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UK Emissions Trading Scheme: Free Allocation Review Main Authority Response

A joint response from the UK Government, Scottish Government, Welsh Government and the Department of Agriculture, Environment and Rural Affairs for Northern Ireland

November 2025

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Executive Summary

The UK ETS Authority – comprising the UK Government, Scottish Government, Welsh Government, and the Department of Agriculture, Environment and Rural Affairs for Northern Ireland – is committed to ensuring the UK ETS remains a robust, fair, and effective tool for reducing greenhouse gas emissions while mitigating the risk of carbon leakage for industries across the UK.

Following extensive engagement with stakeholders through the Free Allocation Review Consultation (December 2023 – March 2024)[1] and the Carbon Leakage Consultation (December 2024 – March 2025)[2], this document responds to both of those consultations and sets out the Authority's final decisions on reforms to free allocation rules.

The Authority is grateful to all respondents who contributed to these consultations. The feedback received has been instrumental in shaping the final policy decisions. This response confirms the implementation of a number of technical changes to the free allocation calculation for the next allocation period from 2027, while also setting out the pathway to further reforms aligned with the introduction of the UK Carbon Border Adjustment Mechanism (CBAM) in 2027. These decisions have been developed in light of the UK and EU's announcement of 19 May to work towards linking the UK ETS and EU Emissions Trading System (EU ETS), further details on this can be found later in this section.

Summary of Authority Decisions

Key decisions include:

- Operators able to choose to have activity data for either the years 2020 only, or 2020 and 2021 excluded for the purpose of determining historical activity level (HAL) for the 2027-2030 allocation period,
- The retention of current benchmarks for 2027, with the in principle intent to adopt updated EU benchmark values from 2028-2030,
- Retaining the current carbon leakage list[3],
- No introduction of tiering of free allocation for sectors at risk of carbon leakage,
- No early phase out of free allocations for sectors not on the carbon leakage list,
- No additional methodologies to be introduced in 2027, which would introduce conditions on the provision of free allocation. With a pathway set out to reconsider their introduction for future allocation periods, and
- A gradual phase out of free allocations for sectors covered by the UK Carbon Border Adjustment Mechanism beginning in 2027, with an indicative phase out trajectory of 9 years.

[1] https://www.gov.uk/government/consultations/uk-emissions-trading-scheme-free-allocation-review
[2] https://www.gov.uk/government/consultations/uk-emissions-trading-scheme-free-allocation-review-carbon-leakage
[3] With the exception of temporary amendments made to the list for 2024 – 2026.

The Authority has taken a deliberately balanced and pragmatic approach to reform, ensuring that free allocation continues to provide meaningful support to UK industry during the transition to net zero. Key decisions, such as not introducing tiering of free allocation, not bringing forward the phase out of free allocation for sectors not at risk, and retaining the current Carbon Leakage List[4], reflect a commitment to policy stability and certainty for industry. The decision to phase out free allocation for UK CBAM sectors gradually over an indicative period of nine years, and to apply this only to relevant sub-installations, ensures a fair and proportionate transition. Importantly, the Authority has also chosen not to introduce conditionality on the provision of free allocation, recognising the administrative burden and limited decarbonisation benefit such a change would bring. Adjustments to HAL to account for COVID-19 impacts further demonstrate the Authority's commitment to fairness. Taken together, these decisions prioritise a supportive approach that will enable industry to plan and invest with confidence, while ensuring that free allocation continues to work effectively alongside other policy mechanisms.

These reforms mark a significant step in the evolution of the UK ETS. By updating the free allocation rules to reflect a large data pool of latest emissions efficiencies taken by industry to drive decarbonisation, the UK ETS Authority is ensuring that the scheme remains environmentally robust and aligned with net zero ambitions across the UK. The intent to adopt updated EU benchmark values from 2028 (subject to assessing their impacts), the retention of a robust Carbon Leakage List, and the gradual phase out of free allocation for UK CBAM sectors all contribute to a more targeted and effective scheme. These changes maintain the incentive for installations to decarbonise ensuring that efficient operators are rewarded and that the scheme continues to drive emissions reductions for industries across the UK.

As the UK does not have access to updated EU benchmark values at the time of decision-making, the Authority has taken the decision to retain the existing benchmark values for the 2027 scheme year. This approach ensures continuity and provides necessary certainty for operators as they plan for the forthcoming allocation period. The Authority intends to adopt the updated EU benchmark values from 2028 onwards, subject to an assessment of their impacts on UK businesses, for the remainder of the allocation period to 2030. This phased approach balances the need for predictability with the commitment to update the scheme to reflect updates in emissions efficiencies.

The Authority will continue to engage with stakeholders on the implementation of these changes in the lead up to 2027.

[4] With the exception of temporary amendments made to the list for 2024 – 2026.

Interaction with UK – EU ETS Linking

As part of the new UK-EU Strategic Partnership, announced on 19 May 2025, the UK and EU have agreed to work towards linking the UK ETS and the EU ETS. There are many benefits to a linked scheme, including the creation of and access to a larger, deeper and more liquid carbon market. Overall, linking the UK and EU ETS would mean a cheaper path to net zero.

The decisions set out in this Authority Response, which will take effect from 1 January 2027, have been made in this context and with a view to minimise competitive distortions between the UK and the EU. However, it should be noted that it is possible the UK's free allocation policy may be subject to change following the outcome of the formal linking agreement. We will provide further updates related to linking negotiations at the appropriate times.

UK Carbon Border Adjustment Mechanism

The UK Government will introduce the UK CBAM on 1 January 2027. This will ensure highly traded, carbon intensive products that are imported from overseas face a comparable carbon price to that which would have been payable had they been produced in the UK, so that UK decarbonisation efforts lead to a true reduction in global emissions rather than simply displacing carbon emissions overseas.

The UK CBAM will place a carbon price on some of the most emissions intensive industrial goods imported to the UK from the aluminium, cement, fertiliser, hydrogen and iron & steel sectors that are at risk of carbon leakage. Within these sectors, the UK CBAM will only apply to specific imported 'CBAM goods'.

The UK CBAM will work cohesively with the UK ETS. That includes on free allowances, where the methodology to determine the UK CBAM rate will reflect the availability of free allowances to domestic producers.

As part of this Response, the UK ETS Authority are announcing a reduction to free allocations for sectors that will receive mitigation from carbon leakage through inclusion in the UK CBAM.

Further information on the UK CBAM can be found on GOV.UK.

Industrial Decarbonisation Strategy

We are committed to supporting industries across the UK to decarbonise, protecting thousands of jobs in regions across the UK and enabling the country to take advantage of new opportunities that can promote growth and wealth creation. UK Government will bring forward a clear plan for industrial decarbonisation. A renewed Industrial Decarbonisation Strategy will set the strategic direction for our approach to working with industry towards a competitive and low carbon industrial base in the UK, ensuring growth opportunities are captured in tandem with emissions reductions.

Introduction

Free Allocation of UK ETS allowances is the primary policy instrument through which carbon leakage[5] risk is currently addressed in the UK. The provision of free UK ETS allowances means that an operator needs to buy fewer allowances to cover their emissions; in effect, reducing the carbon price they pay and mitigating the risk of carbon leakage. The incentive to decarbonise is maintained as, in general, recipients of Free Allocation that decarbonise keep any surplus Free Allocations. They can sell these on the secondary market to their benefit.

Free Allocations are calculated using the following equation:

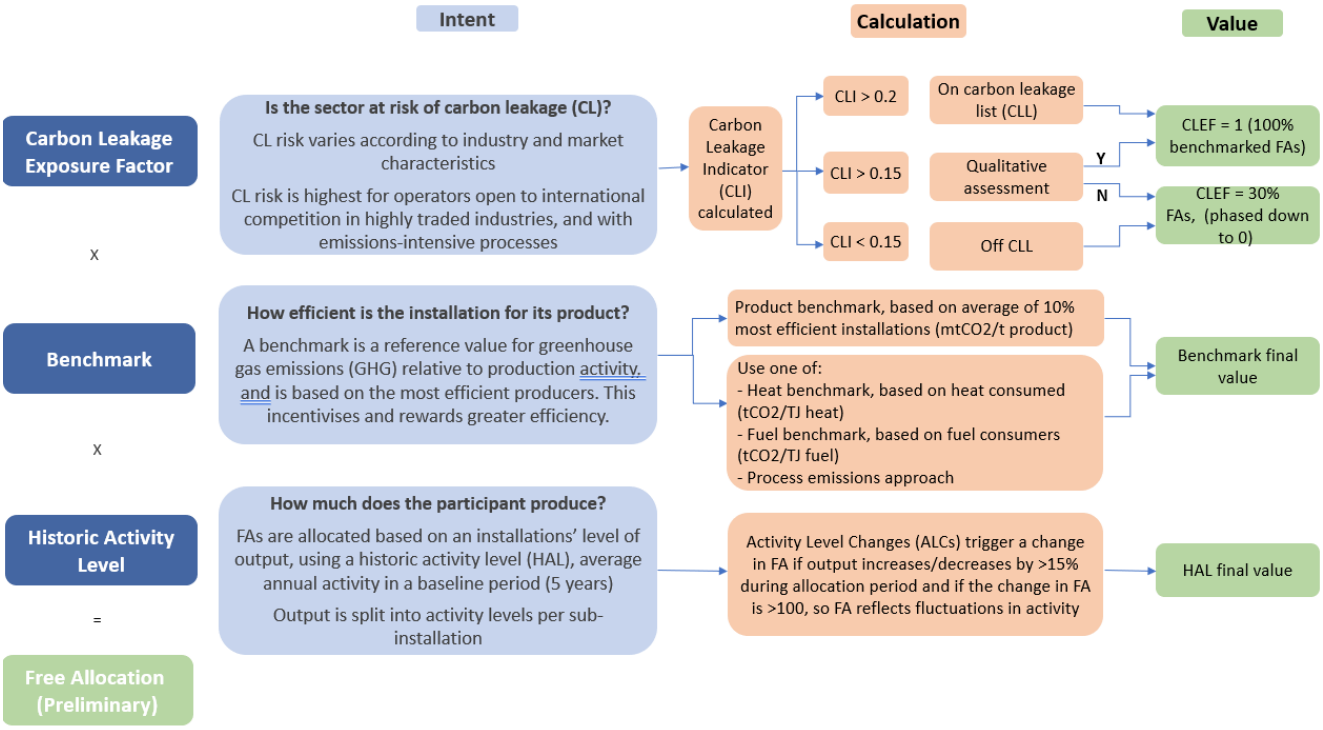

Figure 1 How Free Allocations are Calculated

Our current approach to Free Allocations for stationary installations under the UK ETS prioritised continuity for operators and largely carried over methodology from the EU ETS Phase IV, to ensure continuity for UK participants who had previously been operated under the EU's scheme. The Authority launched a review into Free Allocation policy in 2021 with the aim to ensure Free Allocation policy is working effectively in the UK context to both incentivise

[5] Carbon leakage is the movement of production and associated emissions from one country to another due to different levels of decarbonisation effort through carbon pricing and climate regulation. As a result of carbon leakage, the objective of decarbonisation efforts – to reduce global emissions – would be undermined.

emissions reduction and protect energy intensive, trade exposed industries from the risk of carbon leakage. We have carried out this review in a phased approach:

- The first phase focused on the share of Free Allocations under the cap available to be given out for free as part of the Developing the UK ETS consultation.
- The second phase focused on the methodology for calculating, and distributing, Free Allocations as part of the 2023 and 2024 Free Allocation Review and Free Allocation Review Carbon Leakage Consultations.

This Authority Response sets out final decisions that will inform the calculation of free allocations in the next allocation period from 2027. The Free Allocation Review timeline in Figure 2 demonstrates the evolution of the review and sets out timings of future reporting stages.

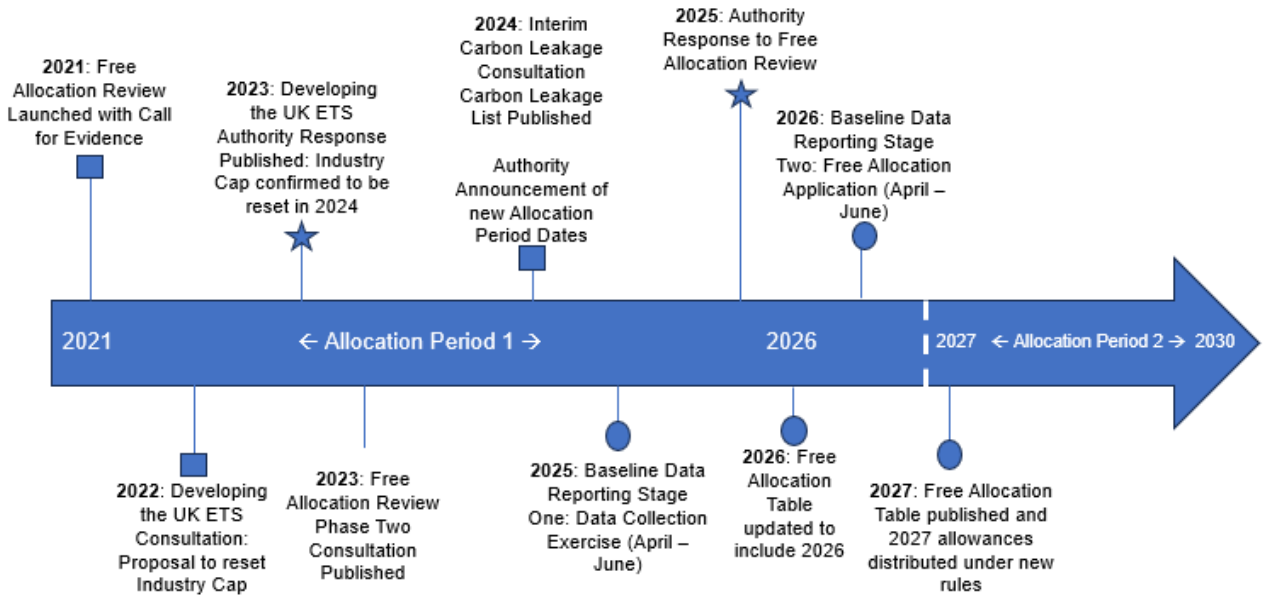

Figure 2 Free Allocation Review Timeline

Chapter 1: Treatment of Activity Levels

This chapter covers proposals set out in the Free Allocation Review Consultation (December 2023 – March 2024) on how the UK ETS should treat historical activity levels (HAL) and activity level changes (ALC).

