

UK IN A
CHANGING
EUROPE

INSIGHT

LINKING EMISSIONS TRADING SCHEMES: KEY CHALLENGES



Photo by Daniel Moqvist on Unsplash

JOËL RELAND

SUMMARY

In May 2025, the UK and EU committed to linking their respective emissions trading schemes, which levy tariffs on carbon emissions in industrial sectors. Unless these systems become 'linked', the two sides face the prospect of new taxes and administrative costs on trade in industrial goods once their respective Carbon Border Adjustment Mechanisms (CBAMs) take effect from 2026 (EU) and 2027 (UK). With formal talks set for the autumn, this briefing explains how linkage could work and assesses the key issues that will need to be addressed – as well as potential points of contention – in the forthcoming negotiations. It makes the following key findings:

- » As with all UK-EU negotiations, there could be differences of opinion on key points of detail, such as the sectoral scope of linkage, the extent of UK dynamic alignment with EU law, and whether the UK can get a temporary exemption from the EU CBAM.
- » If the UK cannot obtain a temporary EU CBAM exemption by the start of 2026, British exporters will face significant new costs on EU exports until linkage is completed. The EU may be reluctant to grant a temporary exemption if it fears that other countries will ask for the same treatment.
- » The EU proposes that linkage should cover all EU ETS sectors, except domestic heating. That would mean the UK having to expand its ETS to cover international maritime emissions. Completing that work could potentially slow down the implementation of linkage.
- » The agreement will require UK 'dynamic alignment' with EU law, but there could be disagreement over the extent of alignment necessary to make linkage work, and the influence which the UK has over future EU law which applies to it.
- » Linkage will see the UK 'carbon price' rise to match the EU's, creating short-term costs for businesses. Though these are more than offset by the wider benefits of linkage, the government will need to consider whether to help firms manage the immediate costs.
- » The two sides may need to discuss 'level playing field' issues. Both the UK's continued use of 'free allowances' for emitters and EU plans to exempt some sectors from paying ETS tariffs on exported goods could be deemed unacceptable competitive distortions.
- » Even after linkage, foreign exporters will need to navigate different processes when dealing with the UK and EU CBAMs, which could make the UK a less attractive export destination. This could be avoided by an agreement, alongside linkage, on mutual recognition of CBAM accreditations.
- » The UK will have to transpose all relevant EU ETS legislation into domestic law. This could be done entirely by statutory instrument, which is more expedient but robs Parliament of its ability to scrutinise the legislation. Meanwhile, Whitehall will have to ensure it has the capacity and systems in place to maintain consistent alignment with EU law.
- » The two sides will have to agree a process for governing the agreement and resolving disputes. This is likely to follow the same structures and processes as the UK-EU Trade and Cooperation Agreement, except that the European Court of Justice will have a limited role as the ultimate arbiter of any disputes which relate to a matter of interpretation of EU law.

BACKGROUND

WHAT IS ETS LINKAGE?

The UK left the EU emissions trading scheme (ETS) after Brexit, and subsequently set up its own ETS, which is very similar in design. Both are based on a ‘cap and trade’ model. Businesses have to purchase an ‘allowance’ for each unit of carbon emissions they create, with a finite number of allowances available to buy (the size of the pool reduces year-on-year) and firms able to sell any unused allowances to those in need of more. The limited number of allowances puts an effective cap on industrial emissions, while the ability to trade unused allowances incentivises firms to further reduce their emissions.

The Trade and Cooperation Agreement (TCA) says the UK and EU should give ‘serious consideration’ to linking their ETS systems – a rare example of the treaty foreshadowing closer cooperation; anticipating the trade disruption which would otherwise occur (explained in the next section) from having separate ETS regimes.

What linkage means in practice is that UK and EU ETS allowances would become interchangeable, so a UK firm could purchase allowances on the EU ETS market and vice-versa. There is precedent for this – the EU and Switzerland have had linked schemes since 2020. Under linkage, the UK would retain overall control of its ETS regime rather than being subsumed into the EU ETS, which is governed by the European Commission.

