THE FUTURE OF UK CARBON PRICING

UK Government's and Devolved Administrations' response

Executive Summary

1. The UK Government and Devolved Administrations consulted on the future of carbon pricing in the UK after EU Exit, receiving over 130 responses from a range of stakeholders, with the majority supporting most of our proposals on the design of a UK ETS.

2. The UK Government and the Devolved Administrations are firmly committed to carbon pricing as a key tool for achieving our carbon emissions reductions targets at least cost to business. Our future approach will be at least as ambitious as the EU Emissions Trading System (EU ETS) and will provide a smooth transition for relevant sectors.

3. We intend to establish a UK Emissions Trading System with Phase I running from 2021-2030, which could operate as either a linked or standalone system. As stated in 'The UK's Approach to Negotiations' the UK would be open to considering a link between any future UK Emissions Trading System (ETS) and the EU ETS (as Switzerland has done with its ETS), if it suited both sides' interests. As announced at Budget 2020, the UK Government will publish a consultation later this year on the design of a Carbon Emission Tax as an alternative to a UK ETS, to ensure a carbon price remains in place in all scenarios.

4. The UK ETS will apply to energy intensive industries (EIIs), the power generation sector and aviation – covering activities involving combustion of fuels in

installations with a total rated thermal input exceeding 20MW (except in installations for the incineration of hazardous or municipal waste) and sectors like refining, heavy industry and manufacturing. The proposed aviation routes include UK domestic flights, flights between the UK and Gibraltar, flights from the UK to EEA states, and flights from the UK to Switzerland once an agreement is reached.

5. In light of the UK's commitment to reaching net-zero emissions by 2050, the UK ETS will show greater climate ambition from the start. As such, the cap will initially be set 5% below the UK's notional share of the EU ETS cap for Phase IV of the EU ETS. The CCC will advise later this year on a cost-effective pathway to net-zero, as part of their advice on the Sixth Carbon Budget. We will consult again on what an appropriate trajectory for the UK ETS cap is for the remainder of the first phase within nine months of this advice being published. Our aim is that any changes to the policy to appropriately align the cap with a net zero trajectory will be implemented by 2023 if possible and no later than January 2024, although we would also aim to give the industry at least one year's notice to provide the market with appropriate forewarning.

6. Auctioning will continue to be the primary means of introducing allowances into the market. To safeguard competitiveness in the UK ETS and reduce the risk of carbon leakage, a proportion of allowances will be allocated for free. Some free allowances will also be made available for new stationary entrants to the UK ETS as well as existing operators who increase their activity – these allowances will be accessible through the New Entrants Reserve. Our initial UK ETS free allocation approach will be similar to that of Phase IV in order to ensure a smooth transition for participants for the 2021 launch.

7. However, we recognise the range of views expressed in response to the consultation and the crucial need to take a fair, proportionate and considered approach to potential improvements to free allocation and we will begin a full review of possible future changes in the coming months.

8. In a standalone UK ETS we will introduce a transitional Auction Reserve Price (ARP) of £15 (nominal) to ensure a minimum level of ambition and price continuity during the initial years of UK ETS. To address concerns around the reactiveness of the UK ETS in managing high price spikes, in years one and two of a UK ETS the Cost Containment Mechanism (CCM) will have lower price and time triggers, providing a mechanism by which the UK Government can decide whether to intervene sooner should very high prices occur. We will revert to the EU ETS CCM design in year three of a UK ETS, or sooner if we link with the EU ETS. We will consult separately on the design of a Supply Adjustment Mechanism (SAM) in a standalone UK ETS if required.

9. We will implement a Small Emitter and Hospital Opt-Out for installations with emissions lower than 25,000t CO_2e per annum and a net-rated thermal capacity below 35MW. We will implement an Ultra-Small Emitter Exemption for installations with emissions lower than 2,500t CO_2e per annum.

10. International credits will not be permitted in a UK ETS at this time. This is without prejudice to ongoing reviews on how best to implement the UN global offsetting scheme, CORSIA, alongside a UK ETS.

11. The Government will implement two of the three reviews proposed in the consultation document, with the mid-phase review being incorporated into the second whole-system review of the phase. An initial review of the UK ETS to be conducted from 2023 to assess whole system performance during the first half of the phase (2021-2025) with any necessary changes to design features implemented by 2026; a full review from 2028 onwards to assess whole system performance across all of Phase I (2021-2030) with any update to the UK ETS rules implemented for 2031 (Phase II). These reviews are aligned with the EU ETS Phase IV reviews and Paris Agreement Global Stocktake efforts.

12. The UK ETS will play an important role in cross-government efforts to deliver the net zero target as part of a coherent policy package alongside £2 billion to support decarbonisation in a range of sectors, and the £315m Industrial Energy Transformation Fund to support industry to invest in energy efficiency and decarbonisation technologies.