Institute of Directors

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THE RT HON GRAHAM STUART MP

Minister of State for Energy Security and Net Zero

Department for Energy Security and Net Zero

1 Victoria Street, Westminster,

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Dear Minister,

Addressing carbon leakage risk to support decarbonisation: A consultation on strategic goals, policy options and implementation considerations

The IoD is an independent, non-party political organisation representing approximately 20,000 company directors, senior business leaders, and entrepreneurs. It is the UK's longest-running organisation for professional leaders, having been founded in 1903 and incorporated by Royal Charter in 1906. Its aim is to promote good governance and ensure high levels of skills and integrity among directors of organisations. It campaigns on issues of importance to its members and to the wider business community with the aim of fostering a climate favourable to entrepreneurial activity in the UK.

The IoD welcomes the opportunity to contribute to this consultation on proposals for policy measures to mitigate carbon leakage risk in future. Meeting the UK's climate commitments in a manner consistent with free and open trade is a topic of considerable interest to the IoD and its membership, and we are therefore pleased to present our views.

In the first section, we provide a summary of our key perspectives. We then provide more detailed responses to the questions laid out in the consultation.

Summary of the IoD view

Carbon leakage — whereby, for reasons of costs related to climate policies, businesses transfer production to other countries with laxer emission constraints — represents a credible risk to the UK's net zero target and to the prospects for investment and growth in UK manufacturing. **Effective policies to prevent carbon leakage will increase businesses' confidence in their ability to recover the costs of investment in decarbonisation measures**, and will be essential elements of economic policy until global carbon prices converge or low-carbon production technologies become economically superior on financial grounds alone.

In a May 2023 survey of over 1000 IoD members, business leaders on balance expressed support for the three measures being proposed in this consultation (see Appendix). Almost half (48%) of business leaders agreed with the concept of a

carbon border adjustment mechanism (CBAM) (as opposed to 28% who disagreed), half (50%) agreed with the principle of mandatory product standards (as opposed to 26% who disagreed), and almost two thirds (61%) expressed support for demand-side policies to drive support for low-carbon products (as opposed to 17% who disagreed).

Specific proposals to address cross-border carbon leakage in high emission sectors are important in the short- to medium-term to deter firms from consciously offshoring their emissions to avoid UK-based carbon taxation. **In the long-run, however, a systematic approach to reporting scope 3 emissions, using international standards for carbon accounting, should be capable of being blind to the country in which those emissions take place thereby removing any financial incentive for carbon leakage.**

Our proposal, laid out in *The Green Incentive: how to put net zero at the heart of business planning* is that companies that have achieved net zero in all their operations, including via their supply chains, international or otherwise, should pay a lower corporation tax rate than those that have not. When polled alongside the other measures outlined in this consultation, two thirds (66%) of business leaders were in favour of this approach, 18 percentage points higher than support for a CBAM.

There is also a need to combine measures to mitigate carbon leakage with support for businesses to decarbonise — including accelerating technology development and improving access to cheap and clean energy — in order to achieve the overall aim of supporting businesses to decarbonise rather than offshore their operations.

In order to minimise the regulatory burdens placed on businesses as a result of the policies laid out in this consultation, **government should align the various domestic and international sustainability standards being placed on businesses where possible, rather than introducing a new framework for the reporting and collection of product level emissions.**

Carbon leakage policy measures

Question 1.3: How should the government act to mitigate future carbon leakage risk? Please explain your reasoning.

Government should ensure that any domestic measures are consistent with international and multilateral action. Multilateral cooperation to set a global price on carbon which drives private sector investment in decarbonising measures and the technologies needed to achieve net zero is essential. However, until a global carbon price is achieved, domestic measures to prevent carbon leakage and support UK businesses in their decarbonisation efforts are needed.

In our research with IoD members, we found concern around the efficacy of the measures proposed in this consultation, were they to be implemented without accompanying progress on multilateral cooperation:

> "[A]ny regulation needs co-ordinating around the globe to ensure businesses have a level playing field" – IoD member, information and communication sector, large business

> "All options require standardised reporting on scope emissions globally - that would seem difficult to achieve" – IoD member, professional, scientific and technical sector, SME

> "I'm sceptical about labelling - there would need to be international agreement on measuring methodology and how to apply" – IoD member, services sector, SME

> "Carbon taxing needs a rigorous & consistent approach, ideally based on international consensus on methods & standards" – IoD member, administrative and support services sector, SME

Carbon border adjustment mechanism

In the absence of a global carbon price, a CBAM would be a positive step forward in the UK's journey to achieve a true net zero economy status as long as it was designed in a way that was proportionate for smaller businesses and/or those in lower emission sectors.

