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Consultation on the Form and Content of New Climate Change Agreements

March 2009

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Full text of the consultation and Partial Impact Assessment can be found on DECC's website:
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Consultation on a Review of Climate Change Agreements

Climate Change Agreements were introduced in 2001 in response to the Marshall Report on "Economic Instruments and the Business Use of Energy". Under Climate Change Agreements, eligible energy intensive industry benefit from an 80% reduction in the Climate Change Levy, if they meet challenging energy efficiency targets. Climate Change Agreements were introduced in recognition that the Climate Change Levy could affect the competitive position of energy intensive industry. The aims of the Agreements are to offset that competitive disadvantage and to reduce energy demand, thereby reducing emissions of greenhouse gasses.

Current Climate Change Agreements expire in March 2013. However, the Government announced in the Pre Budget Report in 2007 that *"the scheme will continue until 2017, subject to State aid approval, and* [it] *will discuss with business the most effective way of taking this forward"*.

In this consultation, the Government makes proposals and asks for views on the form and content of the new Climate Change Agreements.

Issued 12 March 2009

Respond by 4 June 2009

Review Of Climate Change Agreements

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Section I: Introduction

This Consultation

1. This consultation is about extending Climate Change Agreements to 2017. The current scheme ends on 31 March 2013[1], the final date on which the reduced rates of Climate Change Levy (often referred to as a Levy discount) may be claimed. The aim is to simplify the agreements for the benefit of business and government and to achieve greater coherence with other relevant climate change policy.

2. The Government announced in the Pre Budget Report in 2007[2] that *"the scheme will continue until 2017, subject to State aid approval, and* [it] *will discuss with business the most effective way of taking this forward".*

3. In this consultation document a number of proposals are made for change to the form and content of existing Climate Change Agreements, on which the views of interested parties are sought. A number of questions are also raised about other matters on which the Government may decide to make proposals, subject to the nature of the responses it receives. Where in this document there is no proposal for change or question raised, the Government proposes that the approach taken in current Climate Change Agreements should continue.

4. This document is split into three sections:

   - This section, the introduction, sets out the background to the consultation and how you can respond.
   - Section II summarises the possible changes that the Department of Energy and Climate Change (DECC) has identified, and raises a number of other issues on which your views are sought.
   - Section III analyses each issue where change is possible or proposed, identifies the inter-relationship between the different issues, lists the options considered and raises a number of questions to which you are invited to respond.

What are Climate Change Agreements?

5. The Climate Change Levy is a tax on certain forms of energy supplied to the non-domestic sector to encourage the efficient use of energy, and to help reduce energy demand and reduce emissions of greenhouse gasses. It was introduced in 2001 following recommendations made in the Marshall Report on 'Economic Instruments and the Business Use of Energy'[3]. However, recognising that such a tax could affect the competitiveness of energy intensive industry, Lord Marshall recommended a system of reduced rates targeting relief at plant level. Consequently Climate Change Agreements were introduced at the same time as the Levy.

[1] Subject to obtaining an extension to the existing State aid approval (see paragraph 9).
[2] See paragraph 7.37 of PBR 2007: http://www.hm-treasury.gov.uk/d/pbr_csr07_chapter7_258.pdf.
[3] http://archive.treasury.gov.uk/pub/html/prebudgetNov98/marshall.pdf.

6. Under these agreements, eligible energy intensive facilities benefit from reduced rates of Climate Change Levy (20% of the full rates) if they meet challenging energy efficiency or carbon reduction targets. Eligibility to enter a Climate Change Agreement was initially confined to energy intensive users operating a Part A process listed in Schedule 1 to the Pollution Prevention and Control (England and Wales) Regulations 2000 (SI 2000/1973)[4]. In 2006 eligibility was extended to include other energy intensive industries that meet a specific energy threshold and, in certain circumstances, that are exposed to international competition.[5]

7. Climate Change Agreements apply throughout the United Kingdom. The scheme comprises 52 industrial sectors and about 10,000 facilities, grouped into around 5,000 target units. Targets are set at the sector level through a process of negotiation between DECC and sector associations. Sector associations allocate the target to target units within their sectors. Sector associations play a number of other key roles in the operation of the agreements, including in their management and administration, making the process more efficient. They also provide advice and guidance to their members, leading to the sharing of best practice.

8. Industry benefits from Climate Change Agreements both in terms of the reduced rate Levy payable and in the value of energy saved. Total energy cost savings from baselines are estimated at around £500m in 2002, £780m in 2004 and £1,500m in 2006, although not all of this can be attributable to Climate Change Agreements alone. Climate Change Agreements have also been highly successful in reducing carbon emissions. Against baselines, Climate Change Agreements sectors saved a total of 16.4 million tonnes of carbon dioxide ($MtCO_2$) in 2002, 14.4 $MtCO_2$ in 2004 and 16.4 $MtCO_2$ in 2006. Against Business As Usual projections, it is estimated that meeting Climate Change Agreement **targets** will provide savings of over 10.5 $MtCO_2$ annually by 2010.

State aid approval

9. The Climate Change Agreements scheme was the subject of a State aid approval by the European Commission, granted in 2001 for a period of 10 years (the maximum period for which approval could be given) until 31 March 2011. The Government will be seeking an extension to that approval to 31 March 2013 (the end of the current scheme) in due course. A further State aid notification covering the new scheme will be submitted once the form and content of the new agreements have been determined.

Developments since the introduction of Climate Change Agreements

Stern Review

10. Man-made greenhouse gas emissions will cause dangerous climate change with economic, social and environmental consequences unless action is taken to reduce them. The Stern Review of the Economics of Climate Change[6] concluded that the benefits of strong, early action on climate change far outweighed the economic costs of no action. Stern outlined three main ways to achieve a low carbon economy:

[4] http://www.opsi.gov.uk/si/si2000/20001973.htm.

[5] The basic eligibility criterion in these cases is that the value of energy used must be 3% or more of production value for the sector. In addition, the sector must meet or exceed an import penetration test of 50% or more. Sectors that have an energy intensity of 10% or more do not need to pass the international competitiveness criterion. The sector qualification is based on the average energy cost and production values for three consecutive years. More details on these eligibility criteria can be found at http://www.defra.gov.uk/environment/climatechange/uk/business/cca/eligibility.htm.

[6] http://www.hm-treasury.gov.uk/sternreview_index.htm.

- Putting a price on carbon through emissions trading, taxation and regulation.
- Supporting the development of a range of cleaner, more productive technologies.
- Actions to encourage behaviour change and energy efficiency.

Climate Change Act 2008

11. The Climate Change Act 2008[7] sets the UK on the path to a low carbon future. The Act makes the UK the first country in the world to have a legally binding long-term framework to cut greenhouse gas emissions and adapt to climate change. It puts into statute the UK's targets to reduce greenhouse gas emissions by at least 80% by 2050 and carbon dioxide emissions by at least 26% by 2020, against a 1990 baseline, and introduces a system of carbon budgeting to manage these reductions.

12. Carbon budgets set a cap on greenhouse gas emissions that the UK must not exceed. Each budget will cover a five-year period, with three budgets set ahead to help long-term business planning and investment. The new Committee on Climate Change, established by the Act, provided its initial recommendations to Government on 1 December 2008 on the first three budgets, covering the period 2008-2022[8]. The Government will announce the levels of the carbon budgets alongside Budget 2009. The Act requires that carbon budgets must be set in law by 1 June 2009, followed by a report setting out the policies and proposals for meeting the budgets, which will be published in mid 2009.

13. To meet carbon budgets, every new Government policy will need to be examined for its impact on greenhouse gas emissions; where emissions rise in one sector there will have to be corresponding falls in another sector. The new Climate Change Agreements must therefore play an important role in helping the UK to meet its carbon budgets.

Environmental Audit Committee

14. During autumn 2007, the Environmental Audit Committee undertook an inquiry into the role of the Climate Change Levy and Climate Change Agreements in reducing carbon emissions from UK business. Their report was published in March 2008[9]. A number of the recommendations made by the Environmental Audit Committee are taken forward in this consultation.

Simplification Review

15. In 2006, Defra undertook a review of its key instruments that are to be used to tackle climate change (EU ETS, Climate Change Agreements and the Carbon Reduction Commitment) with a view to removing overlaps, simplifying existing regulations, and ensuring that the regulatory burden on business is kept to a minimum. While climate change policy continues to develop and evolve over time, the Government is committed to looking strategically at the overall regulatory and policy burden and developing a framework that delivers emissions reduction objectives with minimum regulatory requirements.

16. In 2007 the conclusions of the simplification project, which suggested broad principles and eleven recommendations for dealing with these issues, were put out to consultation (see the document 'Climate Change Instruments: Areas for overlap and Options for Simplification')[10]. The results of that consultation are taken into account in this document.[11]

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[7] http://www.defra.gov.uk/environment/climatechange/uk/legislation/index.htm.

[8] http://www.theccc.org.uk/reports.

[9] http://www.publications.parliament.uk/pa/cm200708/cmselect/cmenvaud/354/354.pdf.

[10] http://www.defra.gov.uk/environment/climatechange/uk/business.

[11] See proposals related to the setting of targets in absolute terms (paragraphs 47 to 54); carbon trading (paragraphs 89 to 104); the overlap with EU ETS (paragraphs 116 to 124) and alignment of the compliance year with the EU ETS (paragraphs 134 to 140).

EU ETS

17. The EU Emissions Trading Scheme (EU ETS), introduced in 2005, sets a cap on greenhouse gas emissions for energy intensive industry, including the electricity generators. There is overlap between EU ETS and Climate Change Agreements in the emissions and industries covered. The EU Commission has made proposals for changes to EU ETS for its Phase III[12], which will begin in 2013. The potential implications for Climate Change Agreements are taken into consideration in this document.

Carbon Reduction Commitment

18. The proposed Carbon Reduction Commitment is a mandatory emissions trading scheme aimed primarily at the large non-energy intensive business and public sectors, though it will also include manufacturing outside the Climate Change Agreement scheme. Commencing in 2010, the Carbon Reduction Commitment will apply a cap and trade scheme to cut carbon emissions. Organisations or subsidiaries with at least 25% of their emissions covered by a Climate Change Agreement will be temporarily exempt from the Carbon Reduction Commitment.

Target setting

19. This consultation does not deal with the level at which targets will be set. Targets will be negotiated with sector associations as under the current Climate Change Agreements once the form and content of the new Climate Change Agreements have been determined. In proposing targets DECC will take into account a number of issues, in particular: analysis from the Committee on Climate Change on the contribution Climate Change Agreements sectors could make towards the achievement of Carbon Budgets; past performance; the latest Business As Usual projections; and technological developments.

Start of the new Climate Change Agreements

20. Target units that have agreements under the current scheme may only qualify for Levy reduction for the period 1 April 2011 to 31 March 2013 (but see paragraph 9) by meeting their targets for the fifth target period according to the rules of the scheme. Eligibility for future Levy reduction will be subject to joining and meeting the rules of the new scheme. Target units that have previously held agreements under the current scheme but no longer do so may join the new scheme, if eligible, and, in most circumstances, qualify for Levy reduction subsequent to meeting targets in the first target period of the new scheme. Target units that have not previously held Climate Change Agreements and join the new scheme will benefit from Levy reduction from the date of joining, or from 1 April 2011, whichever is the later.

Delivery

21. Climate Change Agreements are currently delivered by a dedicated DECC team with support from its technical consultants AEA Technology. DECC is currently examining the possibility of contracting out delivery of the new Climate Change Agreements.

[12] http://www.defra.gov.uk/corporate/consult/euets-2013amendments/index.htm.

Charging

22. The Government is considering the possibility of introducing a scheme of charging for the administration of Climate Change Agreements in line with its general policy of seeking cost recovery, where this is possible. Should it decide to proceed with this, DECC will consult on a detailed proposal in due course.

Consultation Process

23. The current formal written consultation exercise is only part of the consultation process envisaged by DECC. The process began in March 2008 when DECC explored initial ideas with sector associations at a Plenary Meeting. Subsequently DECC has received written comments from some sector associations and has participated in a number of other meetings with groups of sector association representatives at which issues related to the new Climate Change Agreements have been considered. In parallel with this written consultation DECC plans to hold additional meetings with sector associations and interested parties to analyse further the options and develop the new Climate Change Agreements. Subsequently a proposed new Climate Change Agreement will be published for comment. Once this process has been completed, the Government response will be published – probably by end 2009.

24. This written consultation will run for a 12-week period, commencing on 12 March 2009 and will close on 4 June 2009.

25. Please refer to the partial Impact Assessment that accompanies this consultation document for information on the costs and benefits of the options identified. The partial Impact Assessment can be found at: http://www.decc.gov.uk/en/content/cms/consultations/open/open.aspx

26. You are requested, where possible, to use the electronic version of the consultation response form, which can be found at the web address given in paragraph 25 above, and to forward your reply to: ccaconsultation@decc.gsi.gov.uk

27. Alternatively, please complete a paper copy of the consultation response form and forward it by post to:

    Sam Lutterodt
    Department of Energy and Climate Change
    Climate Change Agreements Team
    First Floor
    3, Whitehall Place
    London
    SW1A 2HD

28. For any enquiries, please telephone 020 7238 4732

29. Respondents in Scotland, Wales and Northern Ireland are invited to copy their submission to the appropriate Devolved Administration:

Scotland

By email: james.simpson@scotland.gsi.gov.uk

By Post:
James Simpson
Energy Efficiency & Microgeneration Team
Energy Markets Division
The Scottish Government
2nd Floor, Meridian Court
5 Cadogan Street
Glasgow G2 6AT

Enquiries: 0141 242 5831

Wales

By email: Ruth.Gow@wales.gsi.gov.uk

By Post:
Ruth Gow
Climate Change and Water Division
Department for Environment, Sustainability and Housing
Welsh Assembly Government
Cathay Park
Cardiff CF10 3NQ

Enquiries: 029 2082 3615

Northern Ireland

By email: Brendan.forde@doeni.gov.uk

By Post:
Brendan Forde
12th Floor,
River House,
48 High Street
Belfast
BT1 2PT

Enquiries: 028 9025 7317

30. This consultation is in line with the Code of Practice on Consultation. This can be found at http://www.berr.gov.uk/bre/.

