



BEIS Consultation: The Future of UK Carbon Pricing

Centrica plc
12 July 2019

ABOUT CENTRICA

- We are an international energy and services company focused on satisfying the changing needs of our customers.
- Our business strategy is designed around five offers; energy supply, wholesale energy, energy insight, energy optimisation and energy solutions. We supply energy to over 1.2 million business customer accounts, around half of which are in the UK
- Our investment is increasingly shifting towards our customer-facing businesses, with our areas of focus being Energy Supply & Services, Connected Home, Distributed Energy & Power (DE&P), UK Business, Energy Marketing & Trading (EM&T) and the optimisation of our Central Power Generation.
- We serve our 25 million customer accounts across our businesses through strong brands with distinctive capabilities which include British Gas in the UK, Bord Gáis Energy in the Republic of Ireland and Direct Energy in North America.
- We provide market-leading products and services that give customers greater choice, control and understanding over their energy, this includes the £1.2bn investment we are making in our global Connected Home and Distributed Energy & Power businesses (DE&P) to the end of this decade.
- As part of this £1.2bn investment, we announced the construction of a 49MW battery storage facility at Roosecote (now complete) and a £19m local energy market trial in Cornwall. The trial will test flexible demand, generation and storage, supporting increased use of renewables
- DE&P also focuses on delivering efficient heat and power to the non-domestic sector, using combined heat and power (CHP) together with smart technology to optimise energy use and deliver carbon savings.
- Our DE&P business is active in offering on site solar generation to business clients. We have designed and installed >150MW of solar globally (with 85MW in the UK across 1,000 sites) that we continue to operate and maintain.

EXECUTIVE SUMMARY

- We welcome the Government's decision to consult on linking to the EU Emissions Trading Scheme (EU ETS) once the UK has left the European Union.
- Our emphasis in our response to this consultation comes from our business focus as an energy company, where we have experience of both the ETS and domestic carbon price support policies.
- Our preferred position would be for the UK to remain a full participant of the existing EU ETS scheme. However, in the event that this is not possible, we believe linking to the EU ETS in a similar manner to Switzerland, is the next best outcome.
- Either of these outcomes would be significantly better than a stand-alone UK ETS or (in the event of a no-deal Brexit) the abandonment of emissions trading in favour of a UK Carbon Emissions Tax.
- Achieving linkage to the EU ETS promptly at the end of the Brexit Transition Period should be an objective of the wider Brexit negotiations on climate envisaged by the proposed Political Declaration, where we note that maintaining a close relationship with the Internal Energy Market (IEM) is also a priority. Close alignment with the EU ETS is also important for aligned carbon pricing across the island of Ireland. Divergence would undermine the efficient operation of generation dispatch within the Integrated Single Electricity Market (ISEM).
- In the case of the EU ETS and the UK's ongoing relationship with the IEM, the priority for the UK Government should be to replicate the existing benefits of both markets as far as is possible, given the carbon and security of supply benefits both arrangements bring.

- Seeking to diverge from specific aspects of the EU ETS risks jeopardising timely ETS linking negotiations and would potentially delay or put at risk the ability of the UK energy market to transition smoothly into a close post Brexit energy relationship with the EU27. On that understanding we have not recommended divergence on aspects of the EU ETS which sit outside of those components of scheme design where scheme members currently enjoy discretion, i.e. arrangements for country specific funds.
- In the case of the EU ETS, seeking to secure linkage in itself will require significant preparation. Designing and implementing a UK registry for allowances and separate monitoring, reporting and verification arrangements will require careful preparation, and will involve implementation timings which are likely to result in the UK remaining a full member of the ETS as it transitions into Phase IV (this recognises that an extension to the Transition Period might be necessary to complete the wider future relationship with the EU).
- While we note that the scope of this consultation does not address current compliance issues and the interaction between the EU ETS and domestic GB carbon price support policy, we would urge the Government to consider both related aspects as part of its current activities:
 - In the case of the UK's relationship with the current Phase of the EU ETS, we would flag that continuing uncertainty around the current suspension of the auctioning of allowances will eventually impact market liquidity and is already damaging trading confidence in the market. An early resolution of this issue should be a priority, especially in the case negotiations continue beyond 31 October 2019.
 - In the case of the interaction with the GB carbon price support policy, we would welcome clarity that the UK will continue to commit to domestic support, and in the context of a net zero emissions target, take the steps needed to indicate what a rising trajectory for carbon in the UK economy should be. This should clarify how an emissions trading scheme and GB price support mechanism will interact.
- Finally, it is likely that the UK could continue to remain a full member of the EU ETS as the scheme transitions into Phase IV (from 2021), if some form of Brexit deal is agreed this year and the Brexit implementation period (currently ending on 31 December 2020) is extended so that Brexit 'phase two' negotiations can be concluded. The consultation seeks views on whether the UK should seek changes to certain aspects of the design of Phase IV. We do not consider this to be a credible exercise, given:
 - The UK has already been extensively involved in the design of Phase IV of the EU ETS scheme.
 - Implementing measures of the Phase IV directive are currently being discussed and adopted in comitology with EU member states.
 - Regulators have already begun collecting the information required for Phase IV, with scheme participants having recently completed an extensive exercise to compile data and submit National Implementation Measure (NIMs) returns in June of this year. This was a significant exercise requiring submissions of a NIMs template, a monitoring methodology plan, a verification report proving the data provided has been validated and verified, and a range of relevant supporting information.

