Title: **Proposals on the future of Climate Change Agreements**	**Impact Assessment (IA)**
	IA No: DECC0040
	Date: 07/07/2011
Lead department or agency: DECC	**Stage:** Consultation
	Source of intervention: Domestic
Other departments or agencies: N/A	**Type of measure:** Voluntary
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Summary: Intervention and Options

What is the problem under consideration? Why is government intervention necessary?

The Government announced in the 2011 Budget that the Climate Change Agreements (CCAs), which were due to end in March 2013, will (subject to state aid approval), be extended to 2023. Since the start of the current CCAs in 2001 the UK climate change policy landscape has changed noticeably with, for example, the introduction of the EU Emissions Trading System (2005), the Climate Change Act (2008) and the CRC Energy Efficiency Scheme (2010). As a result, and following the recommendations of the Environmental Audit Committee (2008) and conclusions of the DECC Simplification Review (2006), the Government is looking to simplify the future CCAs to reduce business admin costs without affecting the scheme's carbon savings.

What are the policy objectives and the intended effects?

The objectives of this review of the CCA scheme are twofold: (i) simplify the structure of the CCAs and thereby make them easier to operate, and (ii) maintain the effectiveness of the agreements in cutting carbon emissions.

This IA assesses a number of simplification proposals by comparing them to the ‘Business as Usual’ (BAU) scheme, which is characterised as a continuation of CCAs in their current form up to 2023.The IA does not assess the costs and benefits of achieving different levels of carbon mitigation.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

This IA considers two options for the future of the CCA scheme: (i) the continuation of the current scheme and (ii) a modified scheme that incorporates administrative simplifications.

The IA does not consider abolishing the CCA scheme because of commitments made in the 2011 Budget.

Will the policy be reviewed? It will be reviewed.

If applicable, set review date: 2020

What is the basis for this review? Policy mechanism; targets will be reviewed in 2016

If applicable, set sunset clause date: N/A

Are there arrangements in place that will allow a systematic collection of monitoring information for future policy review?	Yes

Ministerial Sign-off For SELECT STAGE Impact Assessments:

I have read the Impact Assessment and I am satisfied that, CHOOSE FROM LIST

Signed by the responsible Minister: Date:

Summary: Analysis and Evidence Policy Option 2

Price Base Year 2009	PV Base Year 2011	Time Period Years 9	Net Benefit (Present Value (PV)) (£m)		
			Low: £2.4	High: £3.4	Best Estimate: 2.7

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0		0.06	£0.5
High	0		0.06	£0.5
Best Estimate	0		**0.06**	**£0.5**

Description and scale of key monetised costs by 'main affected groups'

Under the current scheme, if a sector meets its target every target unit in that sector receives the Climate Change Levy discount, including any target units that have not met their targets. The Government has decided that for the future scheme all target units will be required to meet their targets on an individual basis. This increases cost to industry by £0.3m.This IA quantifies the costs and benefits resulting from the future CCA scheme to 2020. If there was another target period ending in 2022 then a State aid extension would be required to grand the CCL discount until March 2025. Without this extension, there would be no incentive for participants to meet their 2021/2022 target.

Currently, there is a requirement to report energy consumption on a biennial basis. The Government has decided that there will now be a requirement to report annually. This increases costs to industry by £0.2m.

Other key non-monetised costs by 'main affected groups'

There may be one off costs associated with amending data collection procedures and related IT for target units and sector associations. Through removing the requirement for agreement holders to verify their emissions compliance may be reduced. While this may provide an administrative saving there could also be a social cost associated with higher emissions. No estimates of these costs have been made, but any costs are expected to be marginal.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		0.36	£2.8
High	0		0.45	£3.5
Best Estimate	0		0.40	**£3.2**

Description and scale of key monetised benefits by 'main affected groups'

Key benefits for industry arise from: removing trading, verification, removing overlap with the EU ETS, aligning reporting periods with the EU ETS, and modifying the 90/10 rule. For government there will be benefits from UK ETS closure and simplifying the reporting periods. Over the duration of the impact assessment (2012 to 2020) it is estimated that the total benefit arising from the proposed changes will be around £3.7m on the basis of a scenario where some of the current 54 sectors amalgamate into 49 sectors (high) and £2.8m under a scenario where no amalgamation takes place (low). The bulk of the savings are realised by the industry no longer incurring costs in trading allowances at the end of their target period. The Government saves most in the administration costs of the UK ETS when the scheme is closed. The table below provides a breakdown of the benefits under these high and low scenarios.

	Central Scenario		
NPV simplification savings (£000)	**Government**	**Industry**	**Total**
Target Negotiations and reviews	28	12	39
All target units required to meet targets		- 299	- 299
Reporting Periods		195	195
Baseline Years	11		11
Risk Management Tools and Buyout Mechanism	161	1,579	1,740
Overlap with EU ETS-Double Counting Mechanism	52	214	266
Removing Verification		832	832
Option 2 Agreements	5		5
Scheme Rules	18		18
Annual Reporting		- 166	- 166
Site Coverage: 70/30 Rule	17	50	66
Total	**291**	**2,416**	**2,707**

Other key non-monetised benefits by 'main affected groups'

Some of the simplification options will make CCAs more effective, clear and fair but it is difficult to quantify these benefits. For example, the majority of respondents (79%) to previous consultations agreed that requiring all target units to meet their targets individually would improve the equity of treatment between target units and limit free riding.

Key assumptions/sensitivities/risks **Discount rate** 3.5

CCA holders do not keep records of the admin cost of maintaining the Agreements, so it has been necessary to make estimates. CCAs have been in place since 2001 and DECC has collected data from previous consultations exercises and has received feedback from participants, which forms the basis of some of this analysis. Many of the proposals in this documents have been consulted on previously. It has not been possible to quantify the costs or benefits of a number of the simplification options proposed. Instead, these are assessed qualitatively.

Direct impact on business (Equivalent Annual) (£m):			**In scope of OIOO**	**Measure Qualifies as**
Costs: 0.06	**Benefits**: 0.40	**Net**: 0. 34	Yes	OUT

Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?			United Kingdom		
From what date will the policy be implemented?			01/01/2013		
Which organisation(s) will enforce the policy?			DECC		
What is the annual change in enforcement cost (£m)?			Voluntary scheme		
Does enforcement comply with Hampton principles?			Yes		
Does implementation go beyond minimum EU requirements?			N/A		
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** **N/A**	**Non-traded:** **N/A**	
Does the proposal have an impact on competition?			No		
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?			**Costs:** N/A	**Benefits:** N/A	
Distribution of annual cost (%) by organisation size (excl. Transition) (Constant Price)	**Micro**	**< 20**	**Small**	**Medium**	**Large**
Are any of these organisations exempt?[1]	No	No	No	No	No

Specific Impact Tests: Checklist

Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

Please note this checklist is not intended to list each and every statutory consideration that departments should take into account when deciding which policy option to follow. It is the responsibility of departments to make sure that their duties are complied with.