31. When this consultation ends, a copy of responses will be made available to the public. Members of the public may ask for a copy of responses under freedom of information legislation.

32. If you do not want your response – including your name, contact details and any other personal information – to be publicly available, please say so clearly in writing when you send your response to the consultation. Please note, if your computer automatically includes a confidentiality disclaimer, that will not count as a confidentiality request.

33. Please explain why you need to keep details confidential. Your reasons will be taken into account if someone asks for this information under freedom of information legislation. But, because of the law, it will not always be possible to keep those details confidential.

34. All responses will be summarised and the summary placed on the DECC website at http://www.decc.gov.uk/consultations. This summary will include a list of names of organisations that responded but not people's personal names, addresses or other contact details.

35. To see consultation responses and summaries, please contact:

Sam Lutterodt
Department of Energy and Climate Change
Climate Change Agreements Team
First Floor
3, Whitehall Place
London
SW1A 2HD

Telephone: 020 7238 4732
Email: levy.agreements@decc.gsi.gov.uk.

36. Please allow 24 hours' notice. There may be a charge for photocopying and postage.

37. If you have any comments or complaints about the consultation process, please address them to Marjorie Addo, DECC's Consultation Co-ordinator, Area 7C Nobel House, 17 Smith Square, London SW1P 3JR, or email consultation.coordinator@decc.gsi.gov.uk.

Section II: Summary Of Possible Changes

38. DECC has identified a number of potential changes to enhance or simplify the agreements for the next phase. This section summarises the possible changes identified. Section III analyses each issue independently, identifying the options considered and specific questions that respondents are invited to address. In many cases, DECC's preferred option is identified.

39. **It should be noted that it is not proposed to make any changes to the eligibility criteria for Climate Change Agreements.**

40. Where preferred options are indicated, these are based on DECC's understanding of the issues. They take into account the views of interested parties, where these are known. Responses to this consultation will significantly enhance DECC's understanding of the views of interested parties. Consequently, it is probable that proposals will be revised and developed in the light of those responses and subsequently through the process of meetings referred to in paragraph 23.

41. Many of the individual issues under consideration are closely inter-related and decisions taken on one issue will have implications on what can be done on another. Given the extent of these links, it is difficult to envisage the overall impact of the different options unless presented together as a package. For illustrative purposes, this Section presents two possible scenarios, each of which take account of DECC's preferred options where these exist. In both cases, the aim has been to create a coherent package that delivers essential environmental benefits, while recognising the needs of industry. We have sought to achieve maximum simplification and cost savings, and coherence with other climate change policies, for the benefit of industry and government.

42. The two scenarios are set out in Table 1 below, in comparison with current arrangements. It is clear that potentially the most important and difficult issue to resolve is whether or not sectors and target units should continue to be able to choose between absolute[13] and relative targets, or whether all targets should be set in absolute terms (this question is discussed in detail in paragraphs 47 to 54). Consequently the two scenarios are based on these two alternatives. Scenario A assumes that targets are set only on an absolute basis. Scenario B assumes that targets will continue to be set on absolute or relative basis. The differences between the two scenarios are highlighted in bold.

[13] Throughout this document, in the context of the new scheme, "absolute targets" are as defined in paragraph 49.

Table 1: Two scenarios of proposals

Current Arrangements	Scenario A	Scenario B
Target Setting	**Target Setting**	**Target Setting**
a. Target units able to choose between absolute and relative targets.	a. All targets set in absolute terms (see paragraphs 47 to 54).	a. **Targets set in absolute or relative terms.**
b. Targets set biennially.	b. Targets set annually (see paragraphs 62 to 66).	b. Targets set annually.
c. Targets reviewed in 2004 and 2008.	c. Targets for 2014 and 2015 to be reviewed in 2011 (see paragraphs 67 to 78).	c. Targets for 2014 and 2015 to be reviewed in 2011.
Target Achievement	**Target Achievement**	**Target Achievement**
d. If sector meets the target, all target units are deemed to have met theirs.	d. All target units required to meet their targets either by direct action and/or by purchase of carbon (see paragraphs 79 to 85).	d. All target units required to meet their targets either by direct action and/or by purchase of carbon.
e. Three risk management tools: carbon trading; relevant constraint; and fuel supply disruption.	e. Risk management tools restricted to carbon trading only **(with absolute targets there would be no logic in retaining any risk management tool other than carbon trading** – see paragraphs 86 to 88).	e. Risk management tools restricted to carbon trading only.
f. No provisions for *de minimis* or materiality.	f. Provisions for *de minimis* and materiality to be introduced (see paragraphs 105 to 111).	f. Provisions for *de minimis* and materiality to be introduced.
g. Novem[14] procedure applied to relevant sectors and target units for setting relative targets and measuring performance.		g. **Continue to apply the Novem procedure for setting relative targets and measuring performance for relevant sectors and target units, but make application obligatory** (see paragraphs 112 to 115).
Coverage	**Coverage**	**Coverage**
h. Where there is an overlap between Climate Change Agreements and EU ETS a double counting mechanism is applied.	h. Targets to be split where there is an overlap between Climate Change Agreements and EU ETS, with eligibility for Levy reduction remaining unchanged (see paragraphs 116 to 124).	h. Targets to be split where there is an overlap between Climate Change Agreements and EU ETS, with eligibility for Levy reduction remaining unchanged.

[14] For a description of the Novem procedure, see Box 2 on page 35.

Simplification	Simplification	Simplification
i. Sectors could choose between two agreement types until 2006, after which "Option 2"[15] agreements only applied.	i. Only one agreement type to be available, based on Option 2 under the current scheme (see paragraphs 132 to 133).	i. Only one agreement type to be available, based on Option 2 under the current scheme.
j. Sectors can choose a compliance year beginning the first day of October, November, December or January.	j. The compliance year to be aligned with that for EU ETS and based on a calendar year for all sectors, with adjustments to the dates for the reconciliation process and eligibility for Levy reduction (see paragraphs 134 to 140).	j. The compliance year to be aligned with that for EU ETS and based on a calendar year for all sectors, with adjustments to the dates for the reconciliation process and eligibility for Levy reduction.
k. Different data is required according to whether a sector meets or does not meet its target or if it operates a trading group.	k. All sectors, whether meeting targets or not, including those with trading groups, required to provide the same data at reconciliation (see paragraphs 141 to 146).	k. All sectors, whether meeting targets or not, including those with trading groups, required to provide the same data at reconciliation.
l. Sectors able to choose a baseline from 1990 onwards.	l. A common start date established, for the purposes of measuring the impact of the scheme, based on 2010 performance (see paragraphs 147 to 155).	l. A common start date established, for the purposes of measuring the impact of the scheme, based on 2010 performance.
m. All rules of the scheme embedded in the agreements.	m. Scheme Rules to be established separate from the agreements, to facilitate their adjustment when necessary (see paragraphs 156 to 159).	m. Scheme Rules to be established separate from the agreements, to facilitate their adjustment when necessary.

[15] See paragraph 132 for an explanation of "Option 2" agreements.

43. DECC believes that the fact that Climate Change Agreements are structured around sector associations brings substantial advantages. Sector associations take a collective responsibility for their industry's performance and reputation. They provide advice and guidance to their participants, leading to the sharing of energy efficiency best practice and therefore more rapid energy efficiency savings. Sector associations also play a large part in negotiating, managing and administering the agreements, making the process more efficient and reducing burdens on individual businesses. If either of the two scenarios identified above are adopted, DECC does not wish to weaken the role of the sector association.

Questions

1. Would the scenarios identified in Table 1 lead to a weakening, no change or strengthening of the role of sector associations?
2. If a weakening, what would be the impact and what could be done to mitigate it?

44. In addition to providing an analysis of the proposals identified in Table 1 above, Section III raises a number of other issues on which the views of respondents are requested. These relate to:

a. Whether all targets should be set in terms of carbon emissions only (see paragraphs 55 to 61).
b. Whether carbon trading should take place in the Carbon Reduction Commitment market or a stand-alone scheme, and what measures, if any, should be introduced to limit the generation of allowances from changes in throughput (see paragraphs 89 to 104).
c. Whether the 90/10 rule[16] provides administrative or environmental benefits that could be extended to a larger number of businesses by lowering the threshold (see paragraphs 125 to 131).
d. Whether there are any barriers to access to Climate Change Agreements that can be removed, without the need to make changes to eligibility criteria (see paragraphs 160 to 162).
e. Whether there are ways within Climate Change Agreements to provide increased incentives to install Combined Heat and Power plant (see paragraphs 163 to 169).
f. Whether the "light touch" approach applied to Climate Change Agreement operators under the Environmental Permitting (England and Wales) Regulations 2007 should continue (see paragraphs 170 to 174).
g. Whether there are ways in which good energy management practices (e.g. the development and implementation of energy plans) can be further encouraged under Climate Change Agreements (see paragraphs 175 to 176).

[16] Under the 90/10 rule, where the energy use of an energy intensive installation is equal to 90% or more of the total energy of the site, the whole site is deemed to be an eligible facility. Where total energy is less than 90%, permanent sub-metering is required to measure all energy used within the eligible facility. In the latter case, the eligible facility may be extended to cover non-eligible activities up to an additional 1/9th of its eligible energy use, provided that the activities are discrete and separately sub-metered.

Section III: Analysis Of Possible Changes To Climate Change Agreements

45. The possible changes to the current Climate Change Agreements scheme that DECC has identified are summarised in Section II. This section analyses each issue where change is possible, lists the different options considered, identifies the inter-relationship between the different issues, and raises a number of questions to which you are invited to respond. Please see paragraphs 23 to 37 for information on how to respond.

46. In this section, references to the report of the Environmental Audit Committee refer to the report entitled "Reducing Carbon Emissions from UK Business: The Role of the Climate Change Levy and Agreements".[17]

Issues Related To Target Setting

A. Should all targets be set in absolute terms only?

47. Under the current scheme, target units have the option of absolute or relative targets. The sector "currency" (i.e. absolute or relative) is determined by the currency of the majority of the energy use in the target units within the sector. Around 94% of target units and 49 out of 52 sectors have relative targets.

48. Compared with other climate change instruments, Climate Change Agreements are now unusual in having the option of relative targets. The Carbon Reduction Commitment and EU ETS both have absolute caps. In addition, Carbon Budgets under the Climate Change Act will set binding limits on UK greenhouse gas emissions. The Government therefore needs to consider **whether target units with Climate Change Agreements should continue to have the option of relative or absolute targets.**

49. By "absolute" targets the Government means:

- Targets set at a fixed level of energy use or emissions rather than per unit of throughput (but see paragraphs 55 to 61).
- Targets would not be set against predicted future throughput (see paragraph 50).
- Targets for sectors would be adjusted for new entrants, but not for target units that exited a sector.[18]

50. Under the current scheme, absolute targets are set by reference to a predicted level of throughput, thus allowing for an element of growth within the target. The proposal to discontinue this approach responds to the need to make absolute reductions in emissions in order to meet carbon budgets and reflects the Commission's proposals for future phases of EU ETS in which there will be an EU-wide cap on a declining trajectory.

[17] http://www.publications.parliament.uk/pa/cm200708/cmselect/cmenvaud/354/354.pdf.

[18] Targets are not adjusted for exits because it is assumed that this is part of a process of rationalisation, for which the sector should receive credit. But see paragraph 103 and Box 1, which explain the current "CCA 16" procedure, which prevents significant windfall benefits arising from a reduction in throughput.

51. There is a number of questions that need to be addressed when considering this issue, including:

a. **Can relative targets guarantee reductions in emissions from the Climate Change Agreements sector?** It would seem not, since they can be met with increased emissions if there is increased throughput. However, although most targets under the current scheme are relative, substantial absolute carbon savings have been achieved. For example, when measured against baselines, total savings of 16.4 $MtCO_2$ were achieved during the 2006 target period.

b. **When compared with relative targets, do absolute targets reduce flexibility or restrict growth?** The ability of a sector to meet its target will depend on the availability of cost-effective abatement within the sector and the price and availability of allowances. Firms can meet their targets by purchasing allowances. Thus, if there is insufficient abatement potential within the firm/sector they can buy additional allowances at the market price to meet their target. This is the case whether targets are absolute or relative. However, firms with absolute targets are more likely to have to purchase additional allowances if they expand. Firms with relative targets are more likely to have to purchase additional allowances when they are declining. Relative targets are more difficult to meet in a declining sector of the economy, when these businesses are also likely to be in a less favourable financial position to invest or to purchase allowances. Nevertheless, their actual total emissions, and therefore their impact on climate change, will have reduced.

c. **Are absolute targets more difficult to meet than relative targets?** The difficulty of a target is a function both of the form of the target (absolute or relative) – but see preceding paragraph – and the level at which they are set. Whether targets for new Climate Change Agreements are set in absolute or relative terms, the procedure for setting them will continue to be one of negotiation between DECC and sector associations (see paragraph 19). The form of the target will be one of the factors taken into account in the negotiation.

d. **Would absolute targets discourage some target units from participating in the scheme?** Whether targets are relative or absolute should not in itself prevent firms from participating in the scheme. Climate Change Agreements are negotiated agreements and whether firms decide to accept an agreement should depend on the level the target is set and not whether it is a relative or absolute target.

e. **Would absolute targets contribute to the movement of production out of the UK to locations where there is less robust regulation?** Known as carbon leakage, this is an understood concern whether targets are absolute or relative, and one that the EU Commission is proposing to address in the context of Phase 3 of the EU ETS. It is not one that could be easily addressed in the context of Climate Change Agreements. However, it is questionable if Climate Change Agreement targets, in themselves, whether relative or absolute, would have this effect given that Climate Change Agreements confer on operators two benefits – a reduced Levy (estimated to be worth a total of £350m in 2007/8) and energy savings (estimated at £1,500 million in 2006, when measured against baselines).

