UK STEEL – SUBMISSION TO THE CONSULTATION ON FREE ALLOCATION REVIEW - CARBON LEAKAGE

Date: 10th March 2025
To: ukets.consultationresponses@energysecurity.gov.uk

About UK Steel

UK Steel, a division of Make UK, is the trade association for the UK steel industry. It represents all the country's steelmakers and a large number of downstream steel processors.

Submission to the consultation on Free Allocation Review: Carbon Leakage

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.
UK Steel welcomes this consultation and the opportunity to respond to it. It is difficult to assess whether the data sets used for the emissions intensity and trade intensity are the correct data sets to use, as the UK ETS Authority has not released the data or how it is being used. While we initially would believe that these are the correct data sets to use, it is not possible to provide a definitive assessment without an accompanying, transparent publication of the data used.

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.
We appreciated the difficulties that the Government faces in constructing a viable assessment of carbon leakage with missing data points. We, therefore, agree with the use of the fallback data options, but we would urge caution and also question why the thresholds have been set so high for the sectors using fallback data.

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.
We are concerned that there are such substantial differences between the two thresholds, which indicates that the use of fallback options would produce higher carbon leakage indicator values. This would create questions about the validity of the data sources and the methodology used to create the CLI values. While this may not have the most significant impact on most sectors, in the case where the Government proceeds with tiering of free allocations, the discrepancies within the methodology would become problematic.

4. Do you agree with the Authority's preliminary list of Carbon Leakage Indicator (CLI) values?
It is not easy to assess the validity of the CLI values without the Government releasing the dataset in full alongside its methodology. We would urge the ETS Authority to follow the EU's example of publishing the data sets in full to allow industry to assess and provide suitable feedback. This would be better in line with good governance and best practice in policymaking. We would be concerned that our EU competitors would be able to assess the data behind the EU free allocation methodology, whereas UK industry would not get the same transparency.

In particular, we are concerned that industrial gasses are assigned a lower CLI value than their EU counterparts, which would result in the removal of their free allocations and thus negatively impact their ability to compete. As industrial gasses are a key feedstock and input material for several other industrial processes, many of which have much higher CLI values, it would indirectly damage other sectors and increase their carbon leakage risk. We would thus urge the UK ETS Authority to reassess the CLI for industrial gasses.

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.
See above.

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.

Yes, we support this approach.

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?
The UK ETS Authority must recognise the integration of the EU and UK markets for industrial products and, thus, the implications of applying different rates of free allocations. If the Authority decides to provide lower or no free allocations to sectors that receive free allocations in the EU, then UK businesses will be actively disadvantaged compared to their EU counterparts. Due to the integration of the UK and EU markets, any loss of competitiveness is expected to increase EU imports, the loss of UK market shares, and carbon leakage/deindustrialisation.

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.
It is not possible to provide a full and satisfactory answer to this question without understanding the Authority's decision on tiering of free allocations. If free allocations are to be tiered, then the absolute and relative CLI values matter much more, as these will define the scale of free allocations received. If free allocations are not tiered, then it only matters whether industrial activity is above or below the threshold, but if they are tiered, then the CLI value will matter much more, as it could define whether a company will receive 30% or 90% free allocations.

Similarly, the Government is negotiating with the EU on a number of different policy areas, including the linking of the UK ETS and EU ETS, which would have significant implications for the UK ETS, the CLI, and free allocation overall. It may be preferable to use the existing CLL, as this would ease the linking of the schemes if this were a policy option pursued by the Government.

On balance, if tiering is not applied, then we would prefer to use the existing CLL, as this would ensure UK industrial gasses are not disadvantaged compared to their EU competitors, and it would ease the linking of the EU and UK ETS.

