Global Counsel

What are the UK's options in the face of an EU-US clean tech subsidy race?

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The US' Inflation Reduction Act and the EU's Green Deal Industrial Plan potentially pose a challenge for mid-size markets like the UK caught between these two fronts of evolving industrial policy. But what exactly is at risk? Does the UK's new Subsidy Control Act give the country scope to respond? And what other constraints might define the way the UK – and other similar states – might respond to a US-EU subsidy race?

The US has the $369 bn Inflation Reduction Act (IRA) and the EU is developing a Green Deal Industrial Plan in response. Both have the same aim of strengthening domestic industries and achieving the transition to net-zero economies by increasing the flow of investment to clean tech. The European Commission president, Ursula von der Leyen has urged complementarity, but the subsidy battle is far from over. The EU-US taskforce established to negotiate the issues of the IRA has resulted in a concession from the US: EU companies will now be able to benefit from the Commercial Clean Vehicle Scheme. However, the IRA still excludes other countries and the EU is persisting to gain wider access to subsidies, including to the non-commercial clean vehicle credits.

This raises the interesting question of how the UK might position itself in such a transatlantic dynamic. UK trade secretary Kemi Badenoch wrote to her US counterpart, Katherine Tai before Christmas criticising US policy, and business secretary at the time Grant Shapps said that the US has promised to match any concessions provided to the EU with similar ones to the UK. But the UK has not yet produced anything like the EU's subsidy response and the recent collapse of the UK's leading electric battery producer, BritishVolt, and the Independent Review of Net Zero finding that the UK is not doing enough to capitalise on net-zero opportunities indicate that the UK is falling behind. In thinking through what a UK response might look like, it is worth considering several key potential constraints. The most feasible UK responses are the ones left in available policy and political space.

WTO RULES

The UK is in, principle, free to boost strategically important sectors with targeted subsidies within the bounds of WTO rules. The most incendiary aspect of the IRA – at least for many in Europe - is the way that it challenges these norms, particularly the $7,500 payment for the purchase of any electric vehicle (EV), providing its battery originates from the US and is assembled there. Subsidies "contingent … on the use of domestic over imported goods" are prohibited by the WTO under the terms of the 1994 Subsidies and Countervailing Measures Agreement. Where the US has given access to Mexico, Canada and the EU, the IRA conflicts with the most-favoured-nation principle that countries cannot discriminate between WTO members.

Although not currently included in the EU's draft Green Industrial Plan, if the EU were to similarly introduce local content requirements for its proposed subsidy scheme, it will do so at the same cost in potential WTO non-conformity. It will also have broken a very deep and long-standing reluctance in EU capitals and Brussels to depart from established WTO rules. The UK's instincts are very similar - supporting this system and promoting free trade were also two key tenets of the UK's post-Brexit foreign policy.

THE EU-UK FRAMEWORK

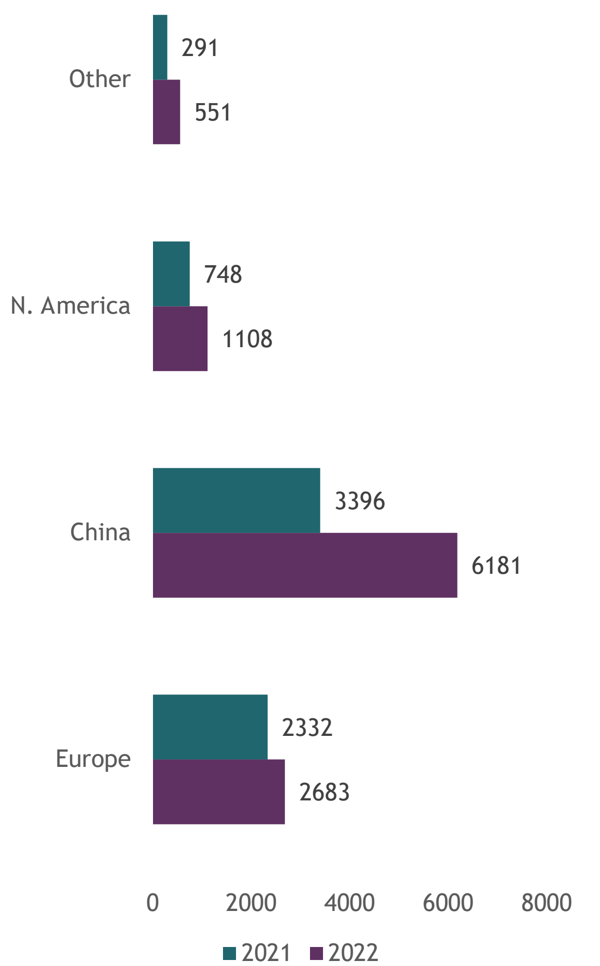
The second key constraint on UK action is in its treaty framework with the EU itself and its domestic post-Brexit subsidy scheme, which started in January 2023. Whilst there are some key differences, the principles underpinning the EU and UK systems - necessity, proportionality, and minimising distortions to international trade - are close to identical.

