WINTER 2022

Divergence Watch

CARBON EMISSIONS PRICING & REMOVALS

"*I am pleased to present to you Ibec Global's third edition of* ***Divergence Watch****, our quarterly publication which looks at the shifting relationship between the EU and the UK to help business leaders navigate the cost and complexity of doing international business. In this issue, we focus on EU and UK divergence and cooperation in the interlinked areas of carbon emissions, carbon pricing and carbon removals up their climate ambitions and providing significant incentives and opportunities for companies to begin or ramp-up decarbonisation, this will be a key issue for business leaders to keep a close eye on in coming months. The key takeaway for business is how important it is for both the EU and the UK to align their policies in these areas to support a future of environmentally friendly industrialisation, rather than risk driving companies out of business, or out of the European market."*

Jackie King, Executive Director, Ibec Global

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Since the publication of the EU Green Deal in late 2019, greenhouse gas (GHG) emissions mitigation has been perhaps the single most debated policy area for both the UK and EU.

The respective levels of ambition in industrial carbon reductions will define the trajectories of our economies over the coming years and given the agenda setting role both jurisdictions have on the world stage, it will impact whether the world can meet the targets under the Paris Agreement, thus limiting global warming to 2 degrees and 'keeping 1.5 alive'.

Key decision makers are currently finalising significant reforms to the regulatory frameworks in these inter-linked policy areas, which may pose both risks and opportunities for businesses leaders. If a coherent and fair regulatory regime regarding carbon emissions and carbon leakage can be put in place, this will make significant strides towards European decarbonisation.

However, given that the new emissions reduction regime comes at one of the most challenging periods in the past 10 years for European businesses, it is imperative there is alignment across both the EU and UK, to avoid business divestment in one jurisdiction, or exposure to new initiatives such as carbon import levies between the trading blocs. Furthermore, with soaring gas and electricity prices, it is critical that both UK and EU policymakers provide for strong carbon leakage protections from third countries, or many companies risk be driven out of business, or out of the European market.

DIVERGENCE AND COOPERATION

Greenhouse Gas (GHG) Emissions

In 2019, the UK became the world's first major economy to legislate for a target to bring all greenhouse gas (GHG) emissions to net zero by 2050. The EU followed shortly after in 2021 with the EU Climate Law, meaning that the climate objectives of both the EU and UK were aligned.

The EU's Climate Law sets the bloc on a course to becoming the world's first climate neutral continent and will ensure that there can be no back-sliding from subsequent European Commission administrations on their Paris Agreement commitments.

To help deliver on its mandate of net-zero emissions by 2050 and a 55% reduction in GHG emissions by 2030 relative to 1990 levels, the European Commission adopted its landmark Fit for 55 Package on 14 July 2021. The Fit for 55 Package is the EU's principal legislative vehicle for achieving said ambitions and includes transformational policy on emissions.

CO2 emissions pricing is seen by both the UK and EU administrations as central to addressing the issue of heavy industry related climate change.

The EU's cap-and-trade scheme for carbon emissions is called the Emissions Trading System (ETS). It has been in place since 2005 and covers around 45% of the bloc's carbon emissions. The ETS is currently subject to a revision in light of the Fit for 55 Package. The European Commission's proposal for the revision increases the ETS reduction target for 2030 to -34% compared to 2005 emission levels, meaning that the cost of carbon emissions will increase significantly for covered sectors.

The scope of the EU's ETS system is also extended to include maritime transport emissions. This will be gradually introduced over the next four years, and will mean that for the first time, ships travelling within the EU (100%) as well as entering and leaving the EU (50%) will be subject to the overall emissions cap and will be required to gradually surrender allowances starting from 2023. The policy is likely to have knock on implications on the cost of international trade and import/export of products.

Finally, a separate but adjacent mechanism is to be set up for buildings and road transport, meaning that the cost of running a car and the cost of heating a home are set to increase. This poses a challenge to the Irish government's carbon taxation policy, and a potential risk to Irish tax revenues for the Just Transition Fund moving forward.

When the revised Directive was published in July 2021, EU allowance prices averaged c. €50 p/t. The Commission had stated that it was aiming for a 50% increase in the cost of carbon emissions on the market, and indeed the latest ETS price, as of end November 2022, is over €80 per tonne. Such significant price rises in a short period of time should once again cause reflection for business leaders regarding what additional steps they can take to decarbonise their sectors.

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The UK Emissions Trading Scheme (UK ETS) went live on 1 January 2021, replacing the UK's participation in the EU ETS. Under the Ireland/Northern Ireland Protocol, electricity generators in Northern Ireland remained within the EU ETS. The UK system is organised in the same way as the EU ETS, with an auction price determined by the market. The ETS price in the UK is around £65 per ton and fluctuates depending on supply and demand in the secondary market. This matters for businesses, as significant price differences between the two jurisdictions could create a more favorable business environment.

To guard against carbon pricing impacting on investment / relocation decisions, a large percentage of ETS allowances – up to 94% for industrial emissions[1] – are currently allocated freely. The EU, however, plans to gradually phase out free allowances, while the UK's free allowances are only in place until 2025, meaning that in the future, EU and UK companies could be put at a competitive disadvantage relative to international companies, operating in countries which do not have a price on carbon.

To address this carbon leakage threat, the European Commission has proposed to introduce a Carbon Border Adjustment Mechanism (CBAM), which is linked to a free allocation phase-out.

