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# Climate, Energy and Green Industrial Policy in the UK-EU reset

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## Key points

- Both the EU and UK have restated their commitment to an ambitious programme of industrial decarbonisation enshrined in their respective domestic laws.
- Brexit has made energy more expensive, cross-border carbon transport impossible, and disrupted carbon markets and green supply chains. In addition, the temporary provisions under which energy markets have operated since Brexit expire in 2026 and need to be renegotiated.
- There is potential for a wide package of energy and climate measures which could contribute to energy security, lower energy prices and facilitate the energy transition for the UK and EU beyond ETS linkage.
- A UK-EU Climate and Energy Agreement could deliver significant benefits to both parties.

## Introduction

On 3 February, UK Prime Minister, Sir Keir Starmer, became the first UK Prime Minister to attend a meeting of the European Council since the UK left the EU five years earlier, marking the start of what is likely to be a long – and potentially controversial – EU-UK 'reset' process. Ahead of the trip, the UK Government was keen to reiterate its key red lines – no return to the EU Customs Union or Single Market. Concern about the potential impact of anything that could be portrayed as pro-immigration policies, particularly in Reform Party-leaning seats, has led the UK to limit the potential scope of the reset and therefore the economic benefits that can be derived from it – even though at the same time the Chancellor of the Exchequer, Rachel Reeves, is advocating for a pro-growth agenda.

Despite these constraints, one area where relationships could be improved relates to climate and energy policy. While commentary to date has focussed on one particular aspect of this – the linkage of the UK and EU Emissions Trading Systems (ETS) – there is potential for a wider package of related measures which could contribute to energy security, lower energy prices and facilitate the energy transition on both sides of the English Channel.

Of course, such a package would have to be negotiated against a challenging backdrop. The UK-EU reset is one part of a broader foreign policy strategy, which seeks to keep the UK's key relationships (particularly with the US) in balance and aims to avoid picking sides. This, in itself, may constrain the UK's ambition further. Also, it may not be possible to isolate energy and climate issues from broader UK-EU considerations, including challenging areas such as fishing and mobility.

## The wider international context

The geopolitical situation in Europe has changed markedly over the five years since Brexit, in ways that underscore the importance of UK-EU cooperation on energy trade. Russia's invasion of Ukraine – and the consequent sanctions imposed on pipeline gas imports – have led to a renewed focus on energy security and of course energy prices. Despite importing relatively little gas from Russia compared to some EU countries (the UK imported around 4% of its gas from Russia in 2021, compared to 55% for Germany) the UK found itself highly exposed to gas price rises as global commodity prices rose (at their peak in August 2022, TTF[1] gas prices were some 620% higher than the 2021 average). The UK has also increasingly found itself competing with EU countries to attract shipments of liquified natural gas (LNG), leading to a price premium of around 3-5% for UK users compared to the EU.

In addition, both the EU and UK have restated their commitment to an ambitious programme of industrial decarbonisation enshrined in their respective domestic laws. One of the primary drivers of this shift in both jurisdictions remains carbon pricing under the respective cap-and-trade schemes. The shift towards net zero implies a considerable ramp up in these prices, with projections suggesting prices could reach €130 by 2030. This common approach also means that both the UK and EU will face a similar problem of carbon leakage – caused when local or regional carbon prices on globally-traded goods such as steel rise significantly higher than equivalent prices in overseas producer countries.

While traditionally, domestic producers have been compensated for carbon leakage risks through the allocation of free emissions permits, this approach is incompatible with a tougher approach to industrial decarbonisation. This explains the EU's world-leading decision to switch to a carbon border adjustment mechanism (CBAM) to effectively equalise carbon prices paid by domestic producers and importers. Not surprisingly – given the UK is faced with a very similar policy challenge – it has decided to follow suit with its own CBAM, based largely on the EU's. However – as with many post-Brexit issues – adopting a similar policy to the EU does not in itself deliver exemptions from new regulatory requirements – which is why UK industry in particular is pushing for closer co-operation. The EU is clear in this regard – UK exemption from the CBAM requires linkage of UK and EU ETS schemes – as is already the case with Switzerland.

Prior to Brexit the gas and electricity markets in Great Britain were fully integrated into the EU systems. Indeed UK policymakers and economists were instrumental in the design and implementation of wider EU energy market liberalisation, the GB energy regulator, Ofgem, was a key player in the ACER, the EU regulatory network, and the UK gas and electricity grid operators played a full part in the industry associations ENTSO-G and ENTSO-E.

These arrangements did not survive the negotiations for the post-Brexit Trade and Cooperation Agreement (TCA). This was partly due to a reluctance on the part of the UK Government of the time to sign up to EU legislation covering things such as network operation and market design, but also due to EU concerns about 'cherry picking' aspects of the single market. The consequence has been a lose-lose for both sides. Trade body Energy UK estimates, for example, that customers in Great Britain paid as much as £320m more for their power in 2022, while power producers in neighbouring countries such as Belgium and France lost export opportunities. And it has made decarbonisation more expensive – for example, joint projects such as the exploitation of the North Sea for offshore wind development are predicated on the ability to export power west and east, depending on demand and market conditions.