The key difference between the two is the permissiveness of the UK regime at the lower end. Public authorities need only demonstrate compliance with seven principles, unless they are providing "subsidies of particular interest". These are defined by their size (£10m+ over three years) or sector. The list of sensitive sectors includes the manufacture of motor vehicles and motorcycles, as well as air and spacecraft, electricity, copper, aluminium, iron and steel. Yet even those subsidies only need to seek non-binding advice from the Competition and Markets Authority.

In its new subsidy regime, the UK has introduced three "streamlined routes", one of which is dedicated to energy usage. These are designed to provide a degree of legal certainty for certain types of subsidies and are similar to the General Block Exemptions under EU State aid, which should make giving subsidies easier and quicker. These are thought be particularly helpful given the absence of case law and the novelty of the UK system and principles. To empower local authorities to make subsidies targeted towards the green areas most in need, the government might consider creating more of these for the specific sub-sectors - such as electric vehicle production (see below).

However, so long as the Northern Ireland Protocol (NIP) remains in place, any measures that affect the trade in goods and wholesale electricity between Northern Ireland (NI) and the EU are within the scope of the EU State aid rules. This carries the risk of requiring all UK-wide measures to conform to EU rules or creating policies that increase divergence between NI and the rest of the UK, as with the recent tax cut on solar panels which could not be extended to NI. Any loosening of EU State aid is therefore positive for the UK in the sense that it is free to match it.

ELECTRIC VEHICLES SALES FOR 2022 VS 2021



Source: EV Volumes

Nonetheless, the EU and UK are said to be closer to a new NIP agreement following a new customs data sharing agreement. If the UK argument that the existing UK-EU Trade and Cooperation Agreement (TCA) and the new Subsidy Control Act are robust enough to remove the need for the additional NIP clause succeeds, negotiations could completely remove EU oversight of UK subsidy control.

WHAT WILL THE UK DO?

Legal freedom to act does not in itself mean the UK will. The cost of a large-scale subsidy boost could be hard for the UK to carry responsibly. Estimates suggest the country spent between £310 to £410 bn during the covid-19 pandemic, and in the face of the energy crisis, the UK is the only G7 country whose economy is expected to shrink in 2023. Obviously, fiscal responsibility is a vague political benchmark (as the US measures show), but government sensitivity to over-spending in the wake of the 2022 brush with market nerves is fairly high. Nevertheless, this hasn't prevented the opposition from setting out a policy to invest £28 bn until 2030 towards a UK Green New Deal. The risk that a higher debt burden linked to increased investment is not naturally offset by the expected gains could be alleviated by the state taking a greater stake in the companies it invests in. Labour have a similar proposal in the nationally-owned energy company, GB Energy.

One sombre fact is that the UK is currently somewhat protected by its lack of green industry, leaving little to be lured away by the US or EU. But there are some points of potentially acute exposure. Probably the most important are the UK's electric vehicle sector and 'green' steel capacity. The car industry contributes £15.3 bn to the UK economy and employs more than 860,000 people. Over 70,000 cars were manufactured for export in 2021 with approximately 55% going to the EU and another 17% to the US. Honda's decision to close its Swindon plant (employing 3500 people) in 2021 because of the "increased pace and requirement for electrification" made clear the changing nature of the industry. The sector is already under strain from rising energy costs and shortages of semiconductors. In 2022, the UK produced the lowest number of vehicles since 1956.

