CLIFFORD CHANCE

CARBON PRICE CLARITY: QUESTIONS REMAIN ON THE DETAILED DESIGN

In this second briefing on the UK Government's proposals for a UK Emissions Trading System, we look at some more detailed issues affecting the design of the system, including the impact of the lower emissions cap, challenges around the linkage to the EU ETS, potential problems of liquidity and volatility, and the continuing mystery of the potential carbon tax alternative.

Key issues

- Prospect of an initial surplus of allowances despite lower cap than the EU ETS.
- No clarity on the prospect of the UK ETS being linked to the EU ETS.
- Concerns regarding market liquidity and volatile prices without linking.
- Uncertainty remains about the carbon tax fallback with a further consultation expected.

THE PROPOSALS

In our briefing Carbon price clarity: a new UK emissions trading system from 2021, we set out the key elements of the UK Government's proposals to establish a UK emissions trading system ("**ETS**") from 1 January 2021 covering energy intensive industries (other than municipal incinerators), the power generation sector and aviation. These proposals are subject to opt-outs and exemptions for small emitters and further reviews in Phase 1 which is intended to run from 2021 to 2030.

Picking up on some of the points from the previous briefing, here we explore some of the key areas of similarity and difference between the planned UK ETS and the EU ETS, and other issues that have been brought into sharper focus by the UK Government's proposals.

Different targets but same result

The UK Government has described the UK ETS as being "ambitious", and it is true that the proposed initial emissions cap will be 5% lower than the UK's notional share of the EU ETS cap for Phase IV of the EU ETS.

The intention is that this reduction in the initial emissions cap is to be taken from the share of allowances for auction, with the allocation of free allowances being broadly the same as it would be if the UK were to continue to participate in the EU ETS.

The reality, however, is that at least in the initial years, the lower emissions cap is unlikely to have a material impact on actual emissions, as these are typically around 10% below the emissions cap under the EU ETS. The probability, therefore, is that there will be a surplus of allowances under the UK ETS, particularly in the initial stages, if economic activity remains depressed as a result of the fallout from the Covid-19 pandemic.

There is also the risk of an increased surplus in subsequent years as a result of allowances banked from previous years (a phenomenon that has been observed in the EU ETS) as the rules for banking allowances under the UK

ETS will mirror those under the EU ETS, although this will obviously not be an issue for the first year of the UK ETS. The importation of international credits has also contributed to the oversupply of EU ETS allowances, but this will not be permitted in the initial stages of the UK ETS.

Linking to the EU ETS

The key focus of attention since the UK Government announced the proposals has been the prospect of linking the UK ETS to the EU ETS. During the consultation period on the proposals, numerous stakeholders providing feedback expressed a preference for the two systems to be linked and, following the announcement, key industry players have reiterated calls for linking.

While it could be expected that this is one area in the discussions around the future relationship of the UK and the EU where the respective starting points of both sides are in relative alignment, the position is not so straightforward. Both sides are willing to consider linking, and the UK is said to be keen to follow Switzerland in linking its ETS to the EU ETS. The UK Government has, however, publicly been reticent about the prospect of a link between the two systems, acknowledging the preference of stakeholders for such a link to be in place from the proposed commencement of the UK ETS on 1 January 2021, but saying that the UK Government would only be open to such a link "if it suited both sides' interests".

The EU's position is that the UK must maintain a system of carbon pricing of at least the same effectiveness and scope as the EU ETS as a fundamental condition to agreeing a tariff-free and quota-free trade deal. As a result, the EU has also reacted cautiously to the UK Government's proposal, with reports that it would not agree to linking without a firm guarantee that the UK ETS would not undermine the EU ETS or disrupt its functioning.

The Swiss challenge

Market observers have suggested that the Swiss model may not be easily followed by the UK given the larger size of the UK and its more significant weight in relation to the EU ETS as a whole (with the UK making up around 10% of the EU ETS allowance supply). In addition, while Switzerland amended its ETS so as to ensure compatibility with the EU ETS, the suggestion that the UK would agree to amendments to follow EU rules now or in the future is likely to be viewed as undermining UK sovereignty.

In any event, it is clear that the road to linking the UK ETS and the EU ETS will need to be significantly shorter than the Swiss experience – the EU and Switzerland commenced negotiations on linking their systems in 2010, and it is only with effect from 1 January this year that linking took effect (although it should be noted that the reason for the delay is largely unrelated to carbon markets).

In the context of the broader Brexit negotiations, there are similarly a number of other sticking points between the UK and the EU, both in relation to linking the two systems and more generally in relation to environmental policy, and it is by no means clear that agreement on linking could be reached before the proposed commencement of the UK ETS on 1 January 2021.

The key concern in relation to linking on the EU side is that the UK is seeking to deal with this issue in isolation, with the EU reported as being concerned that the UK wants to be able to access the EU ETS on a business-as-usual basis, but does not necessarily share the same ambitions in relation to

ensuring the contribution of the future relationship between the UK and the EU to address climate change on an equal footing.

In particular, the UK does not want to agree to a binding level playing field of shared laws, nor does it accept substantive enforceable obligations to comply with the 2016 Paris Agreement as part of a broader trade deal. The level playing field concept is a key issue for EU policymakers across the board, designed to address the risk of an unfair competitive advantage being obtained by political decisions in the future (in this case by decisions on carbon pricing).

