

The EU Emissions Trading System: Preparing for Phase III (and implementation of Phase II)

The EU Emissions Trading System (EU ETS) is one of the primary means by which the UK and EU will rise to the climate change challenge and transform ourselves cost-effectively into a low carbon economy. The revised EU ETS Directive was a central part of the EU Climate and Energy 2020 Package and will apply to Phase III.

This document sets out a plan for the continued implementation of Phase II of the EU ETS (2008-12) and for implementation of the revised EU ETS Directive from 2013 onwards (2013-2020).

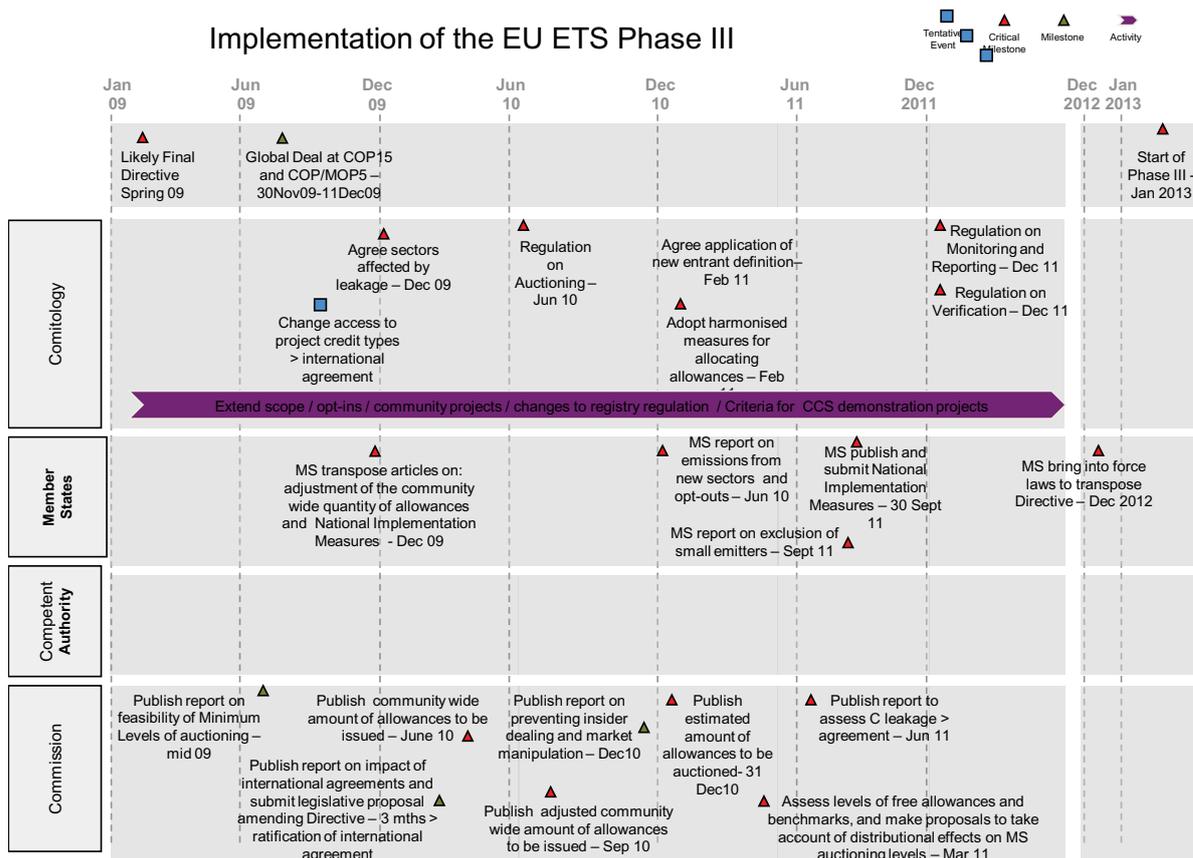
The overall aim of the project is to implement a fully functioning EU ETS that:

- delivers emissions reductions in line with our EU obligations and our national carbon budgets;
- puts the EU on the transit to a future low carbon economy, and encourages innovation in low carbon technologies up to and beyond 2020;
- fosters confidence in the carbon market as an efficient means of reducing emissions;
- establishes itself as a cornerstone of the emerging global carbon market.

