



House of Commons
Environmental Audit
Committee

**Reducing Carbon
Emissions from UK
Business: The role of
the Climate Change
Levy and Agreements:
Government Response
to the Committee's
Second Report of
Session 2007–08**

Third Special Report of Session 2007–08

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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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Third Special Report

1. The Environmental Audit Committee published its report on *Reducing Carbon Emissions from UK Business: The role of the Climate Change Levy and Agreements* on 10 March 2008 as its Second Report of Session 2007–08, HC 354.
2. The Government's Response to the Committee's Report was received on Monday 12 May 2008 in the form of a memorandum to the Committee. It is reproduced as an Appendix to this Special Report.

Appendix—Government response

INTRODUCTION

1. The Government welcomes the Environmental Audit Committee's (EAC) comprehensive report into the role of the Climate Change Levy (CCL) and Climate Change Agreements (CCAs) in reducing carbon emissions from UK business.
2. The Government also welcomes the Committee's view that this is a bold and innovative suite of policies as a result of which there appear to have been significant carbon savings.
3. The CCL package represents an important policy for improving the energy efficiency for UK business, and the Government welcomes the Committee's view that it has not imposed a damaging burden to UK business overall.
4. The CCL has no time limit, but as a tax measure, it is under regular review by HM Treasury. However the current CCAs end on 31 March 2013 and, unless the scheme is extended (see next paragraph), the Levy reduction will cease to be available after this date. When State aid approval was sought for the CCA scheme in 2001, the Commission limited all such approvals to a maximum of 10 years. The current State aid approval therefore expires in 2011. Consequently, the Government intends to apply to the Commission later this year to extend that approval through to the end of the current scheme.
5. It was announced in Pre-Budget Report 2007 that, subject to a further State aid approval, CCAs would continue beyond 2013, until 2017. New agreements will be necessary for this additional period and the Government will be consulting on the form and content of the new agreements in the summer of 2008. Once the form and content of the new agreements have been established, the Government will seek State aid approval for the new scheme, which will be additional to the extended approval referred to in the previous paragraph. In the Government's responses to the specific conclusions and recommendations of the Committee's report, which are given below, references to "new CCAs" relate to the agreements that will apply until 2017.

CONCLUSION/RECOMMENDATION 1

Given the intrinsic difficulties involved in calculating its effects, and in order to improve transparency, we recommend that the Government should give an estimated range of uncertainty for its projections of the Levy's impacts. (Paragraph 12)

As the EAC report has noted, there are intrinsic difficulties in isolating the effects of the CCL, not least because evaluation requires a comparison with a counterfactual scenario in which CCL was not in place. Recognising this, the Government commissioned an independent study of the CCL package from Cambridge Econometrics (CE), which used econometric modelling and the MDM-E3 model, one of the most sophisticated macroeconomic models of the UK economy available with specific energy and environment sub-models. This report was issued by CE in 2005, and a supporting document which highlighted its findings, *The Climate Change Levy Package*, was published alongside Budget 2006. However, the Government will consider how best to undertake future assessments of the Levy's impact and how best to report on its findings through the normal Budget process.

CONCLUSION/RECOMMENDATION 2

According to the evaluation of the Levy relied on by the Government, most of the impacts of the CCL were already established before the policy actually came into effect in 2001, and have only marginally increased since then. (Paragraph 16)

As the independent report by CE concluded, the CCL is estimated to deliver annual savings of about 12.8 million tonnes of carbon dioxide (MtCO₂) by 2010. While the announcement effect itself has led to carbon savings, having the Levy in place provides Government with the capacity and flexibility to make further use of the price effect through variations in rates. Budget 2006 announced that Levy rates would rise with inflation in the following year, and this policy has been extended in subsequent Budgets. The Government will continue to assess the best way to encourage business energy efficiency and to ensure that the environmental effects of the Levy are maintained.

CONCLUSION/RECOMMENDATION 3

Overall, it seems that the Climate Change Levy has not worked as originally planned—particularly for less energy intensive firms and SMEs. While concerned by the weaknesses of the Levy, we welcome the fact that the Government has not ignored these problems. In responding to the recommendations of the Carbon Trust by bringing forward plans for the Carbon Reduction Commitment, the Government is targeting some of the sectors for which the Levy has proved less effective. This shows a commendable flexibility of approach and ability to learn through doing. (Paragraph 22, 23)

Independent analysis from CE suggests that CCL is due to save 12.8 MtCO₂ by 2010, with the majority of savings found to be from less energy intensive firms. The current estimates remain above the 7.3 MtCO₂ figure that was initially projected when the Levy was introduced in 2001.

