REPORT TO SUSTAINABILITY COMMITTEE – 15 JUNE 2022

UK EMISSIONS TRADING SCHEME (UK ETS) UPDATE

1 Executive Summary/Recommendations

1.1 This report updates the Sustainability Committee on the proposals for the development of the UK Emissions Trading Scheme (UK ETS) as set out in the UK Government consultation Developing the UK Emissions Trading Scheme (UK ETS). The UK ETS is a significant scheme for various economic sectors which is why this report is being presented to the Committee.

1.1.1 As the proposals have limited direct interaction with Council business the Council is not planning to submit a full consultation response (deadline 17 June 2022). However, Chapter 7 of the proposals covers a call for evidence on expanding the UK ETS to include waste incineration and energy from waste and this report does highlight the draft response to these proposals from the NESS Energy Project in which Aberdeenshire Council is a partner.

1.2 The Committee is recommended to:

1.2.1 Note the proposals for development of the UK ETS;

1.2.2 Consider and comment on the potential for the proposals under the scheme to impact upon future activities in Aberdeenshire; and

1.2.3 Note the draft response to Chapter 7 of the proposals as set out at Appendix 1.

2 Decision Making Route

2.1 After leaving the EU Emissions Trading Scheme (EU ETS) the UK had a choice between establishing UK carbon taxes or a UK ETS. A UK ETS was chosen and commenced on 1 January 2021. The open consultation Developing the UK Emissions Trading Scheme (UK ETS) was published on 25 March 2022.

2.2 The UK ETS is a significant scheme which impacts and has potential to impact a number of industries, either directly or indirectly. Being aware of this scheme would allow Councillors to understand the potential impacts on local sectors and to potentially provide support and direction to the Council and local businesses as the scheme evolves.

3 Discussion

3.1 The UK ETS is a system where the government sets a total permitted amount of greenhouse gas emissions for selected areas of the economy and then sells ‘allowances’ to emit, which can be used to cover generated emissions or sold on. Within the scheme there is also a number of free allowances given to selected industries or areas of the economy based on perceived need.

3.2 This discussion section provides key points from the nine chapters of the Developing the UK Emissions Trading Scheme (UK ETS) document, as well as referencing (**Appendix 1**) the proposed response to Chapter 7 from the NESS Energy Project in which Aberdeenshire Council is a partner.

Glossary of terms

Allowance	A permit under the UK ETS that allows the owner to emit a certain amount of specified greenhouse gas emissions.
The Authority	UK Government, Scottish Government, Welsh Government and the Department of Agriculture, Environment and Rural Affairs for Northern Ireland, (DAERA).
Cap	Upper limit on the total amount of certain greenhouse gases that can be emitted by sectors covered by the scheme.
Carbon leakage	Where production and associated greenhouse gas emissions are offshored to other jurisdictions with different policies.
Free allocation	Free Allowances awarded by the Authority selected industries or areas of the economy based on perceived need. Free Allocation is considered a mechanism to prevent carbon leakage.
Stationary sector	The UK ETS applies to energy intensive industries, the power generation sector and aviation. The stationary sector refers to the non-aviation sectors.

3.3 **Chapter 1: Net zero consistent cap**

'*Sets out proposals for changes to align the UK ETS cap and trajectory with our net zero target.*'

3.3.1 The cap trajectory is based on the recent UK Government's Net Zero Strategy and provides the foundation for the net zero consistent cap trajectory from 2024. The current cap will remain in place until the end of 2023 to maximise the period of notice to the market from the date of this consultation. It would allow a total cap for the entire first Phase (2021-2030) of between 887 million allowances and 936 million allowances. Compared to the current legislated cap for the whole phase – 1365 million allowances – this would equate to a reduction of between around 30-35% over the course of the phase. The range reflects the fact that there is some degree of uncertainty in expected sectoral emission reductions and in other key assumptions. The Authority is currently minded to set the cap towards the higher end of the range. However the final trajectory, wherever it is set within this range, will be subject to consultee views and updated assessments of emissions abatement progress across all sectors and regions, reflecting different nations' ambition in the 2020s. The Authority will assess the final level of the cap needed in order to achieve the four nations' carbon targets, taking all this evidence into account, and a finalised position will be set out in the government response to this consultation.

3.4 Chapter 2: Free allocation review

'*Considers the role of Free Allocation policy as a carbon leakage mitigation tool in the context of the net zero aligned cap. It also puts forward potential improvements to the current Free Allocation regime based on stakeholder views expressed in response to the 2019 consultation on carbon pricing and the call for evidence on free allocation in 2021.*'

3.4.1 This chapter focuses on changes to free allocations for the stationary installations energy intensive industries and the power generation sector (excluding aviation). It also puts forward potential improvements to the current free allocation regime. This is based on stakeholder views expressed in response to the 2019 consultation on carbon pricing and the call for evidence on free allocation in 2021.

