Department for Business Innovation & Skills

COMPENSATION FOR THE INDIRECT COSTS OF THE CARBON PRICE FLOOR AND EU EMISSIONS TRADING SCHEME (ETS)

Call for Evidence

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DEPARTMENT OF ENERGY & CLIMATE CHANGE

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Compensation for the indirect costs of the Carbon Price Floor and EU Emissions Trading Scheme (ETS) – Call for Evidence

Introduction

EU ETS and the Carbon Price Floor

1. Between now and 2020, the UK requires up to £200 billion of investment to secure a low-carbon energy future – reducing our greenhouse gas emissions whilst ensuring access to secure supplies of energy in the future. The Government is committed to creating a more stable environment for investment in low-carbon electricity generation.

2. The EU Emissions Trading Scheme has created a Europe-wide market for carbon, meaning that businesses and investors are required to factor in the price of carbon when making production and investment decisions.

3. It follows that, the higher the carbon price, the more attractive investments in low carbon technologies become. As such, supporting the price for carbon in the UK electricity generation sector – through the Carbon Price Floor - can reduce revenue uncertainty and improve the economics for investment in low-carbon generation.

The Carbon Price Floor

In practice, the Carbon Price Floor will be achieved through a tax levied on fossil fuel used for electricity generation. In most cases, fossil fuels currently used to generate electricity are exempt from the Climate Change Levy (CCL). The Government will remove these exemptions and tax these commodities at rates that take account of the commodities' average carbon content.

Oils are not subject to CCL but fuel duty is payable at the point oils leave the refinery. Currently, the duty can be reclaimed in full by the electricity generator but, as part of the carbon price support mechanism, the Government will reduce the amount of fuel duty that can be reclaimed, in effect creating 'oils carbon price support rates'.

Competitiveness and Energy Intensive Industries

4. The Government recognises that supporting the carbon price is likely to have a knock-on effect on the wholesale electricity price, which is likely to increase retail electricity prices in the short to medium term. It should be noted, however, the Carbon Price Floor and ETS will not affect the retail price of gas.

5. Rising electricity costs pose a key risk to the competitiveness of the most electricity-intensive businesses, particularly those which are unable to pass these costs through to consumers without affecting their international competitiveness. These industries are critical to growth of the economy and, in many cases, employ significant numbers of people in socio-economically deprived areas across the country.

6. The Government is keen to ensure that these industries remain in the UK and to support their low carbon transition, enabling them play a full part in the green economy – in many cases, it will be energy intensive industries providing the components for renewable energy generation or the materials required to lower the carbon intensity of consumer products. Furthermore, having investment in energy intensive industries occur overseas where it may otherwise have taken place in the UK is damaging to the UK economy and - in the absence of a global agreement on reducing carbon emissions - has negative impacts on efforts to reduce global warming.

7. Therefore, the Government is proposing to take steps to reduce the impact of government policy on the cost of electricity for these businesses, where this poses a significant risk to their international competiveness.

8. The Government announced the following in the Autumn Statement –

The Government is committed to ensuring that manufacturing is able to remain competitive during the shift to a low carbon economy and to minimising the 'carbon leakage' which might happen if investment relocated abroad. The Government intends to implement measures to reduce the impact of policy on the costs of electricity for the most electricity-intensive industries, beginning in 2013 and worth around £250 million over the Spending Review period. As part of this the Government will:

- *compensate key electricity-intensive businesses to help offset the indirect cost of the carbon price floor and the EU Emissions Trading System, subject to state aid guidelines; and*
- *increase the level of relief from the climate change levy on electricity for Climate Change Agreement participants to 90 per cent.*
- *explore options for reducing the impact of electricity costs on electricity-intensive industries as a result of electricity market reform policies where this has a significant impact on their competitiveness and subject to value for money and state aid considerations.*

9. We expect domestic consumers and industry to benefit from investment in lower carbon electricity sources over the longer term, as they tend to have lower marginal costs of generation compared with fossil fuel and, therefore, offer scope to reduce electricity prices. As such, compensation to industry will be transitional – addressing the rise in electricity costs for industry in the medium term, as these reflect the effect of transition to low carbon sources of generation.

10. As neither the Carbon Price Floor nor the ETS affect the retail price of gas, compensation is linked only to electricity.