The key objectives are:

- to implement Phase II of the EU ETS, with a primary focus on delivering auctions; overseeing the Environment Agency's management of a reliable registry system for the UK and including aviation in the system from 2012.
- to negotiate the EU's approach on the key implementation decisions for Phase III, agreed through comitology and including: rules on free allocation (including new entrants and closures); determining sectors at significant risk of carbon leakage; regulation on auction design; measures to determine the usage of project credits; a European Commission report on minimum levels of auctioning; regulations on monitoring & reporting and accreditation & verification (including supervision of verifiers).
- to transpose changes to the EU ETS Directive into UK law, working alongside the Devolved Administrations and Gibraltar;
- to put in place measures to ensure that the UK complies with the obligations set out in the revised Directive, delivers the required emissions reductions and provides certainty to industry. This will include submitting finalised UK National Implementation Measures to the European Commission by September 2011;

- to prepare for an EU 30% emission reduction target and the renegotiation of the Directive and the Effort Sharing Decision through co-decision, to deliver greater reductions at EU level;
- provide input to the UK position in the international climate negotiations, especially on delivering a coherent global carbon market that drives emission reductions.



Transposition of revised Directive

Aim

To ensure the successful transposition into law of the revised Directive (2009/29/EC) within the deadlines set by the European Commission in that Directive.

Summary

Transposition is a process undertaken by EU Member States in which domestic law is amended or adopted in order to implement EU Directives. The revised EU ETS Directive (2009/29/EC) must be transposed in accordance with the timings set out within it.

The first stage transposition, relating to data collection in order to determine installation-level allowances, was completed in 2009 (SI 2009 No. 3130).

The remainder of the Directive must be transposed by 31 December 2012.

TRANSPPOSITION - TIMETABLE		
Completion of stage 1 transposition	Covering Articles on adjustment of the cap (9(a)(2)) and National Implementation Measures (11)	31 December 2009 - complete
Completion of remaining transposition requirements	Covering all remaining Articles	2012

Inclusion of Aviation

Aim

To transpose Directive 2008/101/EC agreed in November 2008 into UK law to enable the Aviation sector to join the EU Emissions Trading System from 2012.

Summary

Due in large part to encouragement from the UK, aviation will be included in the EU ETS from 2012. Aircraft operators will be required to surrender sufficient allowances to account for their verified emissions in the same way as the existing system. Following 17 September 2009 (when the Aviation Greenhouse Gas Emissions Trading System Regulations 2009 entered into force), UK administered aircraft operators were required to submit monitoring plans within 8 weeks of that date or within 8 weeks of becoming an Aircraft Operator.

Applications for a benchmarking plan were required by 31 December 2009 for receipt of free allowances in 2012 and beyond. The 2009 Regulations have now been replaced for most purposes by the Aviation Greenhouse Gas Emissions Trading System Regulations 2010, that came into force on the 31 August 2010.

Due to the way the Aviation Directive was negotiated, the first year of aviation's inclusion will be the final year of Phase II and emissions will be capped at 97% of average emissions for 2004 – 2006. From 2013 to 2020, the cap for Aviation will be set at 95%.

Operators responsible for 99% of the total CO₂ emissions produced by aircraft operators attributed to the UK for regulation on the Commission's list have complied with the scheme and received emissions monitoring plans.

The EU ETS Aviation Directive was transposed in two stages, the first stage was completed in November 2009 and the second stage was completed in August 2010.

Preparation of UK National Implementation Measures

Aim

To submit to the European Commission by September 2011 a list of all installations included within the EU ETS and any free allocation to be made to each installation.

Summary

Phases I and II of the EU ETS required Member States to produce National Allocation Plans (NAPs), which had to be approved by the European Commission before Member States could proceed with the requirements of the scheme and issue allowances. NAPs have now been replaced by National Implementation Measures (NIMs). In Phases I and II, Member States had responsibility for all aspects of the scheme including cap setting and allocation methodology. From 2013 onwards most elements of the scheme will be determined at EU level. Any free allocation to installations outlined in Member States' NIMs will be based on harmonised rules known as the Community-wide Implementation Measures (CIMs). The key outcome is that all Member States interpret the rules of the scheme accurately and consistently, ensuring harmonisation across the EU and avoidance of competitive distortions.