3.4.2 The review from the call for evidence will be conducted in two phases. The first phase will look at aligning the share of free allocation within proposed changes to the overall UK ETS cap. These top-down changes will be implemented during 2024. In addition, some technical amendments will be made to the scheme to address discrepancies. The second phase will focus on the methodology for distributing free allocation to participants. These bottom-up changes will be implemented by 2026 to align with the second allocation period of the UK ETS.

3.4.3 The industry cap sets an upper bound on free allocations that can be issued each scheme year. Under current scheme rules the industry cap is set at the UK's notional share of the EU ETS industry cap for Phase IV of the EU ETS. This equates to around 58 million allowances in 2021 and will reduce annually by around 1.6 million allowances.

3.4.4 As the overall cap tightens to align with our net zero targets, fewer allowances will be available each year over the course of the first phase of the UK ETS (2021-2030). To avoid any unintended impacts to market functioning, stability, or liquidity which could arise if free allocations made up the majority of allowances under the cap, the Authority is considering changes to the industry cap. As part of this consultation, it is setting out the broad options and guiding principles it will use to decide which industry cap is most suitable for the scheme going forward. The Authority's preferred industry cap option will be decided upon following analysis of consultation responses and presented alongside a decision on the absolute level of the cap and impacts analysis.

3.4.5 To maintain the market signal which the UK ETS sends to incentivise participants to decarbonise, it is desirable that auctioning continues to be the main way of bringing allowances to the market, ensuring that a price on emissions is established. Resetting the industry cap to make up a percentage of the overall cap rather than being set as fixed numbers, as in current legislation is the approach being pursued by the Authority. This is due to the impacts to market functioning and liquidity, credibility of the UK ETS as an environmental policy, and as an incentive to decarbonise.

3.4.6 The Authority is mindful of the impacts that may be felt by operators which receive free allocations as the net zero consistent cap is implemented. It is committed to ensuring that these impacts are mitigated in the near term, giving industry time to adapt and factor these into their investment decisions. The Authority will use its reserve of unallocated allowances or the flexible share to mitigate against any reduction to free allocations for the first allocation period, 2021-2025. The Authority will also consider using a lower or higher proportion of the overall cap than 37% and will set out the exact figures as well as reasoning as part of the government response.

3.4.7 As part of the next stage of the review the Authority will look at the current methodology for distributing free allowances and will explore ways to better target free allocations for those most at risk of carbon leakage and ensure they are fairly distributed. They aim to consult on the future changes in 2023 with implementation ready for 2026. A range of approaches could potentially help to address carbon leakage which is caused by different countries mitigating emissions at different rates. The Authority will be publishing more analysis on the possible risks of carbon leakage from the UK in further consultations as part of the Free Allocation Review. This will inform possible changes to free allocation policy to better improve carbon leakage mitigation within the UK ETS.

3.5 **Chapter 3: Unallocated free allowances and flexible share**

'*Sets out proposals for bringing in unallocated allowances and/or the flexible share to the market.*'

3.5.1 Unallocated allowances result from the number of free allowances distributed to operators being below the industry cap, which sets the maximum number of free allowances that can be allocated to stationary operators, in a given scheme year. The flexible share is a pot of allowances representing 3% of the cap for the 2021-2030 trading period. Unallocated allowances and the flexible share currently serve two legislative functions:

1. They can be used to mitigate the application of a Cross-Sectoral Correction Factor (CSCF) which is applied when a number of allowances allocated for free in a scheme year is higher than the industry cap applying a proportionate reduction to each participant's free allocations.

2. They can be drawn from by the Cost Containment Mechanism (CCM) which is a tool for the Authority to intervene if auction prices are elevated for a sustained period, causing market instability.

3.5.2 Neither unallocated allowances nor the flexible share have so far been utilised through existing mechanisms in legislation. This pool of allowances is expected to grow in the 2022-2023 period, as free allowances will continue to be below the industry cap. The Authority is considering options to bring these allowances to market in this consultation.

3.5.3 The implementation of the net zero consistent cap in 2024 will require a significant drop in allowances reaching the market in 2024 compared to previous years. The Authority is considering bringing a portion of 2021-2023 unallocated allowances and/or flexible share to auction, to smooth the transition to the net zero cap. The exact timing of the release of additional allowances into auction would also need to be considered. This would provide a level of support to market participants in the transition to a net zero consistent cap by increasing the supply of auctioned allowances. It would also provide a direct route to market for unallocated allowances and/or the flexible share, supporting market liquidity. The Authority also intends to retain a portion of unallocated allowances and/or flexible share for market stability uses.