Industry investment decisions

11. Many UK-based energy intensive industries are owned by international companies and are sometimes vertically integrated. The companies often also own energy intensive businesses outside the UK. This may mean that UK management has to compete internally over a limited pot of available capital for new or additional investments. Their ability to raise the capital to invest depends on projects being able to deliver risk adjusted rates of return above those from other investment opportunities available to the firm.

12. Businesses will often use hurdle rates of return and defined pay-back periods in making their investment decisions. For example, projects relating to different internal sites of a multi-national business will need to meet a particular ‘hurdle rate’ to enable them to successfully bid for finance.

13. Energy costs will be one factor influencing hurdle rates and investment decisions. Of course, firms will also take into account issues such as labour costs, stability of the tax regime – including corporation tax – and proximity to markets and planning. Where UK costs rise relative to other countries, and this cannot be passed on to customers, the hurdle rate of return becomes more difficult to reach for UK-based projects, particularly where the prices are determined internationally.

14. The existence of EU ETS and the Carbon Price Floor, whilst providing greater certainty for low carbon investments, create additional costs compared with business sites in EU and third countries. If the EU (ETS) carbon price is high, this may raise competitiveness issues for electricity intensive industries across the EU compared with their counterparts in other parts of the world. In instances where the EU carbon price is lower than the UK’s Carbon Price Floor, UK-based industries will face higher costs than their EU and third country competitors.

State aid law

15. The European Commission has sole competence over deciding whether a Member State can provide ‘State Aid’.

Compensation for indirect costs of ETS - The EU ETS Directive provides for temporary measures to compensate for increases in electricity prices resulting from inclusion of the cost of emissions due to the ETS. The Commission will be issuing guidance to Member States around the end of March 2012 which will provide the broad framework for ETS compensation. For ETS compensation, member States will need to set out the detail of how compensation will be applied in their country, including whether additional criteria might be applied to ensure compensation is targeted where it is most needed. Member States must obtain Commission approval in advance of granting any aid.

Compensation for indirect costs of CPF - The UK would like to put forward a robust case to the European Commission, making the case for state aid on Carbon Price Floor. We believe that given the impact of the CPF is analogous to the impact of the EU ETS that there is a strong case to apply to the Commission for permission to provide aid for the carbon price floor where it is necessary and additional. In order for the UK to ensure value for money and 'additionality' for any aid provided for carbon costs we will need to consider and demonstrate that any compensation addresses the following issues:

- Necessity - why is aid needed? What common EU objective is being addressed?
- What is the incentive effect - will aid genuinely change the behaviour of businesses? The UK will have to satisfy the Commission that there is a real risk of carbon leakage without the aid.
- Proportionality - aid generally must be limited to the minimum amount necessary, and aid of this sort is usually only considered proportional where there is a continued incentive to improve environmental performance. This may be done by ensuring that the beneficiary still pays a proportion of the tax or by including some environmental conditionality.
- Distortions to competition and trade – the UK will need to analyse the impacts on all potentially affected markets and demonstrate that the competitiveness of companies in other markets or other Member States is not unduly affected.

16. This call for evidence should enable us to update the information we have on the electricity intensity of different sectors, and how these policies impact on their competitiveness.

Further information on the operation of the State Aid regime may be found at

http://ec.europa.eu/competition/state_aid/overview/index_en.html

Commission guidance on the principles behind the aid assessment:
http://ec.europa.eu/competition/state_aid/reform/economic_assessment_en.pdf

Commission consultation on its proposals for EU ETS compensation (now closed):

http://ec.europa.eu/competition/consultations/2012_emissions_trading/index_en.html

The purpose of this call for evidence

17. Following the Autumn Statement, it will be for the Department for Business, Innovation and Skills (BIS) to manage how the £250m - which has been allocated for the rest of the spending review period - is spent. With a finite amount of money to distribute, we will need to develop appropriate criteria to identify who should be eligible and what levels of compensation would alleviate costs enough to help those business sites which are most at risk.

18. The purpose of this call for evidence is to improve the evidence we have regarding electricity usage in industry across the UK, helping to inform our decisions about how the money will be managed. In particular, we are seeking information and data concerning the electricity and trade intensity of companies, the effects on investment decisions, and views on how criteria might be applied.

