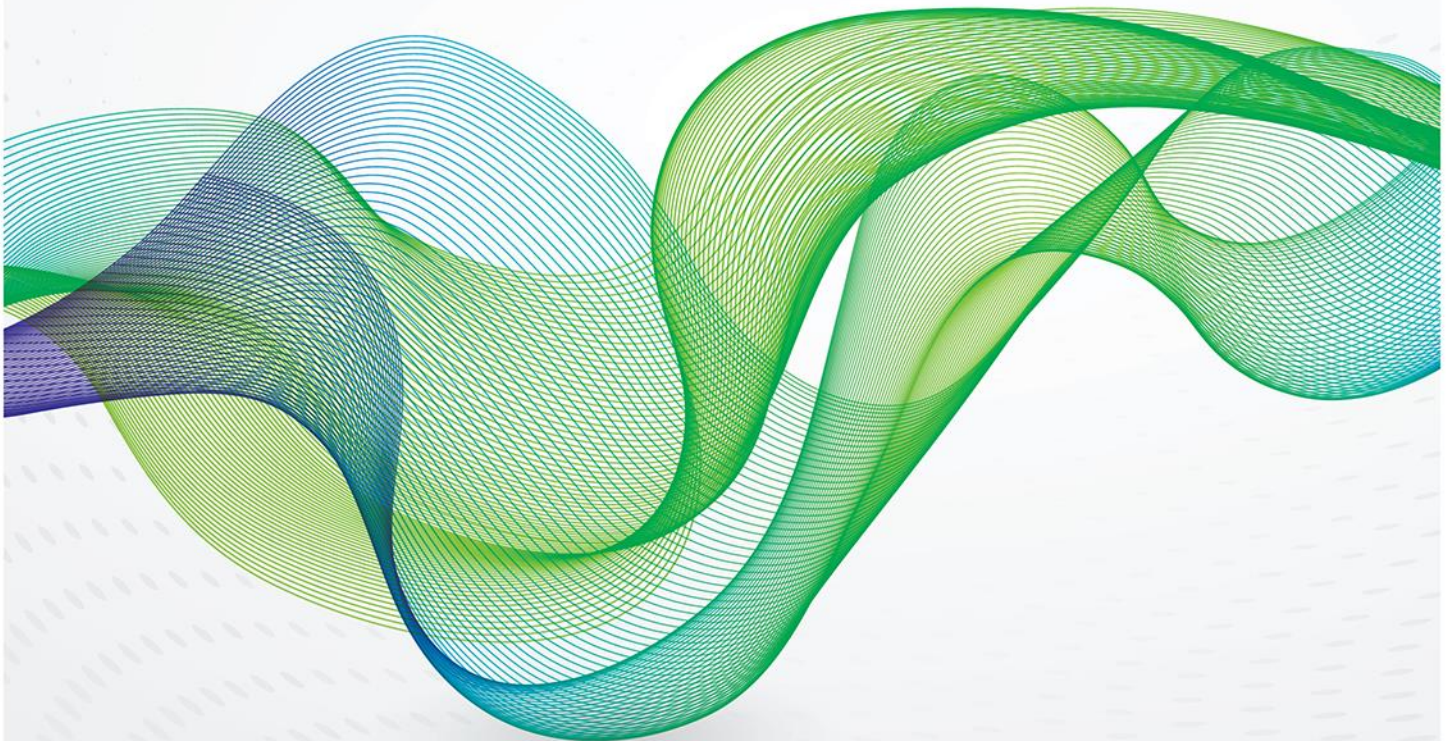


June 2017

Brexit's Impact on Gas Markets

EU ETS:
fasten your seat belts





The first set of Brexit negotiating directives¹ was adopted by the EU Council on 22 May 2017 and they only mentioned Euratom on the energy side. Two draft EU position papers ('Essential principles on citizens' rights' and 'Essential principles on financial settlement'²) were published by the European Commission on 29 May 2017. Even if energy is not yet on the agenda,³ this third OIES Brexit publication is looking at the EU emissions trading system (EU ETS) issues. We argue in this short note that the many burdensome patches to be implemented, together with those that are already agreed or discussed, are as nothing compared to the Brexit unknowns if there is no united political will.

