EXPLANATORY MEMORANDUM TO

THE GREENHOUSE GAS EMISSIONS TRADING SCHEME (AMENDMENT) ORDER 2020

2020 No. 1557

1. Introduction

This explanatory memorandum has been prepared by the Department for Business, Energy and Industrial Strategy (the "Department") and is laid before Parliament by Command of Her Majesty.

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

2. Purpose of the instrument

This Order makes further provision for the UK Emissions Trading Scheme (the "UK ETS"), in particular for the free allocation of allowances and for a registry for the UK ETS. The UK ETS was established by the Greenhouse Gas Emissions Trading Scheme Order 2020 (the "principal Order") as a UK-wide greenhouse gas emissions trading scheme to encourage cost-effective emissions reductions which will contribute to the UK's emissions reduction targets and net zero goal.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

The Department apologises to Parliament that this Order, which comes into force on 31st December 2020, is laid in breach of the 21-day rule, the convention that an instrument should not be laid before Parliament less than 21 days before it comes into force. As this instrument extends to both Scotland and the other nations of the UK, it must be made by Order in Council in accordance with Part 3 of Schedule 3 to the Climate Change Act 2008 ("CCA 2008"). Accordingly, this Order was made on 16th December 2020, the date of the first Privy Council meeting after the meeting at which the principal Order was made, and was laid as soon reasonably practicable thereafter.

When the Department learned that the date of the December Privy Council meeting would not allow this Order to be made and laid with a coming into force date of 31st December 2020 without breaching the 21-day rule, the Department considered whether the Order could have been made with a later commencement date. The Department, however, considers that it is necessary for the Order to come into force on 31st December 2020. Commission Delegated Regulation (EU) 2019/331 (the "Free Allocation Regulation") is an EU instrument enacted for the EU Emissions Trading System (the "EU ETS") that forms part of domestic law after the end of the Transition Period[1] under section 3 of the European Union (Withdrawal) Act 2018. Article 46 of, and Schedule 1 to, the Order amends the Free Allocation Regulation for the purpose of free allocation under the UK ETS. However, regulation 62 of the Greenhouse Gas Emissions Trading Scheme (Amendment) (EU Exit) (No. 2) Regulations 2019, an instrument that was made as part of the Department's previous "no deal" preparations in spring 2019, provides for the Free Allocation Regulation to be revoked with effect from the end of the Transition

[1] The Transition Period ends at 11 pm on 31st December 2020.

Period. Accordingly, article 45(2) of the Order provides for the proposed revocation of the Free Allocation Regulation not to take effect, ensuring that the Free Allocation Regulation is available for the purposes of the UK ETS; and, in order for this to be achieved, article 45(2) (which comes into force at the beginning of the day on 31st December 2020), must come into force before the end of the Transition Period, in breach of the 21-day rule.

Further, the Department considers that it is necessary for this Order to come into force at the end of the Transition Period so that the existing obligations imposed on operators of installations relating to the monitoring of data for the purposes of free allocation (for example, those in Articles 6, 7 and 9 of the Free Allocation Regulation) should continue in force immediately after the end of the Transition Period without any period, however brief, when such obligations do not apply (and when there therefore may be uncertainty about, say, how monitoring should take place) in order to ensure a seamless transition from the EU ETS to the UK ETS.

The Department wishes to draw the Committee's attention to three other matters. First, paragraph 6(1)(a) of new Schedule 5A to the principal Order gives the registry administrator the power to establish "administrative arrangements and rules" for the operation of the registry. Paragraph 16(9) of that Schedule makes it clear what the proposed administrative rules are likely to include. The Department considers that section 90(3) of CCA 2008 includes the power to make such provision. The CRC Energy Efficiency Scheme Order 2013, also made under section 90(3) of the CCA 2008, includes similar provision for administrative arrangements and rules: see articles 50(4) and 53(1)(a) of that Order.

Second, paragraph 6 of Schedule 2 to the CCA 2008 requires legislation made in exercise of the enabling powers to provide that allowances used by a participant for the purposes of a trading scheme cannot be used by the participant for any other purpose. The definition of "surrender" in article 4(1) of the principal Order which included such provision is amended by this instrument; and paragraph 24(2) of new Schedule 5A to the principal Order now contains that requirement.

