Joint consultation response on the future of emissions trading in the UK

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EFET, the Federation of European Energy Traders, and Europex, the Association of European Energy Exchanges welcome the opportunity to take part in the present consultation on the future of emissions trading in the UK, launched by the Department for Business, Energy and Industrial Strategy (BEIS).

Importantly, 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 set, is already having a negative impact on the level of liquidity in the market and on the ability of firms to hedge their risks.

We therefore urge the UK Government to provide clarity on a post-Brexit approach to carbon pricing in the UK in a timely manner.

The UK energy markets are closely linked to the wider EU internal energy market through cross-border trading. GB power prices currently tend to be at a premium to the French and Dutch markets, the UK's main sources of electricity imports. If the UK was to leave the EU ETS, it would lose an important reference for carbon pricing in the UK. This has the potential to increase the price divergence between the UK and the EU post-Brexit even further. Leaving the EU ETS may also distort price signals in the North-Western European wholesale power market as a whole. It could even - inefficiently - reverse the flow of energy between geographic areas, thereby undermining the efficient functioning of the market.

Moreover, additional problems would occur for the functioning of the All-Island Single Electricity Market (I-SEM) in Ireland, whose future hangs on a political agreement between the UK and the EU, should the UK indeed be exiting the European Union. Without such an agreement, the current arrangements may become void, creating high uncertainty about the future of both the electricity and emissions markets in the UK and the Republic of Ireland.

Our strong preference is therefore to ensure the UK's continued participation in the EU ETS which would be beneficial for UK consumers and UK businesses, and would help to achieve the UK's climate targets in the most cost-efficient way.

While remaining in the EU ETS is by far the preferable option over any alternatives, below we provide our comments on the other post-Brexit carbon pricing options for the UK, as set out in the present public consultation:

A linked UK Emissions Trading Scheme (linked UK ETS)

Should a direct participation in the EU ETS not be possible, the second best option would be the establishment of a UK carbon trading mechanism that is as closely as possible aligned with the EU ETS in order to link the two individual systems going forward. 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 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 welcome the potential expansion of the scope of the UK ETS to other sectors, provided that it does 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. In addition, upcoming changes, e.g. the review of the Auctioning Regulation or the update of the monitoring, reporting and verification rules, should be fully integrated.

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.

A standalone UK ETS or a tax on carbon

EFET and Europex 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.

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

The introduction of standalone national or regional carbon abatement measures, such as carbon taxes, may bring a number of adverse consequences for both carbon and power markets, such as:

- A 'waterbed' effect, whereby a decrease in emissions in one country (or sector) is offset by an increase in emissions in neighbouring countries (or sectors), due to the relocation of generation or manufacturing assets, thus harming the effectiveness of the EU ETS (and potentially a linked UK ETS) as the primary mechanism for abatement;
- Carbon leakage through distortions to the interconnected power markets in the EU and the UK, since different CO2-prices would result in different power prices across borders, thereby re-locating the emissions to power plants outside the carbon floor price area;
- Greater fragmentation of the emission allowances market in the EU (and potentially the UK, if a linked UK ETS is established) and the related climate action policies;
- Barriers to linking the EU ETS scheme and the potentially linked UK ETS with compatible schemes on a global level. Indeed, setting the level of a carbon tax is difficult because it needs to be calibrated with an emissions target to ensure cost efficient emissions reduction.

Experience in implementing national mechanisms aimed at strengthening emission reduction incentives has shown that particular attention should be paid to the political risk assessment, as such mechanisms are sensitive to lobbying and political bargaining, which is difficult to forecast and hedge against.

About

The **European Federation of Energy Traders** (EFET) promotes and facilitates European energy trading in open, transparent and liquid wholesale markets, unhindered by national borders or other undue obstacles. EFET currently represents more than 100 energy trading companies, active in over 27 European countries. For more information: www.efet.org

Europex, the Association of European Energy Exchanges, is a not-for-profit association of European energy exchanges with 27 members. It represents the interests of exchange-based wholesale electricity, gas and environmental markets, focuses on developments of the European regulatory framework for wholesale energy trading and provides a discussion platform at European level. For more information: www.europex.org