Department for Energy Security & Net Zero

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Sir William Cash MP
European Scrutiny Committee
House of Commons
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Dear Bill,

The Department for Energy Security and Net Zero had a number of exchanges with your committee over the past 18 months regarding the emerging EU ETS (Emission Trading System) and EU CBAM (Carbon Border Adjustment Mechanism) proposals. Given the provisional agreement reached in December 2022 by the EU Parliament and EU Council of Ministers on both of these subjects, I thought now would be an appropriate juncture at which to provide the European Scrutiny Committee an update, and initial reflections on the implications of these agreements for the UK.

European Emissions Trading System (EU ETS)
We welcome the level of ambition that the EU's provisional agreement on EU ETS reform represents, and the EU's ongoing commitment to the EU ETS as a cornerstone of its policy to combat climate change. Such ambition is particularly welcome as the UK Government progresses with its own ambitious *Developing the UK ETS* ("Develop") policy proposals, and actively seeks to encourage the uptake of carbon pricing globally.

There are a number of shared themes between the EU ETS reform package and the Develop proposals: tightening the overall cap on carbon emissions, expanding the scope of the schemes, and considering how to improve our respective approaches to managing carbon leakage. We continue to monitor the finalisation and roll-out of the EU ETS reform measures, and seek to learn from the EU experience as we build on and improve our own scheme with our UK ETS Authority partners (HMT, DfT, the Scottish and Welsh Governments, and the Northern Ireland Executive). A formal Government Response on the Developing the UK ETS consultation will be published by the UK ETS Authority in due course.

Given that the finalised text has not yet been published by the Commission, and that Council ratification is pending, the EU ETS reform agreement is subject to ongoing assessment. The following headlines are of interest to the UK, however:

a) **EU ETS cap and ambition**: The provisional agreement sets a 2030 target of a 62% reduction in greenhouse gas emissions within the EU ETS, against a 2005 emissions baseline. This target is supported by an increase in the annual rate at which the cap is tightened from 2.2% to 4.3% from 2024-27, and 4.4% from 2028-30. The cap will be rebased on two occasions, with an additional 90m allowances removed in 2024, and a further 27m in 2026.

We will continue to assess both direct and indirect impacts of the tightened EU ETS cap on the UK, including any increase in costs for the power generation sector in Northern Ireland, which remains subject to the EU ETS, under the terms of Article 9 and Annex 4 of the Windsor Framework.

b) **Scope**: The agreed text commits the EU to expanding the EU ETS to include both the domestic and international maritime sectors, and the creation of a separate but parallel "ETS2" aimed at complementing the EU ETS by broadening carbon pricing coverage to include both buildings and road transport. This is to come into effect in 2027, or 2028 if energy prices remain "exceptionally high" (i.e. more than €106/MWh for gas and oil). The agreement also commits the Commission to undertake an impact and feasibility assessment, by end of 2026, on inclusion of installations for the incineration of municipal waste incineration from 2028.

The expansion to the maritime sector (including coverage of 50% of emissions from extra-EU voyages by large vessels) has the most direct implication for the UK, given the cross-border nature of the international shipping sector, and the UK's parallel proposal to expand the UK ETS to cover the domestic maritime sector in the UK. The impacts of different obligations for international operators will be monitored and assessed as the industry adjusts to the new regulatory regime.

c) **Market Stability Reserve**: The EU's Market Stability Reserve (MSR) has largely remained unaltered by the new reform package, with the annual intake rate maintained at 24% until 2030. However, the MSR is now limited to a maximum of 400m EUAs, with any surplus being permanently cancelled. There is not expected to be a direct, tangible impact on UK businesses from this tightening of the MSR regime, although the move should be broadly welcomed, as it can be expected to help prevent a re-run of the structural oversupply of allowances that suppressed EU ETS prices between 2012 and 2018.

A commitment was made in the Trade and Cooperation Agreement for the UK and EU to cooperate on carbon pricing, and to seriously consider linking our respective systems. Noting our shared levels of climate ambition, and the comparable policy development pathways adopted so far by the EU and UK, we remain open to the possibility of linking the UK ETS to the EU ETS. No decision on linking has been made, but we are determined to continue to promote carbon pricing globally.

