

Government should earmark carbon allowance money for green projects.

10 February 2011.

Executive summary.

On 10 February the UK Government will make €1bn from auctions of EU Allowances. The UK Government could make over €64bn more by 2020.

This revenue currently goes to the Treasury. The European Commission (EC) proposes in Directive 2003/87/EC that at least 50% of income should be earmarked for green projects, but the Government shows no sign of adopting this proposal.

Carbon Retirement supports earmarking revenue from allowance auctions. Earmarking revenue would provide stable financing for green projects and is working well elsewhere.

In Carbon Retirement's view, earmarked revenue ought to be used to a) address fuel poverty, b) provide green funds for developing countries and c) help meet UK climate change targets.

Carbon Retirement is a carbon offsetting company that leverages the EU Emission Trading Scheme (EU ETS) to reduce emissions further. Our aim is to increase the transparency and effectiveness of the two markets we bring together: voluntary carbon offsetting and the EU ETS.

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£1bn made from carbon allowances to date.

On 10 February 2011 the UK Government will make €1bn from auctioning EU Allowances.¹

- The UK was the first Member State to hold an auction in Phase II of the EU ETS (in November 2008).
- By 10 February 2011, the UK Government will have auctioned 73m tonnes of EU Allowances (allowances).² This will have generated over €1bn for Treasury coffers.³
 - The UK Government is allowed to auction a maximum of 10% of allowances in Phase II, which runs from 2008-2012.
 - The UK's Phase II National Allocation Plan states that the UK will auction 7% of allowances – approximately 85m across the phase – plus any surplus from the New Entrant Reserve and allowances from closures.
- The amount of money generated by the UK through auctioning allowances is second only to Germany, which has generated over €2bn to date from auctions. Germany has a much higher level of emissions, and as a consequence is allowed under EU rules to auction over twice as many allowances as the UK per year. Other countries using auctions include the Netherlands, Austria, Ireland and Hungary.

¹ An EU Allowance is a "pollution permit". Each allowance represents the right for heavy industry to emit one tonne of carbon.

² This assumes that 4,400,000 allowances will be auctioned on 10th February as planned. This can be verified after the auction has taken place at www.dmo.gov.uk or on the DMO's wire service pages 'DMO14' on Bloomberg and 'DMO/CARBON01' on Reuters. They aim to release the information 'as soon as possible after the end of the auction', which is due to close at 12pm.

³ See Appendix A for a table of revenue generated to date. Information about the revenue generated in the auction on 10th February will be available on that date from the sources noted above. See Appendix B for information about primary participants in the auctions.

Potential to make over €64bn more by 2020.

- After 10 February auction, the Government will auction another 22m allowances in 2011. Auctions for 2012 have not yet been announced. Assuming a conservative average price of €15/tonne, this will generate at least an additional €328.5m by the end of 2011.
- Revenue raised by governments across Europe through allowance auctioning will rise dramatically in Phase III. The EC estimates this figure at €15bn a year across Europe as a whole. The Carbon Trust estimates the revenues for the UK alone will be as high as €4-8bn per year.⁴ Over the 8 years of Phase III this will amount to €120bn across Europe and €32-64bn in the UK.
- The UK gets such a large slice of the pie as it is one of the largest emitting countries, so has a higher volume of emissions covered by the EU ETS than many other countries.

Phase III will see much greater revenue for the UK Government from auctioning permits because:

- **More allowances will be auctioned.** At least 50% of allowances will be auctioned per year from 2013 in the UK, compared to around 7% in Phase II. The reason for this increase in auctioning is to ensure the 'polluter pays'. Currently some industries are given all of their allowances for free in order to avoid them being subject to costs that are not borne by their competitors outside of the EU.
- **The price of allowances will be higher.** To date, prices obtained for allowances in UK auctions have been between €10.98 and €16.15.⁵ In the future the price is due to rise because of a) the reduced supply (cap tightening by 1.74% per year), b) the floor price, which is due to be implemented in the UK through two separate taxes on fossil fuels for heavy industry, and c) there are greater restrictions on offsetting in Phase III, which means that more of the reductions will need to come from implementing projects in the EU rather than purchasing credits generated from projects in developing countries.⁶
- **The volume of emissions covered will be higher.** Although the cap is coming down, more sectors and gases will be covered so the total volume of emissions covered will be higher. Aviation will be covered by the ETS from 2012 onwards. Additional greenhouse gases and manufacturing processes are covered from 2013 onwards.

Revenue ought to be earmarked for green projects.

The revenue generated currently goes to the Treasury.

⁴ Based on a price €28 per tonne in 2013 and €39 per tonne in 2020 and taken from, *Cutting Carbon in Europe: The 2020 plans and the future of the EU ETS* (CTC734), Carbon Trust (2008); for similar price forecasts see SocGen (2010) or for a higher price forecast see UBS (2010).

⁵ See Appendix A for prices achieved in each auction.