But linking systems necessitates greater alignment of the UK scheme with the EU’s. There has to be a common set of linked sectors, an integrated system for trading allowances and a common ‘carbon price’ (what you pay for an allowance). At the moment, there is divergence between the UK and EU in all of these areas, and bridging those gaps will be the core focus of the forthcoming negotiations.

WHAT ARE THE PROS AND CONS OF LINKAGE?

The biggest benefit of linkage is that the UK and EU would be exempted from each other’s Carbon Border Adjustment Mechanisms (CBAMs), which take full effect from 2026 (EU) and 2027 (UK). These levy tariffs on imports of ETS-covered goods, to ensure they pay the same price for their embedded carbon emissions as if they had been produced domestically. This is designed to stop foreign imports, which are not subject to the costs of ETS-style regulation, from undercutting domestic goods.

Unless a CBAM exemption is secured, from 2026, British exporters will have to pay any difference between the UK and EU carbon prices when exporting to the EU. Because the UK price is lower, they would be subject to an estimated £800m in CBAM tariffs over the course of the next parliament, and they would also have to complete complex paperwork to declare emissions embedded in goods, even if the carbon prices are the same. The impact on electricity trading could be especially damaging – as the EU CBAM does not distinguish between renewable- and non-renewable-based exports – with an LSE study estimating it could reduce UK electricity exports to the EU by 164 GWh a year (equivalent to the annual consumption of 50,000 homes). Northern Ireland could also have to apply the EU CBAM on imports from Great Britain – creating new trade barriers within the UK internal market.

Another benefit of linkage for UK firms is that they would participate in a much bigger, more liquid market for carbon allowances (the EU market is more than ten times the size of the UK's). This should create a less volatile carbon price and thus make it easier for firms to develop long-term plans for decarbonisation. Frontier Economics estimates that the economic savings from greater market liquidity could be near-equivalent to the savings from CBAM exemption.

Though linkage could bring short-term costs for business, as the UK's 'carbon price' would have to increase to match the EU's, the vast majority of UK firms appear to be in favour of it, due to the greater carbon price stability it would bring and the avoidance of EU CBAM tariffs. They might also see lower costs longer-term, as, without linkage, the UK carbon price is forecast to surpass the EU's by 2030 – due to a drastic reduction in available allowances in the coming years.

From a government perspective, linkage means less control over the design of the UK ETS in future, as it will be obliged to adopt some or all of the changes which the EU makes to its own regime (discussed in detail further down). It will also affect fiscal headroom, as HM Treasury will likely collect more ETS revenues in the next five years (due to a higher UK carbon price), but potentially lower revenues thereafter.

NEGOTIATIONS: KEY ISSUES

CBAM EXEMPTION

The chief purpose of ETS linkage is mutual CBAM exemption. But one considerable problem is that the EU CBAM takes effect from January 2026 – by when it seems very unlikely that a linkage agreement will have been completed, let alone operationalised. This creates the prospect of the UK being temporarily subject to the EU CBAM. Were no agreement to be in place by 2027, the EU would also start to face UK CBAM costs.

An immediate matter for the negotiations will be how to address the looming 2026 cliff-edge. One option would be for the Commission to exempt the UK from its CBAM temporarily, while linkage negotiations are ongoing. But the Commission might deem this to weaken its negotiating hand – there is less incentive for the UK to conclude a deal promptly if it already has a CBAM exemption – and also harbour concerns that other countries might cry foul and demand their own exemption.

Alternatively, the Commission might point to the fact that, under its recent 'Omnibus' legislation, the deadline for the first CBAM payments has been pushed back to February 2027 – giving UK firms (and the government) more time to prepare for the costs. Or it could offer to waive accrued CBAM charges for UK firms if linkage is completed by the first payment deadline.

If no temporary exemption is agreed, there is still a question to resolve around when mutual CBAM exemption kicks in: when negotiations are concluded? Or when linkage takes effect? There is likely to be a gap between the former and the latter – the length of which will depend on the speed with which the technical work of linking systems can be completed – meaning the UK may well want to push for the earlier date, to reduce its period of exposure to the EU CBAM.

