Government Response to the House of Commons Environmental Audit Committee 4th Report of Session 2009-10: The role of carbon markets in preventing dangerous climate change

Presented to Parliament
by the Secretary of State for Energy and Climate Change
by Command of Her Majesty

August 2010

**Laid before the Scottish Parliament by the Scottish Ministers on (date)
And presented to the Northern Ireland Assembly by the
Department of the Environment on (date)**

Cm 7933

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Government response to the House of Commons Environmental Audit Committee report on The role of carbon markets in preventing dangerous climate change

Introduction

The Government welcomes the report of the Environmental Audit Committee (EAC) on the role of carbon markets in preventing dangerous climate change. The Government especially welcomes the EAC's overall endorsement of the importance of global carbon markets in tackling dangerous climate change.

The 2009 EU Emissions Trading System Directive means that the System will reduce emissions by 500 $MtCO_2e$ per year across the EU by 2020 compared with 2005 levels. These are significant reductions, not matched anywhere else in the world. However, like the EAC, we want the EU to take on a deeper 30% emissions reduction target. The EU ETS is central to how the EU can achieve a 30% target and can help bring on the low carbon investments we need especially in the UK power sector.

We have taken careful note of the recommendations made by the EAC. We will consider the recommendations in greater depth and will discuss further with stakeholders on possible options for enhancing the operation of the EU ETS.

Investment in low carbon technology remains a priority for the Government. Whilst the EU ETS is delivering emissions reductions across the UK and Europe the carbon price has not been sufficient in giving stable, long-term signals to generators and has therefore not been incentivising the required levels of new low carbon investment in the UK. As announced in the Budget, the Government will publish proposals in the autumn to reform the climate change levy to provide more certainty and support to the carbon price. Subject to consultation, the Government will bring forward relevant legislation in Finance Bill 2011.

Like the EAC, the Government supports a vision of a global carbon market - future linking of emissions trading systems may provide emissions reductions at lower cost and accelerate the scale of innovation.

The Government's responses to the specific conclusions and recommendations of the Environmental Audit Committee's report are set out as follows:

Conclusions and Recommendations

The impact of the EU Emissions Trading System

1. **We recommend that, when describing estimates of reductions in emissions, the Government always makes it clear whether they are absolute reductions in emissions or notional reductions against a business-as-usual scenario. (Paragraph 18)**

   We agree with the recommendation. In general, we will use absolute reductions in emissions and this is much easier to do now that we have several years of verified data. However, notional reductions against business-as-usual can also be a useful metric, and are particularly important in estimating carbon prices for policy appraisal.

2. **Taken together, the recession and the over-allocation of allowances could greatly reduce the effectiveness of Phase II of the EU ETS. (Paragraph 26)**

   The current Phase II cap across the EU is largely based on business-as-usual emission projections, especially for the industrial sectors. Reduced manufacturing output in 2008-09 has led to allocations in excess of emissions in many industrial sectors. However, the primary objective of the EU ETS is to limit emissions. The level of emission reductions is determined by the cap and so this objective will still be met regardless of falls in output. It should also be noted that the tighter cap that will come into force in Phase III is having the effect of allowing the market to factor-in future prices for carbon.

3. **We believe that it is imperative that there are mechanisms for reducing the EU ETS cap, whether in response to recession-driven reductions in demand for allowances, the success of complementary policies in cutting emissions, or the efforts of the public in reducing their carbon footprint. We recommend the Government press the EU to consider periodically whether to tighten the EU ETS cap. We further recommend that the Government investigate what financial incentives can be given to companies within the EU ETS to encourage them to cancel allowances they own voluntarily. (Paragraph 33)**

   Under the revised EU ETS from 2013 there will be a much tighter cap on emissions and this will decrease by a linear factor of 1.74% per year to 2020. We will push the EU to demonstrate leadership in tackling international climate change, including by supporting an increase in the EU emission reduction target to 30% by 2020. As and when the EU moves to the 30% target the EU ETS emissions cap will be further reduced.