Does your policy option/proposal have an impact on…?	**Impact**	**Page ref within IA**
Statutory equality duties[2] Statutory Equality Duties Impact Test guidance	No	Annex 2
Economic impacts		
Competition Competition Assessment Impact Test guidance	No	
Small firms Small Firms Impact Test guidance	No	Annex 2
Environmental impacts		
Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance	No	
Wider environmental issues Wider Environmental Issues Impact Test guidance	No	
Social impacts		
Health and well-being Health and Well-being Impact Test guidance	No	
Human rights Human Rights Impact Test guidance	No	
Justice system Justice Impact Test guidance	No	
Rural proofing Rural Proofing Impact Test guidance	No	
Sustainable development Sustainable Development Impact Test guidance	No	

[1] Organisations participate voluntarily in the scheme

[2] Race, disability and gender Impact assessments are statutory requirements for relevant policies. Equality statutory requirements will be expanded 2011, once the Equality Bill comes into force. Statutory equality duties part of the Equality Bill apply to GB only. The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

Evidence Base (for summary sheets) – Notes

Use this space to set out the relevant references, evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Please fill in **References** section.

References

Include the links to relevant legislation and publications, such as public impact assessment of earlier stages (e.g. Consultation, Final, Enactment).

No.	Legislation or publication
1	Consultation on the Form and Content of New Climate Change Agreements, March 2009 http://webarchive.nationalarchives.gov.uk/20110508074721/http://www.decc.gov.uk/en/content/cms/consultations/climate_change_agree/climate_change_agree.aspx
	Partial Impact assessment on the Form and Content of New Climate Change Agreements, March 2009 http://webarchive.nationalarchives.gov.uk/20110508074721/http://www.decc.gov.uk/en/content/cms/consultations/climate_change_agree/climate_change_agree.aspx
2	Second Consultation on the Form and Content of New Climate Change Agreements, December 2009
3	Climate Change Agreements: Consultation on Draft Revised Agreements and Scheme Rules, March 2010
4	Impact Assessment on the Form and Content of New Climate Change Agreements, March 2010
5	Government Response to Consultation on the Form and Content of New Climate Change Agreements, March 2010
6	Budget 2011

Evidence Base

Ensure that the information in this section provides clear evidence of the information provided in the summary pages of this form (recommended maximum of 30 pages). Complete the **Annual profile of monetised costs and benefits** (transition and recurring) below over the life of the preferred policy (use the spreadsheet attached if the period is longer than 10 years).

The spreadsheet also contains an emission changes table that you will need to fill in if your measure has an impact on greenhouse gas emissions.

Annual profile of monetised costs and benefits* - (£m) constant prices

	Y_0	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7	Y_8	Y_9
Transition costs										
Annual recurring cost										
Total annual costs										
Transition benefits										
Annual recurring benefits										
Total annual benefits										

* For non-monetised benefits please see summary pages and main evidence base section

Microsoft Office Excel Worksheet

Introduction

1. The aim of Climate Change Agreements (CCAs) is to mitigate the impact of the Climate Change Levy (CCL) on energy intensive industry and to deliver energy efficiency improvements broadly equivalent to the savings that would be achieved by the application of the full rate of the CCL.

2. This Impact Assessment accompanies a consultation on proposals to simplify the current CCA scheme. It specifically assesses the effects of these proposals. It evaluates the simplification proposals by comparing them to the 'Business as Usual' (BAU) scheme, which is characterised as a continuation of CCAs in their current form up to 2023. It is broken down into the following sections:

    - Option 1: The business as usual counterfactual – continuing the CCA scheme in its current form until 2023
    - Option 2: Simplified CCAs Scheme
    - One in One Out Consideration
    - Risks and Assumptions
    - Preferred Option 2
    - Annexes 1, 2 and 3

3. The section dealing with the proposals for a new, simplified CCA scheme (option 2) presents a cost-benefit analysis for each of the administrative simplification proposals considered in the consultation. The net benefits of the options are estimated relative to the BAU scheme (the counterfactual in this IA). The proposals for simplification differ in their administrative costs. Differences in energy use and emissions have not been quantified because none of the proposals are expected to have a direct impact on emissions coverage or energy demand. The scheme's carbon savings will depend on the targets that Government will negotiate and agree with industry in 2012.

4. The Government made clear in the first Annual Energy Statement that it would be considering the future of Climate Change Agreements to ensure they deliver significant improvements in energy efficiency while reducing complexity and policy overlap. Responses to Lord Marland's letter on regulatory simplification have been taken into consideration as part of this review.

Background

5. Climate Change Agreements were introduced in 2001 in response to the Marshall Report on "Economic Instruments and the Business Use of Energy". Lord Marshall drew particular attention to the need to balance the pressures on the environment, on business and on Government. The report proposed the introduction of an energy tax (CCL) aimed at delivering worthwhile improvements to energy efficiency and reductions to carbon emissions (compared to what they would have otherwise been) but recognised the potential impact such a tax could have on the international competitiveness of energy intensive users (EIUs).

6. Government subsequently introduced the CCA scheme, through which a discount to the CCL was made available to eligible industries in return for agreeing and delivering challenging energy and carbon savings. The Levy discount was set at 80% and subsequently reduced to 65% in April 2011.

7. The current Climate Change Agreements are due to expire in March 2013. However, the Government announced in the 2011 Budget that CCAs will be extended to 2023 and that the Climate Change Levy discount on electricity will be increased from 65% to 80% from April 2013. The Budget also confirmed that the existing 54 participating sectors will continue to be eligible for the CCA scheme and Levy discount. This extension will provide industry with more certainty to invest in energy efficiency measures with longer payback periods.

The rationale for consulting on CCA simplifications

8. Since Climate Change Agreements were first introduced in 2001, the policy landscape has evolved significantly, resulting in a mix of legislation and policy which contribute to a complex environment within which industry and Government must operate. In particular the EU Emissions Trading System (2005), the Climate Change Act (2008) and the CRC Energy Efficiency Scheme (2010) have been introduced. As a result, and following the recommendations by the Environmental Audit Committee (2008) and conclusions of the DECC Simplification Review, the Government is looking to simplify the future CCAs to reduce administration costs while maintaining the level of carbon savings delivered by the scheme.

9. Government committed in the Annual Energy Statement in July 2010[1] to consider the future of CCAs, alongside a review of the CRC Energy Efficiency Scheme, in order to ensure that we deliver significant improvements in energy efficiency with minimal complexity and policy overlap.

10. The policy objectives of the options and proposals for changes to CCAs are twofold: (i) simplify the structure of CCAs and thereby make them easier to operate and (ii) maintain the effectiveness of the agreements in cutting carbon emissions.

