



Select Committee on the European Union

Energy and Environment Sub-Committee

Corrected oral evidence: Post-Brexit carbon pricing

Wednesday 13 February 2019

10.20 am

Watch the meeting

Members present: Lord Teverson (The Chairman); Viscount Hanworth; Lord Rooker; Lord Selkirk of Douglas; Earl of Stair; Viscount Ullswater; Baroness Wilcox; Lord Young of Norwood Green.

Evidence Session No. 1

Heard in Public

Questions 1 - 12

Witnesses

I: Mr Adrian Gault, Chief Economist, Committee on Climate Change; Mr Phil MacDonald, Acting Managing Director, Sandbag.

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Examination of witnesses

Adrian Gault and Phil MacDonald.

Q1 The Chairman: This is our first session on post-Brexit carbon pricing or emissions trading. May I remind Members to declare any interests when they first speak? This is a public session. It is being webcast and transcribed. We will send you a copy of the transcription. If you spot any errors, please do come back to us. We are awaiting Joshua Burke from the Grantham Research Institute and we hope that he will turn up during the session. We will start anyway and perhaps I could ask you to introduce yourselves briefly.

Phil MacDonald: I am from Sandbag, which is a climate change think tank set up in 2008 by the Cross-Bench Peer Baroness Worthington.

Adrian Gault: I am Chief Economist at the Committee on Climate Change, which is the independent body set up by the Climate Change Act 2008 to advise the Government and Parliament on carbon budgets and progress towards meeting those budgets in the UK.

Q2 The Chairman: Thank you. You are both welcome. Perhaps I could start the questions and ask you whether it is feasible to establish a domestic emissions trading scheme by the end of 2020. What decisions have to be made and what steps would have to be taken? We have 50 days or fewer left, or something like that, but I do not want to prejudice the answer. Perhaps Adrian would like to start us off.

Adrian Gault: It is an incredibly tight timetable but let us run through the kinds of issues that will need to be decided. A number of policy decisions will need to be made on the design of that scheme, covering the scope of who is covered, the level of the cap and the trajectory of that cap over time, whether there are going to be price-management proposals within that scheme, how allowances are going to be distributed, whether by auctions or by free allowances, and the method for doing that if it is through free allowances, and questions about small emitter opt-out. There are operational decisions around monitoring, reporting and verification, the auctioning rules, banking and borrowing and a registry. I am assuming that there will be a process of consultation. The Government have said that there will be a process of consultation on future carbon-pricing schemes. If the Government want to go down the route of a UK emission trading scheme, it will have to seek the advice of the Committee on Climate Change on the design of that scheme and on the level of cap for that scheme through the 2020s.

The Chairman: Do you have a back-of-an-envelope, we-have-one-already-prepared option to produce, if necessary?

Adrian Gault: On the level of the cap, which would be one of the key decisions, we would probably be looking at the cost-effective path for the traded sector of the economy that we estimated at the time of providing our advice on the fifth Carbon Budget. That might be a suitable trajectory to consider as a starting point. We would then want to consider what has

changed since that advice that might affect that cost-effective path. From our point of view, that would be a good starting point about what would be a suitable level of cap.

The Government have to make those policy decisions in the light of consultation and in the light of our advice. There is a legislative process to go through to bring that through Parliament and to get parliamentary approval for those Statutory Instruments. If you are linking to the EU ETS, the process for the link needs to be agreed with the EU, which is going to be in part a political decision and will depend on what good will there is.

My assumption would be that it is possible to do this by the end of 2020 if the scheme closely replicates what we have now and there is not much change to that design and operational issues. Whether that is the right thing to do in terms of cost-effectiveness overall is another matter. If you did that, however, I envisage that you could get such a scheme up and running.

The Chairman: Thank you. We will get into some of those issues later.

Phil MacDonald: Narrowly, on the setting up of a domestic scheme, it seems possible to do that because the UK has some experience. We had an ETS, the forerunner of EU ETS. We have separate auctioning through the ICE. The Environment Agency runs the Registry separately. There seems to be therefore some separation that you could do.

