

# EU Emissions Trading Scheme – An overview

The European Emissions Trading Scheme (EU ETS)<sup>1</sup> 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.

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 – establishing a scheme for greenhouse gas emissions allowance trading within the European Community, amending Directive 96/61/EC. Member States were required to implement national legislation to comply with the Directive by 31 December 2003.

<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 is to run from 2013 to 2017 at present, with possible further phases running 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, Phase II or Phase III 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>5</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>6</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 I<sup>7</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 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 due to factors such as an inability to reduce emissions to meet allocated targets through a reduced production, increased efficiency or investment in cleaner technology, 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 compliance period.

The **EU Linking Directive**<sup>8</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. Delivery of these allowances, however, is dependent on linking of the Community Independent Transaction Log and the CDM International Transaction Log and the operation of that link, which have yet to occur.

## 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>9</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**), which has been in place since the EU ETS was established, will record the issue, transfer, cancellation, retirement and banking of all allowances that take place via a national registry. It will indicate

<sup>4</sup> 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.

<sup>5</sup> Article 3(f) Directive 2003/87/EC

<sup>6</sup> Article 3(e) Directive 2003/87/EC

<sup>7</sup> ETS Regulations

<sup>8</sup> Directive 2004/101/EC

when a Member States' registry goes live and when accounts are opened, providing relevant contact details and an indication of whether or not allowances have in fact been allocated in accordance with a NAP.

### 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 (between persons, including companies both within the European Community and between persons within the European Community and third countries), 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 - Allowances Appendix to the EFET General Agreement; ISDA International Swaps and Derivatives Association, emissions working group and Form of Allowances Annex to be used as Part 6 to the Schedule to the ISDA Master Agreement and long form Emissions Allowances Confirmation for an OTC physically settled EU emissions allowances transaction. 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.

## Proposals for Change

A part of a wider package, on 23 January, the EC published proposals for a new directive to amend the current EU ETS, "the EU ETS Reform Directive". If implemented, the new directive will introduce a single EU wide emissions cap, with the EC being solely responsible for setting the total number of EUAs available rather than individual Member States, thereby avoiding perceived problems associated with over-allocation threatening the cap and trade carbon market. In addition, the EC proposes to expand the Scheme to cover new industry sectors from 2013, providing increased auctioning and longer phases, with the Scheme's third Phase being extended to eight years.

The EU has made a commitment to reduce its overall emissions by 20% below 1990 levels by 2020 (or 30% if an international agreement is reached on measures to tackle climate change after 2012), the reform of the EU ETS being a fundamental component of their package of proposals to fight climate change and promote renewal energy in line with EU commitments. Additional draft legislative proposals include:

- A directive on the promotion of use of energy from renewable sources;
- A decision on burden sharing – reduction of greenhouse gases to meet the EU's commitments up to 2020;
- A new regime to cover Carbon Capture and Storage (CCS); and
- A new Directive to cover commercial aviation emissions under the EU ETS – affecting aircraft operators.

## EU ETS "Reform" Directive

Key features of the proposed amendments to the EU ETS can, therefore, be summarised as follows:

- Expansion of the EU ETS to cover new gases and industrial sectors – increasing coverage by 140 to 150 million tonnes.
- Extension of Phase III to 8 years - 2013 to 2020.
- Establishing a single EU wide allocation of EUAs in accordance with a harmonised market and removing

the requirement on Member States to produce NAPs.

- Establishing auctioning as the basic principle underpinning the allocation of EUAs in Phase III with "full auctioning" and no "free" allocation of allowances to participating installations apart from combined heat and power projects. (The EC proposes that 60% of the total number of EUAs will be auctioned in 2013, with this percentage increasing over time so that no free EUAs will be distributed by 2020. The revenues, which have gained from auctioning, are proposed to be utilised in various climate change minimisation mechanisms (e.g. the development of renewable energies, carbon capture and storage, measures to avoid deforestation etc.)
- A single EC Registry to be established, ensuring that there are no impediments to trading resulting from eligibility criteria or the commitment period reserve and facilitating easier linking with other emissions trading schemes. (National registries to be used for domestic emissions programmes and for trading in Kyoto and other credits.)

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