

Without linking emissions trading systems, UK companies face higher bills and red tape

30th October 2023

Executive Summary

- The UK's carbon price has crashed to historic lows over recent months.
- **Weak and volatile carbon prices in the UK Emissions Trading Scheme (ETS) are having a detrimental effect on clean investment** at a moment in which the UK is struggling keep up internationally.
- **Between April and the beginning of October this year, the UK ETS raised over £1bn less than if prices had remained at 2022/23 levels.**
- **If carbon prices continue at the low levels of recent months, the Treasury will be losing out on almost £3bn of revenue annually.**
- The EU's incoming Carbon Border Adjustment Mechanism (CBAM) is set to cause further problems; from 2026, **if the UK-EU carbon pricing dynamics remain the same, British companies will have to pay over half a billion pounds per year into EU coffers simply to export to Europe.**
- The CBAM design also means that our **homegrown clean energy from wind, solar, and nuclear sources will be forced to pay a carbon price despite being 100% clean.** This sends precisely the wrong signal to international investors considering the attractiveness of UK clean energy projects.
- **The solution to all these problems is for the UK to link its ETS with the EU's scheme. Linkage would lead to higher revenues for the UK exchequer, enable a stronger signal for low carbon investment, and ensure that British companies won't be stung by substantial new taxes for simply trading with their largest export partner.**

Background

- The UK has a history of international leadership in climate policy; well before the Climate Change Act (2008), the UK had already implemented a carbon price by becoming the first country to pilot a national Emissions Trading Scheme (ETS) in 2002.
- An ETS works by placing an overall cap on emissions and auctioning allowances (permissions to pollute) to companies who emit. Over time, the cap shrinks and fewer allowances are auctioned annually. As the market tightens, the price increases, and emissions decrease. The combination of a legally binding cap on emissions, and strong market incentives, makes an ETS the most efficient and effective way to price carbon emissions in an economy.
- The UK's pilot ETS programme became the basis for the EU ETS, in which the UK participated for 15 years.
- Putting a price on emissions through an ETS has been one of the key policies which enabled the UK to decarbonise almost 50% of our greenhouse gas emissions since 1990.
- Following the UK's departure from the EU, a new UK ETS began operation in 2021.

A weak and volatile carbon price

- Despite this strong history of UK leadership on carbon pricing, there are increasing concerns that the UK ETS is not delivering.
- An effective carbon price should enable companies to decarbonise and provide the certainty to allow investment in low-carbon alternatives.
- The UK ETS price has been highly volatile over recent months, and has crashed to historic lows.
- Weak and volatile carbon prices are having a detrimental effect on low carbon investment at precisely the moment in which the UK's investability is being called into question.
- In light of growing competition from other key markets such as the US through the Inflation Reduction Act, supply chain cost increases of up to 40%, and disappointing results from

recent renewables auctions leading to projects cancelled or significantly delayed, low and unpredictable carbon prices send the wrong signal about the rapid expansion of low-carbon energy needed in the UK.^{1, 2, 3}

- In addition to sending a poor signal for decarbonisation and low-carbon investment, lower carbon prices lead to significantly reduced revenues for the Exchequer. If carbon prices continue at the low levels of recent months, the Treasury will be losing out on almost £3bn of revenues annually.⁴
- Already between April and the beginning of October this year, ETS auctions have raised £1bn less than they would have done had the prices remained at the level they were at in 2022/23.⁵

Figure 1: UK ETS prices



Source: ICE

The effect of the EU's Carbon Border Adjustment Mechanism

- The EU has legislated to introduce a Carbon Border Adjustment Mechanism (CBAM), which would begin operation next year.
- The EU's CBAM will impose a tax at the border on imported goods which have paid a lower carbon price than the EU ETS. All revenues from this tax will be recovered by the EU.
- For countries exporting into the EU which have no domestic carbon price, this will constitute paying the entirety of the EU ETS price as a tax. **UK companies will have to pay the difference between the UK and EU ETS prices.**

¹ “[No new offshore wind farms in blow to Net Zero Plans](#)” (The Times, September 2023)

² “[Developer halts onshore wind farm due to rising costs and windfall tax](#)” (FT, September 2023)

