



House of Commons
Environmental Audit
Committee

**Government Response
to the Committee's
Fourth Report of
Session 2005–06 on
Pre-Budget 2005: Tax,
economic analysis, and
climate change**

First Special Report of Session 2006-07

*Ordered by The House of Commons
to be printed 9 January 2007*

HC 195
Published on Tuesday 16 January 2007
by authority of the House of Commons
London: The Stationery Office Limited
£0.00

The Environmental Audit Committee

The Environmental Audit Committee is appointed by the House of Commons to consider to what extent the policies and programmes of government departments and non-departmental public bodies contribute to environmental protection and sustainable development; to audit their performance against such targets as may be set for them by Her Majesty's Ministers; and to report thereon to the House.

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References

In the footnotes of this Report, references to oral evidence are indicated by 'Q' followed by the question number. References to written evidence are indicated by page number as in 'Ev12'. number HC *-II

First Special Report

Pre-Budget 2005: Tax, economic analysis, and climate change— Government Response

1. The Environmental Audit Committee published its report on *Pre-Budget 2005: Tax, economic analysis, and climate change* on 21 March 2006 as HC 882.
2. The Government's Response to the Committee's Report was received on 22 May 2006 in the form of a memorandum to the Committee. It is reproduced as an Appendix to this Special Report.

Government response

Recommendation 1. In the context of rising concerns over the dangers of climate change, and of the fact that UK CO₂ emissions are actually increasing once more, this year's Pre-Budget Report was inadequate. This is all the more so considering that the Government's Climate Change Programme Review was delayed to take this Pre-Budget Report into account: the PBR does not hint at the kind of measures that could put the nation back on track to meet its 2010 target for reducing CO₂ emissions. (Paragraph 11)

Recommendation 2. PBR 2005 signifies a continued slowing down of the Treasury's momentum in turning its rhetoric on the environment into action. No really significant new measures were announced, despite the fact that this was the first Pre-Budget Report of a new electoral cycle, and the even more important fact that UK CO₂ emissions are currently rising, not falling. In order to reassure Parliament that it is taking its environmental responsibilities seriously, it is vital that the Treasury publishes a high profile restatement of its environmental strategy, and starts to back it up at once with serious action. (Paragraph 15)

Treasury is fully involved in developing policies to tackle climate change and is committed to implementing policies to encourage cost effective emissions reductions across all sectors of the economy. Since 1997 Treasury has taken a lead in developing and implementing some important climate change policies. For example, the Government introduced the climate change levy (CCL) in 2001, on the business use of energy to encourage them to find ways of reducing energy demand. Complemented by climate change agreements and the Carbon Trust, this package helped reduce emissions by 6.2 MtC/pa in 2005.

Existing measures were built upon in Pre Budget Report 2005 and Budget 2006. Pre Budget Report 2005 outlined funding for loan schemes for energy efficiency investment in the SME and public sector to overcome access to finance concerns. We estimate that these loan schemes could contribute carbon savings of 0.2MtC by 2010. Additionally it also outlined further decisions and plans to introduce the Renewable Transport Fuel Obligation and £300m extra funding to improve heating and insulation in pensioner households which will have consequent carbon benefits. In Budget 2006, the Chancellor announced a

package of measures that would help put the UK back on track to deliver continued and sustainable carbon emission reductions. These included the intention to revalorise the Climate Change Levy next year, reforms to vehicle excise duty, £50m support for microgeneration and energy efficiency measures for households. These complemented further measures announced by the Secretary of State for Environment, Food and Rural Affairs in the Climate Change Programme 2006. Taken together these measures will help the UK exceed our Kyoto target and get closer to the 2010 target to reduce emissions by 20% from 1990 levels. Since Budget, the Chancellor has addressed UN Ambassadors in New York to highlight our support for multilateral initiatives, including an extension of EU Emissions Trading Scheme beyond 2012 and the World Bank's Energy Investment Framework.

In the 1997 statement of intent on environment taxation and 2002 Tax and the environment: using economic instruments, Treasury has already set out the basis of environment strategy, and in particular the use of fiscal instruments. Pre Budget Report 2005 reiterated both our commitment to combining economic growth with robust environmental protection and updated the principles underlying Government action on the environment. Additionally in preparations for the CSR 2007 the Chancellor has identified climate change and natural resource protection as one of the main challenges facing the UK economy. Treasury have been working with other Government departments and external stakeholders to identify on significant trends and implications under this theme; and will widen this debate shortly.

