supposed to be issued by Government to reward efficiency or prevent companies offshoring emitting activities (known as carbon leakage) – have often been handed out too generously, giving some participants a free ride to pollute. Several airlines for example, received more free allowances than their total emissions, eliminating the ETS' financial incentive for decarbonisation.

Many critics have also pointed to the narrow sectoral coverage of the Scheme, arguing that it is not broad enough to generate the significant emissions reductions we need to see across the economy.

The UK ETS is also a much smaller market than the EU ETS, due simply to the fact that the EU Scheme covers installations in the EU, Norway, Lichtenstein, and Iceland, meaning the UK ETS has less liquidity. Moreover, many UK businesses operate in the EU as well, and must meet the administrative requirements of participating in two Emissions Trading Schemes.

Some participants have also expressed concern that there is not enough foresight on the future number of both overall emissions allowances and free allowances that will be available in the future. This negatively affects businesses' ability to accommodate the cost of carbon when making longer-term contracts with customers and suppliers, potentially hampering investment plans in the UK.

Developing the UK ETS

In 2022, the Government launched a consultation that set out a series of reforms to the UK ETS. This included tightening the overall emissions cap so that it reflected the UK's net zero

+44(0)204 5420 946 engagement@aldersgategroup.org.uk www.aldersgategroup.org.uk

ambitions (referred to as the 'net zero aligned cap'); expanding the scope of the Scheme in sectors already included; extending the Scheme itself, so that it covers parts of the waste and shipping sectors; and proposing changes to a number of the Scheme's 'market mechanisms', for example removing the carbon price floor (known as the 'Auction Reserve Price', which sets a minimum price for 1tCO2).

A number of these reforms dramatically improve the ambition of the UK ETS and, if enacted, would go a long way to fixing some long-standing issues, such as an excessive number of allowances and a weak incentive for some sectors' decarbonisation. However, the proposed reforms do not do enough to include other sectors, fail to give foresight of future emissions allowances, and miss the opportunity to begin a discussion on how the Scheme might interact with other forms of carbon pricing, namely a Carbon Border Adjust Mechanism (CBAM), such as the one proposed by the EU.

A net zero consistent cap and the future of free allowances

A net zero consistent cap on overall emissions allowances

The Aldersgate Group welcomes the ambition of the proposed net zero consistent cap on emissions, which will see the excessive number of allowances that have been available, weakening the Scheme in recent years, to be reduced to a level that aligns with our net zero ambitions as a country. This sends a clear market signal to sectors covered by the Scheme about the direction of government policy, improving the business case for investing in assets, fuels and processes that will decarbonise their activities and bring them in line with the more ambitious ETS with which they are required to comply.

However, the UK ETS is not a 'silver bullet', and will be unable to deliver the scale of emissions reductions presented by this revised cap. Therefore, an increase in ambition in the UK ETS must accompanied by supportive policies, such as a CBAM (to prevent cheap high carbon imports from undermining domestic producers that decarbonising), demand-side mechanisms such as mandatory product standards and green public procurement, to grow the market for low carbon products, innovation support to create and scale up new technologies, and investment support so that industries can undertake the large scale upfront capital investment required to decarbonise some processes.

This is what will ultimately enable UK ETS participants to meet the requirements of a new and improved cap on emissions, and respond to the carbon price incentive.

The future of free allowances

As emissions allowances reduce and carbon prices increase, sectors that do not yet have access to the fuels and technologies needed to reduce their emissions will continue to need support to ensure that the carbon price does not prohibit investment into the low carbon technologies it is designed to accelerate. In this regard, free allowances should continue to be allocated based on the efficiency of installations, and their risk of carbon leakage. This will be crucial to maintaining businesses' competitiveness in the face of cheap high carbon imports, and preventing the offshoring of activities to countries with a lower (or no) carbon price. If this were to take place, the UK would increase its consumption emissions while offshoring the opportunity presented by rapidly expanding green markets, along with the existing benefits provided by current employment and GVA generated by domestic industries.

The use of surplus allowances could be particularly useful here, as they will be available when there have been unexpected efficiencies elsewhere in the Scheme, and can be used in a way that does not increase the overall number of emissions allowances being used in the Scheme.

Expanding the UK ETS in sectors already covered

Aviation

The Aldersgate Group strongly welcomes the proposal in this consultation to completely withdraw free allowances from the aviation sector. As the aviation sector is demonstrably evidenced to be unable to simply relocate their activities while continuing to participate in the UK aviation sector, it is not in need of free allowances to mitigate carbon leakage.

We also suggest Government swiftly rectify errors that have led to airlines receiving more free allowances than their total verified emissions, which has given the sector a hidden subsidy.

Bioenergy

However, looking at other sectors already covered by the UK ETS, missing from this consultation is a proposal to apply a carbon price to bioenergy emissions. Biomass is not always a renewable energy feedstock, and can lead to carbon emissions higher than those at coal power stations, ‘carbon debts’ of over 40 years, and harmful air pollutants. Moreover, the global biomass industry is poorly regulated at current, and has been shown to lead to negative outcomes for nature and ecosystem services, such as weakened biodiversity, and damaged natural water filtration.

By excluding emissions from biomass-derived power generation, there are hundreds of millions of pounds in uncollected carbon taxes, with DESNZ estimates showing as much as £556.8m payable from just one biomass installation in the UK were it subject to the UK ETS.[1] This would be of significant assistance to the UK’s offshore wind target of 50GW of installed capacity by 2035. Alternatively, these funds could be used to mitigate the impact of surging energy bills on UK households, or to fund greater energy security measures, such as investments in energy efficiency upgrades.

