

UK Opens Consultation on Policy Responses to Carbon Leakage

April 3, 2023

On 30 March 2023, the United Kingdom Department for Energy Security and Net Zero (DESNEZ) and the UK Treasury opened a public consultation on policies to reduce carbon leakage risk and support decarbonisation, especially in light of the existing UK emissions trading system (ETS).¹ The consultation is open to all interested parties, both in the UK and internationally. This includes companies and representatives from industry, as well as international partners (including foreign governments) and multinational groups. **Submissions are due by 22 June 2023.**

Through this consultation, the UK is joining the growing number of countries considering and adopting specific trade and trade-related measures to address carbon leakage and “level the playing field” for domestic businesses, especially those involved in carbon heavy industries. The UK left the European Union’s Emissions Trading Scheme (EU ETS) and replaced it with its own ETS on 1 January 2021, which replicates the EU ETS. The EU is in the process of implementing a carbon border adjustment mechanism (CBAM), which is intended to equalize the carbon price for EU products under the EU ETS and imported products. The UK’s decision to explore a CBAM to curtail carbon leakage resulting from the UK ETS is therefore not unexpected.

According to the World Trade Organization (WTO), there are currently 70 different carbon pricing schemes, including CBAMs, imposed worldwide. The EU has been at the forefront of developing and imposing such measures, and many countries are now considering and imposing carbon pricing measures of their own in response to the EU’s implementation of a CBAM. In light of this proliferation of carbon pricing measures, the WTO Director General (DG) has warned of fragmentation, suggesting that coordination regarding such measures is critical. The WTO’s efforts follow from the DG’s drive to show international trade as a part of the solution to environmental issues.

The consultation announced by the UK will inform the UK government’s final decision regarding which measures, if any, to take forward for energy intensive, trade sensitive sectors at risk of carbon leakage. It has indicated that it will consider policies for mitigating the carbon leakage risk in the following sectors:

Authors

Alan Yanovich
Partner
ayanovich@akingump.com
Geneva
+41 22.888.2034

Kenneth J. Markowitz
Partner
kmarkowitz@akingump.com
Washington, D.C.
+1 202.887.4513

Alex Harrison
Partner
alex.harrison@akingump.com
London
+44 20.7661.5532

Sarah Sprinkle
Counsel
ssprinkle@akingump.com
Washington, D.C.
+1 202.887.4087

Jan Walter
Senior Policy Advisor
jwalter@akingump.com
Geneva
+41 22.888.2042

Hannes Sigurgeirsson
Associate
hsigurgeirsson@akingump.com
Geneva
+41 22.888.2053

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

These products are in sectors that are already currently subject to the UK ETS (as well as the EU ETS). The consultation document notes that, given that CBAMs are complex, these types of measures may not be suitable for products in all sectors subject to the UK ETS and at risk of carbon leakage. The government therefore asks in the consultation for views on whether CBAM should apply to these sectors. The consultation announcement further notes that, if the profile of sectors at risk of carbon leakage changes, the sectoral scope of policy measures may also change.

The consultation covers the following potential policy measures to curtail carbon leakage from the mid-2020s onwards:

1. A CBAM.
2. Mandatory product standards (MPS).
3. Demand side policies to grow the market for low carbon products.
4. An embodied emissions reporting system.

The CBAM would introduce a carbon price in the form of a border charge on imported products. The government clarifies that this price would reflect both carbon emitted in production, as well as any gap between the carbon price applied in the country of origin and the carbon price that would have been incurred had the product been produced in the UK and subject to the UK ETS. In short, the consultation document provides that liability under the UK CBAM would be calculated using the following formula:

Imported Emissions x (Effective UK Carbon Price - Effective Price Already Incurred)

According to the consultation document, the government is considering a CBAM based on the embodied emissions in a specific imported product, as the government considers this to be the most effective method to mitigate carbon leakage risk. The consultation is intended to illuminate which types of emissions associated with a product down the supply chain should be included in a measurement of its embodied emissions.

With respect to CBAM, the government invites responses to the following questions:

- *Sectoral targeting*: Identifying the sectors and products to which a UK CBAM should apply. Among other topics, the government is seeking comments on whether CBAM should apply only to those sectors already subject to the UK ETS, as well as whether there are products already covered by the UK ETS where application of CBAM would not be effective or feasible.
- *Emissions measurement*: Determining how emissions should be measured as part of a UK CBAM. The government is seeking feedback regarding which emissions embodied in products produced outside of the UK would be relevant for a UK CBAM, how data on those emissions should be collected and assessed, and who should be responsible for providing this information.
- *Emissions scope*: Identifying what emissions should be in scope of a UK CBAM. Emissions embodied in imported products come from different sources, parts of the supply chain, and production processes. The consultation seeks views on three separate categories of emissions scopes: Scope 1 emissions, relating to direct activities owned or controlled by an organisation; Scope 2 emissions, relating to an organisation's consumption of

purchased electricity, heat, steam and cooling; and Scope 3 emissions, relating to other emissions released as a consequence of an organisation's actions that occur at sources not owned or controlled by the organisation.

