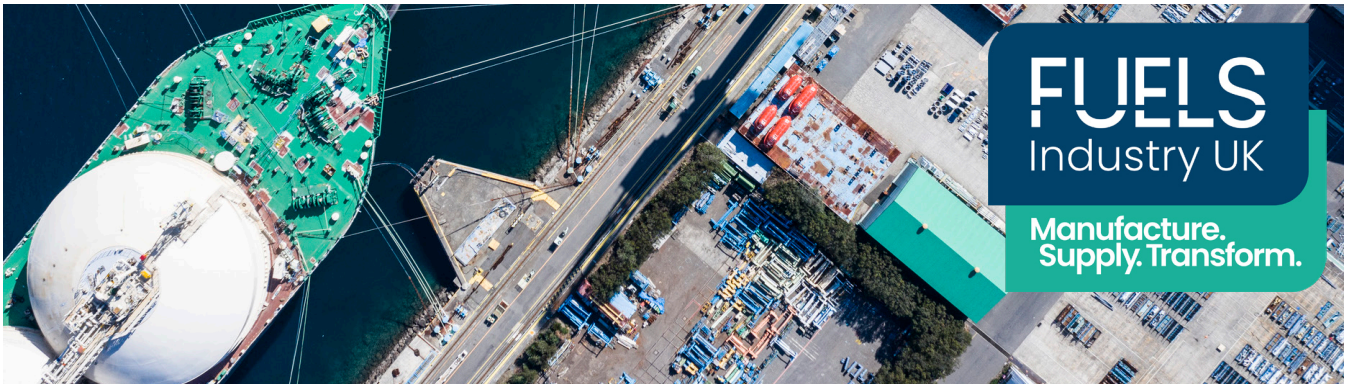


POSITION PAPER:
CARBON LEAKAGE

Problem Statement

Implementation of the UK ETS means that UK refineries incur almost £400m costs per year on their carbon emissions which many overseas refineries, for example in the US, the Middle East and India, do not have to pay. The result is that these overseas refineries can out-compete UK refineries over the long run in both UK domestic and overseas export markets. So over time, UK refineries will close down – costing jobs, increasing emissions and weakening fuel security. At the same time, imported fuels from elsewhere will create at least as much emissions as the refineries that have closed.

Current Situation

a) Free allocations

UK refineries receive a free allocation of allowances which on an aggregate basis covers around 60% of their emissions. This is lower than other UK industrial sectors judged at lower risk of carbon leakage. Furthermore, there is an expectation that free allocation levels will come down and that the free allocation trajectory may be changed at short notice. The government's current UK ETS review work is to update their analysis on the carbon leakage list (Carbon Leakage Index, CLI) and produce new proposals for free allowance allocation.

b) Cross Border Adjustment Mechanism (CBAM)

The UK refining sector is outside of the scope of the CBAM proposals published in November 2023. This is despite being judged by DESNZ as the sector most at risk of carbon leakage, in other words more at risk than cement and steel and glass, which are both included in the latest government CBAM proposals. By way of comparison, the EU is currently operating a transition period to test the systems and reporting processes before the EU CBAM goes live on 1st January 2026.

The UK CBAM start date has been proposed as 1st January 2027. In the view of the membership, Government needs to address the risk of Carbon Leakage, which takes place through the closure of refineries and the offshoring of fuels manufacture, in a joined-up way through (a) fair allocation of free allowances and in the future; (b) the implementation of a well-designed CBAM.

The government needs to make an additional allocation of 60%-80% of free allowances available for the UK refining sector, until there is a border adjustment in place for imports and exports of refined products. An effective border adjustment will put an equivalent cost on

Asks

1. More Free Allowances for UK refineries, at least until a CBAM exists
2. Implement a well-designed CBAM for refined products
3. Coordinate these two policy measures in a timely way ensures essential investment decisions can be made.

