EFET European Federation of Energy Traders
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15 January 2020

Subject: The future of carbon pricing and emissions trading in the UK

We would like to thank the UK Department for Business, Energy and Industrial Strategy (BEIS) for the meeting held between the European Federation of Energy Traders (EFET)[1] Task Force Emissions Trading and representatives of the BEIS' EU Energy and Climate Change division on 13 January 2020 on the future of carbon pricing and emissions trading in the UK. The present letter summarises the main recommendations we would like to put forward to the attention of BEIS, along with the relevant concerns about the subject matter.

While the negotiation process of the UK's withdrawal from the EU continues, there remains a lack of clarity on the future approach to carbon pricing and emissions trading in the UK.

EFET is firmly convinced and has always emphasised that a well-functioning emissions trading system (ETS), together with ambitious and realistic carbon reduction targets, is the most cost-effective means of achieving the objectives of energy and climate policy. At the same time, it gives affected companies long-term visibility, clarity and predictability, which is especially relevant for energy-intensive industries and power generators.

We would like to highlight that the basic principles of continuity and predictability of carbon pricing are key for preserving well-functioning electricity, gas and emissions markets in the United Kingdom. The prevailing uncertainty about the continued participation of the UK in the EU ETS post-Brexit, and about the way in which a UK-only price for carbon will potentially be

[1] The European Federation of Energy Traders (EFET) promotes competition, transparency and open access in the European energy sector. We build trust in power and gas markets across Europe, so that they may underpin a sustainable and secure energy supply and enable the transition to a carbon neutral economy. We currently represent more than 100 energy trading companies, active in over 27 European countries. For more information: www.efet.org.

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set, has been having a negative impact on the supply and demand balance in the market and on the ability of firms to hedge their risks.

We welcome the guidance provided by the terms of the Withdrawal Agreement. Once ratified, we understand the agreement reached between the UK and the EU will ensure that the UK will remain in the EU ETS market until the end of 2020. However, we would like to reiterate that the market needs **long-term regulatory predictability and visibility of carbon pricing beyond 2020**, as companies trade forward on the curve up to three years. Currently, participants to the GB energy market lack visibility of carbon pricing as of 1 January 2021 and are therefore unable to properly hedge their carbon risk in the longer term.

We therefore urge the UK Government to provide clarity on the following matters as soon as possible:

1. The approach to carbon pricing in the UK post-Brexit and a timeline indicating the main actions foreseen for the development and implementation of the given approach. Should a linked UK ETS be chosen option for the future, what would be the milestones to establish it by 1 January 2021?
2. Resumption of UK's EUA auctions and their timeframe.
3. In the event that the transition period is extended for a certain period of time (six months or a year from 31 December 2020 onwards), will the UK be subject to the EU ETS compliance for 2021?
4. The approach to carbon price support before and post-2021.

MAIN RECOMMENDATIONS

- Establishing a UK ETS closely and immediately linked with the EU ETS is a no-regret option.
- Until a linked UK ETS is established, UK's continued participation in the EU ETS must be ensured.
- Neither a standalone UK ETS nor a carbon tax constitute an optimal option/transition mechanism for carbon pricing in the UK.
- Ensuring the UK's 2019 EUAs are auctioned in a proportionate way is necessary in order to avoid market distortions.

No-regret option: establishing a UK ETS closely linked with the EU ETS.

When it comes to the UK's future approach to carbon pricing, we understand that several options are currently being considered. In particular, establishing a UK ETS (linked with the EU ETS or standalone) or a carbon tax.

In order to reduce carbon emissions cost-efficiently and to deliver on the UK's climate ambitions, the United Kingdom post-Brexit would benefit from relying on a market-based mechanism for carbon abatement, through a UK ETS closely linked with the EU ETS.

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At the same time, taking the Linking Agreement between the EU ETS and the Swiss ETS as an example, it becomes clear that the negotiation process is likely to be quite lengthy[2], creating long-term uncertainty for market participants.

UK's continued participation in the EU ETS until a linked UK ETS is established is essential.

In the event that the UK ETS and its link to the ETS is not legally established in time for 2021, it is crucial to ensure the UK's continued participation in the EU ETS. The UK should therefore continue to adopt the same rules as the EU ETS until a linked UK ETS is in place.