3.6 Chapter 4: A call for evidence on future markets policy

'*Calls for evidence on potential drivers of evolving market conditions in the UK ETS and objectives for market stability policy as the scheme evolves.*'

3.6.1 The launch of the UK ETS has created a new marketplace for buying and selling 'allowances' to emit certain greenhouse gases. Markets can be inherently volatile but stability in the market for allowances would instil confidence and allow for better planning from those involved in the market. This section includes consultation on policy measures to regulate various aspects of the allowances market.

3.7 Chapter 5: Aviation

'*Sets out the scope of the review into UK ETS aviation policy. This includes proposals on the future of aviation free allocation, considering responses to the 2019 consultation on carbon pricing, the 2021 call for evidence, and UK government commissioned economic research. It also considers how the use of Sustainable Aviation Fuels (SAFs) could be incentivised under the UK ETS and options for expanding the coverage of the scheme within the aviation sector.*'

3.7.1 Aviation is one of the sectors covered by the UK ETS. The UK ETS covers domestic UK flights, flights from the UK to the European Economic Area (EEA), and flights between the UK and Gibraltar. In 2019, these flights made up 44% of all commercial flights to and from UK airports. The aviation sector currently receives a proportion of UK ETS allowances for free, which they can use towards their scheme obligations. The free allocation policy instrument in general aims to mitigate carbon leakage (definition below) and support industry competitiveness.

3.7.2 The consultation questions around free allocation include the ways in which the free allocations should be distributed among the industry to be as fair as possible and also over what timescale these free allocations should be phased out.

3.7.3 Question 57 of the consultation asks about ways that any unintended impacts on regional connectivity through the UK ETS could be mitigated.

3.7.4 The Council officers who link to the aviation sector via economic development and transport will ensure that the links between the UK ETS proposals are flagged to key partners.

3.8 **Chapter 6: Expanding UK ETS coverage within covered sectors**

'*Sets out proposals and calls for evidence on possible changes to the rules for sectors currently covered by the UK ETS to ensure more greenhouse gas emissions are covered by the scheme.*'

3.8.1 The inclusion of venting and flaring (releasing and burning respectively) of excess gas is included in the UK ETS consultation. Although focused on the oil and gas sector it is of relevance to other sectors that vent or flare. Council landfill sites include passive venting and flaring of methane and carbon dioxide so there is potential for these to be considered for inclusion and officers will provide comments to the consulting Authority.

3.8.2 There is a proposal to expand the UK ETS to allow for transportation of CO_2 through other means than pipeline (e.g. shipping, rail, road) for onward carbon capture without surrendering allowances. The status quo would negatively affect those looking to capture carbon when having to use alternative transportation (i.e not a pipeline) to the carbon capture site. This could potentially impact carbon capture and storage projects in Aberdeenshire, such as The Acorn Carbon Capture and Storage Project and officers are engaging with the promoters of that project on this matter.

3.8.3 Proposals are to apply sustainability criteria to biomass use in all installations to ensure a consistent approach between the UK ETS and other biomass policies. Power generating installations that are biomass only would be exempt from the UK ETS but those using fossil fuels in addition to biomass would be captured. There are also questions relating to the thresholds in terms of thermal energy produced for installations that would be required to participate in the UK ETS. Depending on the set thresholds there is potential for Council generators to be impacted and officers are keeping this under review.

3.9 **Chapter 7: Expanding the UK Emissions Trading Scheme to new sectors**

'*Sets out proposals to expand the scope of the UK ETS to the domestic maritime sector and calls for evidence on expanding the UK ETS to include waste incineration and energy from waste.*'

3.9.1 The Authority has committed to continue exploring options for expanding carbon pricing beyond energy intensive industries, the power generation sector and aviation, to which the UK ETS currently applies.

3.9.2 For the domestic maritime sector the aim of the Authority is to price in some of the externalities of conventional marine fuels, encouraging investment in energy efficiency and alternative fuels. It is proposed that emissions would be calculated based on the volume of fuel multiplied by the carbon intensity of the fuels. The consultation covers proposals to expand the UK ETS to domestic maritime by the mid-2020s under either a vessel activity basis, a fuel supplied basis or a hybrid approach.

3.9.3 There is also a proposed UK ETS expansion to cover waste incineration with no energy recovery, and energy from waste (EfW) by the mid to late 2020s. The consultation on this area covers the scope of proposals, monitoring, the reporting and verification of emissions, impacts on the market and interaction with planned and existing policies.

3.9.4 The proposed response from the NESS Energy Project, in which Aberdeenshire Council is a partner, to the calls for evidence on expanding the UK ETS to include waste incineration and energy from waste is given in **Appendix 1**.