Consideration of options for future CCA scheme

11. This Impact Assessment considers two options for the future of the CCA scheme, the continuation of the current scheme and a modified scheme that incorporates administrative simplifications. The IA does not consider abolishing the CCA scheme because of requirements and commitments made in the 2011 Budget. In addition, the IA does not assess the costs and benefits of achieving different levels of carbon mitigation.

Option 1: The business as usual counterfactual – continuing the CCA scheme in its current form until 2023

12. The counterfactual used in this IA assumes the continuation of CCAs to 2023 in their current form. This represents a ‘do nothing’ counterfactual, in which no simplification changes are made to the current scheme.

Description of Current Scheme

13. There are currently 54 sectors with CCAs, covering around 5,000 target units and 10,000 facilities. The 54 sectors covered by the scheme (which do not include the electricity generation sector) are responsible for emissions of about 57MtCO_2. However, the majority of these emissions are in the traded sector (emissions which are covered by the EU Emissions Trading System (ETS)). Only 10MtCO_2 are non-traded direct emissions.

[1] http://www.decc.gov.uk/assets/decc/what%20we%20do/uk%20energy%20supply/237-annual-energy-statement-2010.pdf

14. CCAs have a two tier structure, with agreements between the Secretary of State and individual industry sector associations (e.g. steel, chemicals, cement, ceramics, food and drink) and agreements between the Secretary of State and individual target units. A target unit is a site or installation or group of facilities sharing one target.

15. Targets are negotiated between sector associations and government, but it is the responsibility of sector associations to distribute the agreed targets among their members. Targets are set to cover all energy used by the CCA target unit, including any covered by the EU Emissions Trading System (EU ETS). Double jeopardy or benefit in relation to emissions covered by both schemes is prevented through a CCA double counting mechanism (more background provided in **Annex 3**).

16. Eligibility for the scheme was initially based on sectors covered by part II of the Pollution Prevention and Control Regulations 2000. Subsequently, eligibility was extended to businesses in sectors where the value of energy used is 3% or more of the production value for the sector, and which have an import penetration ratio[2] of 50% or more. This ratio is calculated for the sector as a whole to determine its exposure to international competition. Sectors where the value of energy used is 10% or more of the production value for the sector do not have to meet the import penetration test.

17. Target units have a choice of currency for their targets, which can be absolute (e.g. the total emissions from the unit) or relative (e.g. the amount of energy used per unit of production), and based on energy use or carbon emissions. The vast majority of targets are relative. This means that if production increases emissions may also increase.

18. In several sectors, and within many target units, it is not possible or practical to have one throughput unit and so a method of target setting and adjustment has been developed. This method is referred to as 'the Novem method' (described further in **Annex 3**). The application of Novem resolves the issue of establishing a common relative target for sectors or target units that have diverse products. The Novem procedure applies only where targets are relative .

19. The current scheme had five target periods (2002, 2004, 2006, 2008 and 2010). Where a sector meets its target, all target units within that sector are deemed to have met theirs (i.e. there will have been sufficient over-achievement by some operators to off-set any under achievement by others). In this case, all operators would be re-certified for the CCL discount for the subsequent two years. Where a sector fails its target, eligibility for re-certification is assessed at individual target unit level. Any target unit within that sector that fails to meet its target could be de-certified.

20. Operators can meet targets either by direct action or by purchasing carbon allowances from the UK Emissions Trading Scheme (UK ETS). The UK ETS (described further in **Annex 3**) was the world's first economy-wide greenhouse gas emissions trading scheme, established in April 2002 as a pilot scheme with a number of direct participants. It closed to direct participants in 2006, immediately after the introduction of the EU ETS. However, it remains open to CCA operators for trading purposes. If an operator over-achieves against its target, that over-achievement can, subject to verification, be sold through the UK ETS or be used against the target unit's own future targets.

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[2] The import penetration ratio is the total value of sector imports, divided by the total value of UK sector sales, plus the total sales value of imports, minus the total value of sector exports.

Current CCA Scheme Administration Costs

21. Administration costs fall onto Government, participants and sector associations. Estimates of BAU administration costs have been derived from a number of sources and are presented below. The admin cost to government has been estimated using data kept on past administration of CCAs, while admin cost estimates for participants and sector associations have been obtained from:
    - A full public consultation on the structure of CCA which took place in March 2009. This produced estimates of aggregate costs for participants and sector associations.[3]
    - Data provided by AEA Technology (DECC's technical consultants for the CCA scheme) on the running of CCAs containing detailed statistics on the number of target units, size, sector structure and energy consumption[4].
    - An estimation of unit costs associated with each of the activities in current CCAs. This estimation was based on a consultation with AEA Technology and a further consultation with some sector association representatives[5].

22. These estimates combine unit cost with descriptive statistics about the size of sector associations and target units. **Table 2** shows the results of this analysis for each main activity in the current CCA scheme. These figures represent the Net Present Value (NPV) of admin costs associated with the CCA scheme from 2012 to 2020. The cost for industry would be around £43m and government £7.9m.

23. A large part of the administration cost is due to maintenance of the agreements, monitoring and reporting energy and emissions. However, many of these activities overlap with requirements under other schemes. For example, some CCA participants are covered by the Pollution Prevention and Control Regulations (IPCC). This IA does not consider monitoring and reporting cost in these cases because there is no significant additional admin cost, as these are already required under the IPCC regulations.

24. It should be noted that Government does not have very good evidence on the scheme's admin costs and it is expected that more evidence will be acquired from the consultation exercise.

Table 2

CCA Scheme 54 sectors Current Scheme from 2012-2020	**£(000) 2009 prices**
Sector Association	4,235
Participant	31,573
Total Admin Cost Industry	43,740
Cost to Government	7,933

[3] DECC consultation on form and content of new climate change agreements http://www.decc.gov.uk/en/content/cms/emissions/ccas/ccas.aspx
[4] Internal Report by AEA based on MS4 and MS5 periods. April 2011.
[5] CCA Stakeholders and Tasks. Analysis of admin cost of CCAs by SKM Enviros for the Food and Drink Federation. Internal Report. April 2011.

Option 2 - Proposals for the future CCA Scheme

25. This section presents how the proposed amendments as part of the future CCA scheme impact on the administration costs for both industry and government of meeting targets. The IA does not assess the costs and benefits of achieving different levels of carbon mitigation. This will depend on target levels rather than administrative changes to the CCA scheme.

26. All proposals are grouped together in one scenario, with the costs and benefits assessed against the BAU assumption, or counterfactual of keeping Agreements as currently constituted (Option 1). Where the proposal is to make no change relative to current Agreements, there are no additional costs or benefits.

27. There have been two previous consultations about the structure of the Agreements, one in March 2009 and the other in December 2009. A major difference with the previous Impact Assessment is that the new CCA scheme will run until 2023, increasing the period of estimation.

