

EXPLANATORY MEMORANDUM TO

THE GREENHOUSE GAS EMISSIONS TRADING SCHEME (AMENDMENT) (NO. 2) ORDER 2023

2023 No. 1387

1. Introduction

- 1.1 This explanatory memorandum has been prepared by the Department for Energy Security and Net Zero (the “Department”) and is laid before Parliament by Command of His Majesty.

2. Purpose of the instrument

- 2.1 This instrument makes various amendments to the UK Emissions Trading Scheme (the “UK ETS”) to provide for the capping of aviation free allocation at 100% of emissions, clarifying the treatment of Carbon Capture and Storage (CCS) plants and amendments to free allocation rules for electricity generation.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

- 3.1 As set out in section 7.5-7.6, this instrument makes various amendments to clarify the treatment of CCS plants, where the existing legislation does not properly represent the Department’s policy. The Department has therefore applied the free issue procedure. In accordance with paragraph 4.7.6 of Statutory Instrument Practice, the Department has consulted the SI Registrar.
- 3.2 This instrument comes into force on 1 January 2024 or, if not made before then, on the day after the day on which it is made. The amendments relating to free allocation for aviation and electricity generators do not impose duties on private persons. The Department is not aware that emissions from activities regulated by the UK ETS are currently being captured and does not consider that they are likely to begin before this instrument comes into force. Accordingly, the Department does not consider that a later commencement date is necessary.

4. Extent and Territorial Application

- 4.1 The extent of this instrument is Great Britain.
- 4.2 The territorial application of this instrument is Great Britain.

5. European Convention on Human Rights

- 5.1 Lord Callanan, Minister for Energy Efficiency and Green Finance, has made the following statement regarding Human Rights:

“In my view the provisions of the Greenhouse Gas Emissions Trading Scheme (Amendment) (No. 2) Order 2023 are compatible with the Convention rights.”

6. Legislative Context

- 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”) 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. The UK ETS is operated by the UK ETS Authority, comprising the UK Government, Scottish Government, Welsh Government and the Department of Agriculture, Environment and Rural Affairs in Northern Ireland. The scheme is regulated by the Environment Agency, the Scottish Environment Protection Agency, Natural Resources Wales, the Northern Ireland Environment Agency, and the Offshore Petroleum Regulator for Environment and Decommissioning. The UK ETS replaced the UK's participation in the EU Emissions Trading System (EU ETS), and the 2020 Order applied EU ETS rules on the monitoring, reporting and verification of emissions with modifications to ensure that they work for the UK ETS.

- 6.2 The 2020 Order was subsequently amended by the Greenhouse Gas Emissions Trading Scheme (Amendment) Order 2020 to include provisions for the free allocation of allowances and the UK ETS Registry, including by amending the domestic law versions of Commission Delegated Regulation (EU) 2019/331 (the "Free Allocation Regulation") and Commission Implementing Regulation (EU) 2019/1842 (the "Activity Level Changes Regulation" or "ALCR"). 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.
- 6.3 Technical and operational amendments, including additional penalties, and improvements to monitoring, reporting and enforcement of scheme rules were made by the Greenhouse Gas Emissions Trading Scheme (Amendment) Order 2021, the Greenhouse Gas Emissions Trading Scheme (Amendment) Order 2022, and the Greenhouse Gas Emissions Trading Scheme (Amendment) (No. 2) Order 2022.
- 6.4 A further amendment to include flights to Switzerland within the scope of the UK ETS from 1 January 2023 was made by the Greenhouse Gas Emissions Trading Scheme (Amendment) (No. 3) Order 2022.
- 6.5 The most recent change to the scheme was made by the Greenhouse Gas Emissions Trading Scheme (Amendment) Order 2023, which implemented various changes.
- 6.6 This instrument is part of a package of legislation to implement the policy decisions in the Main UK ETS Authority Response to the Developing the UK ETS Consultation. Other instruments which implement the decisions are the Greenhouse Gas Emissions Trading Scheme (Amendment) Order 2023 and the Greenhouse Gas Emissions Trading Scheme Auctioning (Amendment) Regulations 2023.

7. Policy background

What is being done and why?

- 7.1 Under the UK ETS, participants are required to monitor and report on, and surrender allowances in respect of, their greenhouse gas emissions. The UK ETS provides free allocation of allowances to eligible installation operators in order to reduce the risk of carbon leakage. Free allocation for installations and aircraft operators is calculated using industry benchmarks and the carbon leakage list, which are the same as those for Phase IV of the EU ETS.
- 7.2 Installations that receive free allocation are required to monitor and report activity levels each year.

