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<u>Response to consultation "Moving the UK ETS Second Free Allocation Period"</u>

Fuels Industry UK represents the eight main oil refining and marketing companies operating in the UK. The Fuels Industry UK member companies – bp, Essar, Esso Petroleum, Petroineos, Phillips 66, Prax Refining, Shell and Valero – are together responsible for the sourcing and supply of product meeting over 85% of UK inland demand, accounting for a third of total primary UK energy[1].

The refining and downstream oil sector is vital in supporting UK economic activity. It provides a secure supply of affordable energy for road and rail transport, aviation, and marine applications, as well as for commercial and domestic heating. It also supplies base fluids for use in lubricants, bitumen for use in road surfacing, and graphite for use in electric vehicle batteries and as electrodes in steel and aluminium manufacture.

The sector is poised to play a central role in enabling a Net Zero future by leading deployment of at-scale decarbonisation technologies to reduce our own emissions and those of others. It also brings expertise in delivery of large scale, complex and capital-intensive projects. Maintaining and accelerating such investment to support the Net Zero transition means the UK needs to be a globally competitive place to invest. However, the UK is now at risk of being left behind, due to domestic disadvantages and international incentives.

[1] BEIS Digest of UK Energy Statistics (DUKES) 2023.

Moving the UK ETS Second Free Allocation Period

Despite some reservations, Fuels Industry UK broadly welcomes the proposal to extend the current free allocation period to include 2026, and the start of the second period moving to 2027.

This support would depend on government making a meaningful revision of the UK ETS free allowance allocation methodology and an extension in scope of the proposed UK CBAM to include refined products. These are key policy measures to mitigate against the risk of carbon leakage for the refining sector which has one of the highest risks of exposure to carbon leakage.

Specifically, the proposed extension to the first period of UK ETS Phase 1 to include 2026 and change in the second period to cover 2027 to 2030 needs to lead to:

- Greater opportunity for the UK ETS Authority and DESNZ to address revision of the free allowance allocation (FAA) methodology such that sectors with the highest levels of exposure to carbon leakage, in particular, refineries receive higher levels of support (see also below).
- Alignment and joint HMT-DESNZ coordination – at least in terms of timing - with the introduction of a UK CBAM for those sectors included in scope. The two methodologies should align in other ways as well, most importantly, in providing support for UK exports.

One reservation we have is that this delay makes forward commercial and project planning even more difficult, as there continues to be little clarity on future FAA and CBAM implementations, and the speed of government policy development remains too slow to allow for effective planning, with the significant outcome that companies remain uncertain of future costs.

A second reservation is that the delay will compound the problem identified in the 2022 consultation '[Developing the UK Emissions Trading Scheme]', where the UK ETS Authority recognised unfair treatment of existing operators (where they implement capacity increases below the 15% threshold) versus new entrants and proposed to remove the imbalance. This issue has not yet been addressed. However, even with this proposed delay in Period 2, we see no reason why this shortcoming cannot be addressed from the start of 2026, alongside changes to the current rules on the electricity generation classification, ref sub clause (v) in consultation document.

Fuels Industry UK notes that timings for the UK and EU CBAM remain unaligned. There are also differences in the products covered, and future changes in free allowance allocation methodologies are likely to introduce further misalignment leading to competitive distortions between the UK and European markets.

<u>Free Allowance Allocation</u>

The domestic refining sector faces high energy costs and exposure to import markets, predominantly from regions where there is no price on carbon. Free allowance allocation under the UK ETS is therefore a key measure for mitigation of carbon leakage risk. Analysis indicates that the UK refining sector is one of the sectors most at risk of carbon leakage. Despite this, the refining sector receives approximately 60% of the free allocations required to cover its emissions from manufacture of fuels and other refined products. This is lower than other sectors with lower levels of exposure to carbon leakage.

Fuels Industry UK notes that the UK ETS free allocation methodology has been inherited from the EU and is based on a benchmark that no longer includes UK refineries and therefor does not reflect UK refinery performance.

Fuels Industry UK therefore urges the UK ETS Authority and DESNZ to use the additional time available to carry out a comprehensive review and update the methodology used to calculate free allocations for the refining sector.

We are happy to discuss this last point.

Yours sincerely

Peter Webb

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