

**EXPLANATORY MEMORANDUM TO**

**THE GREENHOUSE GAS EMISSIONS TRADING SCHEME ORDER 2020**

**2020 No. XXXX**

**1. Introduction**

This explanatory memorandum has been prepared by the Department for Business, Energy and Industrial Strategy (BEIS) 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**

The purpose of this Order is to establish a UK-wide greenhouse gas emissions trading scheme (ETS), to encourage cost-effective emissions reductions which will contribute to the UK's emissions reduction targets and net zero goal. Policy positions for a UK ETS which is operational from 1<sup>st</sup> January 2021 have been agreed by the four Governments of the UK nations, and are set out in the Government Response to the Future of Carbon Pricing consultation, which was published on 1<sup>st</sup> June 2020. This is a policy replacement for the UK's participation in the EU Emissions Trading System, which will cease at the end of the Transition Period on 31<sup>st</sup> December 2020 (subject to the UK's obligations in the Withdrawal Agreement pursuant to Article 96(2) in respect of 2020 compliance and the Protocol on Ireland/Northern Ireland). This would also allow for the possibility and consideration of a link between a UK ETS and the EU ETS, if it suited both sides' interests, in line with the UK Government's document on a future relationship with the EU.

**3. Matters of special interest to Parliament**

*Matters of special interest to the Joint Committee on Statutory Instruments*

This Order in Council, laid under the Climate Change Act (2008), is part of a legislative package which is required to deliver a UK-wide emissions trading scheme to replace the EU ETS by the end of the Transition Period. This Order will come into force on the day after the Order is made. We have had regard to paragraph 3.12.10 of Statutory Instrument Practice in relation to this. The Order does not impose duties that are significantly more onerous than those imposed by the EU ETS or require participants in the UK ETS to adopt significantly different patterns of behaviour. Any requirements on UK ETS participants will only take effect from 1<sup>st</sup> January 2021 (the beginning of the UK ETS's first trading period), rather than from the day the Order comes into force. However, commencement of the Order the day after it is made is required in particular to allow regulators to prepare for the transition from the EU ETS to the UK ETS at the beginning of next year.

To maintain continuity with the EU ETS and facilitate possible linking, this Order relies on two related pieces of EU legislation made in 2018 for technical rules on how the emissions of operators and aircraft operators should be monitored, reported on and verified (see articles 24 and 25). A slightly different approach is taken to the two pieces of legislation, which the drafting refers to as the Monitoring and Reporting Regulation 2018 and the Verification Regulation 2018. Owing to when the Verification Regulation 2018 came into force, it will be retained EU law (as defined in the European Union (Withdrawal)

Act 2018); the Monitoring and Reporting Regulation 2018 will not. Consequently, we are able to amend a retained version of the Verification Regulation 2018 but the Monitoring and Reporting Regulation 2018 is applied by article 24 with modifications to ensure that it works with the UK ETS and that the provisions we are incorporating by reference are within our powers.

*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)*

The territorial application of this instrument is UK-wide.

The powers under which this instrument is made cover the entire United Kingdom (see Section 99 of the CCA 2008) and the territorial application of this instrument is not limited either by the Act or the instrument.

#### **4. Extent and Territorial Application**

The territorial extent of this instrument is England, Wales, Scotland and Northern Ireland.

The territorial application of this instrument is England, Wales, Scotland and Northern Ireland.

#### **5. European Convention on Human Rights**

The Rt Honourable Kwasi Kwarteng has made the following statement regarding Human Rights:

“In my view the provisions of the Greenhouse Gas Emissions Trading Scheme Order 2020 are compatible with the Convention Rights.”

#### **6. Legislative Context**

The power to make an instrument to put in place a trading scheme relating to greenhouse gas emissions is at Section 44 of the CCA. That power is exercisable by “The relevant national authority” (the Secretary of State, the Scottish Ministers, Welsh Ministers, the Department of Agriculture, Environment and Rural Affairs in Northern Ireland).<sup>1</sup>

The statutory procedure for putting in place a UK-wide trading scheme is set out in Part 3 of Schedule 3 to the CCA. Such a scheme must be established by Order in Council. Pursuant to paragraph 11 of Schedule 3, before a recommendation may be made to Her Majesty in Council to make the Order in Council, a draft of the instrument containing the Order in Council must be laid before, and approved by, a resolution of each House of Parliament and the devolved legislatures.

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<sup>1</sup> The definition of relevant national authority is set out at section 47 of the CCA 2008.

