



EIUG and MCCG Joint Response to the Consultation on Developing the UK Emissions Trading Scheme (UK ETS)

Introduction

1. The Manufacturers' Climate Change Group (MCCG) represents key UK manufacturing sectors affected by the Emissions Trading System and other climate change instruments. It comprises: Aluminium, Asphalt, Cement, Ceramics, Chemicals, Fertilisers, Food and Drink, Foundries, Glass, Gypsum, Lime, Metal-forming, Mineral Wool, Motor Manufacturers, Non-Ferrous Alliance, Paper, Plastics, Quarry Products, and Steel. The MCCG represents businesses that manufacture fundamental materials that feed our supply chains, efficiently, safely and with low emissions, provide the solutions upon which the UK's green economy will be built – from hydrogen producers to low emission vehicles, employs 1m+ people to deliver £200 billion in value to UK GDP, supports 1000s of communities nationwide, often in economically deprived areas and invests £100s of millions annually in our infrastructure. Its members represent some of the biggest global brands and household names in the UK.
2. The Energy Intensive Users Group (EIUG) is an umbrella organisation that represents the interests of energy intensive industrial (EII) consumers. Its objective is to achieve fair and competitive energy prices for British industry. It represents EIIs including manufacturers of steel, chemicals, fertilisers, paper, glass, cement, lime, ceramics, and industrial gases. EIUG members produce materials which are essential inputs to UK manufacturing supply chains, including materials that support climate solutions in the energy, transport, construction, agriculture, and household sectors. They add an annual contribution of £29bn GVA to the UK economy and support 210,000 jobs directly and 800,000 jobs indirectly around the country.
3. These foundation industries are both energy and trade intensive – remaining located & continuing to invest in the UK and competing globally requires secure, internationally competitive energy supplies and freedom to export without tariff barriers. However, inward investment, growth and competitiveness have been hampered for years by UK energy costs higher than those of international competitors. In some cases, investment, economic activity & jobs have relocated abroad, leading to a subsequent increase in imports.

4. Because of the potential negative impacts the proposals might have on the members of both the MCCG and EIUG, the organisations have decided to put in a joint response.

Summary

5. The EIUG and MCCG call on BEIS to postpone introducing a Net Zero consistent cap until Government has developed its policies to support industrial decarbonisation further and put in place policies to mitigate the risk of carbon leakage due to direct and indirect emission costs.
6. Furthermore, BEIS should publish an impact assessment setting out its appraisal of the impact of the proposals and giving stakeholders time to engage with the evidence to inform policies before any decisions are taken. The EIUG and MCCG find it concerning that the Government propose to reduce the number of free allowances for industry without a proper assessment of the risk of carbon leakage for these industries. BEIS' Research Paper Number 2020/017, backed the analysis it already has for the compensation schemes and HMT's Net Zero review, should inform such an assessment.
7. The EIUG and MCCG also suggest that Government should remove the discretion of the UK ETS Authority on whether to intervene or not and make intervention automatic, based on clear and transparent rules, similar to the process to set the annual level of the Renewable Obligation, when the CCM is triggered and replace the current threshold with a mechanism that tracks the European carbon price.

1) Do you agree with the Authority's proposed range for the net zero consistent cap?

8. The EIUG and MCCG do not agree with the proposed range for the net zero consistent cap. The proposal increases the risk of carbon leakage, lacks bottom-up analysis and is not aligned with other Government policies and strategies, in particular the Industrial Decarbonisation Strategy.

Risk of carbon leakage

9. HMT's Net Zero Review suggests that the evidence of carbon leakage to date is inconclusive. However, there are now clear examples¹ of carbon leakage in some

¹ <https://www.cfindustries.com/newsroom/2022/ukrestructuringproposals>. The press release states that "As carbon costs continue to increase substantially in the UK, the Company expects that its production will be placed at an even larger competitive disadvantage against imports".

industrial sectors. As the UK adopts more ambitious initiatives to reduce its emissions – such as moving to a Net Zero consistent cap for the UK ETS - the risk of carbon leakage will increase and should be taken into account. Unfortunately, this does not seem to have been the case with the current proposal. The proposed reduction in the cap and the drop in free allowances does not align with the technical, economic and commercial ability for most industries to reduce their emissions. As a result, the proposals are likely to put these industries at a further competitive disadvantage² thereby increasing the risk of carbon leakage.

