House of Commons

Environmental Audit Committee

Reducing Carbon Emissions from UK Business: The role of the Climate Change Levy and Agreements: Government Response to the Committee's Second Report of Session 2007–08

Third Special Report of Session 2007–08

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The Environmental Audit Committee

The Environmental Audit Committee is appointed by the House of Commons to consider to what extent the policies and programmes of government departments and non-departmental public bodies contribute to environmental protection and sustainable development; to audit their performance against such targets as may be set for them by Her Majesty's Ministers; and to report thereon to the House.

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Third Special Report

1. The Environmental Audit Committee published its report on ***Reducing Carbon Emissions from UK Business: The role of the Climate Change Levy and Agreements*** on 10 March 2008 as its Second Report of Session 2007–08, HC 354.

2. The Government's Response to the Committee's Report was received on Monday 12 May 2008 in the form of a memorandum to the Committee. It is reproduced as an Appendix to this Special Report.

Appendix—Government response

INTRODUCTION

1. The Government welcomes the Environmental Audit Committee's (EAC) comprehensive report into the role of the Climate Change Levy (CCL) and Climate Change Agreements (CCAs) in reducing carbon emissions from UK business.

2. The Government also welcomes the Committee's view that this is a bold and innovative suite of policies as a result of which there appear to have been significant carbon savings.

3. The CCL package represents an important policy for improving the energy efficiency for UK business, and the Government welcomes the Committee's view that it has not imposed a damaging burden to UK business overall.

4. The CCL has no time limit, but as a tax measure, it is under regular review by HM Treasury. However the current CCAs end on 31 March 2013 and, unless the scheme is extended (see next paragraph), the Levy reduction will cease to be available after this date. When State aid approval was sought for the CCA scheme in 2001, the Commission limited all such approvals to a maximum of 10 years. The current State aid approval therefore expires in 2011. Consequently, the Government intends to apply to the Commission later this year to extend that approval through to the end of the current scheme.

5. It was announced in Pre-Budget Report 2007 that, subject to a further State aid approval, CCAs would continue beyond 2013, until 2017. New agreements will be necessary for this additional period and the Government will be consulting on the form and content of the new agreements in the summer of 2008. Once the form and content of the new agreements have been established, the Government will seek State aid approval for the new scheme, which will be additional to the extended approval referred to in the previous paragraph. In the Government's responses to the specific conclusions and recommendations of the Committee's report, which are given below, references to "new CCAs" relate to the agreements that will apply until 2017.

CONCLUSION/RECOMMENDATION 1

Given the intrinsic difficulties involved in calculating its effects, and in order to improve transparency, we recommend that the Government should give an estimated range of uncertainty for its projections of the Levy's impacts. (Paragraph 12)

As the EAC report has noted, there are intrinsic difficulties in isolating the effects of the CCL, not least because evaluation requires a comparison with a counterfactual scenario in which CCL was not in place. Recognising this, the Government commissioned an independent study of the CCL package from Cambridge Econometrics (CE), which used econometric modelling and the MDM-E3 model, one of the most sophisticated macroeconomic models of the UK economy available with specific energy and environment sub-models. This report was issued by CE in 2005, and a supporting document which highlighted its findings, *The Climate Change Levy Package,* was published alongside Budget 2006. However, the Government will consider how best to undertake future assessments of the Levy's impact and how best to report on its findings through the normal Budget process.

CONCLUSION/RECOMMENDATION 2

According to the evaluation of the Levy relied on by the Government, most of the impacts of the CCL were already established before the policy actually came into effect in 2001, and have only marginally increased since then. (Paragraph 16)

As the independent report by CE concluded, the CCL is estimated to deliver annual savings of about 12.8 million tonnes of carbon dioxide ($MtCO_2$) by 2010. While the announcement effect itself has led to carbon savings, having the Levy in place provides Government with the capacity and flexibility to make further use of the price effect through variations in rates. Budget 2006 announced that Levy rates would rise with inflation in the following year, and this policy has been extended in subsequent Budgets. The Government will continue to assess the best way to encourage business energy efficiency and to ensure that the environmental effects of the Levy are maintained.

