

Draft UK policy on opting out small emitters and hospitals from the EU ETS from 2013

This informal paper was distributed to EU ETS operators ahead of a stakeholder meeting on 12 October. The paper provides an update on the development of the opt out policy and does not represent final government policy. The UK's final opt out policy remains subject to agreement by Ministers and must then be approved by the European Commission.

21 October 2011



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A. Introduction

1. This paper sets out the Government's¹ latest thinking on a policy that will allow eligible UK small emitters and hospitals to opt out of the EU ETS in Phase III (2013-2020). The Opt-out Agreements Scheme will be voluntary in nature but operators who wish to opt-out will be required to take binding emissions reduction targets. Government Ministers have yet to agree a final policy but in the interests of ensuring maximum consultation with interested operators ahead of a formal decision on opting-out, we are releasing our near final proposal.
2. We are inviting interested and eligible operators to an informal meeting to raise any questions or issues on the small emitter policy and process. This is due to take place in London on 12 October, please contact eu.ets@decc.gsi.gov.uk if you would like to attend.
3. In light of operators concerns about being asked to make decisions whilst there was ongoing uncertainty around the final UK opt out policy, we have managed to secure agreement from the European Commission to submit, if necessary, our definitive list of operators opting out of the EU ETS separately from the UK NIM. On this basis we intend to launch a formal period of consultation, where operators will be asked to indicate whether they wish to opt-out, once we have agreed our opt-out policy with the Commission. We estimate that this will be in early 2012 rather than October 2011 as originally envisaged. .
4. An early 2012 consultation has a number of benefits including providing certainty to operators on the final opt out policy, enabling a longer period to be offered for operators to make their decision and better alignment with the timetables for simplification the CRC and CCA.
5. We are clear that the UK will provide a final opt out list to the Commission before the scrutiny of Member State NIMs is completed as the opt out process must not delay finalisation of free allocations. The final EU wide list of installations opting out must be known so that EU ETS cap can be adjusted² and the cross sectional correction factor calculated.

¹ Policy responsibility for the EU ETS lies with the Department of Energy and Climate Change (DECC), together with the Scottish Government, Welsh Government, and the Northern Irish Executive. References to the Government in this document also cover the Devolved Administrations.

² In accordance with Article 9a 4 of the EU ETS Directive

6. In developing this policy, our priorities have been to reduce regulatory cost burdens on UK small emitters and hospitals, where possible, and avoid putting UK industry at a competitive disadvantage compared to installations in the EU. In line with this we intend to take a robust stance in submitting a more deregulatory opt-out proposal to the European Commission for clearance, despite the strict stance they have taken on equivalence. We are also working to align our approach with those of other Member States.
7. The UK's opt-out policy will ultimately be subject to European Commission approval, which leaves a degree of uncertainty around the final policy and accordingly we have had to adopt a flexible approach.
8. We have therefore developed two variations on our proposal, which are effectively fall backs should our central proposal be rejected. These are set out in order of preference (1 then 2). We are clear that we will present these options to the Commission in a strict order of preference, if our preferred approach is rejected.
9. Over the coming months we will be engaging with the Commission to secure agreement for an opt out policy that offers the greatest savings to business whilst providing incentives to reduce emissions and meeting the requirements of the Directive. We will release our final proposal once agreed by the Commission. At this stage we will also ask operators to decide whether they will opt out. In addition to the details of the proposal and underpinning analysis, we will issue indicative targets for each installation.
10. We very much welcome the input we have received from stakeholders in developing the UK's small emitter proposal, both during the 2010 consultation exercise³ and more recently, via our engagement with the Emissions Trading Group and the Department for Health on behalf of hospitals.

B. Draft UK policy proposal: voluntary EU ETS small emitter Opt-out Agreements Scheme

11. The UK actively supported the European Commission's decision to allow Member States to exclude small emitters and hospitals from Phase III of the EU ETS, from 2013. This was in recognition of the fact that the administrative costs faced by small emitters under the EU ETS are disproportionately high per tonne of CO₂, compared to the costs for installations with larger emissions.

