EXPLANATORY MEMORANDUM TO

THE GREENHOUSE GAS EMISSIONS TRADING SCHEME AUCTIONING REGULATIONS 2021

2021 No. 484

1. Introduction

This explanatory memorandum has been prepared by HM Treasury (HMT) and is laid before the House of Commons by Command of Her Majesty.

2. Purpose of the instrument

This instrument makes provision for the auctioning of emissions allowances to emit 1 tonne of carbon dioxide equivalent under the UK Emissions Trading Scheme (the "UK ETS") and introduces mechanisms to support market stability in this new scheme. The UK ETS was established by the Greenhouse Gas Emissions Trading Scheme Order 2020 (the GGETS 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 Select Committee on Statutory Instruments

None.

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 96 of the Finance Act 2020) 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.

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5. European Convention on Human Rights

The Exchequer Secretary to the Treasury (Kemi Badenoch) has made the following statement regarding Human Rights:

> "In my view the provisions of The Greenhouse Gas Emissions Trading Scheme Auctioning Regulations 2021 are compatible with the Convention Rights."

6. Legislative Context

These Regulations are the first made under the power in section 96 of the Finance Act 2020 to make regulations on the allocation of emissions allowances in exchange for payment.

They set out the rules for auctioning emission allowances created under the GGETS Order.

The GGETS Order was made under the Climate Change Act 2008 on 11th November 2020. The instrument set up a UK-wide Emissions Trading Scheme to be operational from 1st January 2021, which replaces the EU Emissions Trading System. The GGETS Order regulates the emission of greenhouse gases in the United Kingdom, and permits the creation of allowances to emit one tonne of carbon dioxide equivalent. The instrument also sets a cap on the number of allowances which may be created in any scheme year. These Regulations provide for the auctioning of allowances created under the GGETS Order, making equivalent provision in relation to these allowances to that made by Commission Regulation (EU) No 1031/2010 on the timing, administration and other aspects of auctioning of greenhouse gas allowances pursuant to Directive 2003/87/EC (which established the EU Emission Trading Scheme) in relation to EU emission allowances.

These regulations are laid alongside the Recognised Auction Platforms (Amendment and Miscellaneous Provisions) Regulations 2021. That instrument creates an oversight role for the Financial Conduct Authority (FCA) in the UK ETS and emission allowance market.

UK ETS legislation comprises:

- The Greenhouse Gas Emissions Trading Scheme Order 2020: https://www.legislation.gov.uk/ukdsi/2020/9780348209761/contents

  This affirmative procedure Order in Council under the CCA was made at the Privy Council meeting on 11th November. It set up a UK-wide ETS which has been operational since 1st January 2021. Key provisions included in this instrument cover the scope of the system, monitoring and reporting requirements, the cap and trajectory and the roles of the regulators in monitoring and enforcing the rules of the system.
- The Greenhouse Gas Emissions Trading Scheme Order (Amendment) 2020: https://www.legislation.gov.uk/uksi/2020/1557/contents/made

  This negative procedure Order in Council under the CCA was made at the Privy Council meeting on 16th December. It amended the affirmative procedure instrument to include provisions for free allocation and the UK ETS registry.
- The Finance Act 2020: https://www.legislation.gov.uk/ukpga/2020/14/contents/enacted

  The Finance Act 2020 included a charge which provided for the UK Government to charge participants for emissions allowances at auction.
- The Recognised Auction Platforms (Amendment and Miscellaneous Provisions) Regulations 2021 Affirmative Statutory Instrument:

  This uses the ‘deficiency fixing’ onshoring power in section 8 of the European Union (Withdrawal) Act 2018 to make changes to financial services legislation to reflect that there will be a UK ETS. It establishes a market and auction oversight role for the FCA in the UK ETS and establishes UK emissions allowances as ‘financial instruments’, ensuring they are subject to the correct regulatory treatment.

- The Market Abuse (Amendment) (EU Exit) Regulations 2019, which addressed deficiencies in retained EU law in relation to market abuse, kept provisions in relation to the secondary market trading of EU emission allowances under the EU Emission Trading Scheme. The Securities Financing Transactions, Securitisation, and Miscellaneous Amendments (EU Exit) Regulations 2020 removed some of the changes initially included in The Market Abuse (Amendment) (EU Exit) Regulations 2019 (prior to their taking effect) to facilitate the final changes to UK MAR being made in this instrument to include the UK ETS.

