September 2021

Climate
Markets &
Investment
Association

Guidance Note

to the

Trade Agreement for Single or Multiple Deliveries of UK ETS UKAs

DLA PIPER

Waiver

The following Guidance Note was developed by the **Climate Markets & Investment Association** (**CMIA**) in collaboration with the law firm **DLA Piper** exercising all reasonable care.

It serves as a general guide only for the purposes of assisting the users of the CMIA Trade Agreement for Single or Multiple Deliveries of UK ETS UKAs (**Trade Agreement**). The CMIA, the CMIA Working Groups, Representatives, DLA Piper and other Counsel involved in the development, preparation and approval of this guidance, shall not be liable or otherwise responsible for its use and any damages or losses resulting out of its use in any particular case and in whatever jurisdiction. It is the responsibility of each party wishing to use the Trade Agreement to ensure that its terms and conditions are legally binding, valid and enforceable and best serve to protect their legal interests.

This Guidance Note should be read in conjunction with the Trade Agreement. This Guidance Note should not be relied on as absolute advice and does not replace legal counsel.

For information, comments or concerns regarding the Trade Agreement, this Guidance or any related information, contact DLA Piper at: andreas.gunst@dlapiper.com or kenneth.wallace-mueller@dlapiper.com

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Background

UK ETS & the Trade Agreement

- The United Kingdom (**UK**) has withdrawn from the European Union (**EU**) with effect of 1 January 2021.
- In doing so, the UK has withdrawn from the Emissions Trading Scheme (**ETS**) of the European Union.
- The UK has subsequently established the UK ETS, which commenced its first compliance period in May 2021.
- In response, key standardised agreements used for the trade of EU UKAs (**EUAs**) under the ETS have been adapted to the particularities of the UK ETS, allowing for the trade of UK Allowances (**UKAs**). These agreements include:
  - the UKA Appendix to the EFET General Agreement on Power and the EFET General Agreement on Gas; and
  - Part 7 to the Schedule to the ISDA Master Agreement.
- These market agreements are however structured as "master agreements", creating a framework for the parties to execute multiple individual trades on any future dates.
- Master agreements however generally take time to negotiate, often involving multiple rounds of negotiations, in particular on non-commercial points.
- For UKA single trades, this may pose an effective barrier to trading, thus decreasing liquidity in the market.
- To offer an alternative to the market, **CMIA** and **DLA Piper** have jointly developed a new UKA single trade agreement:
  - This is a "one-time" agreement with the option for a single or multiple delivery dates, allowing parties to focus on commercial terms rather than on first establishing a contractual framework.
  - The Trade Agreement is based on single trade agreements commonly used in the energy markets, such as the REC Single Trade Agreement published by RECS International.
  - The provisions of the Trade Agreement are however materially aligned with the positions of EFET and ISDA for the UK ETS, therefore offering market accepted language.

Legal basis & design of the UK ETS

- The Greenhouse Gas Emissions Trading Scheme Order 2020 (**ETS Order**) entered into force on 12 November 2020, established the UK ETS and sets out the general regulatory framework.
- The ETS Order was amended and supplemented by the Greenhouse Gas Emissions Trading Scheme (Amendment) Order 2020 (**Amendment Order**), which entered into force on 31 December 2020. This primarily regulates:
  - the free allocation of UKAs to sectors at risk of carbon leakage; and
  - the establishment and operation rules of the UK ETS registry, including both by aircraft operators and installation operators for compliance purposes and by traders.
- The Greenhouse Gas Emissions Trading Scheme Auctioning Regulations 2021 (**Auctioning Regulations**), entered into force on 22 April 2021, and govern the auctioning of UKAs, the establishment of a UKA secondary market and introducing measures to promote market stability.
- The first phase of the UK ETS is referred to as the first "trading period", which commences in 2021 until 2030. The following are the key features:
  - **Scope** – UK ETS covers the same greenhouse gases and sectors as the EU ETS, including the aviation sector.
  - **Geographical scope** – Northern Ireland will continue to participate in the EU ETS by virtue of the Protocol on Ireland/Northern Ireland to the Brexit Withdrawal Agreement.
  - **Cap** – set 5% below the UK's notional share of the EU ETS cap for Phase IV of the EU ETS, and will be reduced annually by 4.2 million UKAs. The UK annual cap is therefore tighter than under the EU ETS.
  - **Cap adjustments** – a net zero trajectory is to be implemented by 2023, but no later than January 2024.
  - **Allocation** – UKAs are to be primarily auctioned, with a small proportion allocated for free.
  - **Free allocation** will be granted to operators that would have expected free UKAs under the EU ETS Phase IV (i.e. those that are most at risk of carbon leakage) and based on EU ETS Phase IV benchmarks. Some free allocations will be available via a New Entrants' Reserve (**NER**).