The EU ETS is a cornerstone of the EU's policy to combat climate change and is its key tool for reducing greenhouse gas emissions cost effectively. It is the world's first major carbon market and remains the biggest one. And it is a true European-wide trading system – as opposed to electricity and gas that are traded on each country hub, and oil that is a worldwide market using, mostly, the Brent index.

EU ETS, an ongoing very complex process with a UK twist already

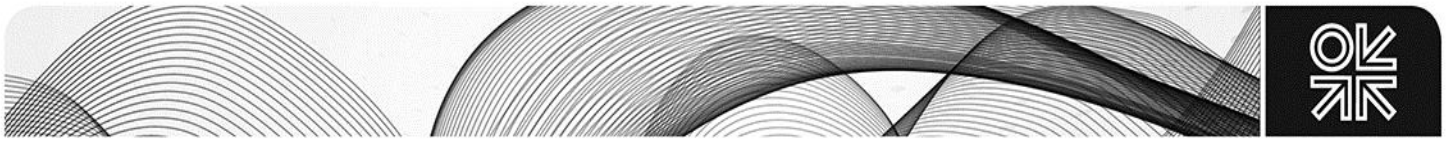
The EU ETS works on a 'cap-and-trade' principle. A cap is set on the total amount of certain greenhouse gases that can be emitted by installations covered by the system. The cap is reduced over time so that total emissions fall. Within the cap, companies receive or buy emission allowances which they can trade with one another as needed. They can also buy limited amounts of international credits from emission-saving projects around the world. The limit on the total number of allowances available ensures that they have a value. After each calendar year, a company must surrender enough allowances to cover all its emissions, otherwise heavy fines are imposed. If a company reduces its emissions, it can keep the spare allowances to cover its future needs or else sell them to another company that is short of allowances. Trading brings the flexibility that ensures emissions are cut where it costs least to do so. Ideally over time a robust carbon price would promote investment in clean, low-carbon technologies. Unlike other trading mechanisms, the EU ETS is trading a set number of emission allowances not a natural commodity where production can increase (or fall) if companies invest (or not). Hence the value of emissions is predicated on continued polluting industrial activities.

The EU ETS is in its third phase (2013–20); it is now a single, EU-wide system with more sectors and gases included, and auctioning is the default method for allocating allowances (rather than free allocation). In total, around 45 per cent of total EU greenhouse gas emissions are regulated by the EU ETS, with the transportation sector (outside airlines) being the most noticeable exception, for the time being. But the EU ETS continues to face the challenge of a significant surplus of allowances that could affect the system's ability to meet more demanding emission reduction targets cost effectively. As a first step, the auctioning of 900 million allowances was postponed ('back-loaded') from 2013–15 until 2019–20. A more structural measure – a market stability reserve – was agreed in 2015. This reserve, which will start operating in January 2019, aims to neutralize the negative impacts of the existing allowance surplus. The 900 million back-loaded allowances will be transferred to the reserve, rather than auctioned in 2019–20.

¹ 'Council (Art 50) authorises the start of Brexit talks and adopts negotiating directives', European Council press release, 286/17, 22 May 2017. www.consilium.europa.eu/en/press/press-releases/2017/05/22-brexit-negotiating-directives/.

² 'Essential Principles on Citizens' Rights', European Commission, Task Force for the Preparation and Conduct of the Negotiations with the United Kingdom under Article 50 TEU, Working Paper, Document No. 1, 24 May 2017, available at: https://ec.europa.eu/commission/sites/beta-political/files/citizens-rights-essential-principles-draft-position-paper_en.pdf; 'Essential Principles on Financial Settlement', European Commission, Task Force for the Preparation and Conduct of the Negotiations with the United Kingdom under Article 50 TEU, Working Paper, Document No. 2, 24 May 2017, available at: https://ec.europa.eu/commission/sites/beta-political/files/financial-settlement-essential-principles-draft-position-paper_en.pdf.