- 7.3 *Aviation Free Allocation Cap*: Free allocation is provided to the aviation sector to mitigate against carbon leakage risks in the current allocation period, ending with 2025. For 2024 and 2025, we are proposing to implement a cap on the maximum amount of free allocation aircraft operators are eligible to receive to 100% of their verified emissions. As allowances are allocated at the beginning of a scheme year, the cap will operate by requiring aircraft operators to return allowances in excess of emissions. Some aircraft operators receive more free allowances than their verified emissions which shields operators from the ETS price signal and provides an opportunity to benefit from the scheme. Capping aviation free allocation entitlement to 100% of verified emissions supports our decarbonisation objectives and increased climate ambition in a way that maintains the market signal the UK ETS sends and supports a viable market.
- 7.4 In 2021, aviation free allocation represented around 127% of the sector’s verified emissions, representing an over allocation of more than 900,000 UK ETS allowances (UKAs) - worth around £50 million based on average 2021 UKA prices, which operators were able to sell for a profit.
- 7.5 *Carbon Capture Activities*: Carbon capture, transport and storage activities are included as “regulated activities” in the UK ETS to ensure the integrity of the scheme. Installations carrying out other forms of regulated activity are allowed to deduct emissions from carbon dioxide that is captured and stored. The emitting installation does not need to surrender allowances in respect of the deducted emissions, but the installations carrying out capture activities need to have permits and monitor and report on any emissions from the stored carbon dioxide to ensure that any emissions are eventually accounted for within the UK ETS cap.
- 7.6 There is currently an inconsistency in how capture activities and installations are dealt with in UK ETS legislation, as a result of which the legislation does not correctly reflect the Department’s policy. Whilst in some places the legislation recognises that capture and other regulated activities might occur at the same installation, in other places the legislation assumes that installations carrying out capture activities will be self-contained and not carry out any other types of regulated activity. This instrument makes amendments to the 2020 Order and the Free Allocation Regulation to rectify this. In particular, it is made clear that it is a regulated activity (for which a permit is required) for an installation to capture carbon dioxide from other regulated activities carried out at that installation as well as at other installations and that an industrial installation that installs a capture plant is not disqualified from receiving free allocation.
- 7.7 *Amending the electricity generator definition to only consider electricity exports in the baseline period*: Installations are currently classified as “electricity generators” under the UK ETS if they have produced electricity for sale since 2005 and if their only regulated activity is the combustion of fuels. Electricity generators are not eligible for free allocation, except in relation to measurable heat produced by means of high efficiency cogeneration (as defined) or exported for the purpose of district heating. If an installation is classified as an electricity generator, operators do not currently have a way of modifying the classification. Changes in circumstance or industrial processes, such as putting a stop to the exporting of electricity, do not change the electricity generator classification. Furthermore, the amount of exported electricity is not currently a factor in the classification as an electricity generator, and installations may be classified as such for very minimal electricity exports.

- 7.8 For the next allocation period, we are proposing to amend the electricity generator definition to consider electricity exports in the baseline period only (i.e., 2019-2023), rather than all electricity exports since 2005. The classification as an electricity generator will therefore be tied to recent activity, rather than all exports since 2005. This will also allow operators to change their classification as an electricity generator if they have put a stop to the export of electricity.
- 7.9 Under this proposal, there is limited opportunity for operators to change their electricity generator classification for the next allocation period, as the baseline period is already underway. As such, we are proposing that operators that can evidence they will no longer produce electricity for sale will not be treated as electricity generators, even if they exported some electricity in the baseline period.
- 7.10 We also acknowledge that there are scenarios in which the sale of electricity is not the primary purpose of generation. This could lead to very small electricity exports classifying an operator as an electricity generator. We are proposing that electricity exports representing no more than 5% of the total produced will also be excluded from consideration.
- 7.11 *Combined Heat and Power (CHP) plants and electricity generator definition:* Some operators have on-site CHP (Combined Heat and Power) plants to generate heat and power for their industrial activity. These operators may export the excess electricity that is generated to the grid, which can lead to the whole installation (the part related to the industrial activity and the CHP) being classified as an electricity generator if their only regulated activity is the combustion of fuels, as per the current electricity generator definition.
- 7.12 We are proposing to effect a change to the electricity generator classification to exclude installations that have produced electricity for sale, if that electricity was produced by means of a CHPQA (CHP Quality Assurance)-certified plant, operating as part of an operator's industrial activity.
- 7.13 This will mean that operators who have invested in on-site CHPQA-certified plants for their industrial activity, and export excess electricity to the grid, will not have their whole installation classified as an electricity generator. This will provide further encouragement for operators to achieve improved efficiency by achieving CHPQA certification and is consistent with UK Government support of good-quality CHP. The CHPQA scheme, an annual assessment process, ensures that all CHP plants that benefit from government support meet a minimum level of energy efficiency.
- 7.14 *Electricity generator operational amendment:* As stated above, electricity generators are not eligible for free allocation, except in relation to measurable heat produced by means of high efficiency cogeneration over the relevant period or exported for the purpose of district heating. But only electricity generators who can demonstrate that they have produced measurable heat by means of high-efficiency cogeneration over a historic period are currently eligible for free allocation. There is no way for electricity generators to receive free allowances during an allocation period if they can subsequently demonstrate that they meet the eligibility criteria.
- 7.15 We are proposing to allow electricity generators who have not produced measurable heat by means of high-efficiency cogeneration at the date of the application, but start to do so in following scheme years, to be eligible for free allowances once they can demonstrate that they meet the high-efficiency cogeneration eligibility criteria.