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.
We do not agree with the position not to take forward the "do nothing" option, as we do not believe that the UK ETS Authority has provided sufficient justification for the reduction of free allocations for sectors within the UK CBAM. There are crucial flaws in the Authority's assessment, which undermines its position to reduce free allocations for CBAM sectors, which are outlined below:

1. <u>Assumption: Higher carbon costs incentivise industrial decarbonisation.</u>

The Authority states that higher carbon costs will drive industrial decarbonisation, but the effectiveness of carbon pricing is undermined by significant variations in global carbon prices, which create competitive imbalances. Due to the high trade intensity of the steel industry, it cannot pass carbon costs onto consumers. Furthermore, the UK ETS does not incentivise decarbonisation itself, as emission-intensive producers are penalised when switching production methods. When Tata Steel and British Steel switch from integrated production to electric arc furnaces, substantially reducing their emissions, they will not continue to receive similar levels of free allowances, which they can sell as part of the investment financing. Instead, the free allocation would be substantially cut as their new free allocations will be based on the EAF benchmarks. The steel industry cannot pass on the cost of carbon to their customers, nor the cost of decarbonisation due to the high trade intensity of the sector, and the UK ETS does not reward them for a switch to electric arc furnaces.

Reducing free allocations to near zero or zero will have enormous implications for the steel industry and the carbon costs it faces. The steel industry is undergoing a rapid transition, with Tata Steel UK investing in a new electric arc furnace, and British Steel in negotiations with the Government for a potential similar investment, meaning UK steel production would be 100% electric arc production by the end of this decade. This would lower the emissions of the sector by roughly 80%, or the entire UK GHG emissions by c.2%. However, despite this rapid decarbonisation, the industry would still face substantial UK ETS compliance costs if free allocations were phased out. Assuming similar production levels and UK ETS allowance value of £115/UKA (the Net Zero

strategy aligned market traded carbon value used by the Government for 2036[1]), the sector would face carbon costs of £136.9m annually[2]. If the UKA price is instead £140/UKA (the 'High Sensitivity – Low Fossil Fuel Prices and High Economic Growth' trade value for 2036), then total carbon costs would be closer to £166.6m annually. For some existing EAF steelmakers, this would increase their ETS compliance cost over tenfold. Due to steel being highly traded, carbon-intensive, and highly competitive, such costs cannot be passed on to consumers without an effective CBAM (which may be questionable – see below). Even if this could be done, there are still risks of export leakage (see below).

For the steel sector, carbon pricing only reduces available CAPEX for investment and generates revenue for the Government. The recent investment in EAF announced by Tata Steel has only materialised after direct co-financing and action to reduce electricity prices. This is also the case wherever steelmakers invest in EAF, H2-DRI or CCUS in North America and Europe, where co-financing is the key policy mechanism to attract green investment rather than carbon pricing:

Country	Funding
France	• €1.7bn investment for ArcelorMittal to replace three blast furnaces with EAF/DRI • €5.6bn for industrial decarbonisation as part of the "France 2030" Investment Plan
Canada	• C$400m in the Arcelor Mittal DRI plant • C$420m in the Algoma Steel EAF plant
Germany	• €1bn grant for Salzgitter for hydrogen-based steelmaking • €5bn for the decarbonisation of Germany's industrial sector • €55m initial funding or ArcelorMittal hydrogen-based steel production • Industrial Carbon Contract for Difference to provide funding model for industrial decarbonisation
Spain	• Signed MoU with ArcelorMittal for hydrogen-based steel plant
Sweden	• Joint venture between state-owned energy company Vattenfall, state-owned mining company LKAB, Swedish energy regulator, and steelmaker SSAB in hydrogen-based steelmaking
Belgium	• Investment in €1.1bn ArcelorMittal DRI plant

The UK ETS Authority wishes to "increase the effectiveness of the decarbonisation incentive set by the UK ETS", but we would caution that higher carbon costs thus only increase the risk of deindustrialisation and carbon leakage. It is worth noting the key characteristics of the steel industry:

- Non-market excess steelmaking capacity is a major challenge for the global steel industry, driving down profits and increasing emissions. Measured as the gap between global capacity and crude steel production, global excess capacity in 2023 was estimated at 543Mt, which is over 70 times the size of the UK market. Conditions are rapidly deteriorating as capacity expansions in Southeast Asia and the Middle East are continuing at an alarming rate – these are largely state-funded, mostly for high-emission blast furnaces and often do not correspond to domestic demand trends. Indeed, steel demand is weakening in key markets, notably China, translating into rising oversupply, which is dampening steel prices and spilling over into other markets. Exports from China in 2024 likely reached 100Mt, the highest since 2016, when the last steel crisis saw several steel plant closures and thousands of jobs lost across steelmaking countries, including the UK.
- This is impacting both the profitability and the carbon footprint of the global steel industry. The average profitability of the steel sector is currently the lowest in a decade, with producers in developed economies losing market share to underpriced imports. This is clearly visible in the UK, where the import share so far in 2024 has jumped to 68% from 60% in 2023 and 55% in 2022. The sharpest import increases have come from non-EU sources, mainly India, Vietnam, China, South Korea, Turkey and Algeria. Importantly, these are also countries that have seen significant increases in imports from China or are within China's top 10 exporting destinations.
- Not only is overcapacity and oversupply undermining profitability and, therefore, investment, including in decarbonisation, but also actively driving up emissions across the globe. Blast furnaces, which are

