

Targeted Consultation Document



UK ETS free allocation rules for hydrogen production

The UK Emissions Trading Scheme (UK ETS) Authority is seeking views on two targeted technical changes to the free allocation rules for hydrogen production. The first would treat hydrogen supplied to another refinery or organic chemical installation in the same way as equivalent on-site use, where it does not serve the production of a UK CBAM good. The second would allow a product benchmark sub-installation to be split between the parts serving the production of UK CBAM and non-UK-CBAM goods, so that the UK CBAM-related free allocation phase-out applies only to the part producing UK CBAM goods.

This consultation is aimed at UK ETS installation operators, particularly those producing hydrogen at refineries and organic chemical installations, and their representative bodies.

This consultation is open until 23:59 on 2 October 2026. Please send responses to ukets.consultationresponses@energysecurity.gov.uk

The UK ETS Authority comprises the UK Government, the Scottish Government, the Welsh Government and the Department of Agriculture, Environment and Rural Affairs in Northern Ireland. The proposals set out in this document would apply across the United Kingdom and, if taken forward, would be given effect through amendments to the UK ETS legislation, subject to the outcome of this consultation.

Background

The UK ETS is a central part of the UK's approach to reducing greenhouse gas emissions. It requires operators in covered sectors to obtain and surrender allowances for their emissions, providing an incentive to decarbonise. Eligible industrial installations receive a proportion of their allowances for free to mitigate the risk of carbon leakage while maintaining the incentive created by the carbon price to reduce emissions.

The UK Government Carbon Border Adjustment Mechanism (UK CBAM) will introduce a carbon price on certain imported goods from 2027. Its purpose is to ensure that relevant imported goods face a carbon price comparable to the carbon price faced by UK producers, thereby reducing the risk that production and associated emissions move from the UK to countries with a lower or no carbon price.

Free allocation and CBAM both mitigate carbon leakage but do so in different ways. Free allocation reduces the effective carbon price faced by eligible UK producers, while CBAM ensures a carbon price equivalent to that paid in the UK is applied to relevant imported goods. As CBAM is introduced, it will provide an alternative form of

carbon-leakage protection for UK production of the goods within its scope. The UK ETS Authority therefore decided that free allocation for sub-installations serving the production of goods that would be covered by CBAM if imported to the UK (referred to as UK CBAM goods) should be gradually phased out from 2027¹.

The policy intention is that the free allocation phase-out should apply where CBAM provides corresponding carbon-leakage protection. Where production does not serve a UK CBAM good, applying the phase-out would remove existing free allocation without UK CBAM providing a replacement form of carbon-leakage protection. The Authority therefore considers it important that the rules accurately distinguish between production serving UK CBAM goods and production serving other goods or uses.

Hydrogen as a CBAM Good

Hydrogen presents a specific issue because hydrogen produced within a single product benchmark sub-installation may be put to different uses. Some hydrogen production may constitute, or serve the production of, a UK CBAM good, while another part may be used within refinery or organic chemical processes that do not result in the production of a UK CBAM good.

Relevant UK CBAM hydrogen goods include pure hydrogen and mixtures of hydrogen with nitrogen usable in ammonia production. Hydrogen production serving these goods would continue to be classified as serving the production of a UK CBAM good and would remain subject to the corresponding free allocation phase-out.

However, where hydrogen is used within a refinery or organic chemical installation without resulting in the production of a UK CBAM good, this is currently treated as outside the scope of the EU CBAM and ETS. The Authority therefore considers that the UK CBAM-related free allocation phase-out should not apply to that part of the hydrogen production. HM Treasury are currently finalising UK CBAM legislation and intend to align with this approach¹.

Example 1: hydrogen used within the same installation

A refinery or organic chemical installation produces hydrogen and uses it exclusively within that same installation for an eligible refinery or organic chemical process that does not result in the production of a UK CBAM good. Under the current rules, this production can be treated as not serving a UK CBAM good and therefore does not have the UK CBAM-related free allocation phase-out applied to it.

Example 2: hydrogen supplied to another eligible installation

A refinery or organic chemical installation produces hydrogen and supplies part of it to another refinery or organic chemical installation, where it is used for an equivalent eligible purpose and does not result in the production of a UK CBAM good.

¹ Under the EU rules the use of hydrogen as a fuel at any refinery or organic chemical installation is exempt from being considered a CBAM good and so has no corresponding free allocation phase out. The UK Government intend to align with this approach in upcoming UK CBAM legislation.

Under the current UK ETS rules, the fact that this hydrogen is supplied to another installation would result in the hydrogen product benchmark sub-installation being classified as serving the production of a UK CBAM good, regardless of how that hydrogen is ultimately used. This would affect the treatment of the whole sub-installation, including production used for purposes for which UK CBAM does not provide corresponding carbon-leakage protection.

The consequence is that the free allocation phase-out would be applied to hydrogen that does not serve the production of a UK CBAM good, simply because part of the output is supplied across an installation boundary.