52. Other factors to be taken into account would include:

f. Absolute targets have the benefit of simplicity when measuring performance, because no throughput measure is required. However, a throughput measure is needed for the operation of the "CCA 16" procedure[19]. Measurement of performance against relative targets can be complex, particularly where there is a range of different products or units of production, which can make choosing a single throughput measure difficult.

[19] For an explanation of the "CCA 16" procedure see Box 1 on page 32.

g. Absolute targets can provide windfall benefits to declining industries or outsourcing industries through the generation of allowances. Where large numbers of allowances are generated this can depress the price of allowances and disrupt the carbon market. This in turn can undermine the achievement of the environmental objectives of the scheme, by making the purchase of allowances a more attractive option to taking direct action to meet targets. Windfall allowances can be limited by rules such as the CCA16 procedure (The issue of windfall allowances and the CCA16 procedure is further discussed in Section G: What arrangements should be put in place for carbon trading? - see paragraphs 89 to 104).

h. Relative targets can also provide windfall benefits when industries are growing, since energy efficiency (energy per unit of throughput) improves in most manufacturing as throughput grows (as base load is spread over more units of production). Target units with relative targets also benefit to the extent that there is no requirement to purchase allowances to cover increased emissions associated with growth.

i. If the option to choose between relative and absolute is retained, target units might be expected to choose absolute targets if they expect to be in a declining market, or relative targets if they expect to be in a growth area, although forecasting the future state of markets has been shown in the current scheme to be difficult. This would magnify any tendency in the scheme as a whole to over-achieve against targets, resulting in the impacts described in paragraph 52g. It should be noted that, under the current scheme, target units with a relative target may decide to change to an absolute target and vice versa. However, target units that change to an absolute target do not have the option to change back to a relative target.

53. If all sector targets were set in absolute terms, **consideration would need to be given to whether target units should be given the choice of adopting relative targets.**

54. In principle, it would be possible to construct a scheme under which sector targets were set on an absolute basis but target units could continue to have the choice of relative or absolute targets. However, an absolute target at sector level would have to be strictly applied. The current arrangement of examining target units individually if the sector did not meet its target could not continue since this would, in effect, result in the sector having a relative target. This would create a number of potential problems. In particular, within a single sector, target units with relative targets could continue to meet their targets with increased energy use/emissions, while target units with absolute targets may also meet their targets in full. But, while all target units would have met their targets, the sector as a whole would have failed due to the rising emissions of those with relative targets. There are two ways in which this could be addressed:

- all target units within a sector that did not meet its target would have to be decertified; or
- the sector could be allowed to establish arrangements at the sector level to purchase allowances to make up the shortfall. This may be difficult given that all target units would have passed their targets.

Links To Other Issues

1. If targets are set only in absolute terms, there would be no logic in having risk management tools other than carbon trading (see paragraphs 86 to 88).
2. The choice of target currency impacts directly on how carbon trading should take place under the scheme (see paragraphs 89 to 104).
3. There would be no need for a Novem procedure if all targets were set in absolute terms (see paragraphs 112 to 115).
4. Consideration is being given to setting all targets in terms of carbon and that the option to set targets in terms of energy be discontinued (see paragraphs 55 to 61).

Proposal

The arguments for and against setting all targets in absolute terms or retaining the current choice between absolute and relative are well balanced. The Government is therefore keen to learn the views of interested parties on this complex issue, before making a proposal. However, comments might focus on three possible options:

1. To retain the current arrangements whereby target units are able to choose between absolute and relative targets and the sector target is determined by the currency of the majority of the energy use in the target units in the sector agreement.
2. To set absolute targets at both sector and target unit level.
3. Set targets at sector level on an absolute basis and allow target units the option of absolute or relative targets with a mechanism for the sector to reach compliance through the market.

Other Options

1. Unchanged procedure for setting absolute targets: i.e. based on predicted throughput, including growth.

Questions

3. Do you agree with the analysis given in paragraphs 47 to 54? If not, in what way and why?
4. Do you agree that all sector targets should be set in absolute terms?
   - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
5. If sector targets were set on an absolute basis, do you agree that targets for target units should also be set on an absolute basis?
   - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
   - If not, how could the responsibility between target units with relative targets and those with absolute targets be shared for achieving an absolute sector target?
6. If relative targets were set, are there ways in which carbon savings could be guaranteed? If so, how?
7. Any other comments?

B. Should all targets be set in terms of carbon emissions only?

55. Under current Climate Change Agreements targets can be set in terms of energy use or carbon emissions. Target units may choose between the two options. Sector targets are determined by the currency of the majority of the energy use in the target units in the sector agreement. Currently, 49 sectors have targets set in terms of energy use and 3 in terms of carbon emissions.

56. Climate Change Agreements were originally established with a view to encouraging increased energy efficiency (see paragraph 5) and consequently to reduce emissions of greenhouse gasses. Removing barriers to behavioural change and improving energy efficiency remains one of the three essential elements laid out in the Stern Review as a means of tackling climate change effectively (see paragraph 10).

57. The Government recognises that, for many target units, setting targets in terms of energy use is more transparent - they understand their energy use, how to manage it and where efficiencies might be achieved. Measuring performance is administratively simpler with, in many cases, a need only to keep records of meter readings. Simplicity is, therefore, a major benefit of setting targets in terms of energy use. But there are other advantages. In particular, such targets recognise the importance of improved energy efficiency in the move

to a low carbon economy, and help reduce costs and vulnerability to energy market volatility. Also, achievement of the UK's challenging target for renewable energy is made easier through reduced energy demand.

58. On the other hand, national and international targets for climate change are set in terms of greenhouse gas emissions levels, with carbon dioxide accounting for about 85% of total UK greenhouse gas emissions. In addition, most things now tend to be carbon rated, including such things as Vehicle Excise Duty, domestic appliances and homes. At industry level, caps under the EU ETS and the Carbon Reduction Commitment are set in terms of emissions levels. Understanding of carbon footprints is therefore growing.

59. To achieve national climate change targets, the Government believes that there are advantages in changing people's mindset away from energy use and towards the extent of their carbon footprint. In particular, operators that understand the carbon content of energy can be motivated to reduce their carbon emissions by fuel switching, where this is feasible (e.g. oil emits more carbon than gas, so an operator looking to reduce carbon emissions could consider switching).

60. The arguments for and against setting targets in terms of carbon or retaining the option are well balanced. The Government is therefore keen to learn the views of interested parties on this issue, before making a proposal.

61. In the case that the choice between carbon and energy targets is retained, because the currency of sector targets is determined by the dominant currency used by its members, entrants and exits can trigger a change in the sector currency. This carries an administrative burden. There could be administrative benefits in fixing the sector currency at the start of the agreement, making no subsequent changes for entrants and exits.

Links to Other Issues
None

Proposal
1. The arguments for and against moving to set all targets only in terms of carbon emissions are well balanced. The Government is therefore keen to learn the views of interested parties on the issue, before making a proposal. Views might focus on the options of:
   - No change, i.e. retain the option of targets based on either energy use or carbon emissions at both sector and target unit levels.
   - All targets set in terms of carbon emissions only.
   - Set sector targets in terms of carbon emissions while allowing underlying targets to be set in terms of energy use.
2. In the case that the option of carbon or energy targets is retained, to fix the currency of sector target for the duration of the agreement, making no subsequent changes for entrants and exits.

Other Options
None

Questions

8. Do you agree with the analysis in paragraphs 55 to 61? If not, in what way and why?
9. Do you agree that targets for all sectors and target units should be set only in terms of carbon emissions?
   - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
   - If you do not agree, please state which alternative option you prefer and why.
10. If the choice of target currency between energy use and carbon emissions is retained, do you agree that the currency of sector targets should be fixed for the duration of agreements, making no subsequent changes for entrants and exits?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
11. Any other comments?

C. Should targets be set annually?

62. Target periods are currently set every two years. A target period is a twelve-month period in which performance is measured against targets during a process known as reconciliation. During reconciliation, target units must prepare and submit data on performance to sector associations, which collate and forward that information to DECC. This is a substantial task for target units, sector associations (particularly for those that have several hundred target units) and DECC. In total, there are around 5,000 target units in Climate Change Agreements, grouped into 52 sectors.

63. A move to annual target periods would have significant advantages. In particular, it would:

- Reduce the risk of significant spikes in the carbon market. This might be particularly important if the Carbon Reduction Commitment market were to be used for Climate Change Agreements (see paragraphs 89 to 104), ensuring a more stable market for both schemes.
- Enable four target periods to be set under the new scheme (2012 to 2015), thus encouraging continuous focus on energy efficiency issues by businesses with Climate Change Agreements.

64. Possible disadvantages of setting annual target periods could include:

- Doubled potential for the creation of allowances, which might impact negatively on the carbon market. The extent to which this might happen would depend, in particular, on the stringency of targets.
- Increased administrative burden on target units and sector associations. However, this is likely to be small. Most sector associations already require their members to report annually. There would, however, be an additional compliance burden.
- Increased administrative burden on DECC.

65. On balance, the Government believes that the advantages of a more stable carbon market and the incentive on businesses to focus more constantly on energy efficiency issues outweigh the disadvantages and **proposes to introduce annual target periods.**

66. If targets are set annually, the period of certification for Levy reduction would also need to be reduced to one year.

Links to Other Issues
Consideration is being given to using the Carbon Reduction Commitment as the carbon market for Climate Change Agreements (see paragraphs 89 to 104). It will be important to avoid disruption of that market as a result of over-supply of allowances from Climate Change Agreements.

Proposal
To set target periods annually, with target periods in 2012, 2013, 2014 and 2015, with one-year certification for Levy reduction.

Other Options
Retain a two-year cycle, with target periods in 2012 and 2014, with two-year certification for Levy reduction.

Questions
12. Do you agree with the analysis in paragraphs 62 to 66? If not, in what way and why?
13. Do you agree that target periods should be set annually, with target periods in 2012, 2013, 2014 and 2015, and with one-year certification for Levy reduction?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative and financial cost.
14. If your preference is to retain a two-year cycle for reconciliation, please set out your reasons, identifying the advantages and disadvantages of this approach, including the administrative and financial cost.
15. Any other comments?

D. Should targets under new Climate Change Agreements be subject to review?

67. The Finance Act 2000 requires Climate Change Agreement targets to be reviewed at least every five years.[20] Current Climate Change Agreements provided for reviews in 2004 and 2008. The report of the Environmental Audit Committee recommended that Climate Change Agreement targets should be reviewed at every target period.[21] The EU State aid guidelines state that where there are agreements of the nature of Climate Change Agreements, *"these agreements must be revised periodically in the light of technological and other developments…"*.[22]

68. It is recognised that target reviews place an administrative burden on both industry and Government, and that industry needs stability between target reviews and target periods to plan and implement investments. Given the costs associated with target reviews and the need to respect normal investment cycles within industry, there would be Better Regulation benefits in not holding a target review under the new scheme. However, target reviews provide an opportunity to ensure that targets continue to represent the real potential for energy efficiency improvements or carbon savings from the Climate Change Agreements sector. There are therefore potential environmental benefits to be gained from regular target reviews. **It is therefore proposed that targets under new Climate Change Agreements should be subject to review on at least one occasion.**

[20] Schedule 6, paragraph 47(1) (g): http://www.opsi.gov.uk/ACTS/acts2000/ukpga_20000017_en_1.
[21] Paragraph 47 of the EAC Report: http://www.publications.parliament.uk/pa/cm200708/cmselect/cmenvaud/354/354.pdf.
[22] Paragraph 159.c.iii of the Community Guidelines on State Aid or Environmental Protection: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:082:0001:01:EN:HTML.

69. Three factors need to be taken into account in determining when a target review or target reviews should be carried out:

a. It is proposed that under new Climate Change Agreements there should be annual target periods (2012 to 2015) rather than biennial, as under current Climate Change Agreements (see paragraphs 62 to 66).
b. In order to allow industry time to take the necessary steps to meet revised targets, any target review would have to be completed at least one year before the start of the relevant target period.
c. Target reviews can only be undertaken if there is information additional to that available at the preceding review. One of the essential pieces of additional information is performance during the most recent target period.

70. The targets for the new agreements (2012 to 2015) will be set by negotiation, probably in early 2010. This will provide time for businesses to prepare for the 2012 target period. Consequently, it will not be possible for the target setting process to take into account information from the 2010 target period. If there were annual target periods in the new agreements, it would be possible to hold reviews:

- In 2011 for the 2014 and 2015 targets taking into account information from the 2010 target period.
- In 2012 for the 2015 targets only taking into account information from the 2010 target period, thus providing industry with up to 2 additional years lead time into the revised target.
- In 2013 for the 2015 targets, taking into account information from the 2012 target period.

71. The options to review targets in 2012 or 2013 would limit the review to the 2015 targets only. This would leave three targets (for 2012, 2013 and 2014) subject to the initial target negotiations only, with no account taken of any subsequent developments in cost effective saving potential. **It is therefore proposed that targets for 2014 and 2015 be reviewed in 2011.**

72. For target reviews under current Climate Change Agreements the agreements provide that *"any such review shall be to ensure that the sector targets being reviewed continue to represent the potential for cost effective savings taking account of any changes in technical or market circumstances".* The Government believes that there are at least two additional factors that should be taken into account when reviewing targets: the performance of sectors in previous target periods and the status of the carbon market.

73. Climate Change Agreement sectors have, overall, over-achieved against targets. The over-achievement witnessed in 2002 and 2004 was reduced for the 2006 target period through the 2004 target review and the 2008 target review is expected to achieve a similar effect. Over-achievement against targets may be due to one of two reasons:

- Target units investing "up front" rather than following the "target profile" in their agreements. There is substantial evidence of early investment in a number of sectors, which provides for a good environmental outcome.
- The targets were not set tightly enough at the outset. Again there is evidence that some sector targets were not sufficiently robust. The target reviews are conducted on the basis of more robust data than was available before the start of the scheme in 2001.