UK ETS design: ensuring alignment with the EU ETS is key.

The design of the UK ETS should be closely aligned to the EU ETS in order to allow the two systems to link. Any diversions from the EU ETS should be avoided in the design of the UK ETS, while minimal technical diversions should be accepted strictly on a "by exception" basis. Ensuring harmonisation of the UK ETS and the EU ETS design would facilitate linkage discussions with the European Commission and increase the likelihood of having the two systems linked from the outset. We therefore urge BEIS to engage with the European Commission's representatives as soon as possible in relation to the UK ETS design, to ensure the latter is ready for an immediate linkage between the two systems.

Once the linking of the two systems is established, this would help to ensure a market-based price for carbon emissions in the UK and that the liquidity benefits from the EU ETS can be maintained. Indeed, the deep level of liquidity provided by the high number of active market participants constitutes one of the key benefits of the EU ETS since its creation. Even when the carbon price and volatility were much lower, the level of liquidity in the market held up very well and market participants were able to efficiently manage their risks on a continuous basis.

With this in mind, we support BEIS' proposal set out in the public consultation document on the future of carbon pricing in the UK[3] to have the minimum scope of a UK ETS match the one of the EU ETS in order to ensure that a UK ETS is indeed linkable to the EU ETS. We would also support consideration of the potential expansion of the scope of the UK ETS to other sectors, subject to the important condition that this should not have a distortive effect on linking the UK ETS to the EU ETS.

The UK ETS should maintain all key design principles of the EU ETS, including all recent and future changes. This concerns in particular the phase out of free allocation and other improvements to the rules addressing carbon leakage in order to enable and maintain a robust link between the two systems going forward. Regarding the EU Market Stability Reserve (MSR), coherence between the proposed UK ETS mechanism and the reformed EU ETS MSR has to be ensured in order to avoid market distortions. Apart from that, the upcoming changes to the design of the EU ETS, such as the extension of the scope of the EU ETS, the review of

[2] Negotiations on the Linking Agreement between the EU and Switzerland started in 2011. The linking agreement was signed at the end of 2017 and entered into force on 1 January 2020.
[3] The public consultation ran from 2 May 2019 until 12 July 2019, see here: https://www.gov.uk/government/consultations/the-future-of-uk-carbon-pricing

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the Auctioning Regulation or the update of the monitoring, reporting and verification rules, would need to be fully integrated in the UK ETS.

Neither a standalone UK ETS nor a carbon tax constitute an optimal option/transition mechanism for future carbon pricing in the UK.

In the event that the linking of the two systems cannot be agreed and/or implemented initially, the UK should maintain an ETS that is strongly aligned with the EU ETS in order to be able to agree the linking of the two systems in the future. Reverting to a standalone UK ETS which is not aligned with the EU ETS would discard this option for the future and be to the detriment of market participants and consumers.

We strongly believe that a standalone UK carbon trading mechanism would not be able to deliver a sufficient level of liquidity for the market to operate efficiently. Without sufficient liquidity, it is likely that the market will have to face wider bid-offer spreads, leading to increasing compliance costs for market participants and end-consumers. In addition, a standalone UK ETS would hinder the possibility of linking the UK system with the EU ETS in the future. We therefore strongly advise against this option, as well as against a carbon tax as an alternative. It is worth noting that important strengths of the ETS also include the progressive nature of the volume of allowances granted and the flexibility of distributional effects.

Resumption of UK's EUA auctions and their timeframe.

We would like to highlight that ensuring the UK's 2019 EUAs are auctioned in a proportionate way is necessary in order to avoid market distortions. We therefore advise against putting all the UK's 2019 EUA volumes on the market within a short period of time (for instance, three to four months before compliance deadline on 30 April 2020), which would disrupt the market and impact price volatility. We believe a balanced approach to actioning the UK's EUA volumes is required, allowing to spread the EUA volumes evenly across at least ten months.

We stand ready to provide further input on the future of carbon pricing and emissions trading in the UK and we are keen to ensure a continued dialogue with BEIS in view of the transition period.