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Special Report: UK government opens consultation on a range of carbon leakage protection measures, including a Carbon Border Adjustment Mechanism (CBAM)

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UK government opens consultation on a range of carbon leakage protection measures



UK set to implement carbon leakage measures to replace free allocation

The UK government have opened a consultation looking for feedback on the implementation of the UK's net zero strategy. Included in the consultation are a range of options looking to address the potential shortfall in free allocation handed out under the UK ETS to protect against carbon leakage. The pursuit of net zero will lead to sizeable reductions in the UK ETS cap which will result in less allowances available to be distributed as free allocation. As part of the net zero strategy document, the UK government have reaffirmed their commitment to the UK ETS as the most efficient and cost-effective mechanism for achieving decarbonisation.

Background

- The UK have committed to implementing a cap consistent with a path to net zero in 2024
- This will substantially reduce the number of allowances freely allocated and auctioned out to 2030 and beyond.
- Estimates suggest the 2030 cap will be in the region of 60Mt as opposed to the current cap trajectory which would set the cap at 118M allowances in 2030.
- The UK government have committed to maintaining the same level of free allocation as currently envisaged until 2026, thereafter, reductions will need to be made as the net zero compliant cap bites.
- Aviation free allowances are to be phased out and further targeting measures will be implemented to ensure the remaining free allocation available to stationary installations is going to those most exposed to the cost of carbon.
- Any changes made need to be harmonised and ensure that the UK's aim to decarbonise is advanced while also protecting wider government priorities such as free and open trade, adhering to WTO rules and creating a high growth economy.

Future carbon leakage measures

The consultation raises the possibility of three possible measures, all of which could be implemented, to replace free allocation and counteract the risk of carbon leakage;

1. A Carbon Border Adjustment Mechanism (CBAM)
 - Places a carbon price on imported products
 - Covers the carbon emitted in production as well as any differential in carbon price paid between the country of production and the UK
 - Because of the focus on price – it is likely a CBAM is the most complimentary mechanism for those industries exposed to the UK ETS





2. Mandatory product standards (MPS)
 - Sets an upper limit on the emissions embodied in individual products placed on the UK market either through imports or produced domestically
 - Products that exceed the emissions limits would be prohibited from entering the market
 - Mechanism based on regulation rather than a cost-based incentive
 - Suitable for sectors currently outside the UK ETS as well as those within it
 - Could operate as a standalone measure or in addition to a CBAM

3. Demand side policies
 - Aim to grow the market for low carbon products
 - Measures could include; voluntary product standards, product labelling and changing public and private procurement guidelines to place an emphasis on low carbon products

Sectoral coverage

The consultation sets out that the following sectors may be covered by one or more of the measures;

- Cement
- Chemicals
- Glass
- Iron and steel
- Non-ferrous metals
- Non-metallic minerals
- Paper and pulp
- Refining
- Fertiliser
- Power generation

Notably, the glass, non-metallic minerals, paper and pulp and refining sectors are in addition to the sectors covered by the EU's CBAM.

Key to the implementation of any of the carbon leakage measures is a framework to collect information on the embodied emissions of products from within, or outside, the UK. A standard methodology to collect such data would increase transparency and assist in the creation of whole life-cycle emissions analysis for individual products.

Further details

UK CBAM

- Embodied emissions would have to be determined and calculated for each product. The UK ETS covers each installation's scope 1 direct emissions, however, scope 2 and 3 emissions may be indirectly included due to the inclusion of other sectors in the ETS, for example