On whether that would produce a functional scheme, at the moment there are about 800 installations in the UK covered in the EU ETS compared to the 10,500 across the EU as a whole. When we talk about cost-effectiveness, there are large benefits to having some kind of flexibility across the entirety of the EU. Therefore, a domestic scheme by itself could be set up but it may not be liquid enough to enable the participants to continue and that is a risk. The next step would be to linking. I have concerns about whether the linking would be possible by the end of 2020. It may be but, as Adrian said, it is very much down to political good will on both sides. We will go on later to talk about the Swiss experience.

The Chairman: The dumb question is that this House is going through a lot of Statutory Instruments and looking at treaties and so on. Much of this involves rubbing out the name "European Commission", putting in the name of a department, BEIS or whatever, changing the website address and carrying on as normal. Is that possible with regard to the EU ETS?

Adrian Gault: I do not know the exact answer to how possible that is. Another question would be: is it desirable or is it something you want to do? Do you want to replicate as close as possible what you have now?

The Chairman: We are talking about moving from one system to the next with the minimum disruption. You then have the rest of time to

think about where you go after that.

Adrian Gault: I do not know the exact details but I think that would be possible in the time that is available.

Viscount Ullswater: Is that figure for 2020 the end of an ETS Phase?

Adrian Gault: Yes, that is right.

Viscount Ullswater: Is that coincidental?

Adrian Gault: Yes, it is basically coincidental.

Viscount Hanworth: I am fascinated by your figures on the number of installations. The question arising in my mind is: what is the proportion of trade relative to the number of certificates? If it is a small proportion and only marginal, then the ETS is not a major issue. If it is a large proportion, then it is. What is the size of the trade relative to the total endowment of permits?

Phil MacDonald: I do not have an absolute number but I believe there is a lot of trading going on and a lot of hedging by the markets. It is now quite well established so there are brokers who are able to do this and give the operators some flexibility about when they are surrendering their analysis. I do not have an absolute number.

Viscount Hanworth: Do you imagine that the main stimulus for trade is hedging or is it that the operators have not predicted precisely what they require in terms of profits or activity?

Phil MacDonald: Currently, they have predicted quite well. It is not public but some of the operators have gone public on their successful hedges and what they have avoided. There has been the price spike over the last year. Some notable operators have said that they have avoided it and that they are well hedged-out until the early 2020s. They have been able to avoid that.

Viscount Hanworth: It is a highly complex question and rather obscure.

Q3 **Lord Selkirk of Douglas:** In linking its scheme with the European Union's, would the EU-Switzerland emission trading scheme link provide an appropriate model for the United Kingdom? The second part of my question is: what constraints does that link place on the design of the Swiss system and what role, if any, do they have in shaping the EU ETS?

Phil MacDonald: It is some kind of an appropriate parallel for what we might go through with linking. It has taken an extremely long period, a decade, give or take, for them to sort out this linking and part of that has been due to referenda and decisions in Switzerland to divorce itself from the EU in different ways. It is unclear, therefore, whether the UK would have to be bound at the same level.

The Swiss and the EU have a Joint Committee which they currently convene to discuss when there are changes to the ETS that the Swiss

would need to implement. My understanding is that there is good will on both sides but the Swiss, in general, have to conform to what is happening at the EU level. The amount of influence that they have, therefore, is probably quite low because the negotiations on the ETS are happening at a higher level in the European Parliament.

Adrian Gault: It is my understanding that the Swiss will not have much influence, if any, on the rules of the scheme overall. The fact that it has taken 10 years or whatever to get that linking does not seem like a good guide to what would be required for the UK to link to the EU ETS given the experience that we have as a participant in the EU ETS to date.

The Chairman: From our evidence on energy and Brexit, the Swiss ambassador for energy was clear that it had very little influence on the energy market generally. That is interesting, therefore, with regard to the EU ETS.

Q4 **The Earl of Stair:** If we fail to achieve political agreement between ourselves and the EU before the final date, UK emissions are going to need to be traded in a much smaller market scenario. Would a domestic ETS be large enough to be effective if it were not linked to the EU ETS?

