Dear Brian,

Consultation on measures to reduce carbon emissions in the large non-energy intensive business and public sectors

Ofgem welcomes this opportunity to contribute to the development of policy to address energy efficiency in the non-energy intensive sector. We recognise the significant challenge that tackling climate change requires. Ofgem fully supports the objectives of the government's Climate Change Programme (CCP).

We welcome the fact that Defra and the Carbon Trust have done a significant amount of work to understand the barriers to greater energy efficiency in this group of customers. The Carbon Trust believes these organisations may not exploiting cost-effective energy efficiency measures, citing factors such as lack of information, management behaviour and inertia as possible barriers to investment in energy efficiency.

We note that a wide range of measures are under consideration to address the issues this work raises. The main proposal put forward in the consultation document for improving incentives for energy efficiency measures in this sector is the Energy Performance Commitment (EPC) and so most of our comments relate to this proposal.

Our main message is that we think that more analysis needs to be carried out to assess a broad range of policy measures including the proposed EPC before a final decision is taken. We think that evidence is emerging that companies and public sector organisations are now responding to the challenges of climate change and the incentives that a range of existing policies already create. Although Defra’s analysis has highlighted the failure of these organisations to implement cost-effective energy efficiency projects so far, there is evidence that attitudes are changing and it will take time for organisations to respond the policy measures already in place.

Our reservations here are not about the need for companies to adopt more sustainable business practices, which we fully support, but about the extent of market failure and the likely effectiveness of EPC as a proposed solution.

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1 See for example the npower Business Energy Index Winter 2006 at www.npower.com/In_business/PDF/nBEI.pdf
The Policy Framework

The Climate Change Programme puts emissions trading and in particularly the EU Emissions Trading Scheme (EU ETS) at the centre of climate change policy. We strongly support the use of broad-based economic instruments which will encourage greenhouse gas emissions reductions to be made where they are most cost-effective. A single price instrument will also be most effective as it provides a transparent price signal and allows businesses to make efficient investment decisions and assess the relative costs of energy efficiency measures against alternative means of reducing their carbon emissions. The Stern Report in late 2006 emphasised the importance of the establishment of a single carbon price as an essential foundation for climate change policy, and pointed to the advantages of a common global carbon price in tackling climate change at the lowest possible cost.

In this context, policies to address climate change should be designed as much as possible to facilitate the transition to a single global carbon price. As set out in our response to last year’s review of energy policy, we think that the EU ETS should be expanded to cover all sectors that are major greenhouse gas emitters and future phases should be longer to align the scheme with investment timescales.

We recognise that changes to the EU ETS require agreement across all 27 Member States and in the interim, the UK government may wish to put in place policies which create additional incentives for emission reductions. However, the EU ETS is targeted at correcting the most fundamental market failure – the external cost of greenhouse gas emissions – and the price signal from this should lead to an efficient level of investment in abatement measures.

Other policies need to be assessed in this context, and ideally should be flexible enough to accommodate the price signals emerging from the EU ETS as it continues to develop. In this regard, the interaction of upstream and downstream policies needs careful consideration, so that the incentives companies face in aggregate are coherent and consistent. On the basis of the consultation document, we do not think enough detailed consideration has been given to EPC in this wider context.

The Interaction between EPC and Other Climate Change Measures

The EPC would cover both direct and indirect emissions and would provide a financial incentive for non-energy intensive users to improve energy efficiency. As electricity generators are included in the EU ETS, electricity consumers already have an increased incentive to make efficient investments in energy efficiency as the cost of emissions is beginning to be incorporated into the wholesale electricity price. In addition, industrial and commercial users pay the Climate Change Levy (CCL) on their energy supplies. A small number of the targeted organisations will also have at least part of their direct emissions covered by the EU ETS.

The EU ETS, CCL and the proposed EPC would each provide separate price signals. For the group of organisations which would be targeted by the EPC:

- 70 per cent of emissions are indirect, suggesting that these are largely associated with electricity generation and hence already covered by the EU ETS.

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Most of the organisations do not have Climate Change Agreements (CCAs) which suggests many will pay the full rate of the CCL.

Organisations may then be paying for the environmental impact of their energy use through two or three separate instruments. As the price in each of these instruments moves independently, the aggregate price signal faced by organisations inside the EPC may become very different to the incentive faced by companies outside the EPC or for households. For example, if EU ETS allowance prices and hence energy prices rise, it may become more difficult to justify policies, such as EPC, that place an additional marginal cost on energy use. This is particularly important because all these policy measures, especially trading schemes, which have significant start-up and learning phases, need to be underpinned by credible, long-term commitments from government if they are to change behaviour.

Organisations inside the EPC may invest in emissions abatement which is more expensive than options available to companies outside the scheme and this would raise the overall cost of meeting emission reduction targets to the UK economy. For the small proportion of organisations that are also in the EU ETS, this same effect could distort investment decisions within the organisation.

Some non-domestic use of gas and other fuels remains outside the EU ETS and it may be appropriate to target those emissions as part of the transition to a single, broad-based market instrument. However, the EPC plan proposes that organisations are identified through their electricity consumption. This ignores the fact that organisations below the proposed EPC threshold level of electricity consumption may have comparable levels of direct emissions. This creates a further inconsistency in the coverage of emissions and may represent a missed opportunity to more fully ensure that more non-domestic gas use pays a price that reflects the carbon emissions associated with its use.

