THE UK EMISSIONS TRADING SCHEME

A SCHEME FOR THE POST-BREXIT ERA

The UK emissions trading scheme (UK ETS) became operational on 1 January 2021. Its primary purpose is to provide continuity for greenhouse gas (GHG) pricing in the UK as a replacement for the equivalent obligations faced by compliance entities under the EU emissions trading scheme (EU ETS) prior to the end of the Brexit transition period.

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What you most need to know about this

The UK ETS largely works in a similar way to the EU ETS. The UK's stated ambition is for the UK ETS to be linked to the EU ETS as soon as possible. The UK Government is facing increased industry pressure to link the two schemes because in leaving the EU ETS, the UK is exiting the world's largest carbon trading market. The industry has long argued that a standalone UK ETS is unable to deliver a sufficient level of liquidity for market participants to hedge their costs efficiently and will ultimately be translated into higher consumer prices.[1] However, until such linkage occurs, UK entities that had EU ETS obligations prior to 31 December 2020 will have to comply with those obligations until the end of the Phase 3 compliance deadline of 30 April 2021[2], whilst in the meantime incurring UK ETS obligations from the start of 2021.

1 EFET Press Statement 12 October 2020

2 The UK left the EU on 31 January 2020. During the transition period, which ended on 31 December 2020, the UK continued to participate in the EU's Emissions Trading System (ETS) and remains a full participant in respect of the 2020 compliance year

Critical Commentary

With the UK's stated objective to maintain continuity with the EU ETS and facilitate possible linking, it is no surprise that there are very few differences in the scope, coverage and processes of the UK ETS compared to the EU ETS. The timing around linkage is unclear as this appears to be as much a political question as a practical/technical one. Ironically, the UK is leaving a trading system it helped design and build, and the recent regulatory developments explored in this article shows that the risk of regulatory divergence increases as time passes, making it harder to link the two systems.

Linkage is most likely to be under Article 25 of the EU ETS Directive[3] which was first used by the EU to link the EU ETS to the Swiss emissions trading scheme (**Swiss ETS**)[4]. The lengthy negotiation period needed to link the Swiss ETS to the EU ETS should not apply in the context of the UK ETS because of the similarities and familiarity between the two systems. That said, the minimum number of legislative steps required by both the UK and the EU, along with resolving any technical linking requirements, would suggest that such linkage is unlikely to be in place before the end of 2021. Related questions, such as, 'would linking with the EU ETS mean indirect linking between the UK ETS and Swiss ETS' would need to be considered at both a policy and legislative level.

For UK compliance entities and UK market intermediaries looking to trade UK ETS allowances (UKAs), the processes required under The Greenhouse Gas Emissions Trading Scheme Order 2020[5] (the UK ETS Order) should nonetheless start in earnest. This is because even if the UK ETS is linked to the EU ETS, it will remain a distinct and separate scheme. As such, local requirements such as needing GHG permits, UK registry accounts and using United Kingdom Accreditation Service (UKAS) accredited verifiers for verification of monitored emissions date, will still have to be carried out by UK compliance entities.

Practicalities and Next Steps

1. **Complying with any remaining EU ETS obligations:** For any UK operators of stationary installations and the 150 or so UK-administered aircraft operators (together **UK Compliance Entities**), their most immediate focus should be on complying with any remaining EU ETS obligations.

3 Directive 2003/87/EC as amended from time to time.

4 After a number of years of negotiation, the EU and Switzerland signed an agreement in 2017 to link their systems. This agreement entered into force on 1 January 2020.

5 SI 2020/1265.

There are two deadlines to meet. Operators must submit verified annual emissions reports for 2020 by **31 March 2021** and allowances for 2020 emission must be surrendered by **30 April 2021**. UK-accredited verifiers are able to verify EU ETS emissions for UK operators (but not EU operators) in respect of their 2020 compliance year. UK-accredited verifiers will continue to have access to their accounts in the Union Registry until 30 April 2021.

2. **Managing Union Registry Account access:** With access to UK administered accounts in the Union Registry being impacted by Brexit, it is necessary for alternative arrangements to have been made by account holders. Non-compliance entities (e.g. UK market intermediaries) lost access to 'Trading Accounts', 'Person Holding Accounts', and former 'Operator Holding Accounts' from 1 January 2021.

   The EU-UK Withdrawal Agreement[6] ensures access to UK-administered 'Operator Accounts' in the Union Registry to facilitate compliance with 2020 EU ETS obligations. However, access to such accounts may no longer be possible after 30 April 2021. So any operator wishing to continue to hold EU allowances (**EUAs**) after 30 April 2021 should move such EUAs to an account in the Union Registry administered by a Member State.