We have grouped key questions under each chapter of the consultation document and provided responses to each of those groups.

CHAPTER 1: SCHEME DESIGN

Overview

There are important lessons to be learned from the recently agreed linkage between the Swiss and the EU-ETS schemes. Annex 1 of that linkage agreement sets out a series of “essential criteria” (detailed below), which we consider the UK would also need to follow if it seeks to formally link to the EU ETS in a way which allows for fully fungible allowances across both schemes.¹

- **Scope:** the same GHG and industry sectors are covered in both schemes, and the same threshold for inclusion applies.
- **Cap:** the annual decrease in the quantity of allowances in the Swiss ETS is in line with the annual decrease in the EU ETS. The level of ambition is aligned in both jurisdictions.
- **Rules on allocation of allowances:** the allocation methodologies for the two systems are compatible.
- **Period covered:** trading periods cover the same years as those set out in EU ETS scheme phases.
- **Penalty regime:** penalty arrangements in both schemes are similar if obligated parties fail to surrender sufficient allowances.
- **Rules on monitoring, reporting and verification (MRV):** Swiss MRV requirements are as stringent as the EU MRV arrangements.
- **Governance:** we note that a governance framework (a joint committee structure) has been agreed between the parties, ahead of (and so separate from) any governance framework for the wider EU/Swiss relationship.

On the basis of the above, we see little scope (or benefit) of the UK diverging away from key aspects of the ETS scheme design and consider that significant divergences stand to compromise the main linkage objective of maintaining fungibility of allowances.

Unlike Switzerland, the UK Government has, however, introduced a domestic carbon price support mechanism for power generators (within GB) to bolster the ETS price and to support delivery against its carbon budgets. The maintenance of this policy should be a key consideration as part of its plans to secure a linkage agreement. A number of EU countries already have national carbon pricing mechanisms.² With reports that both the Netherlands and Germany are now also considering introducing domestic carbon price support measures, the case for retaining a form of domestic carbon price support to complement the EU ETS is strong.

In the GB context, we note that the current total power generation carbon price of c.£40/tonne CO₂³ has proven sufficient in driving coal generation off the system⁴ and is in line with the trajectory for carbon originally anticipated by Government when the CPSM was designed in 2010, as well as with various academic studies assessing the carbon trajectory needed for the UK to decarbonise cost effectively.⁵

The coal closure date of 2025 should not signal an end date for carbon price policy in the UK. Rather, a continuing and escalating carbon price is needed to ensure lower-carbon assets are

¹ We note that a UK/Swiss linking agreement is also likely to be needed in parallel, such that traded emissions allowances are fully fungible between all three linked emissions trading schemes.

² See https://carbonpricingdashboard.worldbank.org/map_data

³ As at June 2019.

⁴ In 2019 the UK experienced a 2 week period with no coal generation, supported by current carbon price signals and the increasing volume of cost-effective renewables.

⁵ See, for instance, reports published by the London School of Economics.

dispatched ahead of high-carbon assets, as well as to drive the efficient dispatch of flexible assets, demand side response and support the continuing operation of existing low carbon generation (renewables, nuclear).