The Authority has decided to maintain the current approach to ALCs and not to implement a dynamic approach or change the ALC threshold. Following careful consideration of consultation responses and assessment of the options, the Authority concluded that the current approach offers a reasonable compromise between accuracy in reflecting activity levels, providing certainty to industry, and reducing administrative burden.

Having heard stakeholder concerns regarding the impact of COVID-19 on activity levels during the baseline period, the Authority has decided that operators of UK ETS installations will be able to choose to have activity data for the years 2020 or 2020 and 2021 excluded for the purpose of determining their HAL for the 2027-2030 allocation period.

Summary of Proposals

The Authority sought views on whether to change the approach to how free allocation reflects activity levels and changes in activity. Two options were presented in the consultation, with no minded-to position taken. The Authority also sought views on whether to explore a third option (Option 3) in the event that Option 1 was preferred.

Option 1: Do nothing. Maintain current HAL and ALC rules and thresholds as the mechanism for ensuring that free allocation reflects activity and changes in activity.

Option 2: Dynamic allocation. Change to a dynamic allocation approach, with free allocation distributed on a provisional basis at the start of each scheme year and updated after the end of each scheme year to reflect actual reported activity.

Option 3: Consider reducing the ALC threshold. Maintain current HAL and ALC rules but lower the threshold at which ALCs are triggered (currently ALCs are triggered if activity increases or decreases by 15% or more in any two year period).

Questions (From 2023 – 2024 Free Allocation Review Consultation)

2. Should the UK ETS maintain the current approach to activity level changes or switch to a dynamic approach (i.e., should free allocation be adjusted after the end of the scheme year, based on reported activity levels)?

3. If a dynamic approach were to be implemented, should provisional allocation be calculated based on a rolling period of recently reported activity?

4. If provisional allocation were to be calculated via a rolling period, should this be based on the most recent two full calendar years of verified activity (e.g., 2023-2024 for 2026 allocation)?

5. Under the dynamic approach, should the energy efficiency calculation for fall-back benchmark sub-installations continue to refer to a fixed historical baseline?

6. If the UK ETS does not switch to a dynamic approach, should the UK ETS Authority consider reducing the 15% ALC threshold, and, if so, what would be an appropriate threshold?

Summary of Responses

There were 57 responses to this section of the consultation. Of these, 18 (32%) supported maintaining the current approach, 31 (54%) supported changing to a dynamic allocation approach (although with caveats in many cases), and 8 (14%) did not state yes or no.

Among the 18 that supported maintaining the current approach, the main reasons given were uncertainty caused by not knowing levels of free allocation until after compliance (13 respondents), increased administrative burden on regulators leading to delay in changes being processed (9 respondents), increased administrative burden on operators and verifiers (5 respondents), and avoiding divergence from the EU ETS (3 respondents).

Among the 31 that supported changing to a dynamic allocation approach in principle, the main reasons given were that the current ALC threshold is difficult to meet during times of expansion (7 respondents), removing perverse incentives (4 respondents), and avoiding under- or over-allocation (4 respondents).

Eighteen of these 31 added caveats to their support. Eleven stated that annual adjustments to free allocation must be completed before the compliance deadline of 30 April or ideally before the end of the UK financial year on 5 April. A further 7 stated that the ALC process must be streamlined.

Of the 8 respondents that did not state yes or no, 3 noted concerns about the increased administrative burden of annual adjustments to free allocation, 2 stated that annual adjustments to free allocation must be completed before the compliance deadline and/or the end of the financial year, and two said the ALC process must be streamlined.

There were 44 responses to the question of whether the Authority should consider reducing the ALC threshold, with 25 respondents (57%) opposing a change, 17 respondents (39%) supporting a change, and 2 (4%) not stating yes or no.

Among the 25 that opposed changing the ALC threshold, the most common reasons given were: increased burden on regulators leading to delay in changes being processed (10 respondents); greater uncertainty as to final levels of free allocation (4 respondents); and avoiding divergence from the EU ETS approach (2 respondents). One respondent suggested that there should be a separate process for free allocation to take account of capacity expansions.

Of the 17 respondents that supported changing the ALC threshold, 9 suggested a threshold of either 5% or the lowest possible, and 5 suggested either 10-12% or a small reduction. One respondent suggested removing the 100 UKA threshold on the grounds that it can impact smaller installations. Three respondents stated that any reduction in the threshold should not increase the time taken to process ALCs each year.

Four respondents expressed concern that the impact of COVID-19 on activity during the baseline years could result in HALs that are not representative of normal activity levels.

The Authority Response

The Authority has decided to maintain the current approach to HAL and ALC and not to implement a dynamic approach or reduce the ALC threshold. This will provide continuity and certainty for operators and avoid increased administrative burden. Following assessment of both the current approach (Option 1), dynamic allocation approaches (Option 2), and reducing the ALC threshold (Option 3), the Authority concluded that the current approach offers a reasonable balance between accuracy in reflecting activity, certainty to industry, and administrative burden.

Having heard stakeholder concerns about the impact of COVID-19 on activity levels during the baseline period, the Authority has decided that operators of UK ETS installations will be able choose to exclude activity data for the years 2020 or 2020 and 2021 for the purposes of determining HAL for the 2027-2030 allocation period. Operators will be able to indicate whether they wish to exclude 2020 or 2020 and 2021 activity from HAL at sub-installation level during the second stage of the free allocation application process (1 April – 30 June 2026). Guidance on how to do this will be made available before the second stage window opens on 1 April 2026.

Current approach

The Authority consulted on the possibility of changing the approach to activity and ALCs for two related reasons. Firstly, using historical activity data means that free allocation may not be reflective of more recent activity levels. The ALC mechanism allows for responsiveness to changes in activity levels greater than 15% above or below HAL during an allocation period,

but changes below that threshold are not captured. Free allocation therefore may not be accurately directed to where carbon leakage exposed activity is occurring.

Secondly, the Authority was concerned that the +/-15% threshold could create perverse incentives. Activity levels above HAL but below +15% relative to HAL do not result in additional free allocation and may create a perverse incentive not to increase activity unless the increase will be +15% above HAL. Activity levels below HAL but not more than -15% relative to HAL do not result in reduced free allocation and may create a perverse incentive to reduce activity.

The Authority assessed the effectiveness of the current approach from both these perspectives. A review of recent data suggests that the current allocation system led to a higher overall distribution of free allowances than a fully dynamic approach would have. This was due to specific activity patterns during the sample period, not necessarily a sign of future trends. Most activity changes were small, and there was no strong evidence that the ALC thresholds influenced production decisions across the scheme.

Moving to a more sensitive threshold would likely increase the number of ALCs that need to be processed each year, placing a disproportionate administrative burden on both regulators and the Authority. Processing a higher number of ALCs under a more sensitive threshold would also likely take longer, reducing certainty for operators regarding their free allocation levels following the ALC process. This uncertainty could limit operators' ability to manage carbon cost exposure effectively, making it harder to engage confidently with the UK ETS or plan decarbonisation investments. The Authority concluded that the current approach fulfils the policy intent of offering a reasonable compromise between accurately reflecting activity, offering certainty to operators and administrative burden.

Further information, including an assessment against Critical Success Factors, can be found in the Impact Assessment on GOV.UK published alongside this response.

Dynamic allocation

The consultation outlined an indicative design for a dynamic allocation approach. Under this approach, provisional free allocation would be distributed at the start of the year, based on the rolling average of the most recent two years of available data (e.g., 2027 provisional free allocation would be based on 2024 and 2025 activity). Free allocation would then be adjusted after the end of the year to reflect actual reported activity for that scheme year. The time required to process a significantly greater number of ALCs each year would mean that adjustments took place after the deadline for surrender of allowances. Assuming no change to current processing times and capacity across the UK ETS Authority and Regulatory bodies, adjustments to, e.g., 2027 free allocation (reported in 2028) would not be completed until after the compliance date for surrendering allowances, in 2029.

Of the 31 respondents who supported dynamic allocation in principle, 18 made clear that their support was conditional upon ALC processing times being shortened compared to now. There was a preference for final free allocation to be known before the compliance date for the scheme year, or ideally before the end of the financial year.

The Authority investigated options to accelerate the ALC process. Options considered included: reducing checks carried out on data or removing them below a certain threshold; increasing regulator capacity; technical solutions to automate parts of the process; and a greater role for verifiers. It proved challenging to quantify the likely impact of these options without implementing them in practice. Given the estimated time required to develop and thoroughly test these options, and lack of certainty around their impact, the Authority concluded that delivery of the improvements required to implement dynamic allocation could not be guaranteed in the timeframe.

The Authority concluded that, due to the uncertainty around delivery, implementing dynamic allocation would carry a high risk of significant disruption or delay to distribution of free allocation ahead of the next allocation period and would not meet the conditions of the respondents who preferred this approach.

ALC threshold

The Authority considered whether to reduce the threshold for ALCs. An assessment of a sample period indicated that reducing the ALC threshold to 10% would result in an increasing in number of ALCs processed each year. Assuming no change to current processing times and capacity, this would lead to ALCs taking longer to process, with more being processed after the compliance deadline for the following scheme year. This assessment also indicated that during the sample period, the impact on total quantity of free allowances distributed would have been minimal.

Given the likely very small impact on free allocation, the Authority concluded that the additional administrative burden and delay to processing ALCs would be disproportionate to the benefit of a reduced ALC threshold.

Impact of COVID-19

During the consultation, stakeholders raised concerns about the impact of COVID-19 on activity levels during the baseline period resulting in HALs that are unrepresentative of normal activity. Having heard these concerns, the Authority assessed options to mitigate this. To maintain fairness, the Authority only considered mitigations that: a) could be applied uniformly across the scheme; b) would not reduce free allocation for any UK ETS installation, relative to the ‘do nothing’ option; c) minimised risk of over-allocation of free allowances by producing unrepresentatively high HALs.

Following these principles and the Authority’s acknowledgement of the potential impacts of COVID-19 on activity levels during the baseline period, we have decided to allow UK ETS operators to choose to have activity data for the years 2020 or 2020 and 2021 excluded for the purposes of determining HAL for the 2027-2030 allocation period. This will be available to all UK ETS operators on an opt-in basis. Operators will be able to indicate whether they wish to exclude 2020 or 2020 and 2021 activity from HAL at sub-installation level during the second stage of the free allocation application process (1 April – 30 June 2026). Guidance on how to do this will be made available before the second stage window opens on 1 April 2026.

Chapter 2: Benchmarks

This chapter covers proposals set out in set out in the Free Allocation Review Consultation (December 2023 – March 2024) on the approach to updating benchmarks used in the UK ETS.

The Authority has decided to retain current benchmarks for the 2027 scheme year, with an intent to adopt updated EU benchmark values from 2028 to 2030. Following careful consideration of consultation responses and assessment of the options, the Authority concluded that the EU benchmarking methodology provides more robust values and would maintain the reward to efficient installations and decarbonisation incentive set by the benchmarks. However, as updated EU benchmark values are not available at the time of decision making, the Authority has taken the decision to retain current benchmark values for the 2027 scheme year, ensuring operators are provided with the necessary certainty to plan for the forthcoming allocation period.

The Authority has considered the relationship between the UK ETS and the EU ETS in making this decision. Maintaining alignment with the EU approach could avoid the creation of competitive distortions between both schemes and increase consistency in decarbonisation incentive.

Summary of Proposals

The Authority sought views as part of the 2023 Free Allocation Review Consultation on the approach for updating benchmarks ahead of the next allocation period. The consultation proposals aimed to keep benchmarks attainable, ensuring they represent emissions efficiency performance achievable by UK installations, and aspirational, ensuring benchmarks continue to reward top performers and incentivise decarbonisation.

The Authority presented three options to determine the benchmarks to be used in the next allocation period:

Option 1: No change to benchmarks

A “Do Nothing” option where 2021-2025 benchmarks continue to be in effect for the 2027-2030[6] allocation period. There would be no update to the benchmarks and the values used would not account for improvements in efficiency achieved by sectors since 2018.

[6] The consultation referred to this as the 2026-2030 allocation period as this was published before the Authority announced the move of the start of the second allocation period to 2027.

Option 2: Use updated 2026 EU benchmarks

This option proposed to implement the benchmark values which would be updated ahead of the EU ETS Phase IV 2026-2030 allocation period.

These EU benchmarks are expected to be updated following the same methodology used to determine current values but using recent data from EU installations. This would be reflective of efficiency improvements achieved by industry since the current benchmark values were calculated. This option would align with the EU ETS' approach, minimising competitive distortions for operators who trade with the EU. However, UK data would not be used in the benchmark update, which could mean that the values would reflect efficiencies not available to UK operators.

Option 3: UK focused benchmark update

This option proposed an update to benchmarks for the next allocation period based on UK installation data only, to reflect efficiency improvements achieved by UK installations.