Key elements of the UK ETS (1)

- Market stability and UKA pricing:
  - UK ETS framework introduces a **Supply Adjustment Mechanism** (**SAM**), which is based on the EU ETS market stability reserve (MSR). The SAM will require UK ETS data from the end of the previous year.
  - A transition **Auction Reserve Price** (**ARP**) of £22/UKA for the first few years of the scheme will be introduced. This is only necessary insofar as the UK ETS remains a standalone ETS.
  - The **Cost Containment Mechanism** (**CCM**), which mirrors the design of the EU ETS CCM, addresses significant price spikes by auctioning additional UKAs from within the cap. During the first two years of the UK ETS, the CCM will have lower price and time triggers to avoid significant price spikes. From the third year onwards, it will revert to the EU ETS CCM design in the case that the UK ETS and EU ETS will be linked.
- The exemptions under the UK ETS remain largely aligned with EU ETS:
  - Schedule 7 of the ETS Order: **opt-out for hospitals or small emitters,** provided they emit less than 25,000t of CO_2e each year and (where applicable) have a thermal input of less than 35MW.
  - Schedule 8 of the ETS Order: **exemption for a ultra-small emitters**. Under this exemption, the installation operator does not need to hold a permit and does not need to surrender UKAs. The threshold to qualify as an ultra-small emitter is in line with the EU ETS.

Key elements of the UK ETS (2)

- Planned reviews of UK ETS:
  - An **initial review** will take place during first half of first "allocation period" (2021 to 2025) to assess performance of the scheme from 2023. Any changes to the scheme will be implemented by 2026; and
  - A **second review will take place** from 2028 onwards will assess the whole scheme in the first trading period. Any changes will be introduced before the second trading period, which starts in 2031.
- The reviews will be aligned to the EU ETS Phase IV reviews and the global stocktake under the Paris Agreement.
- **Monitoring Reporting and Verification** (**MRV**):
  - The Verification Regulation 2018 (EU) 2018/2067 is retained EU law under the European Union (Withdrawal) Act 2018. The ETS Order amends this to make it operable in the UK following Brexit.
  - The Monitoring and Reporting Regulation 2018 (EU) 2018/2066 is not retained EU law. The ETS Order however sets out similar provisions, and therefore the monitoring and reporting regime remains comparable to the EU ETS.
  - The aim of MRV under UK ETS is to achieve more simplified procedures than those that the EU ETS currently has in place.
- The UK **allows the use of international carbon credits** (**under Kyoto Protocol**), which may be held in a separate UK registry operated by the same registry administrator as for UKAs. These credits however cannot be used for UK ETS compliance.
- With respect to aviation, the UK ETS covers UK domestic flights, flights between the UK and Gibraltar, flights departing from the UK to aerodromes within European Economic Area (**EEA**) states, flights to offshore installations, and flights departing from the UK to aerodromes within Switzerland. Flights arriving in the UK from the EEA may be covered by the EU ETS in the future, depending on whether a dedicated agreement will be concluded between the EU and the UK.
- In line with EU ETS Phase IV, all UKAs will be **tradable between participating sectors**, i.e. participants in the stationary sector (e.g. power plants) will be able to use aviation allowances, and vice versa.
- Compared to the EU ETS however, the UK ETS has only **one type of allowance** – i.e. UKAs for aviation and installation operators are identical.