10. The Net Zero Review points the Government's options to mitigate the risk of carbon leakage, such as free allowances, subsidies, revenue recycling, carbon border adjustment mechanism (CBAM) and mandatory product standards. However, CBAMs or product standards are unlikely to be introduced – if at all – before the reduction in the cap and free allowances. There is therefore no certainty for industry regarding measures, and their timing, to mitigate the risk of carbon leakage.
11. The consultation states that "*Carbon border adjustments should be considered as a part of an international, multilateral effort which is the best way to prevent carbon leakage*" raising the question whether Government will consider the future design of the UK ETS also as a part of international, multilateral effort to prevent global warming.
12. The proposals recognise that the trajectory needs to be smoothed out and proposes the use of unallocated allowances to do this. However, use of these allowances for this purpose comes with the trade-off that there will be fewer available should they be required later to mitigate a cross sectoral correction factor or to be brought to market to reduce the impact of sustained high carbon prices, increasing the risk of carbon leakage further down the line.
13. A cap set at the lower end of the range, requiring a decarbonisation trajectory exceeding the ability for sites to deploy deep decarbonisation technologies, combined with a loss of free allowances and little to nothing to mitigate against the carbon price differential in products from abroad, will increase the risk of carbon leakage and the UK ETS will therefore fail on one of its objectives.
14. Despite the HMT Net Zero review stating that the "*UK takes the risk of carbon leakage seriously*", the failure to propose measures to mitigate against the risk of carbon leakage, in tandem with the proposals in the consultation, undermines this assertion.

² Companies on other regions, such as the EU, America and Australia have made public announcements to invest in decarbonised ammonia, but not in the UK as its higher carbon costs are deterring such investments.

