Government Response to the Environmental Audit Committee's Report on the Energy Intensive Industries Compensation Scheme

Presented to Parliament
by the Secretary of State for Business, Innovation and Skills
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The Government welcomes the Committee's timely enquiry into the Energy Intensive Industries Compensation Scheme. The Committee's consideration and its helpful conclusions and recommendations have informed the Government's decisions on the compensation package for energy intensive industries.

1. ***We recommend that the Government require energy intensive industries to remove the cost of any self-generated electricity when calculating the sums due under the proposed compensation scheme. (Paragraph 21).***

In its guidance, the Commission has stated that "In order to ensure equal treatment of sources of electricity and avoid possible abuses, the same CO2 emission factor applies to all sources of electricity supply (auto generation, electricity supply contracts or grid supply)."

The Government considers that compensation should be made payable for electricity where the generation of that electricity is subject to ETS and CPS costs, and where the electricity is used for the manufacture of eligible electricity intensive product. Self-generated electricity generated from fossil fuel will face the same policy costs (EU ETS and CPS costs[1]) as electricity generated by electricity suppliers and supplied to manufacturers through the grid. For this reason, auto-generated electricity used in the manufacturing process will be eligible for compensation. The exception to this will be:

- Renewable auto-generation – ETS or CPS costs will not be incurred in the generation of renewable electricity. Therefore compensation will not be payable to companies for electricity generated by this means.
- Auto-generation using waste gases – some industries use waste gases derived from the manufacture process to generate electricity. Electricity generated by this means will still be subject to ETS costs and, as such, will attract indirect ETS compensation. However, electricity from waste gases will not be subject to CPS costs and will not attract indirect CPS compensation.

2. The Government should help energy intensive industries, possibly through the Green Economy Council, to form consortiums for bulk-purchasing energy, and thereby reduce their costs and potentially the compensation that the Government would pay. (Paragraph 23).

BIS has discussed the issue of bulk-purchasing energy agreements with energy intensive industries. There are a number of barriers and issues to be addressed in order for bulk-purchasing to be taken forward. In particular, competitors operating in the same sector will often, understandably, be reluctant to work together and share information regarding their cost base. BIS will continue to explore this issue with energy intensive industries, including the extent to which supply chains can come together in order to purchase energy and reduce costs.

[1] For CPS costs, generators using 2mwh or more will be captured by CPS costs

However, negotiating a better energy deal would not reduce the amount of compensation payable. Compensation will be paid according to a formula based on the amount of electricity consumed and the amount of EU ETS and CPF policy costs associated with that electricity.

3. The Government should be ready to reduce or increase the budget cap available for compensating energy intensive industries for the indirect costs of the Emissions Trading System and Carbon Price Floor in light of actual cost data identified in compensation claims. To facilitate scrutiny by Parliament, the Government should provide a statement to the House on the budgetary position of the scheme after the first year of operation, including projections of expected outturn. (Paragraph 26)

The Department for Business, Innovation and Skills has a limited budget for compensation for the indirect costs of EU ETS and the Carbon Price Support (CPS) mechanism, because the Government wants to ensure that the costs associated with the scheme are kept to a minimum, whilst effectively addressing the needs of those businesses at most competitive risk. Current estimates suggest that the budget will be sufficient to provide indirect ETS and CPS compensation to eligible businesses.

As the Committee recommends, the Government agrees to provide a statement to the House regarding the budgetary position of the scheme after the first year of operation, including projections of expected outturn.

4. The Government should monitor development of compensation schemes for indirect energy and climate change policy costs in other EU member states for signs of competitive disadvantage. It should review the case for a UK compensation scheme beyond 2014-15 using such data, taking account of aggregate subsidies and disbursements in other countries beyond those linked to the EU Emissions Trading System. (Paragraph 29)

The Department for Business Innovation and Skills commissioned a study in 2012[2], examining the electricity policy costs faced by energy intensive industries in different countries. This study took account of the different compensation and exemption schemes that reduce the cost of electricity for industrial consumers in other EU member states and in other countries. The Government has announced that Carbon Price Floor compensation will continue into 2015/16. The Government will continue to monitor the relative position of UK and EU industries including both the need for and the effectiveness of the UK support mechanisms.

5. We recommend that the Government publish at the earliest opportunity its assessment of the impact on electricity bills, and the effect on other companies of having to pay additional levies, of its proposal to exempt energy intensive industries from the costs of electricity market reform. (Paragraph 33)

[2] https://www.gov.uk/government/publications/international-comparison-of-energy-and-climate-change-policies-impacting-energy-intensive-industries-in-selected-countries

The Government will be issuing a consultation shortly setting out the different options for exempting energy intensive industries from the costs of Contracts for Difference (CfDs) which are being introduced as part of Electricity Market Reform. This will include an estimate of the additional costs faced by other consumers – business and domestic – as a result of the exemption.