The UK ETS Registry

- The **registry administrators** are, jointly, the respective regulators for England, Wales, Scotland and Northern Ireland. Currently, the Environment Agency carries out the function on behalf of the other administrators for the whole of the UK.
- Operators of stationary installations and aircraft operators will be required to hold a registry account to enable compliance with their obligations, and traders may open an account too.
- Provisions for a UK ETS registry are made by virtue of **Schedule 5A**, which is inserted by the Amending Order.
- The registry is an online platform which tracks UKAs held by participants and allow for the transfer between different accounts. The approach is generally similar to that of the Union Registry of the EU ETS.
- The UK Registry is comprised of:
  - the UK ETS Registry that can only hold UKAs; and
  - the UK Kyoto Protocol Registry that can only hold international units (which cannot be used for UK ETS compliance).
- Types of accounts at the UK ETS Registry available to market participants:
  - Holding Account – used for compliance obligations, which are either an Operator Holding Account (**OHA**) or Aircraft Operator Account (**AOHA**);
  - Trading Account – only used to hold and trade-in UKAs & cannot be used for UK ETS compliance obligations; and
  - Person Holding Account in the UK Kyoto Protocol Registry.
- Since May 2021, participants of the UK ETS have been able to open their respective accounts on the UK ETS Registry.
- The first UK ETS auction took place on 19 May 2021 on ICE Futures Europe.

Guidance on the use of the CMIA UKA Single Trade Agreement

Cover Sheet: Details on the Parties and the Transaction

- The sections **Seller**, **Buyer** and **Transaction Details** provide fields for users to insert details on the contracting parties and the UKAs to be traded. If the users wish to include additional information beyond these listed fields, they may do so under **General Details**. Examples include:
  - where the authorised signatory for a party is a different person from the contract manager, this may be separated included; and
  - where a party is a larger corporate entity with a dedicated trading team, the contact details may be included as well as instructions on the responsible contact person in different circumstances.
- The section **General Details** contains the following fields:
  - **Effective Date** relates to the date upon which the parties wish the Trade Agreement to become effective. This may be different from the date on which the parties sign the Trade Agreement.
  - **Relevant Penalty** relates to the financial payment an Aircraft Operator or Installation Operator must make under the ETS Order, should it fail to surrender sufficient UKAs by the Compliance Deadline. Where Parties agree for the Relevant Penalty to apply, the default compensation payable by the Seller for a failure to Deliver is increased by the penalty that the Buyer is liable for to the relevant UK ETS authority.
  - **Base Rate**, **Interest Rate** and **Default Cost of Carry Rate**:
    - Instead of the GBP-SONIA-COMPOUND applying as default, the Parties may agree a different Base Interest Rate on the **Cover Sheet**.
    - The Interest Rate is agreed upon between the Parties by reference to the Base Interest Rate. (e.g. Base Interest Rate plus 1%).
    - Where nothing is specified, the Default Cost of Carry Rate is equivalent to the Cost of Carry Rate (i.e. the Base Interest Rate), in respect of each day in the Cost of Carry Calculation Period. Whilst a commercial consideration, users may wish to add a credit adjustment spread so that it fairly reflects the cost of carrying the position.
  - **Special Conditions / amendments to General Terms** – allows users to add, remove (or disapply), or modify any provisions of the Trade Agreement. We advise that any such amendments are discussed with local counsel to ensure their enforceability.

