Global Counsel

The EU ETS and Brexit's first billion euro problem

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Summary

Complex, arcane and underperforming, the EU Emissions Trading Scheme has emerged as Brexit's unlikely first billion euro problem. Superficially, the challenge is a technical one; how to manage the uncertainty over what might arise from a disorderly UK exit from the EU ETS, including the future of UK allowances worth almost €1 billion to UK government and industry in 2018 alone. But attempts to find a solution have revealed the difficulty of isolating seemingly technical issues from the broader politics of the Brexit negotiation. The UK has proposed a feasible solution which should be able to address the EU's concerns, for 2018 at least. But with time running short, the challenge now lies in convincing those on both the UK and EU sides to act with the trust, imagination, and flexibility that will be required to make it work.

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Getting the timing right

The basic challenge of Brexit to the EU ETS is timing, or rather, mistiming. As an EU member state, emitters in the UK will be required to comply with the EU ETS at least until the UK leaves the EU on 29 March 2019. However, the 'compliance cycle' for the ETS means that the country will have left the EU before its businesses are required to report their annual 2018 emissions (31 March 2019) or to surrender the appropriate number of allowances (30 April 2019). This is not to mention the emissions for Q1 2019 that would need to be reported and surrendered in Spring 2020 – a full year after the UK exit.

The UK's future in the EU-ETS post-Brexit remains up for negotiation with the UK remaining coy on its intentions. However, the concern is that, should the UK choose to leave the EU ETS after Brexit, UK businesses – safe in the knowledge that they will no longer have to comply with the EU ETS – might simply sell off the allowances they had already received, flooding the market, depressing the price, and undermining the environmental integrity of the scheme.

One solution is already on the table. The European Commission has tabled an amendment to the EU ETS Directive which is to be discussed, and could be agreed, on 30 November[2]. Its adoption would mean that from January 2018, all emissions allowances from any country with "obligations lapsing" – ie. one leaving the EU ETS before the next compliance date – will be automatically tagged with its country of origin. If that country does then leave the EU ETS, these allowances would be made void, but could be restored in value if the country remains in the trading scheme. In practice, this means that from 1 January 2018, the UK could face millions of euros worth of its allowances being marked, and ultimately voided.

1 The EU ETS is a scheme which requires those businesses in sectors covered by the scheme – power generation, heavy industry and now aviation – to present one 'allowance' for every tonne of emissions on an annual basis. These allowances are allotted to, and allocated by, each country to their businesses and can subsequently be traded in a marketplace which sets the price of the allowances.

2 Technically the amendment will be made through the revision to the Aviation EU ETS file, and is implemented through a draft regulation amending the EU ETS Registry Regulation. It enters comitology on 30 November.

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In one sense, the proposal would do the job. UK businesses would be unable to flood the market with allowances that all market participants would be able to identify as possible duds. But the proposal also poses some significant problems. First, the logistics of implementing the new system are costly, complex and time-consuming, even in the basics of updating the relevant IT systems. The Commission's decision to reserve the right to suspend the EU-ETS from 1 January 2018 until the system can successfully be put in place acknowledges as much, but has been resisted by trading exchanges who have called for such measures to be avoided.

Second, by marking out UK allowances, the proposal would create a two-tier system in which the price of UK allowances becomes a function of the probability that the UK remains in the ETS; if the UK stays, you cash in, if the UK leaves, you lose out. On a basic level, this violates the principle of the fungibility, or interchangeability, of allowances. It would create a distortion in the single market as a carbon price differential opened up, affecting power generation (particularly in the Single Electricity Market (SEM) which is a unified market across the border on the island of Ireland) and key industrial sectors where UK installations would face a lowered carbon price during their remaining time in the single market. More concretely, carbon, energy, and financial traders alike have flagged the question of how allowances futures contracts would be settled in a system which had developed two subsets of differently priced allowances; who would want to receive compromised UK allowances?

Third, the scheme would impact international aviation operators who are regulated by, and receive free allowances from, the UK. Even if the UK were to leave the ETS, companies such as Singapore Airlines, Emirates and Cathay Pacific would continue to be obliged to produce allowances for any flights between EEA member countries, as well as many UK airlines that operate across the EEA, such as Easyjet. Fourth, although of less interest to the UK's counterparts, the proposals threaten the UK Treasury with the loss of an estimated revenue of up to £500m from the sale of allowances that are no longer valid.

