BIS Department for Business Innovation & Skills

ENERGY INTENSIVE INDUSTRIES IN THE UK – MAINTAINING INTERNATIONAL COMPETITIVENESS

Compensation for the indirect costs of EU ETS and Carbon Price Support - Consultation on scheme eligibility & design

Response form

OCTOBER 2012

DEPARTMENT OF ENERGY & CLIMATE CHANGE

Introduction

This document is the official response form to be read and used alongside the Compensation for the indirect costs of EU ETS and Carbon Price Support - Consultation on scheme eligibility & design consultation.

It provides a single format for responding to the consultation

For clarification or background to the questions pleas refer to the consultation document.

The deadline for receipt of responses is the 21 December. You may respond by either:

Emailing the complete document to: energyintensiveindustries@bis.gsi.gov.uk

Or by posting the completed document to:

Energy Intensive Industries
Green Economy Team,
Orchard 2, 4th Floor
Department for Business Innovation and Skills
1 Victoria Street
London SW1H 0ET

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

We agree.

Insofar as this (0.411tCO2/MWhr) emissions factor is a truer indication of the carbon intensity of the electricity that energy intensive users will actually purchase, we feel compensation should be determined on this basis and not on the (0.58tCO2/MWhr) figure in the State Aid Guidelines.

While industry will naturally seek to maximise its financial support from the government, any compensations which do not reflect genuine costs will violate the spirit of the State Aid guidelines and should be avoided on principle. The guidelines are clearly intended to err on the side of under-compensating industry rather than over-compensating them in order to avoid market distortions and preserve some incentives for energy efficiency. Paragraph 12 of the State Aid Guidelines reads:

> *“Furthermore, in order to minimise competition distortions in the internal market and preserve the objective of the EU ETS to achieve a cost-effective decarbonisation, the aid must not fully compensate for the costs of EUAs in electricity prices and must be reduced over time.”*

The package is not intended as an exercise in subsidy matching Germany or other international competitors and should not be treated as one.

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

We feel these eligibility criteria can be improved.

Based on its own carbon leakage assessments, the European Commission has defined the list of sectors eligible for any State Aid compensations for indirect ETS costs, but not all actors within these sectors are necessarily exposed to carbon leakage. Recognizing this, the BIS consultation recommends applying an additional carbon leakage assessment at company-level to disaggregate those firms that genuinely need leakage protections from those that do not.

Sandbag welcomes the application of this additional eligibility filter, but note that the BIS consultation seems to have followed the Commission's lead in using an exaggerated carbon price to determine carbon leakage risks:

- The Commission used an obsolete €30 carbon price to determine the sectors exposed to carbon leakage. The ETS carbon price is currently €6 and is expected to remain below €10 out to 2020 unless the ETS cap is tightened.

- For its company filter, BIS has proposed a carbon price of £33 be used – the 2020 UK carbon price expected – despite the fact that the relevant spending review period ends at the start of 2015, and the average UK carbon price will be approximately £17 over that period.

- In addition the BIS consultation uses the Commission's grid emissions factor of 0.58tCO_2/MWhr to determine *eligible* companies rather than the more accurate 0.411tCO_2/MWhr it recommends for its *compensation* calculations (see next section).

The inflated carbon prices and grid emission factors used in the eligibility assessment will unduly multiply the number of companies deemed eligible for compensation. Sandbag therefore recommends that:

The government should apply the indirect carbon costs (in £/MWhr) that it actually expects over the spending review period when determining the companies eligible for compensation in that specific timeframe.

We make detailed remarks about improving the specific *metrics* used to calculate compensation for indirect ETS costs in the final comments section below.

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

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

Please refer to our answer to Question 2 (above).

Again we feel that it is inappropriate to assess exposure to carbon leakage for a Spending Review Period finishing in early 2015 using a carbon price from the year 2020. Neither do we believe that a carbon price in 2020 can be realistically assessed against GVA from over a decade beforehand (i.e. the 2005-11 average GVA).

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

Are there any comments you wish to make?

There are two significant changes we would recommend be introduced to the metrics for compensating energy intensive users.

Firstly, we note that the level of aid supplied to EIIs is, quite rightly, set to decline when their output declines. We note, however, that these aid reductions *do not keep pace* with output reductions and might therefore lead to significant overcompensations.

Under the guidelines, aid levels are not reduced at all until a recipient's output drops 50% below baseline levels. This could lead to some energy intensive users receiving almost twice the compensations their output levels actually merit. This could create perverse incentives to raise or lower output levels to maximise government support. Sandbag therefore recommends that: ***The thresholds used to reduce aid when output is lowered should be narrowed (e.g. to 10% production bands.)***

In other words, compensation would be unaffected if output dropped by less than 10%; compensation would drop by 10% if output fell by 10-19%, compensation would drop by 20% if output fell by 20-29%, and so on. If output falls by more than 90%, no compensation would be received as per the current guidelines.

Secondly, we note that in its National Allocation Plan for Phase 2 of the EU Emissions Trading Scheme, the UK government awarded manufacturing sectors sufficient free allowances to protect them from any compliance costs the scheme might impose on them. This was a measure to protect UK manufacturers against the threat of carbon leakage. Following the recession, however, these industries were left holding far more free allowances than were required to cover their emissions over the period. Over 2008-2011 UK industrial sectors were oversupplied by some 64 million free allowances.

Some of the companies who accrued the largest surpluses from the UK government are the same energy intensive users the government is looking to compensate for their indirect carbon costs. To illustrate, Tata steel's UK operations received some 31 million surplus allowances over 2008-2011, with an average value of €15.50 across that period. This equates to £389 million at current exchange rates, more than the whole compensation package under discussion. The Tata surplus remains roughly equal in value to the £250 million compensation package even if we use forward price estimates for the Spending Review Period.

Whether companies like Tata elected to sell these allowances for revenue in Phase 2, retained them for ETS compliance later on, or intend to sell these allowances at a later date, they represent government assets awarded to defend against carbon leakage over 2008-2012. They were not needed for that purpose, and companies have either financially benefitted from these assets already or will financially benefit from them in the future.

(*continued overleaf...*)

Sandbag therefore recommends that:

No company should receive new government compensations over the spending review period until such a time as the volume of CO_2 passed through to it in its electricity-use exceeds the number of surplus free allowances it received in Phase 2.*

*Any surpluses a company can clearly demonstrate were achieved through low-carbon investment should be disregarded in this calculation.

Some stakeholders will contend that compensations for *indirect* costs under the EU ETS should be treated totally separately from government protections from *direct* costs. We strongly disagree. Insofar as the EU ETS poses a real carbon leakage threat to companies operating in Britain, we feel the government should have a coherent and cost-efficient policy response to meet it. Direct and indirect costs under the ETS are intimately linked: for instance, when an energy intensive company sells its carbon allowances on to the market, the most likely end user of these allowances is an electricity generator who will then pass these costs on to its consumers. *In other words, the UK Government is at risk of compensating energy intensive companies for the indirect costs of European Allowances it originally awarded them for free.* As it stands, the proposed framework potentially exposes government coffers to “double dipping” from energy intensive companies.

By adopting this last measure, the compensation package would better target the companies that genuinely need carbon leakage support and would stretch the budgeted £250 million further in assisting them. It could also potentially lead to a substantial *diminution* of that budget.

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