The introduction of a CBAM would also encourage other countries to set effective carbon prices, thus aiding movement towards a global net zero economy. However, a CBAM holds the potential to be protectionist and add complexity and friction to cross-border trade at a time when importers are already struggling with post-Brexit trading arrangements, so any CBAM should be carefully designed to ameliorate its impact on importers as far as possible.

The principle of a CBAM is supported by half of business leaders (48%) and opposed by 28% (see Appendix). However, IoD membership is not concentrated in the sectors likely to be targeted by initial iterations of a UK CBAM and our ongoing research has consistently found that IoD members are still struggling to acclimate to the post-Brexit trading environment and thus would find any additional cross-border friction difficult. Examples of this sentiment from the qualitative feedback to our survey question on a CBAM include:

> "Our concern is the potential impact on free trade of poorly developed legislation giving undue advantage. There is also a significant cost to compliance which should not be underestimated" – IoD member, services sector, large business

> "Carbon tax would be good in theory, but unlikely to be practical to get realistic carbon assessments for all imported goods" – IoD member, manufacturing sector, SME

> "Carbon taxes can be seen as a variation on tariffs and other forms of protectionism, but designed carefully they should reflect the true costs which include pollution" – IoD member, information and communication sector, large business

As the EU implements its CBAM in the near future, the UK should prioritise close multilateral cooperation in the development of its own CBAM, given the UK's strong trading links and supply chain integration with the EU and its importance in increasing long-term investment security for carbon-neutral production processes for UK industry.

Question 2:1: Should a CBAM only apply to products in sectors that are subject to the UK ETS?

Yes, strongly agree. A CBAM should target imports whose production is carbon intensive and thus at most significant risk of carbon leakage. Reflecting the EU's CBAM in initial sectoral targeting — of cement, iron and steel, aluminium, fertilisers, electricity and hydrogen — would be a logical first step.

> "Whilst a general carbon tax on imports would be opposed. One targeted at high carbon production produces might be acceptable (but difficult to manage)" – IoD member, services sector, large business

Question 2.3: If the scope of a CBAM is initially limited, should it be designed to potentially cover other products in future?

Yes, agree. The initial focus should be limited in scope to the sectors most at risk of carbon leakage, but if the CBAM proves effective in mitigating carbon leakage and a global carbon price is not achieved through multilateral cooperation, the scope of the CBAM should be gradually widened to include other sectors with evidence of carbon leakage. A

transition period should be used to gather feedback and refine the methodology and future sectoral targeting of the CBAM to minimise compliance costs for business.

Question 2.5: Should importers be required to provide accurate, independently verified emissions data for the products they import where available?

Yes, agree. Accurate, independently verified emissions data will realistically need to be generated at the point of production, and the growing international alignment around the use of CBAMs is such that pressure will be exerted through supply chains for such data to be routinely produced by companies involved in production in carbon-intensive sectors. As such, it is not unreasonable for importers to be generally expected to provide this data as part of routine customs declarations, so long as sufficient notice and guidance are provided to companies ahead of the change.

However, the definition of 'independently verified' will need to be made clear, alongside the liability of importers. While verification will be crucial to the credibility of the CBAM, adding significant verification-related burdens to importers, particularly infrequent importers and SMEs, would be unrealistic and could lead to disengagement with the trade system.

It is also unclear how the availability or otherwise of the data could be verified by government, although the use of default values (see answer to Question 2.6) could make such a debate redundant; it would not be for government to verify whether such data exists as importers would have the option of providing accurate, independently verified emissions data or of using default values.

As discussed below, any requirement to provide emissions data should also be designed into the operation of the UK Single Trade Window to minimise compliance costs. Furthermore, given that much of the compliance would in reality be dealt with by customs agents, ensuring they are provided with the advice and guidance they need will be crucial.