SECTORAL SCOPE

Another central issue for the UK and EU to settle is which sectors should be linked. The UK-EU ‘[Common Understanding](#)’, published in May, said this should include ‘electricity generation, industrial heat generation (excluding the individual heating of houses), industry, domestic and international maritime transport and domestic and international aviation.’ This is, in essence, all of the sectors covered by the EU ETS bar domestic heating.

The EU reiterated this position in its [July negotiating mandate](#). Should the UK to agree, it will have reform its ETS to align with the EU’s. Specifically, it will have to expand it to cover international maritime emissions (domestic maritime emissions will come into scope of the UK ETS [from 2026](#)). It would also need to iron out differences in approach to the pricing of aviation emissions (the UK does not, for example, zero-rate biofuels). Though it seems unlikely given the commitment in the Common Understanding, the UK could in theory seek to exempt maritime and aviation from linkage, citing the precedent of the EU-Switzerland agreement, which does not cover aviation.

There are two key questions for the UK when considering full-scale sectoral alignment. First, are there any policy costs from sacrificing existing divergence over maritime and aviation? The decision not to cover international maritime emissions, for instance, was borne of a desire to make UK ports more attractive destinations for foreign ships. Second, how long would it take to expand the scope of the UK ETS to match the EU’s? Unless it can be done as quickly as it takes to operationalise the rest of the linkage agreement, this could delay the implementation process. There might thus be a case for linkage to initially be based on sectors where the UK and EU are currently aligned, with a UK commitment to expand its ETS to fully match the EU by a given date.

The EU negotiating mandate says nothing about UK alignment with its [ETS₂](#) (covering buildings, road transport and smaller industrial sectors), which takes full effect from 2027. This may reflect a pragmatic acknowledgement that the UK has no equivalent ETS₂ plans (and is instead taking a different approach to road and heat decarbonisation), making linkage infeasible in the short term. That said, the EU might ask for the UK to commit to expanding its regime to match ETS₂ by a given date.

DYNAMIC ALIGNMENT

Back in May, the two sides stated that ETS linkage will be based on dynamic alignment, whereby the UK is subject to relevant EU legislation, both now and as it evolves, without any decision-making powers. But the critical question is how far that alignment extends. The [EU position](#) is that the UK should ‘guarantee dynamic alignment with all the relevant European Union rules’, including ‘all the provisions of the EU financial regulatory and supervisory framework’. On a maximalist reading, this could mean the UK adopting the entirety of the EU ETS acquis – much as [EEA/EFTA states do](#).

Yet the UK may push back, and argue that dynamic alignment should only occur where it is necessary to make linkage work, namely the [monitoring, reporting and verification of emissions](#). In other cases, it might argue that equivalence of standards should suffice, such as on [price stability mechanisms](#), where the UK is planning to use a [slightly different method](#) to the EU. The UK might cite the precedent of the EU-Swiss deal, which was not initially based on dynamic alignment; and the fact that there is already a large degree of alignment between the EU and UK systems (reflecting the UK's role a chief architect

of the EU regime), which means that many differences are only technical and should not pose a risk to either fair competition or the functioning of linkage. It might also argue that it will be harder for other countries to link to the EU/UK ETS in future, if it entails comprehensive dynamic alignment.

As per the Common Understanding, the two sides will also need to agree ‘a procedure to further expand the list of sectors to be covered by the linking agreement’. Will the UK automatically be subject to all changes to the EU ETS’s sectoral scope? Or will there be procedures to mediate this on a case-by-case basis? And what influence, exactly, will the UK get over any changes to which it is subject? The Commission says that the UK, as a non-member state, should have no right to participate in ‘decision-making’ processes but ‘should be involved at an early stage and contribute appropriately... to the decision-shaping process’. That implies participation in policy discussions but no right to vote on the legislation itself. But the UK may, at a minimum, insist on explicit guarantees over the nature of that participation, given the depth of policy work already underway on its own ETS expansion.