Third, paragraph 3.2 of the Explanatory Memorandum to the principal Order explained that Commission Implementing Regulation (EU) 2018/2067 (the "Verification Regulation 2018") would be retained EU law but Commission Implementing Regulation (EU) 2018/2066 (the "Monitoring and Reporting Regulation 2018") would not and that, consequently, incorporating rules from these measures into the UK ETS required different drafting approaches. However, this Order makes a change in relation to the Verification Regulation 2018, eliminating the difference. This was on the expectation, having seen draft EU legislation with amendments related to free allocation, due to come into force on 1st January 2021, that the version of the Verification Regulation 2018 we wanted to use for the UK ETS would not now be retained EU law. Unfortunately, the EU amendments were not ultimately finalised in time for this Order to refer to them. Nevertheless, we have kept the new drafting approach for the Verification Regulation 2018, just applying the original version with modifications for the purpose of the UK ETS instead of applying the amended version that we expected, on the basis that it may facilitate later amendments that may be desirable to mirror the EU scheme.

Matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business (English Votes for English Laws)

As the instrument is subject to the negative resolution procedure there are no matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business at this stage.

4. Extent and Territorial Application

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

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

5. European Convention on Human Rights

As this instrument is subject to the negative resolution procedure and does not amend primary legislation, no statement is required.

6. Legislative Context

The principal Order set up the UK ETS which will be operational from 1st January 2021. Key provisions included in the principal Order covered the scope of the scheme, monitoring and reporting requirements, the cap (the total level of emissions permitted) and the trajectory (the rate at which the cap declines) and the roles of the regulators in monitoring and enforcing the rules of the scheme.

The principal Order was the first of a legislative package designed in order to deliver a UK ETS which can be operational by the end of the Transition Period, ensuring that no carbon pricing gap emerges when the UK ceases to participate in the EU ETS. A carbon pricing gap could see increased UK emissions and therefore may risk our ability to meet Carbon Budget and emissions reduction targets.

This Order is the second instrument in the package. It provides amongst other things for free allocation of allowances and for a registry for the UK ETS. The Order amends the principal Order, the Free Allocation Regulation and Commission Implementing Regulation (EU) 2019/1842, referred to in the Order as the "Activity Level Changes Regulation", another EU instrument enacted for the EU ETS that forms part of domestic law after the Transition Period and is adopted for the purpose of the UK ETS.

The third instrument in the package will be regulations made under section 96 of the Finance Act 2020 to establish rules for the auctioning of allowances and mechanisms to support market stability.[2] This is due to be in force in the first quarter of 2021.

In addition, a further set of instruments will set up the financial market oversight framework. The first instrument (The Securities Financing Transactions, Securitisation and Miscellaneous Amendments (EU Exit) Regulations 2020) has already been made and retains the necessary market oversight legislation into UK law. A second instrument will amend the financial services legislation retained via the first instrument and will be laid in draft before both the Commons and the Lords. This SI will set out the regulations for the trading of allowances in the UK ETS. It will enshrine an oversight role for the Financial Conduct Authority (FCA) and will ensure that UK ETS allowances are subject to the relevant regulatory oversight and treatment as financial instruments. This is due to be in force in the first quarter of 2021.

[2] Paragraph 5(4) of Schedule 2 to the CCA 2008 prevents legislation made under the CCA 2008 from providing for allowances to be allocated in return for consideration

7. Policy background

What is being done and why?

The UK ETS is a policy replacement for the UK's participation in the EU ETS which will cease at the end of the Transition Period on 31st December 2020[3].

The UK ETS will run for an initial phase of 10 years, divided into two allocation periods, the 2021-2025 allocation period and the 2026-2030 allocation period. Emissions trading schemes work on the 'cap and trade' principle, where a cap is set on the total amount of certain greenhouse gases that can be emitted over a given period of time by installations and aircraft covered by the scheme. This cap is then divided into "allowances"; participants receive or buy emission allowances which they can trade with one another as needed. Operators are required to monitor, report on and surrender "allowances" equivalent to their greenhouse gas emissions in each scheme year. This cap is reduced over time, so that total emissions fall. Operators and aircraft operators with relatively low levels of emissions are either not caught by the scheme or can take advantage of opt-out schemes (there are two opt-out schemes covering hospitals, "small emitters" and "ultra-small emitters").

