

UK Emissions Trading Scheme: Free Allocation Review

March 2024

Background

The Aldersgate Group is an alliance of major businesses, academic institutions, professional institutes and civil society organisations driving action for a sustainable and competitive economy. Our corporate members believe that ambitious and stable low carbon and environmental policies make clear economic sense for the UK. Our members have operations across the UK economy and include companies such as Associated British Ports, CEMEX, Johnson Matthey, National Grid, Suez, Scottish Power, and Siemens.

We develop independent policy solutions based on research and the expertise and diversity of our members. Through our broad membership, we advocate change that delivers benefits to an every-growing spectrum of the economy. The response to this consultation draws on previous Aldersgate Group responses and input from members.

Free allocation

Free allocation should continue to reward efficiency and mitigate the risk of carbon leakage. Free allocation should be based on efficiency (such as benchmarking based on efficiency of energy use) and verifiable threats of carbon leakage (to reward decarbonisation and the use of best practices, support competitiveness, and prevent the offshoring of emissions). Circumstances where participants receive more free allowances than their total emissions or allowances for closed plants must no longer occur.

Over time free allocation must be phased out to ensure the carbon price rises over the next few decades to a level that is high enough to end polluting activities and remove any subsidies on greenhouse gas (GHG) emissions. It is important that free allocation policy support the competitiveness of businesses and prevent the offshoring of economic activity and emissions. With the introduction of the Carbon Border Adjustment Mechanism (CBAM), free allocations should be phased out with a clear roadmap outlining the trajectory for the reduction in free allocations.

Alongside free allocation, other forms of policy and financial support are needed to support decarbonisation (e.g. business models, innovation support, CBAM, competitive electricity pricing, access to grid connections). Effective delivery of these policies at pace will be necessary to not just avoid carbon leakage but ensure fairness in the ETS so that participants have the adequate support measures and incentives to decarbonise. In this sense, enabling policies such as compensation and support are needed to prevent the carbon price from merely being an added cost rather than an incentive to decarbonise, especially when abatement opportunities are not currently available.

Free allocation and the introduction of a CBAM

- 1) Do you have any views on the interactions between other carbon leakage mitigation measures and a CBAM and/or the broad policy scenarios which the UK ETS Authority should explore in the future, in light of the UK Government's decision to introduce a CBAM? Please explain your answer.**

Free allocation policy once a CBAM is in operation must not result in double counting of activities undertaken to meet different obligations. Free allocations must be phased out as a CBAM is introduced. If domestic producers were to receive free allowances while their competitors were also subject to a carbon price at the border, they would face double compensation and a weakened incentive to decarbonise. It is likely that a CBAM would be incompatible with WTO trading rules were free allowances still distributed to domestic producers.¹

The Aldersgate Group recommends that, initially, a CBAM be targeted to as broad a scope of sectors as possible that are both proven to be at risk of carbon leakage and required to participate in the UK ETS. A UK CBAM should aim to align as closely as possible with the UK ETS, meaning that it should follow the same model for emissions reporting and verification and should see to align as closely as possible on pricing. This means that as the CBAM is phased in, free allowances should be phased out. Aligning a CBAM as closely as possible with the UK ETS will enable smoother implementation and administration of the scheme in its early years, and will also minimise the cost of compliance for industry, which already has a good understanding of how to comply with schemes like the UK ETS.

The EU is due to implement its own CBAM, phased in from 2026. This means that high carbon products destined for the EU from abroad will become subject to a carbon price. Based on the lower carbon price of the UK and as the UK will not have a CBAM in place for a year whilst the EU introduces a CBAM, there is a risk that exporters may redirect their high carbon goods from the EU to the UK, severely undermining the competitiveness of domestic producers. It will be important to ensure this risk is mitigated, noting that wider policy levers may be relevant to consider for this transitional period. It is vital that the UK pursue rapid implementation of a CBAM to provide a level playing field for UK producers and accelerate climate action around the world with incentives for both domestic and global producers to decarbonise.

Plans for adjustment at the border should be set out as early as possible with a clear roadmap for how it will interact with the UK ETS and free allocation, outlining the trajectory for the reduction of free allocation. This will provide a clear investment signal for industries covered under both systems. The EU has set out such information for the EU ETS and CBAM, and the Authority should consider the extent and rationale for differing trajectories in the UK and EU, to ensure the UK ETS continues to effectively fulfil its intended purpose for decarbonisation whilst minimising the burden for businesses operating under both the UK and EU ETS. Linking the UK and EU's carbon pricing regimes would help reduce compliance costs for UK producers, lower the administrative burden of participating in two schemes and expand the size of the carbon market (increasing liquidity) for UK producers.