Member States have the option to opt-out small installations and hospitals where they comply with alternative emission reduction legislation. Where sectors new to the EU ETS in Phase III are identified, they are to be included in the NIMs. The UK submitted the relevant emissions data for adjustment of the EU Phase III cap to ensure that it most accurately reflects emissions covered in the trading sector.

UK NATIONAL IMPLEMENTATION MEASURES - TIMETABLE		
(i) Agreement of CIMs	Vote in Climate Change Committee on Community-wide Implementing Measures	December 2010
(ii) Preparation of UK NIM	UK consultation on small emitters/hospital opt-out	January- April 2010
	Further data collection and verifications from UK installations in line with agreed CIMs	to begin Feb/March 2011
	UK Government response to consultation on small emitter opt-out [postponed pending CCL/CCA review]	Summer 2011
	UK consultation on draft UK NIMs	Summer 2011
	Submission of UK NIM to European Commission	30 September 2011

Auctioning

Aim

To deliver and embed auctions in Phase II; and to influence the design of, and implement auctions in Phase III.¹

Summary

The UK was the first Member State to hold an auction in Phase II of the EU ETS (in November 2008) and has held several auctions to date during the phase. The details of these auctions and a future schedule is published on the DMO website (see link below).

Phase III will have much higher levels of auctioning – by 2020 it is estimated that more than 60% of allowances will be auctioned. There will be no free allocation for electricity production in the UK and most other Member States. However, a small number of Member States can receive transitional free allowances to enable them to modernise their electricity generation industry.

On 11 Nov 2010, the EU Auctioning Regulation was formally adopted by the EU Commission. This is an EU-wide regulation which determines how some 1 billion allowances will be auctioned each year during Phase III.

The regulation provides for a common platform which all member states can use, whilst also allowing those member states that wish to host their own platforms to do so. In order to host their own platforms, Member States must submit a notification to the commission by 18 Feb 2011 which will then be proposed to and voted on by the Climate Change Committee (a comitology committee that votes by qualified majority voting). These platforms will then be listed in an annex to the regulation.

Ministers are considering the UK's options for auctioning in Phase III and whether it would be better to set up a national platform or join the EU's common platform. A decision will be made in time to notify the EU Commission if we are opting out by the 18 Feb 2011 deadline.

Auctioning – timetable	
Notify the EU Commission if the UK decides to set up a national platform for Phase III	18 Feb 2011
Procurement and implementation of common and national auction platforms for Phase III	By December 2012

¹ <http://www.dmo.gov.uk/index.aspx?page=ETS/AuctionInfo>

Carbon Leakage

Aim

To achieve the highest possible rates of auctioning whilst ensuring those sectors or subsectors that are genuinely at significant risk of carbon leakage are identified; and that measures are put in place to mitigate that risk.

Summary

Carbon leakage is the relocation of production and/or investment, as a result of EU ETS-related carbon costs, to countries without similar carbon constraints. This would undermine the environmental integrity of the system and lead to an overall increase in global emissions.

Those sectors identified as being at significant risk of carbon leakage will receive 100% of their allowances for free. Sectors not at significant risk will receive 80% of their allowances for free in 2013, declining to 30% in 2020 and 0% in 2027. Member States also have the option to compensate sectors at significant risk of leakage due to the cost of indirect emissions (for example, increased electricity prices as a result of the Directive).

A list of sectors at significant risk of carbon leakage was formally adopted by the Commission on 24 December 2009, following agreement by Member States and the European Parliament.

The European Commission were committed to review this list following the negotiations in Copenhagen and to publish their conclusions as part of their communication on the move to a 30% EU emissions reduction target. The European Commission suggested that the Copenhagen Accord was clearly a step in the right direction and that some sectors might be less at risk of carbon leakage as a result of the Copenhagen Accord pledges. However, as the implementation of those pledges is uncertain, the European Commission considers that the existing measures set out in the Directive (for example, free allocation based on environmentally ambitious efficiency benchmarks) remain justified and are sufficient to address the risk. Border adjustment mechanisms will be kept under review.

