

Explanatory Memorandum to The Greenhouse Gas Emissions Trading Scheme (Amendment) Order 2020

This Explanatory Memorandum has been prepared by the Department for Environment, Energy and Rural Affairs and is laid before Senedd Cymru in conjunction with the above subordinate legislation and in accordance with Standing Order 27.1

Minister/Deputy Minister's Declaration

In my view, this Explanatory Memorandum gives a fair and reasonable view of the expected impact of The Greenhouse Gas Emissions Trading Scheme (Amendment) Order 2020. I am satisfied that the benefits justify the likely costs.

Lesley Griffiths
Minister for Environment, Energy and Rural Affairs
17 December 2020

PART 1

1. Description

The UK Emissions Trading Scheme (“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 from the power, industry and aviation sectors. It has been designed jointly by the Governments of the UK, Scotland and Wales, and the Northern Ireland Executive and will contribute to the UK’s emissions reduction targets and net zero goal, as well as the emissions reduction targets that we have in Wales.

This Order makes further provision for the UK ETS, in particular for the free allocation of allowances and for a registry for the UK ETS.

2. Matters of special interest to the Legislation, Justice and Constitution Committee

Part 3 of Schedule 3 to the Climate Change Act 2008 (“CCA”) states that an emissions trading scheme that applies to England, Scotland, Wales and Northern Ireland – such as in this case – must be established by Order in Council. The appropriate procedure for an Order in Council is prescribed by section 48 to the CCA. As this instrument does not contain any provisions which would be caught by section 48(3) of the CCA, the negative procedure has been used.

As the Order in Council will be subject to UK Parliamentary scrutiny, it is not considered reasonably practicable for this instrument to be made or laid bilingually.

This Order, which comes into force on 31 December 2020, is laid in breach of the 21-day rule, the convention that an instrument should not be laid before the Senedd less than 21 days before it comes into force. This Order was made on 16 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. A later commencement date is considered impossible for two reasons. Firstly, in order to ensure that there will be no pause in the obligations on operators of installations relating to the monitoring of data for the purposes of free allocation. This avoids uncertainty for participants and ensure a seamless transition from the EU Emissions Trading System to the UK ETS. Secondly, there is a need to undo a prospective revocation of Commission Delegated Regulation (EU) 2019/331 (“the Free Allocation Regulation”) by regulation 62 of the Greenhouse Gas Emissions Trading Scheme (Amendment) (EU Exit) (No. 2) Regulations 2019, which takes effect from Implementation Period completion day. This instrument was made as part of the UK Government’s previous “no deal” preparations in spring 2019.

There are three other matters which we would like to draw to the Committee's attention. 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 the CCA includes the power to make such provision. The CRC Energy Efficiency Scheme Order 2013, also made under section 90(3) of the CCA, 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 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, in drafting the principal Order, the Department envisaged 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 (for example, in the context of any linking).

3. Legislative background

The principal Order set up the UK ETS which will be operational from 1 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 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 emissions and 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. This 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 IP completion day 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 stability¹. This is due to be in force in the first quarter of 2021.

In addition, a further instrument that will amend financial services legislation will be laid in draft before both the House of Commons and the House of 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.

The UK Government has stated it is open to considering a link between the UK ETS and the EU ETS, if a linking agreement is in both sides’ interests, and recognises both parties as sovereign equals. A link between the UK ETS and the EU ETS could help to establish a much larger carbon market, which could increase opportunities for emissions reduction and cost-efficiency of emissions trading. The delivery of a UK ETS through this legislative package increases the likelihood that we will be able to secure a linking agreement with the EU through negotiations. Further legislation would be required to deliver any link between the UK ETS and the EU ETS.

¹ Paragraph 5(4) of Schedule 2 to the CCA 2008 prevent legislation made under the CCA from providing for allowances to be allocated in return for consideration.

4. Purpose and intended effect of the legislation

The primary purpose of this Order is to provide for free allocation of allowances and for a registry for the UK ETS.

The territorial extent of this Order is England, Wales, Scotland and Northern Ireland. The Order impacts on industry, the power sector and aviation.

The Order makes provision relating to free allocation of allowances and to the UK ETS registry, as follows:

Allocation of free allowances

The Order provides that free allowances can be given to UK ETS participants most at risk of “carbon leakage”.

Application for free allocation for 2021-2026

The Order provides that any applications for free allocation made by UK installations for the 2021-2026 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 to the UK Authority, further supporting a smooth transition.

Benchmarks

The calculation to determine how many free allowances each eligible participant in the UK ETS will be awarded 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.

Carbon leakage list

Another part of the calculation of free allocation entitlement is whether the installation concerned performs a process (e.g. production of cement) which is deemed to be at risk of carbon leakage. Processes which are deemed to be at risk are listed on the Carbon Leakage List and get their full entitlement to free allocation.

New entrants

The Order also states, 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 entrants to the UK ETS as well as existing operators who increase their activity. This is known as the New Entrant Reserve.

Activity Level Changes

From 2021 in the EU ETS, 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. The UK 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 stationary installations, known as the “industry cap”. Electricity generator installations’ free allocation is reduced by the Linear Reduction Factor, set out in this Order, if a CSCF is applied.

Applications for free allocation and the opt-outs

Article 4(4) of the Free Allocation Regulation provides for the operator of an incumbent installation to apply for free allocation for the 2026-2030 allocation period at the same time as applying for status as either a hospital or small emitter or an ultra-small emitter for the allocation period, i.e. as part of the opt-out schemes. If the application to be in one of the opt-out schemes does not succeed, but the application for free allocation succeeds, free allocation will be made in the normal way.

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 who 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 which 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.

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 the registry and suspend 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, which 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.

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 and 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 body to appeal against.

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.

The registry administrator is able to give enforcement notices under article 44 of The Greenhouse Gas Emissions Trading Scheme Order 2020 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, there are some changes in respect of the rules on monitoring, reporting and verification of emissions, 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 and gather together in one place the modifications necessary for the application of the Verification Regulation 2018 in the context of the UK ETS.

5. Consultation

Details of the consultation have been included in the RIA referenced in Part 2 below.

PART 2 – REGULATORY IMPACT ASSESSMENT

A Regulatory Impact Assessment of the UK Emissions Trading Scheme in its entirety was included in the EM/RIA which was laid alongside The Greenhouse Gas Emissions Trading Scheme Order 2020. It is available here:

<https://senedd.wales/laid%20documents/sub-ld13345-em/sub-ld13345-em-e.pdf>