For example, the UK is further ahead than the EU in its plans to let hard-to-abate sectors to make use of ‘carbon removals’ (techniques to extract CO₂ from the atmosphere) to offset residual emissions; and, like the EU, is also planning to expand its ETS to cover waste incineration. It will want to ensure that this thinking is adequately reflected in future EU legislative processes, though it will likely have to accept some trade-offs: such as the fact that the EU is steadfastly opposed to the use of woodland in carbon removal schemes (despite them being considered under UK proposals).

HARMONISATION OF PRICES AND CREDIT-TRADING

Linkage requires the harmonisation of the UK and EU’s ‘carbon price’ for emissions allowances, and the creation of an integrated system for trading credits. This poses both practical and political challenges.

Practically speaking, the UK and EU carbon prices will have to converge by the time that linkage takes effect. Experts suggest that market forces will take care of this once the prospect of linkage is apparent. The price gap has been closing since the turn of the year, when UK ministers began publicly indicating firm interest in linkage, though there was no discernible convergence following the announcement of linkage plans in May. The remaining gap may close once negotiations are closer to completion. Creating an integrated trading system is another technical task: about making two different IT systems and registries interoperable. This is made easier as the UK and EU systems are similar in design and based in part on the same software, though any unforeseen problems could delay the start of linkage.

The political challenge is that UK industry will face higher short-term costs, given the EU’s carbon price has consistently been about a third higher than the UK’s – though the gap is now more like 20%. Though not a matter for the negotiations, the UK government will need to ensure industry is prepared for a carbon price increase, and potentially take action to help them manage higher costs. June’s ‘Modern Industrial Strategy’ promises increased subsidies to heavy emitters to help them with their energy costs, but only from 2027 – meaning shorter-term relief may be needed.

Linkage could also have an impact on the government’s wider economic policy, as ETS revenues would go up in the short-term, due to the higher carbon price, potentially increasing fiscal headroom (ETS linkage will not have been factored into previous OBR forecasts). Post-2030, however, the UK carbon price is likely to be lower than it otherwise would be, meaning reduced revenues for HM Treasury.

CBAM DESIGN

Although a chief purpose of linkage is mutual CBAM exemption, this does not necessarily require the UK and EU to harmonise their CBAMs. However, a paper by Emily Lydgate for the Centre for Inclusive Trade Policy outlines several potential problems stemming from design differences between the UK and EU CBAMs, which may need addressing either in, or alongside, the negotiations.

The different start dates (2026 vs. 2027) create a temporary risk of ‘transshipment’, where goods are shipped to the UK and then on into the EU, without paying the EU CBAM tariff. The EU may therefore insist that the UK apply its own CBAM before it is exempted from the EU’s; or that, until the UK CBAM takes effect, UK exports which are non-UK made are subject to the EU CBAM (in line with the approach taken towards Switzerland - which does not have a CBAM).

The UK and EU regimes also have different approaches to levying CBAM tariffs (the EU’s is a customs regime while the UK’s is a tax regime), meaning businesses will have to navigate different bureaucratic processes for each market. Firms are likely to prioritise compliance with the EU regime as it represents a much bigger market, which Lydgate says potentially poses a ‘host of problems for the UK’ such as delays in processing goods at the border ‘or even firms simply avoiding the UK market as it’s too much trouble’.

Given the risks to the UK, it could take unilateral action to align its CBAM design more closely to the EU’s. But it could also, as part of negotiations, seek some form of mutual recognition agreement which means importers do not need to navigate dual UK and EU CBAM accreditation regimes. One option would be for an EU accreditation to automatically clear goods for the UK market and vice-versa (but this would likely require harmonisation of wider CBAM legislation); while another, simpler, option would be to allow UK and EU bodies to provide dual accreditations for both the EU and UK markets - so an importer does not have to seek separate accreditations from a UK and EU body. The challenge for the UK is that there is not much incentive for the EU to agree to this - indeed it recently rebuffed UK proposals for a similar mutual recognition agreement for conformity assessments.