The European Commission's analysis indicates that, if the EU were to move to a 30% emissions reduction target, some of the most energy intensive sectors (ferrous and non-ferrous metals, chemicals, and other energy-intensive sectors) would experience an additional production loss of between 0.1%² and 1%³ compared to an EU 20% target, assuming the EU moved to 30% and other countries remained at the low end of their Copenhagen Accord pledges.

DECC's recently commissioned analysis into leakage shows that, of the sectors studied, a small number of sectors (essentially those with the highest

² E3MG model

³ GEM E3 model

carbon costs as a share of their Gross Value Added) – would see an additional 1-2% of their production lost as a result of an increased EU target (assuming they received 80% free allocation and that other countries remain at the low end of their Copenhagen Accord pledges). However, this modelling did not take into account any surplus allowances held by firms in these sectors from Phase II of the EU ETS.

Carbon Leakage – timetable	
EU agreement on carbon leakage sectors	December 2009
UK Study on carbon leakage publishedⁱ	September 2010
EU Commission review of carbon leakage sectors and measures following an international agreement	Jan – May 2010
EU Commission’s proposal and agreement of revisions to State Aid Guidance to allow for voluntary compensation to sectors for indirect costs	2011
EU Commission review of carbon leakage sectors	2014

Free allocation

Aim

To secure the agreement of harmonised EU wide allocation methodologies for free allocation from 2013.

Summary

EU Community-wide and fully harmonised implementing measures (rules for free allocation) shall be adopted by the EU Commission by 31 December 2010. Free allocation will be based on product benchmarks (where feasible). Benchmarking is a method of allocating free allowances which can reward early action taken on reducing emissions and encourages installations to further reduce their emissions.

There will be no free allocation for electricity generation or production (with the exception of waste gases and a partial time limited derogation for electricity generation in some Member States). Those sectors not exposed to a significant risk of carbon leakage will receive 80% free allocation (for example, 80% of the benchmarked allocation) declining to 30% in 2020 and zero by 2027. For those sectors deemed to be significantly exposed to carbon leakage, they will receive 100% of their benchmarked allocation for free. This means (using the principle of the benchmark being based on the 10% most efficient in each sector) that virtually all installations will not get enough free allocation to cover their existing emissions and they will have to buy the remaining allowances.

Benchmarks are not feasible in all cases, for example, for small sub-sectors that produce highly specialised products or the combustion sector. In these cases, EU agreement is needed on alternative methods for setting free allocations for installations, which follow the principles of benchmarking (a harmonised EU approach), which encourages emissions reductions.

FREE ALLOCATION – TIMETABLE	
UK study on benchmarking in the upstream oil and gas sector ⁴	Completed February 2010
UK study on heat benchmarking published ⁵	September 2010
UK data collection and verification of production and other relevant data	February –June 2010
European Commission send draft legislative proposal for free allocation rules ⁶ to Member States	October 2010
Vote in Climate Change Committee on Community-wide Implementing Measures	December 2010
EU adoption of free allocation rules	April 2011 ⁷

⁴

http://www.decc.gov.uk/assets/decc/what%20we%20do/global%20climate%20change%20and%20energy/tackling%20climate%20change/emissions%20trading/eu_ets/publications/1_20100305135328_e_@@_benchmarkingupstream.pdf

⁵

http://www.decc.gov.uk/assets/decc/what%20we%20do/global%20climate%20change%20and%20energy/tackling%20climate%20change/emissions%20trading/eu_

⁶ Community-wide and fully harmonised implementing measures (CIM).

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New Entrant Reserve & Closures

Aim

To manage the New Entrant Reserve (NER) framework operating in Phase II and inform the framework and delivery of a harmonised EU New Entrant Reserve in Phase III, including rules regarding closures.

Summary

As there will be some free allocation envisaged in Phase III, consideration needs to be given to the treatment of installations entering the scheme and to those installations that will close. Focus will be on harmonisation to ensure all Member States take the same approach toward new entrants and closures, thus reducing any competitive distortions across the EU.