⁶ The use of project-offset credits from outside the EU will be reduced in Phase III to 50% of the required EU ETS emission reductions; down from 226% in Phase II. These restrictions on offsetting will mean a greater proportion of emission reductions have to be achieved in the EU. This is likely to increase the price of EU Allowances. It likely to have less of a direct effect on the UK, where installations are already restricted to offsetting a maximum of 8% of their free allocation of allowances.

Earmarking revenue from ETS auctions is proposed by the EC, but the UK Government objects to it.

- In 2008 ENVICom (the Environmental Committee of the European Parliament) amended Directive 2003/87/EC, to state that: *“At least 50% of the revenues generated from the auctioning of allowances should be used for the following purposes:*
 - *to reduce greenhouse gases;*
 - *to develop renewable energies, and other technologies contributing to the transition to a low-carbon economy;*
 - *measures to avoid deforestation and increase afforestation and reforestation;*
 - *forestry sequestration;*
 - *capture and geological storage;*
 - *a shift to low-emission and public forms of transport;*
 - *research in energy efficiency and clean technologies;*
 - *improvements in energy efficiency and insulation;*
 - *to cover administrative expenses of the management of the Community scheme.”*⁷
- But the UK Government is against the idea because they believe a) it is inefficient and b) it is inappropriate for the EU to determine Member State spending (see box).⁸

“On hypothecation (also known as earmarking), the Government is opposed to the Commission’s proposal that a proportion of auctioning revenue should be dedicated to climate change measures.

“Whilst earmarking clearly appeals to many stakeholders, it is an inefficient means of determining public expenditure priorities which should generally be looked at in the round rather than by creating artificial links between particular spending programmes and specific revenue streams. Moreover, it is inappropriate for EC legislation to determine national public expenditure allocations, for which national governments are responsible and accountable to their national parliaments. Mandatory hypothecation at an EU level therefore runs counter to the principle of subsidiarity, which the Government strongly supports.”

**Department for Energy and Climate Change (DECC),
response to EU earmarking proposal**

- However, the Government also acknowledges that, in Phase III *“There is a non-legally binding commitment from EU member states to spend at least half of the revenues from auctioning to tackle climate change both in the EU and in developing countries.”*⁹

⁷http://europa.eu/legislation_summaries/energy/european_energy_policy/l28012_en.htm#amendingact

⁸http://www.decc.gov.uk/en/content/cms/what_we_do/change_energy/tackling_clima/emissions/eu_ets/phase_iii/phase_iii.aspx

⁹http://www.decc.gov.uk/en/content/cms/what_we_do/change_energy/tackling_clima/emissions/eu_ets/phase_iii/phase_iii.aspx, second section, fifth bullet point

Earmarking provides stable project finance and is working well elsewhere.

- **Earmarking assures minimum and stable levels of financing for projects**, avoiding periodic haggling, and consequently lowering overall costs.¹⁰ This could greatly aid the UK's ability to meet its ambitious Climate Change Act target of a 34% emission reduction by 2020.
- **Earmarking is working well elsewhere.**
 - Germany is auctioning 40m EUAs each year over 2008-12 – 9% of their allowances. The government earmarks €400m of the revenue generated from allowance auctions.¹¹ The fund is split with €280m set aside for national projects (for small businesses, private households, cities, counties and local amenities to fund small-scale emission reduction projects) and €120m for international projects. Germany expects that this practice will continue in future years.
 - There are plenty of practical examples of earmarking revenue from environmental schemes in other countries. Denmark returns 50% of its CO₂ tax revenues to taxpayers as compensation, while in France, an air pollution tax that existed between 1985 and 1999 used its revenues to subsidise pollution-reducing investments at tax-paying emission sources. Another example is Austria, which earmarks its energy tax for both energy-saving measures and public transport.
 - Previous practice shows it's not out of the question in the UK. Earmarking of funds has occurred through the National Lottery and the Renewables Obligation by declaring these revenues separate to public finances. The Carbon Trust is part financed by funds earmarked from the Climate Change Levy. The Government has shown that earmarking revenue is not only possible but beneficial.

Earmarked revenue should be used to address fuel poverty, provide green funds for developing countries, and help meet UK climate change targets.

The earmarked revenue should be used:

a) To mitigate the undesirable effects of a high carbon price for the 'fuel poor'.

One of the side effects of emissions trading is that, where suppliers have a captive market, as is the case with energy companies in the UK, they can pass the cost of carbon onto their customers. In the main, this is no bad thing - increased energy prices will help to incentivise householders and businesses to reduce energy use, and therefore emissions. However, increases in energy prices are likely to result in more people being tipped into fuel poverty.¹²

¹⁰ McCleary (1991)

¹¹ <http://www.carbon-financeonline.com/index.cfm?section=europe&action=view&id=11344>. In addition, 1.1m allowances were auctioned to cover the costs of administering the ETS within Germany.