The Government welcomes the positive comments of the Committee on its flexible approach to carbon abatement policy and on the introduction of the Carbon Reduction Commitment, which will be the world's first mandatory auction-based trading scheme for public and private non-energy intensive organisations. It will begin operation in 2010 and will deliver savings of at least 4 MtCO₂ by 2020.

CONCLUSION/RECOMMENDATION 4

While in theory the use of carbon trading has no adverse effect on the amount of carbon savings generated by the system as a whole, this depends on the stringency of the original targets: if some targets are weak, then the firms to which they apply may be able to overachieve relatively easily, and thus provide a high volume of cheap credits with a concomitantly lesser effect in driving emissions reductions. Regarding the UK ETS, the first source of credits up to 2006, a Defra report from 2007 describes it as having provided an “over-allocation of allowances [...] linked to generous baseline setting and the inclusion of non-CO₂ GHGs [greenhouse gases].” This points to a serious weakness in the rigour of the CCA system so far, and underlines the fact that in all carbon trading schemes it is the level of the cap, rather than the trading mechanism, which is the key element. It also makes looking at the number of firms and sectors which have passed their Agreements targets an even less useful measure of the environmental impacts of the CCA system. (Paragraph 33)

Despite the low price of allowances under UK Emissions Trading Scheme (UK ETS), it is clear from experience that carbon trading has been used largely as a safety net and that the first choice of the vast majority of participants in meeting targets is actual energy savings. It is also of note that the over-supply of allowances in UK ETS was due mainly to direct participants in the scheme and not to CCA operators.

The CCA scheme is a baseline and credit system, rather than a cap and trade scheme. As such it is the level of the targets that is key. It was also important to seek to achieve equally stringent targets for all sectors, when targets were first set. In practice, differences between sectors, technologies and processes mean that it was difficult to compare the stringency of targets. In addition, the amount and quality of information available and the general level of awareness between sectors were all very variable. Nevertheless, the information base available to industry and to Government is growing with time and the provision for target reviews in the agreements enable adjustments to targets to be made.

CONCLUSION/RECOMMENDATION 5

It appears to us that isolating and enumerating the impacts of the Climate Change Agreements is even more complex and uncertain than accounting for the impacts of the Climate Change Levy. It is remarkable that the performance of most sectors is measured from a variety of different starting points that predate the start of the Agreements, in three cases stretching all the way back to 1990. While measuring the impact of Agreements by reference to business as usual projections avoids some of these problems, it also creates new ones of its own: as we have argued in previous reports, BAU projections intrinsically lack certainty, and depend very much on the quality of the assumptions and data used to generate them. For these reasons we recommend that, when reporting figures for the impacts of the Agreements, the Government gives a range of uncertainty attaching to them. (Paragraph 35)

It is true that there is inherent uncertainty in assessing the impact of CCAs: industry is constantly changing, there is rationalisation and companies regularly enter and exit the scheme; and there are external factors such as the price of energy and changes in technology. The Government also recognises that setting CCA targets on a wide range of

base years makes that assessment more difficult. This was done in recognition of the fact that many industries had already undertaken energy efficiency improvements without any incentive. However, actual targets were based on the state of play in 2000, to which any earlier achievement was added. So there was no effect on the stringency of targets. The Government is considering establishing a common baseline for new CCAs.

Projected savings from CCAs are made against a range of business as usual (BAU) projections. These BAU projections assume a range of levels of fossil fuel prices and associated estimates of industrial sector growth. There is uncertainty in these projections. Given this, the Government recognises the value of reporting figures for the impacts of the Agreements with a range of uncertainty. We will, therefore, examine the scope for undertaking a sensitivity analysis of the final figures, with a low, central and high case scenario analysis.

CONCLUSION/RECOMMENDATION 6

Although there are difficulties in arriving at a firm evaluation of the carbon savings driven by the Agreements, the anecdotal evidence suggests that the process of complying with CCAs has had a very positive effect, leading to a widespread improvement in energy management systems, greater sharing of good practice, and a general raising of energy efficiency as a boardroom priority among participating firms. (Paragraph 41)

The Government welcomes the Committee's comments on the impact of CCAs. The Government accepts that any estimate of carbon savings achieved through CCAs has a margin of error. Nevertheless, it is clear that CCAs have been highly successful. Using best available assumptions it is estimated that around 30 million tonnes of carbon (MtC) were saved in the first seven years of the scheme. In addition, the Government would agree that there is plenty of evidence of a range of qualitative benefits, of the type the Committee mentions. But there have also been substantial economic benefits. It is estimated that, against baselines, the total value of energy saved by operators at the last milestone (2006) was £1,500 million.