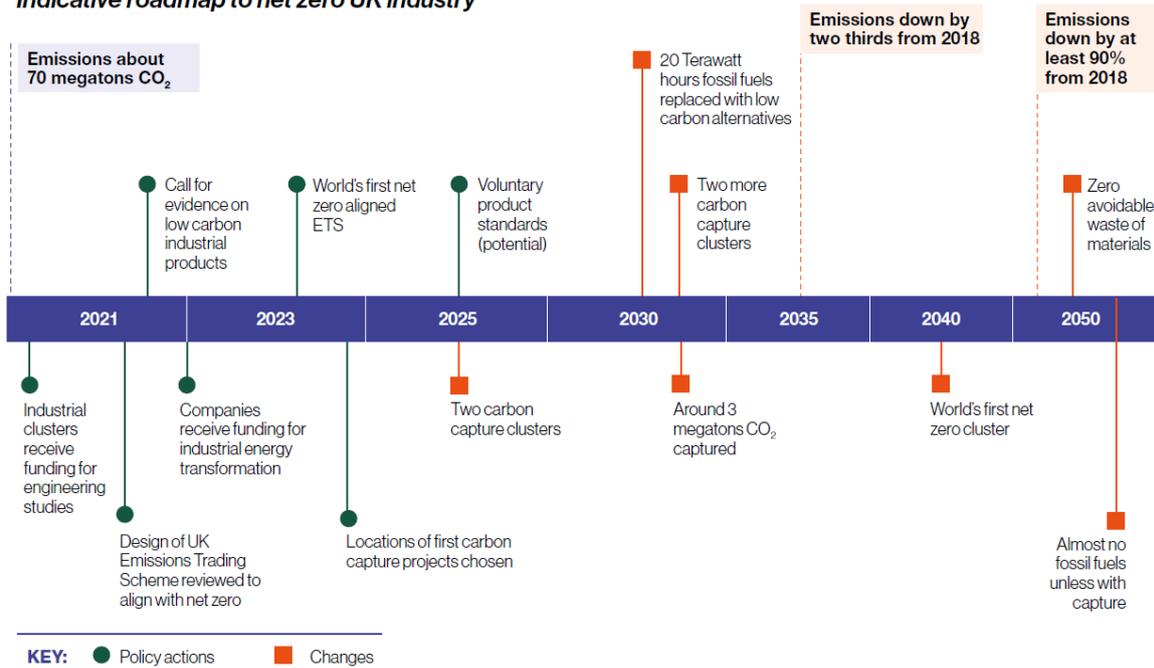
Impact Assessment

15. The lack of an impact assessment appraising the underpinning proposals signals that the Department is short of the evidence of the potential cost and impact of the proposals. This risks negative unintended consequences, potentially undermining the policy objective. It also makes the consultation more difficult to engage with, undermining industry's ability to model the potential impact of proposals and provide constructive evidence back to BEIS.
16. The consultation supports the proposal to reduce the cap from a top-down perspective but lacks a bottom-up analysis in particular with regard to the allocation of free allowances to industry. The proposed range follows a trajectory comprising a steep decline in emission between 2023 and 2024, with a more gradual declining trajectory towards 2030. However, until the technologies in the Industrial Decarbonisation Strategy are deployed and enable a step change reduction in emissions, industrial emissions will continue to decline gradually. For many sites outside of track 1 clusters and in dispersed locations any step change reduction is only likely to be possible after 2030.
17. The EIUG and MCCG therefore call on BEIS to publish an impact assessment well before any publication of a summary of responses or the Government response so that stakeholders have time to engage with it.

Alignment with other Government Policies

18. The proposals do not align with the expected availability of technologies and infrastructure for deep decarbonisation over this period. This includes hydrogen and CCUS deployment for industry and industrial electrification. They are also not aligned with Government policies to support deployment of these technologies and to mitigate the risk of carbon leakage, such as CBAMs and the schemes to compensate certain industries for the UK ETS's indirect emission cost and other options to reduce the risk of carbon leakage – see above.
19. The indicative roadmap to a net zero industry in the Industrial Decarbonisation Strategy is set out below:

Indicative roadmap to net zero UK industry



20. Overlaying this timetable with the timetable to increase the cap and reduce free allowances in 2023-2024 and 2026 highlights the inconsistency.

21. Based on the very-best case assumptions, cost competitive hydrogen is unlikely to be deployed at a significant scale for industry in time to avoid being put at a significant competitive disadvantage due to the reduction in the cap and free allowances. Likewise, the plans for CCUS business models are partly based on the revenue from selling free allowances but these support schemes for these business models are unlikely to be available for deployment before 2027.

22. Government has announced some further measures to reduce industrial electricity prices in the Energy Security Strategy, but a Net Zero consistent UK ETS will increase the carbon price leading to higher wholesale electricity prices, as long as gas-fired power stations set the marginal price. A higher wholesale price will increase industrial electricity prices thereby deterring industrial electrification again.

23. The consultation states that Government will look at options to shift or rebalance energy levies (such as RO and FiTs) and obligations (such as ECO) away from electricity bills over this decade, but without an understanding about how and when, these options may not mitigate the potential increase in electricity prices due to the proposals in the consultation.

24. Even if the Government manages to reduce industrial electricity prices, the infrastructure in the form of network connections may not be available in time to electrify industrial processes.

25. The EIUG and MCCG therefor strongly urge the Government to reconsider the current proposals and align them with policies in the industrial decarbonisation strategy to avoid putting industries at a further competitive disadvantage and significantly increasing the risk of carbon leakage.

2) What do you expect the effect of the cap set at the bottom of the range (i.e. total of around 887 million allowances over the entire phase) to be on your plans for emissions reductions over the 2020s?

26. Government's own analysis shows that certain industries are particularly exposed to the risk of carbon leakage. The proposed range for the net zero consistent cap is too low for much of phase I and setting the cap at the bottom of the range will likely increase the risk of carbon leakage, without any flanking measures to mitigate this risk, such as CBAMs and/or product standards.

3) What do you expect the effect of the cap set at the top of the range (i.e. total of around 936 million allowances over the entire phase) to be on your plans for emissions reductions over the 2020s?

27. The effect of the cap set out the top end would be less compared to the cap at the bottom end, it would still represent a significant reduction within the UK ETS and the impact on UK industries would therefore also still be significant, increasing the risk of carbon leakage significantly. Again, the proposed range for the net zero consistent cap is too low for much of phase I and setting the cap even at the top end of the range will likely increase the risk of carbon leakage, without any flanking measures to mitigate this risk, such as CBAMs or product standards.

4) Do you agree with the Authority's minded to position to reset the industry cap, as presented above?

28. The EIUG and MCCG do not agree with the Authority's minded to position to reset the industry cap.

29. The resetting of the cap follows up a top-down modelling approach and ignores a bottom-up approach assessing which sectors and companies are most exposed to the risk of carbon leakage. It ignores the analysis in HMT's Net Zero Review and for the Government response on the future of the schemes to compensate certain energy intensive industries for the indirect emission cost due to the UK ETS and does not apply the framework set out in BEIS Research Paper Number 2020/017 'UK Business Competitiveness and the Role of Carbon Pricing'. Application of this framework should have been a prerequisite for the consultation.

