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Making the UK a global leader in carbon markets: strategic policy recommendations for leveraging national strengths

Introduction

The UK is well positioned to become a leading centre for carbon markets, bolstered by its green policies and strategies already implemented and planned for the future, coupled with the strength of its financial and related professional services industry.

Our report, Global carbon pricing mechanisms and their interaction with carbon markets, developed in partnership with ICE, offers quantitative and qualitative analysis of carbon pricing mechanisms and carbon markets trends in the UK and globally, emphasising the development of the compliance and voluntary markets in recent years. The report also discusses the role of financial and related professional services in the development of carbon markets. The report concluded that carbon markets could play a significant role in reaching net zero targets, but that greater scale is needed to make this contribution meaningful.

Our policy recommendations, drawn from this report's findings, outline strategic steps for the UK government to capitalise on this opportunity, particularly in the context of the forthcoming COP28 discussions. To scale up carbon markets and for the UK to become a leading global centre, the government should:

- Ensure that the carbon price in the UK is reflective of the true cost of emissions and remains net zero aligned.
- Expand the sectoral coverage of the UK Emissions Trading Scheme (ETS).
- Foster interoperability between the compliance and voluntary carbon markets.
- Consider endorsing the Core Carbon Principles and the Claims Code of Practice, initiatives which provide greater integrity to the carbon credit market.
- Support the growth of voluntary carbon markets in the UK through providing tax, legal and regulatory certainty.

Compliance Carbon Market

The UK's ETS is an important tool in changing behaviours and pricing carbon emissions. It is critical to maintain our trajectory to net zero by 2050. To remain aligned with net zero pathways and incentivise decarbonisation, the government must ensure that the carbon price in the UK is reflective of the true cost of emissions.

The UK ETS has limited sectoral coverage at present. Sectors currently covered include energy intensive industries, the power generation sector and aviation. The government should focus on expanding the size of the UK ETS to increase the proportion of the economy covered. It must also, in the medium term, seek to align the carbon price with comparable markets while ensuring that the UK ETS remains net zero aligned.

In the longer term, the government should foster interoperability between the ETS and voluntary carbon market, allowing purchasers to transfer credits from the voluntary to the compliance market. This will expand the supply of credits and allow firms greater flexibility to cover their emissions by purchasing credits from voluntary markets. However, the government should consider setting a limit on the volume of credits that can be transferred to ensure that the carbon price does not get too low. This approach has been successful in other markets**.** For example, in the California cap-and trade programme, entities can use offset credits to fulfil 4% of their compliance obligation for 2021-2025 emissions, before increasing to 6% for 2026-2030 emissions. Emissions trading schemes in Washington, Quebec, and Mexico are further examples where a share of the compliance obligation can be met using approved offsets.

Voluntary Carbon Markets (VCMs)

Tax

Unlike some other markets, carbon credits in the UK are not currently subject to VAT, and the Terminal Markets Order (which provides zero-rated VAT for certain wholesale commodity transactions made by members on named commodity exchanges or market associations) currently applies to certain carbon emissions trading. The government should provide long-term certainty for traders that this will continue to be the case. This is especially important as the secondary market for carbon credit trading develops. Without this long-term certainty and clarity on tax treatment, the government risks undermining market demand for carbon credits.

Legal definition

The industry view is that English law is flexible enough to encapsulate intangible assets such as carbon credits. The government should play its part by supporting the development of legal principles for VCMs, including:

- Clarifying the legal definition of carbon credits, including offsets, as an asset;
- Helping to foster interoperability between contracts; and
- Helping to ensure the insurability of carbon credits as assets.

Regulation and Guidance

Over the past 12 months there have been significant developments in international standards and guidelines for VCMs. The release of the Integrity Council for the Voluntary Carbon Market (IC-VCM) Core Carbon Principles and the Voluntary Carbon Markets Integrity Initiative (VCMI) Claims Code of Practice represent important steps toward providing greater integrity and quality to the carbon credit market. The government should now consider officially endorsing these standards.

Alongside the quality of carbon credits, the government should also focus on the quality of their custody, i.e. the safekeeping service that a financial institution provides for a customers' assets to minimise the risk of theft or loss. This is an area which has received limited attention to date. However, carbon credits are financial assets which need to be managed properly. The UK has the financial infrastructure and regulatory expertise to become a leader in the custody of carbon credits. The government should consider providing the legal certainty and legislative basis to enable the UK to harness this potential.

There are a number of environmental markets alongside carbon which provide economic tools to promote positive environmental outcomes and navigate a decarbonisation pathway. In time, the government should establish a regulatory framework for carbon and environmental credit markets, covering both mandatory and voluntary schemes. This is necessary to achieve transparency, market confidence, environmental integrity, and standardisation of methodologies for carbon and environmental credit certification.

The government should look to existing regulatory rulebooks when establishing a regulatory framework for carbon and environmental credit markets. In particular, the government should look to the allowances market, which is already regulated and has a similar purpose. However, the government should recognise that the market is rapidly developing and avoid undermining this growth with disproportionate regulation.

Conclusion

The UK is recognised as a leading green finance centre internationally and has the potential to become a global centre for carbon markets. Expanding the size of the UK ETS and ensuring that the carbon price remains net zero aligned, alongside fostering interoperability with the voluntary market, will help to position the UK on a net zero trajectory. The UK also has huge potential to foster growth in VCMs and help provide capital to fund the net zero transition. To enable the UK to seize this opportunity, the government should provide tax, legal and regulatory certainty.