EXPLANATORY MEMORANDUM TO

THE GREENHOUSE GAS EMISSIONS TRADING SCHEME (AMENDMENT) ORDER 2026

2026 No. [XXXX]

1. Introduction

1.1 This Explanatory Memorandum has been prepared by the Department for Energy Security and Net Zero and is laid before Parliament by Command of His Majesty.

1.2 This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Declaration

2.1 Chris McDonald MP, Minister for Industry at the Department for Energy Security and Net Zero confirms that this Explanatory Memorandum meets the required standard.

2.2 Charlie Lewis, Deputy Director for the UK Emissions Trading Scheme, at the Department for Energy Security and Net Zero confirms that this Explanatory Memorandum meets the required standard.

3. Contact

3.1 Rob Wilbraham at the Department for Energy Security and Net Zero can be contacted by email at the following address: LPC@energysecurity.gov.uk with any queries regarding the instrument. Alternatively, the department can be contacted by telephone: 07709853311.

Part One: Explanation, and context, of the Instrument

4. Overview of the Instrument

What does the legislation do?

4.1 This instrument makes amendments to the legislation which gives effect to the UK Emissions Trading Scheme (the "UK ETS"). This includes provisions enabling incumbent installations to have their 2020, or 2020 and 2021, scheme year(s) data excluded from the calculation of their historical activity level ("HAL") for the 2027-2030 allocation period. The primary aim of these provisions is to mitigate the impact of the COVID-19 pandemic on HALs for the 2027-2030 allocation period.

4.2 This instrument also includes provisions to retain current UK ETS free allocation benchmarks used in the free allocation calculation for the 2027 scheme year and adopt updated benchmarks in the free allocation calculation for the years 2028, 2029 and 2030 of the 2027-2030 allocation period to continue to reward efficient installations and incentivise decarbonisation.

4.3 This instrument enables the reduction of free allocation annually during the period 2027-2030 for sub-installations operating in one of the five sectors covered by the UK Carbon Border Adjustment Mechanism (the "UK CBAM"). To do this, operators will be required to inform the regulator which of their sub-installations serve the production of UK CBAM goods and a UK CBAM reduction factor will be applied to those sub-installations in each of the 2027-2030 scheme years.

4.4 This instrument also makes a clarification to the annual reporting requirement that applies to installations that receive free allocation and permanently cease their activities.

Where does the legislation extend to, and apply?

4.5 The extent of this instrument is the whole of the United Kingdom.

4.6 The territorial application of this instrument is the whole of the United Kingdom.

5. Policy Context

What is being done and why?

5.1 The UK ETS is a UK-wide greenhouse gas emissions trading scheme to incentivise emissions reductions in line with the UK's net zero targets. The UK ETS replaced the UK's participation in the EU Emissions Trading System from 1st January 2021.

5.2 The scheme is governed by the UK ETS Authority, comprising UK Government, Scottish Government, Welsh Government and the Department of Agriculture, Environment and Rural Affairs in Northern Ireland, hereinafter "the Authority". The UK ETS is regulated by the Environment Agency, the Scottish Environment Protection Agency, Natural Resources Wales, the Northern Ireland Environment Agency and the Secretary of State (Offshore Petroleum Regulator for Environment and Decommissioning), hereinafter "the Regulators".

5.3 Under the UK ETS, participants are required to monitor, report on, and surrender allowances in respect of their greenhouse gas emissions. Participating operators at risk of carbon leakage[1] are given a certain number of UK ETS allowances for free, to manage their exposure to the carbon price and the risk that business' decarbonisation efforts could be undermined by higher-carbon imports. Participants can also buy allowances at auction and in secondary markets.

5.4 The first change that this instrument makes is to enable operators of incumbent installations to notify their regulator that they wish to have their activity data for the 2020, or 2020 and 2021, scheme year(s) excluded from the calculation of their HAL for the 2027-2030 allocation period in order to mitigate the impacts of the COVID-19 pandemic. These operators will be able to notify their regulator during the second stage of the 2027-2030 free allocation application (1 April – 30 June 2026) that they wish to have their activity data for 2020, or 2020 and 2021, excluded.