Finally, there could be differences in how the UK and EU calculate CBAM charges (e.g. the EU is set to use the average ETS price of the previous week while the UK has proposed the previous quarter) and the value threshold for when imported goods are subject to CBAM charges. This could create a scenario where imported goods are subject to lower, or no, CBAM tariffs in one jurisdiction - and the two sides may want to develop processes to avoid such divergence, which could otherwise distort competition and allow exporters to play one side off against the other.

LEVEL PLAYING FIELD

As with the TCA negotiations, the UK and EU will need to discuss provisions to ensure a ‘level playing field’ - i.e. the maintenance of fair and open competition between their respective markets. Differences in CBAM design could fall under this topic; while the EU may also raise concerns about the higher number of ‘free’ allowances (to help hard-to-abate sectors with their ETS costs) under the UK system - with the disparity set to grow further as the EU phases out free allowances as its CBAM kicks in. That means UK firms receiving comparatively more support for their ETS costs, and the Commission might insist on harmonisation of free allowance allocation as a prerequisite to ETS linkage.

On the other hand, the UK may raise concerns about an [EU proposal](#), yet to be set out in detail, for certain heavy industries to be exempted from paying ETS tariffs on goods which they export beyond the EU. This is [designed](#) to make EU exports more competitive in foreign markets where domestic producers do not have to pay for their carbon emissions. But the UK could justifiably point out that it is no such market – especially if and when ETS linkage is complete – and ask that the exemption not be applied to goods exported to the UK.

Yet, even if this is secured, the UK might have residual concerns about EU firms in effect benefiting from a major ETS subsidy compared to their UK competitors. UK negotiators are unlikely to be able to get the EU to drop the proposal, but they could suggest that the EU accepts the UK’s continued use of more free allowances as a quid-pro-quo, or else the government could introduce a parallel exemption for UK firms in order to level the playing field.

One other potential issue is the question of how ETS revenues are spent. Following a 2023 directive, the majority of EU ETS revenues [must be used](#) by member states to finance energy and climate-related activities, whereas UK revenues are not earmarked for a particular purpose. The EU might deem this a level playing field concern, though the UK could point to the precedent of the [EU-Swiss agreement](#), which does not impose any constraints on how the Swiss government spends its ETS revenues.

FINANCIAL CONTRIBUTIONS

The EU’s negotiating mandate states that the UK ‘should contribute financially’ as part of an ETS agreement ‘to support relevant costs associated with...the functioning of the relevant Union agencies, systems and databases to which the United Kingdom would gain appropriate access.’

There is precedent for this: the EU-Swiss agreement [requires](#) Switzerland to cover technical costs such as linking the EU Transaction Log to the Swiss equivalent. However, the UK government will be keen to ensure that any linkage represents value for money – and that the payments to the EU do not neutralise or outweigh the economic benefits of linkage. Hagglng over payments is the kind of issue which could slow down the finalisation of an agreement.

The UK could in theory also ask for access to the EU Innovation Fund, which invests in net zero technologies – especially as it closed its equivalent [Industrial Energy Transformation Fund](#) in July. But this would, naturally, require a larger financial contribution – possibly involving the direct transfer of some UK ETS revenues to the Commission.

IMPLEMENTATION

The two sides will need agree a formal start date for linkage. They could set a target date at the outset, or broach it closer to completion. The start dates for the two sides’ respective CBAMs are likely to shape thinking here, while another factor is how quickly the UK can make the necessary legal changes.

The UK will have to adopt the bulk of existing EU ETS-related legislation, which could slow things down. Yet, Silke Goldberg, of the law firm Herbert Smith Freehills, [argues that](#), based on the precedent of Swiss linkage and the broad similarities between the UK and EU systems, this should be “reasonably simple and straightforward. Arguably, you do not even need primary legislation in the UK.”