Recommendation 3. In view of the compelling case for more urgent action to reduce carbon emissions, we are concerned that there may be a degree of institutional inertia within the Treasury in the face of the scientific evidence on climate change. We urge the Treasury to give greater priority to climate change; and hope that the Stern Review will lead to a profound and consistent impact in the seriousness with which the Treasury responds to this issue. (Paragraph 16)

The Chancellor has identified climate change as the greatest environmental challenge facing the world, one that could have significant economic costs and jeopardize the development of many nations. To further our understanding of climate change, Sir Nick Stern was asked by the Chancellor to lead a review on the economics of climate change. The Review aims to provide robust analysis of the complex economic challenges around climate change, and form a sound basis for good policymaking at the national and international levels. In an important few years for global action on climate change, the Review's findings should stimulate debate and inform discussions in the Gleneagles Dialogue on climate change, clean energy and sustainable development, and in the negotiations under the UNFCCC. The Review will report in Autumn 2006 to the Prime Minister and Chancellor.

Recommendation 4. We believe that the Treasury should redefine Air Passenger Duty as an environmental tax. We urge the Treasury to ensure that Air Passenger Duty rates more accurately reflect the carbon emissions of the flights to which they apply, to restrain demand for more flights and curb the growth in carbon emissions from UK aviation. The Treasury should consider changing the basis of APD, from taxing individual passengers to taxing flights, so as to incentivise more efficient use of aviation

fuel and airport infrastructure. The overall aim should be to ensure that this tax reflects the environmental externalities of aviation. (Paragraph 22)

Recommendation 5. We applaud the leadership the Government has shown in seeking agreement to include aviation within the EU Emissions Trading Scheme. However, we would argue that the UK can still take action in advance of this, and to supplement it not just by raising Air Passenger Duty but, for instance, by seeking bilateral agreements with other countries to impose aviation fuel duty on flights between them. Furthermore, as the Environment Agency argued in their evidence, simply including aviation within the EU ETS is not enough-what counts is the level of carbon credits it is assigned as a sector. (Paragraph 23)

The Government believes that aviation should meet its external costs, and that the sector needs to take its share of responsibility for tackling global warming. Inclusion of aviation in the ETS is the most effective way to address the international problem of aviation emissions, and would guarantee a certain reduction in emissions across the scheme as a whole. APD increases based on the current structure of the duty would not guarantee a certain reduction in emissions, as a trading scheme does, and APD does not incentivise improved environmental performance. The Government is continuing to explore policy instruments to address emissions, as well as driving forward progress on inclusion of aviation in the ETS.

Taxation of fuel in some member states could lead to tankering (re-fuelling in other locations to provide fuel for internal trips or between particular countries). Carrying of extra fuel can result in higher emissions.

The success of the ETS in reducing emissions from aviation will depend on a number of design factors, and the Government has taken an active role in discussions at EU level regarding design of the scheme. A legislative proposal is expected from the Commission by the end of the year.

Recommendation 6. We echo the Environment Agency's support for the Renewable Transport Fuel Obligation, but also its concern that expansion in the use of biofuels should not result in environmentally valuable habitats, such as rainforests, being cleared in order to grow the relevant crops. In the case both of transport fuel and electricity generation it is important that only biofuels which are from sustainable sources should be rewarded with Renewables Obligation Certificates. We were heartened to hear the Minister take such concerns seriously, and to refer to work by the Department for Transport on assessing the environmental impacts of biofuel sources. We may choose to monitor such impacts ourselves as UK consumption of biofuels rises. (Paragraph 25)

The Government is very clear about the need to consider sustainability issues in taking forward the RTFO. The environmental policy purpose of the RTFO would be undermined if it were delivered through unsustainable sources which not only damaged biodiversity but also delivered little by way of life cycle carbon savings. This is why the Government will make sustainability and carbon reporting mandatory from the start of RTFO, and have commissioned the Low Carbon Vehicle Partnership to develop robust carbon certification and sustainability assurance schemes to form an integral part of the RTFO. Work on both

schemes is progressing well and key stakeholders, including the major oil companies, biofuel producers, and green groups, have been involved in their development.