Questions (From 2023 – 2024 Free Allocation Review Consultation)

7. Do you agree that benchmarking is the appropriate methodology to ensure free allowances reward top performing installations and incentivise decarbonisation? (Y/N Please explain your answer)

8. What are your views on the proposed options for updating UK ETS benchmarks?

9. Do you agree with the proposed minded to position for updating benchmarks using UK data only to set the Annual Reduction Rate (ARR)? (Y/N Please explain your answer)

10. If you do not agree with the suggested methodology, please provide accompanying evidence as to why it should not be pursued and suggestions for an alternative methodology for updating benchmarks.

11. Do you have any views as to alternative methodologies that can be applied for updating benchmarks with zero UK sub-installations?

Summary of Responses

There were 57 responses to Question 7, of which 49 respondents (86%) agreed that benchmarking was an appropriate methodology, 6 (11%) did not agree, and 2 (3%) did not provide a view but offered feedback.

Of the respondents who agreed that benchmarking is the appropriate methodology to ensure free allowances reward top performing installations and incentivise decarbonisation, 4 suggested that the Authority should ensure that the methodology accounts for the availability of

decarbonisation technologies across UK industry, 3 emphasised the importance of alignment with the EU ETS and 3 noted that benchmarks only incentivise gradual improvements.

Of the respondents who did not agree with the statement, 2 raised concerns that incremental improvements made as a result of the benchmark incentive may not drive meaningful change, and 4 emphasised that free allocation should only address carbon leakage risk.

Respondents who did not provide a view emphasised the importance of considering potential competitive distortions between UK and EU installations that may arise as a result of changes to the methodology, and the suggested the methodology should account for the availability of decarbonisation technologies across UK industry.

There were 52 responses to Question 8, of which 10 respondents (19%) supported Option 1, 8 respondents (15%) preferred Option 2, and 13 respondents (25%) favoured Option 3. Twenty-one respondents (40%) did not express a preference but provided feedback.

Of the respondents who supported Option 1, all respondents considered it offered greater security compared to the other options.

Of the respondents who supported Option 2, all respondents considered it provided the highest level of incentive for new technologies and decarbonisation and the highest level of alignment with the EU ETS compared to other options.

Of the respondents who supported Option 3, all respondents considered it provided the highest level of fairness and alignment with industry needs compared to the other options.

Respondents who did not provide a view raised concerns about the small pool of installations in the UK ETS and the risk of benchmarks being influenced by really efficient installations.

There were 49 responses to Question 9, of which 22 respondents (45%) agreed with the minded-to position, 25 (51%) did not agree, and 2 (4%) provided feedback without expressing a view.

Of the respondents who agreed with the proposed minded-to position for updating benchmarks using UK data only to set the ARR, 7 respondents cautioned against high ARR values and ARR values being influenced by outliers, 3 supported further consultation of affected sectors to assess the impacts of the methodology, 2 raised concerns about the lack of consideration for emerging technologies, and 3 supported the approach for its use of up-to-date UK data.

Of the respondents who did not agree with the proposed minded to position, 7 respondents raised concerns about the insufficient number of sub-installations to be representative of industry, 3 raised concerns about reductions to free allocation before the implementation of a UK CBAM, 2 suggested delaying implementation of the minded to position until a UK CBAM is operational, and 3 preferred that benchmarks be completely recalculated based on UK data only, without making use of previous EU benchmarks.

There were 29 responses to Question 10, of which all provided feedback on the UK ARR methodology.

Key concerns with the methodology included:

- Difficulty in commenting without a draft methodology and preliminary benchmark values.
- Existing benchmarks being influenced by unrepresentative installations.
- Risk of diminishing the usefulness of benchmarks as opportunities for incremental improvements decrease.
- Narrow ARR comparison periods vulnerable to operational disruptions.

Alternative methodologies were suggested for consideration by the Authority, including:

- Retaining existing benchmarks (Option 1), supported by nine respondents.
- Using a combination of EU and UK data where sample sizes are small.
- Using EU data or recognised internal standards.
- Including international examples where low-carbon manufacturing is more established, provided replicability in the UK is assessed.

There were 20 responses to Question 11, of which 6 respondents (30%) supported using EU data as a fallback approach, 6 (30%) suggested not updating benchmarks, and 8 (40%) proposed alternative approaches.

Alternative suggestions included:

- Using other international data, supported by four respondents.
- Applying EU ETS ARR to UK thresholds, supported by two respondents.
- Applying the minimum ARR threshold for benchmarks lacking UK data.
- Not updating benchmarks unless UK data is available.

The Authority Response

The Authority has decided to retain current benchmarks for the 2027 scheme year, with an intent to adopt updated EU benchmark values from 2028 to 2030. This will provide continuity and additional time for industrial sectors to plan for future benchmark updates.

Following the assessment of all options, the Authority has concluded that the EU ETS benchmarking methodology provides the most robust and representative framework for reflecting efficiency improvements made by industry and incentivising decarbonisation. However, the updated EU benchmark values were not available at the point of decision making. The Authority intends to adopt the updated EU benchmark values from 2028 onwards, subject to an assessment of their impacts on UK businesses, for the remainder of the allocation period to 2030.

Approach to Benchmarking and Policy Objectives

Current benchmarks used in the UK ETS were calculated via the EU ETS Phase IV benchmark update, which did not use data from UK installations. This followed an ARR methodology where the average performance of the 10% most efficient installations for 2016-2017 for each product benchmark was compared to the EU Phase II benchmark, based on 2007-2008 data

which included data from UK installations. The ARR was then applied up to 2022-2023, the mid-point of the 2021-2025 allocation period. ARRs currently have a minimum and maximum threshold of 0.2% and 1.6% per annum, setting a limit on benchmark reduction. Benchmarks with emissions intensity decreases averaging more than 1.6% per annum since the baseline data were given an ARR of 1.6%, while those with decreases averaging less than 0.2% per annum were given an ARR of 0.2%. This process is described in Figure 3 below.

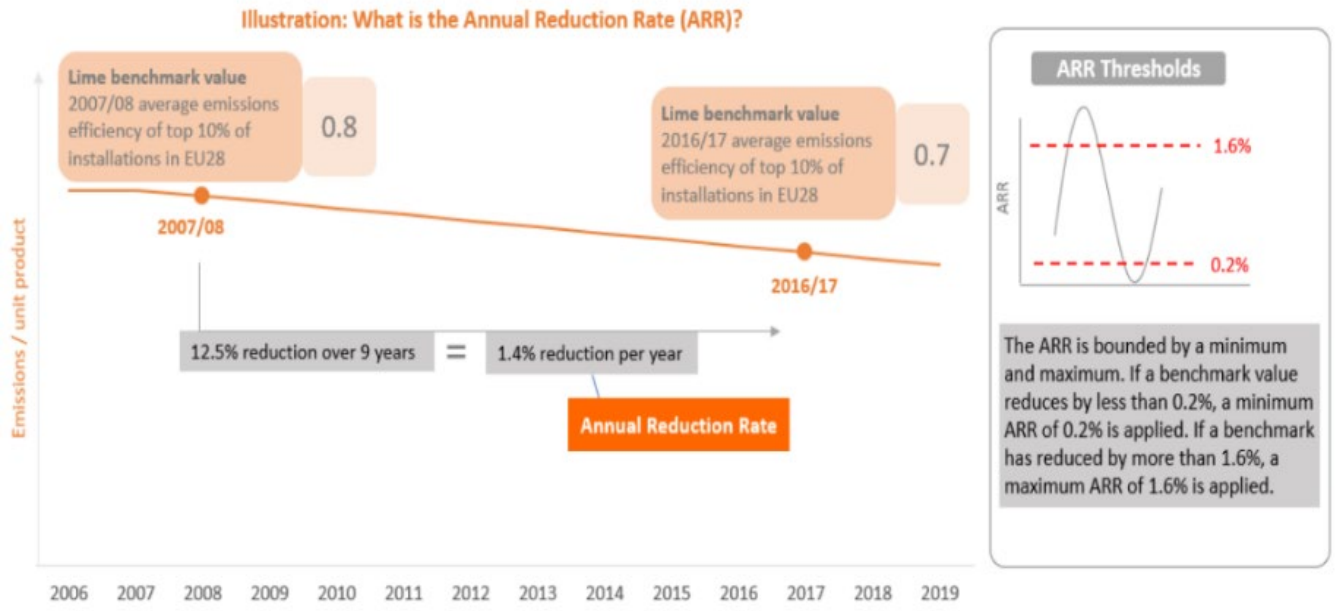

Figure 3 Diagram describing ARR methodology

The Authority has considered the policy intent of benchmarking, as previously set out, as part of the decision-making process:

- The intent of benchmarks is to incentivise decarbonisation. In principle, efficient installations whose carbon efficiency is closer to the benchmarks are rewarded for their performance as they will have a higher proportion of their emissions covered by free allowances; and installations whose carbon efficiency is further away from the benchmark will have a lower proportion of their emissions covered by free allowances.
- The intent of ARRs is to reflect projected emissions intensity in an allocation period by reducing benchmarks according to emissions efficiency improvements achieved by the top performing installations in respective sectors. This sets representative emissions reduction incentives.
- The intent of ARR thresholds is to provide consistency in benchmark reductions. The maximum threshold prevents benchmarks from being overly decreased by top performers, protecting other installations from unachievable decarbonisation performance. The minimum threshold sets a baseline ambition for emissions intensity improvements across industry, ensuring regular benchmark decreases and maintaining a decarbonisation incentive.

Assessment of a UK-focused Benchmarking Approach

While a majority of consultation respondents expressed a preference for UK-focused benchmarks, many raised concerns about the quantity and quality of the data compared to the EU's. The limited sample size of UK installations available to calculate ARRs raised significant concerns about the robustness of the methodology. The following methodology was applied to conduct an assessment of the option, which addresses some of the concerns highlighted by respondents to the consultation:

- The ARR would be determined for each product benchmark by comparing the UK's most efficient installation in 2016/2017 (period used in the previous benchmark update) and 2022/2023 respectively (mid-point of the 2021-2025 allocation period).
- The ARRs would be calculated based on the performance of the most efficient UK installation per product benchmark, rather than the "top 10%", due to the smaller sample size of installations available to calculate UK ARRs compared to EU ARRs.
- The ARRs would be calculated based on the average performance of the 10% most efficient UK installations for fallback benchmarks (heat and fuel), where the sample size is relatively large.
- The data from 'most efficient' UK installation used for the calculation would be included in the ARR calculation even if the sites are different between allocation periods or if the site had since ceased operation.
- The ARRs would be applied to UK ETS Phase 1 benchmarks.
- The ARRs would be extrapolated from 2017 to 2028 (mid-point of the next allocation period), with ARR thresholds of 0.3% and 2.5% per year.

The Authority assessed the feasibility of updating benchmarks using UK-only data and identified significant limitations in the dataset of UK ETS installations. In particular, for benchmarks where only a single UK installation exists, that installation's performance would set the benchmarks, removing any incentive for further decarbonisation. More broadly, the small number of installations makes it difficult to determine whether performance levels are representative of the best achievable by industry, undermining the robustness of benchmarks as an efficiency standard. The Authority concluded that UK-focused benchmarks are less likely than their EU counterparts to reflect achievable efficiency improvements, appropriately reward the most efficient installations, or provide a credible decarbonisation incentive. A fuller assessment of this option against Critical Success Factors can be found in the Impact Assessment published alongside this Response on GOV.UK.

Conclusion on Benchmarking Methodology

Following the assessment of all the options, the Authority confirms an intent to adopt the updated EU benchmark values for the free allocation calculation for 2028-2030. The Authority has concluded that the size and scale of data behind the EU ETS benchmarking methodology means it provides a more robust and representative framework for reflecting efficiency improvements made by industry and incentivising decarbonisation. However, as the updated EU benchmark values are not available at the time of decision making, the Authority confirms that current benchmark values will be used to calculate free allocations for the 2027 scheme year.

The EU has confirmed that it will use updated benchmark values to calculate preliminary free allocations to be distributed in the EU ETS from 2026 to 2030. Continuing to apply the same benchmarks as those used in the EU ETS has the added benefit of alignment with the EU from 2028, minimising the risk of creating competitive imbalances between UK and EU operators.

Current benchmark values will be updated by the EU Commission[7] based on the ARR methodology used in the 2021 benchmark update, using recent data from EU installations. The average performance of the 10% most efficient installations in 2021-2022 will be compared to the average performance of the 10% most efficient installations in 2016-2017 for each of the fifty-two product benchmarks and the fallback benchmarks. The calculations are based on up-to-date, EU-wide data from a larger sample size of installations compared to the UK, making the methodology more robust than a UK-focused benchmark update. The Authority considers that the methodology used to update EU benchmarks will continue to reflect efficiency improvements achievable by industry, reward efficient installations and incentivise decarbonisation.

The Authority acknowledges that EU benchmarks will not be updated using emissions data submitted by UK operators; therefore, UK industry efficiency performance will not be reflected in the updated benchmarks. The Authority will keep this area under review and will continue to explore opportunities to include UK industry data in future benchmark updates.

[7] The EU Commission has also updated certain benchmark definitions and system boundaries, these are described in Chapter 4, operators will not be required to submit any additional data to meet these new definitions for the 2027-2030 allocation period.

Chapter 3: The Carbon Leakage List

This chapter covers proposals set out in the Free Allocation Review Consultation (December 2023 – March 2024) and the Carbon Leakage Consultation (December 2024 – March 2025). These consultations included options for which list should be used to determine carbon leakage risk from 2027, a decision on whether or not to introduce tiering of the carbon leakage exposure factor (CLEF) or cross-sectoral correction factor (CSCF) and a decision on whether to bring forward the phase out date of free allocations for sectors not at risk of carbon leakage.