3. **Immediate steps under the UK ETS:** UK Compliance Entities are required to:
   - Apply for a GHG emissions permit (Article 26 of the UK ETS Order).
   - Surrender allowances as required by the GHG emissions permit in each scheme year (Article 27 of the UK ETS Order).
   - Open an 'Operator Holding Account' (**OHA**), or an 'Aircraft Operator Holding Account' (**AOHA**) at the UK ETS registry. The account opening process can take up to 2 months.
   - For aircraft operators administered by the UK with EU ETS obligations in 2021, deal with their new EU administering Member State once the EU Commission publishes the new attribution list of aircraft operators.

4. **Immediate steps for market intermediaries:** Traders may open an account in the UK Registry to participate in the UKA trading market.[7]

6 Article 96(2) of the UK-EU Withdrawal Agreement

7 The UK Registry will also be the UK registry for the purposes of the Kyoto Protocol and therefore may be used for the purposes of holding Kyoto Units such as certified emission reductions (CERs).

What are the key features of the UK ETS?

Broadly, many of the features of the UK ETS are the same as or very similar to the EU ETS.

1. **Scope** - The UK ETS covers energy intensive industries[8] ; the electricity generation sector; and aviation (i.e. the same GHGs and sectors as the EU ETS).
2. **Aviation** – Within the aviation sector, the EU ETS only applied to flights within the European Economic Area (EEA) – the EU Member States, plus Iceland, Liechtenstein and Norway. The UK ETS covers UK domestic flights, flights between the UK and Gibraltar, and flights from the UK to the EEA.[9] Flights from the UK to Switzerland will be included if an agreement on linkage to the EU ETS is reached.
3. **Caps** – Initially, the cap on UK ETS annual allowances will be set at 5% below the UK's expected notional share of the EU ETS cap for Phase IV of the EU ETS (2021–30). This equates to approximately 156 million allowances in 2021. This "5% below" level will be maintained year on year.
4. **Free allocation and benchmarks** – Carbon leakage occurs when businesses transfer production to other countries with less stringent emissions constraints. Those in sectors at higher risk of carbon leakage receive a higher share of free allowances, based on a formula where production quantity (in tonnes of a product) is multiplied by a benchmark value for that product (measured in emissions per tonne of product). To mitigate carbon leakage, a proportion of allowances will be allocated for free.[10] The overall approach to free allocation and how it is determined will remain largely the same in the UK ETS as in Phase 4 of the EU ETS:
   - UK Compliance Entities who applied for free allocation for the 2021-2025 allocation period under the EU ETS do not have to resubmit an application under the UK ETS.
   - The UK ETS will use the benchmark values for Phase 4 of the EU ETS (2021-2030). Britain's Offshore Petroleum Regulator for Environment & Decommissioning (OPRED) is awaiting publication of these – and also to see whether the EU will apply a cross sectoral correction factor.
   - The UK ETS carbon leakage list will be the same as in the EU ETS.
   - Free allocation will continue to be recalculated each year based on any significant changes to production.
   - The UK ETS free allocation policy for aviation is similar to the EU ETS policy. This is to ensure a smooth transition for aircraft operators which continue to participate in the EU ETS

   The UK Government has said that each business's free allocation for operators' installations will be published in a table – the Allocation Table – "as soon as practicable after 1 January 2021"[11] whereas the UK ETS Aviation Allocation Table (AAT) is likely to be published by 1 June 2021[12]. Other than the aforementioned indications, there are few details as to when the allocation of free allowances will begin.
5. **Auctioning** – The UK Government has signalled its intention to vary the EU auctioning process in the UK ETS. Auctions for the UK ETS are due to commence as soon as is feasible and no later than Q2 2021. ICE Futures Europe will continue to provide the auction platform and secondary market services under the UK ETS until December 2022. The UK ETS will have a transitional £22/tonne Auction Reserve Price (ARP) which establishes a minimum price for which allowances can be sold at auctions. Bids below this price will not be successful at auction. The APR was increased from £15/tonne previously proposed to avoid a significant fall in the UK carbon price. However, the UK Government does not intend to make any further changes to the level of the ARP and it is likely to be withdrawn as the UK ETS matures and the UK aligns the UK ETS cap with a net zero trajectory. There will also be a Cost Containment Mechanism (CCM) which provides a process for the UK Government and Devolved Administrations to address significant price spikes in the market. When compared with the EU ETS, the UK CCM will have lower price and time triggers in the first two years of the UK ETS.