   The cap has the benefit of providing a guaranteed level of emissions reductions for the relevant period. Setting the cap for a Phase allows companies to plan investments with a degree of certainty.

The only financial incentive which is likely to encourage companies to cancel allowances would be to compensate them fully for the value of any surplus allowances they held.

4. **We recommend the Government consult on other mechanisms to remove EU ETS allowances from the market, especially where the threat of being forced to buy and retire allowances could drive other environmentally beneficial actions. (Paragraph 34)**

While the Government is not opposed to initiatives which may remove emissions allowances from circulation, doing so is only likely to contribute at the margin to emissions reductions. The key driver for reductions is the overall level of the cap. The cap will be tighter for Phase III of the EU ETS and we are keen for this cap to be further tightened if the EU moves to a 30% emissions reduction target.

5. **We recommend that the Government commits the UK to cancelling any surplus allowances in its New Entrants Reserve at the end of Phase II, and presses other member states to do the same. (Paragraph 35)**

The Phase II UK National Allocation Plan, which was approved by the European Commission, sets out the legal rules which commits the Government to auction or sell any surplus allowances remaining in the New Entrant Reserve (NER) at the end of Phase II, and any allowances from closures. An upper limit is set at 3% of the total quantity of UK allowances for the auction or sale of surplus allowances from the NER and closures. It remains uncertain whether all Phase II new entrant demand will be met. Currently the main NER, the largest component part of the reserve which provides allowances for general new entrant usage, is oversubscribed and has been since the start of Phase II. The Government is addressing this by reviewing the transfer of excess allowances from other parts of the NER, namely the 'Contingency Fund' and the 'Good Quality Combined Heat and Power' ring-fence.

6. **The more that offset credits are used, the more EU installations will be funding emission reductions in other countries, rather than cutting their own. Therefore, the EU needs a much tougher 2020 cap. (Paragraph 38)**

Allowing access to the international carbon market through the use of offsets is a valuable way to include developing countries in the emergence of this new market and provides the first steps towards greater involvement. However, we accept that access to cheap offset credits affects the incentive for EU companies to make domestic investments.

There is a balance to be struck between access to cheaper abatement options overseas, which will deliver carbon finance and help developing countries towards their own low-carbon growth, and the need to provide a strong incentive for the EU to invest in domestic abatement. The reduction in the level of offset credits allowed across Phases II & III, agreed as part of the EU Climate and Energy Package, is a great improvement over the previously higher levels of access. Access to international carbon credits is now limited in the ETS to ensure that at least half of the required emission

reductions take place within the EU over 2008-2020, whilst also providing finance to developing countries to invest in low carbon projects.

In the context of international negotiations around climate change, flows of climate finance are key to securing developing country buy-in to the climate change agenda. Although the architecture of global finance for climate change mitigation is still being worked out, carbon market credits are likely to have an important role to play.

7. **We recommend that the Government press for a reform to CDM rules, in particular to exclude the construction of fossil fuel infrastructure, and more widely to embed sustainable development at the heart of project eligibility criteria. (Paragraph 44)**

The Clean Development Mechanism (CDM) was designed to promote emission reduction projects in a technology-neutral manner. Although it is true that the CDM may be used to support emission improvements in fossil fuel plants, it is also important to note that the vast majority of new plants supported by the CDM are gas-fired plants in countries where the most common fuel usage was coal (which is much dirtier than gas).

Improving the quality of assessment of the CDM is a way of ensuring that the robustness of offset credits and reform will continue to be a UK priority in international negotiations. This is one of the areas where progress was made in Copenhagen, with a decision to move towards a performance standard approach to the generation of CDM credits. This will not only help speed up the CDM project approval process but also improve the environmental quality of credits.

Our focus over the coming months will be to turn that progress into operational improvements. We also support the agreement and development of large scale emission reductions through a new mechanism based on ambitious emissions reference levels, which could include host country contribution to global emission reductions.