The Authority has decided to retain the current carbon leakage list[8], not to introduce tiering of the CLEF or CSCF and not to bring forward the phase out date of free allocations for sectors not at risk of carbon leakage.

Following careful consideration of consultation responses and assessment of the options, the Authority concluded that the current carbon leakage list is based on robust data sets and remains representative of UK industry risk. The Authority is also confident that there will continue to be a suitable volume of allowances available within the industry cap therefore no tiering or early phase out is required to better target free allocation. These decisions will ensure that industry continue to be supported through free allocations, mitigating the risk of carbon leakage and giving the certainty needed to enable UK businesses to invest in decarbonisation.

Summary of Proposals

As part of the Free Allocation Review, the Authority set out proposals in 2023 and 2024 to reform the Carbon Leakage List and improve the targeting of free allocation from the second allocation period beginning in 2027. These proposals aimed to better target support at sectors most at risk of carbon leakage.

The following key proposals were put forward:

Options for Determining the Carbon Leakage List from 2027
The Authority presented two options for determining the Carbon Leakage List from the second allocation period:

- A revised list based on updated UK-specific data and a new Carbon Leakage Indicator (CLI) methodology.
- Retention of the existing list, based on historic EU wide data

[8] With the exception of temporary changes made for 2024-2026.

Stakeholders were invited to comment on the relative merits of each approach, including transparency, accuracy, and administrative feasibility.

Tiering of the Carbon Leakage Exposure Factor (CLEF) or Cross-Sectoral Correction Factor (CSCF)

The Authority sought views on whether to introduce tiering of the CLEF, allowing differentiated levels of free allocation based on the degree of carbon leakage risk.

In addition, the Authority considered the potential application of the CSCF in the event that free allocation demand exceeds the industry cap. While the Authority did not propose immediate changes to the CSCF mechanism, it committed to monitor allocation levels and consider mitigation measures if required.

Phase out Date for Sectors Not at Risk of Carbon Leakage

The Authority proposed bringing forward the phase out date for free allocation to sectors deemed not at risk of carbon leakage under the revised CLI methodology.

This change would take effect from the start of the second allocation period in 2027, rather than at a later date, ensuring that free allocation is reserved for sectors with demonstrable exposure to carbon leakage.

Questions (From 2023 – 2024 Free Allocation Review Consultation)

17. Do you agree that the Authority should tier the carbon leakage list to better target those most at risk of carbon leakage?

18. Do you have views on the principles that the Authority should use to guide decision making on tier design if we opt to tier the carbon leakage list?

19. Above, we have outlined three illustrative examples of ways we could tier the carbon leakage list. Do you have any views on these? Do you have views on alternative ways that this could be done?

20. Do you have views on whether we should tier the Cross-Sectoral Correction Factor in the instance of its application?

Questions (From 2024 – 2025 Free Allocation Review Carbon Leakage Consultation)

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.

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.

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.

4. Do you agree with the Authority's preliminary list of Carbon Leakage Indicator (CLI) values?

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.

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.

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?

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.

Summary of Responses

Free Allocation Review Consultation Responses

The UK ETS Authority consulted on a range of proposals relating to the tiering of the CLEF and the CSCF. This section summarises stakeholder responses to questions 17 through 20 of the December 2023 Free Allocation Review consultation. A summary of responses to other questions posed in this chapter can be found in Chapter One of the 2024 Free Allocation Review Carbon Leakage consultation.

There were 66 responses to the question about tiering the carbon leakage list. Responses were evenly split: 21 (32%) supported tiering the Carbon Leakage List, 21 (32%) opposed it, and 24 (36%) expressed no view.

Supporters of tiering cited several benefits. Three believed it would address issues with borderline cases, particularly those with CLI values between 0.15 and 0.2. Two respondents suggested tiering should be integrated with the UK CBAM, while 2 others expressed concern that borderline sectors might otherwise receive insufficient protection. Additional suggestions included recognising installations with credible decarbonisation plans and accounting for emerging technologies.

Among those opposed, 5 raised concerns about the methodology and accuracy of the list. Three cited a lack of flexibility to respond to future changes, and others highlighted risks such as penalising borderline installations, market distortions, administrative burden, and misalignment with the UK CBAM.

Of the 66 respondents to question 18 on principles for tier designs, only 24 (36%) provided a direct answer. Nine (38%) emphasised the need to align any tiering approach with the UK CBAM. Four (17%) highlighted the risk of a ‘cliff edge’ for borderline sectors, and another 4 (17%) advised that tiering should prioritise simplicity, accuracy, and certainty. Two respondents (8%) recommended conducting economic impact assessments for sectors currently receiving full allocation that might lose support under tiering. A further 2 (8%) urged consideration of energy security and national resilience, while 2 (8%) others suggested factoring in decarbonisation options and new technologies. One respondent (4%) expressed concern about divergence from the EU and its implications for linking.

Question 19 asked respondents to comment on three illustrative tiering designs: equal tiers, a large high-risk tier, and a continuum-based approach. Of the responses that directly addressed the question, seven (54%) expressed a preference for a sliding scale or continuum (Tier Design Example Three), although one warned this could expose the Authority to legal challenge. Six respondents (46%) preferred a design with a large high-risk tier (Tier Design Example Two).

Other themes included the importance of considering access to decarbonisation technologies (raised by three respondents), combining CLEF and CSCF tiering to avoid cliff edges, and one suggestion to phase out free allocation entirely in favour of the UK CBAM.

Forty-five respondents answered question 20 on tiering the CSCF. Twelve (27%) supported tiering the CSCF, 16 (36%) opposed it, and 17 (38%) expressed no view.

Among supporters, seven (58%) expressed general support, while 3 (25%) recommended considering decarbonisation opportunities. One respondent (8%) suggested applying the CSCF only to low-risk sectors, another (8%) preferred tiering the CSCF over the CLEF, and one (8%) proposed tiering based on company efficiency.

Of those opposed, 10 (63%) expressed general opposition, 3 (19%) believed tiering would complicate the ETS and create uncertainty, and 3 (19%) argued that only one of the CLEF or CSCF should be tiered, preferring the CLEF.

Among those who were agnostic, 5 (29%) requested more information, including clarity on the Carbon Leakage List and sectoral placement. One respondent (6%) called for a 12-week consultation window. Other comments included opposition to the CSCF in principle, the need to avoid cliff edges, and the importance of transparency, simplicity, and CBAM alignment.

Free Allocation Review: Carbon Leakage Consultation Responses

The UK ETS Authority received a wide range of views in response to the 2024 Free Allocation Review Carbon Leakage Consultation. This section summarises stakeholder feedback to questions one to eight of that consultation.

There were 41 responses to question one on data sets used to calculate emissions and trade intensity. Of those, 15 (37%) agreed with the data sets used, 20 (49%) disagreed, and 6 (15%) neither agreed nor disagreed. Supporters welcomed the use of UK-specific data and

considered it more representative than EU data. However, many respondents raised concerns about the robustness and transparency of the data, particularly the use of fallback sources, the inclusion of COVID-affected years, and the accuracy of Gross Value Added and trade intensity figures. Several sectors called for greater clarity on the data sources and methodology, and some questioned whether the data adequately reflected carbon leakage risk.

There were 25 responses to question two on fallback approaches. Of these, 12 (48%) agreed with the fallback approaches used, 9 (36%) disagreed, and 4 (16%) neither agreed nor disagreed. Supporters acknowledged the practical need for fallback data in the absence of robust alternatives and considered the approach reasonable under the circumstances. However, others argued that fallback data introduced inaccuracies and that sectors should have been allowed to submit their own data. Several respondents suggested that a second-level qualitative assessment would have been preferable to reliance on fallback data.

There were 28 responses to question three on the methodology used to determine CLI thresholds. Twelve (43%) agreed with the approach, 11 (39%) disagreed, and 5 (18%) neither agreed nor disagreed. Supporters endorsed the distributional approach and welcomed the clarity it provided. However, critics described the method as arbitrary and not sufficiently reflective of actual carbon leakage risk. Several respondents again called for a second-level qualitative assessment and raised concerns about the use of fallback data in determining thresholds.

There were 39 responses to question four on the preliminary CLI values. Of these, 13 (33%) agreed, 23 (59%) disagreed, and 3 (8%) neither agreed nor disagreed. Those in agreement typically believed their sector was appropriately classified as at risk. Those who disagreed cited unreliable data, lack of transparency, and the absence of a second-level qualitative assessment. Some respondents expressed concern that the CLI values did not align with their understanding of their sector’s exposure to carbon leakage.

To question five, there were 31 respondents who provided further comments on the CLI values. Many reiterated concerns about the reliability of the data, particularly trade intensity and GVA figures. Several sectors submitted additional data, but none passed the Authority’s assessment criteria. Respondents also raised concerns about the potential impact of tiering and the need to consider downstream leakage risks. A number of stakeholders called for greater transparency and the inclusion of EU trade in the CLI calculation.

There was strong support for the Authority’s minded-to position to adopt an additive approach suggested in question six. Of 34 responses, 32 (94%) agreed, 1 (3%) disagreed, and 1 (3%) neither agreed nor disagreed. Respondents welcomed the flexibility to include additional sectors if new data became available, but emphasised the need for clear criteria, further consultation, and a robust methodology. Some noted that the additive approach should be subject to adequate data quality and a second-level qualitative assessment.

There were 38 stakeholder responses to question eight on list preference. Twenty-three (61%) expressed a preference for a UK-specific list, 13 (34%) preferred to retain the current EU list, and 2 (5%) had no preference. However, many of those supporting a UK list did so

conditionally, citing the need for more robust data, alignment with EU methodologies, and further impact assessment. Those favouring the current list highlighted its robustness, transparency, and potential benefits for future EU-UK ETS linking.

The Authority Response

The Authority has carefully considered stakeholder responses to Questions 16–20 of the 2023 Free Allocation Review consultation and Questions 1–8 of the 2024 Free Allocation Review Carbon Leakage Consultation, alongside the analytical evidence presented in the NERA technical report[9] and internal assessments. Following this review, the Authority has decided to retain the EU ETS Phase IV Carbon Leakage List (CLL) for the second UK ETS allocation period (2027–2030). This decision reflects a balanced judgement across policy intent, data robustness, stakeholder confidence, deliverability, and strategic alignment with wider decarbonisation objectives.

The Carbon Leakage List

The Authority has concluded that the EU ETS Phase IV CLL remains the most robust and transparent framework for identifying sectors at risk of carbon leakage. The list was developed using a two-stage methodology, combining quantitative indicators of trade and emissions intensity with a qualitative assessment for borderline sectors. It draws on high-quality, EU-wide data, including UK data, and has undergone extensive scrutiny. The Authority considers that the EU list continues to reflect the carbon leakage risk profile of UK industry and provides a stable and well-understood basis for free allocation policy.

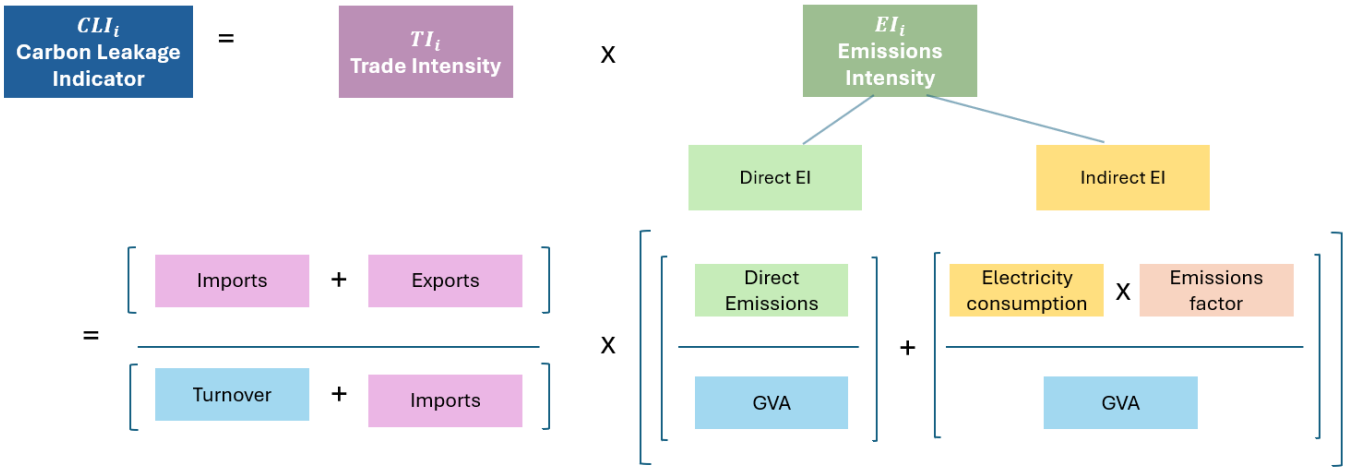

Figure 4 The Carbon Leakage Indicator Calculation

The Authority acknowledges the interest from stakeholders in developing a UK-specific list. However, the draft UK list developed by NERA relied heavily on fallback data due to significant gaps in UK-specific datasets. These fallbacks introduced distortions in CLI values, with some sectors appearing artificially above or below the threshold for inclusion. The Authority

[9] https://assets.publishing.service.gov.uk/media/6760245e0fb02bbe4853ef7d/ukets-nera-technical-report.pdf

concluded that the resulting list did not offer a more reliable or representative assessment of carbon leakage risk than the EU list.

While a majority of consultation respondents expressed a preference for a UK-specific list, this support was largely conditional. Many stakeholders raised concerns about the robustness of the data, the exclusion of EU trade from the CLI calculation, and the absence of a second-level qualitative assessment. Only a minority of respondents supported the draft list without caveats, and most sectors that stood to benefit from the UK list either disagreed with the CLI values or submitted additional data for consideration. The Authority therefore concluded that there was no consensus on the draft list and no clear mandate to proceed with its implementation.