30. As stated in the research paper, the EU ETS has shown that the policy of substantial free allowances mitigated some competitiveness impacts (p.77). It has also come at a cost, but the benefit of free allowances, as stated in the research reports, is unfortunately omitted from the consultation. A selective The report is therefore not a justification for the proposal.

31. The EIUG and MCCG therefore find it concerning that the Government propose to reduce the number of free allowances for industry without a proper assessment of the risk of carbon leakage for these industries of this proposal.

5) Do you agree with the rationale put forward to support decisions the Authority will make in the future if resetting the industry cap?

32. The EIUG and MCCG do not support the rationale since the key consideration regarding what level of free allocation is required to minimise the risk of carbon leakage is missing. BEIS should apply the framework set out in its Research Paper Number 2020/017, backed by the analysis it already has for the compensation schemes and HMT's Net Zero review. The Department should therefore publish an impact assessment before making any decision on free allocation or justify why it cannot provide one.

6) Do you have a preference for a tighter or looser proportion than 37% for the industry cap?

33. Government should not reduce the cap on industry before a proper impact assessment considers the evidence for the risk of carbon leakage. The proportion of the industry cap must be determined by the level of free allocation required to mitigate the risk of carbon leakage in exposed sectors, at least until Government introduces and implements mitigation measures.

7) Do you agree with the principles set out above, by which we will propose future changes to free allocation policy?

34. The EIUG and MCCG broadly agree with the proposed principle but would like to see the following changes:

- Principle One – To ensure that the UK ETS ~~appropriately~~ **effectively** mitigates carbon leakage risk caused by the carbon price it sets, ensuring a true reduction to global emissions.
- *Principle Four – To ensure the UK ETS aligns with other policies that support industrial decarbonisation and mitigate the risk of carbon leakage.*

35. The EIUG and MCCG question whether these principles have been applied to the proposals in the consultation. For these principles to be credible, BEIS should first show that the proposals in the consultation are consistent with them.

8) Do you agree with the proposal to not use a cross-sectoral correction factor to reduce free allocations proportionally for sectors, but to find alternative means of better targeting those allowances?

36. The EIUG and MCCG agree that the cross-sectoral correction factor should not be used to reduce free allocation as it is an arbitrary method causing uncertainty the UK ETS. Instead, BEIS should use the framework set out in its research paper.

9) Are there specific elements of free allocation design with regards to eligibility, calculations, or other rules where you would like to see changes made, if you have not already flagged these via your call for evidence response?

37. The EIUG and MCCG refer to the consultation responses of its individual members.

13) Should the current rules be maintained for the 2022 Activity Level Changes process?

38. The EIUG and MCCG do not think the current rules for the 2022 Activity Level Change process should be maintained.

39. The UK ETS should allow industrial participants to demonstrate that their activity has changed without a substantial decrease in emissions. Covid-19 has impacted on production patterns and economic output and the UK ETS Authority should therefore provide businesses with the option to demonstrate changes to their activities. This would also align the UK ETS with CCA and the compensation schemes.

14) What accurate, robust and verifiable data could you provide to the Authority to evidence that the discrepancy between reductions in output and emissions was caused specifically by the COVID-19 pandemic?

40. The EIUG and MCCG recommend that the UK ETS Authority uses Climate Change Agreement (CCA) data as the CCA team accounted for the impact of Covid-19 for its target period 4 reporting. BEIS can ask for similar information directly from those companies that do not have CCAs because of the min-met exemption.

41. We understand that this information cannot be readily shared between teams in BEIS and therefore suggest that BEIS comes back to the MCCG to agree a framework that would allow the UK ETS team to access the relevant CCA data.

15) How should the determination of “significant discrepancies between reductions in output and emissions” be made? Which data should be used in making this determination?

42. See reply to question 14.

17) If the 2020 year is omitted, which years should be taken into account in the calculation of Activity Level Changes in 2022? Please explain your answer.

43. 2019 and 2021 as these are the most recent years with operations close to the average.

29) Do you agree that, should the industry cap be reset to a level that would fall below free allocation in 2024 and 2025, a portion of unallocated allowances and/or flexible share should be used, as currently legislated, to mitigate against the application of a cross-sectoral correction factor?