5.5 The second change that the instrument makes is to use current benchmarks for the purpose of calculating FA for stationary installations for the 2027 scheme year and to provide for the ability to update the benchmark values used to calculate FA for the years 2028, 2029 and 2030 of the 2027-2030 allocation period. The intent is to use the updated EU ETS Phase IV benchmarks in the 2028, 2029 and 2030 scheme years to reflect emissions efficiency improvements available to production processes that are carried out by UK installations. This is to ensure that free allocation continues to reward installations that reduce emissions and incentivise decarbonisation by covering a higher proportion of emissions from installations close to the benchmarks.

5.6 The third change that the instrument makes is to start to phase out free allocation for sectors covered by the UK CBAM over the 2027-2030 allocation period. This phase out will be implemented through applying a UK CBAM reduction factor to the

[1] 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.

calculation of free allocation and will apply at sub-installation level. To do this, operators will be required to report which of their sub-installations serve the production of UK CBAM goods. This will enable regulators to apply the UK CBAM reduction factor. The instrument provides for the ability to update the UK CBAM reduction factors during the 2027-2030 allocation period, enabling regulators to recalculate final free allocation entitlement in accordance, for those sub-installations producing UK CBAM goods.

5.7 The fourth change is a clarification to the reporting requirement that applies to installations who receive free allocation and who have permanently ceased their activities.

What was the previous policy, how is this different?

5.8 HAL: HAL is the arithmetic mean of annual activity levels during a baseline period, which for the 2027-2030 allocation period is each of the 2019-2023 scheme years. HAL represents the scale of each operator's activity so that levels of free allocation are reflective of their requirements. The impact of COVID-19 during the baseline period could result in operators' HAL being unrepresentative of normal activity. This instrument enables operators of incumbent installations to exclude activity data for the 2020, or 2020 and 2021, scheme year(s) from the calculation of HAL for the 2027-2030 allocation period. This ensures that an operator's HAL is representative even where activity in 2020, or 2020 and 2021, was abnormally low due to the COVID-19 lockdowns or other COVID-19 response measures.

5.9 Benchmarks: Under previous UK ETS policy, benchmarks had been calculated via the EU ETS Phase IV benchmark update, following an Annual Reduction Rate (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. This instrument retains current benchmarks values to be used in the free allocation calculation for the 2027 scheme year and provides for the benchmark values from 2028 to be updated with up-to-date values. The intent is for these updated values to be calculated via the second EU ETS Phase IV benchmark update, based on recent industry data, following an ARR methodology where the average performance of the 10% most efficient installation for 2021-2022 for each product benchmark has been compared to the average performance of the 10% most efficient installations for 2016-2017.

5.10 Free allocation for sectors covered by the UK CBAM: Currently free allocation is the primary means of mitigating the risk of carbon leakage. From 2027 the UK CBAM will apply an effective carbon price to imported goods which represents recent UK ETS allowance market price with a consideration of free allocations distributed to domestic producers. This will level the UK ETS costs associated with goods sold on the UK market, enabling cost pass through and mitigating the risk of carbon leakage. As the UK CBAM will become the primary means of mitigating carbon leakage, we are phasing out free allocation for sub-installations that serve the production of UK CBAM goods to ensure effective implementation of the UK CBAM and to ensure it can deliver its intent of mitigating the risk of carbon leakage.

5.11 Permanent cessation reporting requirement: The policy is for the installations that permanently cease their activities to report on their activity in the year they ceased so that free allocation can be recalculated to reflect the activity undertaken. No change is made to this; legislation is simply amended to clarify the policy.

6. Legislative and Legal Context

How has the law changed?

6.1 The UK ETS was established under the Climate Change Act 2008 by the Greenhouse Gas Emissions Trading Scheme Order 2020 (the "2020 Order"). The 2020 Order applies EU rules on the monitoring, reporting and verification of emissions with modifications to ensure that they are appropriate for the UK ETS.

6.2 In addition, UK ETS legislation includes assimilated law relating to the free allocation of allowances, which has similarly been amended to apply it to the UK ETS, this is contained in the Free Allocation Regulation[2] and the Activity Level Changes Regulation[3].

