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To: HM Treasury and Department for Energy Security and Net Zero

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22 June 2023

By email

Could you please reply by email to the ETG Secretariat at john.craven@etg.uk.com

Dear Carbon Leakage Consultation Team,

Response from the UK Emissions Trading Group to the HMT / DESNZ Consultation on Addressing Carbon Leakage Risk to Support Decarbonisation[1], 22nd June 2023

The UK Emissions Trading Group's (ETG) members represent a high proportion of the UK businesses covered by the UK Emissions Trading Scheme (UK ETS) and, until 2020, the EU Emissions Trading System (EU ETS). The ETG provides a forum for discussion and resolution of all aspects of emissions trading and associated policy matters; and uniquely it provides a regular forum for communication to take place between commerce and industry, the UK Government, Devolved Authorities, and regulators.

The sectors and businesses represented in ETG are important elements of the UK energy, manufacturing, energy-intensive industries, and supporting services such as verification, participants in traded markets and a wide range of advisory functions. They all have a key role in the transformation towards the objective of a net zero economy; and support the UK's ambition for net zero by 2050.

In 2019, ETG established a subgroup to evaluate the Carbon Border Adjustment Mechanism (CBAM) that the EU had started to develop and to consider the potential for a similar approach in the UK.

Our members have raised a number of concerns regarding the proposals set out in the consultation which we wish to bring to your attention. ETG has a broad membership and the views expressed here do not necessarily reflect the exact views of every individual member.

1) Provide Effective Carbon Leakage Mitigation

In the absence of a global pricing mechanism for greenhouse gas (GHG) emissions, different levels of decarbonisation effort through carbon pricing and climate regulation may result in the relocation of operations and/or investments to regions with lower/ no climate costs, nullifying or even worsening the global GHG emission result (i.e. carbon leakage).

Throughout the net zero transition, until new technologies are cost competitive or global carbon pricing is in place, it is essential that the UK policy framework delivers both emissions reductions and mitigation as to the risk of carbon leakage. Otherwise, UK decarbonisation will be achieved through deindustrialisation, and the offshoring of emissions and vital, well-paid jobs.

[1] Addressing carbon leakage risk to support decarbonisation - GOV.UK (www.gov.uk)

The risks of carbon leakage for UK manufacturers are rapidly rising due to the compound effect of escalating unilateral carbon costs, and the erosion of existing carbon leakage mitigation, including by reducing levels of free allocation associated with UK ETS. These carbon leakage risks will accelerate under recent proposals to reduce the overall and industry caps within the scheme[2].

To comprehensively address the risks of carbon leakage, the UK Government needs to both seek international solutions (which will take time to develop) and implement a portfolio of comprehensive domestic mitigation measures.

2) CBAM – A Complex Policy that must be Designed Carefully

The longer UK manufacturers face asymmetrically high carbon costs, the harder it becomes to operate and justify investment in the net zero transition. Carbon Border Adjustment Mechanisms (CBAMs) have an intuitive appeal in helping to level the playing field (at least on the domestic UK market) by applying a comparable carbon price to imported products to equal that incurred by UK-based manufacturers, while also creating an incentive for overseas manufacturers to decarbonise production.

The EU has already developed and legislated for the introduction of its own CBAM policy[3]. This threatens UK industry by introducing significant administrative hurdles and potentially diverting higher-carbon international goods towards the UK, which could profoundly damage UK manufacturers.

However, CBAMs are highly complex instruments, with numerous design elements that impact their overall effectiveness (or not) in addressing carbon leakage risks, as well as their legal and political viability. Careful considerations need to be made in designing such a mechanism to avoid unintended consequences. As such, it is not a universal tool to mitigate carbon leakage risks for all UK ETS sectors.

A successful CBAM scheme would need to:

a) provide effective carbon leakage mitigation across the value chain and prevent the shifting of carbon leakage risks to downstream sectors;

b) address heightened carbon leakage risks for UK producers exporting to low/ no carbon regulatory jurisdictions;

c) be feasible to implement and avoid the creation of trade barriers or other disruptions;

d) be underpinned by robust monitoring, reporting and verification (MRV) systems which prevent importers from using falsified data to evade CBAM charges;

e) impose minimal additional administrative burdens on business (in the UK and overseas) and consumers. including mutual recognition or equivalence with the EU CBAM to prevent significant administrative burdens when trading products between the two jurisdictions.

[2] Developing the UK Emissions Trading Scheme (UK ETS) – GOV.UK (www.gov.uk)
[3] Regulation (EU) 2023/956 of the European Parliament and of the Council of 10 May 2023 establishing a carbon border adjustment mechanism EUR-Lex (eur-lex.europa.eu)

At this stage, most manufacturing sectors remain concerned about the prospect of losing free allocation and replacing it with alternative mitigation measures (e.g. CBAM) whose effectiveness (or not) is subject to numerous and as-yet unresolved design elements.

Whether part of a CBAM or not, all UK manufacturers need strong mitigation to protect against carbon leakage and provide confidence to invest in decarbonisation without fear of being undercut. If taken forward, the effectiveness of CBAM in mitigating carbon leakage risks must be carefully monitored, with any conceptual and methodological shortcomings rapidly addressed. In addition, sectors or products not covered by CBAM must continue to receive sufficient carbon leakage mitigation.

3) Linking UK ETS to the EU ETS

Significant concern remains regarding the lack of progress around linking the UK ETS and the EU ETS. Linking the schemes allows installations and aviation operators to be part of a larger more liquid market, giving better carbon price discovery, and allowing participants to manage their carbon risks more effectively and cheaply, while also providing a level playing-field on carbon costs and sector competition within our larger mutually-linked markets. Establishing a link sooner rather than later further enables the mutual development of the scheme to address important questions on the caps to deliver net zero, free allocation, aviation, and expansion to new sectors; it also avoids scheme regulatory divergence that may make linking harder in future.

In the context of CBAM, linking the UK ETS and the EU ETS would render the UK exempt from the scope of the EU CBAM, in the same way that Switzerland already is. This would enable UK businesses producing goods covered by the EU CBAM to avoid the significant compliance costs associated with the scheme when exporting to the UK's biggest market – the EU. This also includes manufacturers in Northern Ireland trading with the Republic of Ireland.

Linking now allows the UK and EU to face the huge challenge of climate change together and to promote global cooperation in carbon pricing and the avoidance of carbon leakage.

Yours sincerely,

Chair, UK Emissions Trading Group