Question 2.6: Should there also be an option for importers to use default values, where they do not or cannot provide accurate emissions data are? Please explain your reasoning.

Agree, in all cases, in order to reduce disruption to supply chains in which sufficient and reliable data on actual GHG emissions is not available. Where the default values are set at the average emission intensity of each exporting country and for each CBAM good, increased by a mark-up, importers will have a financial incentive to obtain data where possible but will still be able to import goods where gathering accurate emissions data is not feasible.

The decision as to whether to provide available data or opt for default values should be at importers' discretion. Pricing in carbon via default values achieves the policy aim of ensuring that imported goods do not undercut UK-produced goods on account of embodied carbon costs. At the same time, default values provide an option for importers who cannot for various reasons provide reliable GHG emissions data; this flexibility should therefore be built into the design of any CBAM.

Question 2.11: Do you agree or disagree a CBAM should be applied to Scope 2 emissions embodied within imported products?

No, disagree, in the immediate term. The UK's CBAM should initially cover the Scope 1 emissions of selected carbon-intensive industries, given that indirect emissions come from sources other than the reporting entity and can therefore be hard to measure.

It will, however, be important for the overall effectiveness of a CBAM that Scope 2 emissions are at some point brought into the system. When calculating carbon emissions, businesses typically include their Scope 1 and 2 emissions; a CBAM

which applies to Scope 1 and 2 emissions would therefore be a reasonable ask in the medium term, although the design of the CBAM would need to take into account the risk of double accounting with regards to Scope 2 emissions.

Scope 2 emissions should therefore not be included in the initial phase of implementation but should be considered for inclusion in future iterations of a CBAM upon further assessment by the UK government.

Question 2.16: Should a CBAM be applied to the Scope 3 emissions embodied within imported products that are also indirectly covered by the UK ETS?

No, strongly disagree, not initially. The CBAM should initially include Scope 1 emissions and be gradually expanded to include Scope 2 emissions. An ambition to include Scope 3 emissions in the long term would be welcome in order to prevent leakage between the scopes, but issues around the cost to businesses of calculating Scope 3 emissions, as well as double accounting, would need to be addressed.

Question 2.20: Should the price applied by a CBAM be comparable to the effective domestic carbon price paid, including accounting for any discounts available through free allowances or compensation?

Yes, agree, in order to level the playing field for UK manufacturers.

Question 2.21: Should the price applied by a CBAM track the prevailing UK ETS price throughout the year, as opposed to being set at a fixed annual rate?

Yes, agree. The price applied by a CBAM and the prevailing UK ETS prices should be as closely linked as possible to ensure consistency. Such an approach would also mirror the operation of the EU's CBAM, thus improving alignment between the two systems.

Question 2.25: Do you have any views on how a CBAM could be designed to ensure maximum simplicity? For example, by following the mechanism for other border charges such as tariffs and excise duties.

Integrating any CBAM with the Single Trade Window, in order that the documentation involved is digital and is submitted alongside other administrative requirements through a single portal, will be crucial to minimising the burden on importers. Any further steps to simplify the process for importers — such as automating the calculations involved for importers, building in options for repeat consignments, and levying the CBAM price at the same time as any other documentation and payment are required for the same goods — would be welcome.

Question 2.27: Are there further actions government could take to design a CBAM in a way that facilitates the smooth flow of trade?

Maximising regulatory alignment with the EU CBAM will be critical for facilitating the smooth flow of trade. Accessible guidance for businesses as well as for customs agents and intermediaries will be essential for minimising the impact on importers, particularly SMEs. Providing as much information as possible, particularly on approximately how much businesses can expect to pay in tariffs per consignment when importing goods from different countries, will be essential to ensuring that businesses can make accurate plans and forecasts without having to undertake extensive calculations themselves.

Government should monitor the evidence from the EU's CBAM transition period, and consider phasing in a UK CBAM in a similar manner by first requiring importers to report embedded emissions in imports without making financial adjustments. The final rollout of the CBAM, including financial adjustments, would then take into account feedback from importers as to how to best minimise disruption to trade flows.

Question 2.29: Are there further policy interactions that government should consider regarding potential implementation timelines for a CBAM?

