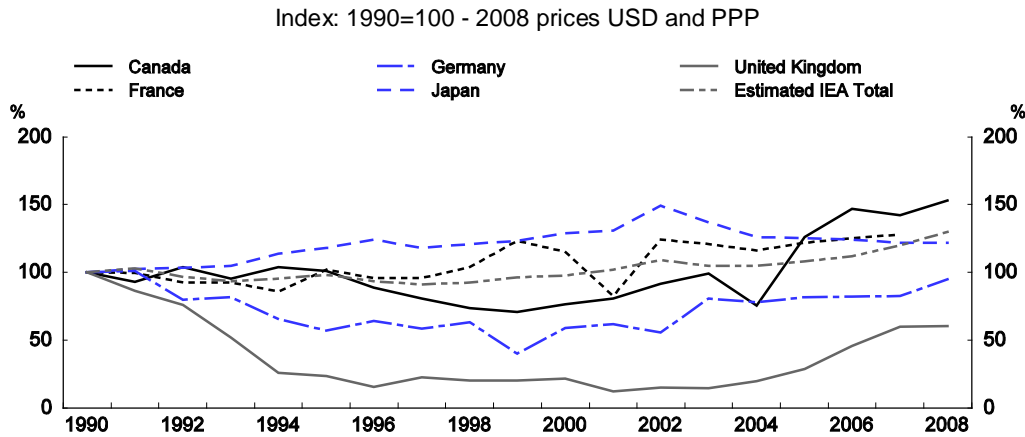


Figure 7. Index of government 'green' energy R&D budgets (excludes fossil fuels)¹

1. 'Green' energy R&D budgets include: energy efficiency, renewables, nuclear, hydrogen and fuel cells, other power and storage technologies, and other technology or research.

Source: IEA database, Energy Technology R&D Statistics.

Although the United Kingdom ranked highly on global patent submission in 'clean' innovation over the period 1980-2007 and 2002-2007, its position slipped slightly in the latter period (Table 4). While the United Kingdom remains a leader in marine energy innovations, its ranking declined in batteries, electric and hybrid vehicles, nuclear, methane, heating, solar, fuel injection and waste. However, the falls appear to be due to higher growth in patenting activity in emerging economies such as Korea, rather than a major decline in the UK.

Table 4. Top 15 nations by share of the world's climate-related inventions

Country Rank	1980-2007		2002-2007	
	Average % of world's inventions	Rank	Average % of world's inventions	Rank
Japan	20.2%	1	20.8%	1
Germany	19.8%	2	17.8%	2
USA	15.4%	3	14.1%	3
France	5.1%	4	4.4%	5
UK	4.5%	5	4.3%	6
Australia	3.8%	6	2.9%	9
Sweden	3.3%	7	1.7%	14
South Korea	3.1%	8	5.6%	4
Canada	2.2%	9	3.0%	8
Netherlands	2.1%	10	1.8%	13
Austria	2.0%	11	2.1%	11
Italy	1.9%	12	2.3%	10
Switzerland	1.9%	13	1.3%	16
China	1.9%	14	3.9%	7
Denmark	1.4%	15	1.4%	15
Total	88.6%		87.4%	

Source: Dechezleprêtre and Martin (2010).

Major policy instruments

The overall policy framework is complex, encompassing several different instruments and objectives

The UK has developed a complex set of measures to reduce emissions since the late 1980s. The aim has been to price emissions, stimulate the development and deployment of clean energy and improve energy efficiency. Policies to promote efficient adaptation to the uncertain impacts of climate change are underdeveloped. The United Kingdom has recognised the importance of international collaboration on mitigation and adaptation, given the global nature of the climate-change problem (Box 1).

Box 1. Contributions to international climate-change policies

The United Kingdom has a proven track record in international action on climate change, which, together with a cross-party commitment to a strong domestic policy framework, is setting a useful international example. The United Kingdom has consistently been in the vanguard of developed nations in promoting international action on climate change. It has strongly supported international climate-change negotiations through the United Nations Framework Convention on Climate Change (UNFCCC) and EU channels, along with considerable unilateral efforts to support adaptation and mitigation in developing countries. At the G8 Summit at Gleneagles in July 2005, the United Kingdom proposed a focus on poverty reduction and climate change. Soon after, the then Labour Government commissioned the Stern Review on the economics of climate change, which helped to push climate change to the centre of the policy debate in the United Kingdom and many other OECD countries (Stern, 2007). The United Kingdom offered strong support for a global climate change agreement at the UNFCCC Conference of Parties in Copenhagen in 2009 (COP15) and Cancun in 2010 (COP16).

Although COP15 fell short of expectations and COP16 made only modest progress on outstanding issues, the United Kingdom continues to push for strong and coordinated action on climate change. In July 2010, the environment ministers of the United Kingdom, Germany and France published joint articles in three leading newspapers emphasising the economic benefits of unilaterally increasing the EU emission-reduction target for 1990 to 2020 from 20% to 30%, a proposal that is now official UK policy. The EU recently raised its emission-reduction target to 25%, although the legally binding 20% target has not been amended. UK policy continues to push for a 30% target. Despite the environment of fiscal austerity, the new Government is also committed to providing finance to assist developing countries manage climate change, including £1.5 billion as its share of fast-start financing of US\$30 billion in 2010-2012 promised in the Copenhagen Accord. The United Kingdom's total commitment to international climate-change finance over the spending review period is £2.9 billion.

The United Kingdom is active in the international arena in other ways, too. The Foreign and Commonwealth Office's three strategic priorities include promoting sustainable growth. The Department for International Development (DFID) supports adaptation in developing countries and, through the International Forestry Group, participates in international forestry negotiations.¹

1. A list of recent and ongoing programmes and initiatives is available at www.dfid.gov.uk/About-DFID/Finance-and-performance/Structural-reform-plan/Climate-change/About-DFID/Finance-and-performance/Structural-reform-plan/Climate-change/

Most domestic UK policies are designed to be 'market friendly', using price signals to encourage firms and households most able to adjust their behaviour cost effectively (Box 2). Policies rely heavily on tradable quota markets, a form of quantity-based instrument (such as the Renewables Obligation (RO)), although there are also primarily price-based instruments (such as the Climate-Change Levy (CCL)). In practice, several schemes are hybrids. There are also regulations mandating specific actions, such as labelling requirements for energy efficiency. One unusual aspect of the UK policy framework is that, since 2008, it has been underpinned by a Climate Change Act, which gave statutory force to domestic carbon-reduction budgets. The Act also set up an independent body, the Committee on Climate Change, with statutory responsibilities to propose appropriate carbon budgets, assess progress towards the statutory long-term emission reduction targets and give advice to government on climate-change policies in general, covering both mitigation of and adaptation to climate change.