74. Similarly under-achievement against targets, which was seen in 17 out of 49 sectors that reported in 2006, can be the result of the targets having been set too tight or lack of energy efficiency action on the part of at least some target units within the sector. The target review negotiations are able to take the most recent evidence from performance at the last target period and supplementary information provided by the sectors on investment and any special circumstances in their sector, to come to a view on appropriate targets for future periods.

75. The Government therefore believes that it is right that the full range of available information should be taken into account in reviewing sector targets and proposes that this be made explicit in the new agreements.

76. Consideration is being given to allowing Climate Change Agreement operators to trade on the Carbon Reduction Commitment market (see paragraphs 89 to 104). In the extreme case, where allowance prices may have collapsed and the cause of that collapse can be attributed to Climate Change Agreements, this could have significant negative consequences for the achievement of the objectives of both schemes. It is of note that, under the Carbon Reduction Commitment, it is proposed that where there is a collapse in the allowance price, the overall market cap might be tightened both between phases and, in exceptional circumstances and subject to certain conditions, within phases.

77. In the less extreme case, an over-supply of allowances (and hence a low allowance price) and/or high levels of ring-fenced over-achievement, can weaken the incentive on industry to take direct action to reduce emissions in later target periods. While it can be true that both these phenomena can reflect early action and that scope for further cuts in emissions is thereby reduced, this will not always be the case. If the UK is to meet its emissions targets, a step change will be needed by all sectors of the economy, including the energy intensive sector. The incentive on industry to take direct action to drive down emissions must remain high.

78. **It is therefore proposed that it be clarified that the criteria to be taken into account in a target review may include additional factors, including previous performance and the status of the market in allowances.**

Links to Other Issues

1. It is proposed that annual targets be set, with target periods in 2012, 2013, 2014 and 2015 (see paragraphs 62 to 66). If targets were set on a biennial basis, as now, with target periods in 2012 and 2014, a review of the 2014 targets could be undertaken in 2011, taking into account performance in 2010 (2012 performance would not be known in time for a sensible review of 2014 targets).
2. Consideration is being given to allow Climate Change Agreement operators to trade in the Carbon Reduction Commitment market (see paragraphs 89 to 104). In this context it will be essential that Climate Change Agreement targets and the Carbon Reduction Commitment cap are equally stringent, if the objectives of either scheme are not to be undermined.

Proposal

1. To undertake a target review in 2011 for the 2014 and 2015 targets.
2. To clarify the criteria for target changes to include other factors, including previous performance and the status of the market in allowances.

Other Options

1. Undertake no target review under new Climate Change Agreements.
2. Undertake a target review in 2012 for the 2015 targets.
3. Undertake a target review in 2013 for the 2015 targets.
4. No change to the criteria for target changes.

Questions

16. Do you agree with the analysis in paragraphs 67 to 78? If not, in what way and why?
17. Do you agree that there should be a target review in 2011 for the 2014 and 2015 targets?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
    - If you do not agree, please state which alternative option you prefer and why.
18. Do you agree that the criteria for setting targets in a target review should be extended to include other factors, including previous performance and the status of the market in allowances?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
    - If you agree, what other factors should also be taken into account? Please explain why.
19. Any other comments?

Issues Related To Target Achievement

E. Should all target units be required to meet their targets either by direct action or by purchase of allowances?

79. Under current Climate Change Agreements, targets are set at the sector level and sector associations are responsible for allocating the target to their members. When performance is assessed in a target period, if a sector as a whole meets its target all target units within that sector are deemed to have met theirs. This is irrespective of the fact that some target units may not have met their targets, provided that there has been sufficient offsetting over-performance elsewhere within the sector. Where a sector does not meet its target, target units within that sector that have not met their targets risk loss of Levy reduction. The rationale for the current arrangements is that if a sector as a whole meets its target the environmental benefits are at least as good as if all target units met theirs.

80. The report of the Environmental Audit Committee noted that *"the NAO has drawn attention to a significant number of businesses which have both failed to meet their Climate Change Agreement targets through their own actions, and failed to make up the difference to these targets through other mechanisms such as carbon trading – and yet which continue to enjoy their Climate Change Levy discount. Regulations should be tightened to ensure that this cannot continue. The trading mechanism established within the Climate Change Agreements system should make this straightforward: any firm that does not meet its target through its own actions should be required to purchase credits to make up the difference, or lose its Levy discount".*[23]

[23] Paragraph 56: http://www.publications.parliament.uk/pa/cm200708/cmselect/cmenvaud/354/354.pdf.

81. This is an issue principally for small target units. Big energy users do not generally rely on a sector meeting its target – the potential penalty would be too great if the sector did not meet its targets. It is estimated that in 2006 around 360 target units (out of 3100 target units in the sectors concerned) would have failed to meet their targets if their sector had not passed and that they would have had to buy around 150,000 allowances in order to meet targets.

82. The current arrangements ensure that savings are made in the most cost effective way. They also promote a collegiate approach in that target units may agree to allow any over-achievement by them to be used by other target units within their sector.

83. However, the Government believes that there are three arguments in favour of requiring all target units to meet their targets by direct action or through buying allowances.

- First, there is an issue of value for money for the taxpayer, in that the current arrangements allow target units to benefit from a tax reduction despite not having met their targets.
- Second, requiring all target units to meet their target would ensure that all target units are treated equitably - each would be responsible for meeting their own target irrespective of the performance of the sector.
- Third, such a requirement would send a stronger signal to target units that they should be active in meeting their targets.

84. Several sector associations already advise or insist on members meeting their target in their own right. Nevertheless, there is a risk that making this obligatory could have negative consequences in that such a policy could be said to effectively remove sector targets. As such, it could undermine the critical role that sector associations play in managing and implementing Climate Change Agreements. Sector associations provide a formal communication channel between Government and target units for reporting and transmission of notices; they customise Climate Change Agreement messages and material for their members; they provide guidance and training and some provide additional services such as carbon brokering and monitoring of performance against targets. Effectively removing the sector target would encourage individual action but could see the sector associations by-passed and prevent sector associations from being representative of their members. This in turn could damage the cohesiveness of some sectors.

85. **The Government therefore proposes that, subject to a better understanding of the impact on the role of sector associations, all target units should be required to meet their targets either through direct action or through purchase of allowances.**

Links to Other Issues
Implementation of this proposal could strengthen the arguments in favour of the proposed introduction of *de minimis* and/or materiality provisions (see paragraphs 105 to 111).

Proposal
Subject to a better understanding of the impact on the role of sector associations, to require all target units to meet their targets either through direct action or through purchase of allowances.

Other Options
No change to existing arrangements.

Questions

20. Do you agree with the analysis in paragraphs 79 to 85? If not, in what way and why?
21. Do you agree that all operators should be required to meet their targets, or purchase carbon allowances, to qualify for Levy discount?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
22. What would be the impact on the role of sector associations should this policy be introduced? Other than maintaining existing arrangements, what might be done to mitigate any negative impacts?
23. Any other comments?

F. Should risk management tools be restricted to carbon trading only?

86. Targets under Climate Change Agreements are intended to be challenging and, as a result, there can be a range of entirely legitimate reasons why a target unit might fail to meet its target. The penalty for not meeting targets is severe – total loss of Levy reduction for the subsequent two years. Consequently the current scheme envisages three risk management tools[24] that provide target units with alternative means of meeting their targets should this not result from direct efforts. These tools are:

- **Fuel Supply Disruption.** Although rarely used, this provision allows for an increase in energy use to be disregarded where this is due to an unexpected disruption in energy supply.
- **Relevant Constraints.** This allows for account to be taken of actions imposed on operators by regulators (e.g. under Health and Safety or Planning legislation) when assessing performance against targets, provided that these were unknown at the time targets were set. It has been used only 12 times since the scheme began. Low use of this provision may reflect the fact that there are costs involved in providing the necessary evidence in support of any claim and that carbon prices under UK Emissions Trading Scheme (UK ETS)[25] have been very low. As the cost of allowances under the revised scheme should be at a more realistic level, there could be greater use of this provision in the future, resulting in additional administrative costs for both industry and Government.
- **Carbon Trading.** The main risk management tool, which allows target units to purchase carbon allowances from the UK ETS in order to make up any shortfall in the meeting of targets. Total allowances purchased in the first 3 target periods of the current scheme (2002, 2004 and 2006) amounted to 0.6, 0.9 and 2.6 million respectively. Given that trading can take place only on the basis of over-achievement elsewhere, the environmental objectives of Climate Change Agreements remain intact.

87. Although little used under the current scheme, the fuel supply disruption and relevant constraints provisions effectively weaken targets, which is difficult to justify in the context of Carbon Budgets. Given the increasing focus on carbon trading in climate change instruments and the need to maintain the integrity of targets, **the Government proposes that carbon trading be the only risk management tool under new Climate Change Agreements.**

88. It is of note that in other sectors of the economy and in other areas of risk, industry is expected to manage risk through purchase of appropriate insurance.

[24] Up to and including the third target period (2006) of the current scheme, two additional risk management tools were available: Product Mix and Output Algorithms and Tolerance Bands.

[25] The UK Greenhouse Gas Emissions Trading Scheme 2002: http://www.defra.gov.uk/environment/climatechange/trading/uk/pdf/trading-consolidated.pdf.

Links to Other Issues

1. If all targets were set in absolute terms (see paragraphs 47 to 54) it would be inconsistent to retain risk management tools that effectively weaken targets.
2. Although the current scheme provides only for total loss of Levy reduction where targets are not met, a softer edge is proposed under the new scheme through the introduction of a *de minimis* and a materiality provision (see paragraphs 105 to 111).

Proposal

Carbon trading should be the only risk management tool under new Climate Change Agreements.

Other Options

Retain all three existing risk management tools (fuel supply disruption, regulatory constraints and carbon trading).

Questions

24. Do you agree with the analysis in paragraphs 86 to 88? If not, in what way and why?
25. Do you agree that carbon trading alone is an adequate and sufficient risk management tool?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
26. Is there scope for industry to insure against failure to meet targets?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
27. Any other comments?

G. What arrangements should be made for carbon trading?

89. Under the current scheme, target units may trade in the UK ETS. As of August 2008, UK ETS contained 13.2 million allowances. In addition, the equivalent of 3.5 million allowances were ring-fenced at the third review period. It is believed that most of this ring-fenced CO_2 is not yet verified and so could add to the 13.2m allowance overhang. This huge overhang of allowances on the market has depressed prices to below £2.00 per UK ETS allowance.

90. For an emissions trading scheme to incentivise emissions reductions an allowance price is needed that would:

- provide an incentive to undertake energy efficiency measures at costs up to the carbon price;
- provide an incentive to go beyond targets where abatement costs are low, to generate allowances for sale;
- continue to provide a lower cost method of meeting targets where abatement costs are high.

91. UK ETS was created in 2002 for Direct Participants and for Climate Change Agreement operators. The Direct Participant element of the scheme ended in 2006, though participants who generated allowances have continued to be able to trade them with Climate Change Agreement operators. The current Climate Change Agreements terminate in 2013, with reconciliation for the final target period taking place in January to March 2011. Though the market has been over-supplied with allowances, the Government believes that it was right that both Direct Participants and Climate Change Agreement operators continued to be able

to trade their allowances for the duration of the current agreements. However, a sufficient market price for the new agreements could not be achieved if the allowances remaining in UK ETS were carried forward into the new scheme. Consequently, **the Government does not propose to use UK ETS as the trading scheme for the new Climate Change Agreements.**

92. In accordance with the guidance on the future of the UK ETS Registry issued on 30 November 2005, the Government intends to keep UK ETS open until 31 December 2012. **However, the Government proposes to close the scheme after this date and to cancel any remaining allowances**, subject to a possible need to populate a new stand-alone scheme, to enable trading to take place from the start (see paragraph 99). Your views on this proposal are requested, in line with Rule G1 of UK ETS.

93. DECC has considered two options for trading under the new scheme: using the Carbon Reduction Commitment market or a new stand-alone scheme.

The Carbon Reduction Commitment market

94. A single trading market for both Climate Change Agreements and the Carbon Reduction Commitment was recommended by the Simplification Review, and 80% of those with Climate Change Agreements that responded to that review supported this recommendation. It would have the benefit of:

- avoiding the proliferation of trading schemes in the UK;
- reducing the operating costs of target units trading in different schemes; and
- establishing a common carbon price across the two schemes.

95. However, this could only be done if there was a low risk that Climate Change Agreements would generate an over-supply of allowances that might undermine the objectives of the Carbon Reduction Commitment.

96. It is anticipated that the total Carbon Reduction Commitment market will be in the region of 55 million allowances. However, the number of allowances traded on the secondary market is likely to be significantly lower than this (the majority simply being held and retired to meet obligations under the scheme). It is likely, therefore, that a relatively small over-supply of allowances from Climate Change Agreements (perhaps less than 200,000) would be sufficient to disrupt that market. In 2006, a net surplus of 1.3m allowances was generated under Climate Change Agreements. This suggests that the risks of a single trading market for both the Carbon Reduction Commitment and Climate Change Agreements are great. However, the Government will continue to consider the option of trading in the Carbon Reduction Commitment market if a suitable mechanism or mechanisms can be identified to ensure that there would not be a significant net flow of allowances from the Climate Change Agreements sector.

97. In June 2007, Government proposed that it should have powers to adjust key parameters of the Carbon Reduction Commitment market within Phases if absolutely necessary. This would include, as a last resort, a reduction in the cap. Two-thirds of respondents agreed, subject to strict controls on the use of the powers. In principle, it would therefore be possible to reduce the Carbon Reduction Commitment cap if substantial additional allowances were generated from Climate Change Agreements operators. However, this would mean that Carbon Reduction Commitment participants would bear the costs of over-supply by Climate Change Agreement operators. The Government does not believe that this would be an acceptable solution to the problem of over-supply by Climate Change Agreement operators and does not propose to deploy it.