While the RTFO is likely to be met at least in part by imports, analysis shows that the UK could deliver 5% biofuels from UK sources with no detrimental impact on UK food supply or biodiversity. For example, the UK currently exports around 3m tonnes of wheat annually. With advances in technology, it is estimated that by 2050 the UK could produce as much as one third of its transport energy needs from biomass.

Recommendation 7. We welcome the discount in duty to support the growth in biofuels, and acknowledge the significant impact that such duty differentials have played in the past, for instance in incentivising the uptake of unleaded petrol and ultra low sulphur petrol and diesel. Moreover, given that fossil fuels will form a significant source of potential tax revenues for some decades to come, but that we need to wean ourselves off them in advance of their depletion and in order to avert dangerous climate change, we believe that there is a strong case for consistent increases of fossil fuel taxes. (Paragraph 26)

It is the Government's intention that main road fuel duty increases at least in line with inflation each year to maintain real value of public revenues and help meet our targets of reducing emissions, but important factors like continuing volatility in the oil market need to be taken into account, alongside environmental, social and all other relevant factors. In addition, the Government has adopted a long-term strategy of promoting lower carbon transport including alternative fuels, improving fuel efficiency and giving economic incentives to individuals to make more sustainable transport choices. The use of fuel duty differentials has played and continues to play an important role in that strategy.

Recommendation 8. We are concerned that the UK is drifting away from the EU target on car energy efficiency. The Government should increase the differentials within Vehicle Excise Duty between the most and least efficient cars, and create a special new band at the top of the spectrum for the worst "gas-guzzlers". The Treasury should also raise consumer awareness by making vehicle tax discs prominently colour-coded, to reflect their energy efficiency banding. (Paragraph 28)

To strengthen environmental incentives, the Government announced at Budget 2006 further reforms to VED. A new higher band of graduated VED (band G), set at £210 for petrol cars, has been introduced for the most polluting new cars (those above 225g of carbon dioxide emissions per kilometre). The VED rate for the small number of cars with the very lowest carbon emissions (band A) has been reduced to £0 to encourage take-up and assist the development of the low carbon car market.

Recommendation 9. In view of the need to cut carbon emissions, and of the likely long-term rises in oil prices as we approach and pass global peak production, the Treasury should develop a strategy for weaning the UK economy off oil, and should publish updates on progress in each Pre-Budget Report. In addition, each PBR should assess the nature and level of economic and national security risks posed to the United Kingdom from the depletion of world oil and gas reserves. (Paragraph 32)

The Energy Review will consider the long term trends and risks in world energy markets for domestic energy policy and the Government's energy policy objectives, which include

ensuring reliable energy supplies and reducing carbon emissions. The Review will report to the Prime Minister in the Summer.

The Government's view on oil production prospects is set out in the 2003 Energy White Paper "Our energy future - creating a low carbon economy" <http://www.dti.gov.uk/energy/whitepaper/index.shtml>:

“Globally, conventional oil reserves are sufficient to meet projected demand for around 30 years, although new discoveries will be needed to renew reserves. Together with non-conventional reserves such as oil shales and improvements in technology, there is the potential for oil reserves to last twice as long.”

This is consistent with the latest assessment by the International Energy Agency (IEA) in its 2005 World Energy Outlook. However, we do not underestimate the challenges and, like the IEA, the Government recognises that significant investment will be required to turn these reserves into production. The UK is therefore working with producers, consumers and the international community to improve the conditions for investment in the international energy sector. On the demand side, the Government is working with developing countries to encourage more effective management of energy demand, through energy efficiency improvements and the development of renewable sources of energy. G8 Finance Ministers have also been monitoring oil issues. Their latest communiqué can be found at <http://en.g8russia.ru/news/20060211/1143117.html> Domestically, the Government is working with the industry to maximise the economic potential of our North Sea supplies.

All Treasury economic forecasts involve an assessment of the economic risks to the UK and world economies, including those arising from oil and energy markets, and the Department of Trade and Industry will continue to monitor long-term prospects for world energy markets.

