UK Emissions Trading Group Ltd (ETG) – Written Evidence (DYN0043)

(ETG) response – Dynamic Alignment Call for Evidence

House of Lords European Affairs Committee -– Call for Evidence on UK/EU Dynamic Alignment

UK Emissions Trading Group (ETG) written evidence on impact of dynamic alignment on Linking of UK Emissions Trading Scheme (UKETS) and EU Emissions Trading Scheme (EU ETS)

The UK Emissions Trading Group (ETG) represents a significant proportion of UK businesses covered by the UK Emissions Trading Scheme. The ETG provides a forum for discussing and resolving issues relating to emissions trading and associated policies, supporting regular dialogue between industry, the UK Government, the Devolved Administrations, and regulators.

Last autumn, the ETG commissioned the consultants Baringa to undertake a review of members' views on the potential impacts of UK/EU ETS linking, including the implications of dynamic alignment. This submission reflects the overarching findings of that work in relation to dynamic alignment.

<u>Linking the UK ETS and the EU ETS: Opportunities and Challenges of Dynamic Alignment</u>

The current interpretation of the Common Understanding agreed at the UK/EU summit in May 2025 suggests that, as part of a future linking agreement between the UK Emissions Trading Scheme (UK ETS) and EU Emissions Trading Schemes (EU ETS), the UK would be required to align its ETS regulations with future changes to the EU ETS. The UK and EU will need to agree a basis for how existing areas of divergence would be treated and what areas the UK will align with future design changes to the EU ETS.

Paragraph 40 of the Common Understanding states that the ETS linking agreement should be based on "dynamic alignment" with relevant EU rules. It is generally understood that dynamic alignment would require the UK to update its ETS regulations in line with subsequent EU ETS reforms, following an initial negotiation to determine which areas fall within scope. However, it remains unclear how much flexibility the EU would allow for UK-specific divergence within those areas, and therefore how far dynamic alignment would require the UK to cede regulatory autonomy. Across sectors represented by the ETG, there is a strong call for the Government to provide clarity on this point, particularly regarding the UK's future influence over EU regulatory updates.

Dynamic alignment, combined with the need for fully fungible allowances and price alignment of allowances appears likely to require alignment across major policy areas such as benchmarks, carbon leakage lists, future Carbon Boarder Adjustment Mechanism (CBAM) design, and cost compensation schemes.

There is particular concern regarding benchmarks, which determine free allocation of allowances to installations based on the performance of the top 10% most efficient plants. Benchmarks are central to carbon leakage protection and are updated periodically (EU ETS Phase 4: 2021-2025 and 2026-2030). Some sectors have expressed a preference for the retention of UK-specific benchmarks or alternatively that UK data should be included in revised EU benchmarks. Sectors have also expressed concern in areas where adopting EU metrics and measures would be expected to place their sector at a disadvantage by replacing existing UK-specific policies.

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With the forthcoming EU benchmark period covering 2026-2030, it is now too late for UK installations to be included in the current benchmark-setting process. As a result, the top-10% performance threshold that determines benchmarks reflects only EU installations, rather than the combined performance of EU and UK operators. It also appears unlikely that these benchmarks could be reopened before 2030 to align with any prospective ETS linking timetable. If UK installations are assessed against EU benchmarks in which they had no role in development, and which exclude UK performance data, there is a clear risk of structural disadvantage - particularly in sectors where UK plant configurations differ materially from the EU average. Any linking agreement should therefore provide for the inclusion of UK data in EU benchmark calculations.

There is also strong support for the UK retaining control over the introduction and calibration of any revised Cross-Sector Correction Factor (CSCF), which adjusts free allocation where the overall industrial cap is exceeded. Maintaining domestic oversight of this mechanism would be important to ensure that free allocation continues to reflect UK industrial circumstances fairly.

There are also areas where the UK has introduced measures that do not exist in the EU framework, such as the option to exclude COVID-affected scheme years (2020/2021) from Historic Activity Level calculations for free allocation. Such justified provisions should be preserved and not abandoned.

Designing a Practical and Fair Approach to Alignment

ETG generally favour an approach whereby the scope of dynamic alignment is negotiated on a case -by-case basis, recognising the need for an independent arbitrator. However, clarity is needed on the dispute resolution mechanism, particularly any role for the European Court of Justice in the UK.

The EU/EEA model, under which Norway, Liechtenstein, and Iceland maintain alignment through the "Text with EEA relevance" process, provides one precedent, although this model involves extensive mirroring of EU legislation. By contrast, Switzerland uses a static alignment approach requiring negotiated agreement before adopting changes - yet resulted in negotiations lasting nearly a decade. How either approach, or a different approach, might apply in the UK context remains uncertain.

Some sectors have raised concerns regarding Clause 44 of the Common Understanding, which states that although the UK would be consulted "at an early stage of policy-making", these rights "would not extend to participation in the work of the Council or its preparatory bodies". This has been widely interpreted as implying that, in areas subject to dynamic alignment, the UK would in effect become a rule taker. It remains unclear how the UK would influence future EU ETS rulemaking in a meaningful way, and how its national perspectives would be taken into account.

Carbon Border Adjustment Mechanisms (CBAM): Alignment, Mutual Recognition and Competitiveness

Separately, the ETG wishes to underline its concerns regarding the implications of alignment of the UK and EU Carbon Border Adjustment Mechanisms. While CBAM is closely linked to the operation of emissions trading systems and carbon leakage protection, it raises distinct issues of trade exposure, competitiveness and administrative burden that merit explicit consideration within any future ETS linking framework.

At present, there remains insufficient recognition within government that the two regimes may diverge materially in both design and application, which could ultimately prevent mutual recognition between the UK and EU CBAMs. Mutual exemption is imperative for trade-exposed and energy intensive sectors, which rely on a level playing field to avoid carbon leakage and competitive distortion. At present, sectors subject to the forthcoming UK CBAM do not yet have sufficient confidence in the strength, scope, and effectiveness of the UK mechanism relative to the EU CBAM and fear it will provide inadequate protection. It is therefore essential that these potential divergences are explicitly acknowledged and addressed within wider discussions on carbon policy alignment.

Scope of the UK ETS and Future Extensions

On scheme scope, there is broad support for continuing to extend the UK ETS into new sectors over time in a manner broadly aligned with EU developments. It is already agreed, that the UK will not seek to participate in ETS2, the EU's separate system covering buildings and road transport fuels.

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