The European Commission shall adopt harmonised rules for the application of the definition of new entrant, particularly in relation to the definition of significant extensions. Five percent of allowances from the EU cap over the period 2013 to 2020 shall be set aside for new entrants. Allowances in this EU Community-wide reserve that are not allocated to new entrants over the period 2013 to 2020 shall be auctioned by the Member States.

In addition, up to 300 million allowances in the NER shall be made available until 31 December 2015 to help stimulate the construction and operation of up to twelve Carbon Capture and Storage demonstration projects or innovative renewable energy technology.

NEW ENTRANT RESERVE & CLOSURES - TIMETABLE	
Phase II New Entrant Reserve Contingency Fund closes for new applications.	December 2009
Phase II Good Quality Combined Heat & Power New Entrant Reserve ring-fence review.	2010, 2011, 2012
Vote in the Climate Change Committee on the Phase III Community-wide Implementing Measures, including new entrants and closures rules.	December 2010
EU adoption of Phase III Community-wide Implementing Measures, including rules for new entrants and closures.	April 2011
Date Phase III new entrant becomes applicable.	June 2011

⁷ The deadline in the revised EU ETS Directive for adoption of the measures is 31 December 2010

Carbon Capture & Storage/Renewables Financing

Aim

To take advantage of the proportion of the New Entrant Reserve made available to carbon capture and storage (CCS) and innovative renewables, providing the option of an EU contribution toward UK CCS demonstrations and innovative renewable energy technology projects.

Summary

As part of the EU Climate Change and Energy Agreement reached at the end of 2008, the UK successfully argued for a funding mechanism to part-fund demonstration of CCS and innovative renewable energy technologies. This resulted in the setting aside of 300 million allowances (EUAs) from the New Entrants Reserve in Phase III (2013-2020) of the EU Emissions Trading System. This could provide a significant amount of support to one or more UK CCS demonstrations and also to innovative renewable energy technology projects.

The European Commission will launch two calls for proposals. The first Call will award 200m allowances and aims to fund 8 CCS projects and 34 innovative renewable energy projects.

The first Call was launched on 9 November 2010 and interested project sponsors have until 9 February 2011 to submit application forms to their Member State. Further information can be found at www.decc.gov.uk/occs and www.decc.gov.uk/ored.

National Registries

Aim

To ensure that the UK has a creditable, functioning registry in place for the purposes of EU ETS and international emissions trading under Kyoto which adheres to UK, EU and UN policy and legal requirements.

Summary

The registry has two main uses:

- holding allowances and Kyoto units (and tracking their movement through the system);
- demonstrating compliance for both EU ETS operators and the UK Government as a Member State and an Annex B Party to the Kyoto Protocol.

The registry is also used by the UK Government for managing UK carbon budgets and carbon accounting under the Climate Change Act. In addition, it is used extensively by market participants for the delivery of allowances and units that they have been trading. However, it should be noted that the registry is not a trading platform (for example, it does not contain any price information or details of contracts and delivery dates). It simply shows where the units and allowances are at a given moment in time.

From 1st January 2012, Article 19(1) of Directive 2003/87/EC requires that all EU ETS allowances are held in the Union Registry in accounts managed by the Member States. In order to ensure that Kyoto units and allowances can be held in the same Union Registry account, the Union Registry must also conform to the functional and technical specifications under the Kyoto Protocol.

From January 2012, Member States will no longer be responsible for procuring their own registry solution.

NATIONAL REGISTRIES - TIMETABLE	
Develop software for the Union registry	In place
Vote in Climate Change Committee on Registry Regulation (V)	Mid 2011
Launch of the Union Registry	January 2012

Monitoring, Reporting and Verification

Aim

To deliver harmonised monitoring, reporting and verification (MRV) for Phase II and Phase III of the EU ETS.

Summary

Robust monitoring, reporting and verification of emissions data is essential to the integrity of emissions trading. It is essential that the monitoring and reporting of the emissions, the verification of the emission reports, the accreditation of the independent verifiers and enforcement is fully guaranteed, uniformly applied and enforced at the same level of stringency in all EU-Member States.

Under Phase II, CCS, Aviation and N2O have been included in the monitoring, reporting guidance.

Additional monitoring and reporting guidance for the new sectors and gases to be included in Phase III have been proposed by the European Commission. This is in preparation for the data collection required by the CIMS.