Adrian Gault: I do not think that there is an absolute yes or no answer to that at this stage. The UK is around 10% of the EU ETS emissions. I can imagine a scheme that would have some trading, but it is getting on the margins of whether that by itself is really viable and produces much by way of cost-effective advantages within the UK for the level of trading that would be associated with that. As we move forward and coal comes off the generation system, you would be removing one of the greatest sources of emissions within the scheme currently, so the opportunities left for further cost-effective abatement in trading would be reduced over time.

Therefore, this is partly an empirical question. There might be some modelling that could be done to look at this question of how much cost-effective potential there would be, but I have not seen that kind of work to suggest whether or not that is viable. It seems to me that it is on the margins. There are some schemes elsewhere in other countries that are that kind of size, but I would be more interested in that kind of approach or that level of scheme if you were doing that because you were keeping trading going with a view to linking to other schemes in the longer term.

Phil MacDonald: It comes back to the question of the size of the cap. We have examples, for instance, with the Swiss scheme and the UK scheme before it turned into the EU ETS. When you have a very loose cap you can continue to operate and it does not place too much of a burden on any operator. If the cap was tight enough to have a meaningful effect on bringing down carbon emissions with a small market, you might move into an area where the price was very volatile. You suddenly get to a year where the allowances have run out and then the price spikes. That is a risk. It is a bigger risk the smaller the market.

The Earl of Stair: It could have a long-term effect right the way down the line.

Q5

Lord Rooker: Who took the decision to prohibit the UK from trading from 1 January this year until the day after we ratify the Withdrawal Agreement? What effect is this having on companies, industry and UK emissions? The subsidiary to that is: if we have an extension to Article 50, what would be the consequences of a further extended prohibition?

Phil MacDonald: As regards who took the exact decision, there was a vote in the European Parliament on this. I do not know if you know any more, but it would have been the European Commission that placed that hold on the Registry. What was the second part of the question?

Lord Rooker: Given the fact that for the last six weeks we have been prohibited from participating, what is the effect on emissions and the effect on industry?

Phil MacDonald: Operators are left in an interesting place. The only carbon tax that they have to pay at the moment is the Carbon Price Support, which is only on the power sector, but there is the possibility that the market does not continue to be frozen and we perhaps continue in the ETS as a full member, in which case they would have to pay the full ETS price. They will know that in hindsight. Initially, we were worried that it might trigger a price spike and, if the no-deal notice that the Government have put out comes true, we may have this spike in emissions because the price is a bit lower. Currently, we have not seen that because it seems that most operators are hedging their bets on what will happen.

Adrian Gault: It remains to be seen exactly what that impact has been. In the first quarter of the year there is now one less instrument, one less price signal, that is impacting on decisions. We know that if we leave the EU without a deal, we have the carbon emissions tax that will be coming in. In the first quarter of the year, however, we have lost part of the price signal, so potentially some operators might be emitting more and might have brought forward some of their decisions on what kind of plant they are going to use in the power sector. Until we see the data, however, I do not know exactly what that impact will have been. It is probably small because of other issues around expectations about what will follow.

Lord Rooker: What if Article 50 was extended? Would that be significant to them or the fact that they could predict what is going to happen? Presumably, if it is extended it will be for a specific time. I do not know any more than anyone else.

Adrian Gault: I do not know the answer. I assume that if it is extended we potentially have a longer period where there is no instrument. There will be one less instrument that is impacting those decisions. With uncertainty about what is going to replace it, I expect there to be some impact on emissions in that period. It will depend partly on the signals given by the Government about what would replace it and when. The fact

that there will be a lower price incentive than last year will probably have some impact on decisions and some increase in emissions.

Viscount Hanworth: Can they unlock the Emissions Trading Scheme for a while?

Adrian Gault: What do you mean?

Viscount Hanworth: Otherwise they cannot trade, but if there was an exemption presumably they could be allowed to trade for a period.