Box 2. A timeline of UK climate-change policies

1989: The Non Fossil Fuel Obligation (NFFO) and the Scottish Renewables Obligation (SRO) were established under the Electricity Act 1989. Originally intended to support nuclear electricity generation, the NFFO and SRO were expanded in 1990 to include renewables. The NFFO and SRO were funded by a **Fossil Fuel Levy** paid by suppliers of electricity from fossil fuels.

2000: Climate Change Programme. This report set out policies and priorities for action both in the United Kingdom and internationally. Updated in 2006, the policies are supposed to reduce CO₂ emissions by 15-18% below 1990 levels by 2010 and overall GHG emissions by 23-25%.

2001: The Climate Change Levy (CCL) was introduced on 1 April 2001, effectively replacing the Fossil Fuel Levy. It is a downstream tax on non-domestic energy use by industry and the public sector, designed to incentivise energy efficiency and emission reductions, with part of the revenue being used to reduce National Insurance contributions. Energy-intensive firms can receive up to an 80% discount if they join a **Climate Change Agreement (CCA)**, which requires meeting energy efficiency or carbon-saving targets. Renewable electricity suppliers are exempt from the CCL. Receipts from the CCL amounted to £0.7 billion in 2009.

2002: The Renewables Obligation (RO) replaced the NFFO and SRO as the primary renewable energy policy instrument. The RO requires electricity end-suppliers to purchase a certain fraction of their annual electricity supply from producers using specific renewable technologies, and they receive tradable Renewables Obligation Certificates (ROCs) for doing so. The supplier can also 'buy out' the obligation by paying a set price per MWh. The buy-out revenue is recycled to participating suppliers in proportion to their ROCs.

2002: The Energy Efficiency Commitment (EEC) was introduced, requiring energy suppliers to achieve 62TWh of savings over the period to 2005 through assisting the implementation of home energy efficiency improvements, equivalent to a reduction in domestic emissions of approximately 1%. The second phase of EEC (2005-2008) raised the total savings required to 130TWh.

2005: European Union Emissions Trading System (EU ETS). The UK Emissions Trading Scheme closed in 2006 and was replaced by the EU's that aims at ensuring compliance with the Kyoto obligations. Under the EU system, member states proposed National Allocation Plans (NAPs) to the European Commission, allocating a set proportion of a country's total 2008-2012 emission budget to sectors covered by the scheme; tradable quotas were then divided among firms (www.eea.europa.eu/pressroom/newsreleases/questions-and-answers-on-key).

2007: The Code for Sustainable Homes establishes minimum performance standards for the design and construction of homes and covers energy, water, materials and waste. From 2008 all new homes must be rated against the Code and government-funded social housing (from 2010) must comply with its Level 3, which requires a 25% improvement in energy efficiency compared with 2006 regulations. The Code is currently being revised. Also relevant for new buildings are the Building Regulations Part L that set energy efficiency standards for all new homes in England and Wales. Although building regulations have existed in the UK since the 17th century, energy efficiency standards first appeared in building regulations in 1995.

2008: Climate Change Act. This Act set a legally binding target of 80% reductions in emissions from 1990 to 2050. A medium-term target of a 34% reduction by 2020 was also adopted, with the promise of a further tightening in the event of a global deal on climate change. To achieve these targets, the Act established the principle of five-year carbon budgets. The first three budgets were set in 2009 and cover 2008-12, 2013-17 and 2018-22. The fourth budget, 2023-2027, which was recently proposed by the UK Committee on Climate Change, is currently under consideration by the Government, and will be legislated in June 2011 (as this working paper was being finalised, the Government accepted the proposed fourth carbon budget. Contributions from the use of carbon trading and offsets will be allowed. There will be a review in 2014 to ensure that the UK efforts are not disproportionate relative to those of other EU members). The Government must submit its policies to meet these budgets to Parliament, as it did in the **Low-Carbon Transition Plan** of July 2009, which set out policies to cut emissions across the power and heavy industry sector; the transport sector; in homes and communities, workplaces and jobs; in agriculture; and in land use and waste management. The Act also requires the government to include aviation and shipping emissions, or provide an explanation why not, by the end of 2012.

2008: Carbon Emission Reduction Target (CERT). This scheme replaced the Energy Efficiency Commitment, with a greater focus on more substantial and robust household energy saving measures such as insulation, and a component targeted at those most vulnerable to fuel poverty. The total lifetime savings required from energy suppliers over the duration of the scheme until 2012 is 293 million tonnes CO₂.

2008: Renewable Transport Fuel Obligation (RTFO). This is administered by the Renewable Fuels Agency and requires suppliers of fossil fuels to ensure that a specified percentage of UK road fuel supply is from renewable fuels. The target for 2009-2010 is 3.25% of fuels by volume. Suppliers may buy out their obligation for 30 pence/litre.

The obligation also requires companies to submit reports on the carbon content and sustainability of the biofuels used.

2008: Energy Performance Certificates (EPS) required whenever a building is built, sold or rented out. The certificate provides 'A' to 'G' ratings for the building, with 'A' being the most energy efficient and 'G' being the least. The current average score for the UK is around a D. From 2012 the *EU Energy Performance of Buildings Directive* will also require all home sale advertisements to have an Energy Efficiency Rating.

2009: Community Energy Saving Programme (CESP). Established to complement CERT, this scheme achieves aims of both carbon reduction and addressing fuel poverty by requiring energy suppliers to achieve 19.25 million tonnes CO₂ lifetime savings in the most deprived areas of England, Scotland and Wales, promoting area-based and whole-house approaches to energy efficiency improvements.