CONCLUSION/RECOMMENDATION 7

We are highly surprised that the Government has not tightened the Agreement targets since data from the first milestone period revealed that both the initial set of targets, and those revised in 2004, were too lax. We recommend that CCA targets should be reviewed at every milestone period. (Paragraph 47)

The current agreements limit target reviews to 2004 and 2008. The 2004 target review did take account of the results of the first milestone period.

The Government is not convinced that there would be significant benefit in more regular target reviews. While it would provide more opportunity to refine targets, there would also be considerable downsides. Target reviews are costly in time and effort for both industry and Government. In addition, industry needs stability between target reviews and target periods to plan and implement investment within normal investment cycles. From a Better Regulation and stability point of view, the current arrangements seem to work well.

The Government would also disagree that targets were too lax at the time they were set. Industry itself can often be surprised at what it can achieve. There can be many reasons why some operators over-achieve against targets, including: the level of priority given to energy efficiency investment; the level of resources available for such investment; decisions to maximise savings early, possibly with the aim of banking over-performance to meet later targets; greater potential to make efficiency gains than anticipated; and developments in technology in specific sectors.

CONCLUSION/RECOMMENDATION 8

Given both that targets have been readily overachieved so far and that meeting them should have saved participating firms money, and given the overall imperative to accelerate carbon reductions, we recommend that targets are considerably toughened at the next milestone period. To help preserve a constructive relationship with industry, protect competitiveness, and accelerate emissions reductions, the Government should increase public investment in low carbon technology, as well as grants or loans to aid its procurement. (Paragraph 53)

While it is true that targets have, in general, been over-achieved, this hides a wide degree of variation between sectors. For this reason, in the current target review, the Government has indicated to sectors that it is minded to tighten 2010 targets across the board by 4 per cent and that, for those sectors that over-achieved in 2006, that over-achievement should be consolidated into the revised 2010 target. This would maintain pressure on industry to maximise their potential for energy efficiency savings and, subject to negotiations to be held with industry over the summer, would realise additional savings of 1.8 MtC. The Government has invited sectors to respond and negotiations will continue over the coming months.

Government is already investing a considerable amount of money to support the development of new renewable and low carbon generation. The Renewables Obligation, along with the exemption from the CCL for renewable sourced electricity, will be worth around £1 billion per year in support of the renewables industry by 2010. Government has also made available around £500 million of spending on capital grants and research and development (R&D) for low carbon and renewable technologies up to 2008.

Public investment in low carbon technology is increasing in the UK through the Research Council's Energy Programme (budget of ~£70 million/year), the Technology Strategy Board (calls for relevant proposals currently valued at £32 million), Energy Technologies Institute (budget of £60 million–£100 million/year) and the UK Environmental Transformation Fund (£400 million over three years). In addition the changes to the Renewables Obligation will triple the amount of electricity produced from renewable electricity technologies in UK in 2015, and the Carbon Emissions Reduction Target in the household sector will require energy suppliers roughly to double the level of activity of the previous Energy Efficiency Commitment in installing low carbon energy and energy efficiency measures over the next three years in order to achieve the new stretching targets.

CONCLUSION/RECOMMENDATION 9

The NAO has drawn attention to a significant number of businesses which have both failed to meet their CCA 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 CCL discount. Regulations should be tightened to ensure that this cannot continue. The trading mechanism established within the CCA 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. (Paragraph 56)

An operator is regarded as having met its targets if the sector as a whole has passed its targets. An operator that fails to meet its individual targets in a sector that misses its sector targets may lose its entitlement to the levy relief in the following certification period—this is the penalty for failure. The rationale for the current arrangements is that if a sector as a whole passes its target the environmental benefits are at least as good as if all operators passed theirs. This also ensures that savings are made in the most cost effective way. In practice this is an issue for small operators. Big energy users do not generally rely on a sector pass—the potential penalty would be too great if the sector failed to meet its targets. In addition, removal of sector targets could damage the critical role that sector associations play in managing and implementing CCAs. Nevertheless, the Government understands the argument of equity that all those that benefit from Levy discount should meet their obligations. We will therefore consider options to achieve this for the new CCAs, following consultation with industry.