Adrian Gault: I do not know. I think that is a question for others and for the EU. I do not know the answer to that.

The Chairman: That is a fair enough answer. We do not expect you to know everything about this area.

Q6 **Viscount Ullswater:** My question relates to the benefits of remaining in for the third Phase, which ends at the end of 2020. Are there any benefits of withdrawing from the EU ETS at the end of that Phase? In your view, should the UK continue to participate in EU ETS during Phase 4 if the transition period is extended? Can you tell me what the benefit might be of joining in? It is not just a question of should we join in but whether there would be a benefit of joining into Phase 4.

Adrian Gault: The Committee has not looked at these issues in detail. I can only give you a few suggestions and not a Committee position. There are benefits to participating until the end of the Phase, which is a logical point for changing the position. The Committee's preference, as expressed in work we did at the end of 2016, would have been to continue in the EU ETS because of the price signal it sends. We would like to see the EU ETS strengthened, as it sends a price signal and we think there are trading and cost-effectiveness advantages of being part of the Scheme.

Whether it makes sense to extend for a year or a couple of years is another question. I cannot see too much advantage in continuing on a temporary basis to be part of Phase 4. I thought the logical position would be more that at the end of Phase 3 you would leave or if it is possible to stay for the whole of the Phase you would stay. I am not sure that I can see too much advantage in terms of the certainty that has been given to industry and the other participants to continue for a temporary period.

Phil MacDonald: There are a number of disadvantages on the EU side. The recalculation of the cap, the recalculation of free allocations and the various funds mean leaving at the end of the Phase would be nice and clean from the EU's point of view. It maybe has less influence on the UK from an administrative point of view. The risk is that if the UK was to leave suddenly, that could cause trouble for the price on the EU market and we do not want our neighbour to have a crash in carbon price because of a sudden exit. It seems to make sense, therefore, if we can do it cleanly.

If possible, it would be good to continue in the ETS all the way through Phase 4, although the key question is how much influence the UK would have. If we were in a system where we were linked but without any influence, would we be hitching ourselves to a scheme that is not yet fixed? The carbon price in the EU has increased substantially. We are not clear that it is for certain that it is going to continue at that high level, so you could imagine a scenario where the price is not as high going forward, and what would the UK do if we have no ability to inform how the further reforms of the EU ETS would happen?

Viscount Ullswater: Are we relying on the EU to put pressure on the Government to have this scheme in operation or would the Government be in a position to and want to have a similar scheme? I wonder if we are using the EU as a sort of pressure to keep going with an ETS.

Phil MacDonald: The EU is definitely putting pressure on to finish the end of the Phase because of the clean break that that would make. I am not clear how much the EU would want us in Phase 4.

The Chairman: That is a very important point. You are saying that it gets very administratively complex for the other side if we wanted to participate for part of Phase 4 because of all this stuff around allocations and everything else. That suggests to me that there would be a real resistance from the other side unless there was some form of permanent membership or permanent linking.

Phil MacDonald: Indeed, yes. If we were only there for a few years, it would be extremely difficult to do all of these calculations. It would be possible but I would not think they would want that.

Q7 **Baroness Wilcox:** Maybe I could continue with you both giving us your opinions, because it is very important to get your opinions and not just what has been written down here. The Minister, by the look of it, is completely confused, and no doubt everybody else is, so you can throw yourselves right into this. What is your assessment of the proposed tax level of £16 per tonne of carbon dioxide and do you agree with the Minister that it provides a similar price signal to the current EU ETS? That one first.

Phil MacDonald: The £16 is slightly lower than the current price in the EU but the EU price has been very volatile and has jumped all over the place. The question of whether that is an equivalent amount for industry to be paying is very much down not to the price but to the degree to which we give free allocation to industry. In industry across the EU in the last year about 80% of emissions are covered for free—the allowances and the allocation for free. The UK has indicated it will continue with that same level but then we would have the ability to adjust that. If we brought it down to 70% coverage, for example, but with a £16 fee, that would have a dramatic change on carbon emissions. That flexibility is part of the issue as well as the price.

