EXPLANATORY MEMORANDUM FOR EUROPEAN UNION LEGISLATION WITHIN THE SCOPE OF THE UK/EU WITHDRAWAL AGREEMENT AND NORTHERN IRELAND PROTOCOL

10875/21

Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2003/87/EC establishing a system for greenhouse gas emission allowance trading within the Union, Decision (EU) 2015/1814 concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme and Regulation (EU) 2015/757 on the monitoring, reporting and verification of carbon dioxide emissions from maritime transport.

Submitted by Department for Business, Energy and Industrial Strategy (BEIS) on 2 August 21.

SUBJECT MATTER

1. On 14 July the European Commission unveiled its 'Fit for 55' package of energy and climate legislation, as part of its Green Deal roadmap. The package covers twelve new or amended legislative proposals to meet the EU's new Nationally Determined Contribution (NDC) – a commitment to reduce emissions by at least 55% by 2030, based on 1990 levels. As part of this package, the European Commission have proposed to amend the EU Emissions Trading System (ETS) Directive to increase the traded sector's share of emission reductions to 61% by 2030 against 2005 levels, up from the current target of a 43% reduction.

2. The EU ETS works 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 covered by the system. This cap is then reduced over time, so that total emissions fall.[1] Within the cap, participants buy or receive emissions allowances, which they can trade with one another as needed. The limit on the total number of allowances available ensures that they have a value ("carbon price"). Sectors currently covered by the EU ETS include electricity generation; energy-intensive industries; and aviation. Together, the sectors covered by the EU ETS currently account for around 41% of EU emissions. At the end of each reporting year, participants are required to surrender emissions allowances for every tonne of carbon dioxide equivalent (CO_2e) they have emitted, to meet their EU ETS obligations.[2]

3. The Commission have proposed a substantive set of proposals to put the EU ETS on a pathway to deliver a more ambitious EU 2030 emissions reduction target. This

[1] EU ETS, European Commission: https://ec.europa.eu/clima/policies/ets_en
[2] Or CO2 equivalent: the EU ETS also covers Nitrous Oxide (NO2) and Perfluorocarbon emissions (PFC).

will be achieved by amending three EU legislative instruments; the EU ETS Directive, Directive 2003/87/EC, which is an existing EU legislative instrument adopted in 2003; Decision (EU) 2015/1814, which established and operates a market stability reserve for the EU ETS; and Regulation (EU) 2015/757 which establishes the monitoring, reporting and verification (MRV) of carbon dioxide emissions from maritime transport.

Proposals to amend the ETS Directive

4. The Commission's proposals to amend the ETS Directive consist of the following:

Expanding the scope of the EU ETS to maritime transport; and introducing a new separate ETS for emissions from buildings and road transport

5. The scope of the EU ETS is proposed to be expanded to include maritime emissions from 2023. Intra-EEA voyages and 50% of emissions from third-country voyages (including the UK) arriving in and departing from the EEA are proposed to be covered. The Commission have proposed that shipping companies should monitor, report and verify their emissions as per Regulation (EU) 2015/757 of the European Parliament and of the Council.

6. Aviation activities within the European Economic Area (EEA), as well as flights to the UK and Switzerland, will continue to be covered by the EU ETS. In parallel, a separate proposal plans to implement the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) for extra-European flights.[3]

7. Buildings and surface transport emissions are proposed to be addressed through a new, separate ETS to the main system, which is proposed to be fully operational from the start of 2025. The Commission would review the new system by 1 January 2028 and would consider integrating the system into the current EU ETS by 31 October 2031. The Commission have separately proposed a Social Climate Fund to address social impacts of extending emissions trading to buildings and surface transport. The fund is expected to raise €72.2 billion during the period 2025-32.

Increasing climate-related funding measures

8. The Commission have proposed a variety of measures to increase climate-related funding. It is proposed that member states must use 100% of revenue raised from auctioning carbon allowances for climate-related purposes, up from the current requirement to spend at least 50% of auction revenue. The size of the Innovation Fund, which supports innovation in lower carbon technologies and processes, is

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[3] DECISION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2003/87/EC as regards the notification of offsetting in respect of a global market-based measure for aircraft operators based in the Union

proposed to be increased and new projects added to the eligibility criteria, including carbon contracts for difference. 2% of the EU ETS cap is currently used to fund energy transition and power sector decarbonisation (“Modernisation Fund”) in lower income member states. The Commission have proposed to use an additional 2.5% of the EU ETS cap for the Modernisation Fund.

Increasing the environmental ambition of the EU ETS, by setting a more stringent benchmark approach and amending free allocation rules to establish conditionality for free allocation

9. To align the EU ETS with a higher EU 2030 emissions reduction target, the Commission have proposed a one-off reduction of the emissions cap and an increase to the linear reduction factor (annual rate at which the cap reduces) from 2.2% to 4.2%.