A new stand-alone scheme

98. A new stand-alone scheme could operate on the same lines as UK ETS and with the same registry. The disadvantages mirror the advantages for a single trading market – a third carbon price within the UK, and higher general operating costs. The advantages would be to contain the effects of potential surplus generation of allowances within the Climate Change Agreements scheme.

99. If a new stand-alone scheme is established, it may be necessary to populate it initially with a limited number of allowances to ensure that trading could take place in the first target period. Options would have to be analysed, but this could be achieved by a number of means, including:

- Allowing purchase from the Carbon Reduction Commitment market or EU ETS.
- Transferring a limited number of allowances from UK ETS (e.g. on a discounted rate of, say, 1 for every 100 allowances held).

100. However, even if trading were to take place in a new stand-alone scheme, it would be important to avoid re-creating the conditions that led to over-supply in the UK ETS. To achieve this, DECC believes that it may be necessary to introduce a mechanism or mechanisms to limit the generation of allowances.

101. There are two main factors that determine the supply of allowances from Climate Change Agreements – energy efficiency measures and changes in throughput. Throughput changes can generate "windfall" allowances in two ways under the current scheme:

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

102. The current scheme recognises this potential for windfall allowances. In the case of relative targets there is a gateway to UK ETS that ensures that there is no net flow of allowances from the relative sector into the market. This is achieved by limiting sales of allowances to the extent that allowances have been purchased by target units with relative targets. In the case of absolute targets, the agreements provide that targets must be adjusted if throughput falls by more than 10% against that predicted (generally known as the CCA 16 procedure from the Climate Change Agreements paper that sets out the procedures to be followed – see Box 1 on page 32). This procedure establishes a relationship between production and energy use and therefore requires analysis of data for each case. It is manageable under the current scheme, where the total number of absolute targets is relatively small and it has usually been applied to only around 60 cases. It would not be manageable if all targets under the new scheme were made absolute, which may require its application in upwards of 1,000 cases.

103. DECC has examined a number of options for the new Climate Change Agreements, which are considered briefly below.

A. Have no restrictions, i.e. all allowances generated to be available to the market with no restriction (no CCA16-type procedure for absolute targets or gateway for relative targets). This could lead to serious over-supply of the market and a low allowance price. To the extent that any over-supply has been caused by energy efficiency measures this is of less concern, since the objectives of Climate Change Agreements would have been met. However, where it is simply a result of throughput fluctuations, it would undermine Climate

Change Agreement objectives and damage the integrity of the scheme. It would be possible for participants to use cheap allowances generated from throughput changes to meet negotiated targets that had been based on cost effective energy efficiency measures. Although this has not happened to a great extent under the current scheme, as targets tighten over time this risk will increase.

The following options aim to restrict either the generation of allowances from throughput changes or the use of such allowances.

B. Implement a CCA16-type procedure for both absolute and relative targets, i.e. adjust targets through an equation linking energy use to throughput, if throughput changes by more than a specified amount, e.g.10%. Although this depends on good data from participants, this can produce a reasonably accurate result (i.e. allowing some distinction to be made for allowances created due to energy efficiency effort). However, this would place a significant administrative burden on both industry and government. Some consideration would also need to be given to the current 10% threshold. Climate Change Agreements cover over 70MtCO_2, meaning that, at the extreme, up to around 7 million allowances could be generated before the CCA16 procedure had effect.

C. Restrict allowance generation through a formula, i.e. establish a limit to the number of allowances that can be generated by any target unit in relation to the fall or rise in throughput. It may be possible to develop such a formula that is simple to administer for large numbers of target units. However, it is likely to be less accurate than a CCA16-type approach in distinguishing between allowances generated through throughput changes and those generated through effort.

D. Set an overall cap on allowances after reconciliation, i.e. reduce the number of allowances generated through throughput changes available to the market when the total supply is known. While this would control supply, it would be direct interference in the market. There could be difficulties in identifying the effect of throughput across sectors and in determining how to reduce the allowances of individual target units in an equitable way. For those that need to buy allowances to meet targets in the first target period, there would be a need to access allowances from another source (e.g. EU ETS).

E. Set a sector cap on allowances, i.e. each sector would have a limit on allowance generation related to throughput changes and would be responsible for managing its application. This would reduce the administrative burden on government but would add considerably to the burden on sector associations. They would need to determine the effect of throughput across the sector. They may be faced with serious complexities in balancing between target units with relative (if these are retained) and absolute targets and those with different growth patterns.

F. Restrict banking between years, i.e. limit the number or proportion of allowances that could be carried forward from one target period to the next. This would be relatively easy to administer and would limit any adverse impact of surplus generation to one target period. However, it may be difficult to establish the correct limit and it could effectively remove the benefit to smaller target units, which can currently accumulate small surpluses over several target periods to reduce the overall cost of verification.

G. Cancel "surplus" allowances remaining in the market at the time of the target review, i.e. establish powers within the agreements for government to review the state of the market at the time of the review and remove some or all of any surplus allowances. This would be similar to the proposed powers in the Carbon Reduction Commitment market. It would shorten the period in which surplus allowances could accumulate, but have no effect in target periods prior to the review.

104. While each of the options identified above have advantages, they also have disadvantages. The Government would therefore like the views of interested parties before seeking to develop detailed proposals.

Links to Other Issues

1. The decision on whether targets should be set in relative or absolute terms (see paragraphs 47 to 54) will impact on the type or types of mechanism needed.
2. If targets are set on an annual basis (see paragraphs 62 to 66), this would double the potential for creation of allowances when compared with current Climate Change Agreements, for which targets are set every two years.
3. Option G above would be valid only if it is decided to hold a target review under new Climate Change Agreements (see paragraphs 67 to 78).
4. The proposals to set absolute targets with no allowance for growth may reduce the potential to generate surplus allowances (see paragraphs 49 to 50).

Proposal

1. To close UK ETS at the end of current Climate Change Agreements and to cancel all remaining allowances.
2. Views of interested parties are sought on whether trading under new Climate Change Agreements should take place in the Carbon Reduction Commitment market or in a new stand-alone scheme.
3. Views of interested parties are sought on how a realistic carbon price can be maintained in the market and whether and how the generation of allowances due to throughput changes should be limited.

Other Options

Maintain UK ETS with or without cancelling allowances remaining at the end of current Climate Change Agreements.

Questions

28. Do you agree with the analysis in paragraphs 89 to 104? If not, in what way and why?
29. Do you agree that UK ETS should be closed after 31 December 2012 and all remaining allowances cancelled?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
30. Do you consider that trading under the new scheme should take place in the Carbon Reduction Commitment market or a new stand-alone scheme?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
31. Do you agree that a mechanism or mechanisms should be introduced to limit the generation or use of allowances due to changes in throughput?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
32. Do you agree with any of the options identified in paragraph 103?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of the options, including the administrative burden and financial cost.
33. Do you have any alternative suggestions for mechanisms to limit the generation or use of allowances due to changes in output? If so, please set out in detail what they are, identifying the advantages and disadvantages, including the administrative burden and financial cost.
34. Any other comments?

Box 1: "CCA16" procedure

1. Under the current Climate Change Agreements, absolute targets are set with reference to predicted levels of throughput at the relevant target period. However, these absolute targets are adjusted according to the CCA16 procedure if throughput in a target period falls to below 90% of the level predicted when the target was set. Identification of the level of throughput may not be straightforward for some sectors, and involves predicting market growth and market share.

2. The CCA16 procedure is applied as follows:

   - It is applied first at target unit level. It applies to all target units with absolute targets, irrespective of whether the sector has an absolute or relative target. Where, in a target period, the throughput of a target unit is below 90% of the throughput predicted at the time targets were set, the target is adjusted downwards in line with one of the methods identified in paragraph 3 below. Such adjustments are made before any adjustment to the sector target for changes in throughput.
   - The procedure is also applied at sector level to all sectors with absolute targets. The throughput of a sector changes as a result of variations in the throughput of all its constituent target units, including those with relative targets. Where the throughput of the sector has fallen by more than 10% from the predicted level, the target is adjusted downwards according to the relevant method in CCA16. The new sector target takes account of any adjusted target unit targets resulting from a fall in throughput.

3. For a target unit, target adjustment is achieved by one of three methods:

   a. A simple change in energy use proportional to the fall in output i.e. the equivalent of a straight line relationship between energy and output through the origin;
   b. Establishing the relationship between the throughput measure and the target unit's energy use through regression analysis; or
   c. An alternative method agreed between the target unit and DECC.

4. The adjustment is tapered so that the full adjustment applies where throughput has fallen by 80% or more.

H. Should provisions for *de minimis* and materiality be introduced?

105. Current Climate Change Agreements provide that where a target unit fails to meet its target or purchase the required allowances, it will be decertified and cannot claim the levy discount for two years, or until the next target period. There is no *force majeure* provision. This has proved a very successful incentive for target units to meet targets, and the Government does not want this incentive to be eroded. In the 2006 target period, over 99% of target units were re-certified.

106. However, for the new scheme, the Government is proposing to require all target units to meet targets either through direct action or through the purchase of allowances (see paragraphs 79 to 85) and to limit risk management tools to carbon trading only (see paragraphs 86 to 88). This would represent a tightening of obligations on individual target units.

107. It is recognised that most failures to meet targets under the current scheme have been due to oversight, where a small number of allowances have not been bought by the due date. Handling complaints by operators concerning decertification is administratively burdensome and time consuming for both operators and government. This burden could be significantly reduced by the introduction of a ***de minimis*** provision, under which the operator is given a short extension of time in which the required number of allowances could be bought and retired.

108. A *de minimis* provision could only apply to very limited failures to meet targets. DECC has considered setting a fixed limit of, say, 50 allowances, or a variable limit, such as 1% of the target. However, in a limited analysis of over 800 target units, targets under the current Climate Change Agreements ranged from the equivalent of 2 tonnes of CO_2 to over 20 million tonnes. 12% had targets equivalent to 500 tonnes of CO_2 or less and 99% had targets equivalent to 5000 tonnes of CO_2 or less. Setting a sensible fixed limit for this range of target units is not possible.

109. A *de minimis* provision of 1% of the target may not provide sufficient flexibility in all circumstances. An alternative approach would be to establish a **materiality** provision. Under such a provision, a target unit that failed to meet its target up to a specified limit would be required to purchase and retire the number of allowances in the shortfall AND make a payment proportionate to the failure. Given the inclusion of a payment, the specified limit could be higher than under a *de minimis* provision.

110. In considering what limit might be applied to a materiality provision, DECC considered both fixed and variable limits. A fixed limit would have the same drawbacks as for a *de minimis* provision, but a variable limit of say, 2% of the target could be considered appropriate. DECC also considered both fixed and variable rates for the payment provision. A fixed rate could be based on the penalty currently applied under EU ETS (€100 per allowance – around £80) and a variable rate could be based on a multiple (say 5 times) the value of the allowances bought to make up the shortfall.

111. Given the proposed tightening of obligations on individual target units (see paragraph 106 above), and given the range of circumstances under which target units might fail to meet targets, **it is proposed to introduce both a *de minimis* and a materiality provision.**

Links to Other Issues

1. It is proposed that all target units be required to meet targets by direct action or by purchase of allowances, irrespective of sector performance (see paragraphs 79 to 85).
2. It is proposed that carbon trading become the only risk management provision (see paragraphs 86 to 88).

Both these proposals may have the effect of tightening obligations on individual target units

Proposal

To introduce:

a. a *de minimis* provision for failure to meet targets by up to 1% of the target. The operator would be required to purchase and retire the relevant number of allowances in the shortfall within 10 working days of notification by DECC; **AND**
b. a materiality provision where failure to meet targets is greater than 1% of the target but no more than 2% of the target. The operator would be required to purchase and retire the total number of allowances in the shortfall within 10 working days of notification by DECC and, for that part of the failure to meet targets beyond 1%, make a payment of £80 for each allowance in this part of the shortfall.

Other Options

1. No change, i.e. decertification, whatever the level of failure.
2. A *de minimis* provision for shortfalls of up to 1% of the target, with the requirement to purchase and retire the number of allowances in the shortfall within 10 working days of notification by DECC, but no materiality provision.
3. No *de minimis* provision but a materiality provision with a limit of 2% of the target, and a requirement to purchase and retire the number of allowances in the shortfall within 10 working days of notification by DECC and make a payment of £80 for each allowance in the shortfall.

Questions

35. Do you agree with the analysis in paragraphs 105 to 111? If not, in what way and why?
36. Do you agree that both a *de minimis* provision and a materiality provision should apply?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
    - If you do not agree, please state which alternative option you prefer and why.
37. If a *de minimis* provision is introduced, do you agree that the limit should be 1% of the target?
    - If not, please indicate what limit you would prefer, and why.
38. If a materiality provision is introduced, do you agree that the limit should be 2% of the target?
    - If not, please indicate what limit you would prefer, and why.
39. If a materiality provision is introduced, do you agree that the payment to be made should be £80 for each of the allowances to be bought?
    - If not, please indicate what other level of payment you would consider appropriate, and why.
40. Any other comments?

I. In the case that relative targets continue, should the "Novem" procedure for setting targets and measuring performance continue to be used in relevant sectors and target units?

112. Under current Climate Change Agreements, the "Novem"[26] procedure has been used by certain sectors and target units for setting relative targets and measuring performance. The Novem procedure applies only where targets are relative. If it is decided to set all targets in absolute terms (see paragraphs 47 to 54), there would be no need for a Novem procedure under the new scheme.

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

114. The Novem method was devised to resolve this problem. The basic principle is that the energy used for the actual production level in the target year is compared with the energy that would have been used for the same level of production and mix of products at the efficiency of production in the base year.

[26] See Box 2 for an explanation of the Novem procedure and a worked example based on relative energy targets. Novem works equally with carbon based relative targets. For further information see Climate Change Agreement guidance paper CCA-D03: http://www.defra.gov.uk/environment/climatechange/uk/business/cca/papers.htm.