³ The UK Committee on Climate Change, an independent statutory body that was established under the Climate Change Act (2008) to advise UK and devolved administration governments on setting and meeting carbon budgets, and preparing for climate change, has published (October 2016) a briefing note on 'Implications of Brexit for UK climate policy', available on <https://www.theccc.org.uk/wp-content/uploads/2016/10/Meeting-Carbon-Budgets-Implications-of-Brexit-for-UK-climate-policy-Committee-on-Climate-Change-October-2016.pdf>.



A legislative proposal for the revision of the fourth trading period (2021–30) was presented by the European Commission in 2015, with the overall number of allowances set to decline at an annual rate of 2.2 per cent from 2021 onwards, compared to 1.7 per cent currently.

The UK has been instrumental, since the early 2000s, in pushing for this ‘cap-and-trade’ system as an alternative option to the increasing CO₂ levy on fossil fuels that was then promoted by other states such as France. But even before Brexit, the UK climate policy had made a U-turn by implementing a Carbon Price Floor (CPF). In 2011, the UK government introduced a Climate Change Levy with a start price of £15.70 per CO₂ tonne. This was due to rise every year until 2020, with all revenue raised to be retained by the Treasury. However, in 2014 the UK government announced that the Carbon Price Support component of the floor price would be capped at a maximum of £18.08 per CO₂ tonne from 2016, and then extended to 2021 to limit the competitive disadvantage faced by business and also to reduce energy bills for consumers.

By adding a further cost component, the UK has achieved the rapid removal of coal from its power mix and therefore a reduction of pollution.⁴ But this lower use of coal, in turn, makes existing allowances more plentiful, thus impacting the price negatively. So, already there is no longer a common carbon price across participants, and hence no level playing field between the UK and the EU. If the UK leaves the EU ETS, UK government would then recover complete freedom to fix the levy according to its sovereign interest (once coal-fired power plants have been shut down it might not be in the UK’s economic interest to have too high a CO₂ levy).

In continental Europe, the idea of a floor has been raised by some countries, while being fully opposed by Poland. The newly elected pro-European French President, Emmanuel Macron wants⁵ to have a common CO₂ floor for all European countries. Even if this looks like an attractive idea, the unanimity required to achieve this seems very thin. A floor to CO₂ prices in France could benefit EDF (EDF is mostly a nuclear generator...). But, with Brexit, the UK is no longer in a position to push for any new improvements to the EU ETS.

The UK shouldn’t get any better link than Switzerland

Linking the EU ETS with other robust systems helps reduce the cost of cutting emissions, increase market liquidity, stabilize the carbon price, level the international playing field, and support global cooperation on climate change.

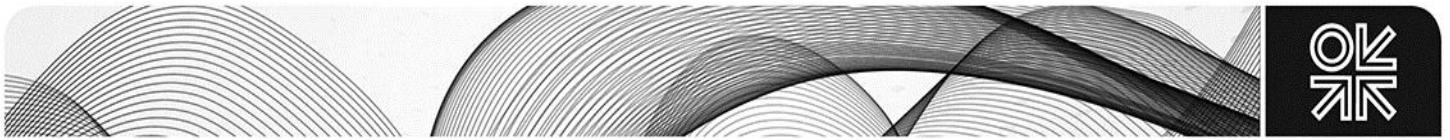
As the UK doesn’t want to be part of EFTA,⁶ it won’t be able to stay in the EU ETS, as the UK doesn’t want to recognize the European Court of Justice. In order to stay in, some new structure would then have to be designed in case of litigation between the UK and the EU. But as this market mechanism hasn’t fully delivered what it was designed for, it could be problematic for UK policy makers to want to stay when the UK has shown that taxation was achieving the required target faster.

The UK could follow the Swiss model of having its own cap-and-trade system, linked to the EU ETS. At the start, this should be easy to implement as the UK was part of the EU ETS, but going forward, the UK will have to follow any EU changes without being in a position to influence them! It must

⁴ In the EU, companies are looking at the Clean Dark Spread vs Clean Spark Spread to decide which power plants to use first. The Clean Spark UK adjusted Spread is now higher than the Clean Dark UK adjusted Spread for most of the time, pushing coal out of the mix.

