EXPLANATORY MEMORANDUM TO

THE GREENHOUSE GAS EMISSIONS TRADING SCHEME (AMENDMENT) (NO. 2) ORDER 2025

2025 No. 124

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.

2. Declaration

2.1 Sarah Jones 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. Telephone: 07709853311 or email: Rob.Wilbraham@energysecurity.gov.uk can be contacted with any queries regarding the instrument.

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"). The UK ETS incentivises decarbonisation by requiring operators to purchase allowances based on carbon emissions. Some operators are given free allocation of allowances to mitigate the risk of carbon leakage. The scheme has two allocation periods, 2021-2025 and 2026-2030, in which free allocation is calculated and provided to eligible operators. This SI moves the start of the second allocation period for stationary installations from 2026 to 2027, making 2026 a standalone year, and provides for the calculation of free allocation in the 2026 standalone scheme year.

4.2 The instrument also makes three changes to other aspects of the scheme. Specifically, these will: require the publication of full details of transactions between accounts in the scheme's Registry after a three year delay; add limited exceptions to the prohibition on disclosure of Scheme data in order to support the development and implementation of related policies, and support the statutory functions of the Climate Change Committee (CCC); and extend qualification criteria so that installations with low levels of emissions which started operations between 2nd January 2021 and 1st January 2024 inclusive can apply to be classed as Ultra-Small Emitters (USEs) during the 2026-2030 period, thereby benefitting from a reduced administrative burden.

Where does the legislation extend to, and apply?

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

4.4 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 to ensure that domestic industry is not disadvantaged by imports subject to lower carbon prices. Participants can also buy emission allowances at auction and in secondary markets.

5.4 Participants' installations can be classed as USE installations, if they are installations emitting less than 2,500 tonnes respectively of carbon dioxide equivalent per year. Installations with USE status do not have to surrender allowances in respect of their emissions but instead are required to keep their emissions below a certain level.

5.5 The scheme has two allocation periods, 2021-2025 and 2026-2030, in which free allocation is calculated and provided to eligible operators. This instrument changes the UK ETS legislation such that the second allocation period commences in 2027 instead of 2026. The 2026 year will become a standalone year subject to the same rules as apply in the first allocation period of 2021-2025. This is achieved through free-standing provisions in Part 2 of this instrument and by amendments to the Greenhouse Gas Emissions Trading Scheme Order 2020 ("the 2020 Order"), the Free Allocation Regulation and the Activity Level Changes Regulation.

5.6 The onset of the second allocation period is being moved to 2027 to ensure that any prospective changes to free allocation policy align with the UK Carbon Border Adjustment Mechanism (UK CBAM)[2]. UK ETS stakeholders have been calling for changes to free allocation to align with the UK CBAM introduction in 2027 and to give more time for policy decisions from the consultation the UK ETS Free Allocation Review[3] to be considered, a move announced in the Authority Response in December 2024.

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[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.

[2]CBAMs are another mitigation for carbon leakage. They address carbon leakage risk by applying an effective carbon price to products being imported into the UK. A UK CBAM will be applied to several sectors covered by the UK ETS.

[3] This review refers to the December 2023 Free Allocation Review consultation, https://www.gov.uk/government/consultations/uk-emissions-trading-scheme-free-allocation-review , and the interim December 2024 Free Allocation Review Carbon Leakage consultation, https://www.gov.uk/government/consultations/uk-emissions-trading-scheme-free-allocation-review-carbon-leakage

5.7 This instrument also makes three further changes to the 2020 Order. Firstly it, imposes a requirement on the UK ETS Authority to publish details of all transfers of allowances between accounts in the UK ETS Registry (other than those between UK ETS Authority accounts) annually, after a three-year delay. This is in line with international standards including the EU ETS. This change will provide transparency and so support effective market analysis.

