The Rt Hon Kwasi Kwarteng MP
Minister of State at the Department of Business, Energy and Industrial Strategy
1 Victoria Street
London SW1H 0ET

20th March 2020

RE: The Future of Carbon Pricing.

CC: Lesley Griffiths AM, Roseanna Cunningham MSP and Edwin Poots MLA.

I am writing in response to the request of the UK Government, Scottish Government, Welsh Government and Northern Ireland Assembly of March 4th, to the Committee on Climate Change, regarding the future of carbon pricing in the UK, specifically in relation to the successor to the EU Emissions Trading System (ETS) after EU exit. We are providing advice to you now, on the understanding that it will only be published once BEIS publishes more details on how it plans to proceed with a UK ETS.

Leaving the EU presents an opportunity for the UK to align the ambition of its trading scheme to the UK's own circumstances. Ultimately, that requires a tightening of the cap of the scheme in line with a trajectory consistent with the UK's new Net Zero target for 2050. We are pleased to see the Government's intention to align the scheme to our forthcoming advice on the Sixth Carbon Budget, and would like to see this enacted as soon as possible after we provide our advice in September. We are also pleased that you have recognised the need to have mechanisms to prevent the price dropping too low or rising too high.

However, the interim proposals for the scheme set out in your letter are inconsistent with the UK's Net Zero ambitions in some respects, primarily relating to the relatively high level of allowed emissions under the proposed cap. In a year when the UK needs to be seen as a climate leader, adopting the proposed trading scheme risks sending a damaging signal internationally ahead of the UN climate talks in Glasgow in November. It also risks undermining the scheme as a trading system, since if the cap is set too high the floor price in the scheme will set the price and become a de-facto tax.

- Your letter proposes launching the scheme with a cap set at 5% below the UK's notional share of the EU ETS. We do not consider that to be a suitable basis, as the UK will no longer be part of the EU scheme. Rather, the starting point for the cap should be the latest data on actual UK emissions in the traded sector.
    - UK traded sector emissions from stationary sources (i.e. power and industry) were around 129 $MtCO_2$ in 2018. Verified emissions for 2019 are likely to be lower than this, given continued reductions in coal-fired electricity generation. 2019 emissions will be published in early April and are likely to be a better basis for informing the cap.
    - The cap as currently proposed would begin the scheme in 2021 with considerably higher allowed emissions from stationary sources of 150 $MtCO_2$ (around 17% above the actual emissions in 2018). That implies a large surplus continuing until the point when a revised cap in line with the sixth carbon

budget advice comes into force (e.g. 2023). That surplus is likely to trigger the price floor (£15/tCO_2) and mean the scheme effectively operates as a tax.

- In theory there may be arguments for creating some initial 'headroom' in the scheme by issuing permits above the level of expected emissions in early years. That would allow participants to buy additional permits beyond their immediate needs in the initial years of the scheme as a hedge against future price increases, and reduce the risk of high prices resulting from the cap being set too tight, which could lead to negative competitiveness effects and 'carbon leakage'.
- However, given the world's current economic position and uncertainty around Covid-19, in practice the need for 'headroom' is likely to be limited. Risks are also limited by your proposals to continue free allocation of allowances for at-risk industries and for the Cost Containment Mechanism.
- If the Government chooses to keep the cap as proposed, then a higher Auction Reserve Price will be necessary since this will effectively become the price-setting mechanism and not merely a backstop.

We also note a change in language over linking to the EU ETS, which was originally the Government preference – and with which the Committee agreed. It is now described only as an option at a later date, and if desired. The Committee remains of the view that a UK ETS should link to the EU ETS as soon as is practicable, for the same reasons as expressed in our advice of 8 August 2019,[1] including increased liquidity and the protection around competitiveness of being part of larger scheme.

Finally, we were pleased to see consideration of increasing the scope of the sectors covered by the scheme, although we believe that the date for starting any extension should be significantly earlier than 2030. Our recent recommendations on agriculture and land use identified the importance of private funding to pay for increased afforestation. That could be achieved by including forestry in the UK ETS (with a tightened cap or alongside emissions from e.g. fossil fuel supply and international aviation). Inclusion of greenhouse gas removals more widely could also be appropriate. The Committee would like the Government to work to an earlier date for expanding the scheme's scope (e.g. by 2026), although it will be important to take into account whether and how increasing coverage would affect the ability to link the UK scheme to the EU ETS.

In our August 2019 advice we noted that carbon pricing alone will not deliver sufficient decarbonisation for the UK's net-zero objectives, and will need to be complemented by specific policies at the sector level. We will offer further advice on these policy requirements, and carbon pricing, in our September advice on the Sixth Carbon Budget, and look forward to seeing how the Treasury's Net-Zero review is considering these issues.

Yours ever,

Lord Deben

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[1] Available at https://www.theccc.org.uk/publication/letter-the-future-of-carbon-pricing/