Clauses 2 and 3: Mechanisms of Delivery and Acceptance

- **Clause 2.1** (*Delivery and Acceptance*) provides for "electronic transfer" as the standard transfer mechanism under the UK ETS, where UKAs are electronically removed from the Seller's registry account and credited to the Buyer's account.
- **Clause 2.2** sets out the transfer of title and risk in UKAs. Title and risk pass when the UKAs are credited to the Buyer's account. Subject to any relief such as under Force Majeure, where UKAs are not credited in the Buyer's Account following transfer, the risk lies with the Seller and the Buyer will not be obliged to pay for such UKAs.
- **Clauses 2.3 to 2.5** provide for the general rule that UKAs are to be delivered free from encumbrances (the "No Encumbrance Obligation"), the breach of which by the Seller triggers payment of the Encumbrance Loss Amount, which comprises the total losses and costs incurred by the Buyer.
- **Clause 3** (*Failure to Deliver and Accept*) provides for two mechanisms in case of a breach, either where the Seller fails to deliver or the Buyer fails to accept the quantity of UKAs (either in full or in part), provided this is not due to force majeure.
  - In either case, subject to a cure period of 3 business days following written notification by the non-defaulting party, the defaulting party is to pay compensation.
  - This is determined using the mark-to-market valuation method, which reflects the loss suffered by the non-defaulting party in selling or buying replacement UKAs.
  - This default compensation includes reasonable transaction costs and expenses which the non-defaulting party has incurred as a result of default. This includes brokerage fees, commissions and other third-party costs and expenses.
  - Under the ETS Order, an Aircraft Operator or Installation Operator, upon failing to surrender sufficient UKAs by the Compliance Deadline, may become liable to pay a fine to the Relevant Authority. The Parties may wish to increase the default compensation payable by the Seller for a failure to Deliver if this failure results in a penalty becoming payable by the Buyer (to the relevant UK ETS authority). If so, the Parties need to specify Relevant Penalty as applying on the Cover Sheet.
    - Parties should be aware that the penalties mechanism under the UK ETS is different to that under the EU ETS. Article 52 of the ETS Order provides for the penalties that may be imposed for a failure to surrender sufficient UKAs.
  - While non-acceptance of UKAs may be considered an unlikely event given the automatic nature of electronic transfer via the registry, it is designed to cover events including where the buyer's account is incapable of receiving UKAs.

Clause 4 and 5: Financial obligations

- **Clause 4** (*VAT*) deals with VAT in relation to the contract price and reflects the general position on VAT in the UK.
- **Clause 5** (*Invoicing and Payment*) sets out the invoicing process, the relevant payment periods, and interest due on late payments. **Clause 5.5** deals in particular with invoice disputes, setting out a payment obligation on the buyer for the undisputed portion, and a true-up mechanism following resolution of the dispute.
- Whilst this appears later in the Trade Agreement, it should be noted that **Clause 20** (*Transaction Costs*) provides that each party bears its own fees and expenses incurred in connection with the Trade Agreement as well as the performance of the UKA transaction contemplated under the Trade Agreement. This provision primarily serves to clarify the positions of the parties during the negotiations and performance of the executed contract.

Clause 6 and 7: Risk allocation provisions

- **Clause 6** (*Representations and Warranties*) provides for:
  - transfer-specific representations and warranties for the Seller and the Buyer separately; and
  - general representations and warranties that apply to both Parties, which are customary to B2B agreements and serve to confirm the relationship between and legal standing of the Parties.
- More detailed representations and warranties of the Seller which may be desirable where the Buyer is a trader seeking to sell the UKAs on for UK ETS compliance purposes.
- **Clause 7** (*Limitation of Liability*) sets a liability cap at an amount equal to the contract value, i.e. the Total Contract Price.
  - This liability cap is subject to mandatory limitation exemptions under national English law.
  - The carve out from the liability cap under **Clause 7.1** of damages caused by gross negligence, intentional default or fraud cap is rooted in statutory English law. This carve out can therefore not be expanded by the Parties, and a competent court would strike out any limitation in this respect.