CONCLUSION/RECOMMENDATION 3

Overall, it seems that the Climate Change Levy has not worked as originally planned—particularly for less energy intensive firms and SMEs. While concerned by the weaknesses of the Levy, we welcome the fact that the Government has not ignored these problems. In responding to the recommendations of the Carbon Trust by bringing forward plans for the Carbon Reduction Commitment, the Government is targeting some of the sectors for which the Levy has proved less effective. This shows a commendable flexibility of approach and ability to learn through doing. (Paragraph 22, 23)

Independent analysis from CE suggests that CCL is due to save 12.8 $MtCO_2$ by 2010, with the majority of savings found to be from less energy intensive firms. The current estimates remain above the 7.3 $MtCO_2$ figure that was initially projected when the Levy was introduced in 2001.

The Government welcomes the positive comments of the Committee on its flexible approach to carbon abatement policy and on the introduction of the Carbon Reduction Commitment, which will be the world's first mandatory auction-based trading scheme for public and private non-energy intensive organisations. It will begin operation in 2010 and will deliver savings of at least 4 $MtCO_2$ by 2020.

CONCLUSION/RECOMMENDATION 4

While in theory the use of carbon trading has no adverse effect on the amount of carbon savings generated by the system as a whole, this depends on the stringency of the original targets: if some targets are weak, then the firms to which they apply may be able to overachieve relatively easily, and thus provide a high volume of cheap credits with a concomitantly lesser effect in driving emissions reductions. Regarding the UK ETS, the first source of credits up to 2006, a Defra report from 2007 describes it as having provided an "over-allocation of allowances […] linked to generous baseline setting and the inclusion of non-CO2 GHGs [greenhouse gases]." This points to a serious weakness in the rigour of the CCA system so far, and underlines the fact that in all carbon trading schemes it is the level of the cap, rather than the trading mechanism, which is the key element. It also makes looking at the number of firms and sectors which have passed their Agreements targets an even less useful measure of the environmental impacts of the CCA system. (Paragraph 33)

Despite the low price of allowances under UK Emissions Trading Scheme (UK ETS), it is clear from experience that carbon trading has been used largely as a safety net and that the first choice of the vast majority of participants in meeting targets is actual energy savings. It is also of note that the over-supply of allowances in UK ETS was due mainly to direct participants in the scheme and not to CCA operators.

The CCA scheme is a baseline and credit system, rather than a cap and trade scheme. As such it is the level of the targets that is key. It was also important to seek to achieve equally stringent targets for all sectors, when targets were first set. In practice, differences between sectors, technologies and processes mean that it was difficult to compare the stringency of targets. In addition, the amount and quality of information available and the general level of awareness between sectors were all very variable. Nevertheless, the information base available to industry and to Government is growing with time and the provision for target reviews in the agreements enable adjustments to targets to be made.

CONCLUSION/RECOMMENDATION 5

It appears to us that isolating and enumerating the impacts of the Climate Change Agreements is even more complex and uncertain than accounting for the impacts of the Climate Change Levy. It is remarkable that the performance of most sectors is measured from a variety of different starting points that predate the start of the Agreements, in three cases stretching all the way back to 1990. While measuring the impact of Agreements by reference to business as usual projections avoids some of these problems, it also creates new ones of its own: as we have argued in previous reports, BAU projections intrinsically lack certainty, and depend very much on the quality of the assumptions and data used to generate them. For these reasons we recommend that, when reporting figures for the impacts of the Agreements, the Government gives a range of uncertainty attaching to them. (Paragraph 35)

It is true that there is inherent uncertainty in assessing the impact of CCAs: industry is constantly changing, there is rationalisation and companies regularly enter and exit the scheme; and there are external factors such as the price of energy and changes in technology. The Government also recognises that setting CCA targets on a wide range of

base years makes that assessment more difficult. This was done in recognition of the fact that many industries had already undertaken energy efficiency improvements without any incentive. However, actual targets were based on the state of play in 2000, to which any earlier achievement was added. So there was no effect on the stringency of targets. The Government is considering establishing a common baseline for new CCAs.

Projected savings from CCAs are made against a range of business as usual (BAU) projections. These BAU projections assume a range of levels of fossil fuel prices and associated estimates of industrial sector growth. There is uncertainty in these projections. Given this, the Government recognises the value of reporting figures for the impacts of the Agreements with a range of uncertainty. We will, therefore, examine the scope for undertaking a sensitivity analysis of the final figures, with a low, central and high case scenario analysis.

