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Gweinidog yr Amgylchedd, Ynni a Materion Gwledig
Minister for Environment, Energy and Rural Affairs



Llywodraeth Cymru
Welsh Government

Mike Hedges MS
Chair
Climate Change, Environment and Rural Affairs Committee

seneddCCERA@senedd.wales

2 November 2020

Dear Mike

Thank you for your letter of 13 October, requesting further information following my attendance at your committee meeting on 8 October to assist in your scrutiny of The Greenhouse Gas Emissions Trading Scheme Order 2020. I attach responses to your questions. I will also take this opportunity to update you on my engagement with the other Governments of the UK and on progress with the framework documentation.

I attended the first Net Zero, Energy and Climate Change Inter-Ministerial Group on 13 October. I took the opportunity to press again for a linking agreement with the EU ETS and to make the case for a stand-alone UK ETS to be pursued in preference to a Carbon Emissions Tax. I sought confirmation as to when this decision would be taken and how the Welsh Government would be involved in that decision. I wrote to Minister Kwarteng further regarding these and other issues following the meeting, including the need for engagement with the Welsh Government on the Industrial Decarbonisation Strategy and the need to ensure fair funding for Wales' industries, including recycling of ETS revenues. I attach the letter for your information.

I can also confirm I have agreed the provisional Framework Outline Agreement and Concordat for the UK ETS and my officials are pressing for swift progress through the final clearance stages in order to provide you with the documents as soon as possible.

Regards

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Rydym yn croesawu derbyn gohebiaeth yn Gymraeg. Byddwn yn ateb gohebiaeth a dderbynnir yn Gymraeg yn Gymraeg ac ni fydd gohebu yn Gymraeg yn arwain at oedi.

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Greenhouse Gas Emissions Trading Scheme Order 2020

Welsh Government responses to questions from the Climate Change, Environment and Rural Affairs Committee

Carbon Emissions Tax

- 1. During your evidence session, you explained that discussions on the UK Government's proposals for a Carbon Emissions Tax were taking place at an official level. Given the significance of a unilateral decision by the UK Government to introduce a Carbon Emissions Tax, what discussions have taken place at Ministerial level on this matter, and what has been the outcome?**

I have consistently pressed for a joint discussion between the four Governments on the policy options around carbon pricing, given any decision to stop operating an emissions trading system in Wales should be for Welsh Ministers to determine. I have used every opportunity to raise my views, such as during quadrilateral meetings on the UK ETS. I am frustrated the UK Government has not entered into any substantive discussions with me or the Ministers of the other Devolved Administrations.

I was asked my opinion on the level of a tax rate many months ago, when discussing a no deal scenario with a previous Exchequer Secretary to the Treasury. However, during our discussion little detail was provided regarding policy detail and in any event the no deal scenario was not taken forward, following the extension to the transition period.

The Exchequer Secretary to the Treasury has indicated she is prepared to listen to my views on the Carbon Emissions Tax (CET) policy. Now the consultation is complete, I will be pressing for an overview of stakeholder responses and emerging thinking on final policy design at the first opportunity. I intend to include my Cabinet colleague, the Minister for Finance and Trefnydd, in any such discussion, given her interest in tax matters. I will also be seeking a discussion on the rationale and relative merits of taxation versus a trading scheme, involving all four UK nations, in order to reach a decision which fairly takes account of our responsibilities over climate policy. Finally, in the event a tax is taken forward, I would expect to discuss the role of Natural Resources Wales, and associated resource needs, given they are a Welsh Government Sponsored Body.

2. Can you clarify whether the UK Government has indicated to you the circumstances in which it would introduce a Carbon Emissions Tax rather than jointly pursue with the devolved administrations a standalone UK ETS?

No, the UK Government has not indicated the basis for introducing a CET in preference to a standalone UK ETS, nor the circumstances in which such a decision would be taken, despite repeated questions from my officials.

3. What assessment have you made of the impact of the proposed Carbon Emissions Tax on Welsh installations and on Wales's progress in reaching net zero by 2050? How does this assessment compare with that for a standalone UK ETS?

The final policy details have yet to be confirmed by the UK Government. The following assessment is based on the proposals within the consultation document.

Around 70 installations in Wales would be in scope of the ETS, and the same installations would be in scope of a tax, according to the consultation document.

However, the tax does not offer the same certainty of environmental outcome as a trading scheme. The CET relies on policy makers setting the appropriate level of tax rate to drive behaviours while the UK ETS will set a cap and trajectory in line with a net zero consistent pathway to create an absolute ceiling on the level of emissions across the business population.

One of the key downsides of a tax is the lack of financial incentives offered to installations who emit less than any freely allowed limit. The UK Government consulted on proposals to address this deficiency by rewarding decarbonisation for main scheme installations. However, the proposals do not offer the same flexibility and generosity as a trading scheme, which will provide the opportunity for installations to take early investment decisions, bank excess allowances and trade them at their full value at a time of their choosing, for instance when carbon prices are high.

