UK Emissions Trading Group

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Post BREXIT UK climate policy options for UK installations and sectors covered by the EU ETS

About ETG
ETG supports, represents and informs UK businesses and installations covered by the UK and EU carbon reporting schemes. ETG offers a forum for discussion and resolution of all aspects of emissions trading and enables communication to take place between commerce and industry, and the UK Government.

Executive summary

1. This paper sets out some pros and cons of five possible alternative post-BREXIT climate policy options for UK installations and sectors covered by the EU ETS, as identified by ETG members at a workshop on 18 November 2016 and subsequently. The 'do nothing' option was not discussed on the basis that the UK will still have Kyoto Protocol, Paris Agreement and UK Carbon Budget obligations after BREXIT. Since the ETG is a broad church, this paper does not make a recommendation as between the five options.

2. The five possible alternative options are:

    1) **EU ETS Reloaded** – EEA or similar arrangement, e.g., Norway (assuming that this is politically feasible).

    2) **Mirror** - a separate – possibly linked UK ETS that mirrors as far a possible the EU ETS but outside an EEA type arrangement.

    3) **Linked UK ETS** – a new 'improved' UK ETS linked to EU ETS by joint recognition and fungible allowances for compliance - cap in line with carbon budgets and agreed with EU - similar basic architecture and broad coverage but flexibility on detailed design (e.g., allocation and leakage criteria, sectors, gases, contribution to EU funds).

    4) **Stand-alone** – A new, bespoke, ETS designed for domestic purposes - Linkage "friendly".

    5) **Something else** (non-ETS options).

3. The option of 'Something else' depends on the measure, e.g. a carbon tax, Climate Change Agreements (CCAs) or some other form of regulation. These non-ETS options are now being considered in more detail in order to identify the pros and cons of any specific scenario(s) within the industry wide context that frames ETG's views.

4. Factors to be borne in mind on all options are the need to:

- assess any post BREXIT policy proposal on its contribution to UK carbon budgets and a future UK Paris Climate Agreement Nationally Determined Contribution (NDC).
- maintain the UK's international competitiveness and to enable UK business to thrive after withdrawal from the EU.
- achieve least cost, most effective abatement options and protection from carbon leakage.
- ensure simplicity of both design and implementation.
- offer a transparent forward path over a reasonable amount of time to allow better decision making.
- take account of possible interlinkage with other EU legislative instruments and robust GHG offsets.

ETG Secretariat
March 2017

Pros and cons of the four ETS-related options and summary of discussion of 'Something else'

Emissions Trading – Overarching comments:

In the interest of consistency and given the momentum of international action to date – for example in relation to the Paris Agreement and the fact that the ETS operates across European markets - there was a significant degree of support for the UK to continue with some form of emissions trading, either by way of "mirroring", "linking" or a stand-alone ETS.

It was suggested that since the UK is seeking to become an open-trading nation, it should apply that principle to abatement policies as well. It was also suggested that ETS could work well if there was both the will for it to do so and the right design - and it was seen as benefitting from being a cost-effective abatement policy, as opposed to a tax.

Although concern was expressed that emissions trading was susceptible to interference by policy makers, it was also recognised that this was applicable to non-ETS options and that the more recent experience of China, California and South Korea in ETS implementation had demonstrated that it was possible to learn from the EU ETS and improve the approach to emissions trading. MiFID, banking and trading issues were also of concern. Some members see BREXIT as a unique opportunity to reassess the wider policy landscape and to achieve decarbonisation via an alternative non-emissions trading route.

Option 1: EU ETS Reloaded

- **EEA or similar arrangement, e.g. Norway; Politically feasible?**

Pros:	Cons:
• Ability to manage across multiple plants located throughout EU under same scheme • Fungibility of allowances • Consistency with EU • Low risk of market failure • At macro scale is delivering / could deliver emissions reduction at lowest cost • Less uncertainty than some options for Government, regulator and industry • In so far as provides certainty, encourages investment • Provides for "level playing field" with other European countries • May be more straightforward than setting up a new scheme from scratch	• Limited by political acceptability of post BREXIT trade agreement • Perpetual discussions on carbon leakage mitigation - inadequate carbon leakage protection especially for Phase 4 • Administrative burdens especially for SMEs (unless exempted) • Acts as a disincentive to UK / EU investment, given also political interference in the market • Benchmarks might not be appropriate for UK industry – can't achieve rates of improvement (proposed for Phase 4). • No say in design / rules, post BREXIT (although the rules should be largely fixed by March 2019) • In so far as doesn't provide certainty it discourages investment • BREXIT drivers (movement of people, self-determination, contribution to EU funds etc) are not addressed e.g. continued UK contribution to modernisation/innovation funds • The failure to join up EU policies or consider the perverse incentives created by a separate renewables target would still be the case in Phase 4 • More stick from Phase 4 not carrot • The Registry and Auctioning are governed by EU regulations rather than UK legislation, so these regulations (as well as the EU ETS Directive) would potentially require amendment to enable the UK to remain in the EU ETS

