Fuels Industry UK response to UK ETS Free Allocation Review Carbon Leakage consultation (link)

Consultation Questions

Question 1. Do you agree with the data sets used to calculate emissions intensity and trade intensity? If you do not, please explain why and suggest alternative data sets.

No.

We are disappointed with the quality of the analytical annex and the statements made on the back of the analytical annex and NERA report. Furthermore, there seems to have been no serious attempt to compare and explain the underlying drivers of the quite large variance in the previous EU-based Carbon Leakage Index (CLI), and those proposed in the NERA report.

We note that the CLI of Cement and Edible fats have increased tenfold and one hundredfold respectively, and we submit that this begs an explanation as it otherwise calls the entire data set into question.

We would observe that, on the whole; high volume, commoditised markets such as the refined products market, tend to be led by international market pricing which prevent local suppliers passing local additional costs to consumers. This squeezes local supplier margins. Differentiated products on the other hand are better able to pass local additional costs on.

This means that, if all else remains equal, commoditized markets like refined products are more at risk of carbon leakage than many other sectors with a higher CLI according to the NERA report.

Specifically with respect to refined products

For the case of refining, the filter for sector information (NACE code, to two-digit level 19.20) and for product information (CN code, to four-digit level 2710) are too broad, with result that many non-refinery businesses and non-refined products are included in the calculation. This is so significant that there are at least 15 non-refining / non-ETS paying businesses included for every refinery included in the data, significantly increasing turnover and GVA values used in the CLI calculation. We would recommend that the trade and GVA data used is limited to just those companies that are in scope of the ETS.

The choice of baseline years is not representative of standard trading years, specifically in 2020 and 2021 the impacts of Covid hit demand and price of crude and refined products in an unprecedented way, leading to lower refining margins, lower imports, lower exports and much reduced GVA. The reason this is important is that trade intensity calculation is strongly influenced by the quantity and value of imports and exports and the GVA of the sector. Furthermore, when GVA goes negative the output of the formula for Trade Intensity does not seem valid.

We propose a method that uses company-based sector information from just the six refineries, product information that is confined by 8-digit CN code to refinery products, and which uses 2019, 2022 and 2023 as the most appropriate baseline years (excluding the Covid outlier years of 2020 and 2021).

Fuels Industry UK assess CLI to be over 5 compared to NERA report value of 2.35

With respect to Hydrogen

We note that the manufacture of industrial gases (20.11) – which includes hydrogen – drops by an order of magnitude from 1.02 in EU to 0.11 in UK.

Our observation would be that the Industrial Gases industry code is very broad, encompassing many high-volume gases such as Nitrogen, Oxygen, Argon and Carbon Dioxide for drinks/food industries. Hydrogen gas plays a very small part in the overall CLI of this group and is not appropriately assessed within it.

This may be another example of why there is a data problem using SIC codes when only part of the industries covered by SIC codes will fall into CBAM, as if the data is not granular enough. The corollary is if you tried to do this for H2 alone, the TI metric would be about 0 as the import/export flow of H2 is basically zero. Similarly, the ability to assign a GVA to just hydrogen would be difficult.

This is a concern for any hydrogen produced outside the refinery benchmark because it would not be eligible for free allowances based on a hydrogen benchmark, whereas it would be eligible if produced under a refinery benchmark. This creates an unfair, unlevel playing field for hydrogen produced in different benchmarks, especially as hydrogen production is emission intensive and it is used within sectors that are themselves subject to carbon leakage e.g. refining. Further consideration is needed to ensure there is sufficient carbon leakage mitigation for hydrogen, consistent with where it is used.

Question 2. Do you agree with the fallback approaches which have been used where gaps have remained in the trade and emissions intensity data sets? If you do not, please explain why and suggest alternatives.

Membership of Fuels Industry UK does not have a strong view on this.

Question 3. Do you agree with the methodology used to update the Carbon Leakage List threshold values i.e. 0.14 and 0.74, determined on the basis of Option A described above? If you do not, please explain why and suggest an alternative methodology.

Given the problems noted above on data choices and availability, it is imperative that a qualitative assessment (as well as the quantitative one), is retained, especially for sectors where accurate and sufficient data sets may be lacking, like hydrogen.

Question 4. Do you agree with the Authority's preliminary list of Carbon Leakage Indicator (CLI) values?

No.

Our analysis indicates that the CLI of refined products is 5.13

Please see Annex A attached.

Furthermore, we have tried to understand the sharp rise in CLI of cement and edible fats, have not been able to do so; this needs to be explained. Until then we question the integrity of the data and other comparative outcomes.

(As per Q3): Given the problems noted above on data choices and availability, it is imperative that a qualitative assessment (as well as the quantitative one), is retained, especially for sectors where accurate and sufficient data sets may be lacking, like hydrogen.

