**Potential Policies to Plug Carbon Leakage from the UK**

High-emitting sectors of the UK economy should take note of a new consultation by the UK Government on developing policy measures to reduce carbon leakage.

Carbon leakage is where efforts to reduce greenhouse gas emissions in one country leads to an increase in emissions in another country that has less stringent climate policies. So for example a UK steel producer may stop making steel in the UK (where it is has to buy allowances under the UK Emissions Trading Scheme to cover its emissions) and instead import steel from China, which does not restrict emissions from manufacturing. The net effect on global emissions is the same (arguably greater as there are the emissions from transporting the steel to take into account).

To reach 'net zero' by 2050, the UK government needs to develop policy measures to reduce carbon leakage, so that achieving decarbonisation in the UK does not lead to an increase in emissions elsewhere.

On 30 March 2023, as part of a large package of 'Green Day' policies, the Government launched a[**consultation**](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1149568/UPDATED_FINAL_CONDOC_-_HMG_TEMPLATE_-_ADDRESSING_CARBON_LEAKAGE_RISK_TO_SUPPORT_DECARBONISATION.pdf) considering several potential policy measures to mitigate the carbon leakage risk. The consultation is open to input from interested parties, both in the UK and internationally, until 22 June 2023.

**Consultation overview**

The consultation consists of two parts: Part 1 sets out potential policy measures that could be introduced to mitigate the carbon leakage risk and Part 2 details proposals on design and delivery features of embodied emissions reporting that could underpin future policy measures.

The proposed measures are:

1. carbon border adjustment mechanism (CBAM);
2. mandatory product standards (MPS);
3. demand side policies to help grow the market for low carbon goods; and
4. an emissions reporting system to support the implementation of carbon leakage mitigation policies.

Each of the above policies has its own characteristics and could work on a standalone basis or in combination with others and could complement the UK Emissions Trading Scheme (ETS).

**Sectors affected**

The consultation considers policies for mitigating the carbon leakage risk in the following sectors (all of which are already subject to the UK ETS):

* cement
* chemicals
* glass
* iron and steel
* non-ferrous metals
* non-metallic minerals
* paper & pulp
* refining
* fertiliser
* power generation

The risk of carbon leakage is not limited to the above sectors and the carbon leakage profile of sectors may change over the course of the UK's transition to net zero. So over time, the sectoral scope of the policies may change too and even include non-industrial sectors that are not subject to the UK ETS (such as agriculture or timber).

**Carbon border adjustment mechanism (CBAM)**

A CBAM would introduce a carbon price on imported products to ensure that they are subject to a comparable carbon price incurred by UK-based production. It would be based on the embodied emissions of a specific product.

The Government is considering that the CBAM would initially apply to products in sectors subject to the UK ETS and which are deemed at risk of carbon leakage. The risk is considered greatest for sectors which are subject to carbon pricing in the UK, meaning that production is likely to be moved to countries with less ambitious climate policies to save costs. The mechanism would subsequently be expanded to new sectors and products.

At the moment, the free allocation of allowances under the UK ETS is the main UK domestic carbon leakage policy measure. The Government consulted on amending this last year (see our article [Developing the UK ETS – the road to net zero](https://www.addleshawgoddard.com/en/insights/insights-briefings/2022/energy/developing-the-uk-ets-the-road-to-net-zero/)) to reduce the number of free allowances each year from 2026. We expect a response to this consultation shortly. The introduction of the CBAM should tie in with the reduction of free allowances and work together as a complementary framework.

Other issues raised in the consultation include how emissions should be measured (e.g., through independently verified emissions data or default values), the emissions scope (the consultation explores a CBAM applying to Scope 1, Scope 2, and Scope 3), how the price should be calculated, and the implementation and timing of a CBAM. As a minimum, any CBAM is likely to apply to Scope 1 emissions embedded within imported products: the same scope as the emissions directly covered by the UK ETS. To ensure that emissions are not paid for twice, the UK CBAM would take into account the carbon price (if any) already paid in the country of production.

The consultation also invites views on the potential impact of a UK CBAM in the context of the EU CBAM, which has been [recently formally adopted](https://www.consilium.europa.eu/en/press/press-releases/2023/04/25/fit-for-55-council-adopts-key-pieces-of-legislation-delivering-on-2030-climate-targets/) and should be phased in from 2026.

**Mandatory product standards (MPS)**

MPS regulations would set upper limits on the embodied emissions of industrial products either produced in the UK or placed on its market, potentially applying to imports. The MPS would relate to the way in which the products are made, rather than their characteristics, aiming to ensure that cheaper high carbon products would not undercut more expensive low carbon alternatives.

