Department for Business Innovation & Skills

Department of Energy & Climate Change

COMPENSATION FOR THE INDIRECT COSTS OF EU EMISSIONS TRADING SYSTEM IN 2013/14 AND 2014/15

Government response to the public consultation

MAY 2013

Contents

Compensation for the Indirect Costs of EU Emissions Trading System in 2013/14 and 2014/15

1. Introduction

1. In the Autumn Statement on the 29 November 2011 the Chancellor announced that 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. Up to £250 million has been earmarked for this over the Spending Review period.

2. As part of this commitment the government has decided to compensate those electricity-intensive industries most at risk of carbon leakage to help offset the indirect cost of the Carbon Price Floor and the EU Emissions Trading System, subject to state aid guidelines.

3. A consultation on the proposal for compensating electricity intensive industries for the indirect costs of EU ETS and Carbon Price Support was held between 5th October and 21st December 2012. The purpose of the consultation was to seek views on the proposed eligibility and design of the scheme.

4. The consultation was available on the BIS website, and was emailed directly to a large number of contacts who have previously expressed an interest in this issue.

5. 58 responses were received. Of these, 34 were from companies, 20 were from trade associations or industry representative groups and 4 were received from NGOs. The full list of respondents is attached at Annex A.

6. Government held a stakeholder workshop on the 23rd October 2012 to discuss the proposals as well as attending 14 other events and meetings. In addition, the Parliamentary Environmental Audit Committee (EAC) undertook an inquiry into the Energy Intensive Industries Compensation scheme. BIS Ministers attended an EAC hearing alongside BIS and DECC officials on the 4th December 2012. The EAC presented their findings in their report which was published on the 4th January. The Government published a command paper as its response to the Committee on the 20th May. This can be found here: www.official-documents.gov.uk/document/cm86/8618/8618.asp

7. This document sets out the issues raised by stakeholders through the consultation and the Government's response. Alongside this document, the Government has published guidance on how businesses can claim indirect EU ETS compensation. The guidance has taken account of, and been influenced by the consultation. Further guidance will be issued later in the year, providing details of the indirect CPS compensation scheme, where we currently await clearance from the European Commission.

2. Analysis

8. The consultation included 5 questions.

1.	Do you agree with the approach of using an emissions factor which is based on gas-generated power being the marginal producer of electricity? If not, please give your reasons why with supporting evidence?
2.	Do you agree with the proposed approach to eligibility for EU ETS compensation? If not, please give your reasons why?
3.	Are there companies which are not on the eligibility list which would meet this test? Please provide evidence?
4.	Do you agree with the proposed approach to eligibility for CPF compensation? If not, please give your reasons why?
5.	Do you agree with the proposal to pay compensation in arrears and on a quarterly basis? If not, please give your reasons why?

2.1 Question 1: Do you agree with the approach of using an emissions factor which is based on gas-generated power being the marginal producer of electricity? If not, please give your reasons why with supporting evidence?

9. There were 40 responses to this question. 9 respondents agreed with the suggested approach and 31 disagreed.

10. A number of responses provided supporting evidence of which some had technical elements specifically related to their particular industry sectors.

11. There were two main reasons outlined for disagreeing with the proposal:

- The inappropriateness of using an emissions factor of 0.411tCO_2/MWh (based on average-efficiency Combined Cycle Gas Turbine) as there are occasions when the marginal plant is made up of other technologies such as coal which has a much higher carbon intensity.

- That the UK Government should seek to maximise the level of compensation available to eligible energy intensive industries by using the maximum allowed by the European Commission (0.58tCO_2/MWh).

12. There was also a comment that there are a number of existing different values used by Government relating to the carbon intensity of the grid. These relate to the values used for the reporting requirements of different policies and the values for appraising policies. There was some concern that to introduce yet another value may only further complicate matters, with no apparent benefit.

13. One respondent considered that if a marginal factor is adopted there should be consideration of how the chosen factor is assessed for validity (perhaps quarterly) and how ex-post reconciliation should operate for periods where the marginal factor is significantly different from the level set ex-ante.

Government's response

14. The Government's approach is to compensate industry as closely as possible for the relevant costs they bear and therefore to use an emissions factor that reflects that. The Government has considered all the responses and recognises that the outlook for fossil fuel price relativities and other factors affecting the economics of operating plant are inherently uncertain.

15. The Government believes using a marginal emissions factor would most closely reflect the costs incurred. However, as the European Commission recognised, there are practical difficulties in establishing the appropriate marginal emissions factor given the variation in the technologies that set prices over different points in time. The Commission guidelines on aid for indirect emission costs therefore allow for the use of an emissions factor based on the average emissions of fossil fuel in the generating mix. This reflects the significance of fossil fuel plants in setting the final price in the wholesale market.