6. The Government must restrict the compensation payable for those companies who have financially benefited from the EU Emissions Trading System by selling surplus European Union Allowances, by reducing the compensation payable by the same amount. (Paragraph 37)

The Government believes that compensation should be targeted where evidence suggests sectors or sub-sectors are at significant risk of carbon leakage as a result of the indirect costs of the EU ETS and CPS, and that the levels awarded should be proportionate to need.

The compensation package is focused on reducing the risk of carbon leakage from the indirect costs of EU ETS – i.e. from the costs that are initially faced by electricity generators and passed through to industrial consumers through their electricity bills.

The Government considers that the issue of free allowances, which are issued to companies that participate directly in the EU ETS, is a different and separate issue, best dealt with through the EU ETS scheme itself, working with the European Commission.

The free allocation process is harmonised across the European Union. If industries have a surplus of allowances, they can chose to sell them or hold their excess for future use. The excess can be due to a range of issues, including their own carbon reduction efforts, but will not relate to the amount of electricity consumed. For Phase 3 of the EU ETS, 2013 to 2020, new rules have been put in place to adjust free allocations to companies whose installations have reduced activity levels or capacity. This will limit the potential for companies to generate allocation surpluses which are not a direct result of efforts to reduce greenhouse gas emissions.

The Government recognises the issue of over allocation in the system, which has contributed to the current supply-demand imbalance. Steps are being taken at EU level to address this, both in the short and in the longer term. In recognition of the need for action at an EU level to address these issues in the short term, the European Commission produced proposals in July 2012 that would modify the timetable for when allowances are auctioned, reducing the amounts auctioned in the early years of Phase III and introducing them in the later years (so called "back-loading").

The UK supports back-loading as a short-term measure pending structural reform of the EU ETS. The Government was disappointed by the European Parliament's vote to reject the current proposals on 16 April. However, the UK hopes that a positive outcome can still be achieved following further discussion of the proposals by the lead Environment Committee.

In parallel, renewed focus on more substantive measures to strengthen the system is essential. We have begun work to consider the reform options in the Carbon Market Report and the detail of Phase IV of the EU ETS (post-2020). We believe that the EU ETS should continue to be a core component of both EU and UK climate change policy. We will be considering the full range of options for reform as we develop the Government's position on the future of the EU ETS with the aim of ensuring the EU ETS continues to be an effective instrument for keeping the EU on a reliably robust decarbonisation trajectory.

7. For consistency with the compensation principles set out by the European Commission, the Government should seek to ensure that this trade intensity factor is better reflected in its eligibility rules for compensation. Businesses in sectors deemed to be at risk of carbon leakage from indirect carbon costs of the Emissions Trading System should be required to demonstrate that they are 'trade intensive' as well as facing significant carbon costs. Similarly, in considering the trade intensity of businesses for compensation for the Carbon Price Floor, the Government should apply a trade intensity ratio consistent with that applied by the European Commission in its guidelines on compensation for indirect costs. (Paragraph 43)

The Government agrees that an important factor in assessing whether a company should be eligible for compensation is the extent to which that company is operating in an internationally competitive market as this impacts on the extent to which a company can pass on policy costs to its customers. In deciding which sectors should be eligible for compensation, the Commission examined the trade intensity associated with the relevant product in question – i.e. all the eligible sectors and products set out by the Commission, and which the UK Government will be compensating, have passed the trade intensity threshold determined by the Commission.

However trade intensity data is neither readily available nor meaningful <u>at a company level</u>. An internationally traded product will be set by global prices irrespective of where an individual company sells its product. Given the European Commission have identified the sectors and sub sectors that they consider are at risk of carbon leakage as set out in their guidance, taking into account trade intensity levels, the Government considers this to be sufficient for purposes of the compensation scheme.

For indirect Carbon Price Support compensation, the Government has allowed some additional companies that are making products which are not within the indirect ETS compensation eligibility list to make a case for inclusion as the impact of the UK policy may go beyond those impacted by the EU ETS costs. In order to make the case, it has to be demonstrated that:

- the company's carbon costs (CPS and EU ETS) in 2020 will amount to at least 5% of GVA.
- that the product is significantly traded within (or beyond) Europe or that imports would become more economically viable as a result of increased carbon costs.

If the Government considers that a good case for inclusion can be made to the Commission on the above basis, then it will do so. In order to demonstrate the second condition, the level of trade intensity at a sector level will be the key factor.