Retaining the EU list ensures continuity for participants and mitigates the risk of competitive imbalances arising between the UK ETS and EU ETS which could lead to carbon leakage risk through trade diversions. The EU has confirmed that it will continue to use the current list until 2031.

As part of the 2024 Free Allocation Review Carbon Leakage Consultation, stakeholders were invited to submit additional data sets for consideration, provided they met the same assessment criteria applied in the NERA report. These criteria included data quality, coverage, UK relevance, transparency, and longevity. Following an Authority evaluation, it was concluded that none of the submitted or referenced data sets met all criteria. In most cases, the data lacked sufficient granularity, consistency across all necessary sectors, or public availability to be used in place of the fallbacks. As such, no submitted data was taken forward, and the Authority does not consider there to be a viable evidence base for constructing a revised UK list at this time.

Tiering of Carbon Leakage Exposure Factor

The Authority also confirms that it will not pursue any of the tiering options consulted upon. Modelling indicates that free allocation will remain below the industry cap through to 2030, and the decision to retain the EU list avoids the increase in allocation volumes that would have resulted from adopting the UK list. The Authority considers that introducing tiering in the absence of a clear need would add complexity and uncertainty to the allocation process without improving targeting.

Tiering the Cross-Sectoral Correction Factor

As described above, the Authority has conducted analysis on the likelihood of levels of free allocation exceeding the industry cap in the next allocation period from 2027 and this is deemed very low. Further detail on this can be found in the Impact Assessment. Since the CSCF is unlikely to be triggered, any changes to the CSCF process would increase complexity without any of the benefits of better targeting free allocations. Therefore, the Authority will not be introducing tiering of the CSCF.

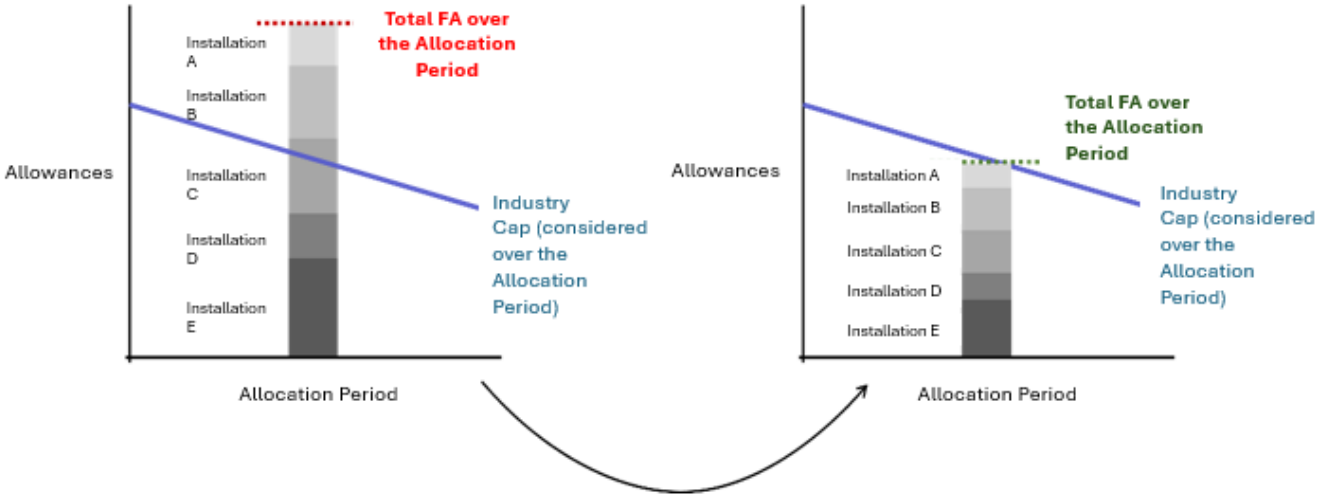

Figure 5 Illustrative diagram of the Cross Sectoral Correction Factor process

Treatment of Free Allocations for not-at-risk sectors

The Authority confirms that it will maintain the existing trajectory for phasing out free allocation to sectors not deemed at risk of carbon leakage[10], as defined by the EU ETS Phase IV CLL. Under this approach, installations operating in sectors not on the carbon leakage list will continue to receive a reduced level of free allocation until 2030, at which point it will be fully phased out.

This decision reflects feedback received through the 2024 Free Allocation Review consultation, where stakeholders highlighted that the uncertainty created by consulting on multiple carbon leakage lists has limited their ability to plan and invest with confidence. The Authority recognises that decarbonisation through the UK ETS requires long-term investment and that policy stability is essential to enable operators to make informed decisions. Maintaining the current phase out timeline provides the necessary certainty for sectors to prepare for the full exposure to the carbon price.

The Authority also notes that the EU will not be accelerating the phase out of free allocation for non-leakage sectors. Maintaining alignment with the EU approach helps to avoid introducing competitive distortion for UK sectors that compete in international markets. The Authority is committed to ensuring that the UK ETS remains a credible and effective tool for decarbonisation, while avoiding unintended impacts.

The phase out of free allocation for sectors not at risk of carbon leakage by 2030 remains a firm commitment. This approach was first set during the inception of the UK ETS and has been consistently communicated to stakeholders. The Authority reaffirms this commitment and will continue to provide clarity and support to affected operators as the phase out progresses.

[10] This will maintain rules as described in existing legislation, and therefore does not apply to District Heating sub-installations.

Chapter 4: Additional Factors for Free Allocation Calculation – Access to Decarbonisation Technologies

This chapter covers proposals set out in the Free Allocation Review Consultation (December 2023 – March 2024) regarding access to decarbonisation technologies.

The Authority has decided not to disaggregate benchmarks or to amend benchmark definitions to account for access to decarbonisation technologies. Following careful consideration of consultation responses and assessment of the options, the Authority concluded that the current benchmarking methodology prevents installations with exceptional access to decarbonisation technologies from impacting the benchmarks.

Summary of Proposals

One of the key principles for the second phase of the free allocation review was to 'consider the availability and accessibility of decarbonisation technology'. The Authority considered whether, and how, the free allocation calculation might take the availability of large-scale decarbonisation technology into consideration.

In response to the Developing the UK ETS consultation (2022), stakeholders raised concerns about the potential that some industry operators with early access to large-scale decarbonisation technologies through government support schemes could become significantly more efficient at a faster rate than those without. They were concerned that operators with access to large-scale decarbonisation technologies could distort free allocation benchmarks, making them unattainable for other operators, or that they could maintain their levels of free allocation and sell them for additional revenue, creating a competitive distortion between operators within the same sector.

The Authority proposed to review this concern following three key principles outlined below:

- Actions taken in this space must take care to not inadvertently disincentivise market-driven investment in large-scale decarbonisation technology.
- The focus of this work should be to look at potential market distortions being created by free allocation policy and whether/how we could address them.
- Free allocation policy should not dictate which technologies sectors should look to for decarbonisation.

The Authority explored two methods that could be used to consider any discrepancies in availability of decarbonisation technologies:

Option 1: Disaggregating Benchmarks

The Authority consulted on an option to disaggregate benchmarks on the basis of whether a sub-installation has access to large-scale decarbonisation technologies, putting installations with different access to decarbonisation technologies on different benchmarks so they would not be measured against each other.

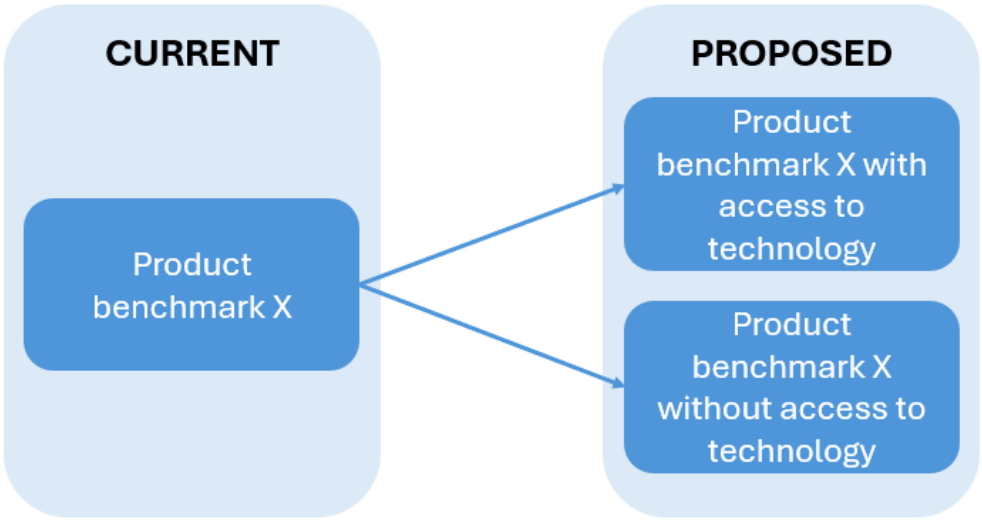

Figure 6 Diagram illustrating approach to disaggregating benchmarks

Option 2: Including low/no carbon production processes in benchmark calculations

The Authority also consulted on an option to consider industrial processes that have very low or no carbon emissions in the benchmark calculation to lower the benchmarks for production and encourage a switch to more efficient processes.

This approach would be implemented through amendments to relevant product benchmarks for which low or no-carbon production processes exist and including their emissions efficiency data in the benchmarks calculation.

Questions (From 2023 – 2024 Free Allocation Review Consultation)

21. Do you have views on the principles we have outlined for consideration of decarbonisation technology?

22. Do you have views on how the UK ETS Authority should define decarbonisation technologies to be included in this work?

23. Above we have outlined two possible methodologies for how we could consider access to decarbonisation technology in FA calculation. Do you have any views on the approaches outlined above?

24. Are there alternate ways that you think we should examine to alter the free allocation methodology to consider access to decarbonisation technology?

25. Are there alternative ways, outside of free allocation, that the ETS could consider access to decarbonisation technology?

Summary of Responses

There were 42 responses to Question 21, of which 33 respondents (79%) supported the proposal to consider access to decarbonisation technologies and the guiding principles for this consideration, and 7 (17%) opposed it, and 2 (1%) did not provide a view.

Of the respondents who agreed with the proposal, nine supported all principles, and three only supported principles 1 and 3, emphasising the importance of a market-led methodology and the benefits of maintaining a free market. Two respondents highlighted that carbon leakage mitigation should be a key principle. Sixteen respondents suggested considering the varying levels of access to technologies and government support between installations in industrial clusters and those in dispersed locations. Five respondents emphasized the role of Free Allocation in decarbonisation investment planning and highlighted its importance in making decarbonisation projects financially viable.

Of the respondents who disagreed with the proposal, the following reasons were cited: that it could increase administrative burden and/or complexity to the scheme.

There were 36 responses to Question 22, of which ten respondents (28%) were in favour of specifically defining technologies in scope of this approach, while 11 respondents (30%) favoured a technology-neutral approach, and 15 (42%) did not provide a specific view on defining decarbonisation technologies but provided some suggestions for the Authority to consider.

Among the respondents, some suggested that the Authority should take into account Technology Readiness Level (TRL), specifically focusing on technologies at level 8 (actual technology completed and qualified through test and demonstration) or above, and their commercial availability at scale; 9 respondents recommended that the Authority should only consider technologies that are accessible, either through government funding or available in all regions.

There were 40 responses to Question 23, of which 31 (77%) provided a view. Nine respondents (22%) did not provide a view, with 2 expressing that they did not have enough information to form an opinion.

Of the respondents who provided a view, 12 respondents (39%) preferred Option 1, 4 respondents (13%) favoured Option 2, and 15 respondents (48%) did not support either of the proposed approaches.

Among those who opposed both options, 2 respondents expressed concerns that implementing the policy could increase the risk of carbon leakage, 3 thought either methodology would add complexity to the scheme, and 3 respondents highlighted the role of

free allowances in supporting business cases and investments for industrial decarbonisation projects.

Respondents raised key themes covering the proposed options. The themes raised for Option 1 included:

- Concerns about the complex methodology of the proposed approach, which could delay implementation.
- Preference to implement the approach post-2030.
- Concerns about the creation of small subsets of sub-installations, which could increase the complexity of Free Allocation policy.
- Preference to implement a methodology that differentiates between the percentage of emissions that different decarbonisation projects would be expected to cover.

The themes raised for Option 2 included:

- Concerns about the penalisation of installations without access to decarbonisation technologies.
- Concerns about a potential sharp benchmark reduction rate which could lead to unattainable benchmarks for some installations.
- Endorsement of the incentive to innovate with new technologies brought by the approach.

There were 45 responses to Question 24, of which twenty-six respondents (58%) did not provide a view.

Of those who provided a view, 2 respondents (10%) expressed a preference for making no amendment to the benchmarking methodology. Six respondents (32%) suggested considering a deemed emissions approach. This would assume that all installations are not using any decarbonisation technology and adjust their emissions data to reflect the absence of efficiencies. Three respondents (16%) proposed an approach that would distribute additional allowances to installations not in receipt of government support for the deployment decarbonisation technologies. Targeting installations located outside industrial clusters was specifically mentioned. These respondents also suggested that benchmarks should only be reduced for installations in receipt of government support for the deployment of decarbonisation technologies.

There were 25 responses to Question 25, of which 17 respondents (68%) suggested alternative approaches to the ones proposed in the consultation and 8 respondents (32%) did not provide any alternative.

Of those who provided alternative approaches, 11 respondents (65%) suggested that Government should provide further financial support to industry for the deployment of decarbonisation technologies through the UK ETS Authority. Respondents suggested this funding could be derived from free allocation reserves or auction revenue, proposing to consider a similar approach to the EU Innovation Fund. Respondents did not suggest this support could come from the distribution of additional free allowances.