3.10 **Chapter 8: Calls for evidence on greenhouse gas removals (GGRs) and agriculture and land use emissions**

'*Calls for early views on the incorporation of greenhouse gas removal (GGR) into the UK ETS and the monitoring, reporting and verification requirements necessary to address greenhouse gas emissions in the land use and agriculture sectors. We do not propose expanding the UK ETS to agriculture.*'

3.10.1 It is recognised that certain industries, such as aviation and agriculture, will be difficult to totally decarbonise by 2050, and using GGRs will be crucial in compensating for the residual emissions coming from the most challenging areas of the polluting sectors. An object of the consultation is to assess whether and how the UK ETS can be used as one potential approach to support GGR growth and deployment, and how this would impact the functioning of the UK ETS.

3.10.2 A further consultation in 2022 will seek preferred business models to incentivise early investment in engineered GGRs with the aim of deployment from the mid-to-late 2020s. There is also ongoing academic research looking at integrating GGRs into cap-and-trade markets and how they should be approached as a path to Net Zero.

3.10.3 Six key opportunities of integrating GGRs into the UK ETS are outlined, including: helping UK meet net zero targets; greater focus on co-benefits from increased nature-based solutions; and ramping up of GGR development and deployment. There are however several key considerations including: GGRs possibly weakening the overall incentive to decarbonise; and issues surrounding monitoring, reporting and verification.

3.10.4 It is noted that agriculture has the potential for positive and negative emissions. Some farms may store and sequester carbon through afforestation or sell carbon services to supply chain partners. For agriculture an object of the consultation is to assess the potential for Monitoring, Reporting and Verification (MRV) in agriculture to improve business level decisions and productivity, and to reduce greenhouse gas emissions from food growing (excluding transportation and processing). The proposed benefits of MRV are transparency and confidence in traded carbon, better informed decisions by food producers, retailers, and government, understanding of source and scale of emissions, and prioritisation of mitigation efforts.

3.11 **Chapter 9: Operational amendments to UK ETS**

'*Sets out proposed amendments to support effective operation of the UK ETS by addressing a number of operational issues identified during the development of policy and legislation for the scheme.*'

3.11.1 This section calls for views on a number of different issues related to the operation of the UK ETS and proposals including the following:

- Electricity Generators exporting heat for district heating but who have not been able to export measurable heat produced in the 'relevant period' do not currently qualify for free allocation. Responses are being sought to ascertain if they should be able to demonstrate eligibility and over what period this would be necessary.

- New entrants to the UK ETS can potentially have their free allocation for a year based on a very limited time frame if they begin operations late in the previous year. The proposal states that they should wait until a full calendar year of information is available before being able to apply for the free allocation.

- Proposal for additional statutory appeal routes against Authority decisions which would apply to specific decisions impacting individual operators (rather than appealing against the overall policy).

- Proposal to introduce two new penalties for 'Failure to submit information' and 'Failure to comply with notification requirements'.

4 Council Priorities, Implications and Risk

4.1 This report links to the Economy and Enterprise Priority under the Our Economy Pillar of Aberdeenshire Council's strategy on account of the UK ETS being a significant national scheme with potential to impact a number of industries, either directly or indirectly. It also links to the Infrastructure Priority under the Our Environment Pillar through the NESS Energy Project, in which

Aberdeenshire Council is a partner. Additionally, it also relates to the climate and sustainability principle underpinning the Aberdeenshire Council priorities.

4.2 The table below shows whether risks and implications apply if the recommendations are agreed.

Subject	Yes	No	N/A
Financial			X
Staffing			X
Equalities and Fairer Duty Scotland			X
Children and Young People's Rights and Wellbeing			X
Climate Change and Sustainability			X
Health and Wellbeing			X
Town Centre First			X

4.3 The screening section as part of Stage One of the Integrated Impact Assessment process has not identified the requirement for any further detailed assessments to be undertaken. This report is only providing an update on a UK Government consultation and providing opportunity for Councillors to review and provide comment.

4.4 The following Risks have been identified as relevant to this matter on a Corporate Level:

- ACORP002 Changes in government policy, legislation and regulation

5 Scheme of Governance

5.1 The Head of Finance and Monitoring Officer within Business Services have been consulted in the preparation of this report and their comments are incorporated within the report and are satisfied that the report complies with the Scheme of Governance and relevant legislation.

5.2 The Committee is able to consider this item in terms of Section R paragraphs 1.1a and 1.1c of the List of Committee Powers in Part 2A of the Scheme of Governance as it relates to approving, reviewing and monitoring the Council's work in respect of sustainable development and climate change.

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List of Appendices:
Appendix 1 - NESS Energy Project proposed response to UK ETS consultation