16. In the absence of being able to identify exactly the marginal emissions factor of the specific generators setting the price over the compensation period, the Government accepts that in line with the Commission's guidance, the average emissions intensity of fossil fuel generation should serve as a reasonable proxy metric for the purposes of the compensation package. The Government is also seeking to minimise the administrative burden on industry and to provide as much clarity and certainty to industry about the levels of compensation companies will receive. Given this the Government will use the emissions factor as set out by the European Commission (0.58tCO2/MWh)

2.2 Question 2: Do you agree with the proposed approach to Eligibility for ETS compensation? If not, please give your reasons why

17. There were a total of 42 responses to this question. 20 respondents agreed with the proposed approach and 22 disagreed. A number of specific issues were raised.

Eligible sectors / products

18. Several responses stated that there are a number of trade-exposed, electro-intensive processes that are vulnerable to carbon leakage but which fall outside the scope outlined in the Commission's guidelines. This included consideration of the costs of industrial gas production for companies within eligible sectors both to determine their eligibility against the threshold and for the compensation calculation.

19. One respondent sought a narrowing of eligibility to focus on the most energy intensive processes within eligible sectors and suggested that a sliding scale of compensation should be introduced to further target the resources.

Government response

20. Government recognises the concerns raised about sectors not covered by the European Commission's guidelines. However the UK Government is bound to follow these guidelines and cannot include additional sectors or processes. The guidelines also set out maximum levels of compensation which the UK Government must adhere to. The Government is targeting its resource by using an additional '5% filter test' which is considered below, and which will compensate all those eligible companies that pass the test, as set out in the Commission's Guidelines.

5% filter test

21. Many responses were received that related to the proposed additional filter. To receive compensation a business in an eligible sector has to provide evidence to demonstrate that their indirect carbon cost (the combined cost of EU ETS and CPS) in 2020 will amount to 5% of their GVA*.*

22. A number of respondents disagreed with this approach. There were specific concerns that the ability to pass this test may be heavily influenced by a company's structure. There were also concerns about the extent to which data relating to non energy intensive activity may be captured by this approach.

23. Concern was also raised that by compensating companies that pass the 5% test and not others that manufacture the same product (because they do not pass the test) the policy may introduce market distortions. To address this some suggested that the filter test should be at the plant or installation level.

24. Some respondents asked that government allows for any changes in baseline activity and / or company structure during the 2005-11 reference period when assessing the 5% test gross value added (GVA) impact test.

Government response

25. Government is seeking to target this compensation on the most energy intensive industrial processes. While we recognise the concerns raised by industry about the company level test, there are a number of problems with moving away from a 'business' or 'company' level approach particularly relating to the calculation of GVA at a plant / installation level and how this can be validated.

26. Government is keen to minimise the administrative burden on business for this compensation and has therefore decided to retain the test at the overall 'business-level' but with an additional provision to account for issues caused by company structure or for companies that manufacture the same product. This is set out in the detailed guidance. Government also accepts the concerns about changes in baseline activity or structure during the reference period and measures to address all these concerns are detailed in the Government's guidance.

Trade intensity

27. One respondent considered that as well as providing evidence that a company passes the 5% test they should also provide evidence of high trade intensity outside Europe.

28. A few respondents disagreed with the use of trade intensity rather than trade vulnerability or exposure as a measure. This is because it is a historic view rather than a reflection of what will happen going forward, where increasing international competition from within the EU and beyond will have an impact.

Government Response

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

Carbon costs

30. The use of 2020 carbon costs were also questioned given the scheme is planned for 2013-15. It was suggested that the expected carbon costs over the life of the scheme should be used.

Government response

31. Government recognises that there is a lead in time for industry to make investment. To ensure that the scheme captures those industries that will currently be considering investments up to 2020, Government considers that using a 2020 carbon cost is the most appropriate measure.

Autogeneration

32. The issue of how to address autogeneration was raised. One respondent proposed that auto-generators will not face the indirect costs of EU ETS and should therefore not be compensated for this.

Government response

33. The Government considers that compensation should be made payable for electricity where the generation of that electricity is subject to EU ETS and CPS costs, and where the electricity is used for the manufacture of eligible electricity intensive product. Self-generated electricity generated from fossil fuels will often face the same policy costs (EU ETS and CPS costs) as electricity generated by electricity suppliers and exported to the grid. For this reason, auto-generated electricity used in the manufacturing process will generally be eligible for compensation. The exceptions to this will be:

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

34. In its guidance, the Commission has stated that "In order to ensure equal treatment of sources of electricity and avoid possible abuses, the same CO_2 emission factor applies to all sources of electricity supply (auto generation, electricity supply contracts or grid supply)."