28. The following section sets out in detail the impact on government and industry of the individual simplification proposals, which are judged against the BAU scenario. In doing so, Government has considered the previous administration's proposals, and industry's responses. Where evidence has already been provided by stakeholders to the proposals, Government has set out its decisions. In addition, there are also a number of new proposals, on which views are sought. **Annex 4** provides the full list of the decisions and new proposals. The spreadsheet attached on page 5 provides details of the calculations behind the cost savings.

Target and Milestone Periods

29. Under the current CCA scheme target units are required to meet performance targets in the second of the 2 year target period, referred to as the milestone year. The Government proposes that under the future CCA scheme the milestone period will be extended to 24 months. This would ensure that performance against targets was measured continuously, and that the scheme is more environmentally robust. It will also provide reassurance that no gaming in the form of scheme participants stockpiling product before a target period so they can reduce their production during the target period, would take place. The target periods of the new scheme would start in 2013, 2015, 2017 and 2019. We will work with industry to develop arrangements to handle structural change.

Benefits:

- It is expected that there would be a greater degree of compliance through the requirement for ongoing monitoring of energy consumption. This benefit has not been quantified.

Costs:

- There will be additional costs associated with reporting energy use every year. This has been assumed to add up to 10% of the previous costs of monitoring for all those not currently required to report annually. This will affect 2,384 participants (This is made up of all energy intensive target units and 5-20% IPPC Eligibility-Energy-intensive industries (defined as industries covered by Part A1 or A2, in Part 1 of Schedule 1 of the Pollution Prevention and Control (England and Wales) Regulations 2000) who currently spend 15 hours at £14.25 per hour. This will add £51k of administration costs every other year.

Reporting Periods

30. Under the existing CCA scheme sector associations have been able to select a starting date for the target period when they joined the scheme: 1 October, 1 November, 1 December or 1 January. However, this date has been fixed thereafter. Many sectors chose a starting point before reporting requirements for the EU ETS were introduced. In the 2009/10 Climate Change Agreements' consultations it was proposed that the target periods for all sectors would commence on 1 January in order to ensure alignment with EU ETS reporting, which takes place on a calendar year basis.

31. The Government has therefore decided to proceed with this proposal. This will be accompanied by necessary adjustments to associated deadlines. In particular, sector associations will be required to submit reporting data biennially, for the previous two calendar years, by 1 April and, for those that meet targets, the two year certification period (for the Levy discount) will begin on 1 June. The end of the certification period for current agreement holders will be the end of March 2013. The first new certification period will commence on 1 April 2013 with the subsequent ones on 1 June 2015, 1 June 2017, 1 June 2019 and 1 June 2021.

Benefits:

- A reduction in the administrative burden on those businesses that are also participants of the EU ETS in terms of recording, reporting and provision of data for audit purposes. Savings are estimated to be around £60,000 every two years, which is £247.50 of time savings from the number of target units (241) who have installations covered by the EU ETS and CCAs (more details provided in the **attached spreadsheet on page 6**).

Costs:

- There may be one off costs associated with amending data collection procedures and related IT for target units and sector associations. No estimates have been made but cost is expected to be minimal.

All target units required to meet targets, regardless of sector performance

32. The impact of some of the simplification proposals needs to be assessed together. Applying a need for target units to meet their targets, excluding EU ETS emissions from CCA coverage and a move to a buy-out mechanism (discussed in the subsequent sections), are all likely to change the behaviour of target units in how they negotiate their targets and the amount of effort that is likely. The net result is unclear, however, and therefore carbon emissions savings have not been considered in this IA.

33. Taking the first measure, the target unit's need to comply will make the industry negotiators less likely to accept challenging targets because the cost of compliance cannot be spread between organisations within a sector, as has been done in the past. The number of units failing to comply with the targets is likely to be lower, however. In the past, the cost of complying with the targets for those sectors that had missed them was very small. The typical UK ETS allowance price has fluctuated between 50 pence to £4 per tonne of CO_2 during the current scheme. This probably made tight targets more likely to be breached, as sectors were more willing to accept the cost of buying allowances.

34. Moving EU ETS emissions out of the coverage of CCA emissions targets reduces the size and liquidity of the UK ETS market to a point where price volatility would likely be high. If a high allowance price is seen as a significant risk, this is likely to have a further impact on the way in which targets are negotiated. This reduces the likelihood of achieving a challenging target because non-compliance is more costly. But switching to a buy-out mechanism with a

pre-determined price, instead of a volatile UK ETS, is likely to lead to a greater willingness to accept challenging targets from sector units.

35. It is unclear whether emissions and the incidence of non-compliance will be higher or lower after these administrative changes have taken place. But as they are likely to have positive and negative impacts to the level of target setting and compliance, they are assumed to be negligible. **Therefore, in this IA no impacts on emissions have been quantified**.

36. Currently, targets are set at the sector level and sector associations are responsible for allocating the target to their members. When performance is assessed in a target period, if a sector as a whole meets its target, all target units within that sector are deemed to have met their targets. This is irrespective of the fact that some target units may not have met their targets. Where a sector does not meet its target, target units within that sector that have not met their targets risk loss of Levy discount. This approach was criticised by the Environmental Audit Committee on both economic grounds (value for money for the tax payer) and on equity grounds (variable treatment between target units).

37. 79 per cent of respondents to the previous consultation[6] agreed that all target units should be required to meet their targets. Therefore, on fairness grounds, for the future scheme the Government has decided that all target units should be required to meet their targets on an individual basis.

Costs & benefits:

- This will promote equity of treatment between target units and prevent free riding.
- The net financial costs and benefits are difficult to determine as set out in the previous paragraphs.
- Because of the need for each participant to meet their targets, there is likely to be a greater need for sectors to conduct target negotiations in a bottom-up approach, rather than top down. If target units are required to meet targets individually it is likely that all sectors will use a bottom-up approach. The current distribution of the 54 sectors is 30 who negotiate in a bottom-up approach and 24 in a top-down way. So this proposal will increase the cost of negotiating for only 24 sectors. Estimates from previous periods indicate that this takes twice as much time to do. The cost of this measure is £165k for each target negotiation.

<u>Risk Management Tools and buy-out mechanism</u>

38. There are three risk management tools available to target units under the current scheme. These include:

- Carbon Trading – Agreement holders were able to purchase carbon allowances via the UK Emissions Trading Registry (more details on how the UK ETR operates can be found in **Annex 3**).
- Fuel Supply Disruption – Agreement holders were able to appeal against their targets being tightened in cases of disrupted power supply.
- Relevant Constraints – Agreement holders were able to apply for their targets to be amended in cases where legislative changes resulted in an increase of energy use or carbon emissions.

39. Under the new scheme only Fuel Supply Disruption will be retained as a risk management tool. It is unlikely that significant legislative changes would be unknown when targets are set that might impact on target achievement during the lifetime of the scheme A target review in 2016 will provide an opportunity to take into account any changes to legislation which could impact on target achievement. In place of carbon trading via the UK ETR, we propose to introduce a buy-out mechanism.

