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Sent by email

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CC: Michael Matheson MSP, Cabinet Secretary for Net Zero, Energy and Transport, Scottish Government; Julie James MS, Minister for Climate Change, Welsh Government; Edwin Poots MLA, Agriculture, Environment and Rural Affairs Minister, Northern Ireland Executive

Date 11 October 2022  
Ref Developing the UK ETS

Dear Graham,

I write in response to the letter from Rt Hon Greg Hands MP dated 17<sup>th</sup> August asking for my Committee's views on the development of the UK Emissions Trading Scheme (UK ETS), particularly in relation to matters set out in the March 2022 consultation *Developing the UK Emissions Trading Scheme*.

The request was for advice on the UK ETS cap, on matters relating to free allocation of allowances and on wider questions relating to the future role of the scheme. We addressed some of these issues in our annual progress report to Parliament in June – in this letter we repeat and build on that advice.

### **The proposed UK ETS cap**

The March consultation set out the proposed path for the UK ETS cap out to 2030. The existing UK ETS cap is not consistent with the path to Net Zero. In proposing the new cap, for implementation in 2024, the intention is to bring it into line with the path for allowed emissions over the period to 2030 in the delivery pathway of the Net Zero Strategy. Due to a different balance of sectoral emissions in the Government's pathway compared to that in our Balanced Pathway (e.g. the Government pathway has lower projected emissions from electricity generation), the proposed UK ETS cap is tighter than that recommended by the Committee. This is appropriate, given the pathway set out in the Net Zero Strategy.

However, prior to implementation of the new cap, which is much tighter annually than that currently in place, a considerable excess of allowances is accruing. This excess was 48 MtCO<sub>2</sub>e in 2021, given actual emissions were 108 MtCO<sub>2</sub>e, and the emissions cap was 156 MtCO<sub>2</sub>e. These allowances are likely to be released by participants and Government to help towards meeting the future, more stringent cap, which means that the downward path for emissions will not be as steep as it appears.

## Changes to free allocation

The Government has proposed to both (1) reduce the level of the industry cap and (2) bring to the market previously unallocated free allowances and/or flexible share. The first action will stop the situation that has occurred from 2021-23, where substantial numbers of allowances have not been allocated each year and accumulated in reserve. The latter action will seek to ensure that, after the industry cap is tightened, enough free allowances are still available to participants at risk closing or switching production abroad due to costs related to climate policies (i.e. carbon leakage).

In principle, my Committee supports both these proposals if their scale is designed so that they ensure no carbon leakage from the UK due to the UK ETS. We recognise that the tightening of the industry cap will allow increased liquidity in the auction market and therefore we support some level of tightening. The bringing of previously unallocated allowances to market is also a sensible approach to resolve the accumulation of allowances before 2024 and likely under-allocation from 2024.

To ensure that the two combined measures, alongside the proposal to change the methodology for distributing free allowances, do not lead to carbon leakage, we recommend that:

- The resetting of the industry cap should leave enough capacity to accommodate a range of potential levels of free allowance allocation, that will be determined by the later change to the methodology for distributing free allocation and any application of carbon border adjustments.
- The change of the methodology for distributing free allocation should carefully account for industry concerns around the tightness of current benchmarks.

These two features should also ensure that the use of a cross-sectoral correction factor is not expected.

More broadly, we expect that a transition from the use of free allowances towards a carbon border adjustment mechanism (CBAM) will provide a better approach to managing carbon leakage from the UK ETS in future and note that the Government has set out its intention to consult on carbon border adjustments before the end of the year. Given the very substantial overlaps between the consultations on these two policies, we recommend that future consultations on the two options are combined. We also encourage Government to bring forward next steps on both options as soon as possible to provide industry with visibility of upcoming carbon leakage protection. This visibility will support investment in the UK sector and the sector's decarbonisation plans.

## The future scope of the UK Emissions Trading Scheme

As the UK ETS was implemented rapidly to replace the UK's participation in the EU ETS, the scopes of the two schemes are currently very similar. However, as they each evolve over the coming years, there is the potential for divergence in their sectoral coverage and/or in other aspects.