- The Scottish Ministers are the relevant national authority in relation to matters within the legislative competence of the Scottish Parliament.
- The Welsh Ministers are the relevant national authority in relation to matters that—
  - (a) are within the legislative competence of the National Assembly for Wales, or
  - (b) relate to limiting or encouraging the limitation of activities in Wales that consist of the emission of greenhouse gas, other than activities in connection with offshore oil and gas exploration and exploitation.
- The Secretary of State or the relevant Northern Ireland department is the relevant authority in relation to reserved matters within the meaning of the Northern Ireland Act 1998
- The relevant Northern Ireland department is the relevant authority in relation to all other matters within the legislative competence of the Northern Ireland Assembly.
- The Secretary of State is the relevant national authority in relation to all other matters.

In addition to this Order, secondary legislation will be introduced under a power in the Finance Act 2020 to establish rules for the auctioning of emissions allowances and mechanisms to support market stability.<sup>2</sup> A further, negative procedure instrument under the Climate Change Act (CCA) will amend this Order, as summarised at 6.5.

This Affirmative procedure Order will set up a UK-wide ETS which will be operational from 1<sup>st</sup> January 2021. Key provisions included in this instrument cover 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.

Additional elements of UK ETS will be introduced through a second, negative procedure instrument, due to be laid in Parliament before the end of the Transition Period. This will amend the affirmative procedure instrument once made to include provisions for free allocation and the UK ETS registry. Free Allocation constitutes free allowances given to UK ETS participants most at risk of carbon leakage,<sup>3</sup> aiming to maintain the competitiveness of certain covered sectors and support the transition of UK industries towards a low-carbon economy. The approach to free allocation policy in a UK ETS is largely in line with the approach to free allocation under Phase IV of the EU ETS. UK businesses should, therefore, be familiar with the free allocation policy to be established in legislation before the end of the Transition Period, helping to ensure a smooth transition to the UK ETS. Registry provisions will establish rules for the operation of the UK registry, where UK ETS emissions allowances are held in registry accounts.

In line with Section 48(3) of the CCA, the instrument which introduces the provisions outlined above will be subject to the negative procedure.

This legislative package has been 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. The introduction of Free Allocation and Registry provisions through legislation later in 2020 ensures sufficient time for policy finalisation and input from key delivery partners.

The UK Government is open to considering a link between a future UK ETS and the EU ETS, if such a linking agreement<sup>[1]</sup> is in both sides' interests, and recognises both parties as sovereign equals with our own domestic laws. A link between the UK and EU trading schemes 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, by ensuring UK ETS legislation is delivered before the end of the Transition Period.

Further secondary legislation would be required to operationalise any linking agreement secured through negotiations with the EU. We would expect to lay any such legislation in the first half of 2021.

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<sup>2</sup> Schedule 2, paragraph 5(4) of the CCA specifically prohibits regulations made under the CCA to provide for allowances to be allocated in return for consideration

<sup>3</sup> Carbon leakage occurs when businesses transfer production to other countries with less stringent emissions constraints

## 7. Policy background

### *What is being done and why?*

At the end of the Transition Period (on 31<sup>st</sup> December 2020), the UK will cease to participate in the EU ETS, subject to its obligations in the Withdrawal Agreement pursuant to Article 96(2) in respect of 2020 compliance and the Protocol on Ireland/Northern Ireland. A replacement carbon pricing policy is required to stimulate emissions reduction from large emitters within the industrial, power and aviation sectors currently participating in the EU ETS.

Climate policy, and therefore establishing a UK Emissions Trading scheme under the CCA, falls within devolved competence. The development of a UK ETS is one of several policy areas across Government in which a Common Framework is being developed, to establish common approaches to devolved policy areas and agree how the UK Government and Devolved Administrations will jointly manage these policy areas going forward. We have worked closely with the Devolved Administrations (as well as Her Majesty's Treasury and Department for Transport) on developing UK ETS policy and legislation; the DAs will be laying this instrument in the Devolved Parliaments.

Through the Parent Act (the CCA), the UK became the first country to set legally binding carbon budgets, introducing limits on the amount of greenhouse gases the UK can emit over a five-year period. The Act was amended in 2019 to recognise the UK's target of net zero greenhouse gas emissions by 2050. The EU ETS covers around 33% of UK emissions, and therefore this policy area is an important part of the UK's efforts to achieve its net zero target and tackle climate change.

The UK has long been an advocate of carbon pricing internationally. The UK established Europe's first emissions trading scheme in 2002, which served as a pilot for the EU Emissions Trading System (EU ETS), and established London as a global centre of carbon trading. On leaving the EU, the UK Government and the Devolved Administrations remain committed to carbon pricing as an effective emissions reduction tool. Placing a price on carbon creates the incentive for emissions to be reduced in a cost effective and technology-neutral way, whilst mobilising the private sector to invest in emissions reduction technologies and measures.

