TIMING AND FREQUENCY OF ALLOWANCES SALES IN THE CRC ENERGY EFFICIENCY SCHEME FROM 2012 ONWARDS

Introductory Notes

- In the light of feedback about the operation of the CRC scheme, the Government is considering simplification of the CRC. In doing so, Government will take into account feedback from stakeholders including:

    1. The effectiveness of the framework for driving energy efficiency in large private and public sector organisations, in the light of wider policy developments in other areas such as the implementation of a carbon price floor[1], electricity market reform[2], implementation of a Green Deal for business[3] and the review of Climate Change Agreements[4], and company reporting of greenhouse gas emissions[5] .

    2. The perceived complexity of the CRC scheme and hence the need to reduce the administrative burden on:
        - those organisations which are subject to the scheme
        - the administrators of the scheme (Environment Agency, Scottish Environment Protection Agency, Northern Ireland Environment Agency).

    3. Optimising the projected emissions savings attributable to the CRC scheme[6] due to an increased focus on energy efficiency by the target sectors.

- This is one of a series of discussion papers which aim to stimulate an informal dialogue between Government and participants about the simplification of the CRC Energy Efficiency Scheme. <u>As such, this paper is not a statement of Government policy</u>.

- These papers have been developed on the basis of feedback from participants about the operation of the scheme since April 2010. Ideas for simplification arising from this dialogue process will help inform consideration and the development the legislation to make provisions for the sale of CRC allowances.

- Please note that details of allowance prices and sales are a matter for the Budget process.

---

[1] http://www.hm-treasury.gov.uk/consult_carbon_price_support.htm
[2] http://www.decc.gov.uk/en/content/cms/consultations/emr/emr.aspx
[3] http://www.decc.gov.uk/en/content/cms/legislation/energy_bill/energy_bill.aspx
[4] http://www.decc.gov.uk/en/content/cms/what_we_do/lc_uk/ccas/ccas_policy/ccas_policy.aspx
[5] http://ww2.defra.gov.uk/environment/economy/business-efficiency/reporting/
[6] Projected savings attributable to the CRC are outlined in Annex G of the June 2010 DECC energy and emissions projections

It is essential that all participants continue to comply with the existing scheme, in full, as set out in the current legislation. The CRC remains a mandatory scheme, and the Environment Agency and other administrators continue to provide support to participants with their CRC compliance. Organisations who fail to comply may be subject to enforcement action and civil penalties. Participants should continue to fully comply with the scheme and use the introductory phase to gain experience on reporting, complying and surrendering allowances in CRC. For advice and support on compliance with the first phase of the CRC scheme participants should refer to the CRC Energy Efficiency Scheme Order 2010[7]and Environment Agency guidance.[8]

Issue

Government has committed to simplifying the CRC scheme and as part of the Comprehensive Spending Review announcement on 20th October announced that the first allowance sale for 2011-12 emissions will take place in 2012 rather 2011. This discussion paper sets out, and invites comments on

1. Issues and potential options for CRC allowance sales from 2012-14
2. Possible options for selling allowances and the market design for the second and subsequent phases from 2014

Background

The CRC has been designed to encourage participants to plan their energy management with allowance sales originally planned for the beginning of each compliance year, based on participants' forecasted emissions.

Feedback from participants has shown that for some organisations measuring, monitoring and reporting their groups' emissions have been more complex than anticipated. As a result, forecasted emissions are likely to be inaccurate in the coming period and participants are likely to under or over buy allowances and incur additional expense, in addition to making financial planning difficult.

We have therefore committed, in the Spending Review, to delay the first sale of allowances until after the end of the 2011/12 compliance year. This means that, for the first sale, participants will have certainty over both their emissions (as the sale is retrospective) and price per allowance. The exact timing of the sale has yet to be determined but would have to be in the period April – July 2012 so that participants can accurately purchase the number of allowances commensurate with their known emissions and surrender these allowances by the last working day of July. As a result of this change participants will have

[7] http://www.opsi.gov.uk/si/si2010/draft/ukdsi_9780111491232_en_1
[8] http://www.environment-agency.gov.uk/business/topics/pollution/98263.aspx

longer to get to grips with measuring, monitoring and reducing their emissions before purchasing CRC allowances. Section 1 considers issues and potential options for allowance sales in the introductory phase.