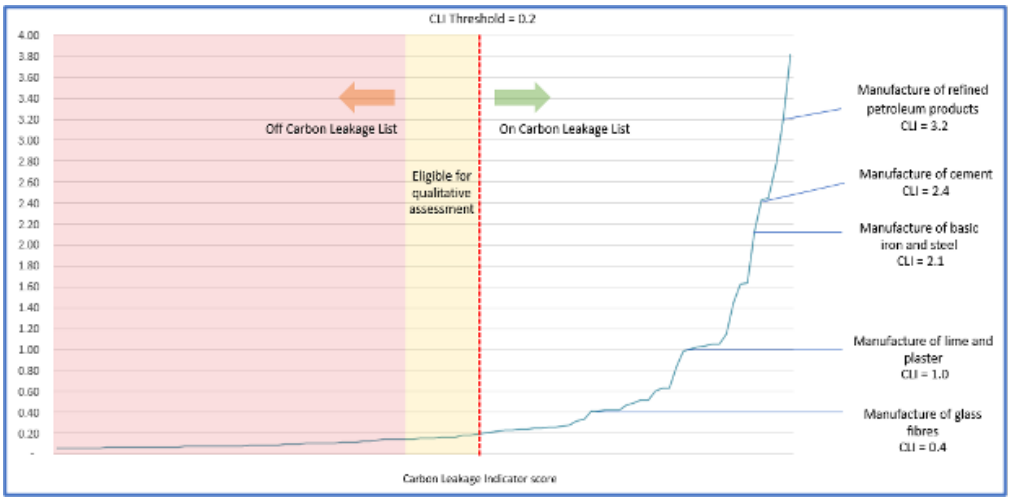
embedded carbon for imports compared to domestically refined products. It will also provide relief for the cost of embedded carbon in UK-manufactured refined products when they are exported to regions with a lower, or no, cost of embedded carbon. And it will do this in a pragmatic way, so administrative costs are reasonable, and in such a way that the risk of circumvention is very low or avoided entirely. As the border adjustment is phased in, the free allocations can be phased out, such that UK refineries can compete in both domestic and overseas markets without disadvantage.

Opportunities and risks

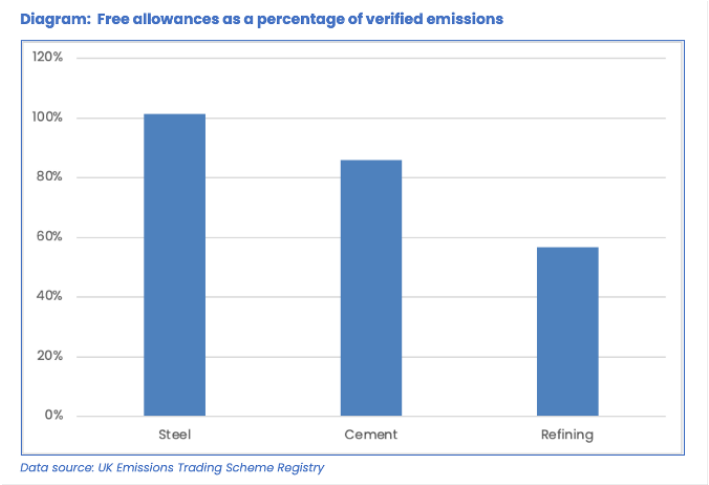
Opportunities: If Government adopts a robust position that responds in a timely way to the asks that we spell out above, then carbon leakage will be prevented, and UK refineries have a better chance of attracting the investment necessary to decarbonise by re-engineering process units (CCS, H2, improved efficiencies) and/or deploying new technologies.

Risks: if Government fails to act and continues to reduce available free allocations with no prospect of a border adjustment mechanism in sight, then refineries in the UK close down as the UK economy moves towards a fuel importing economy, with implications for energy security. Furthermore, refineries overseas continue to emit CO2 that UK refineries once did, potentially with a greater environmental impact than was the case when refineries were in the UK.

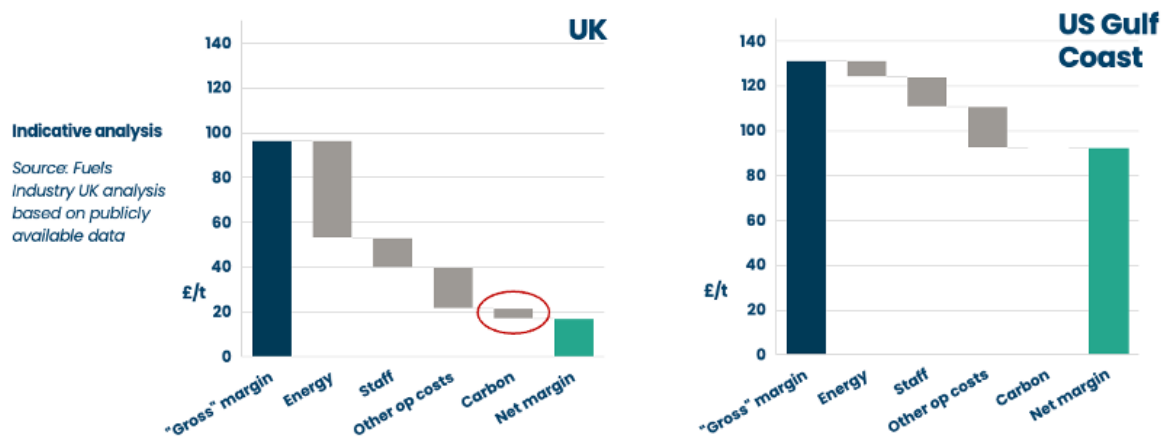
Key evidence



Carbon leakage risk for the UK refining sector based on carbon leakage indicator score; source Analytical Annex to the Free Allocation Review, December 2023



Free allowance comparison: showing that refineries have low %



Comparative costs demonstrating need for a CBAM

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