sandbag
smarter climate policy

Sandbag response to proposed UK ETS, August 2020

Sandbag welcomes the opportunity to present our analysis of the UK ETS proposals to the Environment, Climate Change and Land Reform Committee of the Scottish Parliament. We see a number of issues with the current proposal:

Reduction of the cap

While the move to reduce the UK cap compared to the EU cap is a positive step, the proposed reduction of 5% is not sufficient. This would place the UK cap at 156 MT CO2 per annum, which is higher than total UK emissions for 2019, which were 132.77 MT including aviation emissions. Needless to say, 2020 emissions will be even lower. Our analysis sees emissions from the Power & Heat sector falling in the coming years: this will further increase the gap between actual emissions and the ETS cap. For the cap to be an effective means of achieving decarbonisation by 2050, it must match current emissions and decrease annually on a 2050 net-zero trajectory. Even with the cap reduced by 5%, the trajectory would only aim for a 46% reduction on 2005 emission levels by 2030. Current European Commission projections forecast that emission reductions for Europe as a whole by 2030 will surpass this trajectory.

Maintaining a cap that is higher than emission levels (even one slightly reduced compared to the EU ETS) will create a surplus of allowances. Surplus allowances are a problem that has plagued the EU ETS and is one that is only now being addressed. It would be problematic to knowingly build such surpluses into the UK ETS, given the experience with the EU ETS.

Auction reserve price

The proposed auction reserve price of £15 is too low, as it is lower than the current price of European Union Allowances under the EU ETS. Even the current EU ETS carbon price is far too low to incentivise substantial investments in decarbonisation, with some companies setting internal carbon prices at much higher levels that the EU carbon price to allow for a better evaluation of investment decisions. It is estimated that a carbon price of approx. $54.7/ tCO2 (£41.3) would be required to reflect the true cost of emissions and promote successful decarbonisation.[1] Furthermore, an auction reserve price is a poor remedy for a failure to remove surpluses. If the price is set too low it is ineffective, and if it is set higher than supply/demand fundamentals it will dangerously reduce market liquidity.

[1] Wang, P., Deng, X., Zhou, H., & Yu, S. (2019). Estimates of the social cost of carbon: A review based on meta-analysis. Journal of cleaner production, 209, 1494-1507. https://www.sciencedirect.com/science/article/pii/S0959652618334589?via%3Dihub

Free allocation of allowances

The proposal intends to continue with the free allocation of allowances, with 58 million free UK allowances in 2021. These will be decreased at a rate of 1.6 million allowances annually, a rate that would only see free allowances eradicated in 2057. The fact that the 5% reduction in the cap is taken off the volume of auctioned allowances, excluding free allowances, puts a further delay on the phase-out of free allowances. As with the EU ETS, there are a number of issues with the free allocation of allowances. Free allocation diminishes the incentive on industry actors to invest in decarbonisation and puts manufacturers that produce low-carbon products through non-benchmarked processes at a competitive disadvantage.

Despite this, the proposal sees free allowances as "the main policy instrument through which carbon leakage risk and competitiveness impacts are addressed". This is at odds with the EU's recent steps to introduce a Border Carbon Adjustment Mechanism and to curb the free allocation of allowances. The decision that the UK ETS would continue to rely on free allowances is counterintuitive considering the experience of the EU ETS. The UK ETS should rather seek to phase out all free allowances by 2030.

In addition, the Cross-Sectoral Correction Factor (CSCF) is referred to as a last resort to ensure that free allowances do not exceed the industry cap. However, the larger the number of free allowances, the higher the risk of triggering the CSCF becomes, which increases uncertainty for industrial actors. One of the ways suggested for limiting the need to trigger the CSCF is to use allowance surpluses from previous years to offset breaches in the industry cap. However, this rolling of surpluses risks repeating early EU ETS mistakes, which now need to be corrected under the EU system.

Benchmarks and the Cost Containment Mechanism

Relying on the EU ETS Phase IV Benchmarks and Carbon Leakage List is problematic as the EU ETS uses out-of-date data and often supports high-carbon incumbent installations at the expense of lower-carbon competitors. The proposed benchmark trajectories for the reduction of free allowances under the EU ETS do not align with a net-zero trajectory for the cap. This creates a misleading emissions trajectory for industries which avail of free allowances, causing them to delay short-term actions to reduce emissions. This will leave businesses facing a cliff-edge scenario, required to make rapid changes closer to 2050. In this sense, the proposal's intention to review the use of these EU ETS frameworks is positive. However, this review should not be left until 2023, particularly as the EU will start its own ETS review in 2021.

The inclusion of the Cost Containment Mechanism is a step backwards. The UK was against its inclusion in the EU ETS to begin with. The ability to bank and borrow allowances, which is also included in the proposal, is an infinitely greater shield against price spikes than the Cost Containment Mechanism.

Overall assessment

Some positive aspects of the proposal are that it aims for net-zero in 2050, whereas the current EU ETS still only aims for 80% reductions in CO2 emissions by that date. This puts the UK in a position to lobby for a similar increase in ambition in the EU ETS. (That said, the EU ETS cap is likely to be revised in the coming years so the UK may find that its 5% reduction is soon less ambitious than the revised EU ETS cap.) Additionally, the emphasis on the need for reviews and the recommendation to align the ETS trajectory with the upcoming UKCCC Sixth Carbon Budget are positive steps. As the UK ETS would be on a smaller scale than the EU ETS, it would also offer an opportunity to consider including shipping, biomass emissions, road haulage and emissions from buildings under the scheme.

As we have outlined in our previous submission on the UK ETS, a stand-alone UK ETS will face many challenges. There is a significant risk that the UK ETS will not be able to provide a functional carbon price or market, as it will be a relatively small market subject to volatility and speculation. The cap would have to be reset every year to maintain a carbon price signal that reflected major changes in emissions, such as a large installation going out of business. A stand-alone UK ETS price would be unlikely to mirror the EU ETS price, and the resulting price differences would harm competitiveness.

Nevertheless, given the decision to proceed with a UK ETS, our assessment is that to work, it would require a much lower cap which takes into account the projected impact of Covid-19 on emissions and includes an MSR mechanism. However, this would take time to develop and would be difficult to bring into force by January 2021. As a means of transition, a carbon tax linked to the EU ETS price (with initial tax exemptions to replace the free allowances which installations could avail of under the EU ETS) would be preferable. As it is, the proposed UK ETS will lock in many of the faults of the EU ETS system, with the first opportunity to fix these defects coming in 2026. The urgency of the climate crisis does not allow for such delays. The new UK ETS offers an opportunity to learn from the EU ETS experience and to develop a scheme that can become a real driver of decarbonisation by 2050.

Sandbag is a non-profit think tank which uses data analysis to build evidence-based climate policy. We focus on EU policies such as the EU ETS, the Effort Sharing Regulation and emissions reductions in industrial sectors.

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