Unlike the CBAM, with its focus on price, MPS would operate through regulations prohibiting non-compliant products. This policy could be used on a standalone basis or in combination with CBAM and could also be adopted as a targeted measure in sectors not yet within the scope of the UK ETS. Where introduced together, CBAM and MPS would place a limit on emissions in specified products, combined with a carbon price to incentivise further emission reductions.

If introduced, MPS would form part of a broader system of demand-side policies that would enable manufacturers to distinguish their products as low carbon, reach new markets and attract 'green premiums'.

The consultation seeks input on the industrial sectors MPS would apply to and proposes that standards would first be piloted with a single sector or a small number of sectors. Criteria to guide decisions on which sectors may be suitable should balance factors such as a sector's exposure to carbon leakage risk, climate ambition, ease of deliverability of standards in that sector, and what actions are being taken internationally. Based on these factors, the Government considers that the most suitable sectors for piloting MPS would be steel, cement, and concrete.

The consultation proposes that Scope 1, Scope 2, and some of upstream Scope 3 emissions should be in scope. The consultation also asks for input on: the stage in the manufacturing value chain where they would be applied (i.e., to upstream products, midstream products or even consumer products); when it would be most effective to implement standards; the geographic coverage; and how emission thresholds for MPS should be set (including how their stringency could increase over time).

The consultation emphasises the potential for future international alignment of product standards and that an advantage of its adoption is that it would not depend upon a carbon pricing mechanism and therefore could be implemented in countries which do not have one.

**Demand side policies**

To help grow the market for low carbon products, the consultation explores additional demand-side policies, including voluntary product standards and product labelling.Voluntary product standards would be designed in a similar way to MPS and enable manufacturers that have gone beyond the minimum level of decarbonisation required by MPS to distinguish their products as lower carbon, to attract a green premium.

Product labelling would build upon the existing systems in place that exist to present information to buyers in different ways and would be able to convey the right level of detail that could influence purchasing decisions. The Government favours a lettered grading system similar to an Energy Performance Certificate but welcomes views.

The low carbon market could also be supported via procurement policies, both public and private.

Allowing the use of carbon credits towards meeting MPS or CBAM obligation is not being considered at this stage, due to complexity this would entail, but this position would be subject to review alongside the policy towards voluntary carbon markets and greenhouse gas removals.

**Emissions reporting system**

The CBAM and the MPS only work if there is a consistent way of measuring and reporting on a product's embodied emissions. Adopting a standard methodology could improve the comparability of like products and reduce the administrative burden for businesses in the UK and overseas that report against multiple standards.

The consultation proposes a possible emissions reporting framework that would underpin future carbon leakage policy measures and includes options for the design of embodied emissions reporting of products and use of default values.

It calls for input on the potential options for calculating reported emissions (including the reporting metric, which sectors could be targeted and potential scope for emissions reporting) and the design and delivery of the reporting system (including verification of data and how information would be disclosed to the public).

The Government is thinking at this stage that only those sectors in scope of the carbon leakage measures (see Sectors Affected above) should be subject to emissions reporting, but there could be an option for other sectors to voluntarily report.

Chapter 8 of the consultation looks at an IT system to collect and process embodied emissions data for industrial products manufactured in and exported to the UK and asks for views on how frequently data should be reported.

**Timeline**

According to the consultation, the Government intends to introduce (depending on the outcome of the consultation) embodied emissions reporting in 2025, followed by a phased implementation of the CBAM in 2026 (in a limited number of sectors) in parallel with reforms to the UK ETS. The MPSwould be introduced following successful pilots in the mid to late 2020s.

**Impact on businesses**

The introduction of policy measures to mitigate carbon leakage will have both direct and indirect impacts on businesses in the UK and internationally. Identifying the effects of the policies, collaborating with stakeholders across value chains, and adopting more sustainable practices will be key to effectively mitigating the impacts of the policies and ensuring long-term sustainability and competitiveness.

**AG's Carbon Markets and Emissions Trading Team**

Carbon markets are part of the global solution to climate change but are complex and constantly evolving. The AG Carbon Markets and Emissions Trading Team can work with you on all aspects of carbon markets and emissions trading – from compliance and regulatory issues, structuring of transactions in multiple jurisdictions across the carbon value chain, strategy and policy advice on energy and climate change, to pre-compliance and voluntary markets (both primary and secondary market transactions and advice). Our experts have worked in this space since the inception of carbon markets, in over 40 countries to date. See our web page <https://www.addleshawgoddard.com/en/sectors/energy-and-utilities/carbon-markets-and-emissions-trading/> for more details and to contact us.

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