This instrument makes provision for the free allocation of allowances and a registry for the UK ETS:

- *Allocation of free allowances to stationary (non-aviation) installations*
  The Order provides that free allowances can be given to UK ETS participants most at risk of "carbon leakage". This can occur where industries which cannot reduce their emissions nor pass through the carbon cost to their product could transfer activity, to reduce their production costs, or lose market share to countries with a lower or no carbon price. Giving free allowances means a business needs to buy fewer allowances to cover their emissions, therefore, in effect, reducing the carbon price they pay and mitigating this risk of leakage. The way free allocation entitlement is determined and the overall approach to free allocation in a UK ETS is largely the same as in Phase IV (2021-2030) of the EU ETS. UK businesses should, therefore, be familiar with the approach to free allocation, helping to ensure a smooth transition to the UK ETS.

- Application for free allocation for 2021-2025 allocation period for stationary (non-aviation) installations

  Installations which wanted to apply for free allocation from 2021 will have applied under the EU ETS. As such, this Order provides that any applications for free allocation made by UK installations for the 2021-2025 allocation period under the EU ETS are treated as applications under the UK ETS. This means operators do not have to re-submit any information, further providing a smooth transition.

- Benchmarks

[3] The Withdrawal Agreement requires continuing UK participation in the EU ETS for the purpose of compliance with the 2020 scheme year and on an ongoing basis for installations in Northern Ireland that generate electricity for the single wholesale electricity market in Ireland and Northern Ireland: see Article 96 of the Withdrawal Agreement and Annex 4 to the Protocol on Ireland/Northern Ireland.

The Free Allocation Regulation sets out a calculation to determine how many free allowances each eligible stationary participant in the UK ETS will be awarded. This calculation takes into account how polluting the emitter is compared to its top-performing competitors: this parameter is known as the benchmark, and there is a separate benchmark for each activity which is eligible for free allocation. Benchmarking free allowances in this way should encourage less efficient operators to improve their performance, while rewarding those that perform well. The UK ETS will use the benchmarks determined by the European Commission for the purposes of the EU ETS for the 2021-2025 allocation period, since these use a large set of data and so give the best measure of good performance. The benchmarks have not yet been published, but we expect them to be in first quarter of 2021. This Order provides that, once the benchmarks are published, free allocation entitlement must be calculated and approved and that the UK ETS authority[4] must then compile an allocation table, which must be published as soon as practicable and in any event before 30th June 2020. Policy for the benchmarks used for the 2026-2030 allocation period is the subject of an ongoing review; the legislation will need to be amended to implement the desired policy, if it is different to using the EU ETS benchmarks.

- Carbon leakage list

  Another part of the calculation of free allocation entitlement is whether the stationary installation concerned performs a process which is deemed to be at risk of carbon leakage (e.g. production of steel). Processes which are deemed to be most significantly at risk are listed on the Carbon Leakage List and get their full entitlement to free allocation (i.e. their Carbon Leakage Exposure Factor is 1). Processes not on the list receive only 30% of their entitlement – i.e. their Carbon Leakage Exposure Factor is 0.3 – for the period 2021-2026; from 2026 their entitlement is reduced linearly from 30% to 0% by 2030. As for benchmarks, this Order provides that the UK ETS uses the same Carbon Leakage List as the EU ETS.

- New entrants

  The Order also provides, again mirroring the approach in the EU ETS to provide a smooth transition for businesses, that a portion of allowances will be made available for new stationary entrants to the UK ETS as well as existing operators who increase their activity. This is known as the new entrants' reserve. This means an operator who receives a permit after 30 June 2019 – i.e. too late to submit data to apply for free allocation as an existing operator (an incumbent) – can still receive free allowances, but through a separate application process.