While this instrument is reserved, the UK ETS is one of several 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 manage these policy areas going forward.

7. Policy background

What is being done and why?

At the end of the Transition Period on 31st December 2020, the UK ceased 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 UK ETS, operational from 1st January 2021, was introduced through the GGETS Order as a replacement carbon pricing policy to stimulate emissions reduction from large emitters within the industrial, power and aviation sectors that previously participated in the EU ETS. Under the Northern Ireland Protocol, power sector emitters in Northern Ireland are excluded and continue to be covered by the EU ETS.

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 provides the rules covering auctions and secondary markets for emissions allowances, covering the following key areas:

- Part 1 contains the interpretation provisions.
- Part 2 provides for the products to be auctioned, and sets out how bids are to be submitted and withdrawn. It also provides for how the auction clearing price is to be determined. In UK ETS auctions, there will be an Auction Reserve Price (ARP) below which bids will not be accepted. As stated in the UK Government and Devolved Administrations' response to *The future of UK carbon pricing consultation*, 'there remains a risk that prices in a standalone UK ETS could be very low in the early years. Low prices will undermine our climate ambition, confidence in the market and remove the investment signal necessary to drive innovation in low carbon technologies.'
- Auctions can clear, with allowances being sold to bidders, without the successful bidding of all allowances. If required, remaining allowances can be redistributed to the subsequent four auctions up to a limit of 125% of their original volume. Above this limit, allowances will transfer into the market stability mechanism account. This allows for a smoother flow of allowances from auctions into the wider market promoting market liquidity. It also

provides a route for allowances to be removed from auctions if volumes become significantly higher than originally designed. This protects against the risk of an overload of allowances at auction and of the impacts of repeated low auction demand.

- The rate of the ARP will be set out in secondary legislation pursuant to this Part. The Government is making a one-off technical adjustment to the transitional ARP that was originally set out in the June 2020 response to *The future of UK carbon pricing* consultation from the UK Government and Devolved Administrations (the Response). The rate will now be set at £22 when auctioning starts no later than Q2 2021. Making this technical adjustment before the start of auctioning, and before any trading on the auction platform secondary market has taken place, reduces the risk of government interference in a market-determined price (as opposed to making a change once auctions/trading has started and a market-determined price found).
- In the Response it was explained that a 'transitional ARP' is, in part, intended to 'minimise the potential for a significant fall in the UK carbon price in a transition [from the EU ETS] to a standalone UK ETS.'
- As the UK left the EU ETS on 31 December 2020, the price of an EU ETS allowance was £29.43, while the rounded average EU ETS price over 2020 was £22. Adjusting the ARP to £22 mitigates the risk of a significant fall in the UK carbon price which could undermine confidence in the new UK scheme.
- The Government does not intend to make any further changes to the level of the transitional ARP before it is likely withdrawn as the UK ETS matures. We will consult on how we intend to withdraw the ARP as part of the planned consultation to appropriately align the UK ETS cap with a net zero trajectory which will be launched later this year. More broadly, the Government does not intend to make any further changes to other aspects of the UK ETS unless as part of our existing commitments (such as the planned ETS consultation just mentioned).
- Part 3 makes provision for the auction calendar and when that calendar may be adjusted. This includes in response to auctions that partially clear, auctions that cancel, and amendments to free allocation quantities during a given year. It sets out what happens to the volume of allowances at cancelled auctions and what volume of allowances is to be auctioned annually. This provides clarity for participants on the number of allowances to be auctioned and the limited ways in which the distribution of auctioned allowances across a calendar year can be amended.
- Part 3 also provides for a cost containment mechanism, enabling the Treasury to amend the distribution or volume of allowances to be auctioned in any one year if the carbon price exceeds specified limits. These limits are relative to historic carbon prices. This mechanism guards against sustained high price extremes in the UK ETS, providing an avenue for intervention in limited and specific circumstances. In the first two years of the UK ETS, the cost containment mechanism will be more sensitive than the equivalent mechanism in the EU ETS, allowing intervention more quickly if appropriate.