It was previously proposed that from the second phase CRC allowances would be capped and sold via a sealed bid uniform price auction. Feedback from some participants has been that auctioning creates an additional layer of complexity particularly for those organisations who are inexperienced at trading and in their recent report to Government on the second phase of the CRC, the Committee on Climate Change (CCC) recommend that alternative approaches are considered in particular, extending the first phase design though the second phase. Government wants to ensure that the second phase of CRC minimises complexity, incentivises energy efficiency and delivers the realistic cost effective carbon abatement potential that exists, possible options are considered in section 2.

1. CRC allowance sales in the introductory phase: issue and potential options

Issues
In looking at the options for allowance sales in the introductory phase we have identified four key issues;

1. Under the powers of the Climate Change Act, we have legal *vires* for a CRC scheme which facilitates a market for the trade of allowances; any decisions taken with respect to sales in the introductory phase should not prevent trading in the second and subsequent phases.

2. Forecasting and energy management remain fundamental to the CRC scheme in the longer term, in order to ensure that cost effective opportunities will be fully taken up.

3. Participants should purchase allowances commensurate with their emissions for each year of the scheme from 2011-12 but insofar as is possible a compulsory double sale in any one year should be avoided.

4. Opportunities for additional simplification should be maximised.

Are there any other issues that should be considered?

Options

In order to encourage energy management and ensure there is the opportunity for participants to be able to trade allowances in the second phase any decision on the format of allowances in the introductory phase needs to be able to transition from end of year ‘compliance’ sales to forecast sales for the second phase. Any simple transition will result in a compulsory double sale in one year either during the introductory phase or at the start of the second phase. DECC has already heard from participants who are concerned about the prospect of a compulsory double sale whereby participants are required to purchase two full years' allowances in one year. In light of this, the paper explores options for how to avoid this, but also ensure that participants should still be required to purchase allowances commensurate with emissions for each year of the scheme from 2011-12 onwards.

Should double sale options be considered further?

One option is to hold two fixed priced allowance sales from 2013/14 onwards, as part of the transitional arrangement to phase 2 with one sale at the beginning of the compliance year (ie April) and one prior to the requirement to surrender allowances once actual emissions are known (ie the following May/June). This approach could be introduced after participants have had the experience of measuring, monitoring and reporting on their emissions for 2 full reporting years.

The first sale would enable those seeking to manage liabilities to purchase allowances on the basis of their forecasted emissions and the second sale would provide the opportunity for compliance where emissions were not as forecast.

One way of incentivising the forecasting sale would be to sell allowances at a higher fixed price in the second sale creating a financial incentive for participants to forecast their emissions and plan their energy management.

Participants would be able to trade on the secondary market between the two sales; the second sale would act as a price ceiling to prevent secondary market allowance price going any higher. Participants would have the choice as to whether they purchased their allowances in the forecast sale, secondary market or second sale. However allowances purchased in an April forecasting sale would not be allowed to be surrendered three months later in July for the previous year's emissions.

A compulsory double sale for participants is therefore avoided but there is a financial incentive to move to forecasted allowance sales. Participants can choose an approach which best suits their individual circumstances as to when, how quickly and whether they move to allowance sales based on forecasted emissions. Importantly this approach facilitates all the options for the market design of the second and subsequent phases. Rules around banking allowances would need to be considered in light of decisions on the design of the second phase (i.e. no banking if phase two is capped etc). A timelines for this option is set out in annex A

Would this simplify the scheme and is it fair? Are there other, better, ways to achieve similar outcomes? Is the date for introduction of the two sales the right one? Do you have a preference on timing for the sales based on 'known emissions (April – July)? In addition to 'banking' rules do any other phase1/2 transition issues need to be considered? Are there any other issues we have not considered?