CONCLUSION/RECOMMENDATION 6

Although there are difficulties in arriving at a firm evaluation of the carbon savings driven by the Agreements, the anecdotal evidence suggests that the process of complying with CCAs has had a very positive effect, leading to a widespread improvement in energy management systems, greater sharing of good practice, and a general raising of energy efficiency as a boardroom priority among participating firms. (Paragraph 41)

The Government welcomes the Committee's comments on the impact of CCAs. The Government accepts that any estimate of carbon savings achieved through CCAs has a margin of error. Nevertheless, it is clear that CCAs have been highly successful. Using best available assumptions it is estimated that around 30 million tonnes of carbon (MtC) were saved in the first seven years of the scheme. In addition, the Government would agree that there is plenty of evidence of a range of qualitative benefits, of the type the Committee mentions. But there have also been substantial economic benefits. It is estimated that, against baselines, the total value of energy saved by operators at the last milestone (2006) was £1,500 million.

CONCLUSION/RECOMMENDATION 7

We are highly surprised that the Government has not tightened the Agreement targets since data from the first milestone period revealed that both the initial set of targets, and those revised in 2004, were too lax. We recommend that CCA targets should be reviewed at every milestone period. (Paragraph 47)

The current agreements limit target reviews to 2004 and 2008. The 2004 target review did take account of the results of the first milestone period.

The Government is not convinced that there would be significant benefit in more regular target reviews. While it would provide more opportunity to refine targets, there would also be considerable downsides. Target reviews are costly in time and effort for both industry and Government. In addition, industry needs stability between target reviews and target periods to plan and implement investment within normal investment cycles. From a Better Regulation and stability point of view, the current arrangements seem to work well.

The Government would also disagree that targets were too lax at the time they were set. Industry itself can often be surprised at what it can achieve. There can be many reasons why some operators over-achieve against targets, including: the level of priority given to energy efficiency investment; the level of resources available for such investment; decisions to maximise savings early, possibly with the aim of banking over-performance to meet later targets; greater potential to make efficiency gains than anticipated; and developments in technology in specific sectors.

CONCLUSION/RECOMMENDATION 8

Given both that targets have been readily overachieved so far and that meeting them should have saved participating firms money, and given the overall imperative to accelerate carbon reductions, we recommend that targets are considerably toughened at the next milestone period. To help preserve a constructive relationship with industry, protect competitiveness, and accelerate emissions reductions, the Government should increase public investment in low carbon technology, as well as grants or loans to aid its procurement. (Paragraph 53)

While it is true that targets have, in general, been over-achieved, this hides a wide degree of variation between sectors. For this reason, in the current target review, the Government has indicated to sectors that it is minded to tighten 2010 targets across the board by 4 per cent and that, for those sectors that over-achieved in 2006, that over-achievement should be consolidated into the revised 2010 target. This would maintain pressure on industry to maximise their potential for energy efficiency savings and, subject to negotiations to be held with industry over the summer, would realise additional savings of 1.8 MtC. The Government has invited sectors to respond and negotiations will continue over the coming months.

Government is already investing a considerable amount of money to support the development of new renewable and low carbon generation. The Renewables Obligation, along with the exemption from the CCL for renewable sourced electricity, will be worth around £1 billion per year in support of the renewables industry by 2010. Government has also made available around £500 million of spending on capital grants and research and development (R&D) for low carbon and renewable technologies up to 2008.

Public investment in low carbon technology is increasing in the UK through the Research Council's Energy Programme (budget of ~£70 million/year), the Technology Strategy Board (calls for relevant proposals currently valued at £32 million), Energy Technologies Institute (budget of £60 million–£100 million/year) and the UK Environmental Transformation Fund (£400 million over three years). In addition the changes to the Renewables Obligation will triple the amount of electricity produced from renewable electricity technologies in UK in 2015, and the Carbon Emissions Reduction Target in the household sector will require energy suppliers roughly to double the level of activity of the previous Energy Efficiency Commitment in installing low carbon energy and energy efficiency measures over the next three years in order to achieve the new stretching targets.

CONCLUSION/RECOMMENDATION 9

The NAO has drawn attention to a significant number of businesses which have both failed to meet their CCA targets through their own actions, and failed to make up the

difference to these targets through other mechanisms such as carbon trading—and yet which continue to enjoy their CCL discount. Regulations should be tightened to ensure that this cannot continue. The trading mechanism established within the CCA system should make this straightforward: any firm that does not meet its target through its own actions should be required to purchase credits to make up the difference, or lose its Levy discount. (Paragraph 56)

An operator is regarded as having met its targets if the sector as a whole has passed its targets. An operator that fails to meet its individual targets in a sector that misses its sector targets may lose its entitlement to the levy relief in the following certification period—this is the penalty for failure. The rationale for the current arrangements is that if a sector as a whole passes its target the environmental benefits are at least as good as if all operators passed theirs. This also ensures that savings are made in the most cost effective way. In practice this is an issue for small operators. Big energy users do not generally rely on a sector pass—the potential penalty would be too great if the sector failed to meet its targets. In addition, removal of sector targets could damage the critical role that sector associations play in managing and implementing CCAs. Nevertheless, the Government understands the argument of equity that all those that benefit from Levy discount should meet their obligations. We will therefore consider options to achieve this for the new CCAs, following consultation with industry.