2010: Carbon Reduction Commitment Energy Efficiency Scheme (CRC EES). Established under the Climate Change Act 2008, the scheme covers emissions by firms and public bodies not already subject to the EU system or substantially covered by other agreements. It comprises reporting requirements and a carbon levy. The CRC EES is complemented by several other policies to promote energy efficiency in residential buildings.

2010: Feed-In Tariffs (FITs). From April 2010, the government has offered FITs for small-scale low-carbon electricity generated by households, businesses and communities. Additional payment is provided for electricity fed into the grid. FIT rates vary according to technology, will last from 10 to 25 years, and are adjusted for inflation. A pilot scheme for micro Combined Heat and Power plants has also been launched. In March 2011, the Government announced the first review of the scheme. The review will be completed by the end of 2011 and current tariffs will probably remain unchanged until April 2012. The review will examine all aspects of the scheme with a focus on large-scale solar projects, which have been more popular than envisaged, and a review of tariff rates for farm-based Anaerobic Digestion plants, as fewer of these plants have been accredited than expected.

2010: Carbon Capture and Storage (CCS) Demonstration Project. The government announced £1 billion of capital funding for the first full-scale CCS demonstration project in the UK. The government has also committed to a further three demonstration projects on gas- and coal-fired power stations. However, final details of the funding mechanism for these three additional projects are yet to be announced.

2011: Carbon Plan. Released in draft form in March, the Carbon Plan is a government-wide carbon reduction plan, including domestic and international emissions. It sets out a vision, plan and timetable for achieving the United Kingdom's 2020 emission reduction targets, department by department. Updates on progress will be released quarterly and a final plan will be released following the confirmation of the fourth carbon budget in June 2011.

2012: Green Investment Bank (GIB). A GIB to unlock finance for the transition to low-carbon growth will commence operations during the latter half of 2012. The Spring 2011 Budget committed £3 billion in funding, with borrowing powers available from 2015-16 (conditional on government deficit reduction targets being met).

2012: Renewable Heat Incentive (RHI) will provide long-term financial support across a wide range of renewable heat installations installed after 15 July 2009, and will commence in mid-2011 in two phases. It will initially provide long-term tariff support in non-domestic sectors. Limited support for households, capped at £15 million, will be available through Renewable Heat Premium Payments. In the second phase, which will commence in late 2012 to coincide with the introduction of the 'Green Deal', households will become eligible for long-term tariff support.

2012: The Energy Bill. Currently awaiting Report Stage in Parliament, this bill includes provisions for a 'Green Deal' on energy efficiency, greater security of energy supplies and more low-carbon electricity. More detailed secondary legislation for the 'Green Deal' will be prepared during 2011 with a formal consultation process recently completed. Secondary legislation will be laid before parliament in early 2012 with the first 'Green Deal' expected to be available in late 2012. This policy will be accompanied by funding for training for up to 1,000 'Green Deal' apprenticeships.

(For further details on the Energy Bill: http://www.decc.gov.uk/en/content/cms/legislation/energy_bill/energy_bill.aspx
For progress of the legislation: <http://services.parliament.uk/bills/2010-11/energyhl.html>).

2014: Smart meter roll-out. The Government's response to a recent consultation period proposes a new obligation on energy suppliers to roll out smart meters to all homes in the United Kingdom over the period 2014 to 2019. The roll-out programme will also involve the replacement of around 53 million gas and electricity meters (www.decc.gov.uk/en/content/cms/tackling/smart_meters/smart_meters.aspx).

The DECC Business Plan 2011-2015 outlines detailed plans for future government climate-change policies (www.decc.gov.uk/assets/decc/About%20us/decc-business-plan-2011-2015.pdf).

Related: Taxes on hydrocarbon oils (e.g., petrol, diesel, biodiesel) amounted to around £25.9 billion in 2009. They were first introduced in 1909. In 1993, the Government introduced an annual Fuel Price Escalator (FPE), initially at 3% above the rate of inflation, then at 6% after the election of the Labour Government in 1997. The escalator was abolished in 2000, although rates have been adjusted since. Other transport taxes include the vehicle excise duty on

road vehicles, now differentiated by emissions (£5.6 billion in 2009). Other environmental taxes include the Landfill Tax (£0.9 billion) and the Aggregates Levy (£0.3 billion), a tax designed to price externalities from quarrying, while some taxes designed primarily for other purposes (e.g. revenue-raising), such as Air Passenger Duty (£1.8 billion), have potential significant environmental impacts. The VAT rate charged on domestic energy consumption is 5% in contrast to the standard rate of 20% (IFS 2010).

Carbon pricing is complex, with numerous overlapping instruments

The central pillar of any set of policies to combat climate change must be a method of pricing the externalities caused by emissions. Each tonne of CO₂ or CO₂-equivalent can be expected to do the same amount of damage wherever it is emitted, because emissions mix in the atmosphere quickly. Its price should therefore be the same regardless of location or sector, reflecting the social cost of carbon and giving an incentive to equalise the marginal cost of abatement across technologies, countries and firms⁷. The United Kingdom's main pricing instrument is the EU trading scheme, which covered about 48% of UK CO₂ emissions in 2009 (and the voluntary inclusion of nitrous oxide from 2011), with aviation to be covered from 2012 onwards. From 2013, CO₂ emissions from a wider range of industrial processes will be included, as will some industrial nitrous oxide (N₂O) and perfluorocarbon emissions.

The EU system is a cap-and-trade scheme that sets quantitative limits for emissions by firms within its scope. The carbon price is set by trading emissions quotas, in contrast to a carbon tax that directly sets a carbon price. A quantitative limit delivers a greater degree of confidence about the amount of emissions reduction in the face of economic shocks, and hence can ensure that a long-run emissions reduction target and milestones along the way can be met. However, it may do so at the cost of deviations of the carbon price from the social cost of carbon and large variations in the price signal over time, distorting investment incentives and increasing uncertainty at the firm level.