³ http://www.decc.gov.uk/en/content/cms/emissions/eu_ets/phase_iii/phase_iii.aspx

12. The need to reduce the regulatory cost burdens on small emitters and hospitals, whilst not significantly affecting the emissions reductions achieved by operators in the EU nor introducing competitive distortion, has formed the basis for the UK's approach. Moreover, consistent with the Government's broader aim of simplification of UK climate policy, we wanted to work with the current policy landscape and avoid introducing a new scheme.
13. As set out in the 2010 consultation, we considered using existing UK domestic climate policies as alternative measures, namely the CRC Energy Efficiency Scheme (CRC) and Climate Change Agreements (CCA). However, feedback from industry and the Commission has shown that neither the CRC nor the CCA is suitable as an opt-out policy, largely on the basis of equivalence⁴ with the ETS and, in the case of the CRC, the costs to operators⁵. We are therefore using the legislative framework of the ETS which is now well understood by participants, to provide a lighter touch alternative.

Key features of the UK's voluntary Opt-out Agreements Scheme

14. Operators of eligible installations and hospitals may choose to exclude their installation from the EU ETS over Phase III (2013-2020). By taking this decision, the installation would agree to the installation being subject to a binding emission reduction target as part of an 'Opt-out Agreement'. A fixed penalty for non-compliance would be imposed on any annual emissions above the target. The level of the penalty would be set in line with the expected price of an EU allowance (EUA) for the relevant compliance period.
15. Opted-out installations (opt outs) will not receive a free allocation of EUAs, they will be exempt from the requirement to surrender allowances for their emissions. Opted out installations will not be required to hold a registry account but operators can retain their account if they wish.

Target setting

16. Targets would be set for 2013 by regulators according to the installation's historical emissions by calculating the average emissions over the period 2008-2010 and reducing this by 5.22%.⁶ For sectors deemed to be at significant risk of

⁴ Both of these policies will place a price on carbon emissions, but neither will definitely set the price according to the EUA price. Moreover, neither policy covers all EU ETS emissions as they do not address process emissions.

⁵ The CRC scheme involves installations paying a cost for all emissions whereas under the EU ETS operators receive an allocation of allowances for free. For example, an average hospital would pay £65,000 more under the CRC than the EU ETS in 2013. This additional cost will decline to £40,000 in 2020 as EU ETS free allocation levels decline.

⁶ The EU ETS Directive states that the Phase III cap will reduce annually by 1.74% of the average Phase II (2008-12) cap. The 2013 cap will therefore be 5.22% (3 * 1.74%) lower than the 2010 cap level.

carbon leakage⁷, targets will not decline over the period 2013 -2020. For sectors not deemed to be at significant risk of carbon leakage, targets will decline annually by -1.74% of the 2008-10 average emissions, over the period 2013-2020 in line with annual reductions in the EU ETS cap. The cross sectoral correction factor will not apply⁸.

17. In order to help operators understand the implications of this approach, we intend to release indicative targets on an installation basis. These will be released at the beginning of the period when operators will be asked to decide whether to opt-out.

Penalty setting

18. The level of the penalty for excess emissions will be set in line with the expected price of an EU allowance (EUA) for the relevant compliance period. The price will be based on the average⁹ end of day settlement price of the December futures contract¹⁰ of the relevant compliance year. The average will be calculated across a full year of settlement prices. So the penalty for 2013 will be determined by the average price of the December 2013 futures contract over the period December 2011 – November 2012
19. The price will be set in the December of the year before the compliance period. Indicative prices will also be published for subsequent compliance years. However, the market price is also publically available and therefore will provide operators with up to date information on prices for later years.

Monitoring, reporting and verification

20. Opt-outs will generally be required to comply with the same conditions as EU ETS installations. For example, they will continue to monitor and report annually according to EU ETS regulations but they will be exempt from ETS provisions on third party verification. Opt-outs can undertake third party verification if they wish to but they are not required to. Where an operator decides not to have their emissions reports verified by a third party, they will fall under a cost recovered

⁷ http://ec.europa.eu/clima/documentation/ets/leakage_en.htm

⁸ The European Commission may be required to issue a cross-sectoral correction factor, as set out in Article 10a(5) of the EU ETS Directive, to ensure that the total allocations given to EU ETS industrial installations does not exceed these installations historical share of the cap, as determined by the Commission in 2010. Such a factor would reduce free allocations to installations in the EU ETS by the determined proportion, and may vary annually throughout Phase III.

