

Response to the Carbon Emissions Tax (CET) consultation

29 September 2020

About Energy UK

Energy UK is the trade association for the energy industry with over 100 members spanning every aspect of the energy sector – from established FTSE 100 companies right through to new, growing suppliers and generators, which now make up over half of our membership.

We represent the diverse nature of the UK's energy industry with our members delivering almost all (90%) of both the UK's power generation and energy supply for over 27 million UK homes as well as businesses.

The energy industry invests over £13.1bn annually, delivers around £85.6bn in economic activity through its supply chain and interaction with other sectors, and supports over 764,000 jobs in every corner of the country.

Executive Summary

Overview

- Energy UK emphasises the need for Government to make the earliest possible decision on the replacement scheme for the EU Emissions Trading System (EU ETS). Power station operators hedge electricity several seasons ahead and therefore require as much notice as possible of the new arrangements in order to take the necessary actions to ensure continuity and minimise additional costs. It is also important to provide clarity now for the carbon and power markets, to minimise impacts on prices and customers.
- Energy UK considers carbon pricing to play a pivotal role in delivering cost-effective decarbonisation and is an important mechanism for achieving net zero by 2050.
- It is important to maintain a clear, stable and robust carbon price leading up to and following the UK's departure from the European Union.
- We fully support the UK seeking to establish a UK Emissions Trading System (UK ETS) linked immediately to the EU ETS so as to ensure a smooth transition and provide continuity around the carbon price for UK operators.
- There is consensus across Energy UK that either fallback option currently considered, Carbon Emissions Tax (CET) or standalone UK ETS will be sub-optimal to remaining part of a larger carbon market.
- One difference between the fallback options is that the CET would not have guaranteed decarbonisation funding as under the standalone UK ETS, and HMT should ensure equivalent funding support is made available under both instruments.

Carbon Emission Tax (CET)

- Energy UK welcomes the attempt to provide continuity from the EU ETS through the CET methodology, but has concerns around the introduction of a retrospective risk from the need for additional hedging activity after the point of emission with the proposed ex-post adjustment.
- For simplicity, clarity and to remove retrospective risk, **our preference would be to revert to the previous methodology used to set the CET in the case of a no-deal Brexit from 29 March 2019¹. This would mean having a fixed CET price over 2021 set ex-ante with no ex-post adjustment.**

¹ <https://www.gov.uk/government/publications/carbon-emissions-tax-technical-note>

- The methodology for setting an ex-ante CET rate for future years should be clear and transparent, so that it is predictable and therefore hedgeable for operators well ahead of a fiscal event.
- However, if HMT ultimately decides to pursue the new complicated CET methodology as consulted on, it is critical there are some specific changes to **enable uninhibited use of EU ETS Allowances (EUAs) and EUA-derivatives for ex-post hedging purposes**.
- As such, to minimise risk and cost to hedging activities, any measures which hinder using these should be removed or modified. The specific changes required are:
 - **Removal of the £1 threshold on the ex-post adjustment;**
 - **Changing all EU ETS reference prices to a year-end futures contract set using a period in the future); and**
 - **The proposed uplift within the ex-ante indicative CET rate is set at a sufficient level to ensure it can account for reasonable EU ETS fluctuations.**
- Whilst the EUA component of the indicative CET rate is predictable, it is important that any uplift applied is also predictable (i.e. based on a rules-based mechanism), otherwise it inserts significant levels of political risk, especially given the timescales ahead of the relevant emission year.
- To ensure that operators and other market participants are clear about different components of the CET methodology, data for the calculation of the final CET rate should be regularly published by HMT.

Please find our response to the relevant consultation questions below.

Response to consultation questions

1. Do you have any views on the methodology and process for setting tax emission allowances and adjusting them in light of activity level reports?

Although the power sector does not receive any free allowances under the EU ETS and would therefore have a tax emission allowance set at zero, Energy UK appreciates and supports the approach HMT has taken in setting tax emission allowances to align with the level of free allocation in the EU ETS. This will enable minimal disruption and a smooth transition for current EU ETS participants in sectors who receive free allowances.