CONCLUSION/RECOMMENDATION 10

The effects of implementing a cut in employers' National Insurance Contributions alongside the introduction of the CCL should have been both to win the support of businesses for the idea of the Levy, and to help genuinely change their spending priorities. With the subsequent increase in NICs, announced in 2002, we are far from convinced that these have been the effects. Overall, as we have long recommended, the Government should be far bolder in altering the balance of taxation between 'goods' and 'bads'. (Paragraph 62)

To support UK competitiveness, the CCL was accompanied by a 0.3 percentage point cut in employers' national insurance contributions (NICs). As the EAC has concluded elsewhere in its report, the CCL package has not resulted in a damaging burden for UK business overall. In fact, the combined CCL/NIC package has resulted in a net reduction in tax liability for business as a whole: the lower NICs rate saves about £950 million a year for businesses in sectors paying CCL, while CCL costs these businesses about £600 million a year.

As set out in the Treasury's 2002 publication, *Tax and the Environment*, the development of the Government's environmental policy takes place within a principled framework. Where fiscal measures have been implemented, the Government has looked to shift the burden of tax from 'goods' to 'bads'. Cuts in NICs, for example, also accompanied the introduction of the aggregates levy and landfill tax. However, intervention must take account of wider economic and social objectives—including maintaining sound public finances.

As was announced in Budget 2002, the increase of 1 per cent to the rates of NICs was linked to health spending as part of the Government's overall plans for public spending

announced in that Budget, including the substantial increase in NHS resources. The NHS has always been partly funded by NICs.

CONCLUSION/RECOMMENDATION 11

We note that there appears to be significant demand for the Carbon Trust's SME loan scheme. It is reducing emissions, and it should bring about a net benefit to the UK economy through reducing overheads and increasing the growth of energy efficient products and services. For these reasons we recommend the Government provides funds to expand the scheme significantly. (Paragraph 69)

The UK Government has invested over £50 million in interest-free loans for SME energy efficiency projects through the Carbon Trust since 2003. On 21 February 2008, Defra announced that a further £12 million will be invested in the SME loan scheme over the next three years, funded from the domestic element of the Environmental Transformation Fund.

CONCLUSION/RECOMMENDATION 12

Despite the significant efforts already directed by the Carbon Trust to large firms, some evidence suggests there is a shortfall in provision for energy intensive sectors in terms both of very specialist advice and loans for energy efficiency investment. We recommend that the Government reviews the needs, for more assistance from the Carbon Trust, of larger and more energy intensive sectors, and assesses how best this demand can be met. (Paragraph 70)

The Government believes that the Carbon Trust is best placed to provide direct assistance to the business and public sectors to pursue the most cost effective carbon savings. It relies on the Carbon Trust to maintain under review how best to direct its resources to greatest effect.

There is a clear market failure in the lack of access to affordable finance by small and medium sized enterprises (SMEs), and this evidence led to the creation of Carbon Trust's SME interest-free loans scheme. The Carbon Trust has not identified similar issues for larger energy intensive businesses, where constraints on the availability of capital are less material. Larger energy intensive companies are more willing to invest the capital available to them in energy efficiency, thereby reducing a substantial element of their core operating costs. However, the Carbon Trust does provide a range of services to energy intensive companies, including its strategic Carbon Management product as well as other targeted and tailored services. In addition, the Trust regularly reviews its offerings to all types and sizes of businesses, and has recently piloted a Strategic Insights service, fully funded by customers, which is specifically aimed at larger companies. The aim is to enable them to understand the strategic business risks and opportunities associated with climate change at Board level.

CONCLUSION/RECOMMENDATION 13

Some evidence suggests a lack of awareness of the Enhanced Capital Allowances scheme. This could be linked to the restricted scope of the scheme, which excludes many technologies, such as insulation products. We recommend that the scope of the

scheme be expanded, to include a wider range of energy efficiency products, including those relating to thermal efficiency of buildings, lighting efficiency, whole systems, and sector-specific products. The Government should also state an estimate of the costs to the Exchequer, and effects on the use of the scheme, of increasing the allowance from 100% in the first year to 150% and to 200%. (Paragraph 74)

The scope of the Enhanced Capital Allowances (ECA) scheme is regularly reviewed. In 2008, ultra efficient white lighting has been reclassified as plant and machinery, allowing all types of energy efficient lighting to qualify for an ECA; the list of eligible technologies has been extended to include all necessary equipment for combined heat and power facilities to use solid refuse fuel; and a 10 per cent capital allowance is now available for the active facades and thermal insulation of building retrofits. In addition, qualifying criteria are being revised and will be published later in 2008.