[6] Second Consultation on the Form and Content of New Climate Change Agreements, December 2009

40. The buy-out mechanism would involve the payment of a fee to Government for each tonne of carbon dioxide a target unit had underachieved against its target. This would provide a simplified approach, as it would not involve opening and running UK ETR accounts nor would there be the complications and costs associated with trying to buy small volumes of carbon allowances as can happen at present. This mechanism would therefore be easier for industry and Government to administer than the current approach.

Costs & benefits:

- Abolition of the UK ETS reduces costs for Government. This is estimated to be around £20k per annum. Participants will save the administrative cost of buying, selling and surrendering allowances every other year which has been estimated at £484k at each trading period. This is estimated based on the average management cost per hour (£27.35), the number of management hours required (4) and the number of trading units 4,422).
- Further costs and benefits are difficult to determine and relate to the paragraphs 32 to 35.

<u>Overlap with EU ETS-Double Counting Mechanism</u>

41. A double counting mechanism (further background provided in **Annex 3**) is currently applied where emissions at a target unit are covered by both a CCA and the EU ETS. This mechanism was introduced because over-achievement could result in the generation of surplus allowances under both schemes in respect of the same emissions reductions. Conversely, under-achievement could result in a requirement to purchase allowances under both schemes. Within the area of overlap, over-achievement would therefore result in a double benefit, while under-achievement would result in a double penalty .

42. However, this mechanism is complex and administratively burdensome, and industry have called for it to be replaced by splitting CCA targets, provided it does not result in any loss of Levy discount on the emissions covered by the EU ETS. The Government has therefore decided to implement the splitting of CCA and EU ETS targets. The result of this is that CCA targets will only cover non-EU ETS emissions, but target units will be eligible for the Levy discount on all CCA-eligible energy use. We are looking to duplicate this approach for any EU ETS small emitters opt-out.

Costs & benefits:

- This proposal removes the need to use the double-counting mechanism which is complex and burdensome for target units, sector associations, and Government. Savings from reduced admin costs are expected to have an NPV of around £52k (the administration cost and 20 days of consultancy time) for Government, and £214k (administration costs for 28 sectors and 241 target units) for industry.
- Clear separation between EU ETS obligation and CCA target should incentivise efficient mitigation under each mechanism. This benefit has not been valued.
- Further costs and benefits are difficult to determine and relate to the paragraphs 33 to 36

<u>Setting a relative target across diverse products (NOVEM procedure)</u>

43. The Novem procedure (further explained in **Annex 3**) was adopted in order to set targets for sectors and target units for which it is difficult to establish a common throughput measure due to the production of a variety of products (e.g. a company that manufactures paint by the litre and coated products by the square metre.) Under the current scheme sectors and target units can chose whether or not to apply the Novem method.

44. 91 per cent of respondents to the previous consultation[7] agreed with the proposal that the Novem methodology should continue to be applied, but in an obligatory way, for relevant

[7] Second Consultation on the Form and Content of New Climate Change Agreements, December 2009

sectors and target units, irrespective of whether the result is advantageous or disadvantageous to the sector or target unit concerned. The Government has decided that the Novem procedure will be compulsory for calculating relative targets where there is a diverse product mix.

Benefits:

- This proposal will reduce the administrative burden on industry and government resulting from new target units joining the CCA scheme. This is because it will avoid the development of new bespoke methodologies to handle diverse product streams. This benefit has not been valued.

Costs:

- There will be one-off costs to scheme participants that are currently using bespoke methodologies and have to switch to using NOVEM. This cost has not been valued.
- There will be no additional cost to Government.

<u>Types of Agreements</u>

45. There are currently two different types of agreement in existence for CCAs. For sectors with “Option 2” agreements, the underlying agreement is between the target unit and the Secretary of State. However, under “Option 3” agreements, the underlying agreement is between the target unit and the sector association, approved by the Secretary of State. The terms of the agreements are in all other respects the same. The Government has decided to discontinue ‘option 3 agreements’ and require that all agreements with CCA target units are made directly with the Secretary of State, instead of with sector associations.

Benefit:

- More consistency and transparency of the agreements in structure and operation.
- Reduced administration burden to DECC in checking data. This is estimated to be around £1,600 every other year, which is two days of a consultant’s time.

Costs: .

- The proposal is not expected to increase costs for either Government or business.

<u>Sectors’ Amalgamation Impact on Target Negotiations and Reviews</u>

46. Target reviews provide an opportunity to ensure that targets continue to reflect the full potential for energy efficiency improvements or carbon savings. Under the current CCA scheme, sector targets were reviewed in 2004 and 2008 in order to ensure that targets remained challenging. As the new scheme will run from 2013 to 2023, target reviews will be needed to ensure that targets remain fair but challenging during the lifetime of the scheme. For the future scheme the Government proposes that a full target review will take place in 2016 .

47. There are currently 54 sectors in CCAs for which targets must be negotiated. This process can be administratively burdensome for both Government and sectors. The Government therefore proposes to amalgamate some sectors for negotiation purposes. The consultation document which accompanies this Impact Assessment requests suggestions for potential sector groupings. This proposal would not affect the number of target units covered by the scheme, but could reduce the number of sector targets that need to be negotiated by Government.

Benefits:

- The amalgamation of sectors has been assumed to reduce cost because of fewer sectors required to negotiate targets. The expected consolidation is expected to reduce the sectors from 54 to 49. This saves administration for the sector associations and Government. This analysis assumes that each newly combined sector has a higher administrative burden equal to 1.5 times that of the previous single (pre combined) sectors. Initial estimates indicate that 10 sectors would be suitable for amalgamation. Based on these two initial estimates, there would be savings of £6k at each target negotiation.

Costs:
Government spends a third of its CCA admin budget on conducting and preparing for negotiations. The admin cost is around £330k[8] for each target negotiation. The same reduction in the number of sectors and the increase of 50% would generate savings for government around £15k.

Penalties

48. Under the current scheme the only sanction against non-compliance is to decertify or terminate an Agreement. This normally means that the target unit concerned will not be able to claim the Levy discount until the next target period. For the future scheme it is proposed to introduce a penalty system to provide for a more proportionate, but persuasive way of handling the more minor cases of non-compliance where scheme participants wish to correct their infringement. These penalties are different to the buy-out mechanism discussed earlier. They will cover things such as: late payment of the buy-out fee in relation to under achievement against targets, late notification of the SoS of ineligibility, failure to supply by the set deadline any information requested by the SoS, inadequate record keeping and non-compliance with audits

Benefits:

- Under this proposal there would be a more flexible approach to compliance, helping to ensure that Agreement holders do not face automatic removal from the scheme, losing the Levy discount. This benefit has not been quantified.
- A more proportionate response for the more minor cases of non-compliance. This benefit has not been quantified.

