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Developments in Emissions Trading in the U.K. and EU

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Proposed changes to EU ETS

We have previously discussed the key elements of the European Union's (EU) ambitious "Fit for 55" package in our blog post here, which aims to reduce EU net greenhouse gas emissions by 55 percent by 2030 as compared to 1990 levels.[1]

The EC launched the EU ETS in 2005 and many observers have recognized the system as a highly effective tool for decarbonization. Currently, the EU ETS is applicable to 40-45 percent of EU greenhouse gas emissions, including with respect to the energy, power and aviation sectors. The latest revision of the EU ETS Directive, adopted in 2018, aims to bring emissions allowances during 2021 through 2030 in line with the previous EU emission reduction target—i.e., a 43 percent reduction by 2030 relative to 1990 levels. The proposed revisions to the EU ETS, as part of the Fit for 55 package, go further and look to extend these reduction targets by an additional 18 percent (or an aggregate 61 percent reduction as compared with 1990 levels). The proposal seeks to bring forward achieving these additional reductions by no later than 2030 and intends to do so by increasing annual percentage reductions and applying emissions trading mechanisms to additional sectors as described below.

Maritime

The new proposals plan to gradually extend the applicability of the EU ETS to the maritime sector over the period of 2023-2025. The focus for reducing emissions will be placed on large ships (in excess of 5,000 gross tonnage) and will apply to 100 percent of all emissions generated from intra-EU traffic and 50 percent of emissions generated from extra-EU traffic (i.e., voyages that either start or end at an EU port and regardless of a ship's flag). With the phase-in, shipping companies will be required to surrender 100 percent of their verified emissions as of 2026. There could be significant implications for ships failing to comply with these new measures, including denying entry to EU ports by noncompliant ships.

Aviation

The proposals also increase the impact of decarbonization measures in sectors already under the EU ETS, such as aviation, where free allowances will be phased out for intra-EU flights by 2026. In an attempt to address extra-EU flights made by EU-based airlines, the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA)—a UN scheme to ensure any international aviation emissions above 2019 levels are offset elsewhere—will be implemented in EU law through the EU ETS.

Road transport and buildings

The proposed revisions to the EU ETS go further to establish a new separate emissions trading system for emissions from fuels used in road transport and buildings, which will apply beginning in 2026.[2] The administrative rules for the new system are expected to largely replicate the existing EU ETS, specifically in areas such as transfer, surrender, monitoring and reporting and penalties for noncompliance. The EU has not ruled out integrating the two emissions systems at some stage; however, representatives of the EU have expressed concerns about the potentially destabilizing impact that introducing these mechanisms to road transport and buildings may have on the existing EU ETS, at least initially.

This new system will focus on upstream fuel suppliers, putting the responsibility on fuel producers and suppliers to comply with the system, in accordance with the EC's efforts to prevent individual households or road transport users from having direct obligations under the emissions scheme. Nonetheless, it is likely that consumers (including economically insecure consumers) will be hit with increased prices as a result of the proposals. The proposals contemplate that the compliance obligation would be triggered on the release into the market of fuels for consumption which are used to heat buildings and road transport sectors and which have an emissions factor.

The EC proposals consider the issue of double counting, but place responsibility on the regulated entities to determine whether the obligation is triggered based on end users of fuels (and the sectors in which the fuels are being used). The total quantity of allowances allocated for auction within the new system will be established in 2026. Nevertheless, it is not currently expected for free allowances to be allocated as part of the new system, as the EC determines the risk of carbon leakage in these sectors to be very low.

The EC recognizes that these areas have been challenging to decarbonize, but is quick to emphasize that the potential for innovation in this area is high. The EC, in particular, is hopeful that the new scheme will increase incentives to supply cleaner fuels for existing vehicles and speed up decarbonization. Whilst the EC has sought to address the social impacts from rising prices of fuels and heating bills through a Social Climate Fund, and has plans to incentivize and support the switch to lower-emission alternatives through a variety of approaches, it remains to be seen whether these governmental programs can provide sufficient financial support to low-income households to cover the cost of increasing energy prices and to enable the transition to lower emission alternatives for transport and heating.

Proposed changes to the U.K. ETS – The U.K. Government's Net Zero Strategy

As discussed in our blog post here, the U.K. imposed the U.K. ETS earlier this year to replace the EU ETS as a result of the U.K.'s exit from the EU ETS as part of Brexit.

Currently, the U.K. ETS mirrors the EU ETS, but caps emissions at 5 percent below the U.K.'s notional share of the EU ETS cap for Phase IV of the EU ETS (2021-2030). As part of the NZS, the U.K. government announced that it will consult later this year on a net zero consistent cap, such that the cap will be aligned with a net zero consistent trajectory by January 2023, or January 2024 at the latest. The U.K. government has also expressed its intent in the NZS to review the allocation of free allowances while balancing the risk of carbon leakage to ensure that free allowances are allocated in a targeted manner while preserving the incentive to decarbonize for those industries.

As part of the NZS, the U.K. government proposes to extend the existing U.K. ETS and will consult in due course on extending the U.K. ETS to the two-thirds of emissions that are currently not included in the scheme—one would assume that road transport and heating will be high on the list of sectors to be subject to such expansion.

Finally, the NZS emphasizes the importance of engineered and nature-based greenhouse gas removals (GGRs) for achieving the U.K.'s net zero ambitions—in fact, it establishes that the U.K. currently will not meet its net zero target by 2050 without GGRs. The NZS commits to consider how the U.K. ETS could be utilized as a potential market-based solution for stimulating investment in GGRs where GGRs could represent negative emissions within an emissions trading system and this could offer a long-term market solution to support GGRs.

It is clear that both the U.K. and the EU intend to continue to utilize emissions trading as an effective tool to stimulate private investment and incentivize decarbonization across a growing range of sectors in the economy to meet its aggressive NDC—it remains to be seen whether this can be replicated on the world stage.

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[1] Target is part of the European Climate law, adopted 9 July 2021.

[2] The existing EU ETS already covers some emissions from buildings predominantly through electricity used for heating.

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