In practice, the price of European Emission Allowances (EUAs) has been volatile, and has been highly correlated with the wholesale prices of natural gas (one of the most volatile commodity prices), oil and coal, reflecting variations in energy demand and the scope for switching commercial energy supplies among sources (Mansanet-Bataller, Pardo and Valor, 2007; Geman, 2005). The price dropped some 70% between July 2008 and February 2009 with the onset of the global recession. As the downturn could not have had such a large impact on the social costs, or marginal damage costs, of CO₂, which the price should reflect, the fall was excessive⁸. Volatility is not unusual in cap-and-trade schemes, because shifts in demand translate into price changes due to inelastic supply of quotas (Metcalf, 2009). The high volatility may in turn discourage investment, especially in risky and long-term abatement options.

The price of EUAs may also be too low to achieve the UK 2050 target. In 2009, the UK Climate Committee revised its projection for the carbon price in 2020 from €55/tCO₂ to €20/tCO₂, and commented that such a price might not be sufficient to support the required investments in low-carbon power generation. This fear is corroborated by model-based projections of the carbon price trajectory needed to keep the global temperature increase from pre-industrial times below 2°C⁹. The uncertainty about the long-run emissions reduction goal of the EU, and the low and volatile price at which allowances have recently

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7. Strictly speaking, this is a requirement for efficiency; whether it is desirable depends also on whether the distributional impacts of carbon pricing are acceptable and, if not, whether appropriate redistributive transfers are made.
 8. The marginal damage costs depend on the marginal climate change brought about over a long time period in the future, which is unlikely to be much affected by a transient recession.
 9. See, for example, the reports of the RECIPE and ADAM projects (Edenhofer et al, 2009; Knopf et al, 2009).

been trading, have served to reduce the incentive for covered firms to cut emissions. The most transparent route to ensure carbon prices that are consistent with the 2050 target would be to work for firmer and earlier commitments about the stringency of quota allocations under the EU scheme in the future. An early decision about whether the EU will adopt unilaterally the currently conditional target for more aggressive emissions reductions by 2020 would be helpful in this respect.

Domestic policy instruments should also be used to accomplish the higher, more consistent and less volatile carbon prices that are needed to achieve the transformation of the capital stock needed to meet the UK's 2050 emissions target¹⁰. The UK Climate Committee has argued that there is a case for government underpinning of the carbon price. The government already does this to some extent, as described below. A further step could be taken by shifting part of the burden of uncertainty about the carbon price from firms to the government, on the grounds that carbon price volatility is partly due to policy uncertainty. Policy uncertainty relates to potential time inconsistency problems, whereby governments will be tempted not to deliver the high carbon prices that are needed to reach future targets. This discourages investment in low-carbon technologies predicated upon future carbon price increases. This time inconsistency problem reflects uncertainty about future policy, a risk that may be appropriate for policy-makers to mitigate, unlike the normal commercial risks arising from fossil-fuel price volatility and uncertainties about the success of new technologies. An example of such a policy would be for the government to offer, for a fee, contracts to pay firms if the carbon price at a future date was below some reference level (thereby threatening to make investments in low-carbon capital unprofitable), while firms would pay the government if the carbon price was above that level. The UK is considering options for electricity market reform to encourage more investment in low-carbon power. The Government has already announced a carbon price floor, to be implemented through the imposition of the Climate Change Levy (CCL) and fuel-oils carbon-price support rates on the fossil-fuel inputs to electricity production, augmenting the incentive for fuel-switching provided by the carbon price in the EU ETS (see http://www.hm-treasury.gov.uk/d/carbon_price_floor_consultation_govt_response.pdf).

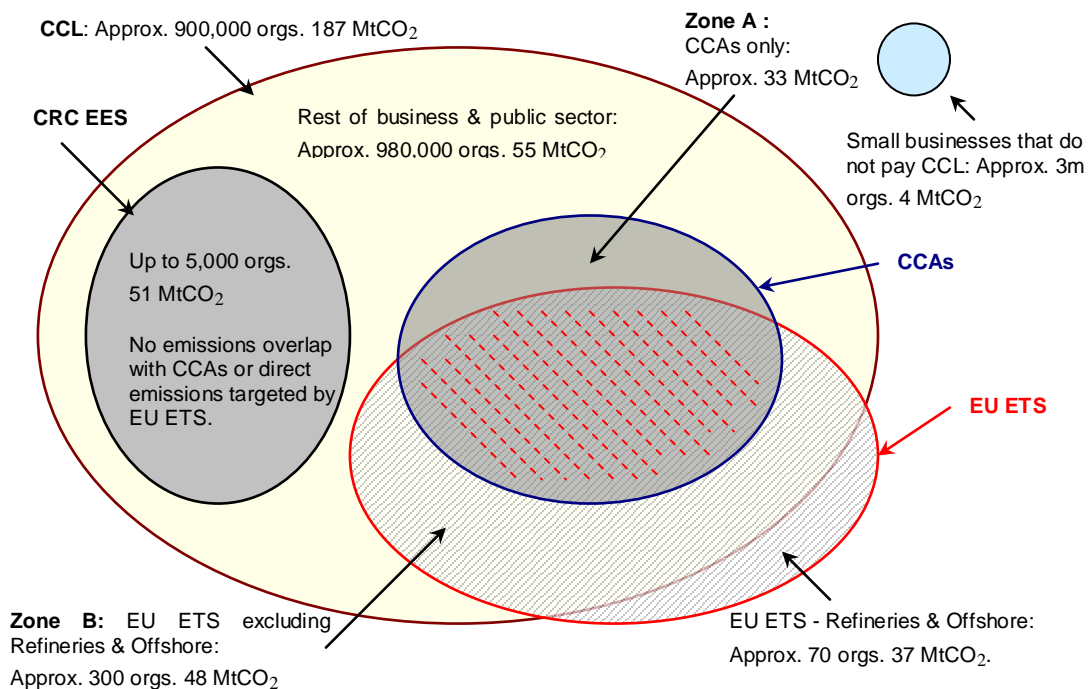
The case for higher effective carbon prices in the UK than elsewhere depends not only on the relative ambition of UK policy-makers but also on the likely extent of 'carbon leakage' – the relocation of carbon-intensive activities to jurisdictions with lower or no carbon prices in response to rises in the UK carbon price. That in turn depends on the tradability of carbon-intensive goods and services, their capital intensity and other factors affecting the ease of expanding capacity elsewhere, and the prospects for the trajectory of the implicit or explicit carbon price in other countries. It is not possible to discuss here the issue of carbon leakage and competitiveness in the detail it deserves (the reader is referred to Stern (2007), Chapter 11, Aldy and Pizer (2009) and Carbon Trust (2010) as examples of the literature). Suffice to say that we take the view that the difficulties in trading electricity across borders, the capital intensity of most carbon-intensive industry, the bulk of many of its products and the prospects for mounting efforts to reduce emissions globally imply that carbon leakage is unlikely to undermine significantly the global cost effectiveness of unilateral UK action along the lines suggested here. However, this is an empirical question that needs to be kept under review. Any derogations from the uniform carbon pricing goal proposed here would similarly need to be justified empirically.