The CBAM Regulation has been one of the most anticipated measures in the Fit for 55 Package and could have major implications for UK-EU trade. The Mechanism aims at setting up a form of import certification scheme, that would lead importers to buy CBAM certificates to import certain goods based on the carbon content of said goods. The price of the certificates will be dependent on carbon price of the ETS system and will have to be paid by third country companies that do not have a carbon pricing mechanism in place, or not to the standards of the EU.

The products covered under the scope of the European Commission proposal are aluminium, cement, electricity, fertilisers, and iron and steel. From 2023, companies exporting to the EU will need to calculate the embedded emissions in the processes and products covered, and from 2026, they will need to pay for the price of embedded carbon in said products, unless exporting companies can demonstrate equivalent policies apply in the place of production.

The UK is also working on a CBAM, and while the UK ETS mirrors that of the EU's, the UK cannot be exempted. Thus, limiting vulnerability of UK trade to the EU is dependent on maintaining similar price levels and market design. It is therefore important for UK exporters, that the UK government expedites the publication of a CBAM Regulation, so that companies can invest in rapid decarbonisation without being exposed to cheaper, more polluting third country products.

1 https://institutdelors.eu/en/publications/no-more-free-lunch-ending-free-allowances-in-the-eu-ets-to-the-benefit-of-innovation/

CARBON REMOVALS

An area in which the UK originally demonstrated global leadership, carbon removals or carbon capture, usage and storage (CCUS) was included in the UK government's 2017 in the Clean Growth Strategy. The strategy aims at making CCUS technologies deployable at scale from 2030, subject to significant cost reductions.

In order to deliver on said cost reductions, the UK is undertaking significant levels of research and development, has committed to working with key trading partners, such as Norway, and has set-up industrial hubs across the East and North-West coasts to house multi-billion-pound carbon capture projects. Should the UK maintain its position as a global leader in CCUS and should there be a wider uptake of carbon pricing internationally, it will mean that UK companies – producing close to zero-emissions products due to carbon removals – will be at a substantial cost advantage to their competitors.

Following the 2022 IPCC reports and the prominent role played by CCUS, the European Commission now appears to understand the importance of carbon removals to achieving a net-zero and negative emissions economy by 2050.

While in 2009, the EU passed the Carbon Capture and Storage (CCS) Directive, laying down the extensive requirements for carbon capture sites, the industry has suffered from a lack of investment and policy prioritisation in the ensuing years. This coupled with market challenges such as the need for enduring liability insurance, means that there are currently no large-scale CCS projects operational in the EU.

However, at a recent CCUS conference in Norway, European Commissioner Kadri Simson announced that "without carbon capture and storage it will be practically impossible to limit the global warming to the 1.5°C". The European Commission is now planning on publishing a Communication in 2023 on the technology. This could lead to a kick-starting of the CCUS sector in Europe and provide an option for companies in hard-to-abate sectors (such as cement), to decarbonise their processes.

In advance of that, the European Commission will publish a Regulation to establish a voluntary market for carbon removal certification, to help support the growth of the sector. On top of that, the revised TEN-E Regulation, which governs large-scale energy infrastructure development has been updated to make specific room for CCUS transportation and storage networks, meaning they will benefit from expedited permitting and capital grant opportunities. Such initiatives will mean greater adoption and cost reductions of CCUS; with cost being a contributing factor to the industry's stagnation since the 2009 CCS Directive.

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KEY TAKEAWAYS

Between ETS, CBAM and Carbon Removals, the framework of legislation being put in place between the EU and UK could mean that not only will companies decarbonise more quickly, but new technologies will also come to the market for those operating in sectors where electrification is not possible.

However, risks abound with reforms to such significant legislation. For example, the EU is committed to phasing out 'free allowances' in the ETS market, meaning that all companies will need to pay for their carbon emissions. It is possible there would be a gap in carbon leakage protection, as industry would have to rely solely on the CBAM, without a proper testing phase in place.

The UK has not put in place a commitment to phase-out free allowances, meaning that the cost of production in the UK could be substantially lower for the aluminium, cement, electricity, fertilisers, and iron and steel sectors.

However, the EU has also committed to introducing a CBAM, meaning that UK exporters to the EU would need to pay the difference in price of their embedded

emissions, in the event that they cannot demonstrate an equivalent policy in the UK. Given the scale of trade between the UK and EU, this has the potential to have major implications on trade between the two jurisdictions.

Should UK companies need to decarbonise their industry for export to the EU, without being protected from cheaper, more polluting products exported from third countries to the UK, this would undercut business' ability to retain price competitiveness. Thus, it is essential that the UK produces its own carbon border levy, to protect its manufacturing base against carbon leakage. If such risks can be mitigated, however, with a coherent carbon pricing and CBAM regime in place, this will make a decisive step towards decarbonising European industry, while protecting from carbon leakage.

In short, this developing regulatory framework is one where alignment between the EU and UK is critical. This would ensure that both jurisdictions decarbonise rapidly, while also protecting each other from cheaper, more polluting imports.

The imposition of this new emissions reduction regime, however, comes at one of the most challenging periods in the past 10 years for European industry. With soaring gas and electricity prices, it is critical that both UK and EU policymakers provide for strong carbon leakage protections from third countries, or many companies risk be driven out of business, or out of the European market.

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ENERGY &
RENEWABLES

The next edition of Divergence Watch will focus on the effect of Brexit on the Energy & Renewables sector as well as looking at the impact of energy policy divergence on international businesses.