The implementation timeline of a CBAM will be crucial in minimising any negative impacts on business. The current inflationary pressures on both businesses and consumers, combined with businesses still struggling to adjust to the post-Brexit trading environment, are such that the implementation of any CBAM should entail a significant implementation period to enable businesses to prepare fully in advance.

Mandatory Product Standards

Our research has found that the principle of mandatory product standards is supported by half of IoD members, and opposed by 26% (see Appendix).

In some sectors significant work is already being undertaken to reduce the carbon intensity of products due to consumer pressure, but competition from carbon intensive products undermines their viability. Well-designed, mandatory low carbon product standards can create the confidence required for the upfront capital expenditure required to achieve decarbonisation and provide an important incentive for manufacturers of materials and finished products to decarbonise. However, they need to be designed to be as simple as possible for manufacturers.

Question 3.2: Which option, if any, would be most appropriate for the initial sectoral targeting of a mandatory product standard? Are there other/additional sectors which should be considered for early targeting, for example to address the risk of substitution?

Option 3: targeting steel, cement, concrete, and chemicals. Mandatory product standards should first encompass a limited number of the most carbon intensive industries so that business and policymakers can learn iteratively from the implementation process.

Question 3.3: Which option, if any, would be most appropriate for emissions scope of a mandatory product standard? Please explain your reasoning, and details of any alternative options.

Option 1: Scope 1, 2, and some upstream Scope 3 emissions, with a view to iteratively including downstream Scope 3 emissions if data collection methodologies mature enough to make such calculations achievable for manufacturers.

Question 3.5: Which option, if any, would be most appropriate for targeting the point of obligation for a mandatory product standard for domestically produced goods? Please explain your reasoning, with reference to specific sectors if possible, and details of any alternative options.

Point of production. Targeting the point of obligation at the point of sale would add considerable complexity for individual retailers; targeting it at the point of production will make for simpler accounting across the economy.

Question 3.7: Do you agree or disagree that any mandatory product standard should apply to imports?

Yes, agree; applying mandatory product standards only to UK-manufactured products would put UK manufacturing at an unfair disadvantage and exacerbate the risk of carbon leakage through offshoring. However, work should be done to gauge the support needed for manufacturers in low-income countries in particular to comply with mandatory product standards, to reduce the risk of supply chain disruption.

Question 3.9: Should mandatory product standards be delivered in stages, broadly moving from a less stringent, relatively focussed application in the late 2020s to a more stringent and potentially broader application during the 2030s? Please explain your reasoning.

Yes, strongly agree. As the purpose of mandatory product standards is to incentivise manufacturers to decarbonise, and doing so typically requires significant investments of capital and time, the standards should be introduced in stages and under clear timelines in order to effectively support the process of decarbonisation.

Delivering mandatory product standards in stages will also support the necessary parallel process of implementing policies to require the standardised data transparency across supply chains needed to make the standards feasible. The current lack of verifiable data on the embodied and life-cycle emissions of different materials is a major barrier to the viability of mandatory product standards which needs to be overcome if manufacturers are going to be able to comply with the standards.

Question 4.18: Should mandatory product standards apply to all UK manufactured products intended for export? Please explain your reasoning, and provide details of any impacts this would have on your sector.

Yes, not only to support the UK in achieving a true net zero economy, but because the direction of policy in other countries is also moving towards product standards. The UK government should work multilaterally to ensure that the standards and methodologies adopted in the UK are as closely aligned, both at inception and on an ongoing basis, with those developed elsewhere; doing otherwise would risk UK export manufacturers being required to comply with differing standards according to their export market.

Question 4.19: Should the use of carbon credits to offset emissions be considered within the assessment of a product?

No. Carbon credits can be a valuable, market-led approach to offsetting emissions from hard-to-abate sectors. However, their extensive use in relation to mandatory product standards risk discouraging countries from setting carbon pricing mechanisms and from investing in decarbonising manufacturing processes. The limited supply of high-quality, effective projects to remove carbon from the atmosphere is such that the use of credits in industries that can meaningfully decarbonise should be reserved for sectors where current technology does not enable decarbonisation, such as aviation.

Growing the market for low-carbon products

Of the three major proposals detailed in this consultation, the proposal to grow the UK market for low-carbon products received the strongest mandate from IoD members, with our research finding that almost two thirds (61%) of business leaders support the principle of such measures, with only 17% opposed (see Appendix).