Baroness Wilcox: The second question is: how frequently should the tax

rate be reviewed and how should any changes to the tax rate be decided? Maybe Adrian would be brave enough on this one.

Adrian Gault: Drawing together what has just been said, when the tax was set, it was set at a level that was trying to replicate what the EU ETS price was. We have seen that the EU ETS price has increased. Setting that tax level in the short term and trying to replicate that kind of price signal from the EU ETS seems a reasonable thing to do. The question would be what would be appropriate for the longer term. We would expect the Government to look at setting a price that would be consistent with that tax making a contribution—an effective contribution towards meeting the carbon budgets. Previously, the Government have issued carbon values which they say are consistent over time with meeting carbon budgets, meeting the 2050 target of an 80% emission reduction in the UK. Those are global carbon values. We would want that carbon price overall to be reaching those kinds of levels, which are rather higher than that £16 figure.

The tax is only one instrument. There are other instruments that may be contributing towards the overall carbon value, so you need to look at the combination of instruments and what they are doing to produce a carbon price signal and promote innovation. Our view would be that that carbon tax level might be reasonably appropriate now but would need to rise over time.

The Chairman: How accurate is that sort of calculation? I was brought up in the age when econometrics was king and they predicted economic growth down to a tenth of a decimal point. It does not work. Is the calculation good?

Adrian Gault: I could not say to you that it is very accurate but it provides a reasonable signal. What would be most beneficial would be if the Government set out values for a carbon tax over time. If it was locked into that instrument, then you want to see a rise in profile of that tax over time and giving that signal to industry about what is going to happen. It is not just setting a tax year to year, therefore; it is setting up a profile over time. Whether the Treasury will be prepared to do that and whether you could expect it to stick to that profile is another question. The advantage if they do stick to it is that they create that expectation which is important for giving certainty to investors. At the same time, you want to maintain some flexibility, in the Committee's view, to change that tax level over time depending on how you are doing against meeting your carbon emission targets.

Phil MacDonald: I agree with Adrian. This ability to have a little bit of flexibility is probably necessary. One example is the coal-to-gas switching price. When the Carbon Price Support was raised to the £18 per tonne level, it was not expected initially that it was going to be enough to take coal off the system. There were then changes in the global prices of coal and gas which meant that we find ourselves now with barely any coal in the system. That question is even more complex for industry. What price would be the level which drove a gradual reduction in emissions but did

not demolish the industry? The Government would need to tweak that regularly depending on what the results of these taxes were.

Q8 Lord Young of Norwood Green: You have probably covered a lot of my question. The Minister has not directly answered the Committee's question regarding whether the proposed price is compatible with the UK climate targets. Is a carbon emissions tax set at £16 per tonne compatible with the UK's climate targets? Would it be compatible in the mid-term if the tax were to be maintained? As a rider to that, are you familiar with the methodology that the Government have used at arriving at the £16 figure?

Adrian Gault: The methodology, so far as I am aware, has been that at the time that decision was taken that was broadly the EU ETS price. It was trying to replicate that signal from the market through the EU ETS with a tax level. I refer back to my previous answer. For the longer term, we would say that would not be an appropriate level of tax. If you were going down the tax instrument in the longer term that would need to rise over time. The Government's carbon values rise to something over £70 a tonne of CO₂ in 2030. That is the kind of value that you would be targeting through the tax but other instruments as well because there are other contributions towards that overall carbon value in the market. It is somewhat above the kind of level that we are seeing now.

The other issue is that we have the Paris Agreement. The Government have asked the Committee on Climate Change to advise on when the Government should be aiming to reach net zero and whether that is CO₂ or all gases, and the implications of that for the 2050 target. That is currently an 80% reduction, but the question is whether that should be increased as an emissions reduction. There is then a question about the implications, if there is a revised target, about the cost-effective path to meeting that target through the 2020s. You would expect if there were a tightening of that long-term target that you would want to tighten the pathway through the 2020s. The work that we did on the suitable pathway through the 2020s was on the basis of reaching an 80% reduction target. It may not be appropriate for a tighter target. You may want a tighter cap or higher price in that period than those current carbon values. That will not be settled immediately, however. We are providing advice in the spring about what we think should happen. The Government will have to make a decision about what they want to do with the long-term targets. It is an issue about not wanting to get too tied into a particular level of tax now or a UK trading scheme with a particular trajectory when we might want to revise that in the light of whatever is decided on Paris.

