CBI ROUNDTABLE:
LEVY CONTROL FRAMEWORK AND CARBON PRICE FLOOR
11/01/17
In the 2016 Autumn Statement, the government committed to setting out the future of the Levy Control Framework in the Spring Budget. It is unclear what level of detail the government will provide, but it is likely to be more fundamental than simply extending the cap. The purpose of this discussion is to refresh the CBI’s position on the LCF, and determine whether it is still the right policy to manage costs and provide investor confidence in the energy market.

In the 2016 Budget the government stated that they would announce the long-term future of the Carbon Price Support at the Autumn Statement. Following the Brexit vote, and the uncertainty of the UK’s involvement with then EU ETS, this decision has been delayed, and we expect a decision later in 2017.

The purpose of this discussion moves the conversation on from the meeting of the Energy and Climate Change Committee in September 2017, and to establish the parameters of a refreshed position for the CBI on the future of the carbon price support and carbon pricing in the UK.
FUTURE OF THE LEVY CONTROL FRAMEWORK
The Levy Control Framework was introduced in 2011 by DECC and the Treasury to control the impact of subsidies on consumers.

- The LCF sets a cap on the costs of some policies that are levied through consumer bills.
- The purpose of the LCF is to provide a clear trajectory of these policy costs over time, in order to support investment in renewable generation, as well as budgetary control to prevent these costs rising too quickly.
- The cap on the LCF was set to reach £7.6bn by 2020/21.
- In 2015, the government announced that the LCF would breach the cap in every year, and come close to breaching the 20% “headroom”.
- This resulted in a series of policy changes, particularly on Feed-in-Tariffs and the Renewables Obligation in 2015 to prevent further cost rises.

The policies covered and costs:

<table>
<thead>
<tr>
<th>Costs (£bn)</th>
<th>2016</th>
<th>2020</th>
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<tbody>
<tr>
<td>Renewables Obligation</td>
<td>£3.8</td>
<td>£5.2</td>
</tr>
<tr>
<td>Contracts for Difference</td>
<td>£0.1</td>
<td>£2</td>
</tr>
<tr>
<td>Feed in Tariffs</td>
<td>£1.2</td>
<td>£1.3</td>
</tr>
<tr>
<td>Capacity Market</td>
<td>£0</td>
<td>&gt;£0.9</td>
</tr>
<tr>
<td>ECO</td>
<td>£0.8</td>
<td>£0.6</td>
</tr>
<tr>
<td>Warm Homes Discount</td>
<td>£0.3</td>
<td>£0.3</td>
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Note: The results of this forecast were published by the Office for Budget Responsibility in its July 2015 Economic and Fiscal Outlook.
Source: National audit office analysis of Department of Energy & Climate Change data
The LCF has a number of benefits that have supported investment and controlled costs:

- By providing a cap on policy costs over time, the LCF provided business with a clear trajectory of expenditure and investment. This provides a useful signal to business generators, investors and the supply chains to plan and secure investment.
- It has provided a limit on expenditure, forcing the government to take action, when costs become too high for consumers.

However, there have also been criticisms of the LCF, which include:

- The cap has not been extended beyond 2020. With many renewable projects years in the planning, the failure to extend this horizon has been damaging to investment.
- The lack of transparency of total spending under the LCF until 2015 meant sudden policy interventions to ensure government stayed within the cap, damaging confidence among investors. The National Audit Office was particularly critical of the government’s failure to “report regularly on the full impact of its policies on energy bills.”
- With Contracts for Difference becoming the one of the predominant factors with LCF expenditure, falling wholesale costs, which benefit consumers, drive up the spending under the LCF.
CBI position to date: The CBI has been supportive of the LCF, as it provides a framework for investment. However, we have repeatedly called for the government to set the cap out beyond 2020, providing at least 5-7 years horizon, and extended every year on a rolling basis.

Option 1: The LCF should be extended – with appropriate transparency and governance – and continue to be the framework by which costs are managed and investors given foresight:

The LCF is the right policy choice. However, for it to maintain confidence of investors the government needs to ensure that there is good governance and transparency to prevent sudden and damaging policy interventions, with a rolling cap set out at least 5 years ahead.