For these two primary reasons, the standalone UK ETS offers the best carbon pricing policy option, both in Wales and across the wider UK.

4. What can you do to ensure that the Welsh Government has a formal role in the design of a Carbon Emissions Tax? How will you seek to ensure that Welsh interests are fully considered, and that Wales receives its fair share of tax revenue?

The devolution settlement does not guarantee a formal role for Welsh Ministers in a CET and the UK Government has not offered to legislate for any such role. Neither have they yet offered to reach political agreement on any co-operation, for instance through a Concordat. Such agreement could set out how Welsh Ministers would participate in the development of policy and our role as sponsors of the environmental regulator in Wales. Unless and until such an offer is made, I will continue to represent Wales' interests at every opportunity, including on the issue of the distribution of tax revenue.

5. In giving evidence to the Committee, you said that a decision by the UK Government to introduce a Carbon Emissions Tax “goes completely...against the principles of the common frameworks that we've agreed back in 2017”. What are the implications of a failed UK ETS Common Framework for the delivery of the wider Common Frameworks Programme?

I entered into the joint work to develop the UK ETS framework in good faith and consider it to be an example of how the programme can successfully deliver co-produced policies. However, the UK Government's decision to progress the alternative policy clearly undermines these efforts.

Even if the tax were the only option available, the lack of engagement with devolved Ministers contradicts the context in which the JMC principles were framed, in particular “*There will also be close working between the UK Government and the devolved administrations on reserved and excepted matters that impact significantly on devolved responsibilities*”.

Within my portfolio, the UK ETS is the only framework area where the UK Government is publicly consulting on an alternative policy using reserved powers. Therefore, I am hopeful this is an isolated incident. However, it brings into question the UK Government's commitment to the Common Frameworks Programme.

Auction revenues

6. Can you outline the arrangements currently in place to ensure that Wales receives its fair share of revenue generated from the UK's participation in the EU ETS?

All funds processed by the UK platform under Phase 3 of the EU ETS are returned to the Treasury, however, they are not currently hypothecated for decarbonisation. The UK Government would point to their reports to the European Commission which show much more than 50% of the funds secured through this route are targeted at climate change measures. The geographical distribution of those funds is not known due to the lack of hypothecation and, consequently, transparency.

7. Can you confirm that creating a UK Industrial Decarbonisation Fund remains your preferred approach to recycling revenue generated from a UK ETS? If not, what has led to a change in your position, and what is your new preferred approach?

A UK Industrial Decarbonisation Fund remains my preferred approach for recycling the UK ETS revenues and also to manage any additional funding which may be required. This fund should be jointly administered by the four UK nations, given the responsibility for emissions reduction is devolved. I will set out my rationale below.

The Barnett formula clearly doesn't work for ETS participants. Welsh installations account for approximately 10% of the emissions captured by the UK ETS. Logic, therefore, suggests Welsh installations should receive 10% of the revenues generated. However, the path to decarbonisation will not follow such a simplistic formula.

Some of the installations in the UK ETS will be cheaper to decarbonise than others. The revenues, therefore, need to flow proportionally to sectors most in need. Wales has a high proportion of difficult to decarbonise installations, involving considerable technical challenges and where the funding required to decarbonise is likely to be higher than average.

There is also a temporal aspect. Not all installations will decarbonise at the same time and their funding needs will vary over time. It may be, in future years, a small number of installations in the UK will need to be in receipt of all the funding for a number of years. For example, in order to decarbonise one of our steel producers, much more than 10% of the funding may be required over a three to four year period, just for a single installation.

For these reasons of flexibility and the need to acknowledge the different requirements of different sectors at different times, there is an argument Welsh businesses are best served by being part of a larger funding arrangement. However, this requires fairness and transparency in the system, which is best achieved through joint governance and administration.

8. What discussions, if any, have you had with the UK Government about Wales's proportion of auction revenue being returned directly to the Welsh Government to fund its spending priorities?

We have not discussed revenues being returned to the Welsh Government. Our preference is for a UK fund which is transparent and fairly distributes funding according to need. However, if a system managed in Whitehall means the odds are stacked against Welsh businesses there may be an argument to take the funding – better to have some funding coming to Wales than none at all. This is why it is essential we are involved in not only the principle but also the design and operation of any funding scheme.

9. The European Commission is considering introducing a carbon border adjustment mechanism as an alternative to free allocation of allowances to address the risk of carbon leakage. What are your views on this? What consideration, if any, has been given to how such a mechanism could work in the context of a standalone or linked UK ETS?

The carbon border adjustment mechanism is an interesting concept as it addresses competitiveness issues by putting a carbon price on incoming goods. This should remove the need for compensation, in the form of free allowances, for industries within the European Union and will be a new source of revenue.

