

What will the **Carbon Price Floor** proposals mean for the UK energy market?

What do the Carbon Price Floor proposals cover?

As part of the wider government consultation on Electricity Market Reform (EMR) the Carbon Price Floor (CBF) consultation document was published jointly by HM Treasury and HM Revenue & Customs on 16 December 2010, with the government intending to publish the agreed proposals in the 2011 Budget.

The CBF proposals envisage radical changes to existing environmental taxes to create a carbon price support mechanism.

Creating a high, stable carbon price through a price support mechanism that is aimed at encouraging investment in low-carbon energy generation by:

- effectively lowering barriers to investment in low carbon energy production
- encouraging a switch to low carbon fuel sources (away from coal and gas)
- increasing wholesale and domestic electricity prices.

The government is proposing that the carbon price support level needs to increase from today's price of around £15/tonne up to £70/tonne by 2030. The rise in the carbon price is intended to increase investment in new low-carbon energy generation capacity by up to 11 gigawatts by 2030.

The CBF would work in conjunction with the EU Emissions Trading System which applies market determined carbon prices to power generators and energy intensive industries.

When will the increased carbon costs be felt?

The key issue is how quickly the increase in the carbon price should be implemented. A delicate balance needs to be struck between encouraging low carbon investment and allowing power generation companies enough lead time to develop new lower carbon power generation plants.

In isolation of other measures being considered the EMR and the CBF will:

- increase wholesale electricity prices over the medium term, although prices would begin to decline in the mid-2020s
- increase household electricity bills in the short and medium term, although prices would begin to decline in the mid-2020s
- marginally increase non-domestic electricity bills, although they would begin to decrease the mid-2020s (compared to a baseline scenario which would leave prices at today's level).

Who will be most affected by these proposals?

The proposed CBF changes will have a significant impact on:

- Fossil fuel providers
- UK power generation companies
- Wholesale energy purchasers (with energy intensive operations)
- UK based manufacturers/industrial processors
- Construction/housing suppliers
- Domestic households

If the power generation companies are unable to develop alternative, low-carbon energy generation facilities within a suitable timescale there is a possibility that all of the rising carbon costs could be passed directly on to electricity consumers.

Areas of the CBF policy that need further clarification

The proposal will be implemented by changing existing climate change levy (CCL) and fuel duty taxes. The additional administrative burden is expected to be reasonably low. However the following areas need further clarification:

- The consultation document does not quantify the potential tax revenue from the proposals
- Will any increased tax revenues be ring-fenced for funding renewable incentives such as feed in tariffs and renewable heat incentive ?
- Is an indirect and untargeted tax approach the most effective option, particularly when assessed against more direct incentives such as enhanced capital allowances?
- Will a higher CBF incentivise creative structuring to avoid the tax burden?
- Could a UK only increase in the carbon floor price put UK Plc at a competitive disadvantage?
- Should an EU wide approach be taken?

Although the government is looking to change its approach to tax policy in this area the longer term carbon price outlook used in investment decisions remains uncertain. A transparent and robust mechanism to provide assurance for longer term investment decision is needed.

What drives investment decisions in low carbon technology?

Low carbon generation technologies typically require greater upfront capital expenditure than conventional fossil fuel power generation. The government recognises that there are a range of factors that affect investment decisions and their importance varies across different technologies. Establishing the appropriate level of support for the carbon price involves considering a number of factors, including:

- The impact on investment in new low carbon generation, including assumptions about generation costs and fossil fuel prices
- The impact on the management of existing generation sites and the closing of existing plants
- The economic and distribution implications of potentially higher electricity prices for consumers and businesses.

It should be noted however, that other potential reforms to the electricity market will affect the economics of investments in electricity generating capacity.

CCL and fuel duty changes

The government has decided carbon price support is best achieved by amendments to the existing tax regime around the CCL and fuel duty being levied on all fossil fuels used in the UK to generate electricity.

In most cases, fossil fuels currently used to generate electricity are exempt from CCL. The government proposes to remove these exemptions and to tax these commodities at rates that take account of the commodities' average carbon content.

Which fuels will be subject to increased rates of CCL?

These rates will be known as the 'CCL carbon price support rates', and will be different from the main CCL rates levied on consumers' use of gas, coal, LPG and electricity, which will be retained. No changes are proposed to existing energy supplies paid through CCL.

Oils are not subject to CCL but fuel duty is payable at the point oils leave the refinery. Currently, the duty can be reclaimed in full by the electricity generator but, as part of the carbon price support mechanism, the government proposes to reduce the amount of fuel duty that can be reclaimed, in effect creating 'oils carbon price support rates'.

The government's proposals also include:

- Electricity used to generate further electricity will remain exempt from CCL
- The CCL liability of electricity supplied to the final consumer arising from generation using fossil fuels will be unchanged, as will the treatment of imported electricity
- Fossil fuels used to generate electricity in the UK that is subsequently exported will be liable to the relevant carbon price support rates
- All fossil fuels burnt in combined heat and power stations (CHP) will be subject to CCL or fuel duty (at the relevant carbon price support rates) regardless of their rating through the CHP Quality Assurance programme
- The government acknowledges that there are good environmental grounds for introducing a partial relief from CCL for fossil fuels used in carbon capture and storage (CCS) plants to reflect the proportion of CO₂ abated and for making a commensurate adjustment to the amount of fuel duty that can be reclaimed on oil used in CCS plants
- Supplies of fossil fuels to auto-generators will continue to be liable to CCL and fuel duty but at the relevant carbon price support rate. Auto-generators will no longer be able to reclaim CCL or fuel duty charged on the fossil fuel they use to produce electricity, which is subsequently supplied to the electricity transmission and distribution networks.

Who should I contact?

For further information regarding how the proposed CBF could impact your business, please contact:

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