Indirect and direct EU ETS

35. The issue of EU allowances was also raised. In particular it was suggested that some firms have received a substantial allocation of permits in phase 2 of EU ETS, which can be carried forward. There was a request that Government should assess the costs and benefits of the whole of the EU ETS scheme (i.e. indirect and direct effects) and should not compensate firms for the indirect costs of EU ETS if they have received major benefits from another part of it. One proposal received was that no company should receive new government compensations over the spending review period until such a time as the volume of CO_2 passed through to it in its electricity-use exceeds the number of surplus free allowances it received in Phase 2.

Government response

36. The compensation package is focused on reducing the risk of carbon leakage from the indirect costs of EU ETS, i.e. from the costs that are initially faced by electricity generators and passed through to industrial consumers through their electricity bills. Industries may or may not be significant participants in EU ETS themselves.

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

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

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

40. The UK supports back-loading subject to greater reassurance being provided on the links between back-loading and structural reform of the EU ETS. The process for longer-term structural reform began with publication of the European Commission’s Carbon Market Report in November 2012. However, the next steps and timings remain unclear, and we continue to press the European Commission to provide greater certainty on these aspects.

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

Energy efficiency / environmental conditionality

42. There was a proposal that compensation should be conditional on environmental improvements. There were also some comments that compensation should be dependent on the efficiency of the installation relative to the industry benchmark. This might take the form of a minimum efficiency requirement or a sliding scale paying a decreasing level of compensation to less efficient installations.

Government response

43. Many energy intensive industries are already very energy efficient because energy is such a high element of their costs. We need to ensure that Government policies do not drive these industries abroad, to those countries which have less stringent climate change or energy efficiency policies. They need to adapt to lower carbon means of production where possible, but it is equally important that they remain competitive and that the UK remains an attractive location for them.

44. The presence of an aid intensity which is at a level of less than 100% and which reduces over time will mean that eligible companies will continue to pay a proportion of the additional passed-through costs from EU ETS and CPF. As such, there remains a further incentive for firms to continue to examine ways to become more energy efficient. For EU ETS compensation, we will also be applying efficiency benchmarks. The benchmarks have been developed by the Commission and are based on the most efficient process for manufacturing that specific product. Companies with processes below the very best level of energy efficiency will, as a result, find that their compensation is further reduced.

45. Many Energy Intensive Industries also sign up to voluntary Climate Change Agreements, which set out stretching energy efficiency targets in return for relief from the Climate Change Levy.

46. These factors will continue to drive greater energy efficiency and carbon reduction amongst those companies eligible for EU ETS and CPS compensation.

2.3 Question 3: Are there any companies which are not on the eligibility list which would meet this test? Please provide evidence?

47. A total of 19 responses were received to this question suggesting sectors/ sub sectors that would meet the test and should be included in the compensation package.

Government response

48. For EU ETS compensation Government is limited to a list of sectors and sub sectors published by the European Commission. However for carbon price floor compensation Government is currently considering the evidence submitted and will respond when guidance for the indirect CPS compensation scheme is published

Product Codes

49. A specific issue was raised about the use of SIC / NACE codes to establish eligible companies and products. There is concern that some companies may not receive compensation because they have previously reported their product using a different code even though they are creating the same product as those that are covered.

Government Response

50. While Government recognises this concern, the use of SIC or NACE codes has been set out in the European Commission's guidance and the UK Government is bound to follow this for EU ETS compensation.

51. Businesses will be able to set out in their application which 'prodcom' code they are claiming for. Whilst this may subsequently be checked against records held at Companies House, any discrepancy will be a trigger for further investigation rather than immediate disqualification.

2.4 Question 4: Do you agree with the proposed approach to eligibility for CPF compensation? If not, please give your reasons why?

52. Government is still considering the proposal for compensating industry for the indirect costs of the CPF. The Government's response to this question will therefore be published alongside final guidance for CPF compensation.

2.5 Question 5: Do you agree with proposal to pay compensation in arrears and on a quarterly basis? If not, can you give me reasons why?

53. A total of 28 responses were received on this question. 26 respondents agreed with the proposal and 2 respondents disagreed.

54. There was widespread agreement to paying quarterly in arrears, although there were 7 responses which considered that monthly might be more appropriate to minimise the impact on companies' cash flow. Of those that disagreed, one respondent considered that payment in advance would be more appropriate for EU ETS compensation with a quarterly reconciliation and for CPS payment monthly in arrears.

Government Response

55. Government has considered the responses received and is keen to ensure that the administration of the scheme is as simple and straight forward as possible to minimise the burden on industry. Given this, and that of the majority view of respondents, Government has decided to proceed with payments quarterly in arrears.