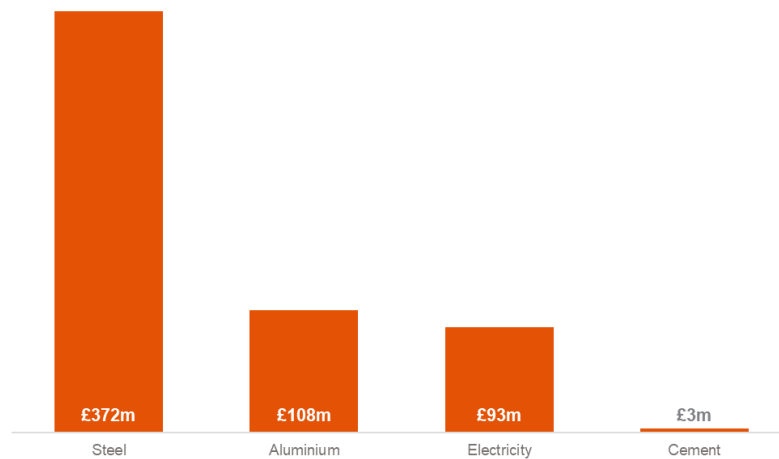
³ “[Giant windfarm off Norfolk coast halted due to spiralling costs](#)” (The Guardian, July 2023)

⁴ In 22/23, ETS raised £6bn (OBR). If all the auctions scheduled for 2024 clear at £45/tonne (higher than the average since July), it will raise £3.1bn, leaving revenue £2.9bn short of what it would have been had prices not fallen.

⁵ Energy UK analysis of UK ETS auctions, accessed via ICE

- According to new Energy UK analysis, if the price differential between the UK and EU ETS endures, it could result in over half a billion pounds per year being transferred from the UK to the EU in carbon taxes.⁶

Figure 2: Potential CBAM costs on UK exports to the EU by sector



Source: Energy UK Analysis

- The CBAM's reporting phase will start in January 2024, and brings with it significant new regulatory obligations and administrative costs for British companies exporting into the EU.
- From 2026, if the UK-EU carbon pricing dynamics remain the same, British companies will have to start paying over half a billion pounds per year into EU coffers simply to have the right to trade into their main export market.

Penalising low-carbon British power

- The EU's CBAM will cover imports of electricity from third countries, including the UK.
- Because electricity trading makes it difficult to track the origin of each electron, the EU has adopted a benchmarking approach to work out how carbon-intensive our electricity is.
- The CBAM will tax UK exports of electricity based on the average carbon intensity of the UK's grid. Around 60% of UK electricity generation is low carbon, whilst 40% is fossil fuel-based.
- **This means that electricity from a British wind farm or nuclear power plant will be forced to pay a 40% carbon tax to export to the EU, despite being 100% clean.**
- This mechanism would penalise homegrown clean energy, and send a perverse signal about the importance of investment in new low-carbon projects in the UK.

The only solution? Linking the UK and EU ETS

- It's clear that the combination of a UK ETS sending poor signals for decarbonisation and low carbon investment, and the imminent arrival of an EU CBAM likely to cost British companies billions of pounds, is simply unacceptable.
- The only solution which neatly solves both these problems is for the UK to link our ETS with the EU ETS.
- Linkage would lead to carbon price convergence between the two jurisdictions, and exempt UK companies from the EU's CBAM.

⁶ Based on Energy UK analysis of *What does an EU Carbon Border Adjustment Mechanism mean for the UK?* (LSE, 2021), taking the narrow, high divergence scenario and adjusting for a UK-EU ETS €28, the average spread between April-October 2023. Electricity costs based on €28 and the export volumes and grid carbon intensity seen in 2022 (DUKES, 2023)

- At a stroke, this would:
 - Lead to higher revenues for the UK exchequer
 - Enable a higher carbon price, and a stronger signal in favour of low-carbon investment
 - Ensure that British companies won't have to pay a CBAM tax to trade with their largest export market
 - Cut red tape for British companies exporting into the EU by no longer having to submit complex carbon declarations about their products
 - Exempt the UK's power sector from a regressive EU tax that would lead to clean homegrown energy paying a carbon price

How would linkage work?

- Linking Emissions Trading Schemes is not a novel concept – it has been done several times around the world, such as between California and Quebec, and between the EU and Switzerland.
- The UK already committed to giving '*serious consideration*' to linkage as part of the UK-EU Trade Cooperation Agreement.⁷
- Linking is not the same as re-joining. It constitutes an international trade mechanism that retains full use of revenues and the ability to set the majority of the rules. This would ensure that such a mechanism is beneficial both for the UK's economy and sovereignty.
- Linkage requires two crucial elements; political will and alignment on environmental ambition.
- Whilst there are small differences between the UK and EU ETS, the two schemes are almost identical in design and environmental ambition; meaning that there should be no two Emissions Trading Schemes that are easier to link.
- Linkage would not happen overnight. Negotiation would be required in good faith with European partners, but given the benefits of linkage in terms of liquidity, price discovery, and the ability to attract abatement across a wider area, it would be in the interest of both sides to resolve any issues.

⁷ "*Trade and Cooperation Agreement*" (HMG, 2020), Article 7.3