The Treasury initially projected needing to reach a carbon price of £70/tonne CO₂ in 2030 and, with the additional constraints posed by a net zero emissions target, careful consideration needs to be given to what the forward trajectory for carbon should look like. It cannot remain subject to the uncertainty of annual change at Autumn Budgets and should take account of the following parameters:

- The need to maintain a multi-lateral approach, through linking to the EU ETS, which avoids carbon leakage and mitigates competitive distortions.
- The need to set a long-term path for the UK carbon price. Ideally this will align with rising out-turn prices from the EU ETS, but a domestic under-pin is likely to be needed in the event ETS prices stall, as they have done historically.

With the UK pursuing tough carbon abatement targets relative to some of its European neighbours, it can be expected that were the UK to remain in the EU ETS, that the UK will become a net exporter of EUAs during the 2020s. This export position would provide an estimated benefit to the economy of c.£0.8-£1.0 billion per annum (see appendices for further detail). This substantial benefit would be foregone if the UK were to leave the EU ETS without transitioning to a linked UK scheme.

Response to Questions

Scheme Scope (*Questions 3-4*)

Considering the need to ensure the principle of linkage is agreed as part of the wider negotiations on the forward energy relationship between the UK and the EU, we do not believe the case to seek changes to scheme scope, which could slow those negotiations, is sufficiently strong. Indeed, alignment on scope was one of the key criteria for establishing the first linked scheme with the EU ETS (the Swiss-EU ETS linkage).

We note that the EU ETS currently covers c.45% of all carbon emissions across the EU. As Europe seeks to decarbonise further, it will need to begin considering widening the scope of the scheme to capture other sectors. This is best achieved on a multi-lateral basis across all members of the EU ETS scheme, given the potential for carbon leakage in the event only some member countries extend scheme scope individually.

Cap and Trajectory (*Questions 5-6*)

These issues are only relevant in the case the UK seeks to implement a stand-alone UK emissions trading scheme (i.e. it has not been possible to secure linkage with the EU ETS). We would reiterate that we see little benefit of spending money establishing a bespoke standalone UK ETS (except if absolutely necessary, as a short term 'stop-gap' before ongoing linkage negotiations can be concluded), given the limited liquidity such a scheme would have. A stand-alone UK ETS would not, in our view, be even a 'second best' enduring solution.

In the event the UK is unable to secure a linkage agreement, rather than establishing/retaining a stand-alone UK ETS, we believe that a total carbon price mechanism would best deliver the price signal required for investment decisions. Such a carbon price mechanism should be designed to provide a forward, rising trajectory for carbon pricing in GB, in line with the rationale set out at the beginning of the response to this section. This forward trajectory should be set a number of years in

advance to provide investor confidence. Care would need to be taken to align this with the EUA price as far as possible, for reasons relating to the ISEM which are mentioned above.

Free Allocation and Carbon Leakage (*Questions 7-11*)

We understand that the Government proposes to maintain the existing arrangements for free allocation. While we understand the rationale for this approach, it will need to be balanced against the objective of driving a step change in industrial decarbonisation (see response to questions 25-33). Taken together with other cost exemptions for EITs, free allocation stands to dampen incentives for industry to invest in low carbon technologies, even if they receive financial support to do so.

However, the need to avoid undesirable carbon leakage (further unnecessary de-industrialisation of the UK economy) must also be assessed. The UK should take into account the EU approach, whether or not there is a linked scheme, in order to maintain a level competitive playing field for energy intensive UK businesses.

Supply Adjustment Mechanism, Auction Reserve Price and CCM (*Questions 12-16*)

We do not support the creation of a stand-alone UK ETS as a policy objective and do not take a view on the related instruments set out here.

Scheme Opt-out and Review Phases (*Questions 17-24*)

We note that the small emitter opt-out is an opt-out from bureaucratic requirements only. Hospitals, for instance, still have to meet equivalent measures or face penalties. We would support continuation of these existing arrangements. Similarly, we support the proposals for an Ultra-Small emitter exemption.

The proposals to reduce the burdens associated with the qualification period for Small Emitter and Ultra-Small Emitter schemes are sensible. This removes the need for three years of operation prior to qualification, adds useful flexibility and reduces the administrative burden for these installations. It is for the operator to decide whether to enter the EU ETS or the small emitter or ultra-small emitter schemes, guided by the potential penalties for non-compliance and the knowledge that emission data has to be supplied.

In respect of review phases we note these should align with the ETS, as was also agreed in the Swiss linkage agreement.