2. Do you agree that small emitters should have their tax emission allowance for 2022 increased by the amount of their unused tax emission allowances from 2021? Do you think that, instead, a payment scheme as outlined below for main scheme installations would be an appropriate means of incentivising decarbonisation for small emitters?

Yes.

3. Do you agree that, if the Carbon Emissions Tax were to be introduced, a mechanism should be introduced to reward decarbonisation?

Yes.

4. Do you agree that there should be no obligation on operators that did not wish to make a claim to submit this additional data? How easily could your installation provide this additional data? How much additional work would it take to calculate (please set out the employee hours and expected costs of doing this)?

No view.

5. Do you agree that the methodology outlined above would accurately demonstrate the extent to which an installation's emissions reductions were achieved through decarbonisation?

No view.

6. Do you agree with the government's proposal to enable installations to submit data with activity level reports and to allow a final deadline of 31 March 2024 for claims relating to the 2021 and 2022 tax years?

No view.

7. Do you agree that the Carbon Emissions Tax rate should be set using EU ETS price data?

One of the key objectives of a fallback carbon pricing mechanism is to maintain continuity of the carbon price signal to avoid market shocks. In principle, indexing the full CET rate to the EU ETS would mean that operators would be subject to the same carbon price for their emissions that they would have faced had the UK remained in the EU ETS. Matching the indexation to prices observed in the EUA futures market would provide a means to mitigate both the price and stranded volume risk allowing operators to unwind their forward hedges.

HMT has proposed that the indicative CET rate is based on the EUA futures price while the ex-post adjustment is based on EUA auction prices. **This discrepancy is unnecessary and all EU ETS references prices should be indexed to the year-end futures contract** on the Intercontinental Exchange (ICE) so as to allow operators to buy and sell to manage their price risk. Operators are unable to sell onto EUA auctions.

If the EUA futures price is used for the ex-post adjustment, which it should be, then due to the December-21 futures Last Trading Date (LTD) on 20 December 2020, the ex-post adjustment should only measure up until this point. After this point the ex-post adjustment will then be known and the CET rate will be in effect fixed for the last few weeks of December as it was under the previous CET methodology.

Since the publication of HMT's document, '*FAQ on the Carbon Emissions Tax rate policy proposal*', many points of clarification which we had planned to raise in this response have been addressed. However, to ensure that operators and other market participants are clear about different components of the CET methodology, data for the calculation of the final CET rate should be regularly published by HMT on gov.uk.

We also note that the Government has subsequently announced that there will not be an Autumn Budget in 2020. Nevertheless, an announcement on the tax rate should still be made in the autumn of 2020 and should not be delayed because there is no Autumn Budget.

8. What are your views on the proposal to adjust the rate?

For simplicity, clarity and to remove retrospective risk, **our preference for a CET methodology would be to revert to the previous methodology, used to set the CET in the case of a no-deal Brexit from 29 March 2019, and have a fixed CET price over 2021 set ex-ante with no ex-post adjustment.**

As a tax based on an annual Monitoring, Reporting and Verification (MRV) report can only be adjusted on an annual average basis, the ex-post adjustment of the CET inserts complexity for hedging and a retrospective risk. The level of complexity and commercial risk involved with this additional hedging activity should not be understated. The need to undertake additional hedging activity after the point of emission could lead to higher costs for the GB consumer and expose UK carbon pricing to the prospective disruption caused by the UK exiting the EU ETS abruptly in January 2021.

The methodology for setting an ex-ante CET rate for future years should be clear and transparent, so that it is predictable for operators well ahead of its confirmation at a fiscal event.