Box 2: The 'Novem' procedure

Relative targets are based on an amount of energy per unit of production, commonly referred to as the specific energy consumption (SEC). Consequently, to set a relative target for a sector or target unit a single production measure needs to be established. This is difficult where a sector or target unit produces a range of different products, e.g. a paint manufacturer may produce paint by the litre and coated (sheet) products by the square meter. The Novem procedure enables targets for such sectors or target units to be set and performance measured.

The basic principle is that the energy used for the actual level of production in the target year is compared with the energy that would have been used for the target year levels of production at the efficiencies of production in the base year. To achieve this, the SEC for each product in the base year must be known and a target SEC for each product agreed. Taking the example of the paint manufacturer, the target is set as follows:

The energy used in the base year (Base Energy) is:

(Base throughput x Base SEC for paint) + (Base throughput x Base SEC for sheet)

The energy used in the target year (Target Energy) is:

(Target throughput x Target SEC for paint) + (Target throughput x Target SEC for sheet)

The target becomes the ratio (R) of these amounts:

$$R = \frac{\textit{Target Energy}}{\textit{Base Energy}}$$

Performance in the target period is evaluated by comparing the ratio (RT) of the base year energy **at target year throughput** to the actual energy used. This ratio (RT) is calculated as follows:

$$RT = \frac{\textit{Actual energy}}{\textit{(Target Year throughput x Base SEC for paint) + (Target Year throughput x Base SEC for sheet)}}$$

The target is met if RT is equal to or lower than R.

Adding figures to the above example, we can determine the following:

Target

Base year production: 10,000 litres of paint at 10 kWh per litre and 500 m^2 of sheet at 50 kWh per m^2.
The target is 8 kWh per litre and 45 kWh per m^2.
Base energy is (10,000 x 10) + (500 x 50) = 125,000 kWh.
Target energy is (10,000 x 8) + (500 x 45) = 102,500 kWh.

Target ratio (R) is: $\frac{102{,}500}{125{,}000}$ = **0.82**

Performance

Target year production: 12,000 litres of paint and 450 m^2 of sheet, using a total of 115,425 kWh.

Target period ration (RT) is: $\frac{115{,}425}{(12{,}000 \times 10) + (450 \times 50)}$ = **0.81**

As the performance ratio (0.81) is lower than the target ratio (0.82), the facility passes.

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

Links to Other Issues
Novem will not be required if all targets are set in absolute terms (see paragraphs 47 to 54)

Proposal
Continue to apply Novem for relevant sectors and target units, but require that Novem be applied in all cases, irrespective of whether the result is advantageous or disadvantageous to the sector or target unit concerned.

Other Options
1. Continue with Novem in its current form for sectors and target units.
2. Develop an alternative methodology for combining diverse targets, for example, a one-off weighting procedure.

Questions
41. Do you agree with the analysis in paragraphs 112 to 115? If not, in what way and why?
42. Do you agree that Novem should continue to be applied, but in an obligatory way, for relevant sectors and target units?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
43. Do you consider that an alternative method should be developed for combining diverse targets?
    - If so, please set out your proposal, identifying the advantages and disadvantages of the proposal, including the administrative burden and financial cost.
44. Any other comments?

Issues Related To Coverage Of Targets

J. Should targets be split where there is an overlap between Climate Change Agreements and EU ETS?

116. Climate Change Agreements cover direct (fossil fuel) and indirect (electricity) emissions and some process emissions. EU ETS covers both direct and process emissions. Consequently a number of target units are partially covered by both schemes in terms of direct and process emissions.

117. Within the area of overlap, the same over-achievement could result in the generation of allowances under both schemes, while under-achievement could result in a requirement to purchase allowances under both schemes. To avoid this possibility of a double benefit or double jeopardy, a double counting mechanism was introduced, under which any EU ETS surplus is netted off from the Climate Change Agreement performance. Industry preferred this to splitting EU ETS emissions from the Climate Change Agreement target.

118. Following experience with the double counting mechanism, it appears that a majority of industry now has a preference to split the Climate Change Agreement target, provided that this has no impact on the Climate Change Levy discount. This view was confirmed by the majority of responses to the consultation on the Simplification Report -"Climate Change Instruments: Areas of Overlap and Options for Simplification", which took place earlier this year.[27]

119. The Government is concerned that, if Climate Change Agreements targets are split, this should have no Levy revenue implications. Target splitting and fiscal neutrality could be achieved through establishing two elements to the Climate Change Agreement target: the emissions covered by the EU ETS; and a residual Climate Change Agreement target. The emissions covered by the EU ETS would be the direct and process emissions of the facility, including any emissions resulting from Combined Heat and Power plant covered by EU ETS, whether or not located on the same site or owned by a third party, that supplies the facility. The residual Climate Change Agreement target would be made up of any indirect emissions, any direct or process emissions not covered by the EU ETS and emissions related to any Combined Heat and Power plant that supplies the facility that is not subject to EU ETS. The residual target would be determined by negotiation between sector associations and DECC, as now.

120. **It is proposed, therefore, that the terms of the Climate Change Agreements be changed so that the reduced rate of Climate Change Levy would be payable on the same basis as the current scheme if:**

a) sufficient allowances are surrendered to meet EU ETS obligations; and

b) the residual Climate Change Agreement target is met.

Only over-achievement against the residual Climate Change Agreement target could be converted into allowances in the context of Climate Change Agreements.

121. The Government announced in the Pre-Budget Report 2008[28] that this proposal will not result in a change to eligibility for the Climate Change Levy discount.

122. In examining the proposal to split targets, respondents may wish to take into consideration the possible impact of the proposal under EU ETS to move from a "medium" to a "broad" definition of a combustion installation.

123. EU ETS and Climate Change Agreements currently have different compliance periods. Compliance with the EU ETS element of the Climate Change Agreement target would therefore have to be based on the most recent EU ETS compliance year available. However, it is proposed to change the Climate Change Agreements compliance year to a calendar year (see paragraphs 134 to 140) that would result in an alignment of the compliance year with that of EU ETS.

124. In their responses to the Simplification Report, some respondents expressed concern that splitting targets should have no impact on the 90/10 rule. There will be no impact. The full extent of the eligible facility, including any element resulting from the application of the 90/10 rule, would still need to be identified, for the purposes of calculating eligibility for Levy reduction. In addition, the residual Climate Change Agreement target could only be assessed once the extent of the eligible facility was known.

[27] http://www.defra.gov.uk/environment/climatechange/uk/business.

[28] See paragraph 7.65 of the Pre-Budget Report 2008: http://www.hm-treasury.gov.uk/d/pbr08_chapter7_159.pdf.

Links to Other Issues
The proposal to align the Climate Change Agreements compliance year with that of EU ETS (see paragraphs 134 to 140) will simplify the implementation of this proposal.

Proposal
1. To change the terms of the Climate Change Agreements so that facilities would be re-certified as eligible to claim the reduced rates of Climate Change Levy if:
   a) sufficient allowances are surrendered to meet EU ETS obligations; AND
   b) the residual Climate Change Agreement target is met.
   This change will not affect the amount of Climate Change Levy discount that re-certified facilities may claim.
2. To establish the residual Climate Change Agreements target by negotiation between sector associations and DECC.
3. To restrict the creation of allowances under Climate Change Agreements to over-achievement against the residual Climate Change Agreements target.

Other Options
No change, i.e. continue with the existing double counting mechanism.

Questions
45. Do you agree with the analysis in paragraphs 116 to 124? If not, in what way and why?
46. Do you agree that Climate Change Agreement targets should be split and agreements amended as proposed?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
47. If the double counting mechanism is retained, is there anything that could be done to make it less complex or more accurate?
48. Any other comments?

K. Has the 90/10 rule provided administrative or environmental benefits that could be extended to a larger number of businesses by lowering the threshold?

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

126. The 90/10 rule was introduced to reduce administrative effort and associated costs for both industry and government. For example, it allows eligible facilities to avoid the need to meter separately a small fraction of their overall energy use. However, it may also provide an additional incentive to business to join a Climate Change Agreement by increasing the amount of Levy discount that can be claimed and widening the scope of measures that could be taken to improve energy efficiency to meet targets.

127. The Government would welcome industry's views on whether the 90/10 rule has had its intended effect. If so, there may be a case to consider lowering the threshold, for example to 70%, to extend the benefit of reduced administrative effort and cost to a larger number of businesses.

128. In addition, the report of the Environmental Audit Committee noted that *"Another common theme from business groups has been to argue that the criteria for inclusion in each carbon reduction scheme should be widened, so that, for instance, it was [...] easier for an Agreement to apply to the whole site. Given the extra progress on energy efficiency which the process of complying with Climate Change Agreements appears to have driven, we recommend that the Government look favourably on such proposals".* This could be achieved by lowering the 90% threshold.

129. However, the Government would need to ensure that any change would represent good value for money, and would thus welcome evidence of the value to participants of amending the rule.

130. Any possible change to the 90/10 rule could also consider the benefits of continuing to offer the 1/9th provision. Currently, where an energy intensive installation fails to meet the 90/10 test the eligible facility may be extended to cover non-eligible activities up to an additional 1/9th of its eligible energy use, provided that the activities are discrete, e.g. an air compressor, and are separately sub-metered. However, for those that claim an additional 1/9th, the attendant record keeping to comply with this provision may add to the administrative burden, which could reduce or even outweigh the value of the additional 1/9th.

131. If changing the 90/10 rule to a lower threshold of 70% would capture the vast majority of existing facilities, as some stakeholders have suggested, the additional 1/9th would become irrelevant to them. However, the limited evidence available to government suggests that there could be a number of facilities that would fall below a 70% threshold. For these facilities, removing this additional 1/9th could therefore decrease the total amount of energy that is subject to a Levy discount on the site by up to 7.7% (69 x 1/9th). The Government would therefore welcome evidence on how many facilities would be affected by such a proposal. In addition, evidence on the value of the additional 1/9th, given the need for it to be separately sub-metered, would be welcomed.

Links to Other Issues
None.

Proposal
None. Views of stakeholders sought.

Other Options
None.

Questions
49. Do you agree with the analysis given in paragraphs 125 to 131? If not, in what way and why?
50. Has the 90/10 rule provided administrative or environmental benefits that could be extended to a larger number of businesses by lowering the threshold?
    - Please set out the reasons for your opinion, including evidence relating to the numbers affected, the administrative burden and financial cost.
51. Do you have any views on the value of the 1/9th provision?
    - Please set out the reasons for your opinion, including administrative burdens and financial costs.
52. Any other comments?

Issues Related To Simplification

L. Should only one agreement type be available, based on "Option 2" under the current scheme?

132. There are two types of agreement under current Climate Change Agreements. For sectors with "Option 2" agreements, the underlying agreement is between the target unit and the Secretary of State. Under "Option 3" agreements, the underlying agreement is between the target unit and the sector association, approved by the Secretary of State. The terms of the agreements are in all other respects identical. Six sectors operate Option 3 agreements. Since 2006, DECC has restricted agreements for all new sectors to Option 2 only.

133. The Government considers that there is no useful purpose served by having two types of agreement and therefore **proposes to issue a single type of underlying agreement between the Secretary of State and target units.**

Links to Other Issues
None.

Proposal
To offer only one type of agreement under new Climate Change Agreements based on the current Option 2.

Other Options
Retain the current choice between two types of agreement.

Questions
53. Do you agree with the analysis in paragraphs 132 to 133? If not, in what way and why?
54. Do you agree that there should be only one type of agreement based on the current Option 2?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative and financial cost.
55. Any other comments?

M. Should the compliance year be aligned with that for EU ETS, based on a calendar year?

134. Current Climate Change Agreements have a variable 12-month monitoring and reporting period (target period). When the agreements were originally established, sector associations were able to select a starting date for the target period: the beginning of October, November, December or January. Thirty-six sectors use October to September; one sector uses November to October; five sectors use December to November; and ten sectors use January to December.

135. A significant number of target units with Climate Change Agreements are also subject to the EU ETS. The issue of aligning the monitoring and reporting periods of Climate Change Agreements, EU ETS and the Carbon Reduction Commitment was addressed in the consultation on the report on "Climate Change Instruments: Areas of Overlap and Options for Simplification"[29]. Since then, it has been decided that the Carbon Reduction Commitment will operate on a financial year basis. However, 87% of respondents to the report supported the alignment of the monitoring and reporting periods of Climate Change Agreements and EU ETS. Given that the monitoring and reporting period for EU ETS is fixed by the EU on a calendar year basis, alignment could only be achieved by basing all Climate Change Agreement target periods on a calendar year.

[29] http://www.defra.gov.uk/environment/climatechange/uk/business.

136. Aligning the monitoring and reporting periods of these two schemes could have a number of potential benefits, including:

a. A reduction in the administrative burden on businesses in terms of recording, reporting and provision of data for audit purposes, since much of the information required under the schemes is common (e.g. data on fuel used in combustion).

b. Reporting under Climate Change Agreements for surrendering sufficient allowances to meet EU ETS obligations and the residual Climate Change Agreement target would be aligned (see also paragraphs 116 to 124 on double counting issues).

137. The Government therefore **proposes to establish a common target period for all sector associations based on a calendar year.**

138. Under Climate Change Agreements, all data must be submitted to DECC by 7 February immediately following the end of a target period. Should a common target period be established for all sectors on a calendar year basis, not all sector associations (particularly those with large numbers of members) would be able to submit data by 7 February. In addition, those sectors with energy use covered by EU ETS would not be able to report on compliance with that scheme. Under EU ETS, operators are required to provide a verified emissions report for the previous calendar year by the end of March and to surrender allowances by the end of April. Taking this into account, the Government **proposes that under new Climate Change Agreements sector associations be required to submit data by 31 March following the end of a target period, and that the reconciliation period be completed by 31 May with the period of qualification for Levy reduction starting on 1 June.**

139. If the start of the period for Levy reduction is to change to 1 June, there would be a potential hiatus between the end of the period of Levy reduction under the current scheme (31 March 2013) and the start of the first period of Levy reduction under the new scheme (1 June 2013). This could be handled in one of two ways:

a. Allowing the hiatus to occur, meaning that all Climate Change Agreements operators would be required to pay the full Levy for the two months in question; or

b. Extending the period of Levy reduction in the final period under the current scheme to 31 May 2013.