The TCA did envisage the two sides working together to put into place new arrangements – short of energy market integration – which would at least improve the situation. But despite best efforts by industry stakeholders, it has proved impossible to make these work in practice. Furthermore, the temporary provisions under which energy markets have operated since Brexit expire in 2026 and need to be renegotiated.

In recent years, both the EU and UK have placed big bets on green industrial policy as a means to deliver net-zero and economic growth at the same time. The EU's Green Industrial Deal and Clean Industrial Deal and the

[1] The Title Transfer Facility in the Netherlands which sets the benchmark for EU gas prices

Labour government's Clean Growth mission contain ambitious targets for the deployment of new technologies such as wind power, electric vehicles and green hydrogen. In the EU's case, the Net Zero Industry Act and Critical Raw Materials Act set specific targets for EU production of key technologies and minerals.

However, the EU and UK both face significant challenges, particularly around affordability. Neither jurisdiction has the budgetary firepower needed to match the incentive levels of, for example, the US Inflation Reduction Act. In addition, the UK faces the challenge that these target technologies generally form part of global or regional supply chains – wind turbines being a good example. It is hard to imagine these supply chains onshoring completely to the UK, given its relatively small market size. More realistically, the UK's success in this area is likely to come through integration into pan-European value chains.

One of the technologies being pushed by both EU and UK policymakers is carbon capture and storage (CCUS). The viability of CCUS is dependent on a number of factors, including transport infrastructure and geologically-appropriate storage sites. The UK has a significant advantage in this regard, given its history of offshore oil and gas exploitation. The UK Government estimates that the UK has around 78 gigatonnes of viable carbon storage capacity – by far the greatest in Europe apart from Norway.

While the UK can deploy this capacity to store its own carbon emissions, another Brexit consequence means that it is unable to store carbon produced by EU emitters. Previous arrangements that allowed carbon to be legally transported across borders expired at Brexit, as well as the exemption from EU ETS charges for EU carbon stored in the UK. Both of these constraints limit the potential for the UK to develop its CCUS market and also cut off EU emitters from a nearby and viable source of storage. Note: despite not being an EU member, Norway's position within the European Economic Area (EEA) means that these restrictions do not apply to carbon stored there.

## Next steps: a package approach?

Given the wider shared interests beyond simply ETS linkage, a broader EU-UK climate and energy package should be considered. This would of course need to be balanced and bring benefits for both sides. Table 1 below sets out some of the components that could be considered as part of such a package.

**Table 1: Potential content of a EU-UK Climate and Energy Agreement**

- UK-EU ETS linkage
- Agreeing arrangements for treatment of UK-EU maritime transport under ETS similar to those already in place for aviation
- UK-EU CBAM alignment
- CBAM exemptions for UK-EU trade and vice versa
- Relinking GB and EU electricity and gas markets
- Observer status for UK organisations at the relevant European bodies for regulatory and technical co-operation[2]
- Agreement that UK produced green goods and critical minerals would count towards the achievement of EU 'domestic' targets and vice versa
- A carbon transport agreement, over-riding the London Convention restrictions on cross-border transport (as already exists within the EU and between the EU and the EEA)
- Amendment of EU and UK ETS legislation to exempt carbon stored in the other jurisdiction from the payment of ETS charges

Such an approach would bring challenges as well as opportunities. While some of these aspects are foreseen within the EU-UK TCA – such as ETS linkage – others are not. The TCA architecture also contains linkages

[2] The European Union Agency for the Co-operation of Energy Regulators (ACER) and the European Networks of Transmission System Operators for electricity and gas (ENTSO-E and ENTSO-G)

beyond the climate and energy space – for example the renegotiation of energy trading is connected to the satisfactory renewal of an EU-UK fisheries agreement.

A package along these lines would also have to be acceptable to the European Commission and the Member States. A 2024 Commission assessment of potential areas for an EU-UK reset specifically noted that energy market linkage of the kind envisaged above would 'not be in the EU's interest' and ran counter to the key doctrine of indivisibility of the single market. While there are strong economic arguments to be made that such arrangements would, in fact, benefit both parties, the doctrinal point may be harder to overcome without significant political goodwill on both sides.

## Conclusion

A UK-EU Climate and Energy Agreement could deliver significant benefits, without compromising key UK concerns around immigration and sovereignty. Thinking beyond the current narrow focus on carbon pricing and CBAM to include broader but related elements, such as energy trading and carbon transport, would deliver a suite of regulatory and policy improvements that would deliver on the wider energy security, competitiveness and decarbonisation objectives that both the UK and EU share.

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