   On 11 February 2021, the UK Government published a draft auctioning regulation.[13] This regulation establishes an oversight role for the FCA in relation to the auctioning of emission allowances, sets rules for access to the ETS auction platform and allows the FCA to monitor and regulate trading of UK emissions allowances. The FCA's role in the new ETS mirrors its role in the UK element of the EU ETS. The regulation has been introduced now so that the regulatory framework for the auctioning and trading of UK emission allowances is in place for the start of auctioning in the UK ETS later this year, in Q2. However, the implementation of this regulation is dependent on the Greenhouse

8 Activities involving combustion of fuels in installations with a total rated thermal input exceeding 20MW (except in installations for the incineration of hazardous or municipal waste) are caught by the scope of the UK ETS.

9 Schedule 1 UK ETS Order 2020

10 Article 18 of the Amending Order inserts a new Part 4A into the UK ETS Order

11 Guidance Participating in the UK ETS (accessed 16.02.2021)

12 Guidance UK Emissions Trading Scheme (UK ETS): apply for free allocation (accessed 16.02.2021)

13 The Recognised Auction Platforms (Amendments and Miscellaneous Provisions) Regulations 2021

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Gas Emissions Trading Scheme Auctioning Regulation 2021 and there is no clear indication as to when auctioning will actually start. This has led to UK market participants continuing to buy EU allowances.

6. **Derogations** – The EU operates two levels of derogations from the main ETS scheme. These are, broadly:
   - hospitals and small emitters[14];
   - ultra-small emitters [15]

   Under the UK ETS, there are simplified provisions for level (a) installations, which will be subject to emissions targets instead of trading allowances. Separate simplified provisions are available to level (b) installations.
7. **Monitoring and Reporting** – ETS participants are subject to a system of monitoring, reporting and verification of their emissions, to ensure 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 versions of the MRR and AVR, adapted to ensure they work in a UK context. In addition and somewhat unexpectedly, the original rather than the amended version of the MRR is used in the UK ETS.
8. **Banking and borrowing allowances** – The UK Government intends to mirror the EU ETS rules on banking and borrowing allowances.
9. **Northern Ireland carve-out** – The UK ETS Order extends to England, Wales, Scotland and Northern Ireland but the Ireland/ Northern Ireland protocol requires continued participation in the EU ETS for installations in Northern Ireland that generate electricity for the single wholesale electricity market in Ireland and Northern Ireland.[16]
10. **Enforcement** – The enforcement of UK ETS rules will be carried out by the relevant environmental regulators. BEIS is responsible for enforcing compliance with offshore installations via the Offshore Petroleum Regulator for Environmental and Decommissioning (OPRED).

14 Installations that emit less than 25,000t CO2 or its equivalent for other greenhouse gases (CO2e) each year and have a thermal input, if applicable, less than 35MW

15 Installations that emit less than 2,500t CO2e.

16 Annex 4 to the Northern Ireland protocol

Further developments

The UK ETS Order will be supplemented in due course by secondary legislation to establish rules for auctioning or emissions allowances and mechanisms to support market stability.

The UK ETS Authority and its regulators are expected to release "How to Comply" guidance in early 2021. One piece of guidance, for aircraft operators, was published on 17 December 2020.

Conclusions

Despite the fact that the UK ETS is currently designed with the aim of compatibility with the EU ETS, there are bound to be areas of divergence. For example, the UK Government has said it will consider expanding the scope of the UK ETS to include other sectors. The current, temporary cap is expected to be changed to align with the UK's Net Zero trajectory by January 2023, and no later than January 2024. This may cause further divergence from the EU cap.

There will be an initial review of the UK ETS during the first half of Phase 1 (2021-25) and any necessary changes to the scheme's design will be implemented by 2026. A second review from 2028 onwards will assess Phase 1.[17] The UK Government is currently reviewing the policy for benchmarking in the 2026-30 allocation period and is consulting on how it will implement the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) alongside the UK ETS. Secondary legislation to implement the offsetting requirements will come into force by April 2022. Whether the UK wishes to follow the EU's approach of including shipping within the EU ETS remains to be seen.[18]

In short, there are many changes yet to come in respect of the UK ETS.

17 Article 17 of the UK ETS Order

18 See https://www.hfw.com/Inclusion-of-shipping-in-the-EU-Emissions-Trading-System-current-landscape-perspective-and-potential-impact

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