5.8 The next technical change this instrument makes is to create an exception to the general prohibition on disclosure of information obtained or held under five pieces of UK ETS legislation for the specific purposes of policy development relating to climate change. Where necessary or expedient, such disclosures will improve policy development or implementation in the specific areas listed at 5.16 below. The UK ETS Authority expects to disclose data to HM Treasury and HM Revenue and Customs to support the development and implementation of the UK CBAM. The instrument will also create an exception to permit disclosure to the CCC. Such disclosures will be made where it is necessary or expedient for the purposes of supporting the CCC in performing its statutory functions.

5.9 This instrument also amends the 2020 Order so that installations with at least one full scheme year of operations before the application deadline are permitted to apply for USE status for the 2026-2030 period, reducing the burden on (those which are likely to be) small businesses.

What was the previous policy, how is this different?

5.10 Free Allocation Period: Previously there were two allocation periods, 2021-2025 and 2026-2030. The Free Allocation Review, which was initially consulted on in December 2023, proposed changes to the free allocation rules for the 2026-2030 allocation period. In responses to that December 2023 consultation, stakeholders called for changes to free allocation to align with the introduction of the UK CBAM on 1 January 2027.

5.11 This instrument allows for alignment of the second free allocation period with the UK CBAM as outlined in 5.5 and 5.6. Any changes to the rules on free allocation resulting from the Free Allocation Review will now be implemented in 2027 instead of 2026. The effect of the legislation is to treat 2026 as an extension of the 2021-2025 allocation period for free allocation purposes.

5.12 In the 2021-2025 allocation period, industrial sites ("installations") classed as electricity generators were not eligible to receive free allocation (except in relation to measurable heat). In 2023, following a consultation, the UK ETS Authority announced that, for the 2026-2030 allocation period, the definition of electricity generator would change to exclude installations that a) exported only a small quantity of excess electricity or b) exported electricity produced by certified high-efficiency co-generation. This instrument leaves the 2026 implementation date of this exclusion unchanged, despite the start of the 2026-2030 allocation period being moved to 2027.

5.13 Operators of eligible installations are able to apply for HSE or USE status, at the same time as applying for free allocation, for five-year periods that align with the previous allocation periods (i.e. 2021-2025 and 2026-2030). This instrument does not change the five-year period for which HSE and USE statuses are valid, despite the second allocation period being split for free allocation purposes. It provides for HSE and USE operators to request to voluntarily exit the HSE or USE scheme and re-enter the main UK ETS for the 2027-2030 allocation period if they wish to do so, and to apply to receive free allocation in that period if they are eligible.

5.14 This instrument also modifies the application process for free allocation for the new 2027-2030 allocation period. Applicants continue to be required to submit certain data during a three-month application window in April-June 2025. Previously, submission of data during this window served as a formal application for free allocation for the second allocation period. Because this instrument delays the start of the second allocation period to 2027, any substantive changes to free allocation methodology that may result from the Free Allocation Review will not be decided and legislated for until after the 2025 free allocation application window has passed. This instrument therefore leaves the 2025 application window in place for data collection purposes and to enable 2026 free allocation to be calculated for some participants, but introduces a second stage to the free allocation application process for the 2027-2030 allocation period. This second stage will take place April-June 2026 after the publication of the Authority Response to the Free Allocation Review. This will allow participants to make an informed decision on whether they wish to continue with their application for free allocation for the 2027-2030 allocation period following any changes to the rules that may be published in the Authority Response to the Free Allocation Review.

5.15 Registry Transaction Data: The 2020 Order required the UK ETS Authority to publish annual reports summarising transactions made in the UK ETS Registry, after a three-year delay (see paragraph 34 of Schedule 5A to the 2020 Order). This instrument amends this requirement so that instead, the UK ETS Authority is required to publish annual reports listing each individual transaction made during the relevant period, with the exception of transactions made between 'central accounts' (accounts owned by the UK ETS Authority). Each report is required to be published three years after the end of the period which it covers. The reports are required to give details for each transaction including: a unique identifier for the transaction; the names of the holders of the transferring and receiving accounts; the date and time of the transaction; the transaction type; and the number of allowances transferred. Replacing the requirement for summary reports with the requirement to publish the full transaction history improves the transparency of the market. It also delivers the original policy intention as stated in *Future of UK Carbon Pricing* (2019) to align the domestic legislative framework for the UK ETS Registry as closely as possible with the equivalent EU framework.