Comparison of international carbon prices

Through discussion with your committee clerk, we understand you are interested in the relative carbon prices of not only the UK and EU ETS's, but also of other international carbon pricing schemes, and the potential impact of such relative differences on international competitiveness.

Over 2022, UK allowances traded on average at a 12% premium to EU allowances. Since late November 2022 however, EU end-year settlement prices have been higher than the UK equivalents – with the EU benchmark trading on Thursday 2nd February at €95.52/t (~£84.63/t[1]), compared to £79.62/t for the UK benchmark.

Both the UK and EU ETS's trade at a significant premium compared to other obligated carbon trading schemes internationally (with the exception of the Swiss ETS, which is linked to the EU ETS). The New Zealand ETS (launched in 2008) is currently trading at around €50/t, with obligated trading schemes at or below €30/t. It should be noted that there are a range of other carbon pricing mechanisms internationally (including carbon taxes) that are set at comparable, or significantly higher, levels than that currently seen in the UK ETS.

[1] Bank of England exchange rate 1st Feb 2023: £1 = €1.1287

The main objective of the UK ETS is of course to drive decarbonisation in the most cost-effective way possible, and so the mitigation of carbon leakage risk is a key design feature. The UK ETS Authority has committed to reviewing the UK's approach to free allocations as the scheme evolves, and this review is currently underway. In parallel, the UK Government is exploring a range of policies to mitigate against carbon leakage and level the playing field for UK business, including the potential for a carbon border adjustment mechanism, and minimum emissions performance standards for imported products.

European Union Carbon Border Adjustment Mechanism (EU CBAM)
The UK and EU share concerns about carbon leakage and we recognise the need to strengthen carbon leakage mitigation measures as part of the drive towards decarbonisation. The UK Government considers that an open and collaborative international approach is the most effective way to address carbon leakage risk, including through the inclusive Climate Club initiated by the G7 in December 2022.

The UK has ambitious carbon pricing through the UK ETS and Carbon Price Support mechanism. The EU CBAM will require businesses which export to the EU from other jurisdictions to comply to reporting requirements on products which fall under the EU CBAM scope. Administration requirements will vary depending on the decarbonisation policies applicable in the exporting countries. It will also depend on the reporting values that businesses apply to calculate their emissions data. Businesses may apply 'default values', which will require administrative reporting but no new emission data collection, or 'actual emissions data' that will result in administrative reporting and emissions data collection. We are engaging industry stakeholders to assess the impact of these requirements on UK exports. We are also conducting analysis on the risk of diverted products to the UK market following the introduction of the EU CBAM.

UK officials continue to monitor the detail of the EU CBAM, as its design and secondary EU legislation develops following the end of trialogues in December 2022. The EU co-legislators are currently finalising the legal text before its formal adoption, expected in Spring 2023. From now until the end of the transition period in January 2026, the EU will review the EU CBAM's 12 implementing acts and 4 delegated acts. The UK government has been appointed an observer of the EU's informal expert group on the analytical methods for the monitoring, reporting, quantification and verification of embedded emissions in goods under the scope of the CBAM, which will address outstanding technical questions.

The Government is currently exploring a package of potential measures to mitigate carbon leakage risk at all stages of the UK's net zero transition, providing industry with a strong signal that they can invest in decarbonisation in the UK without fear that their environmental efforts will be undermined. We are seeking views and evidence across stakeholders on the best possible mix of policies to manage carbon leakage risk. Measures need to be fair, transparent and contribute to a global green economic transition to net zero. We will consider the responses alongside the recent consultation on "Developing the UK ETS". This will inform the ongoing review of the UK's ETS free allocation policy, to ensure that we better target support for those most at risk of carbon leakage after 2026, as well as informing next steps on carbon leakage mitigations.

With respect to updates about Northern Ireland, confidentiality rules surrounding the Joint Consultative Working Group mean that we are unable to comment on specific conversations with the Commission. However, we would like to highlight that under the following explanatory memorandum written by the Department for Energy Security and Net Zero, we are expecting the EU to notify the UK through the Joint Committee once the CBAM regulation has been adopted, in accordance with the process set out in Article 13(4) of the Framework. After that, the Joint Committee will hold an exchange of views on the implications of the regulation for proper functioning of the Framework.

Yours ever,

THE RT HON GRAHAM STUART MP
Minister of State for Energy Security and Net Zero