Option 2: Remove the LCF and use Contracts for Difference and the Capacity Market to provide a longer-term view of investment and expenditure

Rather than the LCF, the government should use auctions for the Capacity Market and Contracts for Difference to provide an indication of the government’s ambition and give the government the capacity to predict manage costs for consumers. This should be accompanied by a clear plan and trajectory for the schemes, accompanied by a clear governance framework to provide transparency.
Questions for members

- Do you agree with the CBI’s assessment?
- Are there any other options?
- If we continue with the LCF, what should be the:
  - Objectives of the cap
  - Mechanisms of the cap, such as governance and transparency, and actions in the case of a breach
- If the LCF is scrapped, what policies should be in a future framework to manage costs?
- What would industry need to ensure long-term certainty? Are there mechanisms other than CfDs and the CM?
- How should other existing policies be used to support investments?
- How should costs for consumers be controlled?
- In either case, how should/do we deal with fluctuations in wholesale price?
FUTURE OF THE CARBON PRICE SUPPORT
The UK government introduced the Carbon Price Floor in 2013 as part of a suite of policies within its Electricity Market Reform (EMR) framework. The mechanism set a ‘target’ carbon price (the floor), reaching £30/tonne in 2020 and £70/tonne in 2030, which would be met by levying a top-up tax (the Carbon Price Support, CPS) above the carbon price set by the EU Emissions Trading System (EU ETS).

The CBI supports the principle of carbon pricing as a way of driving investment in low-carbon infrastructure, however expressed concern that the unilateral nature of this policy risked putting UK industry at a competitive disadvantage compared to its European counterparts. In 2013-14 we argued that this was unsustainable over the long-term given the weak price projections for the EU ETS. As such, the CBI advocated for a three-pronged approach:

- **Freezing the Carbon Price Support:** The CBI successfully lobbied for the Carbon Price Support (CPS) to be frozen at £18/tonne to 2020 in the 2014 Budget in order to prevent any further divergence between the UK and EU carbon prices. We also secured a one-year extension of the freeze to 2021 in the 2016 Budget.
- **Supporting Energy-Intensive Industries:** We have continued to stress the importance of supporting at-risk electro-intensive industries facing the indirect costs of the EU ETS and CPF.
- **Reforming the EU Emissions Trading System:** The CBI believes that the EU ETS should be the primary carbon pricing scheme, and has continued to be a strong advocate of EU ETS reform, actively lobbying in the UK and in Brussels to influence the development of the Market Stability Reserve mechanism (which is intended to make the scheme more responsive to economic developments) and the current reforms to set a new cap and support industries at risk of carbon leakage.

With 2020 fast approaching, the CBI highlighted in its 2016 Budget submission the need to set out the long-term trajectory for the CPS, with the government committing to do so in the 2016 Autumn Statement.

However, the Brexit vote has, by implication, called into question the UK’s long-term participation in the EU ETS, making these decisions much more challenging given the interrelation between the mechanisms. At the Autumn Statement the government delayed a decision on the future of the CPS, which will be taken in 2017.
● Discussions with members have highlighted the benefits of the UK’s membership of the EU ETS:
  - This is currently the world’s largest carbon market enabling the best abatement opportunities.
  - While there are policy issues being debated on post-2020 reform, the market works well.
  - Replacing the EU ETS with a UK market would be costly, time consuming and duplicative.

● However, members have also highlighted some risks, particularly post-Brexit:
  - Leaving the EU may mean that the UK has little influence over future reform of the EU ETS, and has be a rule taker in a market that does not meet our needs.
  - The EU ETS puts competitive pressure on UK businesses due to increased costs of carbon and energy, which may be exacerbated by falling value of the pound against the euro (carbon allowances are priced in euros).
  - Although the market works well, there are still flaws in the system, such as a mismatch between supply and demand of allowances.
• The role of the CPS has changed since its introduction.
  - Originally intended to drive low-carbon investment, this has been driven more by other policies.
  - It has, however, been successful in driving coal off the system, with coal supplying less than 10% of power in the UK in 2016.
  - It has also supported the economics of low carbon generation.

• However, members also have concerns:
  - The CPS has driven up energy costs by around £7-11/MWh, imposing a competitive disadvantage on the UK’s industry. The UK government has provided support to some sectors to manage this cost.
  - As it works with the EU emissions cap, reducing UK emissions has allowed other countries to emit more, at lower cost.
  - Furthermore, there is evidence that reducing UK coal generation has increased coal generation elsewhere via the interconnectors.
Questions for members

● Do members think that remaining in the EU ETS is the best way to achieve our objectives of reducing our emissions at least cost and remaining competitive?

● What are the limits of the UK’s participation in the EU ETS, if the UK cannot influence it? What is “influence” in this case?

● Given mechanisms to drive low-carbon investment and remove coal from the system, what value does a UK carbon price have? (Assuming we stay in the EU ETS)

● What should be the purpose of action on carbon pricing in the UK?
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