

## **Explanatory Memorandum to the Greenhouse Gas Emissions Trading Scheme (Amendment) Order 2025**

This Explanatory Memorandum has been prepared for the Deputy First Minister and Cabinet Secretary for Climate Change and Rural Affairs by the Directorate of Climate Change and Environmental Sustainability and is laid before Senedd Cymru in conjunction with the above subordinate legislation and in accordance with Standing Order 27.1.

### **Minister's Declaration**

In my view, this Explanatory Memorandum gives a fair and reasonable view of the expected impact of the Greenhouse Gas Emissions Trading Scheme (Amendment) Order 2025. I am satisfied that the benefits justify the likely costs.

**Huw Irranca-Davies MS**

**Deputy First Minister and Cabinet Secretary for Climate Change and Rural Affairs**

**3 December 2024**

## **PART 1**

### **1. Description**

1.1 The UK Emissions Trading Scheme (“ETS”) was established by the Greenhouse Gas Emissions Trading Scheme Order 2020 (“the principal Order”) as a UK-wide greenhouse gas emissions trading scheme, to encourage cost-effective emissions reductions from the power, industry, and aviation sectors. It was designed jointly by the Governments of Wales, the UK, and Scotland, and the Northern Ireland Executive, who jointly operate the UK ETS as the UK ETS Authority (“the Authority”). It contributes to the UK’s emissions reduction targets and net zero goal, as well as the emissions reduction pathway in Wales.

1.2 In December 2023, the Authority opened a 12-week consultation entitled “UK Emissions Trading Scheme: free allocation review”, which explored options to better target those most at risk of carbon leakage and to ensure that the free allocation (“FA”) of allowances covering greenhouse gas emissions is fairly distributed. A small number of the technical changes proposed in the December consultation require implementation via legislation ahead of the 2025 Activity Level Report submissions.

1.3 The proposed amendments to be made by the Greenhouse Gas Emissions Trading Scheme (Amendment) Order 2025 (“the amending Order”) are to:

1.3.1 change the treatment of free allowances (FA) in the final year of activity of an installation or sub-installation where permanent cessation has occurred, so that operators’ FA entitlement in the final year of operation would be based on actual activity levels. Where the permanent cessation is due to decarbonisation activity, operators can apply to continue to receive a full year of free allowances. The suggested change will therefore not apply to these operators (subject to sufficient evidence).

1.3.2 update the definition of permanent cessation to capture scenarios where temporary cessation of an activity may be deemed permanent.

### **2. Matters of special interest to the Legislation, Justice and Constitution Committee**

2.1 As the Order in Council will be subject to UK, Scottish, and Northern Irish Parliamentary scrutiny, it is not considered reasonably practicable for this instrument to be made or laid bilingually.

### 3. Legislative background

- 3.1 Part 3 of Schedule 3 to the Climate Change Act 2008 (“CCA”) states that an emissions trading scheme that applies to England, Scotland, Wales and Northern Ireland – such as in this case – must be established by Order in Council.
- 3.2 The procedure for making such an Order in Council is prescribed by section 48 to the CCA.
- 3.3 As the amending Order contains provisions which would be caught by section 48(3) of the CCA, the affirmative procedure applies to it.
- 3.4 The principal Order set up the UK ETS to be operational from 1 January 2021. It runs for ten years, split into two five-year “allocation periods”. The scheme works by requiring operators of energy intensive industrial installations, power generators, and aircraft operators to monitor and report on their emissions and obtain and surrender “allowances” equivalent to their greenhouse gas emissions in each scheme year. There is a cap on the number of allowances that may be created. Some participants receive an allocation of allowances free of charge to help mitigate carbon leakage<sup>1</sup>, details of which are published in allocation tables.
- 3.5 There have been several amendments to the principal Order to give effect to technical changes that improve the operation of the UK ETS for both participants and regulators. These are contained in the following Orders in Council: the Greenhouse Gas Emissions Trading Scheme (Amendment) Order 2020, the Greenhouse Gas Emissions Trading Scheme (Amendment) Order 2021, the Greenhouse Gas Emissions Trading Scheme (Amendment) Order 2022, the Greenhouse Gas Emissions Trading Scheme (Amendment) (No. 2) Order 2022, the Greenhouse Gas Emissions Trading Scheme (Amendment) (No. 3) Order 2022, the Greenhouse Gas Emissions Trading Scheme (Amendment) Order 2023, the Greenhouse Gas Emissions Trading Scheme (Amendment) (No. 2) Order 2023, the Greenhouse Gas Emissions Trading Scheme Order 2024 and the Greenhouse Gas Emissions Trading Scheme (Amendment) (No. 2) Order 2024.
- 3.6 The principal Order and these amending Orders in Council were made under section 44 of the CCA. The amending Order is also being made under that power.
- 3.7 There have also been amendments made to the UK ETS via subordinate legislation made under the Finance Act 2020. These are contained in: the Greenhouse Gas Emissions Trading Scheme

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<sup>1</sup> Carbon leakage is the movement of production and associated emissions from one country to another due to different levels of decarbonisation effort through carbon pricing and climate regulation.