More recently, NGOs have submitted evidence of possible gaming on HFC-23 credits to the CDM Executive Board. In the light of these recent concerns, we wrote to the CDM Executive Board calling on them to investigate the evidence as a matter of priority and take action if necessary.

8. **Because of the unique nature of the revenues raised by auctioning allowances, further consideration should be given to hypothecating the revenues for use on projects directly related to climate change. We urge the Government to consider on a cross-departmental basis how this might be done. (Paragraph 47)**

Government's spending priorities are not, in general, determined by the way in which the money is raised. Hypothecating revenues to particular-spending

programmes imparts inflexibility in spending decisions and can lead to a misallocation of resources, with reduced value for money for taxpayers..

In December 2008, EU Member States made non-legally binding commitments to spend at least half of the revenues from auctioning to tackle climate change both in the EU and in developing countries. This will include reducing emissions, adapting to climate change and reducing deforestation. This commitment has been incorporated into the revised EU ETS directive at Article 10 (3) which sets out the type of activities for which the auction revenues should be used .

The Government already spends substantial amounts of money on climate adaptation and mitigation measures, both at home and abroad, and in reducing the impact of rises in fuel costs on vulnerable consumers.

9. **The EU ought to commit itself to make more significant cuts in its emissions by 2020, commensurate with the IPCC's recommendations of 25–40% for developed economies (paragraph 15), with any purchases of offset credits coming on top of that. In any future negotiations on Phase III, we recommend that the Government presses both for a significant tightening of the cap, and for as high a proportion of auctioning as possible. (Paragraph 50)**

In January the EU made a submission to the UNFCCC on its emission reduction targets for 2020. As part of a global and comprehensive agreement for the period beyond 2012, the EU has reiterated its conditional offer to move to a 30% reduction by 2020 compared to 1990 levels, provided that other developed countries commit themselves to comparable emission reductions and that developing countries contribute adequately according to their responsibilities and respective capabilities.
The UK will continue to push for countries to commit to bold cuts in emissions this year, so that we can build on the progress in the Copenhagen Accord. The offer to move to 30% demonstrates the EU's commitment to maintaining a strong signal to the world on the urgency to act on climate change, and is within the IPCC's range of 25-40% for developed countries. Within the EU, the UK continues to be at the forefront in pushing other Member States to deliver the maximum possible level of ambition.

The UK is keen to demonstrate that in delivering a higher target the EU ETS delivers its share of the reductions. This should involve a significantly reduced EU ETS cap. The European Commission published a Communication on 26th May which suggested that the EU ETS should take on the majority of effort in moving to a 30% EU target. We are undertaking further analysis on the split of effort between ETS and non-ETS sectors, and how this impacts on different parts of the UK economy.

Regarding the use of offset credits, there is a balance to be struck between access to cheaper abatement options overseas, which will deliver carbon finance and help developing countries towards their own low-carbon growth,

and the need to provide a strong incentive for the EU to invest in domestic abatement.

The Government is committed to improve the efficient functioning of the EU ETS. The Coalition's programme includes the commitment to persuade the EU to move towards full auctioning of permits under the EU ETS. A significant increase in auctioning levels will ensure that the cost of carbon is better integrated into business decisions and will reduce the potential for windfall profits from free allocation.

We recognise that for a small number of sectors the costs of implementing the EU ETS may lead to a risk of carbon leakage – the relocation of investment or production to countries without carbon constraints, resulting in an overall increase in global emissions. The best way of addressing carbon leakage is through an international climate agreement. In the interim, the EU ETS Directive provides measures to mitigate the risk through free allocation.

Setting a price for carbon

10. **More research is needed to analyse the risk that some businesses may choose to meet their emissions reduction obligations by transferring activity to countries with looser emissions control regimes, and any impact of this on the competitiveness of British industry. The Government should ensure that such a programme of research is undertaken, to inform this issue. (Paragraph 59)**

A number of reports have been published over the last two years on sectors at risk of carbon leakage as a result of the EU ETS[1]. In order to better understand the specific impacts of an international climate agreement on sectors at risk of carbon leakage, DECC has commissioned further research into the impacts of a possible increased EU emissions reduction target and the optimum measures to address any remaining risk. Under the revised EU ETS Directive, the analysis of sectors at risk of leakage is harmonised across the EU. The research will therefore focus primarily on industry at the EU level. The project will also draw out where there are specific impacts for UK industry.