⁹ Average will be a simple arithmetic mean of the closing prices across all relevant days of trading.

¹⁰ The exchange with the most volumes of trading across the whole period will be used to determine the relevant forward price.

risk-based auditing scheme. They will still be required to hold an emissions permit consistent with the EU ETS Directive¹¹ but this will be modified to reflect the requirements of the opt-out.

21. In the absence of third party verification, emissions reports will be audited by UK regulators (for example, the Environment Agency). Opt-outs will be audited at least twice during the Phase (2013-2020). However, all annual reports will undergo a risk analysis and, where they matched predefined risk criteria, it is likely they will be audited more frequently. Installations with emissions above 20,000tCO₂ per year will be audited annually. Operators will face penalties for misreporting, as they do under the EU ETS. The key steps in the risk based auditing process are:
 - i. Operators undertake self verification and formally certify their reported emissions data.
 - ii. All reports undergo a risk analysis by the regulator.
 - iii. A proportion of reports are audited according to a risk analysis or to meet the requirement that each installation should be audited twice during the Phase.
 - iv. If an installation is selected for audit, operators will be requested to submit additional information as required for audit by the regulator.
 - v. Where necessary, installations will subject to a more in depth review and site visit.
22. A de minimis rule will enable small sources of emissions to be exempt from annual monitoring and reporting. If operators choose to use this rule, they will need to nominate, in monitoring plans, a reasonable annual emission figure for each source of emissions. Agreed annual emissions from sources under the de minimis rule must not exceed 100 tCO₂ for each installation. De minimus emissions will be taken into account in determining whether emissions targets have been achieved. Small emitter installations with annual emissions exceeding 20,000tCO₂ will not be entitled to use the de minimus rule but hospitals may use the rule irrespective of total annual emissions.

Administrative cost savings

23. Administrative costs savings will be offered under the opt out largely through replacing third party verification with risk based auditing.
24. We estimate that the subsistence fees for opted out installations will be slightly higher than EU ETS installations.¹² The annual fee will increase by

¹¹ The EU ETS Directive requires installations carrying out activities regulated by the Directive, as specified in Schedule 1, to hold a greenhouse gas emission permit. This requirement will be retained in UK regulation for opted out installations.

approximately £100 through the combined effect of an estimated £500 increase to recover the additional regulator costs from risk based auditing and a reduction of approximately £400 per year reflecting the annual costs of registry account maintenance. However, this marginal increase should be more than offset by cost savings associated with the exemption from third party verification. Operators that choose to undergo third party verification instead of risk based auditing will have their subsistence fee reduced accordingly. Operators that chose to retain a registry account will face increased fees accordingly.

Coordination with UK domestic climate policies

25. Opt-out agreements will not create additional overlaps with existing domestic climate policies. Overlaps with the Climate Change Agreements Scheme (CCA) will be treated in the same way as overlaps between EU ETS and CCAs. The opt-out scheme will simply replace the EU ETS in the CCA's split EU ETS/CCA target. Therefore, meeting the terms of the opt-out, either meeting the emissions target or paying excess emission penalties, will qualify opted-out emissions for the Climate Change Levy (CCL) discount. Similarly, opted out installations will retain any exemptions to the Carbon Reduction Commitment (CRC) granted by virtue of participation of in the EU ETS.

UK fall back approaches: setting the opt-out targets differently

26. In the event that the UK Opt-out Agreements Scheme is not acceptable to the Commission and pending the final proposals of other Member States, the UK will apply fall back approach 1 and where this is also rejected, fall back 2 (see below). The fall back approaches represent variations on the Opt-out Agreements Scheme in the way that the targets are set. Hence, the administrative cost savings will remain the same for all three approaches but the compliance costs (i.e. cost of required abatement or penalties paid) will vary. Our approach is based on a desire to offer a deregulatory alternative and avoid putting UK industry at a competitive disadvantage compared to opted-out installations in other Member States, and the assumption that the administrative cost savings offered under fall back approach 2 are better than no opt-out at all. Figure 1 below illustrates the variations in targets between the Opt-out Agreement and fall backs 1 and 2.

Fall back approach 1: Setting targets according to sector benchmarks

27. Targets will be set for 2013 by regulators at 100% of the relevant product benchmark (or heat benchmark, fuel benchmark or process emission sub installation, as appropriate) for the installation, as set out in the Community

¹² We estimate the individual annual subsistence of eligible operators to increase from £2550 to £2650.