Clause 8: Force Majeure

- **Clause 8** provides a key exception to the rule that both Parties must fulfil their contractual obligations owed to each other, specifically:
  - an event beyond the control of a party;
  - which it could not reasonably have avoided or overcome; and
  - which makes it impossible for such party to transfer or accept UKAs.
- To provide clarity to this broad definition, **Clause 8.1** specifies that Force Majeure shall not include an event or circumstance where there are insufficient UKAs in the relevant Account, whether that insufficiency is caused by the low or non-allocation of UKAs by the Relevant Authority, or the failure of that party to procure sufficient UKAs to meet its Delivery obligations. Parties may wish to either provide express examples of Force Majeure, or narrow down its scope by setting out transaction specific Force Majeure events in the **Cover Sheet** (under *General Details*).
- **Clause 8.2** sets out the process for a party to claim Force Majeure, and requires such party to use all reasonable efforts to terminate or overcome the event. The claiming party is thereby relieved from its performance obligations (which are not suspended), and under **Clause 8.3** the other party is equally relieved from its obligations.
- Where a Force Majeure events lasts over a certain period of time, **Clause 8.4** offers either party the right to terminate. The relevant time periods are the earlier to occur of:
  - a period of nine Business Days from the date that, but for Force Majeure, would have been the Delivery Date of the relevant UKA Delivery(s);
  - the Compliance Deadline; or
  - the day which falls three Business Days prior to the End of Trading Period Compliance Deadline.
- The right to terminate in accordance with Clause 8.4 is mirrored in **Clause 11.2(e)** (*Term and Termination Event*).
- **Clause 8.5** clarifies that, where an event may be captured by the definitions of both Force Majeure and a Suspension Event, it is to be deemed a Suspension Event only. Furthermore, **Clause 12.3** clarifies that, where an event may be captured by the definitions of a Force Majeure and a Change in Law (detailed in **Clause 12**), it is to be deemed a Change in Law only.

Clause 9: Suspension Event

- **Clause 9.1** provides another key exception to the rule that both Parties must fulfil their contractual obligations owed to each other, specifically:
  - the Registry is no longer established or no longer functioning pursuant to the ETS Order; or
  - an Administrator Event occurs (i.e. the suspension of all or some of the processes of the Registry – for instance due to an emergency or due to a scheduled maintenance).
- **Clause 9.2** sets out the process for a party to claim the occurrence of a Suspension Event, and requires such party to use all reasonable efforts to terminate or overcome the event. The claiming party's obligations are thereby suspended (but not relieved from the obligations, as is the case under Force Majeure), and under **Clause 9.3** the other party's obligations are equally suspended.

Clause 10: Confidentiality

- **Clause 10.1** provides for a general disclosure prohibition of confidential information, subjective to an exhaustive list of exemptions in **Clause 10.2**.
- The contracting Parties may separately agree on further specific documents or information that are to be considered Confidential Information on the **Cover Sheet** (under *General Details*).
- **Clause 10.3** extends the scope of a breach of the confidentiality obligation beyond contractual damages to allow for the affected parties to seek injunctive relief where available.
- Under **Clause 10.4**, the confidentiality obligation survives the Trade Agreement by one year following the last delivery date. Such a survival clause is common in such trade agreements, however if users wish to remove, shorten or extend this period, this may be done in the **Cover Sheet** (under *General Details*).

Clause 11: Term and termination events

- **Clause 11.2** sets out seven exhaustive events which entitle one or both parties to terminate.
  - These events are subject to express cure periods, with exception of insolvency in **Clause 11.2(a)**, long-term Force Majeure in accordance with Clause 8.4 in **Clause 11.2(e)**, a Suspension Event that lasts for more than thirty consecutive days in **Clause 11.2(f)** and an unresolved Change in Law event (however this is subject to a separate negotiating regime) in **Clause 11.2(g)**.
  - The parties may add or remove termination events or vary the length of the cure periods lengths in the **Cover Sheet** (under *General Details*).
- **Clause 11.3** and **Clause 11.4** set out the termination notification process.
- **Clause 11.5** sets out two calculations for the termination amount, which are separate depending on whether the Seller or the Buyer is the Non-Defaulting party.
  - The Termination Amount is determined using the mark-to-market valuation method, which reflects the loss suffered by the Non-Defaulting party in selling or buying replacement UKAs.
  - The Termination Amount calculation includes reasonable transaction costs and expenses which the non-defaulting party has incurred as a result of default. This includes brokerage fees, commissions and other third-party costs and expenses.
- **Clause 11.6** sets out that the non-defaulting party is to calculate the termination amount, and that payment of the termination amount is the sole remedy for losses resulting from the default and the termination.
- **Clause 11.7** provides that the following Termination Events do not give rise to a termination payment or any other financial settlement obligation:
  - long-term Force Majeure in accordance with Clause 8.4 (**Clause 11.2(e)**);
  - a Suspension Event that lasts for more than thirty consecutive days (**Clause 11.2(f)**); and
  - an unresolved Change in Law event (**Clause 11.2(g)**)