Other EU developments

A further complicating factor is the EU's plan to make significant amendments to the EU ETS next year, including the incorporation of maritime emissions and abolition of free allowances for the aviation industry. The extent to which the UK will be involved in discussions around those amendments is up for debate.

European parliamentarians have warned that ultimately a UK ETS that diverges too significantly from the EU ETS could lead to a European carbon border tax being deployed against UK goods (on this, see our briefing European green deal – resetting the EU climate change and environmental agenda), so the challenge for negotiators will be to balance the UK's desire for independence with maintaining the relationship with the EU and being seen to be seeking to achieve common environmental policy objectives.

Liquidity and volatility

If linking the UK ETS and the EU ETS cannot be agreed, there are concerns that liquidity issues and the prospect of volatile prices could arise as a result of the smaller size of the UK market.

The International Emissions Trading Association ("**IETA**") has been reported as saying that linking the UK and EU systems should be the UK Government's number one priority as a standalone UK ETS will not be sufficiently deep or liquid to allow for genuine price discovery. It is expected that the majority of trading under a UK ETS would be between power sector firms which are not allocated any free allowances, and as power sector emissions are expected to fall significantly over the next decade, the potential for an illiquid market may be exacerbated.

Feedback from stakeholders during the consultation process also highlighted the need for price continuity and the ability to respond to price spikes, which is an issue that has been difficult for the EU ETS to address given its regulatory structure.

IETA has welcomed the UK Government's proposed measures to address these issues, namely the transitional auction reserve price set at £15 per tonne to ensure a minimum price in the early years of the UK ETS, as well as the cost containment mechanism providing for UK Government intervention should very high prices occur. The mechanism will mirror that under the EU ETS save that the price and time trigger thresholds will be lower at least for the first two years of the UK ETS.

Possibility of a carbon tax remains

While industry has generally reacted positively to these measures, the urgent need for clarity around the UK Government's carbon tax intentions has been highlighted. The UK Government's proposal expressly states the intention for

Phase 1 of the UK ETS to run from 2021-2030. The degree of certainty for industry that this provides is, however, undermined by the subsequent wording in the proposals around the prospect of a carbon tax.

Not only has the UK Government not expressly ruled out a carbon tax, it has gone as far as expressly reiterating the potential introduction of a carbon tax as an alternative to the UK ETS as announced at Budget 2020. Indeed, the UK Government has committed to publishing a consultation on the design of an alternative carbon tax as a "fallback carbon pricing option".

Given the firm commitment to the introduction of the UK ETS from 1 January 2021, the proposals do not address why the carbon tax option would be necessary, exactly what is being considered in terms of a carbon tax as an alternative or fallback option, or what further proposals will be consulted on.

The UK Government's proposals on the UK ETS do state that it is sensible to have a fallback option given the inherent uncertainty (though with respect to what exactly, we do not know), and that the alternative of a carbon tax is designed to "ensure a carbon price remains in place in all scenarios". This statement is not particularly helpful, and raises more questions than it answers, as it implies that there are foreseeable scenarios where a carbon price in the form of the UK ETS will not be in place. The carbon tax option may just be a Brexit bargaining chip, but no further detail has been provided at this stage, and it remains to be seen what those scenarios may be.

Key issues for industry

It is clear that more certainty is needed by industry around the key structural points of linking the two systems and the role, if any, of the fallback/alternative carbon tax and its interaction with the UK ETS and the existing carbon price floor. There are also important operational matters to be addressed in order for industry to prepare for the proposed commencement of the UK ETS on 1 January 2021.

The UK Government's proposals state that legislation to formally establish the UK ETS will be laid before Parliament later this year. The UK Government has indicated that IT work is going on behind the scenes to set up the UK ETS registry. However, there is a lack of information on a number of important aspects including, for example, when the registry infrastructure will be available for market participants, how market participants will be able to open accounts in the registry, how they will be able to trade allowances, and the allowance auction timetable.

Market participants will also need to adjust their internal compliance systems and ensure that their trading documentation is fit for purpose as changes will inevitably be needed to reflect the new UK rules. In this respect, further clarity from the UK Government around the operation of the UK ETS would be welcome.

CLIFFORD
CHANCE

CONTACTS

James Shepherd
Senior Associate

T +44 207006 4582
E james.shepherd
@cliffordchance.com

Kirsty Souter
Senior Associate

T +44 207006 4178
E kirsty.souter
@cliffordchance.com

Nigel Howorth
Practice Area Leader
Real Estate

T +44 207006 4076
E nigel.howorth@clifford
chance.com

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

© Clifford Chance 2020

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571

Registered office: 10 Upper Bank Street, London, E14 5JJ

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications

If you do not wish to receive further information from Clifford Chance about events or legal developments which we believe may be of interest to you, please either send an email to nomorecontact@cliffordchance.com or by post at Clifford Chance LLP, 10 Upper Bank Street, Canary Wharf, London E14 5JJ

Abu Dhabi • Amsterdam • Barcelona • Beijing • Brussels • Bucharest • Casablanca • Dubai • Düsseldorf • Frankfurt • Hong Kong • Istanbul • London • Luxembourg • Madrid • Milan • Moscow • Munich • Newcastle • New York • Paris • Perth • Prague • Rome • São Paulo • Seoul • Shanghai • Singapore • Sydney • Tokyo • Warsaw • Washington, D.C.

Clifford Chance has a co-operation agreement with Abuhimed Alsheikh Alhagbani Law Firm in Riyadh.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.

69697-5-2337