Implementation Measures¹³ and used in the establishing the UK National Implementation Measures (NIMs).

28. For sectors deemed to be at significant risk of carbon leakage¹⁴, targets will not decline and will remain at 100% of benchmark throughout the Phase (2013-2020). For sectors deemed not to be at significant risk of carbon leakage, targets will decline annually by 1.74% of the implied 2008-10 target¹⁵ over the period 2013-2020 in line with annual reductions in the EU ETS cap. The cross sectoral correction factor will not apply.

Fall back approach 2: Setting targets according to EU ETS Phase III allocation levels

29. Targets will be set for 2013 by regulators according to the level of allowances an installation would have been allocated for free under the EU ETS in Phase III. The cross sectoral correction factor will not apply to opt out targets, therefore targets will be increased accordingly.
30. For sectors deemed to be at significant risk of carbon leakage¹⁶, targets will not decline and will remain at 100% of benchmark throughout the Phase (2013-2020). Carbon leakage sectors will receive the same targets under both fall back proposals 1 and 2. For sectors deemed not to be at risk of carbon leakage, the target will be set according to declining free allocation levels, from 80% of the relevant benchmark in 2013, to 30% of benchmark in 2020, as would occur for non-leakage sectors under the EU ETS.
31. Recognising the increased stringency of targets set according to EU ETS allocation levels, we are offering additional flexibility to meet targets under fall back approach 2 through:
- i. a banking mechanism that would allow overachievement in one year to be offset against the target in following years; or,
 - ii. a borrowing mechanism in the first two years of the phase that would allow underachievement in years 1 or 2 to be compensated for by overachievement the following year. By the end of year three an installation's emissions must be within the cumulative three year target or operators will face a penalty for excess emissions.