10. Under the EU ETS, benchmark values are used to calculate the amount of free allowances issued to participants. These are calculated by ‘product’, based on the average greenhouse gas emissions of the best performing 10% of the installations producing that product in the EU and EEA-EFTA states. To support decarbonisation of energy intensive industries through the deployment of new technologies, the Commission propose to review the benchmark definitions, to ensure equal treatment of installations independently of the technology used (to produce products), including when using low- or zero-carbon technologies. This will help maintain innovative installations in the EU ETS, which will also reduce benchmark values over time and thus encourage greater emissions reductions.

11. Free allocation to industrial sectors is proposed to be made conditional on efforts to decarbonise. Aviation free allocation is to be reduced progressively, with the aim of stopping free allocation to aviation operators by the end of 2026.

Carbon border adjustment measures

12. Free allocation to industrial sectors covered by the Carbon Border Adjustment Mechanism (CBAM) is proposed to be phased out over a ten-year period starting from 2026. The CBAM proposal, which is a separate legislative file to the proposed amendments to the EU ETS, plans to impose carbon emission costs on imports of goods, including steel, iron, cement, fertilisers, aluminium and electricity, as a measure to prevent carbon leakage.

<u>Proposals to amend the Market Stability Reserve</u>

13. The Market Stability Reserve is a long-term policy measure introduced to address structural supply and demand imbalances in the EU ETS. The MSR works by withdrawing and returning allowances to the market when market supply is above and below specified thresholds, to protect the integrity of the system. The MSR has

been in operation since January 2019 and seeks to address the current surplus of allowances in the EU ETS resulting from the 2008 economic crisis (which reduced emissions more than anticipated) and high imports of international credits.

14. The Commission have made proposals to amend the rules of the Market Stability Reserve (MSR) so that it operates on a path consistent with the EU's climate targets. The Commission have proposed retaining a higher intake rate of allowances (to the MSR); a dynamic intake rate to withdraw allowances when the market balance would be between 1,096 million allowances and 833 million allowances (MSR upper threshold); adjusting the rules to cancel allowances in the MSR; and to include aviation and maritime emissions (paragraphs 7 and 8) in the calculation of the market balance. The Commission have proposed to amend the Market Stability Reserve Decision to maintain the higher intake rate; the other proposed changes would be implemented through the amendment to the EU ETS Directive.

<u>Proposals to amend the Monitoring Reporting and Verification Regulation</u>

15. Changes proposed to the Monitoring, Reporting and Verification (MRV) Regulation include introducing new definitions of 'administering authority' and 'aggregated emissions data at company level', to facilitate plans to expand the EU ETS to cover emissions from maritime activities.

SCRUTINY HISTORY

16. The EU ETS Directive (Directive 2003/87/EC establishing a system for greenhouse gas emission allowance trading within the Union) was scrutinised by Parliament as proposal (14394/01: Proposal for a Directive of the European Parliament and of the Council establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC) in 2002. Explanatory Memorandums dated 21 January 2002, 9 July 2002 and 5 November 2002 were put to the Commons European Scrutiny Committee (ESC), who reported on three occasions (final report was report 41, 01/02), before the proposal completed scrutiny in a debate on 25 November 2002 in the Commons ESC. The proposal was considered by the Lords European Union Committee (EUC) sub-committee D and completed scrutiny on 1 April 2002.

17. Decision (EU) 2015/1814 concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme was scrutinised (as proposal 5654/14, COM(14)20: Proposal for a Decision of the European Parliament and of the Council concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme and amending Directive 2003/87/EC) in 2014. An Explanatory Memorandum dated 6 February 2014 was prepared for the Commons ESC, who reported on three occasions and completed scrutiny on 11 March 2015 in their final

report (Report 36, 14/15). The proposal was considered by the then sub-committee D of the Lords EUC and completed scrutiny on 11 March 2015.

18. Regulation (EU) 2015/757 (Monitoring, reporting and verification of carbon dioxide emissions from maritime transport) was scrutinised by Parliament (as proposal 11851/13, COM(13)480: Proposal for a Regulation of the European Parliament and of the Council on the monitoring, reporting and verification of carbon dioxide emissions from maritime transport, and amending Regulation (EU) No 525/2013) in 2013. An Explanatory Memorandum dated 17 July 2013 was provided to the Commons ESC who reported on three occasions and completed scrutiny on the proposal on 25 February 2014 (Report 34, 14/15). The proposal was considered by the Lords EUC sub-committee B and completed scrutiny on 28 October 2013.

