

# EU Emissions Trading Scheme – An overview

The European Emissions Trading Scheme (EU ETS)<sup>1</sup> first came into effect on 1 January 2005. Its aim is to reduce carbon dioxide emissions across Europe by introducing a "cap and trade" scheme for all industries falling within its scope. The Directive has since been revised in order to achieve greater emissions reductions across energy intensive sectors. The changes will take effect from 2013.

This briefing note outlines the main elements of the European regulatory framework, emphasising the key components of the EU ETS and explaining some of the terminology embodied in the regime.

## Industries covered by the EU ETS

In total, approximately 12,000 CO<sub>2</sub> emitting installations are covered by the EU ETS. They include, but are not limited to, energy and combustion companies, oil refineries, pulp and paper installations, producers of steel, cement, glass, and ceramics<sup>2</sup>.

In the UK, if an installation is carrying out one or more activities listed in Schedule 1 to the ETS Regulations<sup>3</sup> (including Annex A and Annex B

activities), which fall above specified thresholds, then the activity in question will be covered by the EU ETS.

Member States set aside a quantity of allowances to be distributed at no cost to new entrants to the scheme, known as the New Entrant Reserve (**NER**), each sector covered by the scheme making a contribution to the reserve. In 2006, the ETS Regulations were revised in the UK in order to accommodate installations operating prior to 2004, enabling them to apply to the reserve.

## Scheme Phases

The EU ETS is divided into three trading periods. The first (**Phase I**) ran from 1 January 2005 to 31 December 2007. Phase II began on 1 January 2008 and is set to run until December 2012, coinciding with the first Kyoto

<sup>1</sup> Directive 2003/87/EC – established a scheme for greenhouse gas emissions allowance trading within the EU - Directive 2009/29/EC revises this Directive

<sup>2</sup> UK participants: EU Emissions Trading Scheme – Guidance Note 1: Guidance on Inclusion - Updated for Phase II (November 2007).

<sup>3</sup> The Greenhouse Gas Emission Trading Scheme Regulations 2005 (as amended).

Commitment Period<sup>4</sup>, which was approved on 16 March 2007. Finally, Phase III will run from 2013 to 2020, in line with the revised EU ETS<sup>5</sup> with possible further phases after this.

## The Mechanics of "Cap and Trade"

Pursuant to the requirements of the EU ETS Directive and national transposing legislation, an overall limit or "cap" is to be set by each Member State for those EU Allowance Units (**EUAs**), to be issued to individual installations that fall under the EU ETS. Member States must develop National Allocation Plans (**NAPs**). These set out final allocations of CO<sub>2</sub> allowances for participating installations, identifying the total allowances to be allocated for each year of the relevant trading period (i.e. Phase I or Phase II of the EU ETS) to individual installations. NAPs must set out how allowances are to be issued to participating installations and require approval by the EC, being consistent with Member States' emissions reduction targets under the EU burden Sharing Agreement for the Kyoto Protocol. Each EUA permits the holder to emit one tonne of CO<sub>2</sub> during the year specified.

The EU ETS, at present, allows up to 10% of allowances to be auctioned in Phase II – the UK's current NAP providing for 7% of their cap to be auctioned, which would otherwise be allocated as "free" allowances to installations. The "auctioning pot" will be augmented by installation closures and surrenders, in addition to surplus allowances from the NER.

A Greenhouse Gas Emissions Permit (**GHG Permit**) is, in effect, a licence to operate and emit CO<sub>2</sub>. Permits are required by all operators undertaking Annex 1 activities. Conditions attached to GHG Permits will require a monitoring and reporting plan to be approved by the Regulator (i.e. the Environment Agency in the UK). For each year of the scheme, data for the previous year must be verified and the equivalent number of allowances surrendered.

**Operator**<sup>6</sup> means: "any person who operates or controls an installation or, where this is provided for in national legislation, to whom decisive economic power over the technical functioning of the installation has been delegated".

**Installation**<sup>7</sup> means: "a stationary technical unit where one or more activities listed in Annex I are carried out and any other directly associated activities which have a technical connection with the activities carried out on that site which could have an effect on emissions and pollution".

In the UK, if there is more than one operator running different parts of the Schedule 1 activities carried out at the installation, the permit for each part should indicate that the operator or appropriate person has been identified. Operators who carry out several activities falling under the same heading in Schedule 1<sup>8</sup>, at different parts of the installation, will have the capacities of each activity added together for the purposes of calculating emissions, regardless of whether they are technically connected or not.

## EU ETS Compliance and Operation

Operators, having been allocated a specified number of allowances in accordance with the NAP are required to surrender allowances equal to the total emissions of their installation for each calendar year of the Scheme (now Phase II), demonstrating to the Regulator that it holds sufficient allowances to cover the amount of CO<sub>2</sub> and other greenhouse gases emitted during the course of that year.

An operator of an EU ETS installation is under a legal requirement to surrender sufficient allowances for each Scheme year to account for its actual emissions, via the Registry. Those installations and operators who do not have sufficient allowances to cover total emissions at the end of the Scheme year may acquire additional allowances from those operators who have an excess or any other person who holds allowances. Surplus allowances can either be

offered for sale or "banked" for use in the following calendar year provided that it is in the same compliance period.