19. There are limitations around the data that Government currently holds on the electricity intensity of business sectors. Firstly, it is dated (covering 2004-2007) and we are aware that industry will have evolved since then – in terms of its structure and its energy efficiency. Secondly it is at a high level of aggregation (four digit SIC code) meaning that important information may be lost in the aggregation. For example, there may be particular companies in a sector which are much more electricity intensive than the sector average. Conversely, we know there are industrial sites which are not very electricity-intensive within sectors with an overall high electricity-intensity. So, overall, we need to have a better understanding of which companies and which sites may have their competitiveness compromised.

20. This means gathering more evidence about how increases in electricity costs due to carbon pricing might affect companies' investment and production decisions. The more information we have in this area, the more reliable the evidence and the more effectively we can target any compensation to those most at risk.

21. This call for evidence does not set out detail around how the scheme will be administered, such as the frequency and nature of data returns and regularity of compensation payment. More detail concerning the eligibility criteria and administration of compensation for ETS and CPF will be set out in a consultation later in the year.

Confidentiality & Data Protection

22. We are aware that for commercial reasons you may want the information you provide to be treated as confidential.

23. However, information provided in response to this Call for Evidence, including personal information, may be subject to publication or release to other parties or to disclosure in accordance with our legal obligations under the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

24. If you want information, including personal data, that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence.

25. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. If you have asked us to treat the information as confidential and provided an explanation as to why you regard it as such then we will consult with you before taking any decision to disclose. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Government.

26. This call for evidence is for a period of eight weeks from 12 March to 4 May. Evidence can be submitted by email or by post. The details of the questions and how to respond are in a separate document: the call for evidence response form.

What happens next?

27. Following the closure of the call for evidence on the 4th May we will assess the results against the data that we already hold and use these to develop proposals, which will include consideration of eligibility criteria for compensation and how a compensation scheme might operate. We will issue a formal consultation on these proposals in the autumn.

28. Following consideration of the results of the consultation we expect the publication of final guidance on compensation will be in March 2013.

29. The compensatory measures will be subject to state aid considerations and we will be engaging after the closure of the call for evidence with the European Commission on our outline proposals. This will be followed by pre-notification and formal notification process which we expect to begin in Summer 2012.

Improving the information we have on the electricity intensity of businesses in the UK.

Data on electricity intensity

30. Based on data covering 2004-2007, we understand the following about the electricity intensity of energy intensive industrial sectors.

	Sector	***Electricity costs as a % GVA (average 2004-7)***
1	Aluminium	55.5
2	Electric arc steel*	36.9
3	Fertilisers and nitrogen compounds	35.9
4	Paper and paperboard	35.4
5	Throwing and preparation of silk	32.4
6	Industrial gases	31.1
7	Inorganic basic chemicals	29.8
8	Non-wovens and articles made from non-wovens	21.8
9	Household and sanitary goods	19.5
10	Preparation and spinning of worsted-type fibres	18.1
11	Clays and kaolin	16.9
12	Veneer sheets, plywood, fibreboard etc	16.7
13	Cement	15.6
14	Hollow glass	15.3
15	Iron and steel**	15.1
16	Copper	14.5
17	Synthetic rubber in primary forms	14.5

	Sector	Electricity costs as a % GVA (average 2004-7)
18	Refineries	14.5
19	Man-made fibres	14.3
20	Sewing threads	13.1

* 2005-7 data

** Total iron & steel sector. Non-EAF production has an electro-intensity of 12.40%, which results in a ranking of 23rd by this metric.

31. This data is derived from Energy Consumption UK from which data is not available for after 2007. The information was collected at aggregate sector 'SIC Code' level, which potentially masks the electricity intensity of sub-sectors and specific industrial sites which may be more or less than the sector average.

32. For Government to effectively target compensation, it will be helpful to understand electricity intensity in more detail – electricity costs as a proportion of overall costs at installation level. For this reason, it is important for companies to provide this information, where at all possible.

33. It is also important that, on the question of electricity intensity, the responses we receive are as uniform as possible, to ensure that appropriate comparisons are made. Please complete and return the following 'Electricity Intensity' pro-forma.

34. In the absence of significant additional evidence from industry, Government will use the data it has from Energy Consumption UK. Whilst the data has its limitations (as explained above) it has levels of quality and assurance associated with 'National Statistics', and has been based on consistent data gathering and analysis techniques that allow us to compare sectors.