Phil MacDonald: One example may be what kind of price we could be looking for. At Teesside there is a carbon capture and storage project and they were talking about prices that they needed in the region of between £30 and £40. It looks as though £16 is not enough to drive large-scale change. I would caution with carbon taxes overall that the price alone is not going to have this radical process change in industry. That is going to

require some innovation funding and other regulations outside of the carbon tax no matter how high it goes.

Lord Young of Norwood Green: You said that there are other instruments that contribute towards this. Can you say what they are?

Adrian Gault: I am thinking of the Carbon Price Support in the power sector. In the power sector, if we had the tax on top of that you would have the Carbon Price Support level of £18 a tonne of CO₂ currently. That would bring that signal overall to a tax of £16 and with a carbon price support of £18 you would be up at £34 a tonne on that basis. You also have contracts for difference, so if you are looking at a mechanism for incentivising renewables and other low-carbon power into the system then you have that instrument to contract for difference which is providing support to encourage that entry. These things will interlink. If you have a lower carbon price, you would need a higher contract for difference potentially. All of these instruments provide some kind of signal to the market.

The Chairman: Mr MacDonald, you mentioned an important point, which I had not come across before: if the caps were lowered, the effect is greater on those organisations. I am interested to explore that. Potentially, do you think that will be done?

Phil MacDonald: Yes, it would make sense. As I understand it, the UK's current allocation within the ETS is very much higher than our actual emissions because of the slightly strange way that the carbon budgets are accounted for. It would seem probable that we would then bring it down to something more in line with the current carbon budgets and that would tighten the market. To what degree would be a political decision and net zero would make a different number.

The Chairman: That would be quite a significant difference.

Q9 **Viscount Hanworth:** The Scottish and the Welsh Governments wrote to the Chancellor objecting to a proposed carbon emissions tax. Can you clarify their objections and tell us what implications the tax might have for the devolved administrations? Are you able to tell us something about the Irish dimension as well?

Adrian Gault: This is an issue on which I have not got any real information. I can see the potential for objection on issues from the devolved administrations on the basis that they had their own emissions targets to meet, which in the Scottish case are tighter than the rest of the UK's target. Clearly, they want to look at what is a cost-effective path for them and what is the cost-effective set of instruments to meet their own targets. I have nothing more to add on that question.

Phil MacDonald: The only thing I would say is that they may have some concerns about where the revenues are going. The revenues are obviously growing substantially and through a tax it would go directly into the Treasury, into the general budget, and be disbursed again, whereas

under the ETS they would get it more directly. That is possibly part of the concern.

The Chairman: We will come on to that in just a second.

Viscount Hanworth: A loss of discretion as well as the fear of loss of income. Could anything be said about the Irish question? Presumably what goes on in Northern Ireland is somewhat dominated now by the Integrated Electricity Market and so on.

Phil MacDonald: I am not aware of that issue, I am afraid.

Adrian Gault: Ireland continues to be part of the EU ETS, so that price will be affecting its investors' decisions and competitiveness. You would want to see Northern Ireland considering the implications of that in terms of trading between Northern Ireland and Ireland. There are different issues there potentially from the rest of the UK.

Viscount Hanworth: More complex.

Phil MacDonald: More complex, but we have not looked at it in detail.

Q10 **Lord Rooker:** Following up on that, what are the UK revenues received from the Emissions Trading Scheme? Do you know how they are divided up between the four countries of the UK? Do you have any figures?