6.3 This instrument amends the 2020 Order, the Free Allocation Regulation and the Activity Level Changes Regulation. Key provisions amended are:

Free Allocation Regulation, Art. 2, on key definitions, defining a UK CBAM sub-installation as a sub-installation producing a UK CBAM good as identified following the requirement in Free Allocation Regulation, Art. 10(4a);

Free Allocation Regulation, Art. 10, on dividing an installation into sub-installations, setting out a process for operators to distinguish whether, in reliance on the PRODCOM and NACE codes set out in Annex 9, a sub-installation serves the production of a UK CBAM good;

Free Allocation Regulation, Art. 4, on application for free allocation in 2027-2030 by operators of incumbent installations, enabling operators to exclude production data from the 2020 scheme year or both the 2020 and 2021 scheme years from the calculation of HAL;

Free Allocation Regulation, Art. 16, on determining preliminary allocation for incumbent installations, setting out the benchmarks used in calculations of preliminary annual number of allowances for the 2026 and 2027 scheme years are those set out in Annex 8 and the benchmarks used in calculations for the 2028, 2029 and 2030 scheme years are those adopted by the UK ETS authority by way of an order under Part 3 of the Climate Change Act 2008; and providing for the UK CBAM reduction factor to be applied to the preliminary annual number of allowances for UK CBAM sub-installations from 2027 to 2030;

Free Allocation Regulation, Art. 18, on preliminary allocation for new entrants, to apply the benchmark and UK CBAM policies to the calculation of preliminary allocation for new entrants;

Free Allocation Regulation, Annex 9, on identifying UK CBAM status under Art. 10(4a), to provide a list of PRODCOM and NACE codes for operators to identify sub-installations that serve the production of a UK CBAM good;

Activity Level Changes Regulation, Art. 3, on reporting requirements, to clarify that the reporting requirement applies in all circumstances in which Article 3za applies (recalculation of FA entitlements) even if the installation is not an "FA installation" at the end of the relevant scheme year;

[2] Commission Delegated Regulation (EU) 2019/331 (the "Free Allocation Regulation")
[3] Commission Implementing Regulation (EU) 2019/1842 (the "Activity Level Changes Regulation")

Activity Level Changes Regulation, Art. 3a, on sub-installations for which no historical activity level is determined, to apply the benchmark and UK CBAM policies to the calculation of preliminary allocation.

Why was this approach taken to change the law?

6.4 As this instrument extends to the UK as a whole, it is necessary for it to be made jointly by the Secretary of State and the devolved governments.

6.5 Legislative change is needed to the Free Allocation Regulation because existing legislation will require regulators to calculate HALs using activity data from all five years of the baseline period. If amendments are not made, there will be no legal basis for regulators to exclude 2020, or 2020 and 2021, data from the HAL calculation for any applicant.

6.6 Further amendments to the Free Allocation Regulation are required to update the benchmarks from 2028; without this, the annual number of allowances for the relevant allocation period will be based on previous benchmarks from EU ETS Phase IV which do not take into account recent efficiency improvements achieved by industry.

6.7 The Free Allocation Regulation is also amended as it currently does not require any UK CBAM adjustment factor to be applied to free allocation calculation for sub-installations that produce UK CBAM goods. These changes will also interact with the way that sub-installations are classified and how operators are required to report under the Free Allocation Regulation. Currently operators only classify their sub-installations as a certain benchmark type (product, fuel, heat, district heating or process) and the corresponding carbon leakage status of that sub-installation. This instrument requires operators to categorise, in addition to benchmark type and carbon leakage status, their sub-installations as UK CBAM or not UK CBAM on the basis of their PRODCOM or NACE rev. 2 codes to allow for the reporting of different sub-installations' UK CBAM statuses. This will then facilitate the calculation of free allocation with an additional reduction factor applied to UK CBAM sub-installations to reduce allocation for those sub-installations annually during 2027-2030.

6.8 Amendments are made to the 2020 Order and Activity Level Changes Regulation to reflect the amendments made to the Free Allocation Regulation to implement the policy in these three areas.

6.9 Article 3(1a) (which will come into force on 1st January 2026) of the Activity Level Changes Regulation is amended to clarify that the reporting requirement applies in all circumstances in which Article 3za applies (recalculation of FA entitlements) even if the installation is not an "FA installation" at the at the end of the relevant scheme year. This amendment is made to ensure that the policy on reporting requirements is accurately reflected in the legislation.

7. Consultation

Summary of consultation outcome and methodology

7.1 We have carried out consultations which is a statutory requirement in the Climate Change Act 2008. The UK and devolved governments carried out these consultations in the 2023 Free Allocation Review Consultation[4] and the 2024 Free Allocation Review Carbon Leakage consultation[5].