Explanations

What did any law do before the changes to be made by this instrument?

- 7.16 Currently, existing legislation does not provide for the amendments referred to in sections 7.3-7.15 of this explanatory memorandum. The provisions in this instrument make minor amendments and additions to existing elements of the scheme.

Why is it being changed?

- 7.17 As a result of feedback from the public consultation the UK ETS Authority are proposing amendments which will support businesses and effective scheme operation. In addition, UK ETS delivery partners identified a list of technical amendments and clarifications needed to support effective operation. This has led to a package of issues included in this instrument and the other legislation referred to in section 6.6. The need to amend these provisions is laid out in sections 7.3-7.15 above.

What will it now do?

- 7.18 The instrument will make changes to a broad range of operational scheme aspects and will amend the 2020 Order and other UK ETS legislation to reflect the policies outlined in sections 7.3 to 7.15.

8. European Union Withdrawal and Future Relationship

- 8.1 This instrument is not being made under the European Union (Withdrawal) Act 2018 but relates 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.

9. Consolidation

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

10. Consultation outcome

- 10.1 Between 25 March 2022 and 17 June 2022, the UK Government, Scottish Government, Welsh Government and Department for Agriculture Environment, and Rural Affairs, Northern Ireland (DAERA), ran a public consultation on a package of proposals to develop the UK ETS, including much of the policy content of this instrument referred to in sections 7.3 to 7.15.
- 10.2 Alongside the consultation, the advice of the Committee on Climate Change (CCC) on the policy proposals in this instrument was sought. The CCC reviewed the policy content of these proposals and only had clarification questions and no further comments.
- 10.3 The consultation received responses from over 300 organisations, representing a wide range of stakeholders from a variety of sectors, such as the energy, industrial and aviation sectors, as well as Non-Government Organisations (NGOs), Think Tanks, Local Authorities, trade associations, academia and advocacy groups.
- 10.4 The policy represented by the amendment referred to in sections 7.5 to 7.6 above were not consulted on as part of the Developing the UK ETS consultation. The Department takes the view that the policy represented by these amendments, being the clarification of inconsistencies in the legislation which are counter to the Department's policy are within the scope of the consultations previously carried out

(including previous advice from the CCC) and is covered by the Government Responses to those consultations. Nevertheless, the scheme regulators and the CCC were separately consulted. Neither exercise raised substantive concern or observation that had a material impact on the proposal.

10.5 The Main UK ETS Authority Response to the consultation was published on 3 July 2023.

10.6 Full details of the consultation and response can be found at:
<https://www.gov.uk/government/consultations/developing-the-uk-emissions-trading-scheme-uk-ets>

11. Guidance

11.1 UK ETS guidance has been published and is available at:
<https://www.gov.uk/government/publications/participating-in-the-uk-ets/participating-in-the-uk-ets>. Guidance will be updated regularly, and updates will take account of relevant changes to legislation as necessary.

12. Impact

12.1 The impacts on business, charities or voluntary bodies of the provision relating to the aviation FA cap and the changes to definitions are outlined in the Impact Assessment. This was published alongside the Main UK ETS Authority Response to the Developing the UK ETS Consultation, in which the UK ETS Authority announced the changes to the UK ETS made in this legislation.

12.2 The other amendments are not covered in the Impact Assessment as they are technical amendments with no substantial direct impacts to be assessed. These include the CCS provision (of which the impact is currently 0) and the “electricity generator operational amendment”.

12.3 A June 2020 regulatory impact assessment of the effect of the UK ETS on the costs of business, the voluntary sector and the public sector is available from the Industrial Decarbonisation and Emissions Trading Directorate, Department for Energy Security and Net Zero, 3-8 Whitehall Place, London SW1A 2EG and is available alongside the 2020 Order on www.legislation.gov.uk.

12.4 There is no, or no significant, impact on the public sector.

12.5 The full Impact Assessment is submitted with this memorandum and published alongside the explanatory memorandum on the legislation.gov.uk website.

13. Regulating small business

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

13.2 To minimise the impact of the requirements of the UK ETS on small businesses, operators with relatively low levels of emissions are either not caught by the scheme or participate in the Hospital and Small Emitter or Ultra Small Emitter schemes.

14. Monitoring & review

14.1 Article 17 of the 2020 Order requires the UK ETS authority to review the operation of the UK ETS (including the measures introduced by this instrument) in 2023 and in 2028. The UK ETS Authority must subsequently publish a report setting out the conclusions of the review.

14.2 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.

15. Contact

15.1 Samuel West at the Department for Energy Security and Net Zero (Telephone: 07720158592 or Email: samuel.west2@energysecurity.gov.uk) can be contacted with any queries regarding the instrument.

15.2 Seamus Gallagher, Deputy Director for UK ETS Operations and Delivery, at the Department for Energy Security and Net Zero can confirm that this explanatory memorandum meets the required standard.

15.3 Lord Callanan, Minister for Energy Efficiency and Green Finance, at the Department for Energy Security and Net Zero can confirm that this explanatory memorandum meets the required standard.