44. The EIUG and MCCG believe that the industry cap should not be reset to a level below free allocation in 2024 and 2025 – see previous replies. However, if the Government goes ahead with the proposal regardless, we agree that a portion of unallocated allowances and flexible share should be used to mitigate against the application of the cross-sectoral correction factor.

30) Do you agree that a portion of unallocated allowances and/or flexible share should be auctioned to smooth the transition to the net zero cap?

45. The EIUG and MCCG do not agree with the proposed range for the net zero consistent cap. If the proposed cap had been set at a level consistent with the Industrial Decarbonisation Strategy and the CCC advice, then there would be no need to use a portion of unallocated allowances.

46. However, if the Government insists on its trajectory, then the EIUG and MCCG agree with the proposals as a sharp reduction in free allocation in 2024 would significantly increase the risk of carbon leakage.

31) Do you agree we should consider auctioning a portion of unallocated allowances and/or flexible share before 2024 to support market liquidity?

47. The EIUG and MCCG agree with the proposal as long as it does not go at the expense of a UK ETS authority's ability to intervene to stabilise the market in another way than the CCM.

32) Do you agree that a portion of unallocated allowances and/or flexible share should be retained for market stability purposes?

48. See reply to question 31 above.

33) Are there features of ETS markets that put them at greater risk of market abuse than other financial markets?

49. There are different aims of participants within ETS markets which can cause problems: investors and speculators buy allowances to make profit, while fossil-fuel power generators and industrial participants buy allowances to comply with the regulations. Currently, it appears investors and speculators have bought up so many allowances that other scheme participants are struggling to find affordable allowances for compliance. There is very little secondary market as such allowances are bought at auction making the UK ETS more of a tax than a trading system. The reductions proposed to the cap could make this situation worse.

50. Additionally, the UK ETS is much smaller - and therefore more illiquid – than the EU ETS. This amplifies any negative effect of market abuse.

36) Do you agree that these are the right objectives for markets policy as the UK ETS matures?

51. The EIUG and MCCG agree that they are the right objectives. However, these objectives need to translate into credible action in the market. Triggering of the CCM in December 2021 and January 2022 led to a discussion in the UK ETS Authority but no action. As a result, UKAs continue to be at a cost premium to the EU ETS putting industrial UK ETS participants at a competitive disadvantage which is damaging the competitiveness of UK industry.

37) On what timescale should we look to withdraw the ARP: as soon as possible; as part of the introduction of a potential wider markets policies package; alongside the introduction of the net zero consistent cap; or another timescale? If another timescale, what timescale? Why that timescale?

52. The EIUG and MCCG believe that Government can withdraw the action reserve price as soon as possible. The UKA price run well above the reserve price, and it is unlikely to come down close to the level of the ARP.

38) Should the ARP be replaced by another mechanism? If so, what type of mechanism should replace it and why?

53. The EIUG and MCCG do not think the ARP should be replaced by another mechanism as there is no longer a need for a price floor of any kind.

39) Do the thresholds for triggering the CCM remain fit for purpose?

54. No, at the current carbon price levels, the threshold is becoming less sensitive. Unless there is a sudden substantial increase it highly unlikely that threshold will be reached again to trigger the CCM.

55. The EIUG and MCCG suggesting replacing the current threshold with a mechanism that tracks the European carbon price. If the UK ETS carbon price exceeds the European carbon price by a certain percentage, it should trigger the release of certain allowances to reduce the carbon price disparity.

40) Do the intervention options available to the Authority remain fit for purpose?

56. The options to intervene remain fit for purpose and should have been used when the CCM was triggered. The discretion the UK ETS Authority used in its decision not to intervene after the CCM was triggered in December 2021 and January 2022 has undermined the credibility of the mechanism and it is therefore no longer fit for purpose.

41) Following the triggering of the CCM in December and January, are there elements of the CCM process or design that could be improved?

57. Government should remove the discretion of the UK ETS Authority whether to intervene or not and make intervention automatic, based on clear and transparent rules similar to the process to set the annual level of the Renewable Obligation, when the CCM is triggered based on the response to question 39 above.

58. The UK ETS Authority failed in its objective to increase the climate ambition of the UK's carbon pricing policy, while protecting the competitiveness of UK businesses when it decided not to act following triggering of the CCM. Its belief that the significant increase in the price of UK allowances over the past year is due to fundamental market conditions is nonsense and its decision not to intervene was therefore the wrong course of action. It has undermined the functioning of the CCM to the extent that is no longer credible.

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