Successful UK carbon pricing reform needs new carbon taxes and a new net zero-aligned carbon market

What are the most efficient and effective ways of pricing carbon as we seek to deliver net zero by 2050 and beyond? What policies do we have already in the UK, what works, and what do need we improve upon? These are critically important questions for the government’s net zero strategy.

There are many very compelling reasons to introduce new and appropriately high carbon taxes in the UK. They could cover the entire economy, can be adjusted year-to-year to balance tax yield with considerations of efficacy and politics, and could be used, together with other interventions, to address carbon leakage through a carbon border tax adjustment. These are, among other reasons, why we should all be very supportive of appropriately high carbon taxes being levied across the UK (and global) economy. We need prices on carbon and this is one way to do it.

Another way of creating carbon prices is through emissions trading or carbon markets (also known as cap-and-trade). These set a cap on emissions and allow the market to seek out and destroy carbon at the least cost.

In the UK we currently have a mix of specific carbon taxes (e.g. the Climate Change Levy and Carbon Price Support) and implied carbon taxes (e.g. Fuel Duty) that both help to create carbon prices. We also have an Emissions Trading Scheme (ETS), as we currently remain part of the European Union ETS. Our departure from the EU and the end of the transition period means we need to replace the EU ETS. The government has already announced plans to do this via a UK ETS.

While there are numerous problems with the EU ETS that need to be fixed, with Brexit we now have an opportunity to correct them in the UK and to create something much more ambitious: the world’s first net zero-aligned ETS.

But an argument is now being made that we should not replace the EU ETS with a return to a UK ETS (we had one prior to joining the EU ETS) and simply go for carbon tax reform on its own. This is a false choice.

The choice is not between one or the other: carbon taxes *or* carbon markets. We need to ambitiously reform *both*. We should deliver carbon *pricing* reform, not simply carbon tax reform. We should introduce a new comprehensive carbon tax regime that makes sense and also introduce a new and ambitious net zero-aligned UK ETS to replace the EU ETS. In our enthusiasm to introduce new carbon taxes, we mustn’t throw the baby out with the bath water.

While carbon markets and carbon taxes both create carbon prices, these prices have different characteristics and can do different things. There is strength in having a composite approach.

Carbon taxes are set in the Budget and voted on in the annual Finance Bill. This means they can change year-to-year and Chancellors have a habit of taking advantage of this by changing taxes with little or no notice. The Fuel Duty Escalator and Carbon Price Support are instructive. They are both environmental taxes where government reneged on promised multi-year tax plans that were intended to provide certainty to investors and businesses.

This is a big problem for the kinds of thing we want carbon pricing to motivate. Carbon pricing, through taxes or markets, is not simply about tax revenue, important though that is. (Taxes by definition create tax revenue, while auctions for permits under ETSs create revenue for the exchequer)

Carbon pricing should primarily be about changing economic and financial decisions. A carbon price that can be changed at a whim means that a business or investor will heavily discount the value of that carbon price when deciding whether or not to invest in clean technology or infrastructure. Carbon pricing through the tax system is probably the least bankable or investable form of carbon pricing.

One of the big benefits of a well-designed ETS, is that it can create credible cash flows that can be used to base larger and longer-term investment decisions on. If you know that the permits you hold or have created are governed by legally defined property rights, market rules, and are independently regulated, then you will have greater in confidence in making investments.

For example, we know that to achieve net zero we need to invest in technologies that can scrub carbon out of the atmosphere (such as Direct Air Capture) and bury it using Carbon Capture and Storage (CCS). In a net zero-aligned UK ETS, these carbon removals could create permits for the companies that successfully capture and store the carbon, and these could then be sold into the market. The value of these permits can be estimated, and an investment case made. It would be much harder to make that investment case on the basis of tax policy, including through tax credits, as you would heavily discount their value.

An ETS creates a market and more credible cash flow producing pathways to removing carbon. This is needed to spur innovation and investment. We also need to create pathways for investments to make money that are not dependent on government-backed contracts, such as Feed-in-Tariffs (FITs) or Contracts-for-Difference (CfDs). FITs and CfDs are vital today, but the government shouldn't end up guaranteeing every single large emission reducing or carbon removing project in the future. A UK ETS means we can eventually move to a market that doesn't need extensive state guaranteed contracts.

The UK ETS can also be used as a tool for diplomacy. It can be linked to other carbon markets in the future to foster stronger bilateral relationships, encourage trade, minimise risk of carbon leakage, and raise the climate ambition of our partners. We can also use a UK ETS to help set high global standards for the use of carbon offsets.

One argument being deployed for a tax-only approach to carbon pricing reform is that a UK ETS would be too small to operate successfully and would need to link to the EU ETS to have sufficient liquidity. That is not the case. The UK is a major economy and we can create liquidity (i.e. supply and demand of permits) through the quantitative caps we set. In a net zero-aligned ETS we will need deep targets, including negative caps, where companies will need to hold permits for the negative emissions required to achieve net zero. We can also adjust the scope of our ETS to include more or fewer sectors of the economy, changing liquidity accordingly.

Carbon markets are good for larger sources of emissions and can create cash flows that will spur innovation and investment in emission reductions and carbon removals. They let market forces find the lowest cost sources of abatement and ensure we meet quantitative carbon targets. Carbon taxes plug the gaps in ETS coverage as it is hard for ETSs to cover small sources of emissions, introduce incentives to improve carbon efficiency at the margin, and will help to raise more money for HM Treasury, but they don't guarantee a target will be met, are much more susceptible to political change, and don't provide a diplomatic lever to ratchet global standards.

Carbon pricing reform should mean ambitious changes to both carbon taxes and carbon markets. The UK has led on the creation of both and by using both in the future we can introduce carbon pricing across the economy in a consistent and effective way. Introducing ambitious and comprehensive carbon pricing reforms will create a model for others to follow and is a critically important signal we can send as COP26 hosts next year. The government has already announced plans to consult on a net zero-aligned cap for the UK ETS before COP26. Let's get on with it.

Dr Ben Caldecott is founding Director of the Oxford Sustainable Finance Programme and the Lombard Odier Associate Professor and Senior Research Fellow of Sustainable Finance at the University of Oxford.

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