- Activity Level Changes

  From 2021 in the EU ETS, for stationary installations, after free allocation is calculated initially in 2021, it will then be recalculated each year based on any significant changes to production, as identified in annual activity level reports submitted by the operators. This is so operators cannot get more free allowances relative to their emissions by simply reducing the amount they produce, and similarly operators can get more free allowances if they increase their production, so as to not make free allocation disincentivise any expansions to the business. The UK

[4] The "UK ETS authority" is defined in article 14 of the principal Order and is a collective reference to the Secretary of State, the Scottish Ministers, the Welsh Ministers and the Northern Ireland Department of Agriculture, Environment and Rural Affairs.

ETS will mirror this dynamic approach to free allocation calculation, and the Order provides for this.

- Correction and reduction factors

  The total number of allowances we give for free reduces over time to incentivise reduction in emissions, and there are a number of "factors" which achieve this reduction. A cross sectoral correction factor (CSCF) is applied if total free allocation to non-electricity generators exceeds the limited amount of allowances that can be given for free to incumbent stationary installations, known as the "industry cap". The CSCF reduces all non-electricity generator stationary installations' free allocation by an equal proportion so that the total free allocation given to all installations is at or below the industry cap. Electricity generator installations' free allocation is reduced by the reduction factor set out in this Order. As above, installations which perform processes not on the Carbon Leakage list have their free allocation reduced too. New entrants also have their free allocation reduced year-on-year by the reduction factor.

- Free Allocation for Aviation

  The approach to aviation free allocation policy is similar to the approach in the EU ETS, particularly to ensure a smooth transition for the many aircraft operators that will continue participating in the EU ETS post-Transition Period. The amendments to the instrument include creating a UK ETS free allocation application process for the sector, as well as defining a free allocation methodology that reflects aircraft operators' historic activity on flights covered by a UK ETS for the 2021-2025 allocation period. We are reviewing free allocation for aviation, considering competitiveness and our domestic and international climate commitments, with any change likely to be implemented by the start of 2024.

- UK ETS Registry

  The approach to registry policy is similar to the approach taken in the EU ETS; therefore participants will be familiar with the process. New Schedule 5A to the principal Order establishes the UK ETS registry and makes related provision, including on how to open/close accounts, access to the registry and suspending accounts. The registry will be an online platform, like an online bank, which will keep track of UK ETS allowances held by participants. The registry is the only platform which can hold allowances. These allowances can be transferred between different accounts. The registry functionality will be such that transfers may not complete immediately, in order to mitigate against potential fraud and security concerns. Alongside tracking allowances, the registry also keeps track of UK ETS participants, their reportable emissions, and the surrender of allowances by these participants. This system is currently being developed and is on track to be ready for January 2021.

  Operators and aircraft operators will be required to hold a registry account, and traders may open an account to participate in the allowance market on terms agreed by the registry administrator. If an account holder cannot access the registry through their authorised registry user ("authorised representative") logging onto the system, then they may instruct the registry administrator to take actions on their behalf.

- Role of UK ETS Authority

  This Order provides for the UK ETS authority to issue (create) allowances in line with the cap; create and hold central accounts to ensure free allocation, auctioning and market stability policy is delivered; and suspend the registry in response to security threats and for technical updates. Furthermore, the registry administrator can be instructed by the UK ETS authority to undertake certain actions.

- Registry Administrator

  The Registry Administrator is responsible for administering the registry. New article 8A of the principal Order defines the "registry administrator" as all five bodies who are the "regulators" as defined in article 9. In practice, the intention is for the Environment Agency to exercise the functions of the registry administrator on behalf of the other bodies. This will be communicated to account holders via guidance and communications. Additionally, any notices/decisions the registry administrator takes will need to be clear which body took that decision. This will enable account holders to know which tribunal to appeal to.[5]

- *Enforcement notices*

  The registry administrator is able to give enforcement notices under article 44 of the principal Order for breach of requirements relating to or imposed by the registry administrator contained in Schedule 5A, for example, an account holder's duty to provide details of a primary contact under paragraph 15 of that Schedule and to comply with information notices given by the registry administrator under article 75. If an enforcement notice given by the registry administrator is not complied with, the intention is that any civil penalty in respect of the breach under article 65 may be imposed by any regulator under article 47.