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 by installations and aircraft covered by the scheme. Within the cap, participants receive or buy emission allowances which they can trade with one another as needed. This cap is reduced over time, so that total emissions fall.

This instrument establishes a UK-wide ETS, covering the following key areas:

- The scope of the UK ETS includes energy intensive industries, the electricity generation sector and aviation. This means that a UK ETS applies to greenhouse gas emitting processes in sectors like refining, heavy industry and manufacturing.

There are two levels of derogation from the main scheme, based on those in the EU ETS. Broadly, the first of these covers, hospitals or installations that emit less than 25,000 tonnes of carbon dioxide (or its equivalent for other greenhouse gases) each year and have a thermal input, if applicable, less than 35MW; the second, installations that emit less than 2,500 tonnes of carbon dioxide (or its equivalent for other greenhouse gases) each year. Installations

in the first category are still required to continue to decrease their emissions through a system of emissions targets. Installations in both categories can be subjected to a change of status if their circumstances change.

- The proposed aviation scope for a UK ETS covers UK domestic flights, flights between the UK and Gibraltar, and flights from the UK to the EEA. Any aircraft operator that meets the thresholds for inclusion will be obliged to report and surrender allowances for emissions from included flights on these routes. Qualifying aircraft operators will be administered by one of the four national environmental regulators depending on where they are resident or (from 2026) have their highest proportion of emissions, with the Environment Agency as the default regulator for new aircraft operators that do not have a registered office or place of residence in the UK.
- The cap on allowances that are created under the UK ETS each year will initially be set at 5% below the UK's expected notional share of the EU ETS cap for Phase IV of the EU ETS. Based on the proposed design scope, this equates to roughly 156 million allowances in 2021. The initial cap will be reduced annually by a little over 4.2 million allowances, meaning that the UK ETS cap will remain 5% below where we would have expected the UK's notional share of the Phase IV EU ETS cap to be year on year. These cap figures include the aviation scope. As set out in the Government Response, it is the Government's intention that this is a temporary cap. The Government will consult on an appropriate trajectory for the UK ETS cap for the remainder of the first phase within nine months of the Committee on Climate Change publishing its advice on the Sixth Carbon Budget. We aim to appropriately align the cap with a Net Zero trajectory by January 2023, and no later than January 2024, while aiming to give the industry at least one year's notice to provide the market with appropriate forewarning.
- UK ETS participants are subject to a system of Monitoring, Reporting and Verification (MRV) of their emissions, underpinning their compliance and the environmental integrity of the scheme. The rules for EU ETS participants are contained in the Monitoring and Reporting Regulation (MRR) and Accreditation and Verification Regulation (AVR). The rules for UK ETS participants are based on EU ETS requirements; this Order therefore adapts the MRR and AVR regulations to ensure they work in a UK ETS context.
- The UK ETS sets up a robust and proportionate enforcement system. The enforcement of UK ETS rules will be carried out by the relevant environmental regulators, whilst BEIS is responsible for enforcing compliance for offshore installations via the Offshore Petroleum Regulator for Environment and Decommissioning (OPRED). Regulators have the power to serve enforcement notices on participants who have contravened, are contravening or are likely to contravene provisions in the legislation. We ensure penalties remain effective, dissuasive and proportionate.
- Where UK participants are aggrieved by decisions determining any applications made them under regulations, they have legal routes to appeal against these decisions. (Appeal bodies are different for appeals against decisions of regulators in the four nations of the UK.)

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

This instrument is being made under powers in the CCA.

This legislation introduces a policy replacement for the UK's participation in the EU ETS. The UK will cease to participate in the EU ETS at the end of the Transition Period (from 1<sup>st</sup> January 2021), as a direct consequence of the UK's withdrawal from the EU.

## **9. Consolidation**

This legislation sets up a UK ETS and does not amend previous legislation. As there is no previous UK ETS legislation, there is no option to consolidate this legislation at present.

## **10. Consultation outcome**

Between 2<sup>nd</sup> May 2019 and 12<sup>th</sup> 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.

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. 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 1<sup>st</sup> June 2020.

Full details of the consultation 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 scheme on 1<sup>st</sup> 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 negative procedure Order to be laid under the CCA before the end of the Transition Period.

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 1<sup>st</sup> 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 derogations (see above).

### **14. Monitoring & review**

This Order commits the UK Government (and Devolved Administrations) to reviewing the operation of the measures introduced by this Order in 2023 and in 2028. The UK Government and Devolved Administrations must subsequently jointly 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](mailto: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.