⁵ Page 21 of Emmanuel Macron’s En Marche! programme, available at: <https://storage.googleapis.com/en-marche-fr/COMMUNICATION/Programme-Emmanuel-Macron.pdf>.

⁶ The European Free Trade Association (EFTA) is an intergovernmental organization set up for the promotion of free trade and economic integration for the benefit of its four Member States: Iceland, Liechtenstein, Norway, and Switzerland. In 1973, the UK left EFTA to join the EU. EFTA is responsible for the management of the European Economic Area (EEA) Agreement, which enables three of the four EFTA Member States (Iceland, Liechtenstein, and Norway) to participate in the EU’s internal market. Switzerland has adopted, via treaties, various provisions of EU law in order to participate in the EU’s single market. This will not be the UK option, as Theresa May’s Lancaster House speech on 17 January made it clear that the UK would be leaving the EU Single market and the Customs Union, and that it would negotiate a new relationship with the EU that would not equate to, ‘partial membership of the European Union, associate membership of the European Union, or anything that leaves us half-in, half out.’ Nor would the government, ‘seek to adopt a model already enjoyed by other countries.’



nevertheless be pointed out that this linking process is very lengthy⁷ and the UK won't be able to access any better link than the Swiss.

Mind the gap!

The UK has until 29 March 2019 to leave the EU and its single market. We can already see here an issue for companies that have to look at a calendar year for their emissions and at the Brexit calendar, not to mention the deal/no deal issue.

With the UK leaving the EU ETS, some permit allowances need to be taken away from the system, but since phase 3 there are no longer any national allowances ... Just as a reminder, the UK was allocated 246 million allowances per annum in the second phase of the EU ETS (2008–12)⁸ from the then EU total of 1,859 million tonnes of CO₂, (in other words, 13 per cent). The EU cap for 2013 has been determined at 2,084 million allowances. On 12 May 2017, the European Commission published, for the first time, the total number of allowances in circulation on the European carbon market: 1,693 million,⁹ with verified emissions of greenhouse gases from stationary installations amounting to 1.75 billion tonnes of CO₂ in 2016.¹⁰

The EU has agreed a reserve mechanism, to start on 1 January 2019, while on 29 March 2019 another patch to the EU ETS will be needed whatever is decided regarding the UK. If the UK leaves, do we take out its former share (13 per cent) or do we opt for an endless round of negotiations? If the EU wants to be stronger and united, it is perhaps the perfect time, following the US decision to leave the Paris Agreement, to sit down and think of a more robust system that is able to deliver what citizens want: a greener world. But the EU could be faced with two options: an ambitious reduction of global allowances or a blocked EU unable to review its global allowances.

Fasten your seat belts!

Now for a minor problem that could derail the all too complex process ... As mentioned earlier, more industries are now included in the EU ETS. And CO₂ emissions from aviation have been included in the EU ETS since 2012. Under the EU ETS, all airlines operating in Europe – European and non-European alike – are required to monitor, report, and verify their emissions, and to surrender allowances against those emissions. They receive tradeable allowances covering a certain level of emissions from their flights per year.

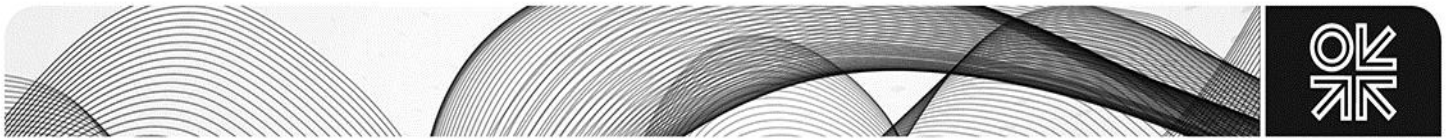
The legislation, adopted in 2008, was designed to apply to emissions from flights from, to, and within the European Economic Area (EEA) – the 28 EU Member States plus Iceland, Liechtenstein, and Norway. The European Court of Justice has confirmed that this approach is compatible with international law. The EU had, however, decided to limit the scope of the EU ETS to flights within the EEA until 2016 to support the development of a global measure by the International Civil Aviation Organization. The European Commission has proposed to continue the current approach beyond 2016. This proposal will now be considered by the European Parliament and the Council of the European Union.