The primary objective in preparation for Phase III is EC-wide adoption of harmonised regulations on monitoring and reporting, and accreditation and verification (including supervision of verifiers).

MONITORING, REPORTING AND VERIFICATION (MRV) - TIMETABLE	
Commission proposals to amend monitoring and reporting guidance to include emissions from new activities and gases	December 2010
Vote in Climate Change Committee	April 2011
Commission proposals for regulations on monitoring and reporting, and accreditation and verification	June/July 2011
Vote in Climate Change Committee	September 2011
EU agreement to regulations on monitoring and reporting, and accreditation and verification	December 2011

International project credits

Aim

To ensure that EU ETS operators have a degree of flexibility in meeting their commitments and have access to lower cost abatement opportunities outside the EU, whilst maintaining the environmental integrity and ambition of the system.

Summary

Access to international project credits in Phase III is linked to levels of access in Phase II. Across the two phases, this is set at 50 percent of required effort although there is flexibility as to how this will be managed. There is provision in the EU ETS Directive for access to credits from certain types of projects to be restricted through comitology.

There is a need to ensure that the EU's demand for international credits is consistent with other priorities. The finance from project credit purchase should flow to the countries that require the most assistance and should provide a real incentive to improve environmental ambition.

PROJECT CREDITS - TIMETABLE	
Vote in Climate Change Committee on qualitative restrictions to the use of international project credits.	January 2010
Process to determine and distribute the levels of access to be granted during Phase III.	2011

Annex A: Comitology Process

Much of the detailed implementation of the revised EU ETS Directive will be given legal effect through the adoption by the European Commission of further tertiary legislation by what is known as comitology, using the regulatory procedure with scrutiny. The EU ETS Directive delegates to the Commission a power to adopt these further implementing measures.

Member States can exercise a degree of control over the process through Comitology committees (made up of representatives of Member States and chaired by the European Commission). Once the Comitology committee has voted in favour of an implementing measure, it must then allow the European Council and European Parliament to scrutinise the implementing measure prior to being formally adopted by the European Commission. In the event of opposition on the part of one of these institutions, the European Commission may not adopt the proposed measure, although it may submit an amended proposal or a new proposal.

The European Council and Parliament do not have absolute power to veto draft implementing measures. This is limited to where the proposal exceeds the implementing powers in the basic EU ETS Directive, is not compatible with the

