



Can COP26 drive the reduction of carbon emissions through carbon pricing?

The World Bank's annual "State and Trends of Carbon Pricing" report in 2021 stated that there is a total of 64 carbon pricing instruments operating around the world. However, these only cover 20% of global greenhouse gas emissions. The World Bank concluded that the full potential of carbon pricing therefore remains largely untapped.

With COP26 taking place in Glasgow, an important question is: could the UK use this opportunity to motivate countries all over the world to take steps to reduce their carbon emissions through the introduction or modification of carbon pricing models?

The answer of course is unfortunately fraught with a number of difficulties surrounding this area. Recent surges in gas and electricity prices across Europe for instance have intensified the scrutiny against the EU's planned changes to its carbon pricing model. And countries such as France and Spain have openly criticised the EU's revamped carbon pricing system, claiming it will plunge poorer households further into energy poverty.

That said, despite the ever increasingly identifiable (i) implications, risks and costs caused by global warming, and (ii) the social and business costs relating to climate change, climate change has been referred to by economists as a "market failure". To address this issue, market economists tend to suggest that these costs should be reflected in the market price of carbon-intensive goods and services.

In principle, carbon pricing is meant to have the effect of encouraging emitters to reduce their carbon emissions while simultaneously also increasing the available funds to put towards renewable energy, carbon reducing technologies, and clean technology.

Applying carbon pricing in practice however is considerably more complicated than it may first appear. The carbon price needs to be high enough to encourage polluters to reduce their carbon emissions but not disproportionately high such that it motivates companies to shift production and investment outside of the applicable country and/or area. The

added difficulty for policy makers is that they also need to try protect the end consumer from picking up all of the increased costs through higher pricing.

While carbon pricing has been used for many years in a range of countries, there is an argument that in the absence of a legally binding international climate agreement, countries and economic zones (such as the EU) will never achieve the full potential and benefits of applying such a scheme. This is due to a number of reasons, including carbon leakage.

Carbon Pricing Models

While the choice of carbon pricing or, as dubbed in the industry, "the instrument" used for this purpose will always depend on national and economic circumstances, there are primarily two approaches use when states apply carbon taxes:

1. Carbon tax based on carbon content model

This approach sets a price on carbon by defining a tax rate on greenhouse gas emissions or the carbon content of fossil fuels.

2. Cap-and-trade model

Under this approach, a total allowable emission limit is set for each country/region in advance (i.e., the cap). The government then creates tradeable permits which can be bought and sold to individual companies. By creating supply and demand for emissions allowances, an emissions trading system is

established whereby the market price for greenhouse gas emissions is set.



EU Approach to Carbon Pricing

In 2005, the European Union Emissions Trading Scheme (**EU ETS**) put a cap on carbon dioxide emitted by companies and created a market and price for carbon allowances (i.e. the cap-and-trade model).

The EU ETS is the largest carbon-trading scheme in the world and recent statistics claim that the EU ETS covers circa 40% to 45% of all EU emissions.

The way it works is that the EU sets a cap on how much greenhouse gas can be emitted each year. Every company within the EU ETS must hold a European Emission Allowance (**EUA**) for every tonne of CO₂ they emit in one year. Every applicable company therefore must either get their EUA or buy additional permits. If a company has a surplus, it can trade them. If a company emits more CO₂ than it has EUAs for, the EU can fine the company EUR100 per excess tonne.

The scheme has already gone through three major phases in creating a centralised EU wide cap, which would implement a reducing cap and ultimately cover more companies and/or emitters as time passed.

While the EU ETS successfully brought down emissions specifically in power generation and energy-intensive industries, a number of commentators concluded that the EU ETS has not been successful in triggering emitters across all of the industries to change their approach and reduce their CO₂. In phase 1, the majority of allowances were given out for free and in huge number. In the third phase, 40% of allowances were being auctioned and free allocation dominated the manufacturing industry. Prices for permits ultimately never achieved the level required to provide emitters with the relevant incentive or reason to change their approach to emissions.

However more recently, the price of carbon has increased to over EUR50 per tonne of carbon. The EU's Green Deal and the European Commission's 2021 Fit for 55 Package have made big steps in increasing the usefulness of carbon pricing. There is, however, far more to be done in order to reach the goals publicised by countries all over the world in reaching net zero.