Mandatory product standards will be an important accompaniment to the introduction of the CBAM. We know from extensive discussions with industry that voluntary standards are unlikely to produce the change needed to establish markets for low carbon goods.

The upcoming consultation on the development of the UK CBAM is a welcome opportunity to further explore these interactions and test proposals with participants to ensure successful implementation.

¹ <https://www.nortonrosefulbright.com/en/knowledge/publications/9c5d9ec6/potential-conflicts-between-the-european-cbam-and-the-wto-rules>

Benchmarks

7) Do you agree that benchmarking is the appropriate methodology to ensure free allowances reward top performing installations and incentivise decarbonisation? (Y/N Please explain your answer).

Yes. Benchmarking is an appropriate methodology to ensure free allowances rewards top performing installations and incentivise decarbonisation. The Authority should also consider options for the requirement of robust decarbonisation plans from ETS participants receiving free allowances, to ensure that installations are still pursuing emissions reduction (see *Conditionality* section). This would help to mitigate the risk of free allocation policy undermining or slowing decarbonisation and becoming an inefficient subsidy upon which installations continue to rely.

8) What are your views on the proposed options for updating UK ETS benchmarks?

Benchmarks in the UK should remain up to date with best-available-technologies and efficiency practice across the world, not just the UK. Where the UK is already leading on efficiency, this means that best-performing firms would also receive a greater reward comparatively to global competitors. Updating benchmarks with UK data only is not sufficient.

As options for abatement become increasingly available and cost-effective, free allocation should be withdrawn to accelerate the take up of new technologies, production processes and/or fuel switching option across ETS participants. Resource efficiency, such as use of recycled material content, should also be incorporated into efficiency benchmarks in line with up-to-date best practice. As these technologies or abatement options scale-up, free allocation based on efficiency can reward early movers and adopters. As emerging technologies such as CCUS and hydrogen are deployed more widely, it will be important for government to have a robust mechanism in place to periodically review the eligibility criteria for free allocation. This can ensure that an optimum free allocation is available on the market and that incentives to decarbonise remain high. Continued use of the current benchmarks (option 1) is not sufficient and would not reflect up-to-date best practice.

In the case that a UK-focused benchmark (option 3) is developed, this should be based on global data and best practice. A UK-focused benchmark risks basing efficiency on a smaller number of installations which could exclude existing best practices from across the globe. The UK ETS suffers from being a small market in comparison to the EU ETS. There are fewer market participants which means that efficiency benchmarks are based on a smaller number of installations. For example, there are only 11 integrated cements plants in the UK meaning that eligibility criteria for free allowances based on the 10% most efficient installations in the sector would provide 1 site with significant competitive advantage over all others.² Potential undesirable consequences are:

- the top 10% most efficient installations (upon which an efficiency benchmark is based) are so few due to limited size of a given sector that individual firms gain a significant competitive advantage over others.
- the benchmark may be less ambitious, not reflecting best-available-technologies on the global market.

² <https://www.cemnet.com/global-cement-report/country/united-kingdom> [accessed 28/02/2024]

Using the updated 2026 EU benchmarks (option 2) would help support consistency for UK businesses operating in both the UK and EU ETS, as well as reflecting efficiency advances. The Aldersgate Group supports pursuing this option. Policy support for industry (e.g. support for innovation, competitive industrial electricity price, mandatory product standards) are necessary alongside the UK ETS and could be targeted to particular areas of challenge, if relevant, following adoption of the 2026 EU ETS benchmarks.

Businesses across sectors have also called for more linkage between the UK and EU ETS to alleviate the burden of complying with two increasingly different systems. Maintaining interoperability between new UK regulation and European and global regulatory initiatives and technical criteria will be important to ensure a high take-up of the UK's evolving (and more ambitious) carbon pricing requirements. With this in mind, the UK should continue to use diplomatic opportunities, such as active engagement in the G7 and G20, to advocate for greater ambition in global carbon pricing systems.

9) Do you agree with the proposed minded to position for updating benchmarks using UK data only to set the ARR? (Y/N Please explain your answer)

No. Benchmarks in the UK should remain up to date with best-available-technologies and efficiency practice across the world, not just the UK. Where the UK is already leading on efficiency, this means that best-performing firms would also receive a greater reward comparatively to global competitors. Updating benchmarks with UK data only is not sufficient.