⁷ Switzerland and the EU have been negotiating the possibility of linking their emissions trading schemes since 2011. Both the Swiss Federal Council and the EU Council of Ministers issued a corresponding negotiating mandate. The technical negotiations were concluded in January 2016 with the initialling of an agreement. Through this bilateral agreement, the two systems will mutually recognize each other's emissions allowances. Once the link is operational, prices should converge, resulting in a level playing field for Swiss and EU based industry. As usual, for the treaty to enter into force, it must be signed and ratified by both sides. The timetable for this is open.

⁸ 'EU Emissions Trading Scheme, Approved Phase II National Allocation Plan 2008-2012', DEFRA, 2017. Available at: http://webarchive.nationalarchives.gov.uk/20121025080026/http://decc.gov.uk/assets/decc/what%20we%20do/global%20climate%20change%20and%20energy/tackling%20climate%20change/emissions%20trading/eu_ets/euets_phase_2/phase_2_nap/ap-phase2.pdf.

⁹ 'Publication of the total number of allowances in circulation for the purposes of the Market Stability Reserve under the EU Emissions Trading System established by Directive 2003/87/EC', European Commission Communication, C (2017) 3228, 12 May 2017. Available at: https://ec.europa.eu/clima/sites/clima/files/ets/reform/docs/c_2017_3228_en.pdf.

¹⁰ 'Emissions trading: emissions fall in 2016', European Commission Climate Action, 17 May 2017. Available at: https://ec.europa.eu/clima/news/emissions-trading-emissions-fall-2016_en.



Why does aviation pose a problem to the EU ETS? Gibraltar has an international airport and flights to and from the EEA are included in the EU ETS.¹¹ Most of the Gibraltar flights are with the UK. Would those be still included in the EU ETS or not? As ‘after the UK leaves the Union, no agreement between the EU and the UK may apply to the territory of Gibraltar without the agreement between the Kingdom of Spain and the United Kingdom’,¹² how is Madrid going to view UK flights using the Gibraltar airport and will the EU ETS apply to them?

Short timing and many unknowns

We conclude that, as the unique European-wide trading system, the EU ETS, already affected by the UK Carbon Price Floor, is going to be even more affected by Brexit. On top of the political will (to stay/to leave on the UK side and to keep/to not keep the UK on the EU side), many adaptations will be needed in a relatively short period of time. We have listed just a few here:

- What happens in the year the UK leaves the EU (2019?) as allowances are calculated on a calendar year? This is now totally discounted by the market, as Business as Usual is used when dealing with Brexit. We argue that this could change once draft EU positions on energy are published, as British companies will then have to decide which strategy to implement. And price volatility could increase due to regulatory unknowns ...
- How to recalculate the allowances for the 30 states left (EU-27 plus Iceland, Liechtenstein, and Norway) if the UK leaves? We argue that the EU-27 will have to find a political solution as allowances are no longer national.
- How is Spain going to deal with Gibraltar and, in particular, with Gibraltar’s airport, as aviation is included in the EU ETS? We argue that Spain could have an extra leverage, even on this point.

¹¹ Gibraltar is part of the EEA, see ‘Frequently Asked Questions, 2013–2016 Regulation amending the EU Emissions Trading System for aviation’, Brussels 30 April 2014. Available at:

https://ec.europa.eu/clima/sites/clima/files/transport/aviation/docs/faq_aviation_2013-2016_en.pdf.

¹² ‘European Council (Art. 50) guidelines for Brexit negotiations’, European Council press release, 220/17, 29 April 2017.

Available at: www.consilium.europa.eu/en/press/press-releases/2017/04/29-euco-brexit-guidelines/