What would influence your decisions to purchase in either sale? We are interested in evidence which could help inform the price differential option between the two sales.

An alternative option is to hold multiple allowance sales throughout the year, for example on a bi-monthly basis. As with the option above this would enable a transition to the second phase and forecasted sales but give participants greater choice as to when they purchase their forecasted emissions and avoid a compulsory double sale. As with the two sale approach a price differential could be used to incentivise early purchase of allowances and accurate forecasting.

Are multiple sales preferable to a two sale approach? If so, why? Are there any other issues to consider with this approach?

Any option where there is the opportunity to purchase CRC allowances once a participants emissions are known, means there is no longer a need to for the safety valve and link to the fluctuating EU Emissions Trading System allowances (EUAs) market in the introductory phase.

Do you agree that the inclusion of sales at the end of the year, when emissions are known, means there is no longer a need for the safety valve/link to EUA market?

2. CRC Allowance sales in the second and subsequent phases: options for simplification

Comments on phase 2 market design were received from interested parties in 2007 and in response a sealed bid uniform price auction was proposed. Since 2007 Government and some participants have experience of EU ETS allowance auctions, the Committee on Climate Change have published their advice to Government on the second phase[9] and CRC organisations will have had some experience of participating in the scheme. Government therefore wishes to review the options for the second and subsequent phases with a view to simplification and minimising the burden on participants.

More accurate data on the size of the CRC sector and abatement potential will be available to Government following the submission of annual and footprint reports by the end of July 2011 however until such time Government does not have a preferred mechanism for allowance sales in the second and subsequent phases; some of the potential options for consideration are set out below

a) Auction allowances but use different auctioning mechanisms (eg English auction[10])

[9] http://www.theccc.org.uk/reports/carbon-reduction-commitment
[10] Also known as the also known as an *open ascending price auction*.

b) Auction allowances but in order to reduce complexity and cost remove the safety valve link to the EUA market and replace with regular higher price CRC allowance sales (potentially linked to the EUA price) in order to continue to incentivise participants to purchase allowances in the auction.

c) Auction with a minimum price (CCC alternative option 1)

d) Replace the auction with unlimited allowances at a fixed price (CCC alternative option 2)

e) Extend the proposed first phase design (ie two fixed price sales at different prices)[11] (variation of CCC alternative option 2)

f) Use a carbon exchange

g) More fundamental reform of the scheme

The options should not be seen as exhaustive, rather are based on feedback already received from interested parties. Government welcomes views on other options and variations on the options above.

Contributing to the dialogue

We would be interested in hearing stakeholder views on the proposed simplification for the introductory phase, particular in response to the questions in purple above, and the options for the second phase onwards.

In addition, we would welcome other detailed proposals on alternative options for changes to the financial mechanisms of the CRC scheme which would:

- Simplify the allowance sales in the introductory phase

- Simplify the market design in the second and subsequent phases

Should you wish to propose an alternative option to changing the CRC in a way which meets the above objectives, you should provide evidence to show that your suggested approach:

- will not result in significant loss of carbon savings through the uptake of cost effective energy efficiency measures from the scheme

- will be fair and applicable to all sectors subject to the CRC scheme

- will reduce admin burdens on participants but without placing significantly increased burdens on the administrators.

Contributing to the dialogue

[11] http://www.theccc.org.uk/reports/carbon-reduction-commitment

If you would like to submit written views on simplifying this aspect of the CRC scheme, or if you would like to make wider comments and suggestions about the scheme as a whole, please send your comments to crc@decc.gsi.gov.uk or CRC Team, National Carbon Markets, Department of Energy and Climate Change, 3 Whitehall Place, London, SW1A 2AW) **by 11th March 2011**.