The Government does not believe that there is a good case for increasing the rate of relief provided by ECAs. 100 per cent is already a very generous relief and the Government has concerns about the potential implications of giving more than 100 per cent relief for investment in these technologies. Such an increase would come at a considerable cost to the Exchequer and it is not clear that tax is an appropriate instrument to provide more support, if more support is needed. By providing more than 100 per cent relief, the possibility that businesses will seek to exploit this allowance for the avoidance of tax would be considerably increased and complicated anti-avoidance rules would be needed to ensure that the schemes would not be abused.

CONCLUSION/RECOMMENDATION 14

We note the fact that the Treasury has explicitly accepted the principle of hypothecating funding in the case of the Climate Change Levy. This only makes it more important that the Government be more transparent and consistent about its use of CCL money. We recommend that the Government clarifies whether CCL revenues are offset by the 2001 cut in NICs, *or* whether they are available to fund low carbon programmes—since Levy receipts are too small to fund both. If the CCL is being used to fund low carbon investments, the Government should report on what it is funding each year, and how much if any revenues are left over to go into the Consolidated Fund. (Paragraph 78)

The Levy was introduced on a revenue neutral basis with a 0.3 percentage point reduction in employers' NIC's, in order to protect the competitiveness of UK business and as part of the Government's commitment to switch the burden of taxation from "goods" to "bads" over time. The Government also announced that over three years, £100 million of the CCL revenues would be directed to the Carbon Trust.

As stated above, the value of the NICs cut to business now exceeds the value of CCL receipts. Moreover, the Government's spending priorities are not, except in limited circumstances outlined in the Treasury's budgeting guidance, determined by the way in which the money is raised. Hypothecating taxes to particular spending programmes causes inflexibility in spending decisions and can lead to a misallocation of resources, with reduced value for money for taxpayers.

Funding for low carbon investments is allocated through three-year settlements under the Spending Review process, which ensures that resources are allocated efficiently to deliver Government objectives, and ensures priorities, such as education and health, receive the increased levels of funding, as set out in the Comprehensive Spending Review (CSR).

CONCLUSION/RECOMMENDATION 15

Whether or not the Levy receipts are treated as replacing the tax lost from the 2001 cut in NICs in terms of meeting general spending commitments, we believe that devoting only around 10–15% of the size of these funds to the work of the Carbon Trust is short-sighted. We note that the Climate Change Levy brings in around double the amount in each year that the Government’s new domestic Environmental Transformation Fund will spend over three years. We recommend funding for the Carbon Trust and the domestic Environmental Transformation Fund is increased, to match or go beyond receipts from the Climate Change Levy. (Paragraph 80)

The 2007 CSR allowed for an increase in support for the Carbon Trust’s technology programmes through the domestic element of the Environmental Transformation Fund (ETF). The domestic element itself provides £400 million over the next three years for the demonstration and deployment of low-carbon and energy efficiency technologies. Defra’s overall settlement over the 2007 CSR period is set to increase annually by an average of 1.4 per cent in real terms, within which resources will be prioritised to meet departmental objectives.

CONCLUSION/RECOMMENDATION 16

It seems clear that the exemptions from paying the Levy on electricity from renewables and combined heat and power plants have had very limited effects on the construction of new renewables and CHP generation. Where the exemptions have had an effect in helping to increase business demand for supply contracts offering electricity generated by renewable sources, this can face the same problems widely reported as facing private consumers who switch to ‘green tariffs’ for their household supplies: power companies may simply brand as ‘green electricity’ a certain amount of their supply contracts, up to the proportion of their overall output already generated by renewable sources, without this necessarily having any real effects on the building of new renewable sources. (Paragraph 90)

The Government is aware that there is lack of clarity about the benefits from purchasing green tariffs and other consumer demand-led approaches to encourage uptake of renewable energy in the context of other mechanisms, such as the Renewables Obligation. This is why the Energy White Paper in 2007 stated that the Government is committed to working with Ofgem and the Energy Saving Trust to ensure consumers have accessible, transparent and user friendly information on the “green electricity” tariffs available to them. Ofgem has been reviewing this issue in both the business and domestic consumer sectors since the publication of the Energy White Paper and consulted on proposals to issue revised guidance on this subject in November 2007. In February 2008, Ofgem indicated that they needed to further develop elements of the guidelines, notably on the subject of "additionality" of benefits from green tariffs. They aim to publish finalised guidelines in the summer of 2008, and work with industry on an independent accreditation

scheme which would identify the environmental benefits from the schemes that suppliers offer.