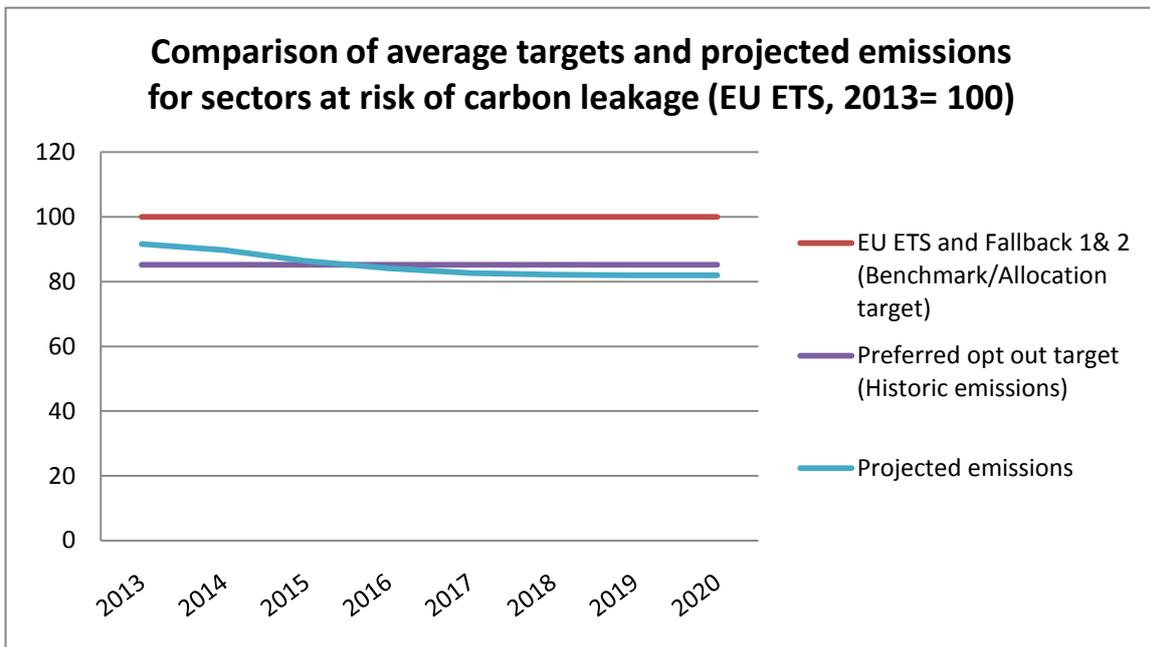
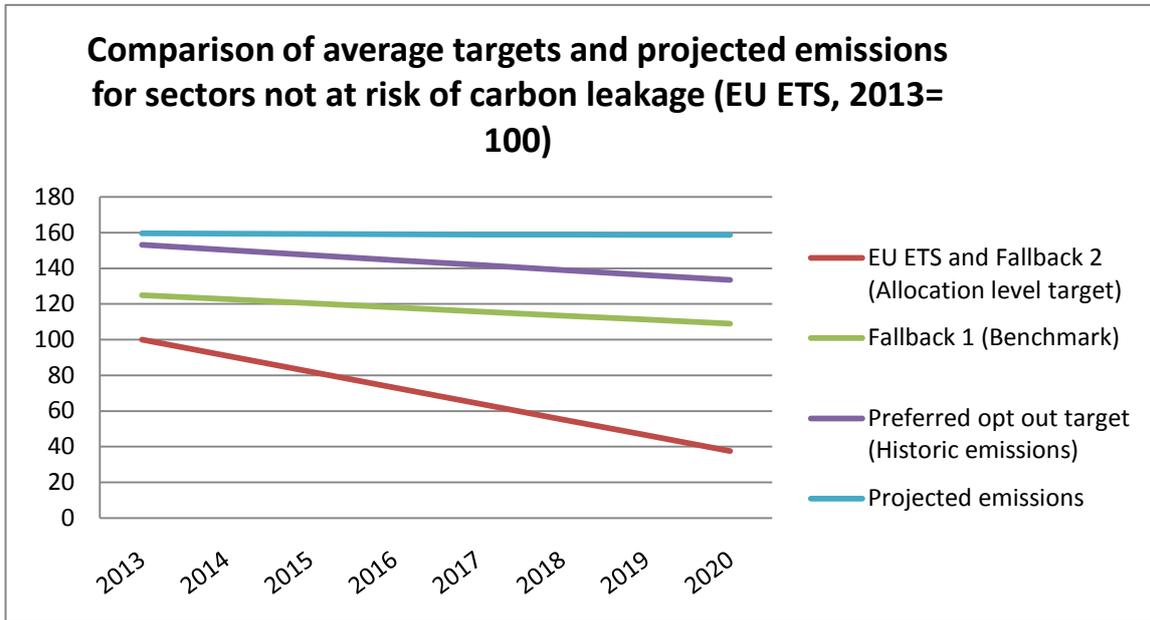
¹³ <http://eur-lex.europa.eu/JOHtml.do?uri=OJ:L:2011:130:SOM:EN:HTML>

¹⁴ http://ec.europa.eu/clima/documentation/ets/leakage_en.htm

¹⁵ The overall 2013 EU ETS cap level has been set at 5.22% below the average Phase II cap. Therefore we have estimated an implied Phase II target from the 2013 benchmark allocation in order to determine the annual decline.

¹⁶ http://ec.europa.eu/clima/documentation/ets/leakage_en.htm

Figures 1 & 2. Comparison of average targets under the opt-out agreement and fallbacks 1 and 2, for sectors at significant risk of leakage and non-leakage sectors.



These graphs are illustrative only and the relative positions of projected emissions, historic emission targets and benchmark targets will vary for individual installations. For many installations at risk of carbon leakage an historic emissions target will be higher than one based on benchmarks.

C. Key process points for UK Opt-out Agreements Scheme

Eligibility

32. Small emitter installations will only be eligible for the Opt-out Agreements Scheme if they meet the criteria set out in Article 27 of the 2009 EU ETS Directive¹⁷, where:
- i. reported annual emissions are less than 25,000tCO₂e in 2008, 2009 and 2010, and subsequent years; and,
 - ii. the rated thermal input below 35MW (net) in 2008, 2009 and 2010.
33. Hospital installations will only be eligible for the Opt out Agreements Scheme if they are installations that are associated with and that primarily provide services to a hospital facility. The operator must identify the relevant hospital and the association must be confirmed by the Department of Health or relevant Devolved Administration.
34. Article 27 of the Directive applies only to stationary installations, therefore aircraft installations will not be eligible. Installations joining the EU ETS at the beginning of phase III will be eligible if they are included in the UK NIMs.