The Authority Response

The UK ETS Authority has considered the proposals regarding access to decarbonisation technologies on the basis of a UK-focused benchmarking methodology. These proposals would not be applicable on the updated EU benchmarks which will be used for the 2027-2030 allocation period, as set out in Chapter 2.

The UK ETS Authority has decided not to disaggregate free allocation benchmarks or amend benchmark definitions to include low or no carbon production processes on calculation to account for access to decarbonisation technologies for the 2027-2030 allocation period. The Authority will keep these changes under review for future benchmark setting exercises.

In the consultation, the Authority cited several challenges with the options consulted on and invited operators to suggest alternative approaches. From the responses no suggestions were made that could be delivered through changes to the free allocation methodology. The challenges set out in the consultation are described below:

- The approach to Option 1 would introduce a new methodology which could prove challenging to implement due to the small number of installations in the UK and the need for emissions efficiency data once decarbonisation technologies have been installed, which may not align with the reporting or allocation periods.
- To implement Option 1, it may be necessary to develop a robust methodology that differentiates between the % of emissions that different technologies are expected to cover, to ensure that various installations are not disproportionately impacted by the approach. It could be difficult to design this methodology to be flexible and compatible with any future policy implementation.
- The approach to Option 1 may reduce the decarbonisation incentive set by the benchmarks considering less efficient installations would no longer be assessed against the most efficient installations for a given sector.
- As there is limited deployment of very low or no-carbon production processes across industry, the approach to Option 2 was anticipated to lead to minimal impacts on benchmarks for the 2027-2030 allocation period.

The UK ETS Authority undertook an assessment of the potential risk that early deployment of decarbonisation technologies by some installations could significantly improve their efficiency performance and disproportionately influence benchmark values, based on UK data, which could make benchmarks less attainable for other installations with diverging access to technologies and increase their exposure to the carbon price.

The assessment was conducted based on the proposal to implement a UK-focused benchmark update. Under this option, benchmarks would be updated via the ARR methodology, based on historical emissions efficiency data from UK installations from 2016-17 and 2022-2023. As a result, emissions reduction achieved after 2023, such as those from potential large-scale decarbonisation technology deployment, would not be reflected in the new benchmarks.

Additionally, the ARR methodology includes upper and lower thresholds to ensure benchmarks remain proportionate to industry performance. A maximum ARR threshold (1.6% under the UK-focused benchmark proposal) is applied where emission intensity has declined more rapidly, preventing excessive reductions in benchmark values. This approach helps mitigate the risk of carbon leakage for less efficient installations while continuing to reflect the decarbonisation potential of each sector.

Our assessment concluded that there is no evidence of widespread deployment of large-scale decarbonisation technologies at UK industrial sites that could significantly affect benchmark values. Therefore, in a UK-focused benchmarking methodology, there would be no risk of early adopters setting unattainable benchmarks for the next allocation period. Further details can be found in the Impact Assessment on GOV.UK published alongside this response.

As noted in Chapter 2, the Authority has decided to use updated EU benchmark values for the 2027-2030 allocation period. To ensure the UK ETS remains responsive to future policy developments, we will continue to consider evidence on how technology deployment interacts with free allocation, and consider the implications on UK ETS participants, to maintain a fair and effective scheme ahead of future benchmark setting exercises.

The Authority notes that the EU ETS has amended the definitions and system boundaries for the “sintered ore”, “hot metal”, “grey cement clinker”, “white cement clinker”, “tissue”, “soda ash”, “refinery products”, “EAF carbon steel”, “EAF high alloy steel”, iron casting”, “mineral wool”, “plasterboard”, “carbon black”, “ammonia”, “steam cracking”, “aromatics”, “styrene”, “hydrogen”, “synthesis gas (syngas)”, and “ethylene oxide/ethylene glycols” product benchmarks to strengthen incentives to reduce greenhouse gas emission and improve energy efficiency and to ensure no negative competitive distortions for new and existing technologies. These changes impact the data EU operators have reported to the EU Commission, which will be used to update current benchmarks, as described in Chapter 2. Since UK data will not be used in the benchmark update, and to minimise administrative burden and costs on UK operators, the UK ETS Authority is not adopting these changes ahead of the 2027-2030 allocation period.

Chapter 5: Additional Factors for Free Allocation Calculation – Conditionality

This chapter covers proposals set out in the 2023 Free Allocation Review consultation regarding the possible implementation of conditionality for free allocation.

The Authority has decided not to introduce conditionality for the free allocation period beginning in 2027. This is in response to stakeholders concerns and to ensure continued support for industry against carbon leakage risk. The Authority concluded that the introduction of conditionality would have posed implementation challenges which would not be outweighed by potential environmental benefits. The UK ETS Authority will keep conditionality under consideration for future free allocation periods.

Summary of Proposals

As part of the 2023 Free Allocation Review Consultation the Authority sought views on the possible implementation of conditionality for free allocation.

Positive conditionality focuses on rewarding installations who are most efficient or innovators in their sector. This could involve giving additional free allocation to operators or protecting their existing levels of free allocation through excluding them from processes which might reduce their allocation. Negative conditionality aims to incentivise decarbonisation by not giving, or reducing, free allocation to operators who are not actively engaging with reducing their emissions.

Conditionality can be used to ensure that free allocations are allocated to installations who are actively engaging with decarbonisation efforts. In this way, conditionality could help to address concerns that free allocations overly protect some industries from the full intended impact of the carbon price and weaken the incentive to invest in longer term improvements.

The Authority consulted on three example conditionality designs which focused on incentivising decarbonisation by not giving, or reducing, free allocation to operators who are not actively engaging with reducing their emissions.

The three proposed example conditionality designs were:

Design Option 1	Design Option 2	Design Option 3
Reducing free allocation to an installation by a pre-determined amount (for example 10%) if an installation has not made any emissions reductions or resource efficiencies over a certain period of time.	Exclude the most efficient installations from any potential application of a CSCF. This option could define most efficient installations as those who are operating at the benchmark level and then ensure that these installations would not see a reduction in their free allocation from a CSCF.	Require installations to have a decarbonisation plan in place or they will have their free allocations reduced by a pre-determined amount (e.g. 10%).

Questions (From 2023 – 2024 Free Allocation Review Consultation)

26. Do you have views on whether the Authority should introduce conditions, related to decarbonisation efforts, on receiving free allocations?

27. Above we have outlined three illustrative designs for conditions for free allocations. Do you have views on whether we should introduce any of these options, how they are designed, and do you have a preference out of the stated options?

28. Do you have views on alternate conditions that the Authority should consider for receiving free allocations?

29. Do you have views on whether there are alternative decarbonisation incentives that could be implemented through free allocations?

30. Do you have views on whether there would be barriers to an equitable application of conditionality in principle, if the Authority was to pursue this option?

Summary of Responses

There were 53 responses to question 26, of which 42 (79%) opposed the introduction of conditions related to decarbonisation efforts for free allocation, and 11 (21%) expressed support.

Twenty-four (45%) respondents argued that conditionality would be counterproductive to the core aim of free allocation, the mitigation of the risk of carbon leakage. Fourteen (26%) respondents opposed conditionality on the grounds that it would duplicate the effort of other

UK policies, including UK ETS benchmarking, and 18 (34%) worried that it would be difficult to implement fairly. The risk of over-burdening stakeholders with an increased administrative burden was also a key concern and was raised by 9 (17%) of respondents.

There were 56 respondents to question 27, of these, 34 (61%) opposed all three illustrative design conditions. 12 (35%) of these respondents objected to the illustrative design conditions because they were opposed to the implementation of conditionality on principle.

Illustrative design condition three was the most popular amongst respondents. It was identified as either the preferred option, or the least objectionable of the options proposed, by 10 (18%) respondents. Those that supported option three argued that it would be the most straight forward to implement, the least potentially unfair, and could encourage additional decarbonisation efforts. However, those who opposed the option asserted that the extensive administrative burden involved in complying with design condition three would outweigh any anticipated benefits.

Overall, respondents felt that illustrative design conditions one and two would be difficult to implement fairy across industry, risked additional carbon leakage, placed an unjustifiable administrative burden upon industry, whilst duplicating policy effort elsewhere. Whilst some respondents felt that option one was the fairest of the three example options, and some supported option two, all respondents acknowledged the difficulties inherent in implementing any of the options.

There were 28 responses to question 28. Eighteen (64%) of these respondents took the opportunity to restate their opposition to the introduction of conditions to the allocation of free allowances, whilst 3 (11%) further respondents re-emphasised the importance of free allocation to the mitigation of carbon leakage risk. Four (14%) respondents stated that they did not have any further suggestions for possible design conditions, whilst 3 (11%) argued in favour of positive conditionality instead of negative. Four (14%) further respondents argued for further support, including financial and additional stakeholder engagement, to help installations to decarbonise.

There were 29 responses to question 29. Seventeen (59%) of these respondents opposed the implementation of any kind of decarbonisation incentives through free allocation, in principle. Five (17%) respondents argued in favour of some form of positive conditionality, where decarbonisation efforts were rewarded with additional free allocation.

There were 29 responses to question 30. Some of possible barriers to an equitable application of conditionality in principle suggested in these responses are listed below:

- Limited Authority resources
- Site-level differences in the availability and access to net zero technologies
- Inequality of access to decarbonisation infrastructure and low carbon fuel
- The length of investment cycles
- The difficulties involved in designing requirements applicable across all scheme participants without duplicating, or overlapping, existing regulatory requirements
- Regulatory constraints

- Dependence on DESNZ's industrial cluster sequencing approach

The Authority Response

The Authority has decided not to introduce any forms of conditionality on free allocation from 2027. The Authority has carefully considered the feedback on the three conditionality options presented in the consultation as part of its assessment. One of the most significant concerns expressed by stakeholders regarding the three example conditionality design options was the risk of an increased administrative burden for operators. The Authority is mindful of not increasing complexity or administrative burden as part of free allocation changes and weighed the benefit of introducing conditionality against the burden and cost that would be imposed on operators and regulators to facilitate its introduction.

To ensure minimal administrative burden, the Authority would need to ensure that any operational conditionality system could be tied to another existing Government scheme. To this end, the Authority explored the possibility of tying a conditionality approach to schemes like the Energy Savings Opportunities Scheme (ESOS), Climate Change Agreements (CCA) scheme, and Decarbonisation Readiness Permits (DRPs) to assess the viability of this approach.

Other UK Government Schemes Assessed:

The ESOS requires business to find energy efficiencies to contribute to net zero targets. It is a mandatory energy assessment scheme for organisations in the UK that meet the qualification criteria.

The CCA scheme involves voluntary agreements made between UK industry and the Environment Agency to reduce energy use and carbon dioxide (CO2) emissions. In return, operators receive a discount on the Climate Change Levy (CCL).

In respect of DRPs, the intention of Decarbonisation Readiness (DR) is to provide a clear decarbonisation pathway for new build and substantially refurbishing plants, and for existing high carbon combustion power plants, to decarbonise voluntarily. This requires developers to create a viable plan for how their plant can achieve decarbonisation according to its individual circumstances.

The Authority acknowledges that the aims of conditionality for free allocation and the objectives of existing schemes are often sympathetic, focusing on encouraging decarbonisation and working towards the net zero targets of UK Government, Welsh Government, Scottish Government and the NI Executive. However, the scope of the existing schemes, in terms of areas of interest and range of participants, would not meet the requirements necessary to effectively implement conditionality for free allocation. Furthermore, it was determined that the implementation timelines for these existing schemes, and any planned updates to them, did not align with the upcoming free allocation period. As such, the Authority determined that it would not be viable to link conditionality for free allocation to an existing government scheme.

The Authority ruled out conditionality policy design two on the basis that current Authority assessments indicate that the CSCF is unlikely to be triggered and conditionality will therefore not be required as a way of better targeting support within the context of the industry cap.

Option three received the most favourable feedback from stakeholders. However, during the assessment process, the Authority determined that the benefits of this option were outweighed by the costs, effort and resources required to implement it for both the Authority and industry. The Authority also concluded that it would have a limited impact on industry decarbonisation rates. Further information on this assessment can be found in the Impact Assessment published alongside this Response on GOV.UK.

As a result of this assessment process, and stakeholder feedback, the Authority has resolved not to introduce conditionality from 2027. The Authority notes the potential benefits of introducing conditionality and will continue to consider its merits for the future.

Chapter 6: Free Allocation for Sectors Covered by the UK CBAM

This chapter covers proposals set out in the Free Allocation Review Carbon Leakage Consultation (December 2024 – March 2025) for adjusting free allocations for sectors covered by the UK CBAM from 2027.

The Authority has decided to gradually phase out free allocation over the course of a number of years and into the 2030s for sectors covered by the UK CBAM. This phase out will occur at sub-installation level to ensure only free allocations corresponding to products where the UK CBAM charge will be applied are affected. This phase out of free allocation will ensure a gradual transition for industries across the UK from free allocations to the UK CBAM as the primary carbon leakage mitigation.

The approach taken mirrors the pace and scale of phase out of free allocation in the EU ETS for sectors covered by the EU CBAM. This will support consistency in the transition for UK and EU businesses. This change will have impacts on the second stage Baseline Data Reporting, more details can be found in the Next Steps section of this document

Summary of Proposals

In Chapter 2 of the 2024 Carbon Leakage Consultation, the UK ETS Authority set out proposals to adjust the approach to free allocation for sectors that will be covered by the UK CBAM from 2027. These proposals aimed to ensure consistency between domestic carbon pricing and border measures, while maintaining support for sectors at risk of carbon leakage during the transition.