CONCLUSION/RECOMMENDATION 17

What effects the Levy exemptions do have are reduced almost entirely in respect of companies covered by Climate Change Agreements, since they already benefit from an 80% reduction in the Levy in any case; this affects CHP particularly badly. We recommend the Government re-examines ways in which to increase the incentives to install CHP plant, or buy CHP electricity from outside sources, available for industrial firms within CCAs. (Paragraph 91)

The Government provides support for combined heat and power (CHP) via a number of mechanisms. As well as the CCL exemptions, CHP is also supported, for example, through its treatment in the EU Emissions Trading Scheme (EU ETS) and exemption from business rates and ECAs.

The Government will continue to assess the level of support provided to CHP in light of on-going reviews in this area by BERR, Defra and Ofgem.

CONCLUSION/RECOMMENDATION 18

Given the relatively limited price impact of the Levy, and the cost-savings that should accompany meeting Agreement targets, we believe that the CCL package has not been a damaging burden for UK business overall. In many cases it may have been good for the economy, given the savings in energy costs available for investment elsewhere, and the stimulus given to providers of energy efficiency products and services. (Paragraph 96)

The Government agrees with the view that the levy package has not presented an undue burden for UK business. Indeed, independent modelling from Cambridge Econometrics suggests that the reduction in energy demand, together with the reduction in employers' NICs, has led to a reduction in costs for business as a whole.

A study undertaken by Barker, Ekins and Foxon in July 2007 estimated that the energy used in CCA sectors has reduced by 2.6 per cent, with negligible effects on inflation and a slight increase in growth through improved international competitiveness. It is also estimated that, in the 2006 target period, total energy savings were around £1,500 million. Together with the benefit of the Levy discount, this provided substantial resources for investment, including in further energy efficiency.

CONCLUSION/RECOMMENDATION 19

A common call from business groups was that the number of different instruments be reduced, with measures such as the Climate Change Agreements and EU Emissions Trading Scheme becoming increasingly consolidated. We would urge the Government to treat these calls with caution, at least for the time being. In the future it may be possible to rely on fewer instruments to set a single carbon price to deliver all the Government's climate change policy outcomes. Until carbon markets have matured, however, it is wise to continue to target carbon emissions with multiple policies. Furthermore, one of the lessons that the CCL and CCAs teach is that simply increasing the cost of energy (or emissions) may be a necessary component in any attempt to

increase energy efficiency, but not enough in itself; in which case multiple instruments will always be necessary. (Paragraph 99)

The Government welcomes the Committee's recognition of the need for a pragmatic approach. The Government agrees that the cost of energy or emissions in itself may not be a sufficient motivator and that, at least in the short-term, multiple instruments are necessary. However, this will be kept under review, particularly in the light of developments in EU ETS.

CONCLUSION/RECOMMENDATION 20

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. (Paragraph 100)

CCAs were developed specifically for energy intensive industry because of the impact the CCL would have on their competitive position. This reasoning does not apply to non-energy intensive sectors, many of which will be subject to the Carbon Reduction Commitment. Within the context of energy intensive industry, the Government will consider ways to simplify scheme arrangements in the way the Committee suggests when developing the new CCA scheme.

CONCLUSION/RECOMMENDATION 21

Overall, we have sympathy for businesses, dealing with a multiplicity of policy instruments; the climate change policy landscape in the UK is messy, and is only going to become more so with the introduction of the Carbon Reduction Commitment. However, we are also aware that much of this complication has arisen from the evolving recognition that one size of instrument does not fit all, and we welcome the constructive efforts of Government to tailor its policies to the needs and drivers of different types of business. (Paragraph 101)

The Government welcomes the Committee's recognition of its efforts to tailor its policies. We are always conscious of burdens on industry and the need to apply Better Regulation principles. But we are also conscious of the need to drive down carbon emissions and to ensure that all sectors make an equitable contribution. This can only be achieved if policies properly reflect the potential of the different sectors and the fact that different parts of the economy have different drivers. The Government will continue to keep the number and range of instruments under review, and their interaction, to ensure the most effective environmental impact at the lowest cost to industry.

CONCLUSION/RECOMMENDATION 22

The reason given by the Government for introducing the CRC applies equally to all the SMEs too small for inclusion. The Government must set out what it is going to do

instead to help drive down emissions from SMEs while addressing the particular obstacles they face. (Paragraph 102)

The Government recognises the importance of encouraging SMEs to save energy. That is why we fund the Carbon Trust, which provides a range of support for SMEs including interest-free loans, website and call centre support, and free site surveys for companies with energy bills over £50,000 per annum.