Fit for 55 Package

In June 2022, the EU adopted a new climate law which binds members to reduce net greenhouse gas by at least 55% by 2030 as compared against 1990. These ambitious goals need new rules and legislative changes to become achievable. Some of the most important proposals are as follows:

- Reduce ETS emissions caps by 4.2% every year;
- Cap aviation allowances in the ETS at current levels and thereafter reduced these annually by 4.2%;
- Include in the ETS any ship over 5,000 gross tonnes that calls at or departs from an EU port, regardless of the flag they fly; and
- Include fuels distributed by road transport and buildings in a new emissions trading system which will run separately from the EU ETS.

UK Approach to Carbon Pricing

On 1 January 2021, the UK Emissions Trading Scheme (**UK ETS**) became the UK's equivalent of the EU ETS. The scheme is managed by the UK Emissions Trading Registry and replicates the EU ETS in that it implements the cap-and-trade approach to carbon pricing. Equally, the allowances are scheduled to reduce year on year.

The UK ETS applies to:

- 1) Energy intensive industries;
- 2) The power generation sector;
- 3) The aviation sector (including specific routes between the UK and the European Economic Area as well as domestic flights within the UK); and
- 4) Activities covering the combustion of fuels in installations with a total rated thermal input exceeding 20MW.

To minimise the impact of the transfer from the EU ETS to the UK ETS, the latter features an approach as well as benchmarks used to calculate a company's free allocation entitlement that will be similar to the EU's proposed approach for Phase IV of the EU ETS.



What can be discussed at COP26?

1. Expand the participants in each scheme

In 2019, the UK legislated to reduce net emission of greenhouse gases by 100% back to 1990 levels by 2050. In 2020, Boris Johnson announced an interim target for the UK amounting to a 68% reduction by 2030.

It is reported however that currently only circa 30 to 40% of UK emissions are generated from businesses included in the UK ETS.

While it is controversial and not entirely risk-free, the EU's Fit for 55 Package is nevertheless welcomed by many, as it considerably expands the categories of emitters captured by the EU ETS. The impact and possible benefits of the scheme overall will therefore increase.

Increase the number of countries using carbon pricing schemes

The World Bank estimates that only 13% of emissions generated across the world are subject to any form of carbon pricing. This statistic demonstrates how much more work needs to be done to increase the coverage of carbon pricing schemes globally to ensure every avenue is being identified to reduce carbon emissions.

Many interested parties argue that there should be a worldwide carbon price. This is primarily based on the rationale that irrespective of where the carbon is emitted, it causes the same damage everywhere in the world. This approach would avoid greenhouse gas emitters strategically organising their businesses to avoid jurisdictions with higher carbon prices and

moving to "pollution havens" where there may be a lack of environmental regulations. This phenomenon is often referred to as the "carbon leakage" impact.

The counterargument is that a non-unified carbon price can lead to producers in one country being undercut by competitors in another country where producers face lower carbon prices. A global agreement eliminates this risk.

It is of course important to recognise that despite being suitable for some countries, a carbon pricing approach may negatively impact those countries that are in most need of a green transition. Striking this balance involves traversing a difficult and fine line.

COP26

We have no doubt how difficult negotiations on this issue are and will continue to be. The complexities of carbon pricing will only be exacerbated by the recent events across Europe and the UK, as outlined in this article. There are many variables and issues to consider on a per country basis.

Attempts to date to develop a legally binding international climate agreement have failed for a number of reasons. Primarily, countries do not have the incentives to go beyond their nationalistic or group (for example, EU) interests.

Nevertheless, regardless of the approach taken by governments in order to motivate emitters to reduce their carbon emissions, the applicability of carbon pricing must: (1) be costly enough to force change quickly and globally; (2) ensure carbon leakage does not occur; and (3) prevent those countries that are considered to be the worst-off from finding themselves being negatively impacted by the approach chosen.

Finding a solution that addresses all concerns effectively is difficult. However, COP26 provides all interested parties with an ideal opportunity to address the issues raised in this article, and ultimately try to increase the usage and effectiveness of carbon pricing globally.

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