Data requirements

35. If operators wish to opt-out and have not yet submitted annual verified emissions and thermal capacity data for the years 2008-2010, for each small emitter installation and sub installation, they must contact the Environment Agency at euets@environment-agency.gov.uk.
36. Verified data will need to be received and checked by the Environment Agency in advance of submission of the opt-out list to the European Commission in early 2012.
37. Where operators have not already reported emissions data through the national data collection but have previously reported data to the CITL, data from the CITL will be used. Reported data will be used to calculate draft emissions reduction targets due for release alongside the consultation asking for a final opt out decision. To submit further data, using phase III scope, for use in setting targets and submission to the Commission, operators should contact the Environment Agency, as above.

¹⁷ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2003L0087:20090625:EN:PDF>

Opting out of the EU ETS

38. Once we have reached agreement with the Commission on our policy for opt-outs, we will launch a window in which operators of small emitter or hospital installations can inform us of whether they intend to opt out of Phase III of the EU ETS. We expect this will be in early 2012.
39. By requesting that they be excluded from the EU ETS, operators will be agreeing to the conditions of their Opt-out Agreement. This will include agreement to the indicative emissions reduction targets, which will be finalised in consultation with the relevant operator. It is anticipated that alterations to indicative targets will only take place where new data has been submitted or where there are inaccuracies in the calculation. Targets will be based on a set formula and will not be subject to negotiation. If an operator does not respond by the end of the consultation period, the relevant installation shall remain in the EU ETS.
40. A list of eligible installations that want to be excluded from the EU ETS in Phase III and be subject to the UK's Opt-out Agreements Scheme will be published and submitted to the Commission shortly after the consultation finishes. Three months after publication the European Commission then has six months to accept the list, see timetable below. [How does this work with the fact that we'll be putting it in late – do they still have 6 months from that point?]

Re-entering the EU ETS

41. There are two conditions under which an installation will re-enter the EU ETS:
- i. Opted-out small emitter installations will re-enter the EU ETS if their annual emissions exceed 25,000tCO₂. Opted out hospitals installations will not re-enter the EU ETS if emissions exceed 25,000tCO₂ per year.
 - ii. Opted out small emitter or hospital installations will re-enter the EU ETS if they fail to pay the penalties associated with not meeting their emissions reduction target. On re-entering the EU ETS operators will remain liable for any unpaid penalties and any further sanctions applied for non-payment.
42. Opted-out small emitter installations that breach the emissions threshold (i) or opted out installations that do not meet the terms of the opt out (ii) will re-enter the EU ETS from the beginning of the following year. The installation will be required to comply in full with the requirements of the EU ETS from the year of re-entry onward. They will be awarded a free allocation at the level set out in the Phase III NIMs; the allocation will come from the UK auction pot.

43. The Directive does not provide for operators to alter their decisions regarding the opt out provision. So if an operator opts-out before the start of Phase III, it cannot choose to opt back in later in the Phase. Similarly, if an operator decides not to opt-out an eligible installation before the start of Phase III, it cannot choose to opt-out during the Phase.

Provisional Timetable

Note: Timings after submission of UK NIMs are approximate only as they depend on decisions taken by the European Commission.

23 September	Government releases near final proposal for small emitter Opt-out Agreements Scheme.
12 October	Informal stakeholder meeting on Government small emitter Opt-out Agreements Scheme proposal and process.
End October	Government submits opt out policy to the Commission for agreement.
Early December	Government submits UK NIMs to the European Commission.
Late 2011/Early 2012	Agreement expected to be reached with European Commission on Member State opt out policies
Quarter 1 2012 (expected)	Government launches a period for operators to indicate whether they want to opt-out of the EU ETS in Phase III and therefore agree to the conditions of the UK's Opt-out Agreement Scheme.
Quarter 1 2012	Government submits UK's final opt out list to the Commission
Mid 2012	European Commission agrees the UK's final opt out list Following agreement of opt out lists for all Member States the Commission will finalise free allocations EU wide.

If you have any further questions about the UK's proposal on the EU ETS small emitter Opt-out Agreements Scheme, please contact DECC at eu.ets@decc.gsi.gov.uk. For queries about data please contact the Environment Agency at euetsphase3help@environment-agency.gov.uk.