Recommendation 10. On energy efficiency, we recommend that the Treasury considers reducing both Stamp Duty and Council Tax for those homes built or refurbished to high environmental standards. At the very least the Government should give local authorities the support to allow them to introduce their own Council Tax rebate schemes, designed to incentivise household energy efficiency improvements. Equally, the Treasury should do far more to join up its policies on energy efficiency with those relating to improving the productivity of British industry, and those relating to fuel poverty. (Paragraph 35)

The Government notes the recommendation and keeps all taxes under review. The Government has taken a number of measures to promote energy efficiency in households, including reduced VAT rates on a range of professionally-installed energy saving materials, the Landlords Energy Saving Allowance, and the Energy Efficiency Commitment (EEC). Such policies have supported households to make cost-effective energy efficiency improvements and have also helped to reduce the number of households in fuel poverty. Half of energy efficiency savings under EEC must come from the most vulnerable households, and the 2005 Pre-Budget Report announced £300 million to help pensioners with the cost of installing central heating in their homes. Local authorities are free to offer Council Tax rebates for energy efficiency measures in conjunction with energy suppliers if

they wish, and a number have done so in the context of the Energy Efficiency Commitment. Budget 2006 also announced £20 million over the next two years to help local authorities and others work in partnership with energy companies to promote and incentivise energy efficiency measures in households.

The Treasury's environmental tax strategy

Recommendation 11. In order to assist Parliamentary scrutiny of its record, the Treasury should publish figures in each Pre-Budget Report of the total revenues it receives from the Climate Change Levy, Aggregates Levy, and Landfill Tax as a proportion of the total taxes and social contributions it receives from those businesses which are subject to them. (Paragraph 39)

The Government already provides details of receipts derived from different taxes and national insurance contributions in its Budget document. In Budget 2006, table C8 provides a breakdown of the sources of current receipts.

Recommendation 12. We are far from convinced by the Treasury's argument that the relative decline in levels of environmental taxes could actually be a sign of the effectiveness of its environmental tax programme (in that it might show these taxes were successfully discouraging the activities they were being levied on). Most significantly, environmental taxes are failing to sufficiently discourage the processes and activities that emit CO₂. (Paragraph 43)

The Government has introduced a wide range of measures to support its aims on the environment, consistent with the objective it set itself in 1997. The Government reiterates its belief that revenues are not necessarily a good indication of the relative importance or success of environmental policy. Looking at each of the environmental taxes in turn, in the case of the aggregates levy, we have observed an 8 per cent reduction in sales of virgin aggregate and an increase in production of recycled aggregate between 2001 and 2003. The Government's policies on waste, including the landfill tax, has seen a 28 per cent reduction between 1997 and 2005 in the total quantity of waste going to landfill, at a time when the UK economy has grown 7%. The climate change levy and climate change agreements (which offer opportunities for business to reduce their liability to the levy) are key components of the climate change levy package. This package is estimated to deliver annual emissions savings of over 6MtC by 2010 – accounting for a third of the UK's total carbon reductions.

Recommendation 13. Given that the Treasury has accepted the principle of increasing taxes on "bads" as opposed to "goods", and given that any new or increased environmental taxes could be designed to be broadly revenue neutral and fairly distributed, its reluctance to take bolder steps in reforming the tax system is mystifying. (Paragraph 45)

The Government's 1997 Statement of Intent on Environmental Taxation set out the Government's intention to reform the tax system to increase the incentive to reduce environmental damage. This Statement, and the Treasury's publication *Tax and the Environment* in 2002, highlighted that any such efforts should take place within a principled framework. In particular the decision to intervene to achieve environmental aims must take account of wider economic and social objectives and, if there is an

evidence-based case to for the Government to take action, the most effective instrument should be used. Environmental taxes must also meet the tests of good taxation.

Within this framework, the Government has introduced fiscal measures that have played a key role in its wider environmental strategy. To tackle climate change, the climate change levy package (including CCL itself; climate change agreements; enhanced capital allowances for energy-saving technologies) has been the main instrument used to encourage businesses to reduce their energy demand. In the household sector, the Government has introduced reduced VAT rates for professionally-installed energy-saving materials, and launched the Landlords Energy Saving Allowance to correct particular market failures in the private rented sector. In the transport sector, the Government has introduced the Company Car Tax, carried out significant reforms to Vehicle Excise Duty, and used duty differentials to encourage the development of environmentally-friendly fuels. The Government has also introduced measures to tackle other environmental issues, such as managing waste and protecting natural resources. For instance, the Government has carried out significant reforms to the Landfill Tax and introduced the Aggregates Levy.