[4] https://www.gov.uk/government/consultations/uk-emissions-trading-scheme-free-allocation-review
[5] https://assets.publishing.service.gov.uk/media/6760062fb745d5f7a053ef7a/ukets-free-allocation-review-carbon-leakage-consultation.pdf

7.2 The 2023 Free Allocation Review consultation ran from 18th December 2023 to 11th March 2024 and received responses from over 66 organisations. The 2024 Free Allocation Review Carbon Leakage consultation ran from 16th December 2024 to 10th March 2025 and received responses from over 54 organisations.

7.3 The relevant consultation responses are summarised in the Authority Response: https://www.gov.uk/government/consultations/uk-emissions-trading-scheme-free-allocation-review .

7.4 Following the consultation, the advice of the Climate Change Committee (CCC) on the associated policy proposals in this instrument was sought and taken into account, which is a further statutory requirement in the Climate Change Act 2008. The CCC reviewed these proposals and had no comments.

8. Applicable Guidance

8.1 UK ETS guidance on meeting the requirements for the first FA application stage has been published and is available at: UK ETS 2025 Baseline Data Collection and HSE/USE scheme status: how to meet the data submission requirements - GOV.UK. This guidance will be updated regularly, and updates will take account of relevant changes to legislation, as necessary, including the changes in this instrument, before the second stage of the free allocation application window opens on 1 April 2026.

Part Two: Impact and the Better Regulation Framework

9. Impact Assessment

9.1 A full Impact Assessment is submitted with this memorandum and published alongside the Explanatory Memorandum on the legislation.gov.uk website.

Impact on businesses, charities and voluntary bodies

9.2 The impact on business, charities or voluntary bodies has been published in an impact assessment alongside the UK Emissions Trading Scheme Main Authority Response to the Free Allocation Review.

9.3 The changes made to legislation through this instrument do not impact small or micro businesses. This is because small or micro businesses (employing up to 50 people), operators with relatively low levels of emissions are either not caught by the scheme or participate in the HSE or USE schemes, which have lower compliance burdens than the main UK ETS.

9.4 There is no significant impact on the public sector. Hospitals participate in the HSE scheme, which has lower compliance burdens than the main UK ETS and the HSE scheme does not involve Free Allocation.

10. Monitoring and review

What is the approach to monitoring and reviewing this legislation?

10.1 The approach to monitoring this legislation is set out in the 2020 Order. Article 17 of the 2020 Order requires the UK ETS Authority to review the operation of the UK ETS in 2023 and in 2028. The UK ETS Authority published the 2023 scheme review in December 2023 https://www.gov.uk/government/publications/uk-emissions-trading-scheme-review-2023.

10.2 The instrument does not include a statutory review clause. The requirement under section 28(2) of the Small Business, Enterprise, and Employment Act 2015 to make provision for review does not apply to this instrument as it falls within an exception in section 28(3) of that Act.

Part Three: Statements and Matters of Particular Interest to Parliament

11. Matters of special interest to Parliament

11.1 The provisions of this instrument come into force on the day after the date on which it is made. The Department considers that this instrument provides reasonable chance for UK ETS participants to adapt to the significantly more onerous aspects of the instrument. This is because the onerous aspect of the UK CBAM reduction factor reducing free allocation for UK CBAM sub-installations will only apply to free allocation from 2027 onwards. Additionally, the Department does not consider that the instrument requires UK ETS participants to adopt different patterns of behaviour for the purpose of compliance with scheme rules. In particular, whilst changes have been made to the requirement to submit a stage 2 application for free allocation in the 2027-2030 allocation period, operators who wish to apply for free allocation during that period are already required to submit a stage 2 application. Accordingly, the Department does not consider that a later commencement date is necessary.

12. European Convention on Human Rights

12.1 The Minister for Industry at the Department for Energy Security and Net Zero has made the following statement regarding Human Rights:

"In my view the provisions of the Greenhouse Gas Emissions Trading Scheme (Amendment) Order 2026 are compatible with the Convention rights."

13. The Relevant European Union Acts

13.1 This instrument is not made under the European Union (Withdrawal) Act 2018, the European Union (Future Relationship) Act 2020 or the Retained EU Law (Revocation and Reform) Act 2023 ("relevant European Union Acts"). It does however relate to the withdrawal of the United Kingdom from the European Union because the UK ETS is a policy replacement for the UK's participation in the EU ETS.