Industrial Energy Funding (*Questions 25-33*)

As carbon budgets tighten, particularly over the 4th carbon budget period (2023-2028), the industrial sector will need to begin to decarbonise its energy use further. For some industrial users who rely on particularly energy intensive processes, the economic case to invest in energy efficiency, decentralised solutions and lower carbon generation can be weak or negative.

Financial support to reduce payback periods for investments in energy efficiency and lower carbon generation can be a key way to drive investment. Using EUA revenues to help provide such financial support could therefore deliver significant benefits. Decision making here will need also to take account of:

- The interaction with the proposed Industrial Energy Transformation Fund (IETF). The IETF is designed to replace the foregone benefit brought by the withdrawal of Enhanced Capital

Allowances (ECAs) from 2020. However, the £315m fund is time limited to 4 years and will not provide an enduring solution for the abolition of ECAs. Any industrial energy funding from a UK linked ETS scheme could help provide a sustainable solution.

- The interaction with current EII exemptions schemes. The introduction of funding schemes needs to be done to align with the progressive withdrawal of existing exemption arrangements which currently dis-incentivise investment. The Government needs to review these exemptions as it phases in new incentives if there is to be a step change in industry engagement.

We provided a response to the Government's recent call for evidence on the IETF where we provided more detail on how policy can better incentivise demand for low carbon technologies, as well as the interaction with existing cost exemptions policy for EIs.

CHAPTER 2: OPERATION OF UK ETS

Overview

A UK linkage agreement should seek to align as closely as possible to the current operational arrangements of the EU ETS. There are two main areas where bespoke arrangements will be required: the creation of a UK registry of allowances (see response to questions below) and the establishment of a dispute resolution model.

As the need to withdraw from the jurisdiction of the European Court of Justice (ECJ) is one of the key drivers informing the UK's future relationship with the main European schemes (including the EU ETS) a new form of arbitration model will be needed in the event operational disputes emerge. We believe the approach taken under the recently agreed Swiss linkage sets a helpful precedent, and the UK should aim to replicate its core features, i.e.:

- Establishment of a joint committee to address dispute resolution. This committee considers disputes referred by either party relating to the linkage agreement.
- Ultimate referral to the Permanent Court of Arbitration (PCA). The PCA provides arbitration and conciliation services for a number of private and public entities globally. The United Kingdom was among the signatories of the original 1989 Convention from which the PCA evolved.

Response to Questions

Reporting and Scheme Operation (Questions 33-35)

We broadly support the simplification proposals proposed and believe there is scope to extend these further. We also note that the proposal to retain the power to implement simplified M&R plans for "simple emitters", however these have yet to be introduced in the UK. Additionally, we consider there is scope to increase further the proposal to increase the total aggregated volume (10t CO₂ for single line entry items).

Finally, we note it is proposed to reduce the number of off-shore visits (currently every 3 years) to two visits per phase (subject to verifier risk assessment analysis). As a business with a number of off-shore assets captured by the EU ETS, we believe this approach is proportionate and an improvement on existing arrangements.

Banking and Borrowing and UK Registry Creation (Questions 36-42)

We see no case to diverge on banking and borrowing requirements, for instance, borrowing across phases is not permitted in the EU-ETS, and to diverge on this requirement would risk linkage. Early communication of the rules on banking and borrowing between compliance years and compliance phases is essential for compliance parties to be able to plan ahead and manage positions from an operational and financial perspective. Different arrangements in UK and EU schemes would also make it more burdensome in terms of administration and compliance for international operators, who would be subject to both regimes.

The establishment of a UK registry will take time. We understand Government has already taken steps to issue an invitation to tender for the delivery of a UK Emissions Trading Registry. There are a number of options through which a UK registry could be delivered (not all of which are assessed in the consultation document), set out below in ascending order of complexity:

- **Retain:** The UK retains access to EU Registry largely on current terms, but with possible ring-fencing of UK accounts to become a registry within the Union Registry. How this could be done would depend on the future degree of linking or separation and, hence, whether regulatory provision would need to be made to allow third countries to use the Union Registry. Such an arrangement works with EEA countries, albeit they effectively participate fully in the EU ETS. Such an approach should be possible during any transitional deal which saw the UK commit to finishing Phase 3 on current terms.
- **Shadow contract:** The UK contracts to use the Union Registry under a service agreement (rather than under a regulatory umbrella).
- **Implicit access:** UK government and/or market participants open trading accounts in the Union Registry and annually cancel EU allowances equal to their verified emissions. This does not solve the wider issues of taking the UK out of the EU ETS but has the merit of being achievable quickly and without an agreement with the EU 27.
- **Buy or rent:** The UK buys or leases a copy of the EU Registry for its own bespoke usage.
- **Revert:** The UK rolls back to the UK Registry used during EU ETS Phases 1 and 2 up to 2012.
- **New build.** A new registry and associated architecture is constructed.