19. On 1 June 2021, the Department for Business Energy and Industrial Strategy submitted an Explanatory Memorandum C(2021)3188 for application and selection procedures under the Innovation Fund. The Explanatory Memorandum was cleared in the Commons on Wednesday 23 June, Fourth Report of Session 2021-2022. The Lords cleared the Explanatory Memorandum during sift 3, Tuesday 10 June 2021.

MINISTERIAL RESPONSIBILITY

20. The Secretary of State for the Department for Business, Energy and Industrial Strategy is responsible for the residual application of the legislation implementing the EU ETS Directive in the UK for scheme years prior to 2021 and compliance with Withdrawal Agreement legislation.

21. From 1 January 2021, responsibility for matters regarding the continuing participation in the EU ETS in Northern Ireland has been mostly transferred to the Department of Agriculture, Environment and Rural Affairs (DAERA). The Secretary of State for the Department for Business, Energy and Industrial Strategy retains limited functions in matters relating to national security and the provision and disclosure of information.

INTEREST OF THE DEVOLVED ADMINISTRATIONS

22. Under Article 9 and Annex 4 of the Northern Ireland Protocol, electricity generators in Northern Ireland remain subject to the EU ETS. This applies to five electricity generating installations in Northern Ireland.

23. Officials in the Department of Agriculture, Environment and Rural Affairs in Northern Ireland have been consulted about the content of this Explanatory Memorandum.

LEGAL AND PROCEDURAL ISSUES

i. Legal Base: The legal basis for this proposal is Article 192 TFEU. In accordance with Article 191 and 192(1) TFEU, the European Union shall contribute to the pursuit, inter alia, of the following objectives: preserving, protecting and improving the quality of the environment; promoting measures at international level to deal with regional or worldwide environmental problems, and in particular combating climate change. The proposed instrument is a Directive.

ii. Voting Procedure: qualified majority voting

iii. Timetable for adoption and implementation: The EU legislative procedure should be completed by December 2022. The proposed deadline for the domestic transposition of Article 1 and Article 2 of the proposed Directive is 31 December 2023.

iv. *Does the proposal affect the substance of EU law that will remain in effect under the Northern Ireland Protocol or is it likely to be the subject of a request by the EU to be added to the Protocol under Article 13(4) thereof?*

The Northern Ireland Protocol provides that limited areas of EU law will continue to apply to and in the UK in respect of Northern Ireland. This EU legislative proposal amends Directive 2003/87/EC, which applies to the UK in respect of Northern Ireland in accordance with Article 9 and Annex 4 of the Northern Ireland Protocol to the Withdrawal Agreement.

The Commission's Carbon Border Adjustment Mechanism proposal is a separate legislative file to the proposed amendments to the EU ETS Directive. In a meeting of the JCWG on 19 July 2021, the EU informed the UK that its proposed Carbon Border Adjustment Mechanism was a new draft act that falls within the scope of the Protocol, but which neither amends nor replaces a Union act listed in the Annexes to the Protocol. The EU clarified that it would notify the Joint Committee of the act when it is adopted, which would not be for some time.

POLICY IMPLICATIONS

24. The UK Emissions Trading Scheme (ETS) came into force on 1 January 2021, replacing the UK's participation in the EU ETS. The UK ETS covers greenhouse gas emissions from electricity generation, heat generation, industry and aviation.

25. Article 9 and Annex 4 of the Northern Ireland Protocol helps to maintain the continued operation of the Single Electricity Market by providing for electricity generators in Northern Ireland to continue to participate in the EU ETS after the Transition Period.[4] The Greenhouse Gas Emissions Trading Scheme (Withdrawal Agreement) (EU Exit) Regulations 2020 (SI 2020/1369)[5] was laid on 30 November

[4] This is to ensure a consistent carbon price is paid for electricity generation in Ireland and Northern Ireland.
[5] https://www.legislation.gov.uk/uksi/2020/1369/made

2020 to fulfil this commitment in the Protocol. There are five electricity generating installations in Northern Ireland who continue to participate in the EU ETS under the terms of the Northern Ireland Protocol.

26. Some of the Commission's proposals would have implications for the continued participation of Northern Ireland electricity generators in the EU ETS. These implications either concern how the electricity generators will participate in the EU ETS; or affect the governance of how revenues raised from the share of EU ETS allowances auctioned in respect of Northern Ireland should be used. Specific proposals include:

Carbon contracts for difference and increase of the Innovation Fund

27. The Commission have proposed to increase the scope of the Innovation Fund, to allow it to provide support to projects through competitive tendering mechanisms such as Carbon Contracts for difference. The Commission also propose to increase the size of the Innovation Fund by taking 40 million allowances from the allowances available for free allocation, 10 million allowances from the allowances to be auctioned, 150 million allowances from the proposed new system for buildings and road transport, and allowances not issued for free to sectors covered by the proposed CBAM.