Costs:

- Any additional costs associated with administering the penalty scheme are judged to be marginal. There are already costs associated with managing non-compliance under the current scheme. No additional costs have been quantified.

Distributional Effects:

- There will be some change in the transfers from business to Government, since there will be different financial penalties to be paid. These will be dependent on the nature of the penalty system, and these will be assessed alongside the responses to the consultation.

Scheme Rules

49. Under the current Agreements, each umbrella and underlying agreements contain substantial details on the mechanics of the agreements. Any changes to the scheme therefore need to be reflected in changes to every agreement, requiring the approval of all target units (around 5,000). Consequently, making changes to the scheme is administratively burdensome and makes the agreements inflexible and potential improvements, to the benefit of industry and Government, are not pursued. The result has been that, in the lifetime of the current agreements, only one change has been made (CHP inputs and outputs algorithm). In order to simplify the operation of the scheme, it is proposed to separate the operational mechanisms into two documents: scheme rules, and short

[8] Based on DECC's administrative data.

agreements between government and sector associations (umbrella agreements) and government and operators (underlying agreements).

Benefits:

- Reduced administrative costs to Government and admin burdens on sector associations, estimated to be around £2,700 per annum, which is as a result of the time saved in amending the agreements.

Costs:

- It is expected that the costs of implementing this change will be minimal. This cost has not been quantified.

Site Coverage: Introduction of 70/30 rule

50. The Government proposes to keep the 90/10 rule[9] (further explained in **Annex 3**) but to reduce the threshold from 90% to 70%. It is expected that more energy will qualify for CCL discount as a result of this change but the impact is expected to be small. The change should also increase the opportunity for the installation of energy efficiency measures, but the impact is again expected to be small.

51. This change is not expected to have any material impact on costs for either industry or government. There will be marginal benefits to industry in extending the amount of energy to which the Levy discount will apply and in a reduced need to sub-meter.

Benefits:

- There will be savings to industry resulting from new entrants not being required to purchase sub-meters. This is assumed to be 300[10] new entrants, with a cost saving of £750[11] per meter. Annual maintenance savings of 5%[12] of the capital cost of the meters have also been assumed for those new entrants who no longer have to acquire a meter.
- There are reduced costs for Government in not having to process as many eligibility assessments of 10 day's administration.

Costs:

- There will be some small additional compliance costs resulting from the additional coverage of energy/emissions. These costs have not been quantified.

Removing verification

52. Under the current scheme, agreement holders that over-achieve against their targets 'earn' carbon allowances under the UK Emissions Trading Scheme (UK ETS). However, before these agreement holders can trade their allowances or retire them to meet targets, the allowances have to be verified by a third party.

53. Verification is a requirement under the current scheme for two main reasons: UK ETS is a fully fledged trading scheme; and there was an obligation placed on the UK for verification under State aid approval. With the closure of the UK ETR, Government proposes removing the requirement for third party verification of over-achievement, subject to normal audit

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[9] The rule provides that where the energy use of the energy intensive installation is equal to 90% or more of the total energy use of the site, the whole site is deemed to be an eligible facility.
[10] This is based on some informal discussions with the CCA sectors
[11] The electricity sub-meters start at £500 and gas sub-meters start at £1,000 (installed). This is based on DECC and AEA knowledge and some internet research, Have therefore used the mean value of £750.
[12] CCA Stakeholders and Tasks. Analysis of admin cost of CCAs by SKM Enviros for the Food and Drink Federation. Internal Report. April 2011.

procedures. It is estimated that this would have a net present value of £1.2m in the high scenario and £476k in the low. Participants will still be subject to the normal audit arrangements, which will not change as a result of these proposals.

Benefits

- Reduction on the cost of gaining verification for industry.

- An assessment of the verification costs has been based on the number of target units who over achieved in milestone 5, the latest period where there is data. The frequency with which verification takes place depends on the number of ring-fenced allowances which has varied in the past from 2150 in 2002 to 884 in 2010. The number of verifications has been estimated using data from the UK Emissions Trading Registry (UK ETR). Assuming this, costs are based on the likelihood of having had to verify (25% and 10% in scenarios high and low, respectively) and having a high or low cost of verification cost (25% have a £5k cost, 75% a £1.5k cost). The £1,500-£5,000 range is taken from p.7 of the Climate Change Simplification report (http://www.larpnet.com/downloads/climatechangeinstruments.pdf). The cost of verification depends on the complexity of the sites whose CCA emissions are being verified. The range of complexity of all verifying sites has been captured by assuming that 75% of verifying sites are at the bottom end of complexity and 25% are at the top end of complexity

Costs

- It is not expected that there will be any significant additional cost to Government or industry, however any resulting decrease in data accuracy could have a social cost. This has not been quantified.

Summary of New Proposals' Savings

54. There are a number of proposals where monetary estimates have not been possible but responses from previous consultations show that they would improve the operation of the current scheme. This could be by reducing uncertainty about emissions and targets, improving the clarity of the Agreements or making sure that each participant makes a fair contribution to achieving sector targets.

55. Estimates in **Table 3** differ from previous figures contained in the IA that accompanied the 2009 consultations for two main reasons. There is a substantial reduction in the admin costs because it is proposed that trading will be replaced by a simplified buy-out mechanism. It is also expected that the proposals will lead to some amalgamation among a number of sectors, reducing the overall compliance costs to industry. An increase in administration costs is expected if there is no move to amalgamate sectors, as sectors are likely to negotiate their targets in a bottom-up way, rather than a simpler top-down way.

	Central Scenario		
NPV simplification savings (£000)	**Government**	**Industry**	**Total**
Target Negotiations and reviews	28	12	39
All target units required to meet targets		-299	-299
Reporting Periods		195	195
Baseline Years	11		11
Risk Management Tools and Buyout Mechanism	161	1,579	1,740

Overlap with EU ETS-Double Counting Mechanism	52	214	266
Removing Verification		832	832
Option 2 Agreements	5		5
Scheme Rules	18		18
Annual Reporting		-166	-166
Site Coverage: 70/30 Rule	17	50	66
Total	**291**	**2,416**	**2,707**

<u>One-in, one-out (OIOO)</u>

56. The simplification of CCAs will deliver significant savings compared to the baseline situation of the extension of the existing scheme. These savings are estimated at £4m (see table 3), which will be delivered over the 2013-2023 period.

57. Using the OIOO formula, with a 9 year appraisal period and a 3.5% discount rate, the equivalent annual net benefit to business (the "out") is estimated at £271k.

<u>Risk and Assumptions</u>

58. A number of risks and uncertainties have been identified in relation to the costs and benefits associated with the simplification proposals outlined under Option 2 above. Based on knowledge of how the scheme currently operates and of the sectors which currently participate in the scheme, it is not anticipated that the above uncertainties will have a significant impact on the estimated costs and benefits associated with the simplification proposals.