[1] DESNZ (2024), Traded carbon values used for modelling purposes, 2024, Research and analysis, Published 17 December 2024, https://www.gov.uk/government/publications/traded-carbon-values-used-for-modelling-purposes-2024/traded-carbon-values-used-for-modelling-purposes-2024

[2] Estimated by using £115/UKA, production levels of 7m annually, and a scope 1 emission intensity of EAF production of 0.17tCO2e/tonne of steel.

the more carbon-intensive steelmaking technology, account for more than 74% of capacity additions in Asia, while 89% of blast furnace energy input globally comes from coal. Over two-thirds of steelmaking capacity is in countries that have Net Zero targets later than 2060 or none at all. Carbon price differentials are a key risk factor contributing to carbon leakage.

- With such high levels of international trade in steel and carbon intensity, the steel industry is at significant risk of carbon leakage. The ETS compliance costs erode UK producers' thin margins and are so substantial that some companies consider them an existential threat to their ability to operate in the UK.

We would therefore urge the UK ETS Authority to recognise that higher carbon costs do not drive industrial decarbonisation within themselves but risk deindustrialisation.

2. Assumption: The current carbon price and cost aren't sufficient to ensure the CBAM works.

The Authority states that no reduction of free allocations "*would render the CBAM ineffective as a carbon leakage mitigation*", the logic being that free allocations reduce the CBAM tax faced by importers and thus reduce the CBAM compliance cost. However, this argument fails to recognise that there is already a gap between *current* free allocation benchmarks and actual emissions, meaning that without further free allocation reductions, there would already be a significant CBAM cost.

We only need to consider the EU, which is ahead of the UK in terms of implementing its CBAM. While the EU is reducing free allocations by 2.5% in 2026 for the sectors within the EU CBAM, the EU is also reforming the EU ETS benchmarks, which will lead to a significant decrease in free allocation for the EU steel market. Based on the most recent information on the EU ETS benchmark reforms, it is suggested that BF/BOF producers will be 25.5% short in 2026[3]. Add to this the 2.5% reduction in free allocations for CBAM sectors, and BF/BOF producers will receive 27.4% fewer free allocations than their emissions. The implications of this are outlined in the example below:

A non-EU steelmaker exports to the EU market:

- EU steel installation produces 30,000t of steel, with annual emissions of 54,000tCO2, i.e. 1.8tCO2/t
- EU installation receives 39,200 free allowances covering 72.6% of emissions, paying a carbon price on the remaining emissions
- Non-EU steel installation also produces 30,000t of steel, with annual emissions of 54,000tCO2, i.e. 1.8tCO2/t
- Non-EU steel installation pays no carbon price
- An average EUA carbon price of €75/tCO2

If importing 20,000t of steel from non-EU steelmakers to the EU, the likely cost would be:

- Liable emissions: (Emissions of installation – emissions covered by free allocation for EU producers under EU ETS) * (total tonnes): (1.8-1.3)*20,000 = 10,000
- EU CBAM obligation: The liable emissions multiplied by the average weekly UKA price equals the CBAM obligation: 10,000*€75 = €750,000
- Final CBAM cost: EU CBAM obligation – carbon price effectively paid in third country = CBAM cost: As no carbon price has been paid in the non-EU country, the €750,000 would be the CBAM cost
- The additional CBAM cost per tonne of steel would therefore be: €750,000/20,000 = €37.5/tonne of steel.

As the steel market is very trade intensive, operates on thin margins, and with a background of global increasing oversupply, it has been the case that a price difference of even £5/tonne of steel would be able to make or break a commercial contract. An additional charge of €37.5/tonne of steel would thus be more than sufficient to deter high-emission steel from the UK market. As the UK benchmarks are unlikely to differ substantially from the EU benchmarks, it is likely that the current UK CBAM cost would be adequate to incentivise the use of lower-emission steel.