Phil MacDonald: We have some figures. We think that in 2017 about €600 million came in through the ETS to the UK Government. It is not clear exactly how they are split. Scotland receives about 10% of those, but I am not sure by what method that is done. An estimate for this coming year, were we to continue trading, goes up to between €1 billion and €2 billion, depending on the price, which is now skyrocketing. That might be expected to continue to increase.

Lord Rooker: Do you know what the €600 million was spent on?

Phil MacDonald: Part of the ETS Directive has a suggestion that 50% should be spent on climate and energy. The UK Government have reported to the Commission that they spend 100% of those revenues on climate and energy, but they do not give a breakdown of what those are. They just say that there is this amount of money that has been spent and then make some suggestions. It is not quite clear therefore. That money goes into the general budget and then comes out somewhere else.

Lord Rooker: We know Whitehall does not do devolution anyway. The other part I was going to ask has been covered by Viscount Hanworth. It is the issue about whether these allocations should remain devolved. That is not something that you have already been asked about. I will not pursue that, however. I think we have got the message.

The Chairman: You have shown how naive I still am in this area because I assumed that there was some form of serious hypothecation in terms of half of these revenues towards something that was identified. Maybe, with the best will, it was not something that the Government

would have been doing anyway and they can put this money against it. Am I being naive? "Yes" will be a suitable answer.

Phil MacDonald: Previously, it was easy for all EU Member States to say that they were spending a large chunk of these revenues on climate and energy issues because they were receiving such small revenues. As of this year and last year, we are now going up into the billions and it becomes more difficult to say that. The reporting is quite irregular from the Commission as to what Member States say they are spending and what percentage they are spending.

The Chairman: Maybe that is something we should look out for.

Q11 **The Earl of Stair:** The Government are currently adopting a five-year carbon budget which is then netted off against the EU ETS. If we were to leave the EU ETS, I believe that any payments we would make would be based on actual emissions as they stand, with no balancing off over five years. What changes would need to be made to the UK's carbon budgets if the carbon emissions tax was to be implemented and what steps would we need to take to implement those changes?

Adrian Gault: As I said, the Committee's assessment of the cost-effective path to keeping our carbon budgets on track for the 2050 target is tighter through the 2020s and by 2030 than our share of allowances for the traded sector—our share of the EU ETS. But the carbon budget reflects net trading, so it reflects our share of the EU ETS cap. If our gross emissions are lower in the traded sector than our share of the cap, we have allowances that we sell. Those allowances that we sell do not count towards the budget.

What would need to happen is that, if you had a carbon emissions tax, you should be using that for those sectors that are covered by the tax to target meeting the cost-effective path. That would be to target a level of gross emissions for those sectors consistent with meeting the carbon budgets. With that tax and other instruments, that is what you would be trying to achieve. That is a tighter path than our share of the ETS. Either you would change the level of the carbon budgets to make them tighter or you would have to find a way through the accounting regulations to account for that difference between the cost-effective path and the existing level of the carbon budgets. If you do not change that and you still use the tax to target a gross level of emissions and you achieve that, the non-traded sector would have a higher amount of emissions allowed to it because the non-traded sector share of the carbon budget is the overall carbon budget, which is set, less the non-traded share of the EU ETS cap, or less gross emissions. If it was gross emissions and there was not any trading, and the gross emissions were less than the traded sector share, the amount that is left for the non-traded sector would be higher than was originally intended when the carbon budget was set.

Sorry, I am not sure I am making this clear. You would therefore want to find a way to adjust for that, either by changing the cap and the overall budget or by using the accounting regulations in some way. Otherwise,

you may achieve what you want in the traded sector but you would be loosening the requirement on the non-traded sector.

The Chairman: I will be going through the transcript very carefully.

Adrian Gault: You may decide that you would like a note on that.

The Chairman: Sandbag has been fairly vocal about carbon budgets and trading and the fudge factors that are allowed on the Climate Change Act.

Phil MacDonald: As we can see, it would make a lot more sense to have actual emissions as the way that we calculate our carbon budgets. That seems clear and maybe this is the point at which we can try.

The Chairman: This gives us the opportunity to do that. Earl of Stair, do you want to ask the second part of that?