Auctioning Regulations 2021, the Recognised Auction Platforms and Greenhouse Gas Emissions Trading Scheme Auctioning (Amendment) Regulations 2021, the Greenhouse Gas Emissions Trading Scheme Auctioning (Amendment) Regulations 2021, the Greenhouse Gas Emissions Trading Scheme Auctioning (Amendment) (No. 2) Regulations 2021, and the Greenhouse Gas Emissions Trading Scheme Auctioning (Amendment) Regulations 2023.

#### **4. Purpose and intended effect of the legislation**

4.1 As the scheme matures the Authority has been looking to improve how it functions. In December 2023, the Authority opened a 12-week consultation entitled “UK Emissions Trading Scheme: free allocation review”, which explored options to better target those most at risk of carbon leakage and to ensure that the FA of allowances covering greenhouse gas emissions is fairly distributed. A small number of the technical changes proposed in the December consultation require implementation via legislation ahead of the 2025 Activity Level Report submissions, and so the Authority is providing an early response to these changes.

4.2 The two technical changes contained in the amending Order are:

- Technical Change One: Treatment of permanent cessations
- Technical Change Two: Updating the definition of permanent cessations

4.3 Technical Change One concerns a change in the treatment of FA in the final year of activity in the case of a permanent cessation (where the operator permanently ceases a regulated activity at an installation, or operations at a sub-installation).

4.4 Under current legislation, in cases of permanent cessations of activity, operators retain FAs they were entitled to during the final year in which the installation or sub-installation operated. FAs are then no longer distributed in the year after activity or operations stop. This is because operators will continue to be exposed to the carbon price in the final year of activity, and as such will still have a carbon leakage exposure which must be mitigated. However, this can lead to some operators receiving more FAs in the final year of activity than they require to adequately mitigate their carbon leakage risk, and in certain cases has resulted in them receiving FAs beyond their reported emissions.

4.5 The amending Order therefore seeks to amend the permanent cessation rules so that an operator’s FA entitlement in the final year of activity or operations is based on actual activity levels, not estimated activity levels. There will be an exemption for operators who provide evidence that the cessation is due to decarbonisation reasons, in order to maintain the incentive to decarbonise. These operators will therefore still receive the full year of FA based on their previous activity levels

(provided sufficient evidence of the closure being for decarbonisation is submitted).

- 4.6 Technical Change Two concerns a change in the definition of permanent cessation, to provide further clarity in the scenario where temporary cessation of an activity or operations may be deemed permanent.
- 4.7 Under current rules, an installation has ceased operation if a regulated activity is no longer being carried out at the installation and it is "technically impossible to resume operation". A sub-installation has ceased operation if the sub-installation is no longer operating and is it "technically impossible to resume operation". These definitions can lead to difficulties as "technically impossible to resume operation" can be interpreted in various ways.
- 4.8 The Authority has therefore proposed to update the definition of permanent cessation to remove the reference to "technically impossible to resume operation" and instead refer to the permanent cessation of regulated activity or operations.
- 4.9 The territorial extent of the amending Order is the whole of the United Kingdom.
- 4.10 The main changes are summarised below:

#### *Changes to Greenhouse Gas Emissions Trading Scheme Order 2020*

- 4.11 Article 5 of the amending Order changes the definition of what is meant by "ceased operation" and links to the provision setting out when installations must be treated as having ceased operation.
- 4.12 Article 6 of the amending Order revokes Article 34C(1)(e), which requires the Authority to update the allocation table when an installation has ceased operations.
- 4.13 Article 7 of the amending Order extends the appeal provisions to the scenario in which a regulator gives notice that an installation or sub-installation is to be treated as ceasing operation.
- 4.14 Article 8 of the amending Order amends Schedule 6 to update the conditions attached to a greenhouse gas emissions permit, to include the cessation condition (the requirement to notify the regulator of various matters related to a cessation), to alter the conditions under which regulators can give notice that an installation is to be treated as having ceased operation, and to reword the requirements which must be met for a permit to be considered surrendered (and therefore the regulated activity ceased).
- 4.15 Article 9 of the amending Order amends Schedule 7 to require a

hospital or small emitter permit to include the cessation condition.

- 4.16 Article 19 of the amending Order requires the regulator to vary, in accordance with Schedule 6 to the principal Order, every installation's permit to take into account the amendments made by the amending Order.