In practice, effective carbon prices in the UK economy have been higher and more pervasive than the EU Allowance price would suggest. For example, the Climate Change Levy (an energy tax) and the Carbon Reduction Commitment Energy Efficiency Scheme (CRC EES) in effect apply additional carbon price. Indeed, these policies overlap each other (Figure 8). Firms not covered by a Climate Change

10. This problem illustrates one reason why many economists prefer a carbon tax to a cap-and-trade system, as long as the tax rate is regularly reviewed in the light of its impact on cumulative emissions. See Weitzman (1974), Pizer (1998) and Hepburn (2006). It could also be argued that a global recession warrants revising quantitative emission targets downwards to reflect the reduced costs of meeting any given target.

Agreement (CCA) (see Box 2) could be paying a form of carbon tax three times over: first, through higher payments for electricity produced by generators subject to the EU scheme and sold by suppliers subject to the Renewables Obligation; second, through the Levy; and, third, through the Energy Efficiency Scheme. That could result in an effective carbon price more than triple the EU price. In contrast, energy-intensive firms outside the EU scheme but covered by a Climate Change Agreement would have to pay only 20% of the Levy (35% from April 2011)¹¹ and would not be affected by the implicit carbon tax in the electricity price if they used fossil fuels directly (although they would then be paying fuel duties).

Figure 8. Climate policy overlap¹



1. Million tonnes of Carbon Dioxide (MtCO₂)

Source: Based on a figure from Defra presented in CBI evidence to the House of Commons Environmental Audit Committee report, *The role of carbon markets in preventing dangerous climate change, Fourth Report of Session 2009-10*.

Outside the sectors subject to the EU scheme, other measures such as Vehicle Excise Duty and graduated company car taxation are based on emissions and hence provide an incentive to promote more environmentally efficient behaviour, although that is not their prime objective. Air Passenger Duty also provides environmental signals. Hydrocarbon fuel duties can be thought of as a form of carbon tax, too, although there is no rebate for biofuels (the Renewable Obligation, a quantity-based instrument, is the main tool to achieve greater market penetration of biofuels). If the entire fuel duty were treated as a carbon tax, the implicit rate on unleaded petrol would be in the region of €250/tCO₂. But the tax can also be regarded as a road user charge, congestion charge, tax on local pollution and means of raising revenue from a commodity for which demand is relatively inelastic. A more explicit assignment of taxes to specific purposes, or the introduction of instruments targeted at specific externalities such as road pricing schemes,

11. Firms in certain energy-intensive industry sectors are offered an 80% discount if they join a negotiated CCA, adopting a specific target for energy consumption or carbon emissions. The discount will temporarily decrease to 65% in April 2011, but will return to 80% in April 2013.

would help to clarify whether the implicit tax rates are set at appropriate levels. At the retail level, energy for domestic use is only subject to a VAT rate of 5%, much lower than the standard rate of 20%, thus reducing the incentive for households to increase energy efficiency and cut energy use. As a result the effective carbon price can vary widely across the economy because of the interaction of these different ways of pricing carbon, leading to inefficient (and therefore unnecessarily costly) allocation of abatement activity across sectors and distorting relative prices of final goods and services. The extra cost burden and perceptions of unfairness risk undermining the popular acceptability of climate-change policies.

The Climate Change Levy provides an example. It is a tax levied ‘downstream’ on energy use in the business sector (rather than ‘upstream’ on primary energy providers), which now adds around 3-6% to business energy bills. The implicit rates of taxation on energy from different sources differ; the rate charged for electricity use does not depend on the primary energy mix used by the electricity suppliers (Table 5). Given its carbon content, coal is relatively lightly taxed, which some commentators have ascribed to the desire of the previous Government to put less of a burden on the coal industry than other energy providers (Pearce, 2005a; Helm, 2010). The carbon input to electricity production is taxed relatively heavily (and will be more so as lower carbon generation technologies are deployed, unless the tax rate per kWh is reduced *pari passu*). Hence implicit carbon prices vary across firms and sources in a way that makes abatement less effective and more costly.

Table 5. Implicit rates of carbon taxation, 2001

Fuel type	Tax rate [Pence/kWh]	Fuel price	Implicit carbon tax [£/tCO ₂]
Electricity	0.43	4.25	8.45
Coal	0.15	2.46	4.36
Gas	0.15	0.91	8.17
LPG	0.07	0.85	5.99

Source: Martin, de Preux and Wagner, 2009.