The proposed changes would allow the rules to reflect hydrogen uses for the purpose of UK CBAM classification. To note this would not create a general exemption for hydrogen from free allocation phase-out where it serves the production of a CBAM good.

Hydrogen and industrial decarbonisation

Low-carbon hydrogen can support emissions reductions in industrial processes that are difficult or expensive to electrify. The UK Government's hydrogen strategy identifies low-carbon hydrogen as an important enabler of a lower-carbon energy system and as having a role in decarbonising vital UK industries².

The production and use of low-carbon hydrogen can therefore contribute to the transition away from unabated fossil fuels in appropriate industrial applications. However, the proposed changes are not based on an assumption that all hydrogen is inherently low carbon. Hydrogen production within the UK ETS will remain subject to the UK ETS carbon price, and the level of emissions associated with its production will continue to be reflected through operators' obligations under the scheme.

The policy rationale is instead to ensure that carbon-leakage protection is applied consistently and accurately. Where hydrogen production serves a UK CBAM good, the relevant free allocation will be phased out as CBAM protection is introduced. Where it does not serve a UK CBAM good, existing carbon-leakage protection should not be removed solely because the hydrogen is supplied across an installation boundary.

The UK Government has also recognised that transport and storage infrastructure will be important in connecting hydrogen producers with consumers and in supporting the development of the hydrogen economy³. The way hydrogen is treated under UK ETS free allocation rules where it is supplied between installations is therefore relevant to how those supply arrangements develop.

The current UK ETS rules may discourage otherwise viable hydrogen supply arrangements if supplying a small proportion of hydrogen to another installation causes the whole product benchmark sub-installation to be treated as serving UK CBAM production. The proposed changes are intended to remove the perverse incentive which can disincentivise downstream uses of hydrogen, it also ensures that the free allocation phase-out only happens at sub-installations which serve the production of UK CBAM goods.

Relationship with EU approach

The current UK ETS treatment was developed by reference to the EU CBAM methodology that applied under the EU framework at the time the UK ETS Authority took its decisions on free allocation for UK CBAM sectors.

The equivalent EU rules were subsequently revised in December 2025⁴. The revised EU provision focuses on the consumption of hydrogen as a precursor within refineries or organic chemical installations, where the hydrogen is exclusively used within those plants and is not used to produce goods listed in Annex I to the EU CBAM Regulation⁵.

The Authority considers that aligning the UK approach with the equivalent EU treatment is appropriate where this supports the underlying UK policy objective. Alignment would reduce the risk of equivalent hydrogen production and uses receiving materially different treatment under the UK and EU ETS frameworks and of UK operators being placed at a competitive disadvantage relative to comparable EU operators which could increase carbon leakage risk.

UK ETS Authority proposal

The UK ETS Authority proposes two connected technical changes:

Proposal 1: Treatment of hydrogen use

The Authority proposes that hydrogen used at another refinery or organic chemical installation should receive the same treatment as equivalent on-site use, provided it does not serve the production of a UK CBAM good.

This would ensure that the free allocation phase-out is properly targeted, avoid discouraging eligible hydrogen supply between installations, and support consistent treatment between the UK and EU. Hydrogen serving the production of a UK CBAM good would remain subject to the phase-out.

Proposal 2: Splitting product benchmark sub-installations

The Authority proposes allowing operators to split a product benchmark sub-installation between the parts serving production of UK CBAM and non-UK-CBAM goods. The phase-out would apply only to the part producing UK CBAM goods.

This is expected to apply solely to hydrogen, where a single sub-installation may serve different end uses. Operators would need to evidence the destination and use of the hydrogen, with the split subject to regulatory approval.

Proposed Implementation

We propose the following approach to implementation:

- i.) The proposed changes would apply to free allocation for the 2027 to 2030 scheme years. They would not change the level of free allocation already distributed, and no adjustments would be made to free allocation for scheme years before 2027 as a result of these changes.

- ii.) Operators of product benchmark sub-installations wishing to split their sub-installation to reflect different treatment applying to different parts of their production would be required to modify their Monitoring Methodology Plan (MMP). This modification would be subject to approval by the operator's regulator. In practice, we expect this to affect only a small number of operators, primarily hydrogen producers, and we will engage with affected operators and their regulators to support this process.

Question 1: Do you agree with the UK ETS Authority's proposal that hydrogen used at another refinery or organic chemical installation should receive the same free allocation treatment as equivalent on-site use, where it does not serve the production of a UK CBAM good? Please explain your answer.

Question 2: Do you agree with the UK ETS Authority's proposal to allow operators to split a product benchmark sub-installation between the parts serving UK CBAM and non-UK-CBAM production, so that the free allocation phase-out applies only to the part serving UK CBAM production? Please explain your answer.

Please send your response to this consultation to
ukets.consultationresponses@energysecurity.gov.uk.