  This exclusion from the general obligation to make a termination payment does not apply for:
  - any UKAs Delivered which were not prevented due to Force Majeure; and/or
  - any portion of the terminated UKA Deliveries not excused due to Force Majeure.

Clause 12: Change in law

- The performance of the Trade Agreement is highly reliant on legal structures (including the UKAs themselves, the rules under the ETS Order, the Registry, and the Relevant Authorities).
- A change in for example the ETS Order, ancillary legislation or a court judgment or administrative decision which materially affects the interpretation of these may cause performance of the Trade Agreement to be frustrated.
- **Clause 16** allows Parties to renegotiate the Trade Agreement where a Change in Law:
  - makes it impossible or unlawful to give effect to the Trade Agreement; or
  - makes it impossible for a party to perform its delivery or acceptance obligations.
- The parties are then obliged to negotiate in good faith (under **Clause 16.1**) for a period of 30 calendar days (under **Clause 16.2**), after which either party may terminate the Trade Agreement.
- Users may establish guidelines for these negotiations, introduce an escalation instance (such as a meeting between senior officers of the parties or arbitration), vary the negotiation period, or add further events which may trigger the change in law negotiation rights in the **Cover Sheet** (under *General Details*)
- **Clause 16** does not exclude price adjustments as part of these negotiations. Users may however elect to restrict this right or add further conditions using the **Cover Sheet** (under *General Details*).

Clause 13 to 21: Operation of the agreement

- Under **Clause 13** (*Assignment and Novation*) the Trade Agreement can only be assigned or novated from one of the Parties to a third party subject to prior written consent from the other party.
  - Such consent is not required where the transferee is an affiliate of the transferor (as defined in **Clause 1**) incorporated in the same jurisdiction and has equivalent or greater creditworthiness.
- **Clause 14** (*Notification and Correspondence Terms*) sets out deemed delivery dates for any communication between the parties. This has particularly relevance to notification obligations and cure periods of termination events under **Clause 11** (*Term and Termination Event*).
- **Clause 15** (*Telephone Recordings and Personal Data Protection*) entitles parties to record any telephone conversations between themselves.
  - Users may wish to review this clause with local counsel, particularly to ensure that they have appropriate data protection measures in place with respect to the collection, processing and holding of personal data.
- **Clause 16** (*Severability*) provides that where a competent court deems any individual provision of the Trade Agreement to be invalid or unenforceable, the remaining provisions remain valid and enforceable. This clause is subject to **Clause 12** (*Change in Law*).
  - Users may wish to review this clause with local counsel, as such severability clauses may not comply with statutory requirements in some jurisdictions.
- **Clause 17** (*Entire Agreement*) provides that previous agreements, including oral agreements, are superseded by the Trade Agreement. Where two parties wish for an existing agreement to continue in force, this should be carved out from this provision using the **Cover Sheet** (under *General Details*).
- Under **Clause 18** (*Amendment*) any amendments or additions to the Trade Agreement must be written and signed to have effect. This includes any amendments following change in law negotiations.
- **Clause 19** (*Third Party Rights*) excludes third parties from exercising rights under the Trade Agreement.
- Under **Clause 21.1** (*Governing Law and Dispute Resolution*) the Trade Agreement is governed by English law.
- Under **Clause 21.2**, the courts are those of England and Wales have exclusive jurisdiction.

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