The Climate Change Agreements have been controversial. One review claimed that there had been a substantial announcement effect from the introduction of the Climate Change Levy (Cambridge Econometrics, 2005) and that the agreements strengthened the effectiveness of the Levy (Ekins and Etheridge, 2006). Firms themselves have claimed that the Agreements were effective in winning managerial attention to energy efficiency (EAC, 2008). However, others have argued that they have not been very demanding, given the way in which targets were negotiated and the underlying trend in energy efficiency improvements. Martin and Wagner (2009a, 2009b), utilising more detailed micro-level data allowing better identification of the impact of the Agreements, have cast serious doubt on their efficacy; participation in an Agreement had a strong *positive* impact on both energy intensity and energy expenditures relative to firms having to pay the full Levy. The case for the Agreements on competitiveness grounds, protecting energy-intensive industries particularly vulnerable to foreign competition, is weak, as there was no sign of an impact of the full Levy on output, jobs or productivity. The studies also showed that the full Levy, but not the Agreement, was successful in promoting energy efficiency and innovation. Negotiating and monitoring the Agreements was also a resource-intensive process. Their research provides persuasive evidence of the effectiveness of the full Levy, its lack of adverse side effects and the inadequacy of the Agreements, suggesting that there is a case for the abolition of the latter. Along with a rise in the VAT rate on domestic energy use, this would also raise revenue at a time of fiscal retrenchment. Raising the VAT rate to the standard 20% could raise of the order of £4 billion (around six times the receipts from the Climate Change Levy and nearly ten times the receipts from UK EU ETS auctions in 2010), assuming a price elasticity of energy demand of -0.3, which is consistent with the empirical literature (*e.g.* Oxera, 2006). However, any rise in VAT would impose significant new cost burdens on households at a time of slow real income growth, and may need to be accompanied by targeted support for

the most exposed groups. The timing of any rise in VAT on energy use would need to be carefully considered to avoid undermining public support for climate policies.

The new Energy Efficiency Scheme also applies a carbon price downstream, to businesses that are not subject directly to the EU trading scheme and for which less than a quarter of emissions are covered by an Agreement. It covers emissions from energy use (including electricity and heat) in large but not particularly energy-intensive public and private organisations (the latter are likely to be covered by the EU ETS). In the first year of allowance sales, allowances will be sold at a price of £12 per tonne of CO₂. The Government has stressed the scheme's role in promoting energy efficiency. The registration and monitoring requirements placed on organisations, and the publication of league tables, should help to tackle the lack of managerial focus on energy efficiency, bringing down the very high implicit discount rates reported for investments in this area. The UK government will be consulting on simplifications for the second phase of the Scheme. The Climate Change Committee (2010c) also offered recommendations to simplify the scheme. A further simplification, reducing compliance costs and risks from policy overlap, would be to develop a single downstream carbon tax to supplement the inadequate signal given by the EU price, merging the Levy and the levy component of the Efficiency Scheme. The downstream layer could be justified on two grounds. First, it would push up the overall carbon price while the EU scheme was giving an insufficiently strong signal. Second, it would help to focus the attention of energy users on the need to improve energy efficiency, as would the new reporting requirements on energy use brought in by the Efficiency Scheme, which could be maintained. For the household sector, the carbon subsidy implicit in the reduced rate of VAT on domestic energy should be removed, as there are more narrowly focused tools with which to tackle energy poverty. Upstream carbon pricing could also be simplified, by relating hydrocarbon fuel duties outside the EU scheme more closely to their carbon content. The guiding principle would be to simplify the structure of carbon pricing to one upstream and one downstream layer. Remaining anomalies in the overall incidence of the carbon price could be reduced extending the coverage of both layers.

In the event of such changes, two issues would remain about the interaction of the downstream layer of taxation with the quantity constraint imposed by the EU scheme. First, the layering would be designed to reduce UK emissions further than would the EU scheme alone. However, in so far as it succeeded in reducing demand for the output of plants and establishments subject to the EU scheme, their demand for the allowances would be reduced and they would sell more of them to the rest of the EU, reducing their price. Hence greater stringency of UK policies would tend to weaken abatement incentives elsewhere in the EU, unless the overall cap was tightened or the UK government bought up the allowances. And if other countries were to pursue a similar approach to the United Kingdom, the allowance price could fall significantly. This is why economists have stressed the need to coordinate multiple interventions by administrations at different levels carefully (Boemare *et al*, 2003). Second, the layering would result in a higher implicit carbon price for energy downstream than for other carbon-intensive products such as steel. For that reason, layering is very much a second-best option as a means of raising the carbon price. Strengthening and extending the EU scheme (and applying upstream carbon taxes in sectors not subject to the cap-and-trade scheme) would be a more attractive approach.

However, some downstream policy intervention is warranted to focus attention on opportunities to improve energy efficiency where information is currently scarce or energy accounts for only a small proportion of total costs. One option is to create a UK carbon reduction certification agency that could help to address the latter concern (Martin and Wagner, 2009b). It could take on the monitoring, verification and reporting requirements in the Efficiency Scheme, Levy and possibly EU schemes, and promote public and shareholder interest in firms' success in cutting emissions and energy use. Standards-setting and obligations to provide information, for example by labelling, may also have a role to play, although care needs to be taken to avoid imposing less cost-effective energy efficiency improvements than market incentives would encourage

As long as the EU allowance price remains an inadequate price signal to achieve UK emission-reduction objectives in a cost-effective way, domestic measures to move towards higher and more uniform carbon pricing across the economy are desirable. They should preferably be introduced in the context of more wide-ranging reforms of environmental and energy taxes such as those proposed by Newbery (2005) and IFS (2010):

- adjusting Climate Change Levy rates and hydrocarbon fuel duties to reflect carbon content (and the content of other pollutants) more closely;
- merging the Levy and Efficiency Scheme into a single levy related to carbon content (while keeping new reporting requirements);
- ceasing to make Climate Change Agreements that effectively reduce the implied carbon tax rate;
- raising the VAT rate on domestic energy use from 5% to the standard rate of 20%, while using more focused payments to help those deemed to be in ‘energy poverty’; and
- considering ways of giving firms greater certainty about the trajectory of the carbon price.

Promoting clean energy

Efforts to promote clean low-carbon energy have focused on the promotion of renewable energy, although nuclear power and ‘carbon capture and storage’ equipped fossil fuel plants are also low-emissions energy sources. The EU has adopted a target of deriving 20% of final energy demand from renewables by 2020 and has agreed on country targets to achieve this; the United Kingdom’s target is 15%¹². Carbon pricing via the EU scheme provides an incentive to switch to renewables (and nuclear). However, further incentives, are justified, if appropriately designed. Market failures afflict technology development as a result of the public good nature of much knowledge, including some of that acquired by learning-by-doing. Support now for a range of the most promising renewables technologies is one means of building credibility of climate policies over the long term, as long as that support is seen to be designed to correct market failures rather than supplement an inadequate carbon price¹³. There are other social objectives apart from mitigating climate change served by promoting renewables, such as lower local pollution and (in the UK’s case) greater energy security.

