

Energy UK Position Paper: EU Carbon Border Adjustment Mechanism (CBAM)

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About Us

Energy UK is the trade association for the UK energy industry. We have over 100 members; from established FTSE 100 companies through to new, growing suppliers, generators and service providers across energy, transport, heat and technology. Our members deliver nearly 80% of the UK's power generation and over 95% of the energy supply for 28 million UK homes, as well as businesses.

Paper Aim

This paper aims to highlight, to both the UK Government and the European Commission, the key concerns and remaining questions of Energy UK with regards to the European Union's (EU's) Carbon Border Adjustment Mechanism (CBAM).

The UK energy sector asks for the European Commission to address these outstanding concerns and questions in order for the sector to better understand how its CBAM will work in practice.

Whilst CBAMs can protect domestic production against imports from jurisdictions with lower carbon costs, Energy UK believes that CBAMs are sub-optimal to linked carbon markets. We, therefore, urge the UK Government to prioritise beginning negotiations with the EU to link the UK Emissions Trading System (ETS) with the EU ETS as soon as practicable.

Carbon Leakage: High-Level Positions

The EU CBAM is a carbon tariff on carbon intensive goods entering into the EU. Carbon border adjustments are designed to create a level playing field between jurisdictions and minimise the risk of carbon leakage by applying fees on imported goods based on their emissions content compared to the price that would be paid to manufacture these goods in that territory, country, or state.

Energy UK is supportive of appropriate and robust measures to minimise the risk of carbon leakage and support global decarbonisation efforts. With regards to CBAMs, it is our belief that any carbon border adjustment framework must have two equally important objectives:

1. Where trade is between markets where there are significant differences in carbon pricing and decarbonisation objectives, CBAMs should limit the offshoring of emissions.
2. Where trade is between markets with similar carbon pricing and decarbonisation objectives the risk of carbon leakage is low. Instead, CBAMs must be applied appropriately, in line with World Trade Organisation rules, to ensure barriers to the trade of goods are minimised.

EU CBAM Impact: UK Electricity Sector

Despite similar climate policies and the shared ambition to reach Net Zero by 2050, the UK is currently not among countries exempt from the EU CBAM. Indeed, the EU's CBAM Regulation infers that the UK will not be exempt unless the UK and EU ETSs become linked.

As the EU is the UK's biggest trading partner, we are concerned that the EU's CBAM could have serious implications for sector specific UK exports to the EU - such as electricity - as well as on the broader EU/UK relationship.

As the UK transitions to Net Zero, we expect electricity export capacity from Great Britain (GB) to increase due to the build-out of offshore wind around the British Isles. In general, efficient and effective cross-border electricity trade is needed to help both the UK and EU reach Net Zero in the most cost-effective way, to support the mass build-out of offshore wind around the UK, continental Europe and Ireland and to ensure security of supply.

However, the EU's CBAM has the potential to increase barriers to electricity trade between GB and the European Economic Area (EEA) through the creation of additional costs and administrative burdens relating to compliance with the mechanism. Whilst the fiscal implementation of the EU CBAM is not until 2026, the UK energy sector is still expected to feel the administrative costs of the mechanism during its transitional phase.

Following the publication, by the European Commission, of the CBAM guidance and the electricity webinar held 28 September 2023, Energy UK has identified a number of areas where concern persists, clarity is needed and questions which remain unanswered. Whilst it is understood that the transitional period will be a learning curve for all involved parties, clarification from the European Commission on the issues and questions identified below will help the UK energy sector to:

- Better understand how the EU's CBAM is to work in practice
- Understand how importers to the EU can meet their obligations in time and comply with the Regulation obligations
- Ensure that the most accurate data is submitted

Concerns and Questions

Reporting Obligations

At present, it remains unclear where the CBAM reporting obligations lie and with whom. We would ask for clarification, accompanied by clear examples, to be provided by the European Commission.

Additionally, according to the CBAM Regulation, in order to be eligible for a rebate against CBAM costs, an importer to the EU must provide proof that the goods they are importing have had a specific carbon price paid in the third country. However, electricity is largely traded anonymously via exchange-based platforms, with a unit of electricity potentially being traded multiple times before flowing across an interconnector. Confirmation from the European Commission is sought with regards to:

- How importers (or any other electricity market participant) would be able to verify and prove that a precise carbon price has been paid for any individual traded volume despite the fact that the traded electricity prices reflect the carbon costs paid within the entire supply chain of that electricity export.
- How it would be ensured that there is no risk of double taxation on electricity imported from GB to the EU.