2.6 Additional Comments

56. There were a number of additional comments that were received relating to energy intensive industries and the compensation scheme.

Budget

57. There was concern that the carbon costs would be felt by companies beyond the life of the compensation scheme. There was also a concern raised that the budget allocated for the scheme may be insufficient. Budgets are currently set at £110m and £100m for EU ETS and CPF respectively for the current spending review period. A further issue was raised about the flexibility between these budgets and whether they would allow business to properly address the relative burdens of these two policies at the time the compensation is applied.

Government Response

58. Government recognises the concerns about the ongoing indirect costs of EU ETS and CPF. However all funding decisions beyond the life of the scheme are for future Government spending discussions and will be considered at that time. Government considers that the budget allocated for compensation will be sufficient to address the indirect costs of EU ETS and CPS for those industries most at competitive risk over the life of the current Spending Review. Government will manage the budgets flexibly to address any variation in the relative costs of both EU ETS and CPF.

Levels of compensation

59. There was a suggestion that the proposed thresholds used to reduce aid when output is lowered should be narrowed (e.g. to 10% production bands).

Government Response

60. Government seeks to minimise the administrative burden for businesses in delivering the scheme and for simplicity and clarity intends to use the guidance as set out by the Commission in compensating industry for reduced production.

Other issues

61. There were a number of issues raised including calls for:

- Firm measures to address renewable subsidies.
- Support for developing UK supply chains for growth in the renewable sector.
- A Green Manufacturing Strategy.
- A 2030 decarbonisation target in the Energy Bill.
- Allowing the Green Investment Bank to borrow and lend as soon as possible.
- Stronger strategy and policy for both industrial CCS and CHP.
- Revamp of available Enhanced Capital Allowances.
- Help for low-carbon power contracts, such as the Remote Net Metering proposal.
- Reinstatement of the Carbon Trust's Industrial Energy Efficiency Accelerator Programme.
- Extension to the principle laid out in this consultation (that those hardest hit by carbon taxes should be helped to meet these extra costs) to domestic customers as well as industry.

62. Government notes these requests but maintains that these are outside the scope of the compensation package considered here.

3. Annex A

Respondents to the consultation

1.	ABB Ltd
2.	Aluminium Federation Ltd
3.	Association for the Conservation of Energy
4.	BASF
5.	BOC
6.	Boortmalt
7.	British Ceramic Tile
8.	British Ceramics Confederation
9.	British Compressed Gases Association
10.	British Glass Manufacturers Confederation
11.	British Lime Association
12.	British Polythene Ltd
13.	British Tyre Manufacturers Association
14.	CELSA Manufacturing UK Ltd
15.	CEMEX UK
16.	Chemical Industries Association
17.	Confederation of Paper Industries
18.	DSM Nutritional Products UK Ltd
19.	EDF Energy
20.	EEF / UK Steel
21.	Energy Intensive Users Group
22.	Friends of the Earth

23.	Grantham Research Institute
24	Growhow UK Ltd
25.	Imerys Minerals Ltd
26.	Ineos Chemicals Grangemouth Ltd
27.	Ineos Chlorvinyls Ltd
28.	Ineos Enterprises
29.	Innovia Films
30.	Johnson Tiles
31.	Lafarge Cement UK
32.	Lucite International Group Ltd
33.	Mainetti UK Ltd
34.	The Maltsters' Association of Great Britain
35.	Mersen Scotland Holytown Ltd
36.	Mineral Products Association
37.	Minesco
38.	North East Process Industry Cluster
39.	Novelis Uk Ltd
40.	Petroineos Manufacturing Scotland Ltd
41.	RWE npower
42.	Sabic UK Petrochemicals Ltd
43.	Saffil Ltd
44.	Sandbag Climate Campaign
45..	Sandvik Materials Technology Ltd
46.	Scotch Whisky Association

47.	Scottish Power
48.	SGL Carbon Fibers Ltd
49.	Sheffield Forgemasters
50.	Sibelco UK
51.	Tata Chemicals Europe
52.	Tata Steel Europe
53.	Tees Valley Unlimited
54.	UCM - Magnesia Ltd
55.	The Utilities Exchange Ltd
56.	UK Petroleum Industry Association
57.	Unifrax Ltd
58.	Wood Panels Industry Federation

This publication available from www.gov.uk/bis

Any enquiries regarding this publication should be sent to:

Department for Business, Innovation and Skills
1 Victoria Street
London SW1H 0ET
Tel: 020 7215 5000

If you require this publication in an alternative format, email enquiries@bis.gsi.gov.uk, or call 020 7215 5000.

BIS/13/859