Implementing the agreement entirely through secondary legislation would, however, give Parliament very little ability to scrutinise it. There are unresolved questions about how to ensure adequate oversight of the new legislation being adopted under dynamic alignment, especially as there is no longer a European Scrutiny Committee in the House of Commons – with some MPs pushing for the re-establishment of such a committee. There is a related challenge for Whitehall to ensure it has the capacity and systems in place to maintain consistent alignment with EU law.

It is also worth noting that the Commission published its SPS and ETS mandates simultaneously, and drew links between the two agreements, for example in terms of common governance processes. It is not inconceivable that the EU opts to treat them as linked negotiations (to enhance its leverage) and refuses to sign off on one without the other. Sign-off on the ETS and/or SPS deals could also be made conditional on agreement being reached on a ‘youth experience’ scheme, which is one of the EU’s top priorities in terms of deepening the relationship.

GOVERNANCE AND DISPUTE RESOLUTION

Finally, the Commission says governance of the agreement ‘should build on the institutional framework laid down in the Trade and Cooperation Agreement, in particular as regards the role of the Partnership Council’. This suggests that technical discussions (for instance on the agreement’s administration, implementation or potential adjustment) could occur via the TCA’s specialised committee system, while the Partnership Council (co-chaired by UK minister Nick Thomas-Symonds and Commission vice-President Maroš Šefčovič) would have the power to change the substance of the agreement (for example expanding it to cover new sectors) by mutual consent. The UK has not expressed a view on governance processes, though it will presumably be amenable to using the existing TCA structures – which it is supportive of – rather than having to design a bespoke new system.

More contentious could be the process for resolving disputes over the application of the agreement. Here, in a departure from the TCA approach, the Commission says the European Court of Justice (ECJ) should be ‘the ultimate authority for all questions of EU law’. This does not mean that the ECJ is the arbiter of all disputes – initially they would follow the same process as the TCA, where they are taken to an arbitration tribunal comprised of three judges: one UK-nominated, one EU-nominated one, and one from an independent list. However, when the dispute relates to a matter of interpretation of EU law, the panel would ultimately have to turn to the ECJ for a final ruling on the question of interpretation.

The Commission insists on this role for the ECJ because the UK will be subject to EU law under the ETS agreement – which it is not under the TCA. Nevertheless, the ECJ has been a sensitive issue throughout the Brexit years, and the UK may seek to push back on the extent of its role (even though the EU proposal is consistent with the EU-Swiss ETS agreement) or seek clarificatory language in the agreement emphasising the precise limits of the ECJ’s powers.

A process will also have to be agreed for the conditions under which the agreement can be suspended or terminated. The EU-Swiss agreement could set a precedent here: the mutual recognition of allowances may be suspended by either party, if it deems the other to not be complying with core obligations of the agreement, until the dispute is resolved. Either party can also initiate a three-month suspension if it is notified by the other party of its intention to link its ETS to a third party’s; or to terminate the agreement. Either party can terminate the agreement at any time, via written notification after consultation with the Joint Committee, with termination taking place six months after the notification is made.

GET IN TOUCH

UK in a Changing Europe promotes rigorous, high-quality and independent research into the complex and ever changing relationship between the UK and the EU. It is based at King's College London.

The *Insight* series exists to provide short, sharp, timely analysis into the most important developments in the UK-EU relationship as they unfold.

If you would like to hear more from any of our experts about a particular topic, you can get in touch with us on info@UKandEU.ac.uk.

You can also contact the authors of this paper directly:

- Joël Reland, Senior Researcher, joel.reland@ukandeu.ac.uk

☎ 020 7848 2630

✉ info@UKandEU.ac.uk

📘 [TheUKinaChangingEurope](#)

📱 [@UKandEU](#)

www.UKandEU.ac.uk

How to cite this publication:

Reland, J. (2025)

Linking emissions trading schemes: key challenges.

London: UK in a Changing Europe.

<https://ukandeu.ac.uk/reports/linking-emissions-trading-schemes-key-challenges/>

This is an open access work published under a Creative Commons Attribution 4.0 International License.