Equally, if a company has purchased import capacity on an interconnector but flows zero electrons during the reportable period, we would welcome clarification as to whether that company would be required to complete a CBAM declaration.

Confirmation is also needed with regards to whether there will be a different treatment for a company that is importing electricity purely to trade on the wholesale market (Power Exchanges) compared to a company that is importing to supply an asset in the EU.

We would welcome confirmation as to whether it will be ensured that the relevant parties and authorities from third countries can corroborate that the data (required by importers to meet their regulatory reporting requirements) is available and that this data is reliable and accurate for reporting purposes.

Energy UK is also concerned that compliance with the EU CBAM Regulation will lead to increased administrative burdens for EU importers, particularly for smaller businesses. For example, during the transitional period, UK companies will face upfront costs in view of establishing new documentation and

data gathering processes for reporting purposes, templates, IT requirements/upgrades and so forth to comply with the EU CBAM reporting obligations. This will result in increased administrative costs and obligations for customers who are trading over the interconnectors. For customers outside of the EU, additional costs associated with appointing an indirect customs representative (who would need to be established within the customs territory of the Union) will also need to be taken into account.

Adding complexity through burdensome reporting and compliance processes may also have an adverse impact on trade flows over the interconnectors.

Default Values

We are concerned about the proposed use of default values in the calculation of embedded emissions for traded electricity into the EU, and the impact that the use of default values could have on the cross-border trade of electricity over the interconnectors between GB and continental Europe.

Unlike other goods included in the EU CBAM scope, the physical characteristics of electricity and the fact that electricity is largely traded anonymously via Power Exchanges means that it is challenging to assign a precise value for the carbon content of each MWh of traded electricity. The approach taken in the EU CBAM Regulation, therefore, is to use default values based on the average carbon intensity of the GB's electricity grid for the carbon content of traded electricity. Energy UK is concerned that the default value for GB will inaccurately label all exports of electricity from GB as originating from the same high carbon intensity fossil-fuel sources. This has serious implications for companies with renewable and low-carbon generation assets.

Additionally, during the aluminum (21/09/2023) and fertilizer webinar sessions (26/09/2023) it was flagged that default values are only applicable until July 2024. After this point, the European Commission expects to receive actual emissions data from importers. It was also noted that there will be no verification requirements until the start of the "definitive period". Energy UK seeks confirmation as to whether this is applicable for electricity under its CBAM, and if so, whether electricity flows are expected to meet the criteria for actual emissions reported during the transition period i.e., "no congestion, a Power Purchase Agreement (PPA), firm capacity etc."

We would also welcome confirmation as to whether grid factors from the Transmission System Operators (TSOs) would be accepted for actual emissions values. Particularly, for spot trading where there is an absence of a PPA in place.

Ireland and Northern Ireland

Energy UK seeks clarity from the European Commission with regards to the interaction between the EU CBAM and the Single Energy Market (SEM) between Northern Ireland and the Republic of Ireland. As it stands, the EU CBAM is not consistent with the SEM Annex within the UK's Withdrawal Agreement with the EU, given that the CBAM would technically apply between Northern Ireland and the Republic of Ireland. We note that there would be added complexities due to the fact that Northern Ireland and the Republic of Ireland operate within the same electricity market, so are in effect coupled, and Northern Ireland electricity generators in effect remain in the EU ETS, and so are in effect linked.

Explicit and Implicit Trading Arrangements

Within the regulation, the CBAM will apply only to explicit trades at borders with EU Member States, while implicit trading is not subject to the CBAM. We would ask the European Commission to address whether the future implementation of Multi-Region Loose Volume Coupling (MRLVC) arrangements between GB and the EU's Internal Energy Market (IEM) would enable the UK to qualify for exemption from the EU CBAM.

Netting of Interconnector Flows

The netting of flows is another issue which shows the unique challenges of the EU's CBAM application to electricity trading over Power Exchanges. According to the GB Electricity Interconnector Standard Licence Conditions¹ (condition 11A(3)(a)), GB interconnectors are required to maximise their available

¹ Electricity Interconnector Standard Licence Conditions 03/08/2021 (ofgem.gov.uk)

interconnector capacity, which includes 'the netting of capacity of any power flow in the opposite direction over the interconnector.' This means that during a given settlement period, customer requests to import electricity into an EU country from GB must be offset against customer requests to flow in the opposite direction.