In particular, carbon labelling could support environmentally-conscious customers to make informed choices in favour of more sustainable options, thereby increasing the scale and consistency of consumer demand for low-carbon products.

Question 5.1: Which of the following statements corresponds most with your view?

Both embodied emissions data and energy efficiency style lettered and coloured ratings. While embodied emissions data would likely be impactful with a subset of consumers, having both embodied emissions data and energy efficiency style lettered and coloured ratings would maximise the effectiveness of the labelling scheme. Consumer familiarity with the energy efficiency style lettered and coloured ratings is such that applying a similar system to this scheme would be particularly effective in sensitising the public to the varying carbon intensity of the products they consume.

Question 5.2: Should the government adopt mandatory labelling for products that are required to have their embodied emissions reported?

Yes, agree. Mandatory labelling would need to be applied at the point of production; applying it at point of sale would add significant cost and complication. The mandated labelling should be made as simple as possible, mirroring the work already done on energy efficiency labelling.

However, while labelling has the potential to nudge consumers towards lower-carbon products, its impact is likely to be less minimised among lower income groups and at times when in periods where disposable income of all households is under pressureis being squeezed. Labelling could prove to be a valuable component of a wider strategy to increase the supply of, and demand for, low-carbon products, but will not shift the dial without significant further government intervention in other areas.

Designing the mechanism for embodied emissions reporting

Question 7.5: Should the government introduce a data collection period before the full implementation of carbon leakage policy measures? What are the advantages or disadvantages of the options?

Yes, agree, as a data collection period before full implementation would enable businesses to establish requisite reporting infrastructure and gain insights into the emissions intensity of their products without having to make financial adjustments. However, the length of this data collection period should be proportional to these aims, with a mirroring of the EU's CBAM transition period of approximately two years being reasonable.

Question 7.7: Should only those businesses in scope of current or upcoming policies be required report information about the emissions of products? Please explain your reasoning.

Yes, strongly agree. Requiring businesses out of scope of current or upcoming policies to report information about the emissions of products would create a regulatory burden disproportionate to its impact on decarbonisation.

Summary

A phased implementation of the main policy measures proposed in the consultation holds the potential to rapidly accelerate decarbonisation in the UK and overseas manufacturing. However, these policies will only be effective if supported by a wider framework of policies to support decarbonisation, including a corporation tax system designed to create a clear business case for investment in net zero, cost-competitive clean electricity, support for deploying low-carbon technologies which are not currently cost effective, and support for UK manufacturing negatively impacted by differences in input costs caused by faster climate progress in the UK compared with elsewhere.

The long-term aim of policies in this space should be to develop a systematic approach to reporting scope 3 emissions, using international standards for carbon accounting, thus organically nullifying any financial incentives for carbon leakage.

I hope you have found our comments helpful. If you require further information about our views, please do not hesitate to contact us.

With kind regards,

A Hall-Chen

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Appendix

IOD MEMBER SURVEY RESULTS: MAY 2023

THE GOVERNMENT IS CONSULTING ON HOW TO ADDRESS 'CARBON LEAKAGE', WHEREBY BUSINESSES TRANSFER PRODUCTION TO OTHER COUNTRIES WITH LAXER EMISSION CONSTRAINTS TO GET ROUND UK REGULATIONS. WHAT IS YOUR VIEW ON THE FOLLOWING SUGGESTED MEASURES?

1026 RESPONSES

Count of Attribute	Column Labels			
Row Labels	A carbon price tax on imported products	A lower corporation tax payable by firms that are net zero in all global operations	Mandatory product standards, which would set an upper limit on the amount of carbon used to make individual products sold or produced in the UK	Voluntary product standards and low carbon product labelling so consumers can make informed choices based on the carbon footprint of products
Strongly support	17.1%	31.5%	15.7%	20.7%
Support	31.2%	34.3%	34.1%	40.0%
Neither support nor oppose	20.3%	15.0%	20.8%	20.0%
Oppose	17.4%	9.6%	15.7%	9.6%
Strongly oppose	10.6%	6.9%	10.0%	6.9%
Don't know	3.4%	2.7%	3.7%	2.9%
Grand Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**
Support	48.2%	65.8%	49.8%	60.6%
Oppose	28.1%	16.5%	25.7%	16.5%