The **EU Linking Directive**<sup>9</sup> enables allowances issued under the Clean Development Mechanism (**CDM**) (Certified Emission Reductions (**CERs**)) or Joint Implementation (**JI**) (Emission Reduction Units (**ERUs**)), excluding allowances in respect of land use, land use change and forestry activities and nuclear facilities in Phases I and II, to be used to meet compliance limits under the EU ETS, subject to certain conditions and caps.

## Consequences of a failure to comply with EU ETS

Those operators who fail to surrender sufficient EUAs will be fined with an excess emissions penalty of €100 for the period 2008 to 2012 for each tonne of CO<sub>2</sub> emitted for which EUAs are not surrendered<sup>10</sup>. In addition, operators will also be obliged to provide the requisite quantity of missing EUAs for surrender in the following year.

## Registry

All transfers and surrenders of EUAs must take place via an electronic registry, Member States being required to establish, maintain and manage such registries. In the UK, the EU/UN ETS Registry is operated by the Environment Agency, which carries out the role of Registry Administrator, enabling the Agency to monitor and approve all registry accounts. Such computerised registries are key components of the EU ETS and wider international emissions trading under the Kyoto Protocol. The Community Independent Transaction Log (**CITL**), records the issue, transfer, cancellation, retirement and banking of all allowances that take place via a national registry.

4 Kyoto Protocol: Protocol to the UNFCCC Convention which commits various countries who ratified the Protocol to reduce their greenhouse gas emissions below levels specified within a five year time frame between 2008 and 2012.

5 Directive 2009/29/EC

6 Article 3(f) Directive 2003/87/EC

7 Article 3(e) Directive 2003/87/EC

8 ETS Regulations

## Trading Accounts

An operator holding account will automatically be created for all holders of GHG Permits at their national registries, into which any allocation of EUAs will be issued. Trading accounts will reflect the cancellation of EUAs equal to the number of EUAs surrendered for CO<sub>2</sub> emissions that took place at an installation for a given year of the Scheme. Organisations and persons wishing to participate in the EU carbon trading market will also be able to open accounts at national registries.

As EUAs are transferable, EU ETS trades can take place in a number of ways:

- Direct trade with other EU ETS companies;
- Use of intermediaries (e.g. banks, specialist traders) to buy and sell;
- Brokers; and
- Specialist exchanges that list carbon allowances products.

A number of international market organisations have published standard form agreements for the documentation of emissions trades. These include IETA, International Emissions Trading Association, EFET European Federation of Energy Traders and the ISDA International Swaps and Derivatives Association. Many trades are carried on the basis of such agreements. It should be noted, however, that these trading contracts do have different characteristics to primary emission reduction purchase agreements.

## New EU ETS Directive - Reform

The revised Directive (agreed in April 2009) will apply to Phase III of the EU ETS and is a key component of the EU's "2020" package<sup>11</sup> and its commitment to reduce overall emissions by 20% below 1990 levels by 2020 (or 30% if an international agreement can be reached).

From 2013 onwards there will be a new centralised EU community-wide cap on emissions and NAPs put together by individual Member States (as used in Phase II) will no longer apply, thereby avoiding perceived 'risks' of over allocation that may threaten the cap and trade system. Auctioning is

to be a cornerstone of EUA allocation in order to ensure that the cost of carbon is better integrated into business and heavy industry such as electricity generation, oil refineries, cement and paper manufacture will be compelled to make a marked contribution towards reaching the EU's 20% goal. Access to international project credits (CERs and ERUs) will be limited to 50% of the reductions required in the EU ETS and the scheme itself will be extended to cover new sectors and gases including the petrochemical and aluminium industry and associated emissions. A new consolidated community Registry<sup>12</sup> is to be established and will be responsible for co-ordinating all EUAs issued from 2012 onwards, together with a new monitoring and verification system. In the UK, the Directive will be transposed into domestic legislation in two stages, the first by 31 December 2009 and the second by the end of 2012.

In line with the new EU-wide cap on emissions, the EC will publish the total number of EUAs available for 2013 no later than June 2010 and a decreasing trajectory will apply throughout Phase III. EUAs will no longer be allocated free of charge; rather, they will be auctioned, with purchases set to start at 20% with an 80% free allocation in 2013, rising to 70% of purchases in 2020. Electricity generators, unlike other sectors will be required to purchase all of their required EUAs at auction from 2013 onwards. The new EU ETS will provide for a New Entrant Reserve of 5% of the total quantity of EUAs. Any surplus allowances that are not allocated to new entrants during Phase III will be auctioned by the Member States accordingly.

The EC is set to monitor and report on progress of the 'carbon market'.

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9 Directive 2004/101/EC

10 Article 16 of the EU ETS Directive

11 2020 Package – new EU measures including a revised EU ETS and Renewable Energy Directive, an Effort Sharing Decision, a new Regulation limiting emissions from cars, a Biofuels (Fuel Quality) Directive and a Carbon Capture and Storage Directive aimed reducing GHG emissions by 20% and achieving 20% of the EU's overall energy consumption from renewable sources by 2020 - agreed in December 2008

12 EC Regulation 994/2008

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