The following proposals were presented:

Adjustment of Free Allocation for UK CBAM Sectors
The Authority proposed to begin adjusting free allocation levels for sectors in scope of the UK CBAM from the start of the second allocation period in 2027. This adjustment would reflect the introduction of a carbon price on imports, reducing the need for free allocation as a carbon leakage mitigation tool.

Parameters for Adjustment
The consultation set out a range of options for how the adjustment could be calculated, including:

- Timings of the adjustment based on start year, end year and trajectory.
- Extent of the adjustment, and
- Technical implementation of the adjustment.

Assessment Criteria

The Authority proposed to assess the appropriate level of adjustment using a combination of:

- Mitigating carbon leakage risk for imports;
- Mitigating carbon leakage risk for exports;
- Impact of a Free Allocation adjustment on ETS effectiveness;
- Technical feasibility of the free allocation adjustment methodology; and
- Affordability to government of the final policy choice

These proposals were designed to ensure that the UK ETS and UK CBAM operate in a complementary manner, ensuring a smooth transition of carbon leakage risk mitigation.

Questions (From 2024 – 2025 Free Allocation Review Carbon Leakage Consultation)

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.

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.

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

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.

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.

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

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.

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.

Summary of Responses

This section summarises stakeholder feedback to the consultation questions relating to the adjustment of free allocations for sectors covered by the UK CBAM. Responses were received from a broad range of stakeholders, including industry representatives, environmental groups, academic institutions, and local authorities.

Twenty-eight respondents provided views on the Authority's minded-to position to not take forward the 'do nothing' option (Q9). Of these, 17 (61%) agreed, 7 (25%) disagreed, and 4 (14%) neither agreed nor disagreed. Supporters emphasised the importance of active adjustment to ensure the effectiveness of the UK CBAM and the UK ETS, citing environmental integrity, WTO compatibility, and alignment with the EU. Those opposed questioned whether adjustments would enhance effectiveness and raised concerns about competitiveness and carbon leakage. Neutral respondents highlighted the need for sector-specific assessments and further clarity.

Twenty-two respondents commented on the parameters of adjustment identified by the Authority (Q10). Nineteen (86%) agreed, 2 (9%) disagreed, and 1 (5%) response was not applicable. There was broad support for a phased approach, alignment with the EU, and the inclusion of review mechanisms. Some respondents suggested that adjustments could be varied by sector to reflect different decarbonisation timelines. Those opposed raised concerns about the adequacy of the parameters in addressing export leakage and called for further evidence of UK CBAM effectiveness.

Twenty-seven respondents expressed preferences regarding the start year, adjustment length, and trajectory (Q11). Many supported a 2027 start to coincide with the introduction of the UK CBAM, while others favoured a delayed start to allow for evaluation. A 10-year adjustment period was widely supported, with some advocating for flexibility and interim reviews. A gradual or S-shaped trajectory was the most commonly preferred, with some respondents recommending sector-specific adjustments. Alignment with the EU was a recurring theme, alongside calls for clear communication and robust enforcement.

Seventeen respondents provided views on the rationale for the adjustment parameters (Q12). Twelve (71%) agreed with the rationale, while 5 (29%) disagreed. Supporters cited the importance of aligning with the EU and mitigating carbon leakage. Concerns included the risk of early reductions, the need for review mechanisms, and the importance of planning and enforcement. Some respondents acknowledged technical knowledge gaps and requested further clarity.

Twenty-five respondents commented on the considerations the Authority should take into account when determining the extent of adjustment (Q13). Seventeen (68%) agreed, 6 (24%) disagreed, and 2 (8%) neither agreed nor disagreed. Supporters highlighted the importance of mitigating carbon leakage, addressing export risks, and aligning with the EU. Dissenters questioned the effectiveness of the UK CBAM and raised concerns about premature adjustments and competitiveness impacts.

When asked whether the adjustment should be to zero or a non-zero amount (Q14), 25 respondents provided a view. Eight (32%) supported a zero adjustment, 14 (56%) preferred a non-zero approach, and 3 (12%) had no preference. Those favouring zero cited alignment with the EU and the need for UK CBAM to function independently. Those preferring a non-zero adjustment emphasised export leakage risks, the need for gradual change, and the importance of balancing decarbonisation with competitiveness.

Ten respondents commented on the Authority's mapping of SIC codes to UK CBAM goods (Q15). Six (60%) agreed, 3 (30%) disagreed, and 1 (10%) neither agreed nor disagreed. Supporters generally endorsed the mapping but suggested more granularity. Dissenters raised concerns about data quality, baseline years, and proposed alternative methodologies.

Twenty-four respondents provided views on whether free allocations should only be adjusted for goods covered by the UK CBAM (Q16). Thirteen (54%) agreed, 8 (33%) disagreed, and 3 (13%) neither agreed nor disagreed. Supporters cited environmental and trade benefits, while opponents argued for broader coverage and raised concerns about administrative burden and sector-specific impacts.

Nine respondents commented on the methodology for disaggregating UK CBAM and non-UK CBAM goods (Q17). Respondents highlighted the importance of identifying sub-installations, the complexity of production processes, and the need for adequate time and clear methodologies. Sector-specific considerations and environmental integrity were also raised.

Nineteen respondents provided views on the assessment criteria proposed by the Authority (Q18). Eleven (58%) agreed and 8 (42%) disagreed. Supporters emphasised technical feasibility, ease of compliance, and future linkage with the EU. Dissenters questioned the inclusion of government affordability and the impact on UK ETS effectiveness, and suggested additional criteria such as economic growth and competitiveness.

The Authority Response

Following consultation on the future of free allocation for sectors covered by the UK CBAM, the Authority confirms that free allocation will be gradually phased out for these sectors from 2027. This decision reflects the introduction of the UK CBAM as a new carbon leakage mitigation instrument and the need to ensure coherence between overlapping policy mechanisms.

The Authority consulted on whether to retain free allocation for UK CBAM-covered sectors, including to address residual risks such as export and downstream leakage. While some

stakeholders supported maintaining a level of free allocation for these purposes, the Authority has concluded that a full phase out is the most appropriate course of action.

The introduction of the UK CBAM fundamentally alters the carbon leakage risk profile for covered sectors. By applying a carbon price to imports, the UK CBAM ensures that the decarbonisation efforts of domestic producers are not undermined by emissions intensive imports into the UK market. If free allocation were to continue alongside the UK CBAM, the effective carbon price faced by domestic producers would be significantly reduced, weakening the price signal needed to drive decarbonisation and resulting in a reduced UK CBAM rate on imports.

While export leakage remains a risk[11], the Authority has concluded that free allocation is not currently the best mechanism to mitigate it. There is currently no robust, evidence-based methodology for targeting free allocation to export-exposed installations in a way that accurately reflects future leakage risk. Attempts to develop such methodologies—such as modifying the Carbon Leakage Indicator (CLI) to reflect export intensity—have been found to rely heavily on incomplete or inconsistent data, and would introduce significant complexity and potential distortions into the allocation system.

Phase Out Trajectory

The Authority confirms that the phase out of free allocation for sectors covered by the UK CBAM will commence in 2027, with a trajectory that mirrors the EU's pace of phase out, ensuring a gradual and smooth transition to an alternative carbon leakage mitigation measure. By aligning the start of the phase out with the implementation of the UK CBAM, the Authority ensures that domestic producers are not exposed to carbon leakage risks before border measures are in place. This approach reflects stakeholder feedback calling for a cautious and evidence-based transition, and supports the UK's broader climate and trade objectives.

The trajectory and pace of the phase out will be aligned with the EU's approach, supporting consistency in carbon pricing and leakage mitigation across both jurisdictions. However, to note, the UK's phase out will begin one year after the EU's to align with the introduction of the UK CBAM. The Authority recognises the importance of ensuring that carbon leakage protection mechanisms are coherent across borders.

The Authority also confirms that the phase out will begin gradually, with limited reductions in free allocation during the early years. Stakeholders have consistently called for a cautious approach that avoids premature reductions in free allocation before the UK CBAM is proven to function effectively. The Authority has taken this feedback into account and designed a trajectory that provides certainty to operators while maintaining flexibility to respond to future developments.

Whilst this Response only sets out the rules for free allocations for the next allocation period, in order to provide greater clarity for UK businesses, the Authority are also providing an indicative

[11] Further details on this can be found in the Impact Assessment published alongside this Response.

trajectory for the phase out beyond 2030, allowing businesses to plan their decarbonisation investments ahead of time.

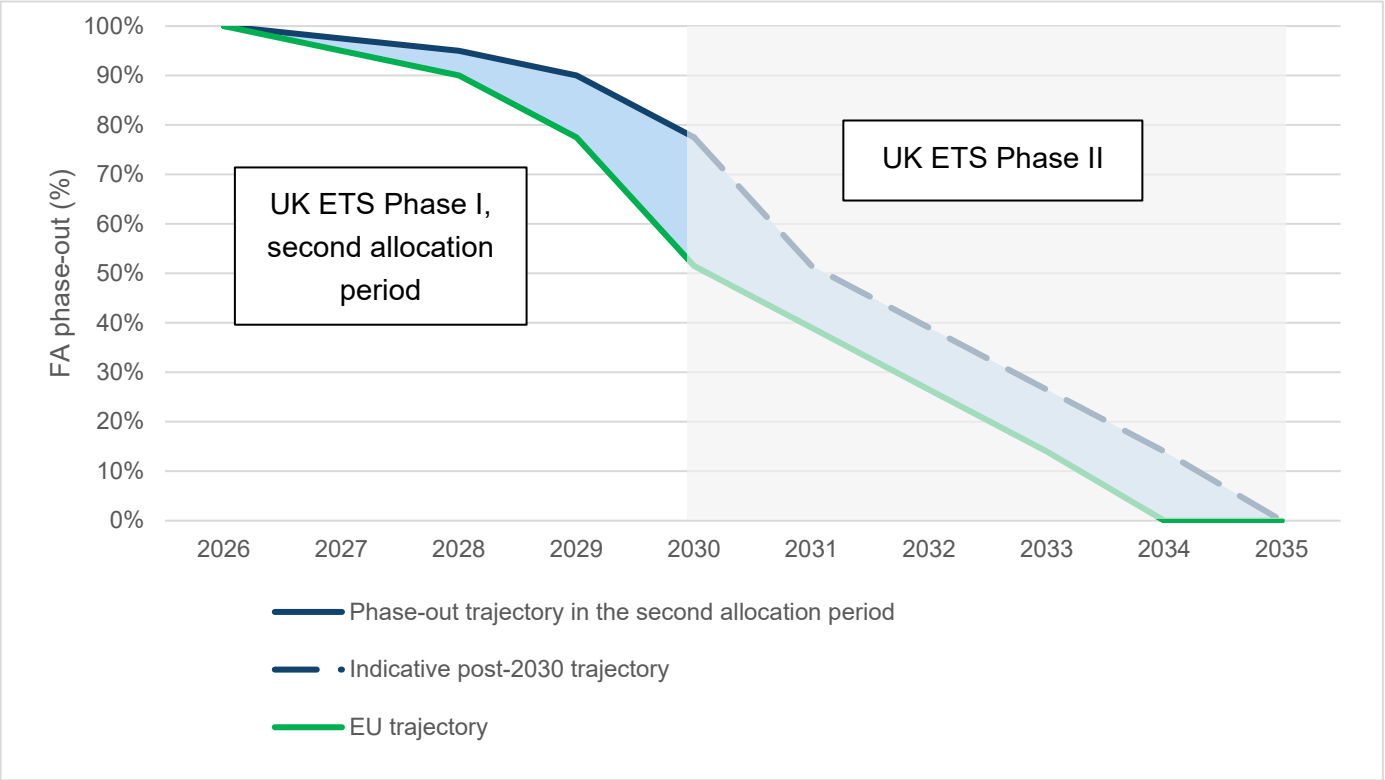

Figure 7 Graph showing free allocation phase out trajectory for sectors covered by the UK CBAM

Implementation Approach

The phase out of free allocation for UK CBAM sectors will begin in 2027, aligning with the start of the UK CBAM. The adjustment will be implemented at the sub-installation level to ensure that only emissions associated with UK CBAM-covered goods are affected. This approach avoids unintended impacts on non-UK CBAM activities and ensures that carbon leakage protection remains in place for sectors not covered by the UK CBAM.