In theory, each option could exist either in a UK ETS that was fully linked and fungible with the EU ETS (as previously under Phases 1 and 2) or in a “mirror/linked” mode where the rules and instruments for UK and EU allowances are essentially similar. The latter would require an additional “bridge” if transfers between the schemes were permitted. This bridge would perform the function of the EU Transaction Log (which superseded the CITL/ITL).

CHAPTER 3: AVIATION

As an energy and services business, we have no specific comments on the chapter on aviation. Broadly, we support the proposed approach to ensure the aviation sector remains within the scope of a linked UK-EU ETS arrangement.

CHAPTER 4: MEMBERSHIP OF PHASE IV

Overview

In the event the UK secures a Brexit deal, we consider it likely that an extended implementation period will be required during which time the UK will remain a full member of the EU ETS.

Considering each of the steps needed in agreeing to a linked scheme, we envisage this taking a total of 18 months, which in any conceivable scenario, is likely to mean that the UK will be a full participant for part of Phase IV of the EU ETS. Our assessment of timings is detailed below:

Process	Time Required
1) UK reviews the essential requirements and components for a UK ETS that can be linked to the EU ETS	3 months
2) UK prepares an outline proposal for the linked UK ETS and opens negotiations with the EU. 3) The outline proposal needs to specify the basis of each essential component of the UK ETS, but the detailed component itself does not need to be complete and in place at this stage.	3 months
4) Negotiations proceed, leading to an agreement with the EU on a linkable UK ETS	6 months
5) In parallel with EU negotiations, UK makes detailed preparations for each key component of the UK ETS, including implementing Regulations (but the Regulations cannot be approved by Parliament until EU agreement is reached, as details may change)	6 months (in parallel)
6) Upon agreement with the EU, the Regulations are finalised and processed through Parliament	2 months
7) Once the Regulations are in place, new UK ETS permits can be issued and the other UK ETS components put in place	4 months
Total time required: 18 months*	

* The total time required is 18 months, which assumes each stage is completed in the minimum feasible time.

Considering the above, we do not consider it credible for the UK to also seek to make changes to the design of Phase IV of the EU ETS in parallel. In addition, we note:

- Regulators already collecting data for Phase IV and allocation has begun.
- Companies have begun submitting compliance data already (in June of this year).
- Implementing measures of the Phase IV directive are currently being discussed and adopted in comitology with EU member states.

Response to Questions

We have the following specific observations:

- All the flexibilities offered by Articles 27 and 27a should be implemented fully as they reduce the burden for small sites. Easements could also be introduced to the qualifying period for new entrants.
- The rules for banking of overachievements of targets within the Article 27 appear overly complex. It is proposed that overachievement is only bankable within each 5 year allocation period. This should be changed to bankable within all of Phase IV.

APPENDIX: Economic Benefits of Linking to EU ETS

Centrica worked with Vivid Economics in 2017 to assess the economic benefits accruing to the UK in the event that it maintained a trading relationship with the EU and ETS and delivered on its domestic carbon budgets. That work found:

- The UK has historically been a net buyer of emissions permits and benefits when the cost of abatement in other parts of the EU is higher than it is in the UK itself.
- Given the ambitious UK carbon budgets (i.e. a UK abatement target of 57% over 1990-2030 compared to a 40% EU abatement target over the same period), this position is set to change during the mid to later 2020s, if the UK remained in the EU ETS and carbon budgets were met.
- In this scenario, the UK would become a net seller of emissions permits, with the Committee on Climate Change (CCC) estimating this annual net sales volume rising to 31 MtCO₂ by 2030.
- As a result, UK GDP would be reduced by the EUA sales revenue foregone in the event of leaving the EU ETS. At an EUA price in the range of £25-32/tonne by 2030, UK foregone GDP could rise to around **£0.8-£1.0 billion per annum** by the end of the 2020s.