There are technical challenges associated with such a mechanism and it will be interesting to see how the European Commission addresses them to ensure it can be effectively and fairly implemented.

We do not yet have sufficient details about the mechanism to fully understand how it will operate, or how it might work differently in a linked or standalone UK ETS. However, if we were to establish a linking agreement, considerations such as these would be managed through the associated governance arrangements.

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Llywodraeth Cymru
Welsh Government

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30 October 2020

Dear Kwasi

Further to the inaugural meeting of the Net Zero, Energy and Climate Change Inter-Ministerial Group (IMG) on 13 October, I would like to take this opportunity to emphasise some of the most important points relating to our discussion. The UK Government and Welsh Government are mutually dependent on one another as we both work to meet our emissions targets and I would like to thank you and your Officials for working with us to develop the closer inter-governmental cooperation we need in this area.

During the meeting, we discussed the UK Emissions Trading Scheme (ETS). I welcome the formal role of the IMG in governing the ETS. The early decisions on a revised cap and any changes to free allocations following the review will require strong co-operation between us to ensure future policy meets the needs of our individual nations and the UK as a whole.

We can only achieve global emissions reduction goals through international co-operation to establish a consistent carbon price. Our focus should be leading the development of a network of robust and effective, interconnected global carbon markets and linking the UK ETS to the large, established EU system is the logical first step. Achieving a successful ETS linking agreement with the EU is clearly in the best interests of all parties and I would appreciate your assurance you will continue to work towards a solution on this with the EU over the coming weeks. Our industry is already feeling the pressure of the COVID pandemic, on top of the potentially damaging impacts of trade disruption or border delays when we leave the EU. Linking the carbon markets is one area where there is an opportunity to lessen the blow.

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Accordingly, even if an agreement is not reached with the EU, we should establish a standalone UK ETS, in line with the commitment all four Governments made when we agreed to a common framework in this policy area, with a view to future linking opportunities, with the EU system or other global markets. However, despite the progress made on the UK ETS legislation and operational preparedness, I understand the UK Government are continuing to progress two parallel options for a standalone scheme. As I have previously made clear, I am ready to participate in discussions on the relative merits of both options with you, though given we are on track to implement a UK ETS from 1 January, the option to fill a policy gap with a Carbon Emissions Tax (CET) will not be required. I am seeking clarity on the circumstances in which you might consider introducing a CET, rather than a standalone UK ETS, as well as when this decision will be taken. Given Wales' emissions profile is considerably different from the UK as a whole, including a relatively high proportion of emissions from Industry and Agriculture, I would expect to be involved in the decision as it relates to Wales.

I would also appreciate further details of the outcomes and proposed response to HM Treasury's important review into the costs and benefits of net-zero. The revenues raised through an ETS will be substantial and I am anxious Wales gets its fair share of this funding. Ongoing support from the UK Government is essential to maintain progress with decarbonisation of Welsh industry and I look forward to a discussion with you on the forthcoming Industrial Decarbonisation Strategy, which I understand your officials are arranging.

Funding will be equally important in other areas. In order to achieve net zero, we will need to invest in a range of renewable and low carbon technologies, in addition to off-shore wind. We therefore need a commitment from the UK Government that Wales will receive the funding it needs in areas like Carbon Capture Usage and Storage, and Hydrogen, which will support long term environmental and financial sustainability for industries based in Wales. We cannot afford to lose the skilled workforce and economic influence attached to these companies and their supply chains.

Across my portfolio, there are further interdependencies on which closer collaboration would deliver benefits to the UK and Welsh Governments. For example, if we are to collectively provide clarity and certainty for the sectors involved, we need to understand the UK Government's plans with regards the long awaited Energy White Paper. The same is true of your work on the UK's Net Zero Strategy and sixth carbon budget, on which I understand officials have had preliminary discussions.

Your letter of 2 October regarding the UK National Energy and Climate Plan (NECP) was helpful. We of course support the UK Government's immediate actions in submitting this plan in accordance with the Withdrawal Agreement. However, I am concerned about what will replace certain targets required by EU legislation, such as energy efficiency, after we leave the EU arrangements. I encourage the UK Government to be more ambitious in its targets for renewable energy. In Wales we already generate the equivalent of 50% of our electricity consumption from renewable sources. I expect the IMG to serve as a forum for discussing the topics and targets currently contained in the NECP.

Finally, I must emphasise our determination to embrace all opportunities to rebalance the UK's economy and to address long-standing inequalities in the context of both tackling and recovering from the coronavirus pandemic. I believe this is a shared ambition on which we can collaborate going forwards.

I am copying this letter to my counterparts in Scotland and Northern Ireland and to the Secretary of State for Wales

Regards

A handwritten signature in black ink that reads "Lesley Griffiths". The signature is written in a cursive style with a large, sweeping flourish at the end of the name.

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