11. **The Government is right to support emissions trading, and is to be commended for promoting it internationally. The focus ought to be on how to bolster the carbon price when it is particularly low, through**

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[1] Droge et al (2009), Leakage in a world of unequal carbon prices, *Climate Strategies*
Graichen et al (2008) Impacts of the EU Emissions Trading Scheme on the Industrial Competitiveness in Germany, Oko Institut
The Economics of Climate Change Policies and Options for Global Action beyond 2012, OECD, September 2009
World Bank Policy Research Working Paper 5123: *Reconciling Climate Change and Trade Policy, 2009*
Carbon Trust (due for publication 23 February 2010), Tackling Carbon Leakage: Sector-specific solutions for a world of unequal carbon prices.

setting auction reserve prices, incentives for low-carbon electricity generation and emissions regulation. (Paragraph 76)

The Government welcomes the EAC's support for emissions trading, which we believe is a vital tool in avoiding dangerous climate change.

Whilst the EU ETS is delivering emissions reductions across the UK and Europe the carbon price has not been sufficient in giving stable, long-term signals to generators and has therefore not been incentivising the levels of new investment in low carbon electricity generation required to meet our .

Longer term, the best way to strengthen the EU carbon price would be for the EU to move to a 30% target for 2020, and the UK is at the forefront of pushing the EU to greater ambition. As part of the EU process, we are committed to reviewing and tightening the cap further as part of any move from 20% to 30%.

As announced in the Budget, the Government will publish proposals in the autumn to reform the climate change levy to provide more certainty and support to the carbon price. Subject to consultation, the Government will bring forward relevant legislation in Finance Bill 2011.

12. **We consider that, as experience elsewhere has shown, carbon taxes are not incompatible with carbon trading schemes, and their use to address an insufficiently high carbon price should be explored urgently. (Paragraph 77)**

    See paragraph 11.

13. **We recommend that the Government establish what conditions must be met for a reserve auction price to be effective as a floor price within the EU ETS (for example what proportion of allowances would need to be auctioned to set the price across the entire System, and what level the reserve price should be set at). If all the practicalities can be addressed, we recommend that the Government work with the European Commission and other member states towards implementation of this proposal in Phase III. (Paragraph 78)**

    See paragraph 11.

14. **We recommend that the Government explore with the European Commission and other member states the creation of a floor price for the EU ETS, which could increase progressively as the market carbon price rises. Any such scheme should only be rolled out after participants have received ample notice of how it will operate. (Paragraph 81)**

    See paragraph 11.

15. **We welcome the Government's recent announcements on funding offshore wind and carbon capture and storage. Such funding must be large enough, and aimed widely enough, to accelerate the provision of**

low-carbon electricity in the UK. We recommend that the Government establish carbon contracts to encourage more low-carbon electricity generation, or otherwise reform and extend the Renewables Obligation to the same effect. This should be designed to encourage the construction of innovative as well as more advanced low-carbon technologies, rather than of new fossil fuel power stations. (Paragraph 88)

The Government is undertaking the Electricity Market Reform Project to develop and deliver a new market framework that will enable the cost effective delivery of secure supplies of low carbon energy.

The current market has worked well delivering adequate capacity margins and investment in new plant and is still delivering new investment that will maintain medium term security. But the investment challenges we face as we move in to the 2020's will strain the current system. The current market arrangements is unlikely to deliver the investment in the low carbon, secure energy mix that the UK needs to develop over the coming decades.

The coalition document explains that a range of mechanisms can be used to reform the way the market functions in order to address these issues. These mechanisms include Renewable Obligation Certificates (ROCs), Feed in Tariffs (FITs), an Emissions Performance Standard, a Carbon Price floor and other options including RABs.