*Changes to the Commission Implementing Regulation (EU) 2019/1842 (the Activity Level Changes Regulation, (ALCR)) as it applies in domestic law*

- 4.17 Article 11 of the amending Order amends Article 2 ALCR to change the definition of what is meant by “ceased operation” and links to the provision setting out when sub-installations must be treated as having ceased operation.
- 4.18 Article 12 of the amending Order inserts Article 2a ALCR to allow a regulator to give notice that the regulator considers that all operations have permanently ceased at a sub-installation. It also sets out the circumstances in which such a notice may be given and withdrawn.
- 4.19 Article 13 of the amending Order amends Article 3 ALCR to specify details that must be included in the activity level report that operators submit when operations have ceased at a sub-installation.
- 4.20 Article 14 of the amending Order inserts Articles 3za, 3zb and 3zc. Article 3za provides for the calculation and adjustment of FA in the last year of an installation's operation to be based on the activity level in that final year. Article 3zb provides for the scenario where an installation ceases operation but provides evidence of that cessation being for decarbonisation purposes, in which case an application can be made for there to be no adjustment to FA in the final year. Article 3zc allows an application to be made to extend the time in which Article 3zb can be fulfilled. Article 20 of the amending Order sets out transitional provisions i.e. circumstances in which Article 3za will not apply.
- 4.21 Article 15 of the amending Order revokes Article 5(4), which requires the regulator, where a sub-installation has ceased operation, to calculate an adjustment to the FA of that sub-installation to zero as of the year following the cessation of operations.
- 4.22 Article 16 of the amending Order revokes Article 5a-5c, which allow for the omitting of 2020 data in activity level change calculations (due to the impact of the COVID-19 pandemic).
- 4.23 Article 17 of the amending Order amends Article 6a to ensure that where the regulator determines an activity level or adjusts FA under Art. 3za, the approval of the Authority is required.

*Changes to the Commission Delegated Regulation (EU) 2019/331 (the Free Allocation Regulation, (FAR)) as it applies in domestic law*

4.24 Article 18 of the amending Order revokes Art. 26 FAR, which provides that no allowances may be allocated to installations that have ceased operations, and that the Authority must approve the final annual allowance allocation to such an installation.

## **5. Consultation**

5.1 Before making an Order in Council under section 44 of the CCA, the Welsh Ministers are required to obtain, and take into account, the advice of the Climate Change Committee (section 48(1)(a) CCA). They are also required to consult such persons affected by the draft legislation as they consider appropriate (section 48(1)(b) CCA).

5.2A 12-week consultation ran from 18 December 2023 to 11 March 2024<sup>2</sup>, which detailed the technical changes proposed. The consultation was drawn to the attention of a wide audience of key stakeholders including affected scheme participants and any other organisation that may have wished to provide views.

5.2 Stakeholder responses to Technical Change One were majority in favour, with 40 responses to the question, of which 33 respondents agreed with the proposal (83%) and five respondents disagreed with the proposal (13%).

5.3 Generally, stakeholders felt it would ensure fairness in allocation of FAs in circumstances where there has been a permanent cessation and prevent overallocation. Concerns raised were related to potential administrative burden and complexity of calculating the actual activity levels of the final year.

5.4 Stakeholder responses to Technical Change Two were majority in favour, with 27 responses to the question, of which 18 respondents agreed with the proposal (67%) and 9 respondents disagreed with the proposal (33%) but did not provide a reason.

5.5 Copies of both the consultation document and Authority response are available on request.

5.6 The Climate Change Committee was consulted and has indicated that it is content for this legislation to be progressed.

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<sup>2</sup> [UK Emissions Trading Scheme: Free Allocation Review](#)

## **PART 2 – REGULATORY IMPACT ASSESSMENT**

### **6. Options**

6.1 This legislation makes two changes in the form of Technical Change One and Technical Change Two, as described above.

6.2 Regarding Technical Change One, there are two options available:

6.2.1 The business-as-usual option - keep the current rules for permanent cessation, and base FA entitlement on average activity levels within the five years prior.

6.2.2 Proceed with Technical Change One and base FA entitlement on actual activity levels in the final year of operation.

6.3 Analysis has shown that there is a potentially significant issue of equity and lack of targeting FA where it is required to mitigate carbon leakage. This is due to the possibility that some operators who permanently cease activities may receive FA in excess of their emissions in their final year. The proposed Technical Change One would work to remedy this issue.

6.4 Officials have therefore recommended to proceed with Technical Change One.

6.5 As detailed above, public consultation has been completed for the proposed change and stakeholders were majority in favour of the proposal.

6.6 Regarding Technical Change Two, this is considered a small definitional change and is therefore not expected to impact the market. It is in line with FA objectives and is technically and operationally feasible. This Regulatory Impact Assessment therefore focusses on Technical Change One.