3. Assumption: The UK CBAM will provide sufficient carbon leakage protection

[3] Preliminary free allocation: 1.335 EAUs/t crude steel and a carbon intensity: 1.793 kg CO2/t crude steel results in a free allocation shortage of 25.5%. Source: Eurofer.

UK Steel and its members have expressed significant concerns about the Government's proposals for its CBAM policy and question whether it can provide sufficient carbon leakage protection. In particular, HMT has outlined significant deteriorations of the UK CBAM policy that would weaken the UK CBAM. Below are key examples of concern:

a) **Default values**: If importers cannot provide emission data for the products they wish to import, the Government has proposed to provide default values based on a global average value. As emissions from steel varies substantially (0.3 - 3.7 tonnes of CO_2 per tonne of crude steel (tCO_2/tCS)), basing the default values on the average of $1.85tCO_2/tCS$ will provide a substantial discount to the highest emitting steel producers, which will only pay CBAM carbon costs for c. $1.85tCO_2/tCS$ instead of $3.7tCO_2/tCS$. This will favour the most carbon-intensive global steel producers by allowing them to under-declare their emissions and carbon costs at the border. In contrast, the EU is only proposing to allow importers to use default values for 20% of their imports.

b) **Robustness tests**: CBAM policies are untested and have not been implemented anywhere yet, so it is unclear how they will work, how easy they will be to circumvent, or how widespread fraud will be. Robustness tests should be built into the UK CBAM to ensure the CBAM works as intended. This would include regular evaluations of the policy and backup policy if proven ineffective, such as increasing free UK ETS allowances. HMT/HMRC has not built in robustness tests. In contrast, the EU Commission is required to report on the application and functioning of the CBAM every two years.

c) **Exports**: When carbon pricing is applied to UK steelmakers, it reduces the industry's competitiveness in export markets. The EU Commission will publish a report this year on exports and likely introduce an export mechanism for goods produced in the EU for export to third countries that do not apply comparable carbon pricing.

d) **Scope**: The UK has only committed to applying its CBAM to the aluminium, cement, fertilisers, hydrogen, and iron and steel sectors. In contrast, the EU is already considering expanding the EU CBAM to downstream products to prevent circumvention, where steel-containing cars and white goods avoid CBAM costs. At a time of structural reduction in UK steel demand, reducing free allocations prematurely would only exacerbate the decline in domestic steel production and downstream manufacturing. Increasing the cost of UK-made steel before the CBAM covers a broader range of sectors would put downstream manufacturers at a disadvantage, as they could be outcompeted by imported products not covered by the CBAM (i.e. value chain circumvention or downstream carbon leakage). This would undermine the policy's objective by accelerating carbon leakage rather than preventing it. Maintaining free allocations until the CBAM applies to a broader range of products, including a wider group of manufactured goods, is essential to ensuring a fair transition and avoiding unintended economic and industrial consequences.

e) **Threshold**: HMT has increased the minimum registration threshold fivefold, meaning the CBAM will only apply if companies import more than £50,000 within 12 months, resulting in 80% of businesses avoiding facing any CBAM costs. In comparison, the EU CBAM threshold is currently at €150, although the Commission is considering increasing it.

The Government must balance the needs of importers and domestic producers to ensure that the UK CBAM does not impede trade unnecessarily or place too many burdens on importers. However, as a result of the above developments, UK Steel believes that HMT has prioritised importers over UK steel producers. Separately, while the UK Government should assess how to achieve this balance, it also seems to have ignored that the biggest and closest trading block is implementing a similar policy sooner than the UK. As such, while HMT may have views on default values, timelines, or exports, it cannot ignore the properties of EU CBAM policy and its implications for the UK. If, for example, the UK permits the use of default values based on global average emissions, while the EU only allows default values to be used for 20% of consignments, then significantly more high-emission steel destined for the EU markets will be diverted to the UK, where its CBAM liability will be lower.

We do, therefore, not believe that it is advisable to reduce free allocations drastically before the UK CBAM has been proven to work. It is not prudent or wise to rely solely on an untested policy for carbon leakage protection, and we would be concerned that the Government does not seem to have contingency plans in case the UK CBAM is not efficient in preventing carbon leakage. For those reasons, we do not agree with the position not to take forward the "do nothing" option, as we do not believe that the UK ETS Authority has provided sufficient justification for the reduction of free allocations for sectors within the UK CBAM.