This is best illustrated with the example below:

During a given settlement period, any customer requests to import electricity into an EU country from GB must be offset against customer requests to flow in the opposite direction. For example, if the day-ahead position on IFA is 2000MW FR→GB then 4000MW of capacity is made available in the direction GB→FR into intraday auctions. However, if prices reverse and four parties all trade 1000MW intraday GB→FR what should be stated in the CBAM declarations? All four parties have not each exported 1000MW to the EU physically.

Under the EU CBAM Regulation (Article 5(4)) and the Implementing Regulation, it should be further clarified by the European Commission as to whether an importer's CBAM liabilities will be based on the pre-netted position (i.e., all nominated flows on an interconnector that would export power into the EU) or on the final net position on the interconnector (i.e., only the power which is physically exported to EU Member States).

We would also welcome clarity on how electricity imports are to be determined for the purposes of the CBAM reports. For example, would this be done on the basis of the information provided in the customs declarations i.e., final nominations (Long-Term, Day-Ahead and Intraday) which constitute pre-netted positions that interconnectors are then required to net? We would note that it is the final net position on the interconnector that corresponds to the electricity that is actually physically exported to the EU.

Technical Losses

With regards to the technical losses for the transfer of electricity over long distances through interconnectors, we would ask for clarification as to which quantity of electricity would be subject to the CBAM. For example, would it be the electricity MW quantity that leaves the GB border or the MWs that physically enters the EU Member State?

Balancing Actions

We would ask the European Commission to clarify how balancing actions (System Operator (SO) to SO trades) will be treated under its CBAM Regulation.

Use of Indirect Customs Representative

According to the EU CBAM Regulation, non-EU established importers must submit declarations via an indirect customs representative. Energy UK seeks clarification as to whether this means that such importers will have to use a separate agent for electricity imports into the different EU Member States or if there is the possibility for using a "central" or "one-stop" representative for CBAM reporting? We note that the latter option would greatly simplify the process.

Additionally, in some EU Member States, the interconnector operator currently submits customs import/export declarations for all parties. We seek clarification as to whether an importer (or an indirect customs representative) reporting under CBAM on behalf of customers, while customs declarations are submitted by the interconnector, would create issues under the EU CBAM Regulation (assuming the volumes match).

Penalties During the Transitional Phase

We would ask for clarification on the following questions:

- What is the period from which penalties will start to apply in the transitional phase?
- On what basis can these penalties be established?
- Who will the liability for penalties apply to in case a customer is using an 'indirect customs representative'?
- How can penalties be disputed?

- Will there be a uniform application of this provision, provided that each EU Member States is responsible for imposing such penalties?

Carbon Price Support

Energy UK seeks confirmation from the European Commission as to whether the carbon price for electricity exported from GB will take account of the Carbon Price Support (CPS) which applies in the UK power sector in addition to the carbon price of the UK ETS.

Actions: UK Government and European Commission

The EU's CBAM reinforces the need for UK engagement and dialogue with EU policy makers on both carbon pricing and borders; reaffirming and highlighting both Parties shared and high ambitions towards decarbonisation across all sectors of the economy, but especially in electricity.

Energy UK sees a role for the UK Government to ensure that UK sectors included within the scope of the EU's CBAM (such as the UK power sector) are not adversely affected by the mechanism.

The EU has made clear that it is open to third-country engagement and agreements on its CBAM. Energy UK would therefore encourage active engagement and dialogue between both Parties during the current transitional period of the EU's CBAM. We would ask for the UK Government to raise the concerns and questions of Energy UK – stated within this paper - directly to the European Commission.

Energy UK would ask for the European Commission to address these concerns and questions in full to ensure a heightened understanding of its CBAM, as well as full compliance with the mechanism from the UK electricity sector.

UK engagement with the EU on this mechanism is absolutely necessary before the fiscal start of the EU CBAM at the start of 2026.

Linkage

We would reiterate that whilst CBAMs can protect domestic production against imports from jurisdictions with lower carbon prices, Energy UK believes that CBAMs are sub-optimal to linked carbon markets.

Establishing a link between UK Emission's Trading System (ETS) and EU ETS removes the need for carbon borders between the UK and EU markets. Linkage would also align decarbonisation pathways identifying the lowest cost abatements from across the market, reduce transactional costs from lower liquidity in smaller markets, provide a more stable environment to encourage investment into low-carbon alternatives and show continued shared international leadership in tackling climate change.

Energy UK would restate that the UK energy sector remains strongly in favour of linkage and continues to encourage the UK Government to commence action and dialogue towards negotiating a link between the UK ETS and EU ETS as soon as possible.