CONCLUSION/RECOMMENDATION 10

The effects of implementing a cut in employers' National Insurance Contributions alongside the introduction of the CCL should have been both to win the support of businesses for the idea of the Levy, and to help genuinely change their spending priorities. With the subsequent increase in NICs, announced in 2002, we are far from convinced that these have been the effects. Overall, as we have long recommended, the Government should be far bolder in altering the balance of taxation between 'goods' and 'bads'. (Paragraph 62)

To support UK competitiveness, the CCL was accompanied by a 0.3 percentage point cut in employers' national insurance contributions (NICs). As the EAC has concluded elsewhere in its report, the CCL package has not resulted in a damaging burden for UK business overall. In fact, the combined CCL/NIC package has resulted in a net reduction in tax liability for business as a whole: the lower NICs rate saves about £950 million a year for businesses in sectors paying CCL, while CCL costs these businesses about £600 million a year.

As set out in the Treasury's 2002 publication, *Tax and the Environment*, the development of the Government's environmental policy takes place within a principled framework. Where fiscal measures have been implemented, the Government has looked to shift the burden of tax from 'goods' to 'bads'. Cuts in NICs, for example, also accompanied the introduction of the aggregates levy and landfill tax. However, intervention must take account of wider economic and social objectives—including maintaining sound public finances.

As was announced in Budget 2002, the increase of 1 per cent to the rates of NICs was linked to health spending as part of the Government's overall plans for public spending

announced in that Budget, including the substantial increase in NHS resources. The NHS has always been partly funded by NICs.

CONCLUSION/RECOMMENDATION 11

We note that there appears to be significant demand for the Carbon Trust's SME loan scheme. It is reducing emissions, and it should bring about a net benefit to the UK economy through reducing overheads and increasing the growth of energy efficient products and services. For these reasons we recommend the Government provides funds to expand the scheme significantly. (Paragraph 69)

The UK Government has invested over £50 million in interest-free loans for SME energy efficiency projects through the Carbon Trust since 2003. On 21 February 2008, Defra announced that a further £12 million will be invested in the SME loan scheme over the next three years, funded from the domestic element of the Environmental Transformation Fund.

CONCLUSION/RECOMMENDATION 12

Despite the significant efforts already directed by the Carbon Trust to large firms, some evidence suggests there is a shortfall in provision for energy intensive sectors in terms both of very specialist advice and loans for energy efficiency investment. We recommend that the Government reviews the needs, for more assistance from the Carbon Trust, of larger and more energy intensive sectors, and assesses how best this demand can be met. (Paragraph 70)

The Government believes that the Carbon Trust is best placed to provide direct assistance to the business and public sectors to pursue the most cost effective carbon savings. It relies on the Carbon Trust to maintain under review how best to direct its resources to greatest effect.

There is a clear market failure in the lack of access to affordable finance by small and medium sized enterprises (SMEs), and this evidence led to the creation of Carbon Trust's SME interest-free loans scheme. The Carbon Trust has not identified similar issues for larger energy intensive businesses, where constraints on the availability of capital are less material. Larger energy intensive companies are more willing to invest the capital available to them in energy efficiency, thereby reducing a substantial element of their core operating costs. However, the Carbon Trust does provide a range of services to energy intensive companies, including its strategic Carbon Management product as well as other targeted and tailored services. In addition, the Trust regularly reviews its offerings to all types and sizes of businesses, and has recently piloted a Strategic Insights service, fully funded by customers, which is specifically aimed at larger companies. The aim is to enable them to understand the strategic business risks and opportunities associated with climate change at Board level.

CONCLUSION/RECOMMNEDATION 13

Some evidence suggests a lack of awareness of the Enhanced Capital Allowances scheme. This could be linked to the restricted scope of the scheme, which excludes many technologies, such as insulation products. We recommend that the scope of the