Question 5. If you do not agree with the Authority's preliminary list of CLI values, please explain why and suggest any additional data (that meets the assessment criteria). If you do not agree and would like to propose an alternative methodology or data set which does not meet the assessment criteria, please explain why this data should be used.

Please refer to our analysis of the NERA report at Annex A, which gives the context.

Consistent with our answers to Q1 and Q4: we at-least-in-part disagree with the Authorities preliminary list of CLI values because of the lack of transparency into the build-up of the final CLI numbers. For example, what are the new sector-specific TI and EI and GVA values compared to the previous values calculated by EU policy makers?

As described in Annex A we have been unable to replicate the determination of CLI by in the NERA report using the same data sources, these raises questions around the transparency of the determination made by NERA.

(As per Q1):

Specifically with respect to refined products

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(As per Q4):

No. Our analysis indicates that the CLI of refined products is 5.13

Question 6. Do you agree with the Authority's minded to position to take an 'additive' approach to the Carbon Leakage List, should new data provided through this consultation change the current CLI values? If you do not agree, please explain why and suggest an alternative approach.

Membership of Fuels Industry UK does not have a strong view on this.

Question 7. Are there any other facts or matters that you would like the Authority to take into account before making a final decision on the Carbon Leakage List?

Our views are covered in our responses to Q1, Q4, Q5 and in our Annex A with an analysis of the NERA report. Furthermore, we note that:

• The frame of the consultation is those sectors included in a CBAM, and we are not included in that group, despite that we believe we should be.

• Nowhere do we see the policy team asking, "are current levels of free allocations doing an adequate job of mitigating the risk of carbon leakage", which for the refining sector – we believe - they are not. See Annex A diagram 2 and footnote for recent refinery closures.

• Specifically, this question deserves consideration: are the number of free allowances available for the refining industry set at the correct level to mitigate carbon leakage risk for UK refineries?

• We are being asked about options without knowing what the alternatives are.

Question 8. On the basis of the information presented in this Chapter do you think we should update the Carbon Leakage List to be based on UK data or do you have a preference to continue to use the existing Carbon Leakage List? Please explain your answer.

We support an approach of moving to UK based information for UK companies and UK trade flows.

However, the points we make in our answers to Q1-Q7, and Annex A and our accompanying report need to be addressed, and the differences with the previous EU CLI list need to be fully understood and explained.

Question 9. Do you agree with the Authority's minded to position to not take forward the 'do nothing' option? If you do not agree, please explain your reasoning.

Fuels Industry UK strongly disagrees with the framing of a consultation which assumes that the industry cap is staying level or coming down without considering whether there is sufficient protection from carbon leakage for UK industry.

Neither the consultation document nor the analytical annex considers whether the existing level of free allocation is sufficient to provide effective carbon leakage risk mitigation. The CCC's 2024 progress report to Parliament suggests that it is not, "… whilst UK territorial emissions fell 47% from 1990-2021, imported emissions increased by 21% over the same period, resulting in a reduction of UK consumption emissions of only 24%." This is evidenced by announcements of industrial plant closures from the likes of CF Fertilisers, British Steel, Tata Steel and Petroineos over the last year. Carbon costs and competitiveness are highlighted in all these cases.

For those sectors outside the UK CBAM regime, the free allocation levels should at least remain the same and potentially reset now that the risk of carbon leakage is better understood.

For the refining sector, the free allocation method should be reviewed such that the sector receives sufficient FAA to provide meaningful protection against carbon leakage, which means receiving close to 100% of total emissions as some other sectors currently do. We note that the refining sector has the second highest ETS costs next to the power sector (which is not at risk of leakage).

If the industry cap continues its downward trajectory, then the annual rate of reduction needs to be re-assessed with UK assets and a UK-specific benchmark in mind.

Question 10. Do you agree with the parameters of adjustment that have been identified by the Authority? If not, please explain your reasoning and any other parameters which should be considered.

Broadly these are parameters that would define any transition towards a world with CBAM and free allowances for industries that have no export exposure.

On this point, export exposure should also be a part of the end state discussion – that is export exposed industries should not be targeting a 0% Free Allowance at the end of the adjustment period unless some other form of export leakage mitigation is put in place.

There is also the question of allowing for new manufacturing facilities and new process units, both within and outside of existing refinery boundaries because the existing historic activity level (HAL) approach does not take account of known

step changes such as announced closure of refineries and/or installation of a new Hydrogen manufacturing capability.

Question 11. Do you have a preference for the start year, adjustment length or trajectory? Please explain your reasoning for each preference.

We agree with the principle that Free Allowances (FAs) should not be taken away before an adequate CBAM policy is in place to prevent further carbon leakage and UK de-industrialization.

Any CBAM needs to be established prior to significant adjustments to FAs. For example, it seems reasonable to expect 2 years of a CBAM being applicable at benchmarked FA levels before any significant adjustment is made. This cautious approach is justified as ETS costs become more significant. The market will need the chance to absorb and balance costs without suffering shocks.