28. The Innovation Fund is only open to applications for projects in EU/EEA Member States, however project investors may be based in the UK. Any applications made to the Innovation Fund for projects situated in the UK are not eligible to the Innovation Fund.

29. Projects in Northern Ireland are eligible to apply to future calls for the EU ETS Innovation Fund, for any projects concerning the generation, transmission, distribution, and supply of electricity (and as long as they are in line with the general eligibility criteria and conditions for all projects under the EU Innovation Fund). There were no NI applications to the Innovation Fund in the first call for funding which closed in October 2020.

Use of auction revenues

30. Revenues from UK ETS auctions and EU ETS auctions of allowances in respect of Northern Ireland are allocated to the UK Government's consolidated fund. The Government is currently preparing for the auctioning of these allowances to take place later this year. The proposal for 100% (up from 50%) of EU ETS auction revenue to be spent on climate-related measures may apply to Northern Ireland's share of allowances auctioned in the EU ETS.

Removal of barriers for innovative low-carbon technologies by modifying the EU ETS scope and benchmarks

31. The Commission have proposed that if an installation's installed capacity falls below the EU ETS participation threshold, as a result of reducing the total capacity of their combustion units to reduce greenhouse gas emissions[6], they should remain in the system until the end of a five-participation period (currently installations immediately exit the system). The rationale for this approach is that maintaining innovative installations in the EU ETS would encourage greater emission reductions. This would apply to the electricity generators in NI if their total capacity were to reduce below the EU ETS participation threshold.

32. Some proposals made by the Commission have the potential to indirectly impact the revenue raised from the share of allowances auctioned in respect of Northern Ireland (resulting from changes to the volume of allowances available for auction as a consequence of other policy measures). Final revenue will be subject to the carbon price on the day of auction. Proposals that could affect this include:

Linear Reduction Factor and one-off cap reduction

33. The proposal to tighten the EU ETS cap would reduce Northern Ireland's volume of auctioned allowances.

Modernisation Fund

34. The Modernisation Fund redistributes allowances from higher income member states to beneficiary member states. The proposal to increase the size of the Modernisation Fund would reduce Northern Ireland's volume of auctioned allowances.

Market Stability Reserve

35. The MSR operates by adjusting the volume of allowances auctioned by member states. Northern Ireland's share of auctioned allowances are included in MSR adjustments, so the proposed amendments to the MSR would apply to Northern Ireland.

<u>UK-EU Trade and Cooperation Agreement</u>

36. The level playing field for open and fair competition and sustainable development chapter of the Trade and Cooperation Agreement (TCA) includes carbon pricing obligations. The TCA prescribes that the UK and EU should implement effective systems of carbon pricing from 1 January 2021, covering greenhouse gas

[6] Where an installation that is included in the scope of the EU ETS due to the operation of combustion units with a total rated thermal input exceeding 20 MW changes its production processes to reduce its greenhouse gas emissions and no longer meets that threshold.

emissions from electricity generation, heat generation, industry and aviation (to be included within two years of 1 January 2021 at the latest, if not already included). The effectiveness of each Party's system of carbon pricing should uphold level of climate protection. There is also a requirement to cooperate on carbon pricing, including by giving serious consideration to linking the Parties respective carbon pricing systems in a way that would increase their effectiveness and preserve their integrity.

37. The UK ETS is similar in design to the EU ETS, and currently covers the same sectors. The Government is exploring expanding the UK ETS to other sectors of the economy and we will set out our aspirations to lead the world on carbon pricing in the run up to the UN Climate Change Conference (COP26).

CONSULTATION

38. Member States, industry representatives from the private sector, non-governmental organisations, research and academic institutions, trade unions and citizens have been involved in the development of these proposals.

39. The Commission first invited feedback on an inception impact assessment, outlining the initial considerations and policy options of the revision. The Commission then organised an online public consultation with a questionnaire for each of the proposals of the 'Fit for 55' package, receiving almost 500 replies.

40. These proposals are currently open for public consultation. The consultation period commenced on 15 July 2021, and closes on 20 September 2021.

FINANCIAL IMPLICATIONS

41. The European Commission have produced an Impact Assessment for their proposed amendments to the EU ETS. The Commission's Impact Assessment estimates that the EU ETS carbon price in 2030 could range from €50 (£42.90) to €85 (£72.93). The Impact Assessment did not assess the impact of the proposals on Northern Ireland electricity generators.

42. The Government has not undertaken an Impact Assessment for this instrument.

MINISTERIAL NAME AND SIGNATURE

The Rt Hon Anne-Marie Trevelyan MP
Minister of State for Energy, Clean Growth and Climate Change
Department for Business, Energy and Industrial Strategy