### **7. Scale of Change and Costs and Benefits**

#### *Scale of the changes within the Scheme*

7.1 The scale of the impact of these changes is expected to be minor. A breakdown is provided below.

7.2 In 2022, 16 installations across the UK closed within the scheme year, triggering permanent cessation rules, with 2 of these 16 installations being based in Wales. In total, these sites received around 800,000 UK allowances from FA. This represents around 2% of total FA given in 2022 and affected roughly 2% of sites. For such sites, recorded emissions within the year of closure equalled a total of 150,000 (tonnes of CO<sub>2</sub> equivalent), significantly less than the total amount of FA given and around 0.1% of total ETS emissions.



- 7.3 It should be noted that there was significant variation in the net difference between FA and emissions for individual sites: roughly a third received more FA than their annual emissions, and two-thirds received less FA than their annual emissions. These individual outcomes were affected by the rate at which FA is given to a site and the timing of closure, with earlier closures associated with lower emissions but still receiving full FA for the scheme year under current rules.
- 7.4 In 2023, there were 10 closures in the UK ETS, none of which being based in Wales. Closures represented a much smaller proportion of emissions and FA: sites which permanently ceased regulated activity received a total of 10,000 UK allowances from FA, and such sites recorded a total of 60,000 emissions, less than 0.1% of total FA and emissions respectively.

#### *Costs and benefits of the business-as-usual option*

- 7.5 The business-as-usual option is not considered to offer any additional benefits, only that current processes would remain in place.
- 7.6 A key cost of this option as highlighted above, is that it can be considered to not adequately target carbon leakage support of FA in some cases of closures. Unnecessary allowances are therefore given to closed sites.
- 7.7 An additional wider risk is that current rules may result in market supply shocks if closing sites sell large volumes of allowances on the market. Given the majority of UK ETS secondary market purchases are from a broker or other intermediary, rather than direct operator-to-operator, this is considered a low-likelihood risk. Nonetheless, the Technical Change would actively lower these risks by reducing large surpluses that closing operators may sell into the market.

#### *Costs and benefits of proceeding with Technical Change One*

- 7.8 A key benefit of the change to rules is that FA is more accurately targeted, and given in proportion to activity, as is intended by the Free Allocation Methodology. Therefore, this change should support the intended objectives of emissions reductions through the UK ETS. This rule also retains the flexibility to allocate full FA when expected to support decarbonisation, whilst closing a loophole in other situations.
- 7.9 The change would have an impact in comparison to the business-as-usual option in that operators who close for non-decarbonisation purposes and would have received FA in excess of their actual emissions, no longer will receive this overallocation. They therefore would be unable to sell these unrequired allowances to the market. However, FA is a key policy lever for carbon leakage mitigation. The business-as-usual option does not adequately target carbon leakage

support. This is because on some occasions unnecessary allowances (above their final emissions) are given to closed sites. This means these sites are financially benefiting outside the purpose of the policy and so the rule change is justified.

- 7.10 Overall, this option is considered to be feasible to implement within current rules and the requirements of the Free Allocation Methodology, without any major issues identified which could lead to implementation challenges or significant costs.
- 7.11 In terms of technical and operational impact, this change is deemed straightforward and feasible. There may be both a familiarisation and administrative cost to Regulators in each of the four nations, in adopting the rules and implementing changes. However, given the reporting requirements already in place and the small number of closures, this is not expected to result in a significant increase in administrative costs relative to the business-as-usual option.
- 7.12 The historical compliance data (detailed above) showed that permanent cessation affects a small subset of installations and a small proportion of FAs. As such, we have assessed that it is unlikely to have a large impact on scheme parameters such as FA availability and likelihood of exceeding the Industry Cap – although this impact cannot be ruled out in cases of large closures.
- 7.13 In terms of potential consumer impacts of this change, we do not expect significant impacts on household bills or consumers. As noted, FA associated with permanent cessation has represented a very small proportion (0.1% - 2%) of total FA in recent scheme years. We do not expect impacts to the UK ETS, or to the price of UK allowances, therefore consumer impacts are not expected. Additionally, the changes would apply to closing operators, and therefore are not expected to significantly affect operators whose installations remain open.
- 7.14 Overall, the Authority assessment indicates that this policy change is technically feasible, likely to improve the targeting of FA, and reduce risks of overallocation in cases of permanent cessation relative to the counterfactual. As above, this policy is not expected to increase costs or pose implementation challenges relative to the current rules and requirements of the FA rules. Finally, wider market impacts or risks are likely to be reduced as a result of this change relative to the business-as-usual option.
- 7.15 As the impact to the market itself is expected to be limited, it follows that competition impacts to the involved sectors (industry, power generation and aviation) will also be limited.