140. The Government acknowledges that, as the change of target period is intended to reduce administrative burden, it would be illogical to penalise businesses by requiring them to pay the full Levy for two months. It therefore **proposes to extend the final period of Levy reduction under the existing scheme to 31 May 2013**. However, given that the aim is simply to bridge a potential hiatus between the current and the new scheme, **this extension would only apply to those that have agreements under the current scheme and enter into agreements under the new scheme.**

Links to Other Issues
Adoption of this proposal would simplify the handling of double counting issues for target units that have overlap with EU ETS (see paragraphs 116 to 124)

Proposal

1. To establish a common monitoring and reporting period with EU ETS based on a calendar year, with sector associations being required to submit data by 31 March, reconciliation to be completed by 31 May, and Levy reduction to be valid from 1 June.
2. To extend the period of Levy reduction under the final target period of the current scheme to 31 May 2013 for those operators with agreements under the current scheme that enter into agreements under the new scheme.

Other Options

1. No change, i.e. sector associations should continue to be allowed to choose the monitoring and reporting period as under the current scheme.
2. Establish a common monitoring and reporting year as proposed but grant no Levy reduction in the period 1 April to 31 May 2013.

Questions

56. Do you agree with the analysis in paragraphs 134 to 140? If not, in what way and why?
57. Do you agree that a common target period should be established under Climate Change Agreements based on a calendar year?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
58. Do you agree that, if the start of the period for Levy reduction was to change to 1 June, that the period for Levy reduction under the current scheme should be extended to 31 May 2013 only for those target units that have agreements under the current scheme and that enter into agreements under the new scheme?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
59. Any other comments?

N. Should all sectors, whether meeting targets or not, be required to provide the same data at reconciliation?

141. When reporting performance at the end of each target period, sector associations that meet their targets are not currently required to provide DECC with the same detail of information as those that do not meet their targets. Schedule 3 to the umbrella agreements sets out the requirements (see Box 3).

142. In addition, sectors that operate "model 2" trading groups[30] report any trading activities on a group basis only, and not the effective trading of individual target units. Consequently it is not possible to confirm correct reporting at reconciliation without a sector audit or to evaluate the performance of the sector in any depth.

143. Clause 6.8 of the umbrella agreement provides that the Secretary of State may at any time serve notice on the sector association to provide him with such information as he may require in connection with his functions under Schedule 6 to the Finance Act 2000.

[30] Under "model 2" trading groups, members voluntarily surrender the right to participate as individuals in the UK ETS. The sector association assumes full responsibility for any emissions trading for the members of the group. DECC recognises the benefits of trading groups as a low-cost option to achieve compliance (e.g. through bulk verification of over-achievement) and does not wish to discourage their formation.

144. In operating the agreements, DECC has found it necessary to request considerable additional information to test whether the sectors and target units have met their targets. In addition, the absence of full reporting data for those sector associations that have met their targets has hindered DECC's ability to understand fully individual sector performance and comparative performance between sectors, and to carry out full data analysis in order to monitor the performance of the scheme as a whole. It is important that the Secretary of State has access to all information necessary for the proper functioning of the scheme. Examples of what data is not immediately available and the use to which that data might be put are given in Table 2 below.

Table 2: Use of data supplied at reconciliation

Data Not Immediately Available	Potential Use of data
Numbers of target units meeting their individual targets at a reconciliation.	Target reviews – evaluation of sector performance in other axes than a sector axis.
Fuel usage by target unit.	• Evaluation of carbon coefficients for accurate energy to carbon conversions/ carbon emissions evaluation by subgroups e.g. those with absolute targets. • Enables accurate cost/ benefit analyses. • Understanding EU ETS / Climate Change Agreement interactions. • Understanding changes in fuel usage.
Analysis of performance of target units.	Evaluation of impacts of potential changes/ enhancements to Climate Change Agreements.
Clarity on sector performance submissions.	Facilitates accurate and rapid assessment of sector performance at reconciliation for re-certification.

Box 3: Information to be provided at reconciliation under current Climate Change Agreements

Information to be provided by Sectors that meet targets (Part 1 of Schedule 3 of the Umbrella Agreements)	**Additional information to be provided by Sectors that do not meet targets** (Part 2 of Schedule 3 of the Umbrella Agreements)
1. The total number of units of energy used by relevant facilities during the relevant target period calculated in accordance with paragraph 2 of Schedule 2 with a sufficient breakdown of that information to determine whether the currencies of the sector targets need to be changed under paragraph 7 of that Schedule. 2. If the sector target for the relevant target period is a carbon target, the total number of units of carbon emitted from the relevant facilities during that period calculated in accordance with paragraph 3 of Schedule 2. 3. The total throughput for the relevant facilities in the sector for the relevant target period calculated in accordance with paragraph 4 of Schedule 2. 4. The adjustment to be made to the sector target for the relevant target period in accordance with paragraph 1.2 of Schedule 2. 5. For each target unit with an absolute target for the relevant target period, the throughput of that target unit during that period calculated in accordance with paragraph 4 of Schedule 2 to the relevant underlying agreement.	1. For each target unit, the total number of units of energy used during the relevant target period by the target unit in relation to each type of fuel calculated in accordance with paragraphs 2 and 5 of Schedule 2 to the relevant underlying agreement. 2. For each target unit with a carbon target for the relevant target period, the total number of units of carbon emitted from the target unit during that period calculated in accordance with paragraph 3 of Schedule 2 to the relevant underlying agreement. 3. For each target unit with a relative target for the relevant target period, the throughput of that target unit during that period calculated in accordance with paragraph 4 of Schedule 2 to the relevant underlying agreement. 4. For each target unit where the target is to be adjusted under paragraph 1.2 or 1.3 of Schedule 2 to the relevant underlying agreement, the information needed to calculate the adjustment. 5. For each operator which relies on clause 7.4(a), a copy of its energy plan and a description of the steps taken to implement the plan. 6. For each operator which relies on clause 7.4(b), details of the relevant constraint or requirement and of its impact on the performance of the operator.

145. All sector associations require full data reporting from their members in order to be able to assess what trading is possible/necessary (where a "model 2" trading group exists), whether or not the sector as a whole has met its target and, if not, to provide the necessary information to DECC. Provision of full data to DECC in all cases should, therefore, be possible at little or no additional administrative burden or financial cost. Indeed, a number of sector associations that meet targets currently provide full reporting to DECC on a voluntary basis.

146. The Government therefore **proposes to require the same detailed reporting from all sector associations under the new Climate Change Agreements, irrespective of whether or not the sector meets its target, including the effective trading position of all target units.** The detail of the data reporting requirements could be set out in the proposed Scheme Rules (see paragraphs 156 to 159).

Links to Other Issues

1. Frequency of reporting would increase if the proposal to establish annual target periods is adopted (see paragraphs 62 to 66).
2. Details of reporting requirements could be contained in the proposed Scheme Rules (see paragraphs 156 to 159).

Proposal

To require the same detailed reporting from all sector associations, irrespective of whether or not the sector meets its target, including the effective trading position of all target units.

Other Options

No change. Continue with existing reporting requirements.

Questions

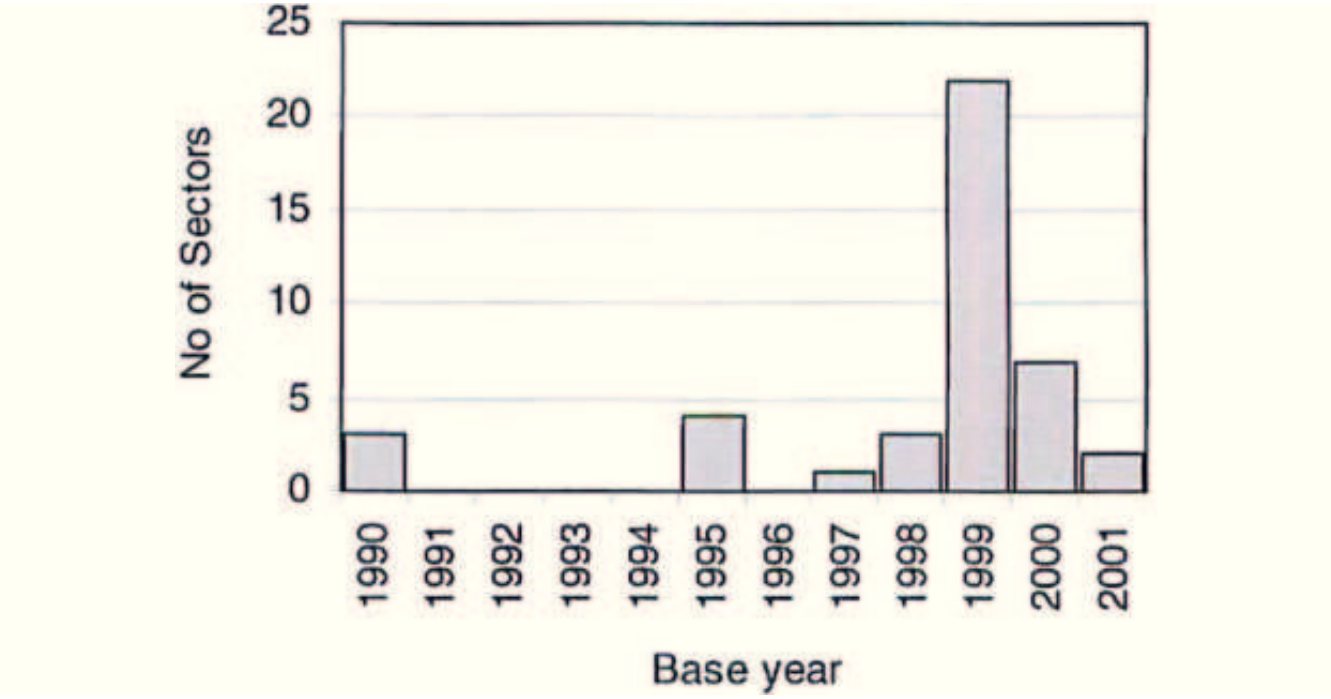
60. Do you agree with the analysis in paragraphs 141 to 146? If not, in what way and why?
61. Do you agree that all sector associations should be required to provide full data reporting, including the effective trading position of all target units?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative and financial cost.
62. Any other comments?

O. Should a common start date be established, for the purpose of measuring the impact of the scheme, based on 2010 performance?

147. The impact of Climate Change Agreements is measured by comparing actual **energy or carbon savings** achieved by all sectors against an estimate of what might have been achieved under Business As Usual conditions. The savings are currently calculated against particular points in time – the base year for each sector. It should be noted that assessing the impact of Climate Change Agreements is different from assessing the performance of individual sectors or target units, which is done by comparing **energy use or carbon emissions** against targets.

148. Under current Climate Change Agreements different sectors have different base years. This was in recognition of the fact that many industries had already undertaken energy efficiency improvements without any incentive and an earlier base year allowed this to be demonstrated. Figure 1 shows the number of sectors by base year for early entrants.

Figure 1: Distribution of base years



149. Base year data is not used in setting targets. Under current Climate Change Agreements targets were set against the state of play in 2000, to which any earlier achievement reflected in the choice of an earlier base year was simply added. So the base year chosen had no effect on the stringency of targets. Targets under the new Climate Change Agreements will be set by reference to a number of factors, in particular against advice from the Committee on Climate Change on the level of contribution to be expected from the Climate Change Agreement sector to meet carbon budgets. Targets will be set, as now, by negotiation with sectors, so that sector specific factors can be taken into account.

150. The report of the Environmental Audit Committee noted the complexity and uncertainty in accounting for the impact of Climate Change Agreements, and commented that *"it is remarkable that the performance of most sectors is measured from a variety of different starting points that pre-date the start of the Agreements, in three cases stretching all the way back to 1990"*[31].

151. Two factors in particular have made it very difficult to provide a reliable assessment of the impact of current Climate Change Agreements across the whole scheme: the use of different base years between sectors and the inherent uncertainties in the calculation of Business As Usual projections. Improvement to the calculation of Business As Usual projections falls outside the scope of this consultation. Establishing a common start date across all sectors for assessing the impact of Climate Change Agreements would remove one level of uncertainty.

152. The Government recognises that a disadvantage of using a common start date is that the date chosen may be untypical (e.g. a year of high growth or recession) either across the UK economy generally or specific to one or more sectors. Nevertheless, the start date would simply establish a yardstick and results could be interpreted accordingly.

153. There are a number of options for a start date:

a. 1990 is the base year for UK national carbon reduction targets and the Kyoto Protocol, but many sectors do not have accurate data this far back.

[31] Paragraph 35: http://www.publications.parliament.uk/pa/cm200708/cmselect/cmenvaud/354/354.pdf.

b. 2002 is the first year for which actual performance data is available under current Climate Change Agreements. However, a number of additional sectors have joined since and these sectors are unlikely to have reliable data going back to 2002.

c. 2010 is the final target period under current Climate Change Agreements, and the first for which there will be sound performance data from all current sectors. Using performance data from 2010 would also have the benefit of producing an assessment of the impact of the new Climate Change Agreements alone.

154. The Government therefore **proposes to establish a start date for the purposes of measuring the impact of Climate Change Agreements based on performance data in the 2010 target period.**

155. The scope for additional sectors to join Climate Change Agreements is now very limited. However, should a new sector join the scheme, the expectation would be for them to use the common start date, unless that was totally impractical. In the latter case the most recent appropriate year would be chosen.

Links to Other Issues
None.

Proposal
To establish a common start date for the purpose of assessing the impact of Climate Change Agreements, based on performance in the 2010 target period.