5.16 Information Disclosure Exemption: The 2020 Order contains a prohibition on the disclosure of information obtained or held under five pieces of UK ETS legislation ("UK ETS information") and provides for exemptions (see article 75B of the UK ETS Order). There are a number of policy areas related to emissions trading for which it is, or may in future prove, justifiable to disclose UK ETS information to support policy development or implementation. Such disclosures may be justified by the improvement in the amount and accuracy of data used to develop and implement such policies, as well as the avoidance of unnecessary additional reporting requirements on UK ETS participants. This instrument introduces a new exemption to the prohibition on the disclosure of UK ETS information, such that a national authority is permitted to disclose such information where necessary or expedient for the purpose of supporting policy development or implementation in three specified areas. These are: (i) limiting, or encouraging activities which reduce or remove, greenhouse gas emissions; (ii) countering carbon leakage; and (iii) mitigating the effects of climate change. This instrument also introduces an exemption such that a national authority is permitted to disclose UK ETS information where necessary or expedient for the purpose of supporting the CCC in performing its statutory functions.

5.17 USE Eligibility: From 1 April 2025 to 30 June 2025 eligible operators will be able to apply for USE status for the 2026-2030 period. USE status is available for installations that emit less than 2,500 tonnes of carbon dioxide equivalent per year and exempts the operator from the requirement to purchase and surrender allowances to cover its emissions. The 2020 Order did not permit applications for USE status from operators which started operations after the start of the scheme on 1 January 2021 (see paragraph 3 of Schedule 8 to the 2020 Order). It is appropriate that operators which started operations after that date should be able to apply for USE status, and the UK ETS Authority has determined that one full scheme year of data is sufficient to demonstrate eligibility for USE status. Therefore, this instrument amends the criteria so that operators with at least one full scheme year of operation are permitted to apply for USE status for the 2026-2030 period. This means that operators which started operations between 2 January 2021 and 1 January 2024 inclusive are eligible to apply for USE status for the 2026-2030 period.

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 the Monitoring and Reporting Regulation 2018 and Verification Regulation 2018 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. This is contained in the Free Allocation Regulation[4] and the Activity Level Changes Regulation[5]. The Free Allocation Regulation has been amended several times[6], notably by The Greenhouse Gas Emissions Trading Scheme (Amendment) (No. 2) Order 2023 (S.I. 2023/1387), which provided for the changes to the definition of electricity generator referred to in paragraph 5.12 above.

6.3 The Greenhouse Gas Emissions Trading Scheme Auctioning Regulations 2021 (made under the Finance Act 2020) established the rules for auctioning allowances and mechanisms to support market stability.

6.4 A number of amendments have been made since the UK ETS was established which can be found in the 2020 Order, available on legislation.gov.uk and assimilated law in the Free Allocation Regulation and the Activity Level Changes Regulation.

6.5 This instrument amends the 2020 Order, notably changing the definition of terms in articles 4 and 4A, inserting article 34AA to provide for publication of the free allocation table in 2026, and amending Schedules 7 and 8 to maintain the next five-year period in which operators can seek to obtain HSE and USE status. It also introduces free stranding provisions, included in Part 2 of the statutory instrument, which provide for the calculation of free allocation for the 2026 scheme year.

6.6 The Free Allocation Regulation is amended to change the definition of free allocation periods to split the former 2026-2030 free allocation period into a standalone 2026 period and a 2027-2030 allocation period. It amends Article 4 to allow for the new two-stage free allocation application process. The instrument makes provision for determining the quantity of free allowances to be distributed to industrial participants

[4] Commission Delegated Regulation (EU) 2019/331 (the "Free Allocation Regulation")
[5] Commission Implementing Regulation (EU) 2019/1842 (the "Activity Level Changes Regulation")
[6] By S.I. 2020/1557, 2021/1455, 2022/1173, 2023/850, 2023/1387, 2024/192, and 2024/1366.

in 2026 and makes consequential amendments so that the previously legislated process for determining free allocation for the former 2026-2030 allocation period now applies to the new 2027-2030 allocation period.