These measures have supported wider efforts to protect the environment and put the UK on track to meet its Kyoto commitment, whilst also ensuring that progress towards wider economic and social objectives—in particular, strong and stable economic growth—is supported.

14. The Treasury cannot afford to leave it to chance to get its wider messages on environmental taxes across to the public: it should develop a coherent communications strategy, possibly involving high-profile advertising campaigns. As a first step, the Treasury should commission research into the public awareness of the environmental purpose behind its taxes, in particular fuel duty; this should provide a baseline to measure the effectiveness of any communications strategy it develops. (Paragraph 50)

The Government recognises the importance of highlighting the responsibility that falls to society to protect the environment and the need for government intervention—through environmental taxes and other measures—to correct market failures. As such, the Government introduced a new chapter into the Pre-Budget Report and the Budget Report that outlines how environmental taxes can play to meet environmental objectives as part of a wider range of measures. This chapter also emphasises the need for the development of fiscal measures to take place within a principled framework that ensures that any use of fiscal measures takes account not only of environmental but also economic and social objectives. More broadly, the chapter also outlines how domestic action—such as use of environmental taxes—needs to fit with action taken at the international level. In addition, the Government has regular meetings with a range of stakeholders—including both environmental groups and business organisations—to discuss environmental tax issues.

The Department for Environment, Food and Rural Affairs leads for the Government in raising awareness of environmental issues and policy. It already supports a number of initiatives, through bodies such as the Carbon Trust and WRAP, and intends to do even more: for example, in late 2006, Defra expects to launch Environment Direct as a new environmental information service for consumers to provide simple information and advice about the impacts of goods and services.

15. Moreover, the Treasury should be far bolder in providing "carrots" which it can show to the public are accompanying environmental taxes, in terms both of investments in alternatives to the activities being taxed (for example, R&D investment in new technologies) and of reductions in other taxes or tax rebate payments. (Paragraph 51)

In line with the principled framework set out in the Statement of Intent on Environmental Taxation, the Government has introduced several incentives and support measures alongside environmental taxes. For instance, as part of the climate change levy package, the Government introduced climate change agreements that provide an 80% reduction on a firm's CCL liability if that firm makes specific energy efficiency improvements. A CCL exemption has also been introduced to encourage the development of low-carbon energy sources, such as combined heat and power (CHP), renewable energy and coal mine methane. The CCL package also contains enhanced capital allowances for energy-saving technologies, which provide support firms investing in energy efficiency.

The Government has also introduced other support measures that complement environmental taxes. For instance, in PBR 2005 the Government announced additional funding for Carbon Abatement Technology demonstrations, extra funding to explore the possibilities of carbon capture and storage technologies, and an extra £35m to offer interest-free loans for energy-efficiency investments in the business sector. In Budget 2006, the Government announced £50m of spending to develop microgeneration technologies.

16. We suggest the time is right for the Government to reconsider establishing a Green Tax Commission. Without such a body, the absence of a proper communications strategy to sell its environmental programme to the public is all the more damaging. (Paragraph 52)

The Government is committed to developing the environmental tax agenda in an open and consultative way, encouraging the views of all interested parties and trying to build consensus where possible on the best way forward. Indeed, the Government has engaged stakeholders and interested parties through a number of consultations since 1997. In addition, the Government has introduced a new chapter to Pre-Budget and Budget reports that covers environmental issues and sets out the Government's approach to the use of taxation within its environmental programme. This provides a regular and detailed statement on the importance of tackling environmental issues, the need for government action - using tax and other instruments - to take place within a principled framework to ensure effective action, and the impact of these measures to date and new measures that are to be introduced.