The Carbon Trust's work with SMEs made up 40 per cent of their customer base in 2006–07. Over the last three years, the Trust has provided around £90 million of support to SMEs to help them cut both their energy costs and carbon emissions. Of the 5,000 site surveys conducted in 2006–07 two-thirds were for SMEs, and 70 per cent of the business-related calls taken by the Trust's dedicated advice line were from SMEs.

But the Government also recognises that further support for SMEs is needed, if the sector is to achieve its potential for cost-effective carbon savings over the next five years, and is taking action. First, as stated in the Energy White Paper, the Government plans to roll out advanced metering to all but the smallest businesses. This will provide much better information to SMEs, energy services companies and energy suppliers about consumption patterns and potential areas for improvement. Second, the Government intends to enter into voluntary agreements with suppliers to this sector, under which suppliers would provide advice and support to SMEs in reducing their energy bills, through the promotion of energy efficiency and energy services.

CONCLUSION/RECOMMENDATION 23

We have sympathy with the Royal Society's argument that the Climate Change Levy should have been set up as an economy wide carbon tax. Once the Government decided to implement the Levy as a downstream tax, however, the practical scope for basing it on carbon emissions rather than energy efficiency was greatly reduced. We still recommend that the Government should look into the practicalities and potential benefits of basing Levy rates on carbon content, and in particular the potential to vary rates on electricity depending on the carbon profiles of different suppliers and tariffs. However, the overall environmental value of the CCL does not depend on its being based on the carbon content of different fuels, and this should not be an overriding priority. (Paragraph 111)

The Government agrees with the Committee's assessment that the environmental value of the CCL is not contingent on targeting the carbon content of different fuels. Since its introduction in 2005 the EU ETS has established a carbon price for approximately half the UK carbon emissions, including all emissions from electricity across the economy. As the Stern Review sets out, removing barriers to behavioural change and improving energy efficiency forms an essential element in the effort towards tackling climate change effectively. The most important policy for improving efficiency for UK business has been the CCL, and independent analysis estimated that it will have reduced energy demand in the commercial and public sector by nearly 15 per cent a year compared with the situation had the levy package not been in place.

Energy efficiency creates a double dividend: it helps to minimise costs for business and the economy; it also provides an important complement to carbon pricing through EU ETS

and helps achieve the EU ETS cap. The real priority for overall emissions is to agree to a strong EU ETS which can ensure emissions reductions across the whole of the EU.

The driving force for energy efficiency improvements in energy intensive industries is the CCA scheme. Firms entering into CCAs get an 80 per cent reduction in the Levy in return for meeting challenging energy efficiency targets. The price effect of basing Levy rates on carbon content would therefore be weak, being limited to the 20 per cent Levy to be paid. Industry's focus would be more on meeting targets in order to benefit from the reduced rate.

CONCLUSION/RECOMMENDATION 24

We recommend that the Government reform the Climate Change Agreements to express all targets in the form of absolute reductions in carbon emissions. This would help to align CCAs with the EU ETS and CRC, and with national carbon budgets; and be relatively straightforward to introduce. We appreciate the concerns expressed about this idea by some business groups, but do not agree with the suggestion from the CBI that some CCA sectors should be allowed room for "efficient growth in emissions": any sector of the economy whose emissions are allowed to rise exacerbates the problem and increases the pressure on all others to cut theirs. The Government should investigate other means of meeting the concerns of business groups, for example by ensuring that CCA targets were set with reference to the differing scope for carbon reductions in different sectors. Businesses would still be able to use the CCA trading mechanism if they exceeded their targets. (Paragraph 114)

The issues here are complex. On the one hand, relative targets can mean that operators with rising production can meet targets but total energy emissions may rise. On the other hand, absolute targets can be said to penalise expanding industry, benefit contracting industry (through windfall allowances), or encourage carbon leakage. Similarly, setting targets in terms of carbon could be said to bring CCAs closer in line with other climate change policies, but one of the three essential elements of the Stern Review was actions to encourage behavioural change and energy efficiency in the move to a low carbon economy.

The Government will undertake careful analysis of these issues, in consultation with industry, before reviewing options in the context of the new CCA scheme.

The Government would like to confirm that CCA targets are already set with reference to the differing scope for carbon reductions in different sectors.