Beyond that, a multi-year trajectory to a retained level of FAs (i.e. not zero), following which further evaluation can be made, seems a reasonable timeline. It seems sensible go to slower than the EU, and to be especially mindful of the impacts on sectors in the CBAM regime that have a large export exposure

The ETS Authority should have regard to the quantity of imports that are subject to CBAM, the fewer imports there are of a product the lower the risk to 'ETS Effectiveness' from retaining free allocation. As CBAM rates will be applied by sector, not all sectors within CBAM would need to have free allocation reduce at the same rate or trajectory. Hydrogen has very limited imports, only £4M in 2023 (data taken from HMT's 2024 CBAM consultation). Hydrogen imports are not expected to increase as low carbon hydrogen will be converted to a carrier molecule (e.g. ammonia) for transportation to the UK. As a result, the only impact from reducing free allocation for hydrogen will be further loss of competitiveness of UK industry, with no environmental benefit, as explained in our response to Q3 above.

Question 12. Do you agree with the rationale that has been presented for consideration within each of the parameters of the adjustment? If not, please explain your reasoning and any other considerations the Authority should take into account.

Membership of Fuels Industry UK does not have a strong view on this.

Question 13. Do you agree with the considerations the Authority will take into account when determining the extent of the adjustment to free allocations? If not, please explain your answer.

As a CBAM will only cover imports, UK exports will continue to have exposure to carbon leakage and may face further consequences to downstream products. Therefore, we support the view to factor in the potential risks highlighted for export leakage protection and consider changes to free allocations that will be compatible with WTO rules and other relevant trade law obligation

Fuels Industry UK calls on the government to explain why they appear to be more concerned about a potential WTO challenge, than they are about providing sufficient carbon leakage protection for their industry, and the people working to manufacture the things that the nation and the economy depends upon.

Question 14. Do you have a preference on whether the adjustment should be to zero or a non- zero amount? Please explain your answer.

For those sectors in scope of a CBAM regime, we would support adjustment to a non-zero amount of FA; and we can describe methods to use either Free Allocations or interventions at other tax points to make an effective export adjustment in the case that refined products were brought into scope of the UK CBAM at some future date.

On a point of detail: we note that the retention of FAs on total production may reduce the CBAM liability on imports, and therefore the 'effectiveness' of the CBAM. Because of this, any FAs intended to address providing relief for UK ETS on exports needs to be considered export (only) protection. And therefore *not* included in the calculation of the CBAM liability that would be applied on imports.

Question 15. Do you agree with the mapping of SICs to CBAM goods provided by the Authority? If not, please explain your answer.

No. (As per Q1):

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broad, with result that many non-refinery businesses and non-refined products are included in the calculation. This is so significant that there are at least 15 non-refining / non-ETS paying businesses included for every refinery included in the data, significantly increasing turnover and GVA values used in the CLI calculation. We would recommend that the trade and GVA data used is limited to just those companies that are in scope of the ETS.

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Question 16. Do you agree with the Authority's minded to position that free allocations should only be adjusted for goods covered by the UK CBAM? If not, please explain your answer.

Broadly speaking yes.

However, for those sectors outside the CBAM the free allocation levels should at least remain the same, and for the refining sector the method should be reviewed such that the sector receives sufficient FA to provide meaningful protection against carbon leakage, which means receiving close to 100% as some other sectors currently do.

Question 17. Do you have any other factors that you would like to flag to the Authority for consideration in how CBAM and non-CBAM good free allocations should be disaggregated? Please provide an explanation of how you think this methodology could be implemented.

Disaggregation of CBAM and non-CBAM good free allocations could be complex and problematic. The proposal seems to imply that if (for example) a refinery had a Steam Methane Reformer (SMR), which produces hydrogen, then the SMR should be disaggregated from the refinery for the purpose of calculating free allowances. This would mean a change to the Historic Activity Level (HAL) as well. Refineries may find this challenging. It's possible that integrated hydrogen should be treated differently from merchant hydrogen and should not be in the CBAM. Or that hydrogen should be outside the CBAM in totality because the flow is so small it's a distraction.

A further point is that if there was a requirement to disaggregate products that are manufactured by multiple process units (gasoline, for example), this would be very difficult because the conventional complexity weighted tonne (CWT) method determines free allocations based on a process unit and throughput basis not on a product basis.

Question 18. Do you agree with the assessment criteria that has been put forward for consideration by the Authority? If not, please explain your answer and provide other assessment criteria for consideration.

Membership of Fuels Industry UK does not have a strong view on this.

Question 19. Please rank the assessment criteria in order of most important to least important.

Membership of Fuels Industry UK have reached broad though not unanimous agreement that this would be the order of priority:

1. Exports
2. Imports
3. Technical feasibility
4. Impact on ETS effectiveness
5. Affordability