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.

We broadly agree with the parameters of adjustment that have been identified by the Authority if free allocations are to be phased down. However, we would emphasise the point made in our answer to question 9 that even without further reduction of free allocations, there will still be a sizable CBAM tax for steel imports, as benchmarks are highly unlikely to match emissions, with a considerable gap between the two.

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

In determining any start year for reduction of free allocation, it is essential to recognise that there will very likely be a gap between benchmarks and average emissions, which will result in a non-insignificant CBAM compliance cost, even without further reduction of free allocation for CBAM sectors. As such, we would urge the UK ETS Authority to wait a minimum of two years before further free allocation reduction to assess the effectiveness of the UK CBAM. This would allow HMT and the Authority to evaluate whether CBAM is achieving its aims, the degree of circumvention and fraud, and HMRC's ability to enforce the policy. We, therefore, advocate that any start year for free allocation reductions should not be earlier than 2029 at the very earliest (option 2.3b in the analytical annex). Due to the sheer size of UK ETS compliance costs, if free allocations are phased out (creating ETS costs of up to £166.6m annually), we caution the Authority against reducing free allocations too quickly before the CBAM's effectiveness has been established.

While the UK CBAM and free allocation are separate policies managed by separate parts of the UK Government, HMT/HMRC and the UK ETS Authority, respectively, they are intrinsically linked. As such, any reduction of free allocations can only happen when the UK CBAM has been proven effective. To assess this, we would support the tests suggested by the Mineral Products Association:

- Are there substantial changes to import and export, both relative and absolute? Have imports increased, and in particular, imports from countries without carbon pricing? Have exports to countries without carbon pricing decreased?
- What are the levels of embodied emissions in imported products? Are imports of high-emission steel increasing?
- How prevalent is the use of default values compared to independently verified emissions data? Are imports from countries with predominantly high-emission steel production using default values more than imports from countries with lower-emission steel production?
- What is the level of suspected fraud? In evaluating independently verified emissions data, are there any particular trends, such as the frequent use of one particular verification organisation? Does the submitted emission data align with broader global data?
- What is the degree of resource-shuffling, where global producers export their lower-emission steel to the UK while retaining higher-emission steel for domestic consumption? Has the CBAM actually led to industrial decarbonisation or simply a shift in consumption emissions?

Until these questions are answered satisfactorily, free allocations should not be reduced any further.

It's worth restating the concern that reducing free allocations prematurely would only exacerbate the decline in domestic steel production and downstream manufacturing at a time of structural reduction in UK steel demand. Increasing the cost of UK-made steel before the CBAM covers a broader range of sectors would put downstream manufacturers at a disadvantage, as they could be outcompeted by imported products not covered by the CBAM (i.e. value chain circumvention or downstream carbon leakage). This would undermine the policy's objective by accelerating carbon leakage rather than preventing it. It is, therefore, incredibly risky to reduce free allocations before the scope of the CBAM is expanded.

Furthermore, UK Steel is concerned that the UK ETS Authority has not presented a contingency plan for the scenario where the UK CBAM initially seems to meet its aims but subsequently fails to prevent carbon leakage. While the Authority can plan and set out a trajectory, it must also prepare for scenarios where the policy does not deliver as intended, in the same way it has set out the Cost Containment Mechanism and Auction Reserve Price for scenarios where the UK ETS price either rises too fast or drops too low. It would be incredibly problematic if the Government keeps raising carbon costs on a decarbonised UK steel industry by cutting free allocations when imported steel bypasses these costs by circumventing the CBAM. As such, we strongly urge the Authority to develop mechanisms for pauses of free allocation phase-downs and subsequent increases of free allocation in the event that the UK CBAM did not successfully prevent carbon leakage.

It is not easy to provide feedback and informed evidence to questions on the potential phase-down of free allocations when the Authority has not presented actual percentage reductions but only possible lines in an

illustrative chart. We would recommend that the Government publishes actual percentage reductions and consults on these so industry stakeholders can provide proper feedback.