¹² Someone is defined as being in fuel poverty if they spend more than 10% of their income to maintain a satisfactory heating regime <http://www.poverty.org.uk/80/index.shtml>

The increasing proportion of people being defined as such is due to energy prices outstripping income growth since 2004, and this trend is likely to continue into the foreseeable future as domestic output growth remains depressed, while demand for scarce commodities, particularly from the BRIC countries, continues to increase. Most worryingly, of the 4.5m people in fuel poverty, over 80% are classified as being 'vulnerable'.¹³ This means that the household contains someone who is disabled, elderly, a child, or long-term sick.

It has been indicated that energy efficiency measures are key to the government's long term strategy for dealing with fuel poverty.¹⁴ Earmarking revenues from EU Allowance auctions for subsidised community energy generation or energy efficiency in social housing would be a very sensible way of balancing out the potential adverse effect of the EU ETS on this group.

- b) To support mitigation and adaptation in developing countries** through the Green Climate Fund, recently agreed at the Cancun Summit, helping to achieve the funds target of \$100bn a year of climate funding.
- o The UK Government has not yet specified where their proportion of the \$100bn climate funding for developing countries will come from.
 - o Earmarking revenue from EU ETS auctions would set an example that the rest of the EU may follow, thereby ensuring new and additional finance for developing countries.¹⁵
- c) To help the UK meet its climate change targets.** The UK has committed to a 34% reduction in carbon emissions from a 1990 baseline by 2020. It also has a commitment to generate 15% of our electricity using renewable sources by 2020. Additional funding would help to ensure that we meet these targets.
- o In particular, the UK is struggling to meet the renewables target. Currently the UK ranks third from bottom in Europe for renewable energy generation, ahead of only Luxembourg and Malta.
 - o Funds could also be used to support emissions reductions in non-ETS sectors, such as transport.

¹³ Government Statistics 2008

¹⁴ <http://www.publications.parliament.uk/pa/cm201011/cmhansrd/cm100916/debtext/100916-0001.htm>

¹⁵ That the finance needs to be 'new and additional' is a point of great importance to developing countries. These countries have been disappointed in the past by developed country pledges for finance that, when delivered, have turned out to be funds already committed to them in aid budgets.

Appendix.

Appendix A: UK Government EUA auction revenue to date

Date	Number of EUAs auctioned	Auction clearing price	Revenue generated
19-Nov-08	3,999,875	€ 16.15	€64,597,981.25
24-Mar-09	3,999,226	€ 10.98	€43,911,501.48
04-Jun-09	4,200,000	€ 13.83	€58,086,000.00
09-Jul-09	4,200,000	€ 13.38	€56,196,000.00
10-Sep-09	4,199,840	€15.00	€63,207,592.00
08-Oct-09	4,199,925	€13.00	€56,110,998.00
05-Nov-09	4,199,480	€ 14.20	€59,632,616.00
07-Jan-10	4,199,951	€ 12.15	€51,029,404.65
04-Feb-10	4,399,950	€ 12.66	€55,703,367.00
18-Mar-10	4,499,330	€ 13.00	€58,491,290.00
10-Jun-10	4,399,560	€ 15.60	€68,633,136.00
08-Jul-10	4,399,750	€ 14.65	€64,456,337.50
09-Sep-10	4,399,800	€ 15.58	€68,548,884.00
07-Oct-10	4,399,875	€ 15.46	€68,022,067.50
04-Nov-10	4,399,845	€ 14.51	€63,841,750.95
13-Jan-11	4,398,950	€ 14.00	€61,585,300.00
10-Feb-11	4,400,000	€ 10.00 ¹⁶	€44,000,000.00
TOTAL	77,295,357		€1,006,054,226.33

Appendix B: Who buys the allowances in an auction?

The majority of participants in an auction are 'primary participants'. They are all banks. Other entities that are registered in the EU ETS can make a non-competitive bid for allowances. Non-competitive bidding allows account holders to submit one bid of up to 10,000 allowances before competitive bidding begins.

¹⁶ The auction clearing price of € 10.00 has been used as a conservative estimate for the auction on 10 February, it is highly unlikely that it will fall to this level. This is simply to demonstrate that the auction is almost certainly going to tip UK Government revenue over €1bn.

Who we are.

Carbon Retirement is a carbon offsetting company that leverages the European Emission Trading Scheme (EU ETS) to reduce emissions.

We work on behalf of organisations and individuals that want to offset their unavoidable emissions.

The approach involves buying EU Allowances from the EU ETS and permanently removing them from the scheme so they cannot be used. This reduces emissions from heavy industry in Europe and incentivises investment in low carbon technology.

Carbon Retirement provides an innovative and robust alternative to traditional project-based offsetting. Our clients range from FTSE 100 private equity firm 3i, to the Church of England and the UK Committee on Climate Change.

Our aim is to increase the transparency and effectiveness of the two markets we bring together: voluntary carbon offsetting and the EU ETS.

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