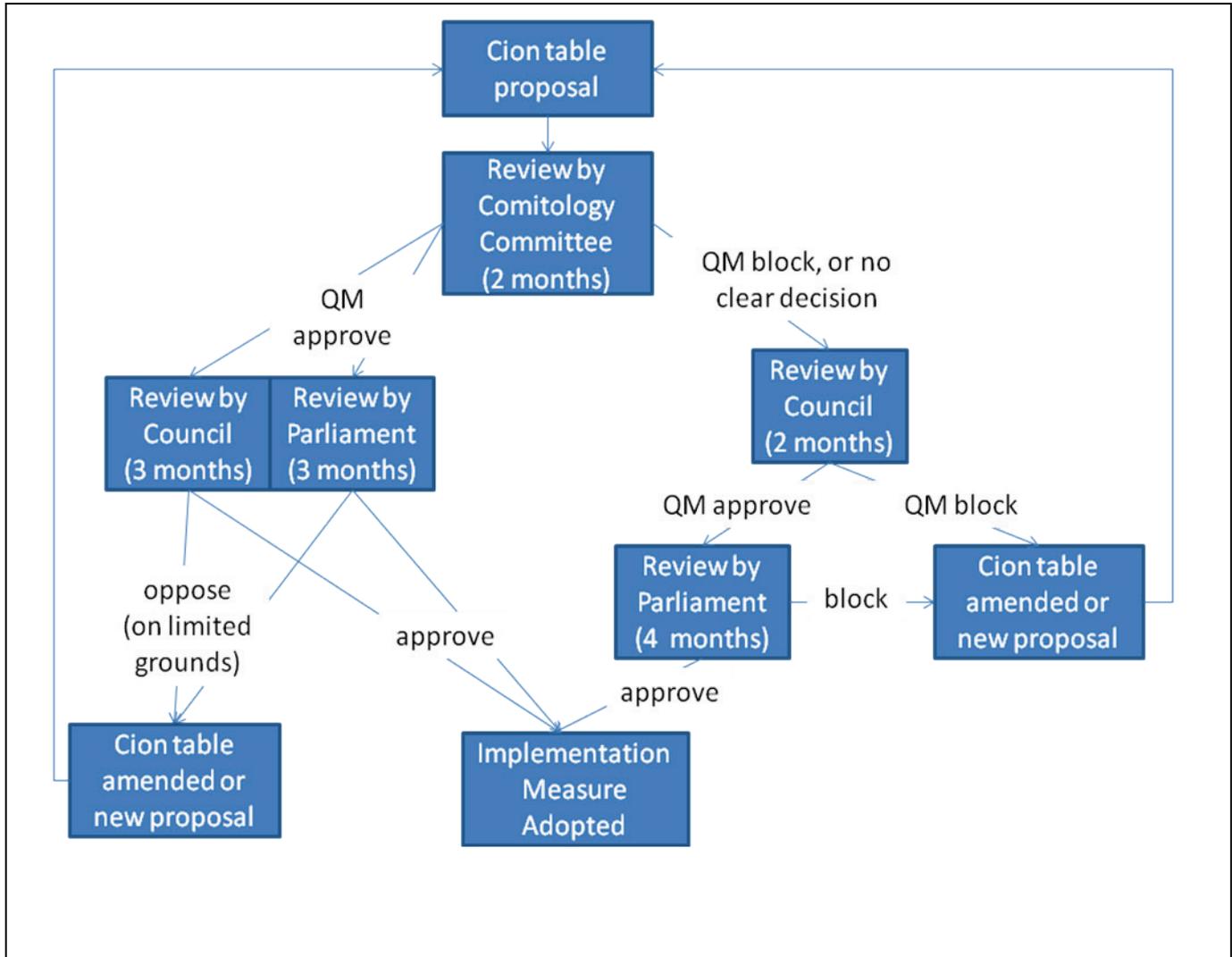
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aim and content of the basic Directive or does not respect the principles of subsidiarity or proportionality. However, the European Council does have absolute power to block draft implementing measures that have not been approved by the Comitology committee.

The comitology process:



EU ETS Comitology Decisions

The revised EU ETS Directive makes provision for twelve implementing measures to be agreed through comitology (and there are six further decisions which may need to be taken).

COMITOLGY DECISION		DATE
<i>Set decisions necessary to implement eu ets</i>		
1	Agree sectors or sub-sectors affected by carbon leakage	December 2009
2	Agree criteria for selection of demonstration projects for Carbon Capture and Storage and innovative renewable energy technology	December 2009
3	Regulation on Auctioning	July 2010
4	Agree harmonised rules Community wide Implementation Measures including the application of new entrant definition and partial closures definition	December 2010
6	Adopt harmonised, community wide measures for allocating allowances	March 2010
7	Set exact quantitative limits for use of CER/ERU credits during period 2008 to 2020 – determination of shares for incumbents, new entrants & aviation to ensure no breach of 50% rules	Early 2011
8	Regulation on monitoring and reporting of emissions	December 2011
9	Regulation on verification of emissions & accreditation and supervision of verifiers	December 2011
10	Software and legislation for new functions of the Single Community Registry	March 2011
11	Guidance on transitional free allocation for modernisation of electricity generation	No date set
12	Revision of the list of sectors deemed to be exposed to carbon leakage every 5 years (and potential addition of sectors every year)	December 2014
POTENTIAL DECISIONS (no set date specified in the revised EU ETS Directive)		
13	Jl / CDM quality criteria. Measures may be applied to restrict the use of specific credits from project types	No date
14	Extend scope / opt-in additional activities and gases	No date
16	Agreements on linking the EU ETS with other comparable emission trading systems	No date
17	Implementing measures that set out the details for crediting Community-level projects	No date
18	Measures in the event of excessive price fluctuations	No date

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http://www.decc.gov.uk/en/content/cms/what_we_do/change_energy/tackling_clima/emissions/eu_ets/publications/publications.aspx

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