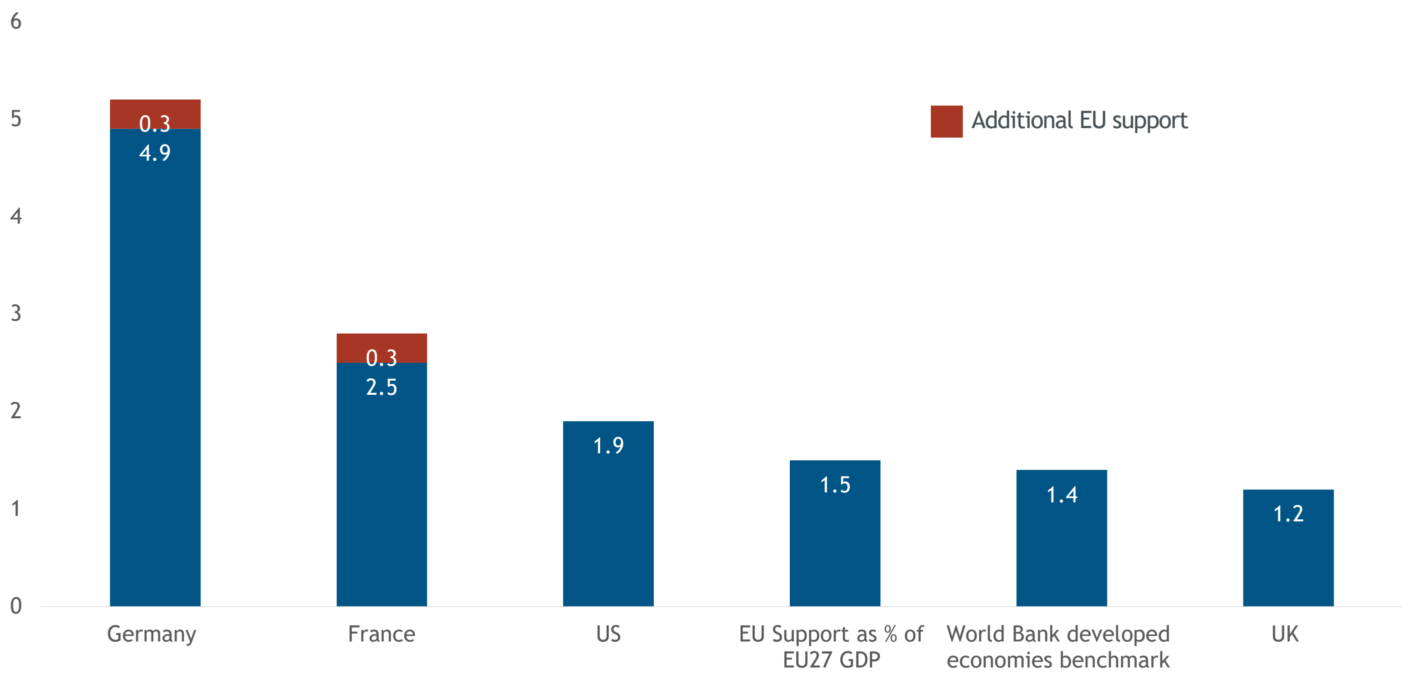
Investments in EV capacity in the UK by Vauxhall and Nissan are two of the most important - an importance reinforced by the BMW decision to move electric MINI production out of the UK to China in 2022. With the UK struggling to match the EU's ramping up gigafactory capacity and EU trade policy likely to increasingly incentivise EU car manufacturers to draw on battery production capacity in the EU, the incentive to shift capacity out of the UK is already there and could be increased by a subsidy race. The UK government's recent £600m bailout of British Steel and Tata Steel to help the transition to clean steel production demonstrates the government's recognition that it will need a clear set of incentives for manufacturers to choose the UK.

Working to the limits of its tight purse strings, the UK might also prioritise simplicity and certainty. The EU has done something similar for similar reasons and the IRA has also embedded its measures in a ten-year framework to signal policy stability. The lack of exactly this quality was recognised by Chris Skidmore in the Independent Net Zero Review, in which he found that one of the reasons the UK was missing its green targets was "due to inconsistent policies".

If EVs are an obvious initial area of focus, the next challenge will be identifying potential future strengths. Carbon capture, where Britain is leading the way with economic hubs planned for the North East, Humber, North West England and North Wales might be one. As a general facilitative technology for green energy, this might be seen as a good way of avoiding a head-on challenge to US and EU subsidisation and rather aiming to benefit from the spill-over effects of other areas prioritised by the US and EU. Higher demand and supply driven by subsidised production in the EU and US (and China) is also likely to drive down costs of some technologies for UK firms and consumers. In some cases, the UK may find itself focusing on the gains from implementation of green tech, rather than fighting to produce it. The example of solar panels is pertinent here.

The UK budget and response to the Skidmore review are both expected in March 2023. These will provide important clues to how the UK plans to do a lot with little, protect its perceived industrial strengths and drive forward to net zero. Whether there is a long-term strategic logic to these choices remains to be seen. But what we can say is that the US and the EU are increasingly posing questions that will need practical, pragmatic answers from the UK.

GOVERNMENT SPENDING COMMITTED BY SELECTED COUNTRIES TO CLIMATE CHANGE, % OF GDP



Source: CBI (World Bank, UK's Ten Point Plan, Germany Climate and Transformation Fund, France 2030, Bruegel, US Bureau of Economic Analysis, Press search, CBI Analysis

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