The Electricity Market Reform Project will assess how these mechanisms can best be combined to deliver a new market framework.
Given the current fiscal constraints, value for money is a crucial consideration.

While the promotion of CCS is an important objective, the implied cost of carbon savings needs to be compared with other technological solutions for delivering reductions in carbon emissions and decarbonising generation.

16. **We recommend that the Government introduce emissions performance standards for new and existing power stations. These should be set at a level which precludes the construction of new coal-fired power stations without carbon capture and storage. The Government should also set out a timetable for the retrofitting of CCS technology to gas-fired power stations. We further recommend that the Government work with European partners to set common minimum emissions performance standards across the EU. (Paragraph 92)**

The Government's coalition agreement commits to the establishment of an emissions performance standard (EPS) that will prevent coal-fired power stations being built unless they are equipped with sufficient Carbon Capture and Storage (CCS) to meet the EPS.
The Government is currently working to develop the best approach to take forward an EPS within the context of the wider work currently underway on electricity market reform, in a way that ensures that the UK continues to

move towards a low-carbon future whilst ensuring that we have a diverse and secure energy mix. Once we have done that work we will consider how best to engage with European partners on an EPS.
If the UK is to fully decarbonise its electricity sector the Government recognises there will be a role for CCS on gas fired power stations as well as coal fired power stations. To date Government has considered it appropriate to focus initially on coal as the most polluting fuel and to consider the application of CCS on gas once there is a better understanding of the costs and performance of the technology. However the Government is currently considering new advice from the Committee on Climate Change recommending that serious consideration should be given to funding at least one gas CCS demonstration as part of the demonstration programme. This recommendation will be considered carefully, in light of the objectives for the programme. Whatever the result of this consideration, it is worth noting that there is already a requirement that gas fired power stations in England and Wales with an electricity generating capacity at or above 300MW must be constructed carbon capture ready to ensure there is no foreseeable barrier to retrofitting CCS technology in the future.

Global carbon markets

17. **We recommend that the Government encourages the EU to prepare for linking the EU ETS and other emissions trading systems together, whilst ensuring that the effectiveness of the EU ETS**

    We have been actively participating in discussions through various international fora to promote the expansion of other emission trading systems to which the EU ETS could link. For example the UK's involvement in ICAP (International Carbon Action Partnership), a forum for governments to share experiences and knowledge on emission trading schemes, has been strong. We have been actively providing resources and assistance in designing workshops and conducting research and analysis to promote the expansion of carbon markets, including more recently on measuring, reporting and verification of emission reductions and supporting Summer Schools on emissions trading for developing countries.

18. **The Government needs to set out how the global carbon market can expand, when it may contract, and to what extent emissions trading will deliver the emissions reductions that will meet the world's needs. (Paragraph 103)**

    The Government broadly agrees with the EU vision for a global carbon market. It calls for the development of a network of linked emission trading schemes across OECD countries and for involving advanced developing countries by 2020. We agree that this is an ambitious goal, but firmly believe that we should continue our efforts to expand carbon markets.

We will be conducting more analysis and developing our vision to reflect the global realities of tackling climate change.

19. **If the EU ETS is merged with other emissions trading systems with more generous allowances and greater access to offset credits from other countries, or more generous subsidies for low-carbon emitters, then terms of trade—some sort of carbon 'exchange rate'—will be needed to put all participants of the wider trading system on a level playing field. This would not be a requirement simply of fairness; without it, the greater efficiencies of the expanded system would be jeopardised. The Government, with its European partners, should ensure that schemes are not merged without a well-founded 'exchange rate' in place. (Paragraph 104)**

The Government is collaborating with other countries planning to implement an emissions trading system. Our first priority is to promote compatible design as much as possible in order to facilitate future linking.

In case full compatibility of systems cannot be reached, we will conduct further analysis to assess the desirability and feasibility of exchange rates.

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