Please complete the pro-forma in the Call for Evidence Response Form to provide us with your electricity intensity – at installation level.

We are aware that certain companies have provided Government with some of this information previously. However, due to differing feedback and industry concerns about how electricity intensity criteria may be best calculated, we are seeking to understand what may be most appropriate approach - i.e. costs as a proportion of turnover, GVA, or operating profit? The purpose of the information requested in Annex A is to ensure that any criteria selected is as fair as possible.

Alternatively, if you are unable to provide us with this level of information, tell us what the electricity intensity of your business site is - i.e. as electricity costs as a proportion of GVA, Turnover and operating profit. Please explain your method for calculating GVA.

Information on the potential effect on investment in UK-based businesses.

Q. How much of a factor are future electricity prices when considering investment decisions? Please explain how electricity prices are factored in. Where possible, please provide specific examples which illustrate how projections of the future electricity price have impacted on specific investment decisions.

In providing information, please use the pro-forma, in the Call For Evidence Response Form where possible.

The purpose of this information is to help Government better understand the basis on which investment choices are made and any distortions which may exist between UK compared with Europe or the rest of the world. Ideally, we would like examples which enable comparisons to be made between investments in UK sites and investments in sites elsewhere.

Questions regarding criteria and how it might be applied

35. At the end of March 2012, we expect the commission to publish guidance which will set out the framework for compensation for the indirect costs of EU ETS.

36. However, the UK may wish to apply additional criteria to ensure compensation is appropriately targeted to those business sites most at risk. The Government will also need to decide how best to target compensation for the indirect costs of the Carbon Price Floor should the Commission give state aid approval for such a measure.

37. A modest amount of compensation spread amongst many businesses will run the risk that overall investment behaviour remains unaffected and that the risk of 'carbon leakage' is left unaddressed. Conversely, we will not want to miss businesses whose competitiveness is at risk. Therefore, we need to determine:

- what criteria to use to assess eligibility for compensation - this must be as evidence-based as possible.
- What criteria would allow us to assess the appropriate level of compensation in each case.

38. The Government considers that some measure of electricity-intensity[1] and trade-intensity[2] may be appropriate as eligibility criteria for CPF compensation and, potentially, as an additional criteria for ETS compensation. However, we are keen to seek the views of those in different sectors of the economy.

39. We are also interested in views about the level at which compensation should be targeted. For example, compensation could be focused at:

- **sector or 'sub-sector' level** – this may reduce overall complexity and administration overheads for Government and business. However, by targeting compensation at sector level resources may need to be spread more thinly to the detriment of specific sites which are more electricity-intensive than the sector average. Taking a sub-sector approach may help to better target funding to those that need it most compared to the sector level;
- **company level** – having compensation at company level may risk similar issues to that at sector level. Furthermore, some companies may operate in different sectors and markets.
- **specific sites or industrial processes** – this may the most effective in terms of targeting compensation where it is most needed. However, consideration would need to be given to administrative costs.

Please answer the following questions using the Call For Evidence Response Form –

[1] Electricity-intensity – e.g. electricity costs as a proportion of overall costs or GVA
[2] Trade-intensity – extent to which the market in which a company operates is internationally competitive – i.e. volume of import and export.

Q1. Do you agree that a combination of an electricity-intensity criteria and trade intensity criteria is the best way to assess who is at risk of indirect carbon leakage? If not, please explain what alternative criteria you would support.

Q2. At what level should eligibility criteria be applied – at sector level, sub sector level company level, site level, or at 'industrial process' level ? Please support your answer with evidence.

Q3. What level of compensation would be appropriate to offset the impact of policies on international competitiveness. Should there be a sliding scale of compensation and/or a de minimus threshold to enable compensation to be targeted at those with the greatest exposure? If yes, how should this be determined? Please support your answer with evidence.

Q4. At what level of electricity intensity and trade intensity (or your preferred criteria) would you consider a site or installation's current or future operations to be significantly impacted by rising electricity prices. Please explain your answer with evidence.

Q5. What data collection process could Government put in place to make an assessment of those installations most at risk of indirect carbon leakage that would provide robust data without imposing disproportionate burdens on business?

Q6. Please describe the structure of the industry within which you compete (in the UK and internationally), and any factors that impact on your ability to pass through the impact of Government policies on electricity costs while maintaining your market share.

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