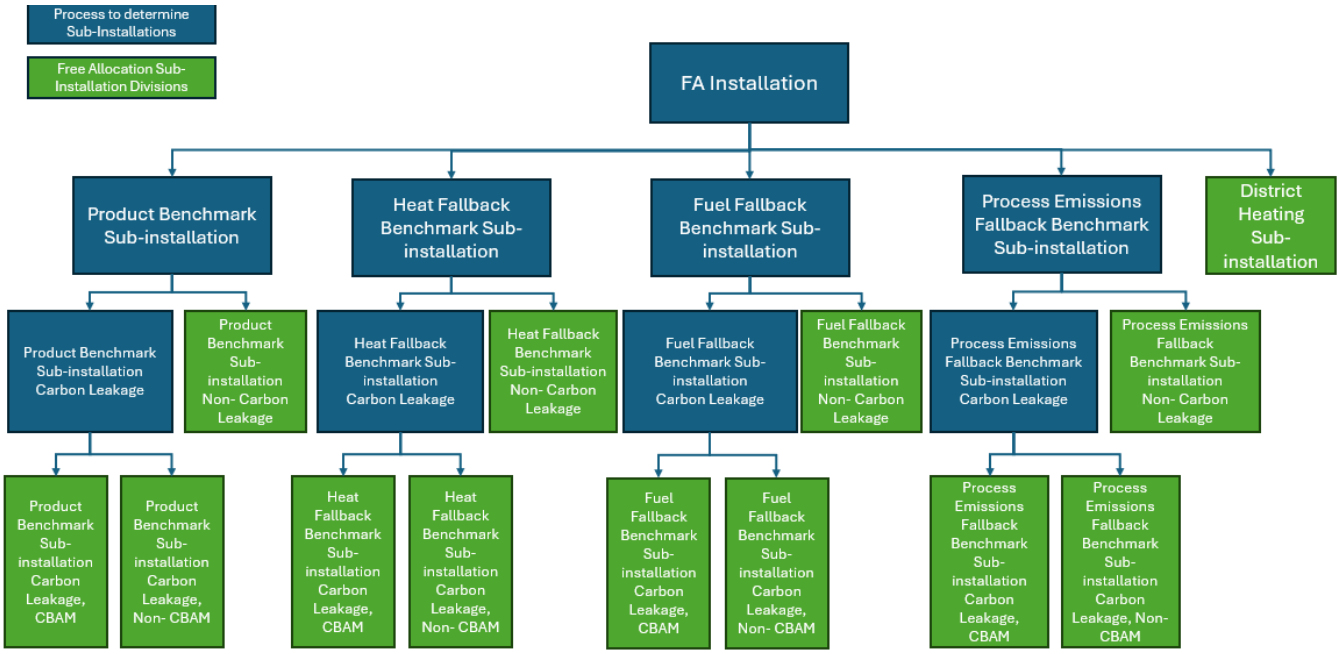

Figure 8 Flow chart describing Free Allocation installation divisions based on new sub-installation splits

The adjustment will be applied uniformly across all UK CBAM sectors. The Authority believes a uniform approach is necessary at this stage to ensure clarity, fairness, and deliverability. The adjustment will be introduced as a new parameter in the free allocation methodology, applied at the point of calculating preliminary allocations. This ensures transparency and consistency with existing allocation processes.

The Authority also confirms that the technical implementation of the adjustment will be based on a mapping of UK CBAM-covered goods (classified under Combined Nomenclature codes) to UK ETS sub-installations (classified under NACE and PRODCOM codes). Operators will be required to identify which of their sub-installations produce UK CBAM-covered goods on the basis of their NACE and PRODCOM categorisations during the second stage of the Baseline Data Report process in 2026, further information on this can be found in the Next Steps section. The tables below describe sectors at NACE and PRODCOM level in the UK ETS that will be classified as UK CBAM sectors and will see a reduction in their free allocation from 2027. Where sub-installations are required to split their sub-installation into those NACE or PRODCOMs covered by the UK CBAM vs those not covered by the UK CBAM they will need to resubmit a verified Baseline Data Report with this information disaggregated during the second stage window. The Authority recognises the additional administrative burden this may place on these businesses however we believe that the benefit of only seeing a reduction to free allocations covered by the UK CBAM justifies the re-submission of data.

The Authority also acknowledges that any potential future expansion of the UK CBAM's sectoral scope may necessitate a reassessment of the approach to free allocation for new UK CBAM sectors. If any such changes were to occur, they would be subject to further consultation and analysis to ensure that they are evidence-based, proportionate, and aligned with the UK ETS's objectives.

As detailed in the Free Allocation Review Carbon Leakage Consultation in 2024, free allocations that are phased out for UK CBAM sectors could result in unallocated allowances under the Industry Cap. It could also result in increased demand for allowances from the auction share. In line with amendments to UK ETS legislation in 2024[12], any unallocated allowances will be deemed 'flexible reserve' allowances and be available for use for Cross-Sectoral Correction Factor mitigation and/or market stability mechanism interventions. The Authority recognises the importance of maintaining allowance supply to market, and will therefore keep the treatment of any unallocated allowances under review for future consideration.

UK Government Approach to Mitigating Export Leakage Risk

Whilst we are not taking forward a UK ETS-based mitigation through the retention of free allowances for export leakage, the UK Government will continue to assess the risk of export leakage, in the context of wider decarbonisation and carbon leakage policy development and the UK's wider objectives and legal obligations.

[12] The Greenhouse Gas Emissions Trading Scheme (Amendment) (No. 2) Order 2024 – new Article 23A.

Chapter 7: Technical Changes

This chapter covers proposals set out in set out in the Free Allocation Review Consultation (December 2023 – March 2024). These proposals included considerations to increase the accuracy of the data reported by operators.

The Authority has decided not to introduce the changes proposed in the consultation, but will keep them under review for future consideration.

Summary of Proposals

Technical Change Three: Updating minimum content of the monitoring methodology plan

The Free Allocation Regulation (FAR) includes a requirement for installations who receive free allocations to maintain Monitoring Methodology Plans (MMPs), which form part of an operator's permit. The regulators are required to include permit conditions requiring operators who receive free allocations to (i) monitor their data in accordance with their MMP and the FAR, (ii) retain records of data in accordance with the FAR, (iii) apply to vary their permits where there will be a significant modification to their MMP and (iv) notify the regulator of non-significant modifications.

The MMP currently requires that at sub-installation level a description of the methods used to quantify the amounts of electricity consumption and production, and the exchangeable part of consumption should be included where applicable.

The Authority consulted on an option to amend the FAR to reflect that only sites generating electricity for export or covered by exchangeability are required to report their electricity balance.

Technical Change Four: Changes to Heat Metering Measurement Hierarchies

The FAR states the most accurate data source quantifying heat hierarchy should be compliant with the Non-automatic Weighing Instruments Regulations 2016 or Measuring Instruments Regulations 2016, however only liquid metering (e.g. water) can ever meet this; therefore, a large number of sites cannot meet the hierarchy and have no accuracy standard to meet – i.e. that metering can be ±10% or more.

The Authority consulted on an option to introduce an equivalent standard for heat metering to include that equivalent accuracy compliant with the Non-automatic Weighing Instruments Regulations 2016 or Measuring Instruments Regulations 2016 can be accepted (e.g. for measurable heat ±3% of actual reads).

Technical Change Five: Adjustment to Monitoring Principles with relation to Hierarchy

There is no requirement to review an MMP where the most accurate measurement methods are not used.

The Authority consulted on an option to adjust the Monitoring Principles in the FAR to request that the operator review where derogations to the hierarchy for monitoring methods are granted every allocation period.

Technical Change Six: Updating the Unreasonable Cost Calculation

The unreasonable cost calculation allows the Authority to consider where an operator's cost estimation would exceed the benefit of a specific determination methodology.

The Authority consulted on an option to update the reference price figure used in this calculation to be more reflective of UK ETS Allowance prices.

Technical Change Seven: Requirement of control system checks to be made at yearly intervals.

Operators are required to make an assessment of their control systems to the Authority upon request and for the purpose of verification. Control activity measuring equipment is currently required to be calibrated, adjusted and checked at regular intervals, including prior to use.

The Authority consulted on an option to introduce yearly checking requirements on measuring equipment to ensure it is performing to the required standard.

Questions (From 2023 – 2024 Free Allocation Review Consultation)

34. Do you agree with the Authority's approach on Technical Change Three to update the minimum content of the monitoring methodology plan? (Y/N Please explain your answer)

35. Do you agree with the Authority's approach on Technical Change Four to change the heat metering measurement hierarchies? (Y/N Please explain your answer)

36. Do you agree with the Authority's approach on Technical Change Five to adjust Monitoring Principles with relation to hierarchies? (Y/N Please explain your answer)

37. Do you agree with the Authority's approach on Technical Change Six to update the unreasonable cost calculation reference price? (Y/N Please explain your answer)

38. Do you agree with the Authority's approach on Technical Change Seven to require control systems checks be made at yearly intervals? (Y/N Please explain your answer)

Summary of Responses

There were 27 respondents to Question 34, of which 11 (41%) agreed to implement the change, 1 (4%) partly agreed, 8 (30%) opposed the change, and 6 did not provide a view.

Respondents who supported the change stated that operators should not be obliged to report data that does not affect their total FA.

There were 24 respondents to Question 34, of which 4 respondents (17%) agreed to implement the change, 1 (4%) partly agreed, 17 (71%) opposed the change, and 2 (8%) did not provide a view.

Of the respondents who supported the change, 2 respondents emphasised that it should not increase costs for operators and disproportionately burden specific sectors.

Of the respondents who opposed the change, 65% cited additional costs and increased administrative burden as key concerns; 53% stated that the proposed standard was likely to remain unattainable for their installations.

There were 30 respondents to Question 36, of which nine respondents (30%) agreed to implement the change, 1 (3%) partly agreed, 10 (33%) opposed the change, and 10 (33%) did not provide a view.

Respondents who supported the change described the proposed period of review (once every allocation period) as reasonable.

Of the respondents who opposed the change, the majority expressed concerns that the review process would incur additional costs and administrative burden on operators without leading to meaningful changes in derogations or free allocation levels.

There were 21 respondents to Question 37, of which 13 (62%) agreed that the reference UKA price should be updated, and 8 (38%) disagreed.

Among those who supported the update, 5 respondents stated that the reference price should better reflect the market price.

Among those who opposed the update, 4 respondents expressed concerns that a higher reference price could result in significant costs to operators.

There were 45 respondents to Question 38, of which 5 respondents (11%) agreed to implement the change, 1 (2%) partly agreed, and 39 (87%) opposed the change.

Respondents who supported the change endorsed the principle of improving data accuracy but highlighted that the proposed review intervals may not be feasible for installations with complex systems and could disrupt business operations.

Among those who opposed the change, 31% highlighted the technical challenges for operators with complex systems, and 21% cited additional costs to operators as a key concern.

The Authority Response

Technical Change Three: Updating minimum content of the monitoring methodology plan

The Authority confirms that it will not amend the FAR.

The Authority considers that current legislation reflects the proposed changed. Section 2.5 of Annex IV to the FAR on annual installation-wide balance of electricity import, production, consumption and export states that the data described in points (a) to (e) only have to be reported by installations that produce electricity.

The Authority remains committed to increasing the accuracy of the data reported by operators and will continue to review and enhance the way the UK ETS operates.

Technical Change Four: Changes to Heat Metering Measurement Hierarchies

The Authority confirms that it will not introduce an equivalent standard for heat metering.

The Authority concluded that, based on the available evidence, there is insufficient confidence that the proposed equivalent accuracy of Non-automatic Weighing Instruments Regulations 2016 or Measuring Instruments Regulations 2016 compliant metering (e.g. for measurable heat ±3% of actual reads) is currently achievable by relevant industries across the UK .

The Authority remains committed to increasing the accuracy of the data reported by operators and will continue to review and enhance the way the UK ETS operates.

Technical Change Five: Adjustment to Monitoring Principles with relation to Hierarchy

The Authority confirms that it will not introduce a requirement on operators to review where derogations to the hierarchy for monitoring methods are granted at least once every allocation period.

The Authority considers that current legislation reflects the proposed change. Section 4.3 of Annex VII to the FAR describes the process for the selection of determination methodologies and data sources representing highest achievable accuracy. It mandates operators to check regularly, and at least once a year, whether new data sources have become available. If these are considered more accurate (in accordance with the hierarchy in sections 4.4 to 4.6) change to their MMP is triggered, requiring the adoptions of the more accurate data source. This is in accordance with the principle of continual improvement of the MMP.

The Authority remains committed to increasing the accuracy of the data reported by operators and will continue to review and enhance how the UK ETS operates.

Technical Change Six: Updating the Unreasonable Cost Calculation

The Authority has decided not to update the reference price figure used in the unreasonable cost calculation at this time. The Authority recognises that the current reference UKA price

does not reflect recent UKA prices, which have been higher than the reference price throughout the current allocation period. However, given the scope of planned and possible changes across the scheme, the Authority considers that it would be prudent to wait until those changes have been finalised before determining any update to the reference price. The Authority may update the unreasonable cost calculation in future.

Technical Change Seven: Requirement of control system checks to be made at yearly intervals.

The Authority confirms that it will not introduce a yearly checking requirement for control system measuring equipment.

The Authority concluded that introducing a yearly checking requirement could impose disruptions and additional costs on some operators, particularly those with complex systems, where production shutdowns or disruptions are necessary to carry out control activities.

The Authority notes that measuring equipment manufacturers provide recommendations regarding the frequency at which users should calibrate, adjust and check their equipment to ensure it continues to perform to the required standard. Operators may find this a helpful guide in maintaining an effective control system in accordance with their obligations under Article 11 of the Free Allocation Regulation.

The Authority remains committed to increasing the accuracy of the data reported by operators and will continue to review and enhance the way the UK ETS operates.

Next steps

The second stage of the application for free allocation for 2027-2030 will take place between 1 April and 30 June 2026. During this window, operators will be required to confirm or withdraw their initial applications for free allocation made in 2025, now that the free allocation review has concluded, as well as confirming their sub-installation UK CBAM status. In addition, some operators who are impacted by the UK CBAM will need to resubmit information relating to their affected sub-installations. Operators will also have the opportunity during the second stage to state whether their 2020 or 2020 and 2021 scheme year data should be excluded from the calculation of their HAL. Further guidance on how to comply with the requirements of this second stage application will be published in advance of the window. Regulators will notify operators when this is available.

Operators who did not submit a first stage application for free allocation in 2025 will not be able to submit this in 2026. It is only when both parts of the free allocation application are completed, and the application is approved by the UK ETS Authority, that the operator will be eligible to receive free allocation for 2027-2030.

Following the publication of updated EU benchmark values, the Authority will publish a final decision on approach to the free allocation calculation for the remaining years of the forthcoming allocation period. This is anticipated to be set out in 2026, with updates to allocation tables made as soon as possible prior to 2028 free allocation distribution before 28 February 2028.

This publication is available from: www.gov.uk/government/consultations/uk-emissions-trading-scheme-free-allocation-review

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