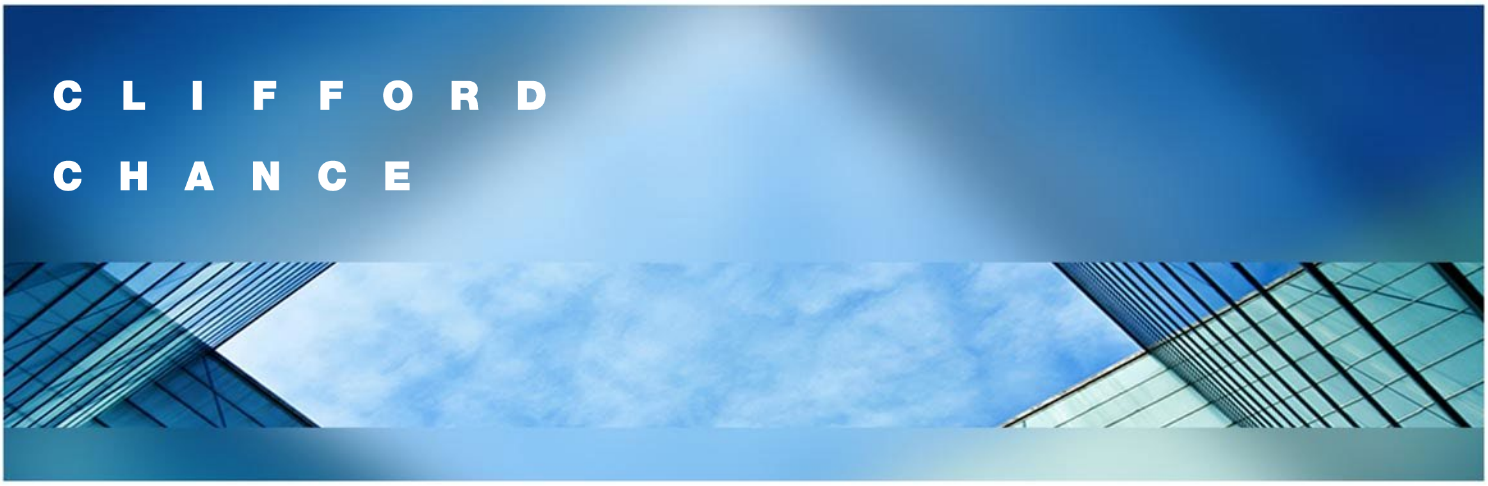

CARBON PRICE CLARITY: A NEW UK EMISSIONS TRADING SYSTEM FROM 2021

The UK Government has confirmed that it intends to establish a UK emissions trading system ("**ETS**") from 1 January 2021. The ETS could operate either as a standalone system or be linked to other systems such as the EU ETS. The design of the system has borrowed heavily from the EU ETS but it is more ambitious in its climate targets, adopting an initial emissions cap that will be 5% lower than the UK's notional share of the EU ETS cap for Phase IV of the EU ETS. Key points to note from the proposal are set out below.

Key issues

- A new UK emissions trading system to start on 1 January 2021
- Emissions cap will be 5% lower than EU ETS
- Initial auction reserve price of £15 / tCO_2e
- Banking of UK allowances permitted
- Use of international credits not permitted
- Carbon leakage provisions included

- **Coverage**: The UK ETS will apply to energy intensive industries (other than municipal incinerators), the power generation sector and aviation. Coverage may be expanded to additional sectors following the first review in Phase I (see below). There will be opt-outs and exemptions for smaller emitters. Aviation coverage is proposed to include UK domestic flights, flights between the UK and Gibraltar, flights from the UK to EEA states, and flights from the UK to Switzerland (if agreement is reached with Switzerland).
- **Price stability mechanisms**: If the UK ETS is standalone, there will be a transitional auction reserve price ("**ARP**") of £15 / tCO_2e to ensure a minimum price, especially during the early years of the UK ETS. A Supply Adjustment Mechanism ("**SAM**"), the equivalent of the EU ETS's Market Stability Reserve, was considered but could not be introduced straightway because it requires at least one year of verified UK emissions data. The UK Government will consult on the design of the SAM, if required, at a future date relying in the meantime on the ARP to ensure prices do not collapse. As in the EU ETS, price spikes will be dealt with by a Cost Containment Mechanism ("**CCM**"), which will mirror the EU ETS's CCM except that the UK trigger thresholds will be lower for the first two years of the scheme.
- **Banking allowances**: Rules on banking allowances will mirror the EU ETS rules; i.e. allowances will remain valid indefinitely and entities can "bank" allowances without limitation. However, in a standalone UK ETS, participants would not be able to use any banked EU ETS allowances for UK ETS compliance.
- **International credits**: International carbon credits (such as those from Clean Development Mechanism projects) will not be permitted in the UK ETS at least initially. However, this will be kept under review as part of the

assessment of how to implement the international aviation offsetting scheme (known as CORSIA) alongside the UK ETS.

- **Phases and reviews**: The first phase of the scheme (Phase I) will run to 2030 and will be subject to two reviews. The first would be carried out from 2023 to assess performance during the first half of the phase (2021-2025) with any necessary changes to design features implemented by 2026. The second would run from 2028 onwards to assess performance across all of Phase I, with any update to the rules implemented for 2031 (Phase II). Other targeted reviews will also take place (e.g. on the relationship between the UK ETS and CORSIA).
- **Potential changes to the cap**: The emissions cap may be reviewed following advice to be provided later this year by the Committee on Climate Change on the Sixth Carbon Budget. Any changes to the cap will be implemented by 2023 if possible and no later than January 2024, ideally with at least one year's notice to industry.

One of the big concerns with any ETS is the risk of carbon leakage – emissions-intensive industries moving to locations where there is no carbon price. The key means of addressing this risk in the UK ETS will be the allocation of a proportion of allowances for free. Initially, the free allocation will be similar to that of Phase IV in the EU ETS: highly exposed sectors and subsectors on the carbon leakage list will receive 100% of allowances for free; less exposed sectors will receive a maximum of 30% free allocation up to 2026, which will then be phased out to zero by 2030. The free allocation will not be affected by the 5% cap reduction as the reduction will be taken from the auctioned allowances only. This will help to minimise carbon leakage between the UK and EU. The approach may however change in later years following additional targeted consultation. The UK Government will need to strike a balance between ensuring the ETS drives the reduction of emissions on a trajectory that aligns with its 2050 net zero commitment while at the same time avoiding the loss of important industries and investment overseas.

Legislation establishing the UK ETS will be laid before Parliament later this year. The UK Government also intends to consult on a carbon emissions tax as a "fallback carbon pricing option" and potential alternative to the ETS.

We will be publishing further detailed briefings on particular aspects of the UK ETS in the coming days.

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