The Earl of Stair: The second part was: what steps would need to be taken to make the changes? You have touched on some of this. We do not need to go into a long description, but was there anything else you wanted to add?

Adrian Gault: The Government have to decide what they are using the tax for, what is the purpose of this tax. If it is about meeting the carbon budgets, you want to set tax on that basis and, from our point of view, hopefully set some kind of profile over time with a rise in tax that would be consistent with meeting the budgets. Those decisions would have to be made. Then you have questions about how you are going to adjust the carbon budgets or adjust the accounting regulations. I would assume that could be done through secondary legislation. Certainly, if you were using the accounting regulations, that would need Statutory Instruments rather than primary legislation. Changing the level of the carbon budget might be primary.¹

The Earl of Stair: Much of what we are talking about is in certain sectors of energy, such as the use of coal in heavy industry. Do you see outwith the EU the carbon emissions being extended into other forms of industry, be it maritime, agricultural or traffic?

Adrian Gault: It is definitely an issue that would be worth looking at. Rather than just rushing to replicate something that we have now, this would be a time to consider whether it makes sense to have a wider carbon pricing instrument, whether through tax or trading. There are certainly advantages to that. Dieter Helm will have done a lot of work on this and he would recommend having an economy-wide or as wide as possible level of carbon tax. As an economist you can see attractions to that kind of approach. But, as has also been said, that is not the only instrument that is going to be required. You are going to need things on

¹ Witness subsequently clarified that changes to the accounting regulations or to a carbon budget would be through secondary legislation. For changes to the level of an existing carbon budget, there is a process – set out in the Climate Change Act – that would have to be followed.

top of that to bring forward industry investment and to encourage that investment to bring forward innovations. Carbon price, whether through tax or trading by itself, is not the answer. Other instruments will be required as well.

- Q12 **The Chairman:** That is a useful message to us: you want to hold or find a way forward that is least disruptive but try to get to a better overall solution in the future. To wrap up, could I ask two things which relate to our other Committee work? One is that we and the Government are keen that we remain part of the Internal Energy Market. The first question is that if the £16 becomes fixed and becomes completely detached from the price in the EU ETS, does that mean that there will be a resistance or that it will be uncompetitive one way or the other? It might be a reason for not becoming a member of the IEM as it is too difficult, or is that not an issue in this area?

Phil MacDonald: The recent flood of interconnectors being built to the UK has been because of this issue that we already have a higher charge with the Carbon Price Support. Therefore, it makes sense for a power plant in the Netherlands to sell into the UK. That would then reverse.

The Chairman: It has not been a problem so far.

Adrian Gault: You could imagine that it could become a problem but then you would want to be looking at not just the level of carbon emissions tax but the other instruments within the UK and what their overall impact is on the electricity prices and how that compares with the instruments in the EU.

The Chairman: I am aware that the Carbon Price Floor is stuck where it is because politically it is almost too difficult to move it, although I know it may be because the carbon price has gone up anyway. Is there not a real risk on carbon price that you are relying on Treasury decisions that are not necessarily anything to do with climate change? Even more than the EU ETS, industry is not confident about what that future price will be because it might be changed year to year or for the wrong reasons.

Adrian Gault: I sympathise with that. The attraction of a trading system would be that you announce a level of cap over time which will be difficult to adjust. Some adjustments may be possible but industries like to have a reasonable level of confidence in that kind of trajectory. Industry may not have much confidence given past experience in announcements from the Treasury about the level of a tax and the trajectory for that tax going forward. Experience has been that the carbon price support was very quickly amended from a long-term profile that had been set out.

Phil MacDonald: To avoid the price being frozen and being stuck at this level, there is a chance for the Government to look at some interesting ways, such as a carbon fee and dividend to citizens, or ways in which there could be popular support for increasing the carbon tax, instead of the onslaught that the Government face every time they want to creep it up.

The Chairman: Thank you very much, Mr MacDonald and Mr Gault. You are welcome to stay for the second session if you wish. Thank you for your participation, which was very useful.