Other Options
1. No change, i.e. continue to use the base years established under current Climate Change Agreements.
2. To establish a common start date, based on performance in a target period other than 2010.

Questions
63. Do you agree with the analysis in paragraphs 147 to 155? If not, in what way and why?
64. Do you agree that a common start date should be established, based on performance in 2010?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
    - If you do not agree, please state which option you prefer and why.
65. Any other comments?

P. Should Scheme Rules be established, separate from the agreements, to facilitate their adjustment when necessary?

156. Current umbrella and underlying agreements are stand-alone (other than linkages between the two levels of agreement) and contain all the detail necessary to implement the agreements. Any changes to the scheme therefore need to be reflected in changes to each agreement, thereby requiring the approval of all target units (around 5,000). Consequently, making changes to the scheme is administratively burdensome and can be difficult if a minority of parties disagree with a change desired by the majority. This makes the agreements inflexible and potential improvements, to the benefit of industry and government, are not pursued. The result has been that, in the lifetime of the current agreements, only one change has been made.

157. This inflexibility was avoided in UK ETS by the establishment of scheme rules. These rules were set out in the UK Greenhouse Gas Emissions Trading Scheme 2002 (as amended). Within that Scheme, the Secretary of State has the power to amend the Scheme at any time, including for the purpose of correcting errors, for improving the functioning of the Scheme, and for the purpose of complying with any decision taken by the Commission in relation to State aids approval for the Scheme. Before exercising this power, the Secretary of State is required to consult those he considers affected by the change, except in certain circumstances, including for the purpose of complying with any decision taken by the Commission in relation to State aids approval for the Scheme, and where the Secretary of State considers the matter so urgent that it is inappropriate to consult.

158. The Government **proposes to introduce similar Scheme Rules for the new Climate Change Agreements.** The structure would be as follows:

a. Agreements between the relevant parties (Secretary of State, sector association and target unit, as at present under Option 2). This would deal with specific details purely relevant to the legal relationship between those parties. As now, any amendment would need to be agreed between each of the specific parties, as provided for in the agreement.

b. Scheme Rules dealing with wider provisions of general relevance to the operation of Climate Change Agreements, which need to be consistent (and, where amended, amended consistently) across the scheme. These would be given force in relation to each participant through the terms of their agreement. Any amendment would be made by the Secretary of State, following consultation with target units and sector associations – taking into account the balance of their views. There may be some specific circumstances in which consultation would not be required.

159. If, following this consultation, it is decided to introduce Scheme Rules, there will be a further consultation on the content of the Scheme Rules.

Links to Other Issues
None – although the precise content of the agreements and the Scheme Rules would depend on decisions taken on other issues.

Proposal
To introduce Scheme Rules and simplify umbrella and underlying agreements accordingly.

Other Options
No change – i.e. all detail in the agreements themselves.

Questions
66. Do you agree with the analysis in paragraphs 156 to 159? If not, in what way and why?
67. Do you agree that Scheme Rules should be established and umbrella and underlying agreements simplified accordingly?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
68. Any other comments?

Other Issues

Q. Are there barriers to access to Climate Change Agreements that can be removed, without the need to amend eligibility criteria?

160. The report of the Environmental Audit Committee noted that *"Another common theme from business groups has been to argue that the criteria for inclusion in each carbon reduction scheme should be widened, so that, for instance, it was easier for businesses to qualify for a Climate Change Agreement, and easier for an Agreement to apply to the whole of a site. Given the extra progress on energy efficiency which the process of complying with Climate Change Agreements appears to have driven, we recommend that the Government look favourably on such proposals."*[32]

161. Climate Change Agreements were developed specifically for energy intensive industries because of the negative impact the Climate Change Levy might have on the competitiveness of energy intensive industry. This reasoning does not apply to non-energy intensive sectors, many of which will be subject to the Carbon Reduction Commitment. Consequently the Government does not propose to extend the scope of the scheme beyond energy intensive industries and, therefore, does not propose to make any changes to the eligibility criteria of the scheme.

162. The Government is not aware of any significant barriers to entry into Climate Change Agreements for energy intensive industries. However, it is prepared to consider introducing additional measures to simplify the administration of the scheme where there is evidence to demonstrate that barriers do exist.

Links to Other Issues
In relation to the Environmental Audit Committee recommendation on making it easier for an Agreement to apply to the whole of a site, see analysis of the 90/10 rule (see paragraphs 125 to 131).

Proposal
None.

Other Options
None.

Questions
69. Are there any significant barriers to energy intensive industry to enter into Climate Change Agreements under the current scheme?
    - If so, please provide a detailed explanation of the barrier or barriers concerned.
70. Other than changes to eligibility criteria, please describe any proposals you may have for changes to the scheme that might mitigate the barrier or barriers you have identified.
71. Any other comments?

[32] Paragraph 100: http://www.publications.parliament.uk/pa/cm200708/cmselect/cmenvaud/354/354.pdf.

R. Are there ways within Climate Change Agreements to provide increased incentives to install Combined Heat and Power plant?

163. The use of Good Quality Combined Heat and Power for the generation of electricity and heat offers significant primary energy savings over the conventional generation and supply of electricity (via the grid) and heat (via boilers). The report of the Environmental Audit Committee recommended that *"the Government re-examines ways in which to increase the incentives to install Combined Heat and Power plant, or buy Combined Heat and Power electricity from outside sources, available for industrial firms within Climate Change Agreements."*[33]

164. The current installed Good Quality Combined Heat and Power generating capacity in the UK is 5,499 MWe. Approximately 90% of this is in industry, with an estimated 35% of the UK total installed at Climate Change Agreement sites. Since 2000 overall capacity has increased by 19%. The increase in industry as a whole has been around 23%, but the increase in sectors covered by Climate Change Agreements has been only 3%.

165. There are a number of factors that may inhibit uptake of Good Quality Combined Heat and Power generating capacity by sectors with Climate Change Agreements. However, poor economic fundamentals earlier in the decade have been a particular contributor to the stalled growth in capacity.

166. The economics of Combined Heat and Power are dependent on the "spark spread" i.e. the difference between the wholesale price of electricity and the cost of the fuel used to generate it. The introduction of the New Electricity Trading Arrangements in 2001 caused the price of electricity to fall and the spark spread to narrow, adversely affecting the economic viability of Good Quality Combined Heat and Power. Whilst the difficult market conditions restrained the development of Good Quality Combined Heat and Power across the board, the effect at sites with Climate Change Agreements has been more pronounced.

167. Even though market conditions have improved for Combined Heat and Power in the last year, it means that in situations where the economic rationale would otherwise be marginal, a Combined Heat and Power scheme will not get built. The full technical potential for this energy efficient technology is therefore being missed. One means of helping investors overcome existing barriers to investment is provided through Climate Change Levy exemptions for fuel inputs and electricity outputs from Good Quality Combined Heat and Power. However, those with Climate Change Agreements already benefit from an 80% reduction in Climate Change Levy. Consequently, the impact of the 100% exemption to Climate Change Agreement operators as an incentive to invest in Combined Heat and Power plant, or to purchase electricity from a third party Combined Heat and Power plant, is effectively reduced to 20%.

168. Under the current Climate Change Agreements scheme, relevant target units were previously required to carry out a 3-stage approach to assessing the viability of installing Combined Heat and Power. Should any stage not indicate a "pass", the subsequent stages were not pursued. The three stages were:

- A simple analysis of the operating hours and energy use of the facility;
- A more detailed examination of energy use; and
- A comprehensive feasibility study.

[33] Paragraph 91: http://www.publications.parliament.uk/pa/cm200708/cmselect/cmenvaud/354/354.pdf.

If the feasibility study indicated there was a cost-effective Combined Heat and Power opportunity, a formal review of future targets was to take place. However, this requirement was abandoned when the economics of Combined Heat and Power deteriorated.

169. The Government strongly supports investment in Good Quality Combined Heat and Power. It wishes to consider the possible reintroduction of a requirement for an analysis of the viability of Combined Heat and Power by relevant target units, which may or may not follow precisely the approach taken under the current scheme. Beyond this, it is not clear how Climate Change Agreements, within their existing framework, could be used to provide further incentives to such investment.

Links to Other Issues
None.

Proposal
1. To consider re-introduction of tests for viability of Combined Heat and Power for relevant facilities similar to those that were applied under the current scheme and, where a cost-effective opportunity is identified, to include Combined Heat and Power as part of the Climate Change Agreement target.
2. To consider other options for removing barriers to Combined Heat and Power more broadly in the context of the Heat and Energy Saving Strategy. The Government will use the results of this consultation on Climate Change Agreements to contribute to that consideration.

Other Options
None.

Questions
71. Do you agree with the analysis in paragraphs 163 to 169? If not, in what way and why?
72. Do you agree that a requirement for a test of the viability of Combined Heat and Power by relevant target units should be reintroduced and that, where cost-effective opportunities exist, targets should be adjusted to reflect this?
    - Please set out the reasons for your opinion, including any views on the type of tests that might apply, identifying the advantages and disadvantages, including the administrative burden and financial cost.
73. Please set out in detail any other proposals you may have for introducing further incentives to investment in Good Quality Combined Heat and Power within the context of the existing framework of Climate Change Agreements.
74. Any other comments?

S. Should the "light touch" approach applied to Climate Change Agreements operators under the Environmental Permitting (England and Wales) Regulations 2007 continue?

170. Within the framework of the Environmental Permitting (England and Wales) Regulations 2007, all operators of installations subject to the Integrated Pollution Prevention and Control Directive[34] have to meet basic energy efficiency requirements, including:

    a. Provision of information on energy consumed or generated by the activities within the permit and the associated direct and indirect carbon dioxide emissions;

[34] 2008/1/EC – the codified version of the former 96/61/EC which is now repealed.

b. Energy management provisions;

c. A description of the proposed measures for the improvement of energy efficiency in operating and maintenance procedures, control of excessive heating and cooling losses and building services; and

d. Provision of an energy efficiency plan that identifies energy efficiency techniques that are applicable to the operation of the activities.

171. Operators of installations covered by Climate Change Agreements are not required to meet certain additional sector-specific energy efficiency requirements that would be applied to other installations. This arrangement is reflected in the Environment Agency's "H2" guidance[35].

172. This "light touch" reflects, in part, the fact that targets under Climate Change Agreements are based on All Cost Effective measures. Coupled with the fact that Climate Change Agreements allow the operator greater choice on how energy savings are achieved, rather than take the more prescriptive approach of the Regulations, it can be said that Climate Change Agreements provide environmental benefits at least equivalent to the full application of the Regulations.

173. On an individual site basis, Climate Change Agreements do not necessarily provide the same level of environmental benefit as would the application of both basic and sector-specific energy efficient requirements of the Environmental Permitting (England and Wales) Regulations 2007. However, carbon dioxide emissions have a global impact and a non-site specific approach has been considered acceptable.

174. Given that the environmental benefits accruing from energy efficiency across all Climate Change Agreement sectors are believed to be equivalent to those that might be derived from a more prescriptive approach under the Environmental Permitting (England and Wales) Regulations 2007, from a Better Regulation perspective there is no need to make Climate Change Agreement operators subject to both. The Government therefore **proposes to continue the "light touch" approach**, but would consider ending it if there were clear environmental benefits to be achieved in doing so.

Links to Other Issues
None.

Proposal
To continue with the existing "light touch" approach.

Other Options
End the "light touch" approach.

Questions
75. Do you agree with the analysis in paragraphs 170 to 174? If not, in what way and why?
76. Do you agree that that the existing light touch should continue?
    - Please set out the reasons for your opinion, identifying the advantages and disadvantages of this approach, including the administrative burden and financial cost.
77. Do you consider there would be environmental benefits in removing the light touch? If so, please set out what you consider them to be.
78. Any other comments?

[35] http://www.environment-agency.gov.uk/business/topics/pollution/32224.aspx.

T. Are there ways in which good energy management practices can be further encouraged under Climate Change Agreements?

175. Current Climate Change Agreements require that certain qualitative requirements are met, but only in the circumstances that a target unit invokes the "relevant constraint" or "fuel supply disruption" risk management tool (see paragraphs 86 to 88). The qualitative requirements are set out in Schedule 3 of the underlying agreements, and include the preparation and implementation of an energy management plan, the monitoring and reporting of energy use; and regular reviews of performance and updating of the plan as necessary.

176. The Government believes that there would be benefits to be gained in providing wider encouragement under Climate Change Agreements to ensure that all target units engage in good energy management practice. However, a mandatory approach (e.g. requiring evidence of the plan, monitoring, reporting and review cycle) would require a system of monitoring and enforcement, which would both add to the complexity of the scheme and increase the administrative and financial burden on business and government. The Government would therefore welcome proposals for non-mandatory measures that would encourage improved energy management practices by target units.

Links to Other Issues
None.

Proposal
Proposals are sought on non-mandatory measures that would encourage improved energy management practices by target units.

Other Options
None.

Questions
79. Do you agree that there are benefits to be gained in providing wider encouragement under Climate Change Agreements to ensure that all target units engage in good energy management practice?
    - If yes, please provide details of any proposals you may have for non-mandatory measures.

80. Any other comments?

Other comments

177. The climate change policy landscape has changed markedly since Climate Change Agreements were first introduced with the establishment of the EU ETS in particular. This has resulted in 46% of direct emissions covered by Climate Change Agreements being included in the overall EU ETS cap. Outside of the EU ETS sector, the Government is planning to introduce the Carbon Reduction Commitment in 2010. Given the Government's commitment to simplify regulation for businesses, are there other more fundamental changes to the structure of Climate Change Agreements not set out in the consultation that you feel could make the operation of Climate Change Agreements simpler and reduce regulatory cost for business?

Questions

81. Are there other changes, including more fundamental changes, to the structure of Climate Change Agreements not set out in this consultation which you feel could make the operation of Climate Change Agreements simpler and reduce regulatory cost for business?
    - If so, please explain your suggestion or suggestions in detail, identifying the advantages and disadvantages, including the administrative burden and financial cost.

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