<table>
<tr><td colspan="2">Option 2: Mirror
A separate, perhaps linked, UK ETS that mirrors as far as possible the EU ETS but outside an EEA type arrangement</td></tr>
<tr><td>Pros:
Equivalence – minimises administrative burden for those with installations in UK and in EU 27.
Fungible allowances (same carbon price)
Way to re-join EU ETS in future
Minimal administrative disruption and avoiding need to re-set accounting and compliance processes to meet new rules/schemes
Possible model for future expansion of remainder of EU ETS to third parties</td><td>Cons:
Depending on degree of difference, possible difficulties in linking a separate scheme to the EU ETS
Some constraints on self-determination in design of scheme rules
Depending on design, scheme could become very complex
Large emissions trading schemes are better than small schemes – so any stand-alone scheme perhaps needs to be linked to an existing ETS, e.g. the EU ETS</td></tr>
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Option 3: Linked UK ETS • **A new "improved" UK ETS linked to EU ETS by joint recognition (under Article 25 of the Directive) and fungible allowances for compliance** • **Cap in line with carbon budgets and agreed with EU** • **Similar basic architecture and broad coverage but flexibility on detailed design (e.g. allocation and leakage criteria, sectors, gases, contribution to EU funds)**	
Pros: • Increased level of self-determination • Some degree of equivalence • Some experience with former UK ETS • If the UK is unable to influence the design of Phase 4 a separate UK ETS would be preferable • Scope to develop a more simplified, harmonised and aligned MRV regime (subject to the need for equivalence)	**Cons:** • Depending on degree of difference, possible difficulties in linking a separate scheme to the EU ETS • It may not be possible to know if linking would be allowed until a long way down the design route – given time constraints of BREXIT this could be a significant issue • Still linked to state aid constraints • Depending on design, scheme could become very complex • Companies would need to see a definite benefit from design changes – and would not want to have to start again • Potential huge amount of work for operating companies (and EA) in designing and establishing a new scheme – at a time when dealing with other BREXIT-related issues • Potential links to funding mechanisms benefitting countries other than UK

Option 4: Stand alone • **A new, bespoke, ETS designed for domestic purposes** • **Linkage "friendly"**	
Pros: • Some experience with former UK ETS • Even more self determination • No money to EU • Better control of carbon leakage mitigation • No link to free movement of people • Revenue determined by UK Government • Competitiveness in hands of UK • Scheme could be marketable to other trading partners • In the long-term potential to regionalise and expand a UK scheme to include non-EU members – consistent with the Paris Agreement • Opportunity to opt back in to EU ETS (via Linking) • Subject to design, scope to have greater access to international credits, as might be necessary in relation to UK carbon budgets • Subject to design, scope to expand to include other sectors and participate in an international sectoral scheme • Scope to develop a more simplified, harmonised and aligned MRV regime (subject to any future linking intention)	**Cons:** • Allowances not fungible • Possible higher risk of market failure in a stand-alone scheme • Increased risk of border tax adjustment • Increased risk of non-recognition due to lack of equivalence • Companies would need to see a definite benefit from design changes – and would not want to have to start again • Significant distortions with the EU ETS would need to be avoided in order for a UK scheme to work with the EU and possibly beyond • A stand-alone scheme could be more expensive to operate and could have an impact on competitiveness • Any linked UK scheme would need to have equivalent carbon leakage provisions to ensure a level playing field so that UK industry is not unfairly disadvantaged, including the resulting administrative burden – this might be difficult • Trading schemes are better the larger they are – introduction of new stand-alone schemes could undermine this • Potential huge amount of work for operating companies (and EA) in designing and establishing a new scheme – at a time when dealing with other BREXIT-related issues

Option 5: Something else

- **All options bounded by UK Carbon Budget requirements and acceptance by Government and Industry**
- **Noted that this depends on measure under consideration – carbon tax, CCAs, regulation**

Summary of discussion

Members generally found it more difficult to address the option of 'Something else' since this depends on the measure, e.g. a carbon tax, Climate Change Agreements (CCAs) or some other form of regulation.

'Something else' would need to be further considered in more detail in order to identify the pros and cons of any specific scenario(s). Some members saw post-BREXIT as a unique opportunity to reassess the wider policy landscape to decarbonise while boosting UK competitiveness, jobs, growth and investment by offering 'less stick' and 'more carrot' e.g. through tax breaks. However, if a variation of the Climate Change Levy was considered, revenue should be hypothecated.

Members commented that CCAs were well-understood and comparatively easy to introduce. It was noted that since CCAs allowed relative targets they took account of production increases, could be site-specific and were particularly suitable for small emitters. It was also noted that the baseline and trade arrangements that had operated under the original CCAs could be effective as could roadmaps. An ETG sub-group has been formed to further evaluate these options.

Against this, concern was expressed both that non-ETS options offered less certainty over achieving abatement targets and there was wariness about taxes.

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