In addition, the following point should be noted with regard to the specified provisions of the Order:

- Changes in respect of the rules on monitoring, reporting and verification of emissions (mainly articles 13, 14, 35 and 36 of this Order) are mostly to support the rules on free allocation. However, the provisions also anticipate likely changes at EU level to both the Monitoring and Reporting Regulation 2018 and the Verification Regulation 2018 (see also paragraph 3.6 above) and gather together in one place the modifications necessary for the application of the Verification Regulation 2018 in the context of the UK ETS.

8. European Union (Withdrawal) Act/Withdrawal of the United Kingdom from the European Union

This instrument is not made under the European Union (Withdrawal) Act 2018 but relates to the withdrawal of the United Kingdom from the European Union because it relates to the UK ETS, which is a policy replacement for the UK's participation in the EU ETS.

[5] A decision or notice of the registry administrator for which a statutory appeal under article 70 of the principal Order is available must make it clear which body was exercising the functions of the registry administrator in making the decision or giving the notice: see new article 71(4) of the principal Order. This will enable any person who wished to appeal against the decision or notice to determine the tribunal to which any appeal must be made.

9. Consolidation

There are no plans to consolidate the legislation amended by this instrument.

10. Consultation outcome

Between 2nd May 2019 and 12th July 2019, the UK Government and Devolved Administrations ran a public consultation seeking views on the UK's future carbon pricing policy. This consultation stated that a UK ETS linked to the EU ETS is the UK Government and Devolved Administrations' preferred carbon pricing policy, and that if this could not be secured alternative options included a standalone UK emissions trading scheme, a carbon emissions tax, or remaining in Phase IV of the EU ETS. The consultation set out policy proposals for a UK ETS and sought views on these proposals from stakeholders.

The public consultation included policy proposals for free allocation and the UK ETS registry, which are legislated for in this Order.

Alongside the consultation, the UK Government and Devolved Administrations jointly commissioned the Committee on Climate Change (CCC) for advice on both a standalone and linked UK ETS.

The public consultation received over 130 responses, from a range of stakeholders including current EU ETS participants and NGOs, with the majority supporting most of the proposals on the design of a UK ETS, including the policy introduced by this Order. A large proportion of stakeholders expressed a preference to link a UK ETS to the EU ETS.

The Government Response to the consultation was published on 1st June 2020.

Full details of the consultation and response can be found at:
https://www.gov.uk/government/consultations/the-future-of-uk-carbon-pricing

11. Guidance

Guidance for UK ETS participants will be published prior to the start of the UK ETS on 1st January 2021.

12. Impact

There is no significant impact on charities or voluntary bodies.

There is no significant impact on the public sector.

Although Government policy does not require an Impact Assessment for this instrument because it is not a regulatory provision, an Impact Assessment of the UK ETS policy being legislated for has been produced. This Impact Assessment considers the expected costs and benefits of the UK ETS in its initial years of operation (from 2021 to 2024) in an unlinked context. It covers UK ETS policy contained within this Order and the principal Order.

This UK ETS is expected to deliver a net benefit to society in its initial years of operation compared to a counterfactual of continued UK participation in Phase IV of the EU ETS.

The Impact Assessment was published on the gov.uk website, alongside the Government Response to the Future of UK Carbon Pricing consultation on 1st June 2020, and is also published alongside this Explanatory Memorandum on the legislation.gov.uk website.

13. Regulating small business

The legislation applies to activities that are undertaken by small businesses.

To minimise any disproportionate impact of UK ETS requirements on small businesses, operators and aircraft operators with relatively low levels of emissions are either not caught by the scheme or can take advantage of opt-outs. This is provided for in the principal Order.

14. Monitoring & review

The principal Order commits the UK ETS authority to reviewing the operation of the UK ETS (including the measures introduced by this Order) in 2023 and in 2028. The UK ETS authority must subsequently publish a report setting out the conclusions of the review.

15. Contact

Sophie West, at the Department for Business, Energy and Industrial Strategy Telephone 02072158455 or sophie.west@beis.gov.uk can be contacted with any queries regarding the instrument.

Charlie Lewis, Deputy Director for Emissions Trading at the Department for Business, Energy and Industrial Strategy, can confirm that this Explanatory Memorandum meets the required standard.

Rt Hon Kwasi Kwarteng MP, the Minister of State for Energy and Clean Growth at the Department for Business, Energy and Industrial Strategy, can confirm that this Explanatory Memorandum meets the required standard.