59. It will not be possible to fully quantify all of the costs and benefits associated with the new scheme until the new rules and agreements have been developed. Some of the uncertainties associated with the estimation are as follows:

- The decision to commence all biennial target periods on 1 January, may mean that some sectors will have to amend their data collection procedures to align with the new procedures leading to one-off costs. Although they are expected to be marginal, as the costs associated with this exercise have not been quantified it is possible that this may have a small impact on the overall administration costs for the new scheme.
- A number of proposals may lead to a greater incentive for sectors and target units to meet their targets, such as the move to individual targets for each target unit and a buy-out mechanism with a higher price. Potential environmental benefits may also result from the proposal to hold a full target review in 2016. It has not been possible to quantify these marginal net impacts.
- It has not been possible to estimate the additional financial savings or costs associated with the proposal to amalgamate sectors for negotiations. It is expected that grouping sectors for this purpose will reduce the number of negotiations that take place, reducing costs for both Government and the sectors. However, grouped sectors may need to spend more time preparing for the negotiations, than in the current scheme, resulting in some extra costs. It will not be possible to quantify these costs until the proposal is in place.

- It is not yet know what level financial penalties will be set at, it is therefore not possible to estimate the costs and the distributional impacts associated with this until this detail is known.
- There may be a set up cost associated with the 70/30 rule, it is not known what this will be however it is expected to be negligible.

Summary of preferred option

60. Option 2, "Proposals for the future CCA scheme", is the preferred option because it reduces admin cost on businesses and government. It is not expected to affect the scheme's carbon savings and does not affect any of the main objectives of the scheme.

61. CCAs have been in place since 2001 and there has been a number of changes in the policy landscape and the wider context. These proposals provide an opportunity to reduce the complexity of the agreements with net benefits to government and participants.

62. Although each simplification option has been analysed individually, they have been presented as a package. For most of these options, this is a sensible approach because they are strongly linked. Equally, the proposals that affect targets are strongly linked to changes to the baseline and reporting requirements. Therefore, all these proposals have been grouped together and presented as a single simplification option.

Annexes

Annex 1 should be used to set out the Post Implementation Review Plan as detailed below. Further annexes may be added where the Specific Impact Tests yield information relevant to an overall understanding of policy options.

Annex 1: Post Implementation Review (PIR) Plan

A PIR should be undertaken, usually three to five years after implementation of the policy, but exceptionally a longer period may be more appropriate. If the policy is subject to a sunset clause, the review should be carried out sufficiently early that any renewal or amendment to legislation can be enacted before the expiry date. A PIR should examine the extent to which the implemented regulations have achieved their objectives, assess their costs and benefits and identify whether they are having any unintended consequences. Please set out the PIR Plan as detailed below. If there is no plan to do a PIR please provide reasons below.

Basis of the review: [The basis of the review could be statutory (forming part of the legislation), i.e. a sunset clause or a duty to review , or there could be a political commitment to review (PIR)]; The new CCAs policy mechanism will not undergo a review until around 2020. However, there will be a target review in 2016 to ensure that the targets are challenging and to maximise any emissions savings . Also the participating sectors' performance against their targets will be measured biennually and a report will be written and published by the administrator of the scheme.
Review objective: [Is it intended as a proportionate check that regulation is operating as expected to tackle the problem of concern?; or as a wider exploration of the policy approach taken?; or as a link from policy objective to outcome?] Please see response above
Review approach and rationale: [e.g. describe here the review approach (in-depth evaluation, scope review of monitoring data, scan of stakeholder views, etc.) and the rationale that made choosing such an approach] To be determined closer to 2020
Baseline: [The current (baseline) position against which the change introduced by the legislation can be measured] The baseline year against which sectors' performance will be assessed is 2008. The aforementioned published report will show the savinges delivered by the scheme against this baseline.
Success criteria: [Criteria showing achievement of the policy objectives as set out in the final impact assessment; criteria for modifying or replacing the policy if it does not achieve its objectives] To be determined closer to 2020
Monitoring information arrangements: [Provide further details of the planned/existing arrangements in place that will allow a systematic collection systematic collection of monitoring information for future policy review] It is the sectors' responsibility to monitor and report their performance data against their targets during the target period. This will be assessed by Government every two years. The methodology for sectors to follow when reporting performance will be embodied in the CCAs Guidance Documents which will be found on our web pages. It will be very similar to the way that is currently operating.
Reasons for not planning a review: [If there is no plan to do a PIR please provide reasons here] N/A

Annex 2: Impact Tests

1. Equality Impact Assessment for Climate Change Agreements (CCAs)

63. This policy has been screened in line with the Public Sector Equality Duty, considering the equality impacts on the protected characteristics of: age; disability; gender reassignment; marriage and civil partnerships; pregnancy and maternity; race; religion or belief; sex; and sexual orientation. The policy has been assessed using the specific screening questions set out in the EHRC guidance on equality impact assessments[15]:

Does the policy affect service users, employers or the wider community?	No, the policy is designed to provide an 80% discount (65% from 1 April 2011) on the Climate Change Levy (CCL) in return for a commitment from energy intensive sectors to achieve energy efficiency improvement targets agreed with Government. They are intended to mitigate the impact of the Climate Change Levy on the competitive position of energy intensive industry while maintaining the environmental benefits of the full Levy.
It is a major policy, with a significant effect on how functions are delivered?	The policy will not affect the delivery of functions.
Will it have a significant effect on how organisations operate?	No. The aim of the policy is to mitigate the impact of the Climate Change Levy on the competitive position of energy intensive industry while maintaining the environmental benefits of the full Levy.
Does it involve a significant commitment of resource?	No. Resource is already in place and no additional resource is expected.
Does it relate to an area where there are known inequalities?	No. This policy has no impact on the equality target groups. This policy is targeted at large private sector organisations not at individuals.

64. Based on the answers to the specific questions above we have decided that a full equality impact assessment is not required. At present there is no evidence to suggest that there are any adverse effects on any of the protected characteristics. The overall policy will be monitored to ensure action is taken if any unanticipated impact occurs but it is generally difficult to know what they would be for the different sectors involved in the scheme

2. Small Firms Test

65. It is not envisaged that the options considered will have a significant impact on small business, primarily because the proposed changes will actually reduce the admin burden to businesses including those of small size. Furthermore, the CCA scheme is voluntary and small businesses do not have to participate in it. If they do they then get the CCL discount which outweighs any of the voluntary participatory costs.

[15] See page 25 of http://www.equalityhumanrights.com/uploaded_files/eiaguidance.pdf

Annex 3: Further Background to the CCA Scheme

Site Coverage: Replacement of the 90/10 rule with a 70/30

66. Current Climate Change Agreements provide that where the energy use of the energy intensive installation is equal to 90% or more of the total energy use of the site, the whole site is deemed to be an eligible facility. Where the total energy use is less than 90%, permanent sub-metering is required to measure all energy use within the eligible facility. The 90/10 calculation must be reviewed annually by the operator.