CONCLUSION/RECOMMENDATION 25

Time and again throughout our inquiry, we heard witnesses argue that there was a gap between economic theory and the actions of businesses in the real world. According to economic theory, businesses should already have been focusing far more on the rational goal of reducing their costs by increasing their energy efficiency. The theoretical basis for introducing the Levy was that it would harness this rational interest. Yet we heard repeatedly that on its own this was not enough to capture the interest and innovation of the majority of firms; they require an extra stimulus to create new organisational structures and cultures, focused on energy efficiency. This has obvious implications for climate change policy, not just covering the business sector, but all sectors of society: it

says that the Government cannot rely simply on increasing the cost of carbon to achieve incremental reductions in emissions. If even large energy intensive companies require additional policy measures then this must be even more true for small businesses, public bodies, and domestic households. We recommend the Government report on how it is applying this lesson in other policies, across the *whole* of the UK Climate Change Programme.(Paragraph 117)

Climate change is a complex problem involving multiple, interacting market failures. The Stern review identifies three broad categories of market failures—the carbon price externality, underinvestment in R&D, and barriers to behaviour change. A comprehensive climate change policy needs to address the range of market failures, and could require the use of multiple instruments in certain circumstances. Carbon pricing—used in key domestic and international policies, such as the EU ETS—is an essential component of climate change policy. Not only does it provide clear and efficient signals to reduce carbon today, it also creates incentives for innovation, reducing the cost of effective action tomorrow. In some circumstances, for example where individuals lack adequate information or where there are other forms of behavioural or institutional inertia, price signals may not be sufficient to drive behaviour change. In these situations, other approaches based, for example, on direct regulation or information campaigns may be necessary; the Government has a range of policies of these types, such as regulations on energy-using products.

Budget 2008 announced that the first three carbon budgets, and the Government's plans for meeting them, would be set out alongside Budget 2009. As part of this work, the Government is considering the broad range of policies that will be required to meet our carbon reduction goals. Defra is also currently developing an economic framework for selecting climate change instruments to reduce emissions from various part of the economy, including the possibility that a combination of instruments may be the most cost effective way of delivering the required emissions reductions. The findings are to be published this summer.

List of Reports from the Committee during the current Parliament

The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2007–08

First Report	Are biofuels sustainable?	HC 76-I & -II (HC 528)
Second Report	Reducing Carbon Emissions from UK Business: The Role of the Climate Change Levy and Agreements	HC 354 (HC 590)
Third Report	The 2007 Pre-Budget Report and Comprehensive Spending Review: An environmental analysis	HC 149-I & -II (HC 591)
Fourth Report	Are Biofuels Sustainable? The Government Response	HC 528
Fifth Report	Personal Carbon Trading	HC 565

Session 2006–07

First Report	The UN Millennium Ecosystem Assessment	HC 77 (HC 848)
Second Report	The EU Emissions Trading Scheme: Lessons for the Future	HC 70 (HC 1072)
Third Report	Regulatory Impact Assessments and Policy Appraisal	HC 353 (HC 849)
Fourth Report	Pre-Budget 2006 and the Stern Review	HC 227 (HC 739)
Fifth Report	Trade, Development and Environment: The Role of FCO	HC 289 (HC 1046)
Sixth Report	Voluntary Carbon Offset Market	HC 331 (HC 418)
Seventh Report	Beyond Stern: From the Climate Change Programme Review to the Draft Climate Change Bill	HC 460 (HC 1110)
Eighth Report	Emissions Trading: Government Response to the Committee's Second Report of Session 2006–07 on the EU ETS	HC 1072
Ninth Report	The Structure of Government and the challenge of climate change	HC 740 (HC 276)

Session 2005–06

First Report	Greening Government: the 2004 Sustainable Development in Government Report	HC 698
Second Report	Sustainable Timber	HC 607 (HC 1078)
Third Report	Sustainable Procurement: the Way Forward	HC 740
Fourth Report	Pre-Budget 2005: Tax, economic analysis, and climate change	HC 882 (HC 195)
Fifth Report	Sustainable Housing: A follow-up report	HC 779
Sixth Report	Keeping the lights on: Nuclear, Renewables, and Climate Change	HC 584 (HC 196)
Seventh Report	Sustainable Development Reporting by Government Departments	HC 1322 (HC 1681)
Eighth Report	Proposals for a draft Marine Bill	HC 1323 (HC 1682)
Ninth Report	Reducing Carbon Emissions from Transport	HC 981
Tenth Report	Trade, Development and Environment: The Role of DFID	HC 1014 (HC 197)
Eleventh Report	Outflanked: The World Trade Organisation, International Trade and Sustainable Development	HC 1455 (HC 354)
Twelfth Report	Transport Emissions: Government Response to the Committee's Ninth Report of Session 2005–06 on Reducing Carbon Emissions from Transport	HC 1718