Unlike the EU’s emissions reduction target, the EU-wide renewables target is not accompanied by an EU-wide policy instrument. As a result, the extent, strength and form of support differ considerably across Europe, with no assurance of a cost-effective distribution of resources across countries or technologies. In the United Kingdom, NAO (2010) reports direct government spending to encourage research, development, demonstration and deployment of renewable energy technologies of around £43 million in fiscal year 2008-09 (an additional £33 million was allocated by Regional Development Agencies to project developers and not-for-profit organisations). However, the main additional instrument has been the

12. The adoption of these targets implies a judgement about the desirable contributions of renewables, gas and nuclear energy to lower-carbon energy supply by 2020, a judgement that could have been left to the interaction of markets and broader energy-sector regulation. The UK emissions target for 2020 might be hit more cheaply if gas were substituted for coal more rapidly and renewable energy were adopted more gradually (Grubb *et al.*, 2008).

13. It would not be sensible for all governments to support the entire range of potential technologies indefinitely. International agreements on some burden-sharing and collaboration would be desirable, together with public guidelines about what would trigger the winding down of support of individual technologies.

Renewables Obligation (Obligation), a quantitative requirement on electricity end-suppliers to increase the proportion of wholesale electricity purchased from producers using renewable energy, with the costs reflected in higher retail electricity prices. There is also a Road Transport Fuel Obligation designed to increase the proportion of transport fuel comprising biofuels. Both these measures are primarily quantity-based instruments mandating that a certain proportion of energy consumption is provided by renewable energy. Certificates are issued for verified renewables use and can be traded. Such quantity-based instruments differ from those that guarantee a price for renewable energy (such as feed-in tariffs) or a premium over the price charged for energy from non-renewable sources, although there are certain similarities with the latter in practice given the fixed buy-out price in the UK Renewables Obligation scheme (see Box 3 for a discussion of different forms of renewables support)¹⁴. However, the revenue from the penalty or ‘buy-out’ price that has to be paid by users who do not meet their Renewables Obligation is recycled to suppliers that over-achieve their targets, providing an additional incentive to hold or acquire certificates, driving up their price. In 2010-2011, the target for renewables penetration of the power generation market is 11%, which compares with the achievement of 6.7% in 2009 (Table 3, panel B).

The Renewables Obligation has evolved since it was launched in 2002, in response to some of the criticisms to which it has been subjected (Box 3). The most significant change was in April 2009, with the introduction of varying rates of certificate allocation across technologies to provide a greater incentive to technologies further from the market but with potential to deploy on a large scale. For example, landfill gas now earns only 0.25 certificates for every MWh produced, onshore wind 1.0, offshore wind 1.5 (although it is temporarily receiving an uplift to two for projects accredited by March 2014), geothermal and solar photovoltaic (PV) 2.0. In April 2010, there were further changes, including the extension of the Obligation’s end date from 2027 to 2037 for new projects, to provide greater long-term certainty for investors and an increase in support for offshore wind projects. The market penetration target is now set in such a way that there is less risk of the success of the policy leading to a collapse in the Obligation certificate price. In 2010, a feed-in tariff system for household and other micro-power-generation (under 5MW) was launched to complement the Obligation system, with the rate paid per kWh varying by technology and size of installation.

Notwithstanding the welcome evolution of the Obligation system, the Committee has warned that “meeting the 2020 renewable energy target requires a step change in the rate of progress and entails significant delivery risk” (CCC, 2010d). It pointed out, for example, that the capacity of electricity generation from wind power needed to increase at an annual average rate of 3GW from 2010 to 2020, yet only 1GW was added in 2008. Also, the subsidiary targets for biofuels and heat generation from renewables appeared to be difficult to achieve sustainably (in the former case) or cost-effectively (in the latter). The recent Energy Market Assessment (DECC, 2010) also acknowledged that current electricity market arrangements were unlikely to result in the required electricity-sector decarbonisation by 2030 and that long-term incentives to invest in low-carbon energy needed to be improved. Pollitt (2010) has suggested that the element of the Obligation system by which the payments from suppliers ‘buying out’ their obligations are recycled to suppliers in proportion to their certificates should be dropped, because it contributes to the high cost per kWh of power from renewables in the UK scheme (Box 3). In December 2010, the UK Government announced a programme of possible market reforms to support additional low-carbon power investment and ensure continued energy security. The proposals are focused on introducing a floor for the carbon price in the UK electricity generation sector, a system of feed-in tariffs for low-carbon generation, an emissions performance standard for new power stations, and measures to ensure sufficient generating capacity is available to maintain security of supply. The Obligation system could be phased out

14. Lipp (2007) counted 38 countries and five sub-national entities with FIT systems, compared with eight countries and 30 sub-national entities with tradable renewables certificate systems.

in favour of a feed-in tariff regime by 2017, potentially reducing some of the risks facing renewable energy suppliers (see Box 3).

While the emphasis on rewarding output of renewable energy helps to compensate for lower-than-desirable and uncertain carbon prices and rewards learning-by-doing, it is unlikely to correct fully for underinvestment in R&D arising from difficulties in appropriating returns to new ideas. Capacity support mechanisms encourage picking winners by government, deliver subsidies to incumbents, weaken the focus on providing a stronger, less volatile, carbon price signal and benefit large foreign utilities and offshore equipment manufacturers disproportionately (Jamansb *et al.*, 2008). Privatisation and increased competition in the early 1990s saw a decline in private energy R&D (Figure 6) and utilities reduced their spending in this area after privatisation, consistent with the ‘public good’ nature of much R&D. In the energy sector, the scope for capturing returns to R&D through product differentiation, charging more for the most innovative products (as many consumer goods manufacturers do), is limited.