- If the CCM is triggered, the relevant decision makers will convene a meeting between officials from the UK Government and the Devolved Administrations to consider what intervention, if any, to make. If there is no agreement on what action to take, the final decision will be taken by the Treasury.
- The cost containment mechanism will be triggered if the average price for one allowance on secondary futures markets is more than:
    - During year one, an amount equal to two times the average price in the preceding two year period for three consecutive months;
    - During year two, an amount equal to two and a half times the average price in the preceding two year period for three consecutive months; and
    - During year three, an amount equal to three times the average price in the preceding two year period for six consecutive months.
- If the cost containment mechanism is triggered, the Treasury may authorise:
    - Changes to the distribution of auctioned allowances within a calendar year;
    - Increases to the volume of allowances to be auctioned in a given year by bringing auctioned allowances forward from future years;
    - The release of up to 25% of the allowances held in the New Entrants Reserve for auction in that calendar year; or
    - The release of allowances from the market stability mechanism account for auction in that calendar year.
- As the price triggers for the CCM are a rolling average of previous years' prices, the threshold can change on a daily basis. It is therefore not practical to publish the price level at which the CCM will be triggered.
- Part 4 provides for access to auctions by participants and details the eligibility criteria and process for persons applying to bid in auctions and participate in the auction platform's secondary market. It also details the grounds upon which the appointment auction platform may refuse, revoke or suspend admission to bid in auctions. By providing these in legislation, we are providing certainty for the auction platform and participants about the way in which checks and applications shall take place. Parts 5, 6 and 7 provide for the appointment and functions of the auctioneer and the auction platform, and their appointment requirements. HMT will hold the power to appoint the auctioneer.
- Part 8 obliges the auction platform to report transactions to the Financial Conduct Authority in order to provide appropriate regulatory oversight. Part 9 provides for the payment and transfer of the auction proceeds, delivering Government revenues. Part 10 provides for the delivery of the auctioned allowances into participants' registry accounts. Part 11 provides for the management of collateral.
- Part 12 provides for fees and costs to be charged by the auction platform. Part 13 provides for monitoring of auctions for issues including market abuse, money laundering, terrorist financing or other criminal activity. This ensures sufficient oversight from bodies such as the Financial Conduct Authority and the National Crime Agency. It also provides for remedial measures and sanctions that may be taken by the auction platform.

- Part 14 provides for the publication of auction results and protection of confidential information and Part 15 makes provision for a right of appeal against decisions made by the auction platform in relation to, for example, admissions to bid. It also provides for the correction of errors.

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

This instrument is being made under powers in the Finance Act 2020.

This legislation is part of a legislative package which introduces a policy replacement for the UK's participation in the EU ETS. The UK ceased to participate in the EU ETS at the end of the Transition Period (from 1st January 2021), as a direct consequence of the UK's withdrawal from the EU.

9. Consolidation

This legislation does not amend previous legislation and therefore there is no option to consolidate this legislation at present.

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. 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 auctioning and market stability mechanisms in a standalone UK ETS, which are legislated for in this SI.

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.

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

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

The Energy White Paper was published on 14th December 2020. This paper confirmed that the UK would introduce an ETS to replace our membership of the EU ETS following the end of the Transition Period. It also stated that 'the UK is open to linking the UK ETS internationally in principle and we are considering a range of options, but no decision on our preferred linking partners has yet been made.'

11. Guidance

Guidance for UK ETS auction participants will be published following the laying of this instrument.

12. Impact

The UK ETS will affect businesses in the power, aviation and industry sectors, and this instrument legislates for price control mechanisms in that scheme. The Impact Assessment has considered the impacts on businesses of this scheme in more detail.

Alongside this, the government compensates energy-intensive businesses for up to 75% of the costs in their electricity bills due to the UK ETS and Carbon Price Support (CPS).

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 SI, the GGETS Order and the GGETS Amendment 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 derogations established in the GGETS Order.

14. Monitoring & review

The operation of the auctioning regulations will be reviewed along with other aspects of the UK ETS under Article 17 of the GGETS Order. This article commits the UK Government (and Devolved Administrations) to reviewing the operation of the UK ETS in 2023 and in 2028.

15. Contact

Joseph Spencer, at HM Treasury (joseph.spencer@hmtreasury.gov.uk) can be contacted with any queries regarding the instrument.

Alanna Barber, Deputy Director for the Energy and Transport Tax team can confirm that this Explanatory Memorandum meets the required standard.

Kemi Badenoch, Exchequer Secretary of the Treasury, can confirm that this Explanatory Memorandum meets the required standard.