While carbon pricing is not a silver bullet for decarbonisation, it is important that financial incentives to decarbonise exist at appropriate levels across all sources

of emissions. In thinking about whether to extend the scope of the UK ETS to cover a wider set of emissions, we consider there to be three key principles:

- **The need for incentives to decarbonise.** Participating in an ETS provides a financial incentive to decarbonise, but other policy mechanisms (e.g. subsidies, obligations) can also incentivise actions to reduce emissions. Important considerations on extending ETS coverage include whether the existing set of incentives is sufficient to pull through necessary action to decarbonise, what feasible alternatives exist to carbon pricing via the ETS and whether these provide better value for money, and whether expanding the scope might weaken decarbonisation incentives for sectors already in the ETS.
- **Removal of distortions.** The existing policy framework is a patchwork of different mechanisms, which leaves some holes or disparities that can lead to perverse outcomes. For example, the threshold of 20 MW for inclusion of energy generation in the UK ETS is distortionary – increasingly so as carbon prices rise – with larger-scale forms of generation being subject to carbon pricing, while those below the threshold are not. Expanding the scope of carbon pricing could remove distortions and lead to better policy outcomes. However, this could alternatively be implemented through parallel policies (e.g. taxation) rather than ETS inclusion if appropriate.
- **Significant risks of adverse impacts.** One reason that the policy framework is a patchwork is that a uniform approach to carbon price would have adverse impacts to vulnerable consumers and/or the competitiveness of UK companies where they compete internationally. Given the current extremely high level of fossil gas prices, and therefore of energy prices in general, it is not appropriate at this time to consider UK ETS expansion to cover sectors such as buildings, where gas plays a major role and affordability concerns are high. Inclusion of such sectors should not be considered until fossil gas prices return to an affordable level.

We now apply these principles to the potential future inclusion in the UK ETS of specific sectors on which advice was requested:

- **Shipping.** There is a strong case to include domestic shipping in the UK ETS, given the current weak incentives to decarbonise the sector. Ideally, international shipping would also be subject to carbon pricing (e.g. via a mechanism agreed through the International Maritime Organisation), but this should not be implemented by the UK unilaterally due to the risk of carbon leakage (i.e. the risk that ships refuel in other countries to avoid the carbon price). Should the EU apply carbon pricing to international shipping, as currently proposed, then the UK should seek to align its approach closely to this, to minimise perverse incentives for operators.
- **Waste.** As we have previously recommended, carbon pricing should be applied to incineration of fossil wastes, including Energy from Waste (EfW) facilities, so that they are used in accordance with the waste hierarchy and that, in future, carbon capture can be fitted cost-effectively to these plants. While there are practical questions around how the carbon costs are passed through (e.g. to local authorities), the fundamental need for carbon pricing to be applied is clear. It should be implemented this decade – and signalled as soon as possible – to feed into decisions over development of waste management facilities and infrastructure. However, it is essential that regulations and incentives across the waste

management system are reviewed to ensure that the application of carbon pricing leads to increased recycling and not increased use of landfill.

- **Engineered greenhouse gas removals.** In the longer term, as we approach Net Zero, it would be sensible to include engineered removals (i.e. those based on carbon capture and storage) in the UK ETS, so that participants with remaining emissions pay for engineered greenhouse gas removals to balance these. The key question is therefore mainly one of timing. Their inclusion in the UK ETS in a way that could allow projects to set the traded carbon price could increase the prevailing price in the UK ETS significantly. This would effectively shift the funding requirement for GGR projects from Government to other UK ETS emitters and, ultimately, consumers. Given that the UK has not yet deployed such technologies at scale, it would make sense to wait before integrating engineered removals fully into the UK ETS until they are more mature (e.g. once there are multiple facilities operating) . Any inclusion of greenhouse gas removals in the UK ETS would need to be accompanied by an appropriate tightening of the ETS cap, so that they do not substitute for the necessary emissions reductions in other sectors.
- **Biological removals** (e.g. through tree planting or peatland restoration) have an important role to play in Net Zero and need to be ramped up strongly over the coming years. However, it would not be appropriate to include them in the UK ETS both because these removals would not be equivalent to emissions reductions and for economic reasons:
  - Storage of carbon in natural sinks is important but lacks the guarantee of permanence needed for an ETS, where any removals must be equivalent to emissions reductions elsewhere in the system. This is because there will always be a risk that trees that have already been rewarded for carbon sequestration are affected by future climate or societal changes (e.g. by fire) and the carbon released. The quantity of carbon absorbed through natural systems is also difficult to measure precisely, which makes it less suitable for trading off against emissions elsewhere in a trading scheme. It is also important that other factors such as biodiversity and food security are part of such schemes, so they need to account for more than carbon.
  - Afforestation tends to be a relatively low-cost measure to reduce net emissions so, given current expectations of future ETS prices, its inclusion in the ETS would be likely to over-reward it. Doing so would therefore raise overall decarbonisation costs, could lead to undesirable outcomes such as monoculture plantations, potentially undesirable upward pressure on land values and slower emission reductions in other sectors. A separate scheme to incentivise biological removals would be more appropriate and better value, and could work in concert with voluntary carbon market funding for biological removals (for more see the forthcoming CCC 2022 report on Voluntary Carbon Markets and offsetting).

My team would be happy to follow up on any of the issues raised above.

Yours,



Lord Deben  
Chair, Climate Change Committee