67. The 90/10 rule allows eligible facilities to avoid the need to meter separately a small fraction of their overall energy use. The current proposal is to lower the 90% threshold to 70% to extend the benefit of reduced administrative effort and cost of sub-metering to a larger number of businesses.'

NOVEM

68. The application of Novem resolves the issue of establishing a common relative target for sectors or target units that have diverse products. The Novem procedure applies only where targets are relative.

69. Under current Climate Change Agreements, the "Novem" procedure has been used by certain sectors and target units for setting relative targets and measuring performance. The Novem procedure applies only where targets are relative and its application is optional

70. To set relative targets a throughput measure is needed that relates accurately to energy consumption or carbon emissions. In sectors and target units that have single products this can readily be achieved, e.g. kWh/tonne bricks, GJ/litre of pure alcohol. However, in sectors and target units that have a range of products a single throughput unit can be totally unrepresentative. For example, a chemical company may manufacture paint by the litre and coated products by the square metre.

71. The Novem method was devised to resolve this problem. The basic principle is that the energy used for the actual production level in the target year is compared with the energy that would have been used for the same level of production and mix of products at the efficiency of production in the base year. The Novem Method corrects distortions in overall and individual Specific Energy Consumptions (SEC) introduced by changes in product mix/output, so that the aggregate result reflects only the improvement in individual SECs.

72. The application of Novem resolves the issue of establishing a common relative target for sectors or target units that have diverse products. If its application is obligatory, it results in a highly accurate assessment of the change in energy efficiency performance of the sector or target unit. However, allowing sectors or target units to decide whether or not to apply the original or lower Novem adjusted target results in an effective weakening of targets. The Government believes that there is a need to establish common targets for the sectors and target units concerned and that targets should remain challenging and effective.

73. Government has therefore decided to continue to apply Novem for relevant sectors and target units, but require that Novem be applied in all cases, irrespective of whether the result is advantageous or disadvantageous to the sector or target unit concerned.

Overlap with the EU ETS: Double Counting Rule

74. Some operators that have climate change agreements in place, under the current scheme, also fall under the Emissions Trading System. Climate Change Agreements cover direct (fossil fuel) and indirect (electricity) emissions and some process emissions. The EU ETS covers direct and process emissions. Approximately 360 operators are covered by both the EU ETS and climate change agreements in respect of the some of the same emissions. These emissions are known as the overlap emissions. An operator covered by a Climate Change Agreement and the EU ETS will be able to trade allowances on both the UK ETS and the EU ETS. The trading registries for each scheme are entirely separate and the allowances in each of the schemes are not fungible. Special rules are in place to ensure that an operator cannot trade in respect of the overlap emissions on both the UK ETS and the EU ETS.

75. If an operator reduces emissions within the overlap, it may generate surplus allowances under both the UK ETS and the EU ETS in respect of the same reduction. Conversely, if emissions increase, the operator may be required to purchase allowances under both schemes. The UK Greenhouse Gas Emissions Trading Scheme 2002 makes provision to prevent the operator being faced with double benefit or double jeopardy by way of the double counting mechanism. This is contained in Rule D3A which was added in 2007 following lengthy consultation with interested parties.

76. The rule operates to provide that where an operator has surplus EU ETS allowances, this is offset by the CCA target being tightened to become more demanding. This is an emissions reduction but is achieved by tightening the CCA target to make it more demanding. Alternatively, if operators do not want to use the double counting mechanism they can avoid it completely by retiring all their surplus EU ETS allowances that form the overlap. Any failure to retire all the surplus EU ETS allowances leads to the full implementation of the double counting mechanism, with no allowance being made for any part of the EU ETS surplus that might have been retired.

UK ETR

77. The UK Emissions Trading Scheme (UK ETS) was the world's first economy-wide greenhouse gas emissions trading scheme. The UK ETS was created in 2002 for Direct Participants and for Climate Change Agreement operators. The Direct Participant element of the scheme ended in 2006, though participants who generated allowances have continued to be able to trade them with Climate Change Agreement operators.

78. The registry is an electronic, web-based system for holding and transferring greenhouse gas emission allowances. These allowances exist only in electronic form, each with a unique serial number. Anyone wanting to hold, buy or sell allowances in the UK Emissions Trading Scheme will need to have an account in the registry which will record the holdings of allowances by all Participants, tracking allowances from their initial allocation through all transfers of ownership right through to final cancellation or retirement.

79. Individual operators and Sector Associations may participate in emissions trading for the purposes of their CCA Umbrella (Sectors) and Underlying (Operators) agreements. These agreements are signed off by the Secretary of State and detail specific targets that each operator/Sector must meet at every Milestone (2 years). Whether an operator has met its target or not is assessed in accordance with rules laid down in the agreements and under the UK Greenhouse Gas Emissions Trading Scheme 2002.

80. Under a climate change agreement, an operator has the option of choosing the currency in which to express their targets. This may be an absolute or a relative target. Absolute targets set an absolute level of energy use or emissions during a target period whereas a relative

target sets, for example, a target based on energy use or emission per unit of throughput during a target period.

81. Where, at the end of a target period, an operator has met its target by reducing emissions below the target level, the difference between the emissions and the target (the overachievement) can be converted into emissions allowances which can be banked or sold via the UK Emissions Trading Registry. Where an operator is not able to meet its target, it can surrender any previously banked allowances or purchase and surrender allowances via the Registry to offset against its target in order to be certified for the purposes of the Levy.

82. Target Units register with DECC to obtain Trading Accounts. Trading Accounts are held by a trading participant or any other participant for the purposes of allocating, holding and transferring allowances. One allowance is equivalent to 1 tonne of CO_2 emissions. The price of an allowance varies according to the market. There are two main factors that determine the supply of allowances from Climate Change Agreements – energy efficiency measures and changes in throughput. Throughput changes can generate “windfall” allowances in two ways under the current scheme:

- for absolute targets when throughput falls – energy use falls, though not necessarily in direct proportion to the fall in throughput, depending on base load;
- for relative targets when throughput rises – base load is spread over more units of throughput, although this is limited by available capacity.

83. The current scheme recognises this potential for windfall allowances. In the case of relative targets there is a gateway to UK ETS which ensures that there is no net flow of allowances from the relative sector into the market. This is achieved by limiting sales of allowances to the extent that allowances have been purchased by target units with relative targets. In the case of absolute targets, the agreements provide that targets must be adjusted if throughput falls by more than 10% against that predicted.

84. Government proposes to end carbon trading by closing the UK ETR. This will remove the need for managing the registry and fall in throughput adjustments as described above which significantly reduces the admin burden of CCAs on both TUs and Sectors. The UK ETS is scheduled to close immediately after the end of the current audit programme.

Annex 4: Summary of New CCA Scheme Changes