17. We find it perfectly understandable for the Government to argue that climate change is something which threatens all nations and requires them all to take action, and the Government is obviously concerned about the consequences of the UK taking action in advance of the rest of the world. We are concerned that the Treasury may not fully appreciate the significant export potential of the new carbon mitigation technologies for the UK economy. Equally, we are concerned that if the Government takes the line of waiting for universal agreement before committing the UK to take bolder steps, this will be a recipe for stasis. We fear that there are not going to be any

international agreements, or none which result in truly effective action, unless individual nations are prepared, to one degree or another, to move first. (Paragraph 57)

As the Chancellor has highlighted in recent speeches analysts expect the global market for environmental technologies markets to grow significantly. The Government has introduced a number of measures to enable British companies to take advantage of this. UK Trade and Investment provide advice and support for firms seeking to export goods and services in the power sector, including low carbon technologies. Additionally, ECGD supported a £50m initiative to promote the export of renewables.

It has been argued by some that carbon capture and storage (CCS)—in which CO₂ is captured and committed to long-term storage—may be one area where there would be benefits for the UK in early adoption of the technology. The Government has not reached any conclusions and, according to our principles of environmental policy making, will only do so on the basis of evidence. HM Treasury's consultation on barriers to the commercial deployment of CCS will contribute to building the evidence-base.

Climate change is a global challenge and securing co-ordinated multilateral action is key if the world is to avoid the more damaging impacts of climate change. The UK is committed to working with international partners to secure this action. Equally the UK has taken steps to reduce emissions beyond the current level of effort required by the Kyoto protocol. The Climate Change Programme 2006 indicated that we are currently projected to reduce greenhouse gas emissions by 23-25% from 1990 levels between 2008 and 2012. The UK has also stated a long term 2050 carbon reduction goal if other countries take similar action and the Energy Review is currently examining options to continue the UK's progress to this goal.

Environmental business reporting

18. What concerns us about the way in which the Treasury has taken the decision to abolish the Operating and Financial Review is the wider attitude it suggests, one which seems simply to oppose competitiveness and sustainability, and views sustainable reporting as an optional extra which can be dispensed with lightly. Our main concern following its abolition is that the Government introduces a new reporting scheme which provides effective incentives for UK listed companies to act more sustainably. We welcome the fact that the Government has issued renewed consultation on the form in which the new Business Reviews should take, and also the Minister's confirmation that the Government is willing to consider any representations on their merits. We may return to these Business Reviews, and the form they finally take, in our inquiry into next year's Pre-Budget Report. (Paragraph 64)

It should be clarified that the statutory Operating and Financial Review (OFR) removed by the Government was not primarily a reporting tool for sustainability. The OFR was a reporting tool prepared by companies for the benefit of their shareholders to help them in assessing the strategies adopted by the company and the potential for those strategies to succeed.

Following public consultation on the full range of options for narrative reporting, the Government has settled upon the Business Review requirements as the appropriate reporting standard. For quoted companies there will be some additional narrative

reporting requirements, to make clear what level of disclosure is expected of them in producing a Business Review. As with the OFR, the Business Review's intended audience is its shareholders; its purpose is to help them assess how directors have fulfilled their duties (to promote the success of the company). In so far as it is necessary for an understanding of the development, performance and position of the business, companies will be required to report on matters related to sustainability. (It is worth noting, however, that companies are not precluded from providing additional voluntary disclosures, or indeed producing additional reports that focus more exclusively on corporate social responsibility and sustainability issues, where this is considered desirable).

19. The Government should ensure that, in examining the economics of different options for tackling climate change, it starts by deciding the level of carbon emissions it wants to achieve, and then looks for the most cost-effective means of getting there. (Paragraph 68)

The Government has already set a long term goal of reducing carbon emissions by 60% from 1990 levels by 2050. This goal is informed primarily by the science of climate change and the goal acknowledges that a response has to be global by committing the UK to this reduction if other countries take similar action. In assessing different policy options for reducing carbon in a manner consistent with this goal, evaluation of the carbon impact as well as economic and social impacts are important to ensure that the policy is fit for purpose. The long term nature of the problem dictates that the Government assess a variety of policies and possible technologies to different criteria.

20. We may review the impacts of the Climate Change Programme Review, the Energy Review, and the Stern Review on Pre-Budget 2006, and subsequent PBRs, to follow the extent to which the findings of these Reviews: a) complement and not contradict each other, and b) are translated into the Treasury's environmental policies. (Paragraph 70)

The Treasury looks forward to the Committee's interest in PBR 2006.

May 2006

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