However, if HMT ultimately decides to pursue the new complicated CET methodology as consulted on, it is critical there are some specific changes to **enable enabling the uninhibited use of EUAs and EUA-derivatives for ex-post hedging purposes.**

As such, to minimise risk and cost to hedging activities, any measures which hinder this should be removed or modified. The changes required are:

- **Removal of the £1 threshold on the ex-post adjustment**, or at least reduce it to £0.01. Only applying an ex-post adjustment if the differential between the CET and the EU ETS is greater than £1, exposes UK operators to a £0.99 price differential with EUAs. This is a large risk delta based on the quantum of emissions.
- All the **EU ETS reference prices should be indexed to the year-end futures contract** on the Intercontinental Exchange (ICE) trading platform, set using a period in the future so they can be traded; and
- The proposed uplift within the ex-ante indicative CET rate is set at a sufficient level **to ensure it can account for reasonable EU ETS fluctuations.**

Whilst the EUA component of the indicative CET rate is predictable, it is important that any uplift applied is also predictable (i.e. based on a rules-based mechanism), or it inserts significant levels of political risk, especially given the timescales ahead of the relevant emission year.

9. For the longer term, do you think other payment methods should be made available (e.g. a transfer involving the Business Tax Account)?

No view.

10. Do you have any views on the practicality of the proposals in Part B of chapter 2 that you cannot cover in responses to other questions?

No.

11. Are there any omissions or do you have any concerns or other suggestions about the operation of the tax?

Energy UK emphasises the need for Government to make the earliest possible decision on the replacement scheme for the EU ETS. Power station operators hedge power several seasons ahead and require as much notice as possible of the new arrangements in order to understand whether it is economic to generate. It is also important to provide clarity now for the carbon and power markets, to minimise impacts on prices and customers.

Given the need to continue to trade EUAs to manage CET price risk under the proposed methodology, HMT is, in effect, expecting UK operators to maintain an ETS registry account in an EU Member State or have a broker do it on their behalf, both of which would add to administrative burden and cost of UK carbon pricing without delivering any incentive towards decarbonisation. In addition to the retrospective risk noted earlier, it also exposes a UK tax rate to any changes implemented in response to disruption of the EU ETS which could be caused by an abrupt UK exit.

Continuing to trade EUAs to manage CET price risk will lead to interactions with EU financial regulation, and could pose additional regulatory burden to operators without EU operations. This should be considered further by the Financial Conduct Authority (FCA) and HMT to ensure that the future UK financial regulation framework accounts for this.

An area where the CET and a standalone UK ETS differ significantly in their design is the proposed decarbonisation fund as part of the UK ETS. Energy UK would strongly advise that HMT signal funding for UK decarbonisation as part of CET revenues equivalent to that with the UK ETS, and EU ETS, otherwise it will significantly hinder the attractiveness of the UK's low carbon investment destination, even if the funding received ends up being the same through commitments through annual budgets over the 2020s.

12. Do you have any views on how, in the years after 2021, a Carbon Emissions Tax could drive decarbonisation in sectors beyond those that would be subject to the tax at introduction?

Energy UK supports Government considering extending carbon pricing to cover other sectors that have not been subject to this so far. Carbon pricing is an efficient driver of decarbonisation and is most effective when applied in conjunction with other tools. These include regulation, incentives and support for financing, targeted at points of significant capital investments.

The most effective package of measures will vary between sectors and activities. When assessing the extension of carbon pricing to other sectors, a guiding principle is that most value can be delivered in sectors which are price sensitive, as so will abate carbon at their marginal abatement cost. For example, carbon pricing has had a significant impact on emissions in the electricity system through steering dispatch decisions, meaning that gas generation has been running ahead of coal, making it uneconomic through limiting its operation. This positive dispatch impact from robust carbon pricing will continue with the development of lower carbon dispatchable generation such as gas with Carbon Capture and Storage (CCS) and hydrogen generation, and on to Bioenergy CCS (BECCS).

Conversely, exposing sectors that are not price sensitive to carbon pricing can increase costs without driving abatement. For example, many energy efficiency measures are economic at current costs, even without carbon pricing, but there are other reasons they are not deployed. Whilst carbon pricing in these areas will raise revenue that could support those in greatest need, it could undermine public support for ambitious climate policy and could mean consumers abate by reducing thermal comfort or their reducing mobility. In these areas, a greater emphasis on regulation, incentives and financing support targeting at points of significant capital investments may be more appropriate tools to drive decarbonisation.