6.7 The instrument makes minor amendments to the Activity Level Changes Regulation so that the processes for annual reporting of activity and adjustments to free allocation function correctly in the context of the new free allocation periods.

6.8 Schedule 5A of the 2020 Order requires the UK ETS Authority to establish an electronic system, the Registry, to keep track of participants in the scheme, allowances held by participants, their reportable emissions and numbers of allowances surrendered. The UK ETS Authority has a number of accounts in the Registry, known as 'central accounts'; participants' allowances are held in their own accounts, known as 'operator holding accounts' (OHAs) for installations; 'aircraft operator holding accounts' (AOHAs) for aircraft operators; and trading accounts for traders. The Recognised Auction Platform, which delivers the scheme's regular auctions, has an account known as the 'auction delivery account'.

6.9 The obligation on the UK ETS Authority to publish annual summaries of transactions made in the Registry, after a three-year delay, is at paragraph 34 of Schedule 5A to the 2020 Order. These reports would have contained the total numbers of allowances transferred from each type of account during the relevant period, broken down by type of receiving account. This instrument amends paragraph 34 such that, instead, the UK ETS Authority will be obliged to publish reports containing details for each individual transfer made in the relevant period, except transfers between central accounts, as described at 5.15 above.

6.10 Article 75B of the 2020 Order prohibits the disclosure of UK ETS information and applies to the UK ETS Authority, the four national authorities, regulators, and the registry administrator. A number of exceptions to this prohibition are listed at paragraph 3 of the article. Sub-paragraph 3(b)(iii) lists purposes for which a national authority may disclose UK ETS information, if it is necessary or expedient for that purpose. This instrument adds two further items to this sub-paragraph. These additions make it permissible for a national authority to disclose UK ETS information where necessary or expedient for the purposes of (1) relevant policy development or implementation by a national authority, a Minister of the Crown, the Commissioners of HM Revenue and Customs, or a Northern Ireland department; (2) supporting the Climate Change Committee in performing its statutory functions. The instrument defines 'relevant policy development or implementation' as having the objective either: to limit, or encourage activities which reduce or remove, greenhouse gas emissions; to counter carbon leakage; or to mitigate the effects of climate change.

6.11 Schedule 8 to the 2020 Order relates to USEs. Paragraph 3 of Schedule 8 sets out the rules governing applications for USE status for the 2026-2030 period. Sub-paragraph 3(4) stated that a USE in the 2026-2030 period must have commenced operations on or before 1 January 2021, and that its reportable emissions must not have exceeded 2,499 tonnes of carbon dioxide or equivalent in each of 2021, 2022 and 2023. This instrument amends sub-paragraph 3(4)(a) so that a USE in 2026-2030 must have commenced operation on or before 1 January 2024. It amends sub-paragraph 3(4)(b) so that the reportable emissions of a USE in 2026-2030 must not have exceeded 2,499 tonnes of carbon dioxide or equivalent in each relevant scheme year. It adds sub-paragraph 3(4A) which defines the relevant scheme years for installations which commenced operations on or before 1 January 2021 as 2021, 2022 and 2023; for installations which commenced operations between 2 January 2021 and 1 January

2022 as 2022, 2023 and 2024; for installations which commenced operations between 2 January 2022 and 1 January 2023 as 2023 and 2024; and for installations which commenced operations between 2 January 2023 and 1 January 2024 as 2024 only.

Why was this approach taken to change the law?

6.12 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.

6.13 Alternative approaches to alignment with introduction of the UK CBAM were considered. Firstly, the possibility of leaving the existing 2026-2030 allocation period in place was considered. Since previous legislation provided for free allocation to be determined at the start of a free allocation period, this would have meant either: a) delaying any changes to free allocation rules made following the Free Allocation Review until 2030. This option was rejected as it would contradict a public commitment; or b) legislating for substantial changes to the methodology for determining free allocation to be made midway through a free allocation period. This option was rejected as it would require much more complex legislative changes than the preferred option. It could also involve reducing the quantity of free allowances for industrial participants after those quantities had already been published, creating uncertainty for participants.