8. We welcome the Minister's commitment to consider the eligibility of sub-sectors of the ceramic industry for the compensation scheme. We urge the Government to engage with that sector and its representative bodies, including the British Ceramic Confederation, to collect the data needed to demonstrate eligibility for compensation. That data should also be used to help develop wider policies aimed at strengthening UK business and delivering growth. (Paragraph 44)

The Government has been engaging closely with the British Ceramic Confederation and businesses in the ceramics industry, amongst other industries, to examine data concerning electricity intensity. This will be used to inform policy, in particular whether a reasonable case for inclusion in the indirect Carbon Price Support compensation scheme can be made to the Commission for any product within the ceramics industry.

9. The Government should review the operation of the compensation scheme after its first year, to ensure that it remains reasonable in view of the costs actually being incurred by energy intensive industries and does not put UK businesses at a competitive disadvantage. (Paragraph 53)

The Government has designed the ETS and CPS compensation schemes within the guidelines set out by the Commission. As such, the compensation schemes will be closely linked to the indirect costs faced by companies as a result of EU ETS and the Carbon Price Support Mechanism. To continue to incentivise energy efficiency, compensation will not provide for 100% relief from ETS and CPS costs nor will it address other policy costs that energy intensive industries face. However, compensation should be seen in the context of other policies being developed to relieve energy intensive industries from energy policy costs, including:

- the exemption from the Climate Change Levy for metallurgical and mineralogical sectors;
- the exemption from the costs of Contracts for Difference (CfDs) as part of Electricity Market Reform.

The Government is concerned that energy intensive industries should not have their competitiveness put at significant risk by energy policy costs. Although the Government will not formally review the compensation in 2014, we will continue to work closely with industry and other stakeholders on this issue.

10. We recommend that the Government sets out a strategy for energy intensive industries, as part of the wider manufacturing strategy needed to ensure that the UK retains a robust manufacturing sector, which should set a path for their maximum feasible decarbonisation and incorporating sector-specific roadmaps. Such a strategy should identify by how much energy intensive industries should be required to decarbonise and improve their energy efficiency and how the Government will help to ensure that this is achieved, including through energy consumption reduction measures and incentives, and support for innovation, technological research, development and investment. Such an analysis would allow a clear articulation of the feasible limits of decarbonisation over the medium and longer term, and thereby provide an assessment of the scale of future compensation requirements. At the same time the Government should set out the extent of the compensation that it is willing to pay in a longer term compensation budget. (Paragraph 75)

11. An energy intensive industries' strategy should not be limited to using piecemeal funding but look more broadly at the measures needed to help energy intensive industries develop in a sustainable way. Greater emphasis should be given by BIS to energy intensive industries and using existing mechanisms such as the Regional Growth Fund and City Deals to support those industries and their supply chains. (Paragraph 76)

Different energy intensive industry sectors face very different challenges with regard to decarbonising and reducing their energy and direct process emissions. In recognition of this, the Policy document "The Future of Heating: Meeting the Challenge[3]" announced that the Government proposes to work with industry over the next two years to develop "roadmaps" for decarbonisation in key UK heat intensive industrial sectors, - covering steel, minerals (cement, ceramics and glass), chemicals, paper, food and drink, and refineries sectors.

In taking this work forward, DECC and BIS will work with industry to:

- develop a shared evidence base for each sector to explore and raise awareness about the low carbon technologies and options; and
- agree on the steps needed to achieve emissions reduction, highlighting actions to be taken by industry, Government and others.

At Budget 2013, the Chancellor announced that the Government will continue to provide support to energy-intensive industries to compensate for the indirect cost of the CPF in 2015-16. Further details will be announced at the forthcoming spending round.

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[3] https://www.gov.uk/government/publications/the-future-of-heating-meeting-the-challenge

The Government considers the needs of specific energy intensive sectors to be different. The City Deals programme enables the Government to work closely with areas such as Tees Valley that are home to large concentrations of energy intensive businesses. Meanwhile, the Regional Growth Fund was open to bids from projects relating to energy intensive industries. The European Regional Development Fund (ERDF) is available from 2014 until 2020 and has a thematic objective of 'Moving to a low carbon economy' which funds must support. Similar to the RGF, funding is to be allocated through Local Enterprise Partnerships (LEPs) who will be responsible for developing strategies which fit with the low carbon theme. Guidance for LEPs which will inform their ideas for projects has been issued.

12. In developing a dedicated strategy for energy intensive industries, the Government should identify the overall extent of cost burdens on companies and how they compare with competitive countries, along with how the mix of costs would be adjusted to help deliver the required overall increase in the proportion of tax made up of environmental taxes. (Paragraph 17)

In making investment decisions, companies will take into account a range of factors. The Government agrees that it will be the overall cost burden, rather than energy costs in isolation, that determine the risk of carbon leakage. However, energy costs are a significant proportion of energy intensive industries' total costs and may drive business decisions on production, investment, and location.

As part of the Call for Evidence issued in March 2012, Government asked companies to provide examples of how energy costs can affect investment decisions, taking into account overall costs. We received some helpful evidence in this area, but the information received is commercially sensitive.

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