One sector that is sensitive to carbon pricing and is a candidate for the application of carbon pricing is the use of gas for domestic heating. There is a cost differential between electricity and gas, as electricity pays a carbon price at the point of generation, whereas gas and oil for domestic heating does not. This cost differential between electricity and gas for domestic usage is acting as a barrier to uptake of low carbon heat options, including heat networks which are investments taken by commercially sensitive sectors, but it also impacts the lifetime cost comparison to disadvantage heat pumps. Carbon pricing should be considered as an option to close this gap alongside redistributing costs from electricity.

A barrier to extending the CET to other sectors would be the use of MRV reports which are compiled by industrial installations. A new tax mechanism may be required for extending carbon pricing to other sectors, although the rate applied can be the same.

13. Do you agree that the government should explore the case for tax incentives to support negative emissions technologies?

Energy UK recognises the vital role that negative emission technologies (NETs) will play in meeting a net-zero emissions target, balancing remaining greenhouse gas emissions from hard-to-abate sectors. There is currently a lack of policy and market frameworks to support the deployment of these technologies and correctly ascribe value to the negative emissions they produce.

Energy UK supports the development of carbon pricing to include a mechanism to remunerate negative emissions to support investment in these technologies, however it is clear that a carbon price alone will not be enough in the near-to-medium term. NETs that are shown to deliver proven, verifiable and

permanent emission reductions should play an integral role in the government industrial strategy and should be deployed across the UK to help assist with post-industrial regeneration.

The UK has the potential to develop negative emissions at scale from the mid-2020s, which as the Committee on Climate Change (CCC) attests, is critical to meeting net-zero emissions by 2050. In a linked UK ETS, remuneration of NETs should be in place by at least 2031 to align with the start of Phase V of the EU ETS, and could in theory be put in place earlier. With this in place, in the long term, a robust carbon price could drive negative emissions in the power sector without an additional cost to taxpayers or electricity consumers.

In the absence of a UK ETS linked to the EU-ETS, or a delay in its implementation, the introduction of negative emissions into a CET will help to support the development of NETs. However, a CET is unlikely to support NETs deployment in the nearer term in the absence of a price floor and contractual regime, which would provide investor certainty. Any additional support beforehand could be provided using revenues from carbon pricing to fund support mechanisms similar to the CfD scheme in the power sector.

14. In designing any tax incentive, what issues should the government consider regarding negative emissions technologies?

Negative emissions should be subject to robust governance to ensure market integrity, and be scientifically verifiable, proven and permanent. Energy UK supports sustainable BECCS and Direct Air CCS (DACCS) being included in any negative emissions incentives.

It should be recognised that negative emissions technologies (NETs) encompass a range of different technological and process solutions to remove carbon dioxide from the atmosphere. This can result in a wide variety of co-benefits, such as the production of both negative emissions and power/hydrogen in the case of BECCS, and ecological/recreation benefits in the case of afforestation. This range can also result in wide variances in permanence, scalability, energy consumption, land use, and cost.

For this reason, it may be beneficial for the government to consider treating NETs differently in a CET, for example through banding, in order to avoid a “race to the bottom” situation. In such a scenario cheap, but difficult to verify or scale, NETs are deployed at the expense of wider NETs which may have additional co-benefits, or may be preferable from a net-zero perspective.

As mentioned earlier, the introduction of negative emissions into a CET alone is unlikely to drive significant deployment of NETs in the near-to-medium term. A carbon price would need to be augmented with a separate policy mechanism for initial deployment. The government should consider which mechanisms are suitable for supporting NETs in conjunction with developers.

If negative emissions are supported through a tradable mechanism like the UK ETS, crediting should initially be done on a limited basis to ensure market integrity, avoiding previous issues with offsets, which contributed to oversupply in Phase III in the EU ETS.

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