6.14 The policy changes relating to transaction history publication, data disclosure and USE criteria for 2026-2030 each required only minor amendments to the relevant sections of the 2020 Order. There were therefore no significant alternative options to the legislative approach taken in this instrument.

7. Consultation

Summary of consultation outcome and methodology

7.1 Two targeted consultations to the affected parties have been published in relation to the provisions provided for by this instrument.

7.2 A targeted consultation on moving the second UK ETS free allocation period was sent by the Regulators to relevant participants in September 2024. It asked current UK ETS participants if they agreed that the year 2026 should be treated as an extension of the 2021-2025 allocation period for the purposes of determining the quantity of free allowances that eligible participants could receive. It set out a proposal for implementing this, as described in section 5 above. The UK ETS Authority received 26 responses to the consultation, mainly from trade associations that collectively represent the interests of a large number of participants. 20 (77%) respondents agreed with the proposal and three (11.5%) disagreed, indicating broad support among participants for the changes and proposed implementation.

7.3 The "UK Emissions Trading Scheme: Moving the Second UK ETS Free Allocation Period Authority Response" has been published on 16/12/2024 and can be found online at this URL: https://assets.publishing.service.gov.uk/media/676000e81857548bccbcfa2a/ukets-moving-second-free-allocation-period-authority-response.pdf

7.4 A targeted consultation[7] on Registry transaction publication, UK ETS information disclosure and USE criteria for 2026-2030 was sent to operators, trading account holders and trade bodies representing operators in September 2024. It asked five

[7] https://assets.publishing.service.gov.uk/media/66f185d434de29965b489c20/UK_ETS_Authority_-_Technical_consultation_September_2024.pdf

questions relating to three legislative proposals. The UK ETS Authority received 27 responses to the consultation. Responses to the transaction publication proposal were balanced between support and opposition. There was a balance of support and opposition for the proposals to permit disclosure of UK ETS information for the purposes of policy development or implementation, and to aid the CCC in the delivery of its statutory functions. All responses to the proposal to extend the 2026-2030 USE eligibility criteria expressed support. The UK ETS Authority response to the consultation can be found at this URL:

https://www.gov.uk/government/publications/technical-and-operational-amendments-to-the-uk-emissions-trading-scheme-uk-ets-authority-consultation-response.

7.5 The Information Commissioners Office was informed of the transaction publication proposal in line with Article 36(4) of the General Data Protection Regulation.

8. Applicable Guidance

8.1 The UK ETS Authority will publish guidance to assist operators with the submission of data required for the Baseline Data Collection exercise and/or scheme status applications, provisionally in February 2025 and in any case ahead of the free allocation data submission window which opens on 1 April 2025. Further guidance will be provided ahead of the second stage of the free allocation application process in 2026.

8.2 The UK ETS Authority will publish guidance for operators wishing to apply for USE status in 2026-2030 before the start of the application window on 1 April 2025. This guidance will be published at: https://www.gov.uk/guidance/opt-out-of-the-uk-ets-if-your-installation-is-an-ultra-small-emitter.

Part Two: Impact and the Better Regulation Framework

9. Impact Assessment

9.1 A full Impact Assessment has not been prepared for this instrument because it is not a regulatory provision.

Impact on businesses, charities and voluntary bodies

9.2 The impact on business, charities or voluntary bodies from the free allocation provisions are minimal as 2026 free allocation will continue to be awarded on the basis of current rules and the ability of businesses who were previously ineligible for free allocation during the first period will still be able to apply for the 2026 scheme year.

9.3 The legislation does impact small or micro businesses. To minimise the impact of the requirements on 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. This provision extends the eligibility criteria for the USE scheme, helping those newly eligible small businesses to reduce their compliance burdens.

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.

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 None.

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 (No.2) 2025 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.