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Brexit and the UK's future climate policy

Principles and options

May 2017

Introduction

the UK has positioned itself as a global leader on climate change, developing innovative approaches and institutions, and achieving an effective and stable policy mix

maintaining this leadership through the Brexit transition will be challenging, and requires a commitment to credible and effective policies

carbon pricing is an essential component of any credible climate policy, and the UK has four main options available in response to the outcomes of negotiations

we propose three principles for assessing the implications of Brexit on UK carbon pricing policy

— the principles help understand the inevitable trade-offs across options under a ‘soft’ or ‘hard’ Brexit

this work builds on Vivid Economics’ analysis of the implications of Brexit for the energy sector, including the impacts of leaving the internal energy market and effects of increased economic uncertainty

Contents

Principles for post-Brexit climate policy

1. consistency

strategic consistency with the broader post-Brexit settlement

harmonise climate policies with other elements of the UK’s energy system

2. efficiency

maintain price incentives for low carbon investment

minimise transition costs for business

3. robustness

maintain environmental integrity

achieve UK carbon budgets

support global action on climate change

Options are limited by the need for consistency with the broader settlement, in turn effecting policy efficiency and robustness

‘Soft’ Brexit ⟷ ‘Hard’ Brexit

1. stay in the EU ETS

- easiest option for climate policy
- continuity for business and government
- questions remain about NDC implications

2. leave, UK ETS with EU ETS link

- most challenging option, full link likely in longer term only
- greater flexibility but retain price parity with EU
- interim one-way link a promising option?

3. leave, UK ETS without EU ETS link

- substantial policy development in short time period
- diverging prices and impact on asset values

4. leave, carbon tax

- climate change levy and price floor likely provide starting points
- reopens design considerations e.g. scope, leakage

a transitional agreement would delay the need to decide, but would not fundamentally change the options

Option 1: stay in the EU ETS

What role for the UK in EU ETS policy?

remaining in the EU ETS would be comparatively easy from and administrative perspective, but would require UK acceptance of diminished policy influence

- simplest model with least challenges, if it can be agreed to
- ‘stay model’ is likely similar to Norway, not Switzerland
- UK-EU leakage not a concern if allocation methodologies unchanged
- would likely retain ECJ jurisdiction

policy uncertainties

- UK price floor delivers UK tax revenue but leads to lower EUA prices; a contender for a negotiated removal?
- implications for UK auction platform and exchange trading?

Option 2: leave EU ETS, but new UK ETS *with* link to EU ETS

More flexibility but faces significant hurdles

requires establishing a functional link between the EU ETS and a new UK ETS

more design freedom may be valued more highly in a post-Brexit UK

— allowance allocation, leakage criteria, sectoral coverage may have some flexibility, although in trade-off that differences in design make linking more challenging

but significant costs

— costs of setting up and administering UK-only trading scheme

— complete loss of influence in broader EU policies relating to EU ETS

practical problems mean developing ETS and agreeing full link unlikely to be feasible in two years

— policy design, changes to MRV regimes, design and build registry

— requires agreement on market sensitive policies (e.g. price floor, allowance allocation, sectoral coverage)

in the short term, an interim one-way link could provide price stability and protect asset values while a full link is negotiated (Australia provides precedent)

Option 3: leave EU ETS, new UK ETS *without* link to EU ETS

Unscrambling the egg

this is akin to delinking, which can be done in two main ways

I. **isolate registries** – EUAs remain in EU registry and cannot be transferred out for compliance use in new UK ETS

II. **limit compliance use** – transfer of EUAs between EU and UK registries is allowed for compliance use in UK for a limited period

supply and demand differ in UK and EU, implementing a new ETS without a link will change relative carbon prices with associated leakage risk

- UK is expected to have a higher abatement cost than rest of EU at comparable levels of ambition
- however stakeholders in UK ETS may seek additional cost containment measures
- lower liquidity in UK market could reduce hedging options and increase costs

in *short term* likely to reduce price for EUAs, with higher prices for UK units

- delinking option I implies lost asset value for UK holders of EUAs (and potential difficulties fulfilling existing contracts?)
- delinking option II implies continued net transfers of EUAs to UK in short term

Option 4: a UK carbon tax

The price of certainty is popularity

relatively straightforward to implement with CCL and price floor as starting points

could improve investment flows

— increased certainty over carbon price and compliance costs for UK firms

— potential additional fiscal revenue

but likely unpopular

— resistance from stakeholders given current low cost of compliance via markets

— may be challenging to increase tax rate over time

— carbon leakage concerns: uncertainty about carbon price *relative* to EU ETS price faced by competitors

limited prospects for linking with emerging carbon markets removes the potential for increased cost effectiveness

There is no clear best option, with all involving trade-offs effecting the efficiency and robustness of climate policy

'Soft' Brexit ⟷ 'Hard' Brexit

	Stay in the EU ETS	Leave, with ETS link	Leave, no ETS link	Leave, carbon tax
Efficiency	— no price impact — no additional transaction costs for business — adopts EU ETS design (passively)	— significant set up cost but limited transaction costs for UK EUA owners — (some) options to change UK design (e.g. increase coverage) in trade-off with friction with EU	— prices may diverge leading to competitiveness concerns — status of EUAs and contracts unclear — more design flexibility (scope, allocations) at cost of reduced market liquidity	— UK can set price as desired — status of EUAs and contracts unclear — option to change tax design (e.g. expand to other sectors)
Robustness	— quantity certain — lower ETS prices if the EU is less ambitious without UK as member — future of price floor uncertain — unable to pursue carbon market links or greater cooperation independently	— quantity certain (once accounting rules established) — future of price floor uncertain — less able to pursue carbon market links or greater cooperation independently	— quantity certain — further fragments global carbon markets at least in the short term — can pursue carbon market links without the EU	— price certain, quantity is uncertain unless government buys or facilitates purchase of overseas abatement, or can flex mitigation in uncovered sectors — more difficult to engage on global carbon markets

Conclusions

a principled approach would develop an efficient and robust policy, that maintains incentives, protects market participants and supports mitigation action globally

of the four main options:

1. staying in the EU ETS is the easiest option (administratively but not necessarily politically), but accepts diminished influence
2. establishing a new ETS and linking with EU ETS is unlikely in the short term, but an interim one-way link provides a potential approach as negotiations progress
3. establishing a new unlinked ETS is likely to have higher prices than the EU ETS, although the UK could pursue additional cost-containment measures and international links
4. a carbon tax can provide certainty for investors but may be less cost-efficient than participation in international markets

options 1 and 2 require a negotiated settlement, while options 3 and 4 are possible without a negotiated settlement

— however, the absence of a negotiated settlement carries significant risks

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Company Profile

Vivid Economics is a leading strategic economics consultancy with global reach. We strive to create lasting value for our clients, both in government and the private sector, and for society at large.

We are a premier consultant in the policy-commerce interface and resource and environment-intensive sectors, where we advise on the most critical and complex policy and commercial questions facing clients around the world. The success we bring to our clients reflects a strong partnership culture, solid foundation of skills and analytical assets, and close cooperation with a large network of contacts across key organisations.

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