Market mechanisms

Liquidity

The Aldersgate Group disagrees with the proposal to use surplus allowances to improve liquidity in the UK ETS. Although this has been recognised as an issue with the comparatively smaller UK Scheme, there are better ways to address this. See the upcoming section on linkage with the EU ETS.

Surplus allowances represent an unexpected overachievement of the UK ETS and its participants, as the available allowances within a specified year were not needed: if allowances did not need to be used, emissions were lower than otherwise expected. The Government should therefore carefully consider how it intends to spend this saving, and whether it is possible to retain the benefits of moments of overachievement (especially as the overall cap reduces).

Cross-Sectoral Correction Factor

[1] https://ember-climate.org/app/uploads/2022/02/2020-Ember-Burning-question-FINAL-1.pdf

Instead, as briefly outlined above, surplus allowances would be much better spent on mitigating the application of a Cross-Sectoral Correction Factor (CSCF). The CSCF is applied when the overall number of free allowances due to be distributed in a given year exceed the number forecast by the pathway for free allocation. The CSCF then reduces, proportionally, the number of free allowances received by industry. As the Scheme reduced the number of overall allowances in the Scheme, as CSCF is more likely to be applied over the coming years.

Aldersgate Group members from across the sectors have highlighted that should a CSCF be applied, the carbon price they pay would increase as their level of effective subsidy, via free allowances, reduces. This additional cost could not be recovered from the market as contracts well into the future have already been agreed upon, factoring in current levels of expected free allowances for future years (and therefore an anticipated carbon price that cannot be renegotiated or recovered). This could represent a significant cost for many businesses. Using surplus allowances to mitigate against this could therefore be an effective way to support businesses during the transition.

This said, it will be important to ensure that surplus allowances/free allowances continue to reflect the efficiency of installations, their risk of carbon leakage, and their ability to decarbonise.

The Auction Reserve Price and Cost Containment Mechanism

The Aldersgate Group also strongly disagrees with the proposal to remove the Auction Reserve Price (ARP), and argues that a clear ARP is needed to provide certainty against sudden price drops. The ARP provides a ‘carbon price floor’ by setting a minimum amount payable for a tonne of CO2 emissions. In the event of an unexpected price collapse, this would ensure that a financial incentive to decarbonise always exists, while also upholding the ‘polluter pays’ principle.

Concomitantly, more clarity is needed on the Cost Containment Mechanism (CCM). When the CCM has been triggered in recent months, Government has not intervened, rendering the mechanism unpredictable. These measures would provide a ‘collar’ on the carbon price that offers a level of stability in the market without affecting day-to-day price discovery.

Expanding the UK ETS into new sectors

Waste

The Aldersgate Group warmly welcomes the proposal to extend the UK ETS to waste incineration and Energy from Waste, and urges the Government to work with industry to understand how this could be done in line with two principles: firstly, creating an incentive to reduce emissions in the waste sector in a timeframe that matches the urgency of the UK’s need to decarbonise; and second, ensuring that a carbon price is introduced in a timeframe that enables the sector to effectively plan for, respond to, and comply with it.

It is crucial to again note that the UK ETS is not a silver bullet for waste sector decarbonisation: parallel policies are needed to help businesses move up the wase hierarchy, beyond disposal to re-use, remanufacturing and repair.

Firstly, measures first proposed in the Government’s Resources and Waste Strategy of 2018 should be implemented at pace – chiefly, mandatory product standards, Extended Producer Responsibility, Deposit Return Schemes, and labelling. Secondly, Government should plug the missing policy gaps on resources and waste – introducing green public procurement criteria, investment in circular infrastructure, introducing VAT reform and other fiscal incentives for repair and resource efficient products, and growing the demand for servitisation business models.

Shipping

We also welcome the extension of the UK ETS to maritime shipping. However, the current proposal only applies to intra-UK journeys, missing a large percentage of the sector's emissions. The UK ETS should therefore cover 50% of emissions from UK-International journeys, matching plans set out by the EU.

There is also a strong case to cover the emissions arising from a broader spectrum of vessels. The current proposal captures emissions only from vessel 5000GT or above. Recent analysis from Transport and Environment shows this would miss 45% of emissions, and suggests a threshold of 400GT to capture an adequate level of emissions while limiting administrative burden.[2]

Should the UK and EU ETS be linked?

It is clear that the Government has some welcome reforms planned for the UK ETS, such as a reduced cap on emissions allowances, expansion to parts of the waste and maritime sectors, and removing free allowances for airlines. In places, this goes beyond the ambition of the EU ETS.

This said, in agreement with the vast majority of businesses, NGOs, and academic institutions, we urge the Government to consider how it can better link the UK and EU ETS. This would resolve issues with liquidity in the small UK market and significantly reduce the administrative burden for firms participating in both Schemes.

As the EU implements a CBAM, in the absence of a UK equivalent, divergence between the UK and EU ETS will also make it more difficult and expensive for UK exporters to sell into the EU.

Looking ahead then: how do we solve the tricky equation of matching increased ambition with linkage of the Schemes? The Aldersgate Group suggests that any divergence between the two Schemes should be based on scientific, rather than political reasoning, and be expressed in a way that will allow future interoperability with other carbon pricing systems. This will allow the UK to more easily adopt ambitious measures in the EU ETS (such as those on shipping), while using its position to lobby for the ambitious reforms presented in this consultation to be adopted globally.

[2] https://www.transportenvironment.org/wp-content/uploads/2021/07/2018_03_ESR_CAR_final_report.pdf