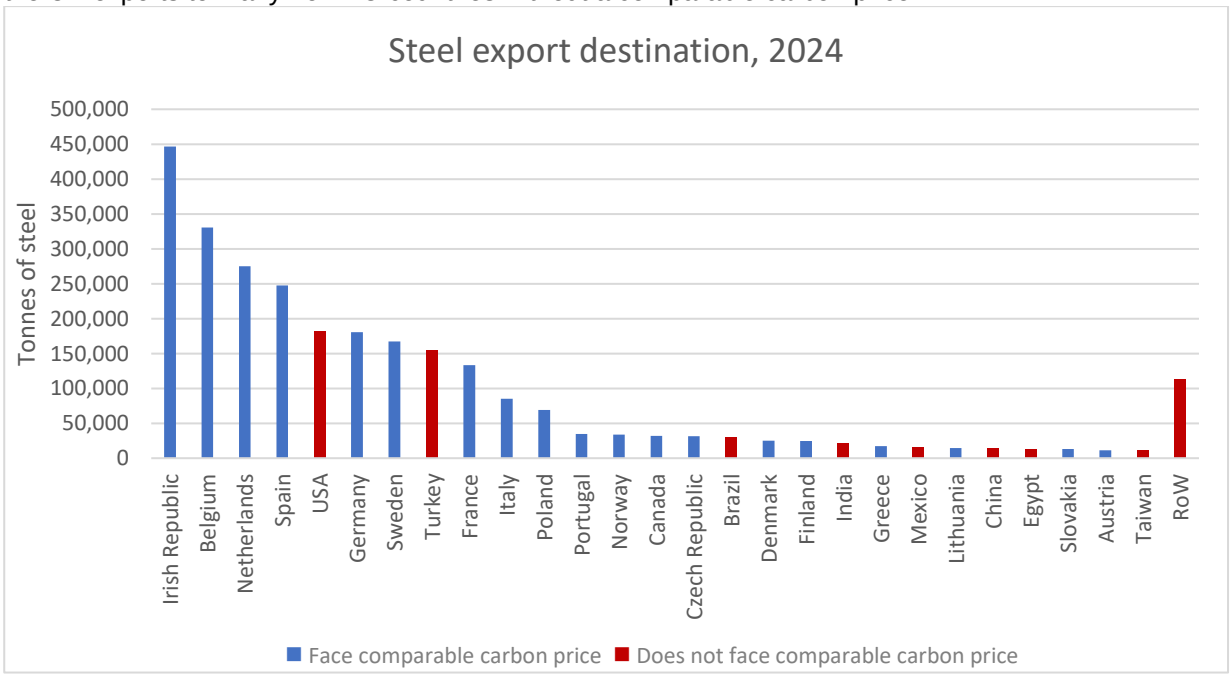
Failing all of the above, we would urge the Authority to backload any reduction of free allocation reductions due to the significant risk that the UK CBAM does not work as intended, i.e. introduce slower/shallower phase down of free allocations. Similarly, we would recommend a 10-year phase-down period, again recognising the risks associated with reducing free allocations. However, we again advise the Authority to reconsider a phase-down of free allocations, introductions of CBAM robustness tests, and contingency plans for CBAM failure.

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.
Please see our response to question 11.

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.
We strongly support any efforts to address export leakage and the risks to exports from the reduction of free allocations.

As outlined above, the steel industry is highly trade-intensive, with high levels of imports and exports. If free allocations are reduced and operating costs increase for steelmakers, there would be a deterioration in their ability to compete in the global market, affecting the UK-produced steel which is currently exported.

It is, therefore, imperative to identify and incorporate an effective approach to the treatment of goods subject to carbon prices which are exported from the UK. In 2024, about 80% of steel exported was destined to the EU, with the remaining 20% exported to countries without comparable carbon pricing. The EU CBAM will take into account the carbon 'effectively' paid in the UK for goods exported to the EU. However, for the remaining 20% of exports to RoW markets, there is no consideration of the carbon price paid in the UK. These products tend to be higher-value products, and while the percentage of UK production they constitute may appear modest, their significance lies in the substantial impact they have on the sector's profitability and the sustainability of operations in the UK. Lower production would impact overall plant efficiency, with higher capacity utilisation tending to result in improved metrics, including (i) lower emissions; (ii) reduced energy consumption; (iii) lower input costs; and (iv) decreased overall production costs; per tonne of steel. A decrease in production levels will consequently compromise productivity and efficiency, negatively affecting each plant's and the industry's competitiveness in the long run. Without export, the viability of the UK steel operations would be brought into question, as steel plants cannot operate without certain volume. The chart below shows that the UK exports to many non-EU countries without a comparable carbon price.