**The Extent of Market Failure**

We note that Defra considers that some of the issues raised by the policy overlaps between EPC and other measures are mitigated by the fact that EPC is intended to address a different sort of market failure. The fact that the investments expected to be incentivised by the EPC are all considered to be cost-effective now, without any further financial incentive, appears to lead Defra to conclude that other issues, including management structure and awareness, rather than carbon price signals, are the key barriers to investment.

We have not yet seen enough evidence to support the view that the market failure is clear and likely to endure to justify a scheme such as EPC. In the light of sharply increasing energy prices and rapidly growing awareness of climate change, evidence from the market (eg surveys of business attitudes and behaviours) tends to suggest that attitudes and action in these sorts of organisations are undergoing a fundamental shift. At least some of the targeted companies have already taken major and high profile steps to minimise their climate change impacts, suggesting that there is no pervasive market failure and that companies are likely to respond without further policy measures. Given the difficulty and lags associated with collecting data from companies, there is a risk that the Government’s analysis could be highlighting a problem that businesses are already tackling.

However, if, having reviewed the evidence from the market, the government’s view is that this transformation is not happening as fast as may be required to meet climate
change objectives across these organisations as a whole, there are many possible ways to deliver the attitude and behavioural changes that are targeted by the proposals.

If management engagement and visibility of the opportunities are the real issues, then a range of alternative measures needs more consideration, including information campaigns, increasing the resources of the Carbon Trust, and fuller exploration of some of the benchmarking options outlined in the consultation document. Such measures might not, upon fuller analysis, be judged to be as potentially effective at changing behaviour, but this may be offset by a reduced scope for unintended consequences and administrative costs.

**Administration and auctioning**

Any new policy will create an administrative burden on the targeted participants. We acknowledge that the proposals give consideration to ideas to reduce the administrative burden on the targeted organisations, for example, through light-touch monitoring and reporting requirements.

Whilst we understand why Defra would like the scheme to be revenue neutral, the recycling of revenues may create further problems. We welcome the proposal to auction allowances as the most efficient mechanism for allocating emission rights. However, recycling of the revenue to participants substantially adds to the complexity of any auction design and could distort the incentives created. It could lead to companies being paid by other companies or organisations in the scheme for activities they were likely to carry out anyway. This could impact on competition and competitiveness. The prospect of the reallocation of revenues is also likely to encourage companies to lobby on the design of the recycling mechanism to minimise their overall exposure or increase their likely reward. This could in some cases actually be a distraction from focusing on energy efficiency measures.

A payment in proportion to average emissions since the start of the scheme would weaken the financial incentive to reduce emissions. If a company reduces emissions, it will avoid buying some allowances but will also reduce the amount of revenue it receives from the auction fund. Conversely, a company which increases emissions will face the cost of buying additional allowances but also receive increased revenue from the auction fund. It would be expected for companies to take this effect into account in their bidding strategy and investment decisions.

Adopting an approach based on emissions reductions received would mitigate this effect to some extent but would still distort incentives. It would also add complexity and uncertainty – it would be more difficult for organisations to calculate their expected revenue from the auction fund – which will increase the administrative burden for the firms and may adversely affect investment decisions. Including further criteria, such as customers’ proportion of automatic metering, would only increase this complexity.

It would be more appropriate to make the measures revenue neutral by an alternative measure, for example by providing a substantial discount on the CCL for companies in the EPC to mirror that for companies in CCAs.

**Alternative Schemes**

The consultation paper identifies a number of alternatives to the EPC, including changes to building regulations, improved provision of information and advice and industry-led
voluntary initiatives and voluntary benchmarking. Of these, only voluntary benchmarking is discussed in any detail.

It is estimated that a voluntary benchmarking programme would only attract around 20% of the participants that are targeted by the EPC. Expected emissions reductions from voluntary benchmarking are estimated to be only 0.2 MtC/year in 2020 compared to 1.2 MtC/year by 2020 for the EPC. However, this appears to assume that benefits will only flow to participants. It is likely that there would also be some demonstration effect for non-participants, especially if the scheme was supported by targeted promotion and facilitation work by the Carbon Trust.

The option of a mandatory benchmarking scheme is not considered. Mandatory benchmarking would appear to offer many of the benefits of the proposed EPC scheme while avoiding some of the drawbacks of the voluntary benchmarking scheme. It would be more appropriately targeted at the identified barriers to energy efficiency investment than the EPC because it is more focused on the reputational drivers identified in the consultation paper. As such, it should be effective in both raising awareness with companies of the importance of energy efficiency policy and targeting issues of split incentives in organisational structure. It would also ensure coverage of targeted organisations which may not happen under a voluntary benchmarking scheme and would avoid the administrative complexity of an auction and recycling mechanism.

Mandatory benchmarking could also serve as a learning phase for a scheme such as the EPC if it was considered desirable to introduce such a scheme in the future, e.g., by providing the monitoring and reporting framework, and the information that would be needed to set caps.

**Summary**

Ofgem remains committed to the objectives of the government’s climate change policy and the use of emissions trading as a central part of that policy. In that context, we think that other policies should be designed so that they are flexible to the long-term development of the EU ETS and should be well-targeted to emissions not covered by existing policies. We recognise that there may be barriers to investment in the non-energy intensive sector. However, these may be better targeted through other policy options which are less complex and will place less administrative burden on the participating organisations. In particular, we would encourage exploration of the option of mandatory benchmarking, supported by further awareness-raising and facilitation work, as a possible policy option.

We are happy to discuss any of the issues raised in this response. We will continue to participate in the cross-governmental steering group and are happy to work with government going forward to develop further analysis of options for this sector.

Yours sincerely

Steve Smith  
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