The UK's €1 billion solution

Alive to the problems, UK civil servants have moved quickly to produce an alternative solution. It begins by dividing the problem into two emissions periods; first between 1 January 2018 to 31 December 2018, and second between 1 January 2019 to 29 March 2019.

The first period is relatively straightforward. The UK is proposing to legislate domestically to move forward its compliance cycle for 2018 to before it leaves the EU. UK businesses would have to report their 2018 emissions by 28 February 2019, and surrender the appropriate allowances by 22 March 2019. This would avoid the UK's obligations under the ETS being considered "lapsing" under the Commission's amendment, avoiding both the marking up of UK allowances and the voiding of UK allowances.

So will it work? At its core, this is an issue of trust; will the other ETS market participants trust the UK to meets its obligations, even as it leaves the EU? The combination of domestic legislation, political guarantees and the agreement of big member states – Germany has reportedly already agreed that domestic legislation would suffice - should be enough. If not, then the UK's counterparts would do well to reflect on the UK's desire to maintain access to the single market, and the concomitant need to remain within the ETS. With the timeline short, the government is already consulting on the plan and is planning to use a statutory instrument to facilitate the passage through parliament, provided time can be found in an exceptionally busy and contentious parliamentary schedule.

However, that still leaves the first three months of 2019 in which UK emissions would continue to be covered by the EU ETS before Brexit. The UK's solution is to highlight its stated goal in the Brexit negotiation for a transition period "of around two years" where access to each other's market would continue on current terms. Beginning from March 2019, this would allow the UK to remain in the EU ETS until the end of Phase III at the end of 2020, after which, the UK could be more cleanly removed from the ETS should it end up deciding to leave. Of course it may not opt to leave, or choose another form of cooperation. A recently signed linking agreement between the EU ETS and the Swiss ETS – which would crucially have no role for the ECJ – suggests a future form of cooperation which could be agreeable to both sides.

The solution to the 2019 problem is obvious; the UK is effectively leaning on something – the transition period – which is not in its sole power to give. Unsurprisingly, both British businesses and the UK's European counterparts have voiced anxiety over relying on the uncertainty of the broader Brexit negotiations to produce such an outcome.

Certainty would be ideal, but Brexit is going to force all parties to accept second best solutions. There are reasons to argue this is a pretty good one. First, as the UK rightly notes in its representations to European counterparts, the immediate problem is 2018, to which the UK has provided a firm solution. There is another year in which to find a solution for

2019. Second, with all the focus on the contentious 'divorce' issues in the negotiation, it is perhaps underappreciated that a transitional deal may not prove as difficult to strike as many fear. The role of the ECJ will be important, but the government has already accepted that "the transition rules could involve an ECJ role for a limited time", and in private some inside government suggest that the UK will seek little else in the way of concessions. Ultimately, and perhaps most pressingly, for those UK companies worried that the allowances they own are about to become worthless, this is the only show in town.

What happens now?

So what happens now? The Commission's amendments are due to be discussed at the EU's Climate Change Committee on 30 November – a niche organisation which has found itself the focus of this billion euro problem. In the meantime, the UK continues to make its case. Reports of the UK threatening to make the acceptance of its Brexit proposals a condition of its support for other wider EU ETS Phase IV reforms this week will not have helped. Nonetheless, it is worth noting that the UK did ultimately vote in favour of the reforms, despite staring down an almost €1 billion loss, effectively being enforced on it by the EU27's current intransigence.

Solutions to the problem of Brexit and the EU ETS are on the table, but there is no guarantee of a mutually acceptable outcome. The UK will be counting on European companies operating in the UK pushing their own governments, and that its European counterparts acknowledge the mutual interest in preventing significant disruption to the EU ETS. With money on the line, tensions are rising and rumours that certain sectors – one or two long-standing opponents to carbon pricing in any form – are advocating in private that the UK simply leaving the ETS are as unsurprising as they are unhelpful. This is an early test of whether both the UK and EU27 can find the imagination, flexibility and trust to overcome the challenges both sides will face as a result of Brexit. Brexit's first €1 billion problem will not be its last.

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