Introducing tax incentives for permit cancellation

Introduction

The UK is now liable to meet legally enforceable carbon budgets.

To account for the fact that ~50% of emissions of CO2 are covered by the EU ETS Government has chosen to count traded effort towards the meeting of these budget (as opposed to counting actual emissions).

This is supported by the argument that emissions reductions are valid contributions to countering global climate change irrespective of where they occur and that trading helps to minimise cost by uncovering least cost abatement.

It is the initial allocation of permits that therefore contributes towards the budget. That is to say purchased permits/credits can be used to counteract or 'offset' any emission occurring above the initial allocation. Similarly any under emission resulting in sold or banked permits cannot be counted towards the budget (since they result in emissions occurring somewhere else).

Options for meeting the budget using trading

If the UK is not on track to stay within its economy wide budget it has a number of options:

It can buy permits/credits to cover excess emissions. This incurs a liability against public spending and would be a direct wealth transfer from taxpayers to firms (particularly if firms are receiving free permit allocations).

It can hold back some of the allocation attributed for auction or for the New Entrant Reserve and cancel them. This would constitute a lowering of the cap and therefore additional effort counting towards the budget (this is permissible under EU law that allows MS's to increase effort within Environmental Directives). Directives but would presumably be subject to public consultation). This would result in revenue forgone from the auction; however it may lead to an offsetting price increase from the auctioning of

remaining permits.

Another way to access permits, without paying for them directly, is to incentivise the voluntary cancellation of permits by non-Government bodies. In this context voluntary means the purchase and/or cancellation of permits by individuals and companies over and above any regulated requirements.

For example:

- A participating company covered by the cap redeems more permits than necessary to cover its own emissions i.e. cancels some of its surplus rather than sells them.
- A non-participating company purchases and cancels permits to 'offset' an unavoidable emission it wishes to compensate for.
- A utility company complying with OFGEMs latest ‘green tariff’ guidelines may introduce an ‘offset’ tariff for its customers using UN backed permits.
- An individual purchases an offset which uses regulated permits.
- An individual (or collection of individuals) purchase and cancel regulated permits.

All of these voluntary actions could be deemed to be contributing towards the UK meeting its carbon budget if they are additional and involve the cancellation of acceptable permits (i.e. UN backed AAUs, EUAs, CERs, ERUs).

For the Government to track and justifiably make claim to the emissions reductions occurring as a result of any voluntary action, however, it should introduce a policy in support of that action.

Arguments in favour of a supporting policy

For Government any expenditure in support of voluntary actions is likely to be a very efficient way of reducing liabilities under the carbon budgeting system because the infrastructure for delivering the abatement is already in place i.e. registries exist, providers exist, participants exist. It is simply a question of incentivising and recording uptake. It is likely to be far easier and quicker than uncovering emissions reductions in non-capped sectors.

One advantage of introducing a supporting policy would be to capture information about the level of voluntary cancellation that is occurring which would otherwise be hard to determine.

Because it is the allocation that determines the contribution towards the budget any emissions reductions occurring as a result of industrial responses to the recession will not count towards the budget since unless spare permits are cancelled they will either

be sold or banked for use in future phases. This makes the meeting of budgets harder than they would otherwise have to be given the current economic climate (and without making future budgets easier to meet since again it is the original allocation that will count).

Introducing policies that build on the existing carbon trading policy further underlines the seriousness with which Government views that policy. Encouraging a shortening of the market through voluntary action also helps to increase the overall price of permits, helping to mitigate the downward pressure on prices caused by the current recession, and insulating the policy against calls that it is not delivering and should be replaced with straight regulation or a tax.

The implementation of policy that could lead to further tightening of allocations would likely further increase the permit price (over and above the current period price impact from voluntary cancellation). This is because an increase in the potential for further permit scarcity will increase the value of holding bankable permits or engaging in abatement opportunities. This may also provide an element of price stabilisation.

Proposed mechanism

The most efficient way of providing the support would be through the existing tax system.

For companies the simplest mechanic would be to issue a tax credit/refund and to create an uplift in relation to that expenditure (as for R&D expenditure and contaminated land remediation relief – currently at 75% for small to medium sized companies – 30% for large companies). Set against company taxation this would represent a 28% reduction in the cost to any main rate corporation tax participant, or 49% with an R&D type uplift. A tax refund arrangement would be necessary to make the incentives applicable to companies not returning a profit. The comparable refund under the R&D system would be 24.5 pence in the pound.

For individuals it could involve a tax rebate against income tax or be treated as a charitable expenditure enabling cancellation agents to claim Gift Aid reducing the cost to the participant by 20%, or 40% to higher rate taxpayers.

Cost to Treasury

Cost per tonne

The partial subsidy of voluntary cancellation will cost the Treasury less per tonne than purchasing themselves. If expenditure/income forgone is offset against tax then the cost to the Treasury per tonne cancelled would fluctuate according to the market price paid by the purchaser. This parallels the Government's liability to purchase permits since it too will fluctuate with the market.

Alternatively the Government could set a minimum price level per year/quarter for determining any tax deduction. Depending on the nature of the tax deduction this could set an implicit floor price for EU ETS permits for UK based companies. e.g. if an R&D

style 175% deduction is available then a EUR20 tax deduction level would mean that prices could not drop below EUR9.80 or it would be economically rational for companies to cancel permits rather than sell them (particularly if sale proceeds are then taxed on disposal).

Extent of tax revenue forgone

The voluntary market in ‘offsets ‘ is not very large but it is growing. A range of 'products' are currently used to fulfill offsets. Not all of them would be eligible to count towards the UK carbon budget – for example, those relying on uncertified actions such as tree planting or using non-UN backed VERs.

The total volume of tonnes to be cancelled (either directly to meet the budget or via the voluntary cancellation route), and therefore total cost, would not be knowable in advance since it is either determined by the level of emissions occurring beyond the target budget or on the level of uptake by voluntary participants. Both could, however, be modeled to afford an estimate of the likely total cost.

In completing this modeling attention needs to be given to the potential increase in auction prices that may result from the increased potential permit scarcity this policy would allow. In fact it may be that the price of auctioned permits increase by such a level that the policy is revenue positive to the Treasury. e.g. if the 4 million EUA's auctioned in November 2008 elicited a EUR0.50 premium due to this policy, it would be revenue neutral if approximately 200,000 permits were voluntarily retired at a tax deduction rate of 49% (using a 175% deduction level) and a fixed deduction level of EUR20.00 per permit.

Conclusion

In considering policy responses to the introduction of legally binding economy-wide carbon budgets, the Government should seek to optimise the use of traded instruments to underline its commitment to that policy and to assist it in meeting its targets.

Harnessing the willingness that already exists in civil society to go beyond regulated requirements is a cost effective way of achieving this objective. The existing tax regime provides a simple way of facilitating a subsidy in support of voluntary cancellation. Costs to the Treasury should be set against the liabilities created by the budgeting system and will likely be a lower cost form of compliance. Depending on uptake the perception of increased scarcity the policy could induce may generate increased revenues from auctions offsetting costs still further.

The outlined policy will also reverse the tragedy of the commons, in that concerned parties (individuals and companies) will potentially forego commercial gain to provide a benefit to the community as a whole.

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