The UK ETS suffers from being a small market in comparison to the EU ETS. There are fewer market participants which means that efficiency benchmarks are based on a smaller number of installations. For example, there are only 11 integrated cements plants in the UK meaning that eligibility criteria for free allowances based on the 10% most efficient installations in the sector would provide 1 site with significant competitive advantage over all others.³ Potential undesirable consequences are:

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- the benchmark may be less ambitious, not reflecting best-available-technologies on the global market.

Carbon leakage list

12) Do you agree that the carbon leakage list should be updated to reflect UK industrial sector's risk of carbon leakage? If you disagree, please explain how you think the carbon leakage list should be calculated in future.

There is a strong case to maintain an up-to-date UK-specific carbon leakage list that reflects the makeup of UK ETS participants and their relative share of the market. This is important for free allocation policy, as it may affect how the Authority allocates sector-by-sector.

The Authority should be mindful of contrasting the risk of carbon leakage with the effect of delayed decarbonisation. As the UK moves further towards its net zero targets for 2030 and 2050, the corresponding reduction of emissions allowances could increase the risk of carbon

³ <https://www.cemnet.com/global-cement-report/country/united-kingdom> [accessed 28/02/2024]

leakage and offshoring, especially as carbon prices increase. To ensure that decarbonisation effort continue at pace, it will be important to implement policy instruments that support industries investing in low carbon solutions from the effect of cheaper low carbon imports. It will be important to ensure that the CBAM operates effectively to protect the UK market from high carbon goods as it is phased in and replaces free allocations.

Tiering the carbon leakage list

17) Do you agree that the Authority should tier the carbon leakage list to better target those most at risk of carbon leakage?

The Aldersgate Group supports the principle of tiering carbon leakage list to ensure support is targeted based on risk level.

18) Do you have views on the principles that the Authority should use to guide decision making on tier design if we opt to tier the carbon leakage list?

With regards to the design of tiers, changes should be communicated clearly and ahead of time to ensure participants are able to prepare. Pragmatically, it will be important to minimise potential complexity, considering that free allocation will be phased out with the introduction of the CBAM.

Conditionality

26) Do you have views on whether the Authority should introduce conditions, related to decarbonisation efforts, on receiving free allocations?

The Aldersgate has recommended that the Authority consider introducing conditionality. To ensure that low carbon investment is encouraged, the Authority should consider implementing a requirement for both new and incumbent installations to provide a decarbonisation strategy. This will ensure that the UK ETS is not designed in a way that hampers decarbonisation efforts, contrary to its purpose.

27) Above we have outlined three illustrative designs for conditions for free allocations. Do you have views on whether we should introduce any of these options, how they are designed, and do you have a preference out of the stated options?

The Aldersgate Group supports requiring installations to have a decarbonisation plan in place or see their free allocations reduced (condition design example 3). This would provide an opportunity for increasing ambition and awareness of actions available to participants to ensure the ETS incentivises decarbonisation. The requirement to submit a plan should be meaningful, and avoid becoming a tick-box exercise, to ensure it fulfils the desired outcome. Requirements for detail and evidence as well as a degree of assessment are necessary to ensure effectiveness of the condition. Consideration should be given to ensure that participants are equipped to fulfil requirements, with support where appropriate.

Reducing free allocation to an installation by a pre-determined amount if emissions reductions or resource efficiencies are not made (condition design example 1) may be a complimentary condition to requirements for decarbonisation strategies, further incentivising participants to action their strategies. Implementation of this option should be considered

carefully with advanced notice and clear communication of timelines to ensure participants are able to plan ahead and not disproportionately penalised, for example where the cost of solutions for emissions reductions is higher or would take longer to achieve. Industry efficiency standards or sector decarbonisation roadmaps and targets may provide a measure for participants to report against with reductions in free allocation if standards are not met. There may be opportunity to learn from the EU ETS conditionality for free allocation, where energy audits required under the Energy Efficiency Directive are used as part of the implementation of conditionality for free allocation (only granted fully if recommendations from the audit are implemented or reduced by 25%).⁴

Excluding the most efficient installations from application of a CSCF (condition design example 2) is not our preferred option. The incentive is uncertain and not guaranteed for participants, with impact only when a CSCF is applied and would not systematically reward participants for efficiency improvements. As a relative scale, with the most efficient installation benefitting, the scale of efficiency improvement will vary for each participant and may be significantly different depending on the range of efficiency within the sector.

The EU ETS has introduced conditionality to access free allocations, with energy audits and climate neutrality plans for certain sectors. The Authority should maximise consistency between the two ETS' and ensure burden is minimised for participants subject to conditionality in both schemes.

⁴ <https://www.pwc.nl/en/services/tax/managing-tax-and-energy-transition/fit-for-55/eu-ets.html>