- power generation. The UK CBAM may therefore include scope 1, 2 and 3 emissions for imported goods.
- Data would need to be verified by an independent and recognised body to ensure equitable treatment of UK and foreign emitters.
 - Where it is not possible to employ an independent and recognised body to verify emissions, default values may be employed based on available product or country level data, international datasets or values derived from UK products.
 - The price applied to CBAM imports could be calculated by either:
 - Regular averages of the ETS secondary market price or,
 - fortnightly UKA auction clearing prices or,
 - a fixed annual price
 - If the effective carbon price paid in the country of origin was equal to or higher than the CBAM price, no CBAM liability would arise. If the effective price was lower in the country of origin, a CBAM liability will arise. The government would therefore have to employ a methodology to measure the effective carbon price in each country.
 - There are also options available on when the price determination is applied to CBAM imports:
 - The point of emitting
 - The point of CBAM payment
 - The point of compliance
 - 2026 is the earliest date a CBAM would be implemented, in line with the net zero aligned free allocation changes.

Mandatory Product Standards (MPS)

- MPS does not rely on carbon pricing so, in theory, is easier to implement and measure, particularly in countries where no discernible carbon price is imposed.
- If introduced, it would be applied to a single sector or small number of sectors in a pilot phase.
- Based on initial analysis, the government considers the following sectors to be the most suitable for an MPS - steel, cement, concrete and chemicals with the following implementation options:
 - Option 1: Steel sector only
 - Option 2: Steel, cement and concrete sectors
 - Option 3: Steel, cement, concrete and chemicals sectors
- According to the UK government: “Option 1 and 2 rank high on deliverability as sector-led reporting and initiatives for these sectors already exist, such as the Responsible Steel standard and certification programme, the International Energy Agency (IEA)’s proposal to define low emissions, and the Low Carbon Concrete Group’s Routemap.”
- Whilst option 3 is more ambitious, it is recognised by the UK government that there would be significant challenges to implementation including;
 - A lack of readiness from the chemicals sector
 - Differentiated chemical products as opposed to the more homogenous steel and concrete products





- Lack of international measures
- The government is considering options that include Scope 1, Scope 2, and upstream Scope 3 emissions data, at a minimum, being included in the MPS. Including downstream Scope 3 emissions is also a possibility.
- The government are also considering which parts of the manufacturing chain an MPS would be applied to and this could vary by product/sector;
 - Option 1: MPS are applied to upstream products, such as processed raw materials or other early intermediary products
 - Option 2: MPS are applied to a narrow range of midstream intermediary products, such as those sold to a specific type of downstream manufacturer or sector, for example, steel products manufactured for the automotive sector
 - Option 3: MPS are applied to a broad range of midstream intermediary products, such as those sold to downstream manufacturers
 - Option 4: MPS are applied to downstream consumer products, such as a car
- Option 2 appears to be favoured by the government.
- Compliance with the MPS also has two potential options;
 - Option 1: The point of sale, in other words when the product is being placed on the UK market.
 - Option 2: The point of production, in other words before the product leaves the factory gates.
- It is unlikely an MPS could be fully operational before the mid-to-late 2020s, a small sectoral scope is expected initially.

Exports

- The UK government recognises that exports will experience difficulties in the above scenarios
- Even where the UK is a net importer of a product, a significant share of UK production may still be exported
- Whilst the measures suggested will provide carbon leakage protection for UK goods produced and consumed in the UK, those that are exported are potentially left without the protection they are currently afforded by free UK Allowance allocation, particularly if the export is going to a jurisdiction with no or very low carbon costs.
- The UK government will therefore need to consider measures that address this carbon leakage risk.

Redshaw Advisors' comment

The changes proposed by the UK government are the furthest reaching carbon leakage measure proposed by any country to date. The potential to include scope 2 and 3 (including the chance of downstream scope 3) emissions will be groundbreaking and will go beyond the EU's own proposed measures, also by including more sectors. If nothing else this measure signals that the UK Government is serious about achieving net-zero and suggests that companies with existing UK exposure, and those with potential exposure through these new measures, should consider getting ahead of the curve via UKA purchases. We will monitor developments and update our customers accordingly.





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If you have any questions or concerns about these potential changes, please don't hesitate to get in touch with your account manager.





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