Source: ISSB

When the UK CBAM takes effect, barriers to trade must be removed by (1) linking the UK ETS and EU ETS to exempt UK-made products from the EU CBAM and (2) exempting UK exports to non-EU countries from ETS costs. This will level the playing field between green, low-emissions UK-manufactured products and competitors in 3rd countries and jurisdictions which do not face a carbon price. This exemption is crucial for promoting the competitiveness of UK production and products where sustainability has been prioritised and investment has been made in reducing carbon emissions. Without such a measure, the CBAM's effectiveness in mitigating carbon leakage risks would be significantly compromised.

Moreover, incorporating this exemption aligns with the broader objective of fostering a global transition towards environmentally sustainable practices. By encouraging the export of green, low-emission goods without imposing additional ETS costs, the UK can position itself as a leader in environmentally responsible production, setting a positive example for other nations to follow.

We appreciate that the UK ETS Authority is aiming to find mechanisms that work within the current UK ETS methodology that could allow the continuation of exports to markets without carbon pricing. However, we are concerned that the Authority is proposing three options, then ruling out the first two options, and subsequently finding risks with the remaining third option. The simplest option would be to exclude emissions associated with exports from the UK ETS. This is by far the most preferable option, as it bypasses many of the risks and concerns the Authority raised in the consultation document.

If the Authority is not able to consider this, then the third option of changing the carbon leakage exposure element of the Free Allocation methodology is superior to no export mechanism. While the Authority has some concerns, we would be less concerned:

- Limited CBAM efficacy: The Authority states that this approach would dampen the carbon price signal and the incentive to decarbonise, and thus "efficacy of the CBAM would always be limited". As outlined above, the UK ETS has not driven any decarbonisation within the steel industry. This has only been achieved through Government co-financing and improved business environment (e.g. reduced industrial electricity prices). This should, therefore, not be a concern.
- Limited cap: The Authority is concerned that continued free allocations are not compatible with a reduced cap or the Net Zero ETS. Ultimately, this is a problem of the Authority's own making, as it did not address exports when it set the ETS cap. This could be addressed by exempting emissions associated with exports from the ETS, as proposed above. Without exports, UK steel production is less viable, and the Authority must make allowances for this.
- Over- or under-allocation: We would again argue that the best approach here is to either exempt emissions associated with exports from the ETS or simply allocate free allocations for each tonne of steel exported, which avoids the issue entirely.

Finally, we are mindful that export intensity varies between companies, with some steel companies over 95% of their products and others exporting less than average and primarily to the UK. Any export mechanism must allow for differences in exports rather than provide an industry-wide average export allocation.

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

If the UK ETS Authority wishes to have a steel industry and avoid deindustrialisation, it MUST allow for the continuation of steel export. To this end, it cannot reduce free allocations to zero while maintaining exports. Unless the authority exempts emissions associated with exports from the ETS, it cannot reduce free allocations to zero without actively pursuing a policy of deindustrialisation and closure of the UK steel industry.

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

-

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.

We believe that the UK CBAM should cover a wider range of products and emissions before free allocations are reduced to avoid value chain circumvention and downstream carbon leakage.

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.

-

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.

-

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

If the policy aims outlined in the consultation has to be prioritised, then UK Steel suggests the following prioritisation:

1. Mitigating carbon leakage risk for imports
1. Mitigating carbon leakage risk for exports
3. Technical feasibility of the free allocation adjustment methodology
4. Affordability to government of the final policy choice
5. Impact of a Free Allocation adjustment on ETS effectiveness

The primary aim must be to avoid carbon leakage and deindustrialisation. As outlined above, the UK ETS has not played a factor in the decarbonisation of the steel industry but only reduced available capital for investment. The current efforts to invest in low-emission steelmaking are only happening due to Government co-financing and an improved business environment. As such, ETS effectiveness should be prioritised last, as it does not play a positive role in the steel industry's Net Zero transition.

For further information, contact:
Frank Aaskov, Director, Energy & Climate Change Policy, 07872 190965, faaskov@makeuk.org