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The Rt Hon. Lord Deben PC
Chairman of Committee on Climate Change
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4⁵ March 2020

Dear Lord Deben

The UK Government and the Devolved Administrations are writing to request, pursuant to s48(1) and s48(2) of the Climate Change Act 2008 (CCA), advice from the Committee on Climate Change (CCC) on our proposals for establishing a UK Emissions Trading System (UK ETS) that is not linked to the EU ETS (a standalone system).

We would like to thank you for your response to our letter of 2 May 2019 requesting advice on a UK ETS applying to the power, industry and aviation sectors which could be linked to the EU ETS.

We would like to follow up on your offer to provide further advice on a standalone system operational from 1 January 2021, which retains the option of being linked to the EU ETS at a later date if desired. Therefore, we are asking for your advice on the key elements of our proposed standalone system, relating to ambition, effectiveness and competitiveness:

1. We acknowledge your recommendation that the cap of a linked UK ETS be set based on the cost-effective path to the UK's net zero target, which you are providing as part of your advice on the sixth carbon budget (CB) later in 2020. However, in order to implement a UK ETS for January 2021, we will need to lay legislation before receiving this advice. Having analysed a number of scenarios, we intend to set the cap on the total number of allowances at 95% of the UK's expected notional share of the EU ETS Phase IV cap. The cap will then be reduced annually, in line with the EU ETS Phase IV trajectory¹. The rationale for setting the cap at this level is that we believe it provides the right balance between climate ambition and business competitiveness in the early years of a UK ETS by signalling our ambition in cutting carbon emissions, whilst minimising the risk of high and volatile prices which could destabilise a new market which could occur if the cap is tightened beyond 95%. We will make it clear in the government response to the consultation that this will be the cap for the initial years of the system, and make a commitment to reconsult on the level of the cap in 2021 following receipt of your advice later this year on Carbon Budget 6 and a net zero consistent cap. We will make an announcement on the cap and trajectory for the remainder of the phase following the consultation, and ensure the implementation of any change provides a reasonable notice period for participants.

¹ The annual % of allowances removed from the cap each year in the UK ETS will be 2.72%. This is higher than the EU's 2.2%; reflecting the lower baseline year used to calculate the UK ETS trajectory. The actual number of allowances that the cap is reduced by annually will be the same as it would be if the UK remained in Phase IV of the EU ETS.

2. We acknowledge your advice that the Government should ensure a tighter cap does not lead to carbon leakage. Therefore, we propose keeping the size of the free allocation share and the new entrants reserve the same as expected if the UK remained in Phase IV of the EU ETS. The reduction in the overall cap set out above will be taken from the auction share.
3. To ensure a minimum and consistent carbon price signal in the early years of a standalone link-ready system, we intend to implement an Auction Reserve Price (ARP) of £15. The ARP is intended to be transitional, and will be reviewed in line with any changes to the cap. The ARP will not apply if the system is linked to the EU ETS.
4. To protect UK participants from the risk of sustained high prices in the early years of the system, which could place them at a competitive disadvantage compared to EU counterparts, we intend to make the Cost Containment Mechanism (CCM) more responsive by lowering the price trigger threshold and reducing the time period before intervention. In a linked system these adaptations would not apply, and we would instead seek to mirror the EU ETS mechanism (subject to negotiations). We intend to implement a CCM which will be triggered if the carbon price is:
 - a. Year one of the system: two times the average carbon price in effect in the UK in the two preceding years, for three consecutive months.
 - b. Year two of the system: two and a half times the average carbon price in effect in the UK in the two preceding years, for three consecutive months.
 - c. Year three of the system and thereafter: three times the average carbon price in effect in the UK in the two preceding years, for six consecutive months.
5. As stated in our consultation, the scope for a standalone system would remain the same as the EU ETS for the first 10 year phase, but we will review how the scope could be increased for subsequent phases.

Your advice should take into account all sectors that will be covered by a standalone UK ETS: power, industry and aviation. Should a standalone UK ETS be required as a long term measure, we would reassess these proposals and seek further advice. In providing your advice on each of the items above, we ask that you consider both the effectiveness in reducing carbon emissions and the impact on participants of the options proposed. In particular, we request your advice on the compatibility of the proposed approach, including the plan for future tightening, with the UK Government's and the Devolved Administrations' commitment to reach their respective net zero emissions targets, as recommended by the Committee.

Pursuant to section 41(3)(b) of the CCA, we request that your advice takes into account the following principles that a UK ETS must:

- be an operational system which facilitates cost effective decarbonisation through trading of allowances;
- be deliverable for operation from 1 January 2021;
- meet the UK Government's commitment in the Clean Growth Strategy that: *"We will seek to ensure our future approach is at least as ambitious as the current scheme and provides a smooth transition for the relevant sectors."* (p.44, CGS);
- maintain industrial competitiveness whilst supporting delivery of the UK's and DAs' domestic and international climate change commitments and targets; and
- be capable of being linked to the EU system, so that UK and EU tradable allowances are fully fungible.

Please provide your advice to the Ministers of the UK and the Devolved Administrations by 17 March 2020 at the latest. We are, as ever, grateful for the work that the Committee does, and look forward to receiving your advice.

Yours sincerely,



**ROSEANNA
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*Cabinet Secretary for
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Rt Hon Kwasi Kwarteng MP

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