- *Price measurement*: Deciding how a UK CBAM price should be calculated. The government's inquiry here is whether the price applied by CBAM should be comparable to the effective domestic carbon price paid, including accounting for any discounts available through free allowances or compensation.
- *Implementation*: Determining how and when businesses should be required to comply with a UK CBAM. The government seeks views on how a CBAM could be designed to ensure maximum simplicity, e.g. by following the mechanism for other border charges such as tariffs and excise duties.
- *Timing*: Understanding when a UK CBAM should be introduced. The government has not yet confirmed a timeline for introducing policy measures to mitigate carbon leakage risk in the future. It therefore requests feedback regarding policy interactions that the government should consider regarding potential implementation timelines for a CBAM.

The government also invites stakeholders to consider the impact of a potential UK CBAM in the context of the proposed EU CBAM and the potential for parallel impacts on UK trading partners.

The MPS would set an upper limit on embodied emissions intensity for individual products and would prohibit the sale or production of products that are more emissions intensive than that defined limit. According to the consultation, the MPS could apply to both domestically produced and imported products.

The government is seeking views on the following issues concerning the MPS:

- The relevant industrial sectors to which such standards should apply. The government is looking to determine which sectors should be covered by such a measure, including balancing factors such as a sector's exposure to carbon leakage risk, climate ambitions, the ease of deliverability of standards for a particular sector and other actions being taken internationally.
- The stage in the manufacturing value chain at which to apply such standards. The government is seeking to explore different options and to identify the optimal part of the manufacturing chain to which it should apply an MPS. The consultation document acknowledges that this point may vary between sectors.
- The emissions scope. The government is requesting views regarding the scope of emissions to which it would apply the MPS. It is considering the same three scope options as might be applicable to a CBAM, as described above.
- The timing for the most effective implementation of such standards. Specifically, the government asks in the consultations for views regarding whether MPS should be delivered in stages, broadly moving from a less stringent, relatively focused application in the late 2020s to a more stringent and potentially broader application during the 2030s.
- The geographic coverage of standards. The government asks for views on whether an MPS should apply to imports.
- How to set emissions thresholds for standards. Finally, the government requests views on how it should set emissions standards, including on whether and how to increase the stringency of any MPS over time. It is looking for views on specific guiding principles for how any MPS thresholds could be set and how the stringency of these standards could be increased over time.

The government notes that a theoretical advantage of MPS is that it is not dependent on a carbon pricing mechanism. Thus, it could be implemented for imports from countries that do not have a national price on carbon.

The consultation also seeks to address the potential impact of the CBAM and the MPS on the competitiveness of UK exports; it poses questions on the carbon leakage risks for UK exporters and approaches to mitigate these risks.

Additional demand side policies would aim to grow the market for low carbon products. The government suggests that potential measures in this category could include voluntary product standards, product labelling, updating public procurement guidelines to prioritise low carbon products, and encouraging private procurers to prioritise low carbon products. In this context, the government is seeking input regarding the following:

- Labelling and voluntary product standards. The consultation document notes that policies such as product labelling and voluntary standards could enable consumers to identify lower carbon products, including imports, from higher carbon equivalents. The government asks for options on developing such a labelling systems.
- Public procurement and the UN Industrial Deep Decarbonisation Initiative (IDDI). As noted in the consultation document, the government is a major buyer of industrial products which allows it to directly increase demand for lower carbon products through its procurement specifications and use of such products. The government asks which level of IDDI pledge would best support the decarbonisation of UK industry.
- Private Procurement and the First Movers Coalition. The consultation document notes that private companies can use their own procurement strategies to provide strong market signals and indicate demand for low carbon production methods. The government asks what it can do to support firms and encourage them to join the First Movers Coalition.

Finally, an embodied emissions reporting system would support the implementation of carbon leakage mitigation policies. The government is seeking views on a possible emissions reporting framework, including options for the design of an embodied emissions reporting system and the use of default values. It further seeks views on options for the specific methodology that could be used for calculating reported emissions and the design and delivery of the reporting system.

According to the consultation document, the proposed measures could be deployed individually or in combination as part of a broader policy framework to reduce carbon leakage and meet UK decarbonisation objectives. The consultation seeks views on what measure or combination of measures would be right for different sectors.

The consultation document asserts that it is the UK's intention to implement measures in a manner that is consistent with the government's commitment to free and open trade, upholding WTO rules as well as respecting international climate change obligations taking into consideration countries' differing levels of development. However, the document recognizes that international solutions will take time to develop and that divergent approaches to decarbonisation, where trade partners rely on regulatory or incentive-based approaches rather than carbon pricing mechanisms, raise questions about whether and how non-pricing measures can be compared to explicit pricing measures. Different approaches to standard setting also create challenges. In this regard, the document specifically invites other governments to engage in the consultations and poses the following two "important international questions":

- First, how can international partners reach agreement on methodological issues? International coordination and ultimately agreement on a methodology, default values and verification, as well as mandatory products standards would smooth the application of such measures, streamline processes for businesses and underpin efforts towards more ambitious multilateral agreements on carbon pricing and carbon leakage.
- Second, how can decarbonisation and carbon leakage policy best take into consideration countries' differing levels of development, particularly for least developed and low-income countries?

Responses to the consultation can be provided through an online form or via email. Submitted responses will be shared across the government unless a respondent specifies that the information included in the response is private. Please do not hesitate to let us know if you have questions or are considering making a submission. The DESNEZ must receive **responses to the consultation by 22 June 2023**.

¹ Carbon leakage refers to the trend of companies leaving jurisdictions with stringent carbon regulations, including carbon pricing, for less regulated jurisdictions. This practice is particularly common in heavy industrial, carbon intensive industries such as iron, steel, cement, chemicals and others.