One option for achieving carbon emissions reductions is the expansion of nuclear power, the generation of which does not produce emissions. However, challenges remain in managing nuclear waste and ensuring operational safety. Policy-makers also face the problem of assessing and managing the small risk of catastrophic outcomes over a very long time horizon. Anti-nuclear sentiment has contributed to a widespread desire to phase out aging capital stock in the nuclear industry. UK nuclear operator British Energy (bought by EDF Energy in 2009) has extended the operating lives of many of its plants in recent years but all plants but one are due to shut by 2023 (BERR, 2008), which will place additional pressure on energy and emission reduction policies. However, official UK policy has been changing. Nuclear energy is increasingly seen as a relatively clean technology likely to make an important contribution to long-term decarbonisation of the power sector. The new Government has voiced support for nuclear power as long as it does not need subsidies beyond those for low-carbon generation generally. New nuclear plants are planned, but the private sector developer of the first does not expect it to be operational until at least 2018.

The UK policy framework could be more effective if there were more support for energy R&D, where the existence of externalities is well-known. More deployment options would be maintained as technologies developed and information about climate change improved. A greater emphasis on R&D relative to the output of renewable energy would also promote the creation of skills enabling firms to respond more readily to shifts in the direction of innovation. Investment in human capital would have a substantial advantage over technology-specific support mechanisms because skills are more transferable (Jamansb *et al.* 2008). It may be possible to identify areas in which the United Kingdom has a comparative advantage at the margin in innovation (*e.g.* using marine technologies) and to co-ordinate the distribution of international research across technologies to avoid excessive duplication of effort. Recent increases in government-financed R&D have been helpful, including the announcement in the October 2010 Spending Review of a commitment to spend up to £1 billion on a commercial-scale carbon capture and storage demonstration project (one of the first in the world on power generation). However, since 1990 UK public spending has fallen relative to other major countries (Figure 7).

The potential interaction of policy instruments aimed at market failures associated with the development of clean energy and those directed at the emissions externality needs to be considered (Braathen, 2007; Fischer and Preonas, 2010). An appropriate combination of instruments can achieve the emissions reduction objective more cost effectively by tackling the two sets of market failures simultaneously (Fischer, 2008; Fischer and Newell, 2008).

However, instrument interaction can also be inefficient. Renewables policies may affect the carbon objective through their indirect impact on the carbon price. By gradually switching electricity generation away from fossil fuels (if successful), renewables policies reduce the power generation sector’s overall CO₂ emissions. If a cap on emissions is already in place, this reduces the sectoral demand for allowances

and thus the carbon price, so electricity producers' costs are offset to some extent, the marginal cost curve shifts, and wholesale electricity prices are lower than they would be if the carbon price were constant (Rathmann, 2007; De Jonghe *et al*, 2009; Stankeviciute and Criqui, 2008). That contributes to a 'rebound' effect, tending to increase energy demand relative to what it would have been with a constant carbon price. If renewables policies are introduced without revising down the emissions cap, their impact on emissions is very likely to be entirely offset by this and other induced increases in demand. Carbon markets can then appear more and more inadequate on their own, apparently justifying more and more direct, technology-specific, support (Blyth *et al*, 2009). The weakened carbon price signal can then point path-dependent technological development and investment away from low-carbon technologies, especially outside the sectors covered by the renewables policies. The weakness of the EU allowance price suggests that the EU has not adequately taken into consideration the impact of renewable energy policies on carbon reduction objectives¹⁵. The recently proposed carbon price support in the power sector may also weaken the EU allowance price, reducing the pressure to abate elsewhere in the EU.

Other market failures may warrant government intervention. At the current conjuncture, the malfunctioning of financial intermediation is a major issue in the developed world and there is widespread concern about the willingness of private-sector banks to commit to risky, long-time-horizon investment projects. The consultants Ernst & Young have estimated that the United Kingdom needs extra capital investment of some £450 billion in energy efficiency and low-carbon energy supply from now to 2025 if it is to meet its green energy goals, but that there will only be some £50-80 billion of capital available from current project finance and infrastructure funds (Ernst and Young, 2010). The 2010 Spending Review announced the setting up of a Green Investment Bank (GIB) to help bridge that gap. It will be capitalised by public funding of £3 billion to encourage investment in green infrastructure. It will be allowed to borrow in the capital markets from 2015, if the Government's deficit reduction plans are on track. However, the Bank alone will not be sufficiently large to close the investment gap even when allowed in due course to function as a true bank, borrowing to apply leverage to the capital provided by government. However, it could play an important role, together with more robust carbon pricing and stronger incentives for renewable energy, in reassuring potential private-sector investors that the United Kingdom is committed to a low-carbon growth path. The main arguments for a public-sector institution focused on green objectives are:

- Investments with intergenerational implications, including many low-carbon investments, should be appraised using a discount rate lower than the market interest rate, for reasons of equity across generations that are not taken into account by markets. If they are to be undertaken at an adequate scale, they may require an interest rate subsidy.
- Many low-carbon projects entail large-scale investments that pay off over very long time horizons. Such investments have often required syndicated project finance, which has become more difficult because of heightened risk aversion among financial intermediaries in the wake of the financial crisis.
- Financial markets may not be prepared to take on all the risks associated with new low-carbon technologies, given their novelty and the dependence of their success on future policies and provision of infrastructure, so that in the absence of further government intervention insufficient finance would be available at the scale and pace needed to meet decarbonisation goals. Private investment in this area is contingent on the credibility of the Government's long-term

15. It can be argued that the EU ETS quotas are consistent with the current EU target for GHG emissions in 2020, so that renewables policies are not undermining the main climate-change policy. But the concern is about the incentives for the R&D and investment in low-carbon plant, equipment and buildings that will determine the capacity to decarbonise beyond 2020.

commitment to carbon pricing and other climate-change policies; subscription of government capital helps build that credibility. This will help to redirect saving flows to low-carbon investments more generally.

The consequences of the Bank for the balance sheet of the government also need to be considered. Government interest rate subsidies and public guarantees to those lending to the Bank would increase public sector liabilities, particularly if the Bank were to focus its lending on riskier products.

In summary, the Government needs to speed up the development and deployment of low-carbon technologies, focusing on correcting inadequate private market incentives for innovation. Its proposal to reform the regulation of the electricity market provides an opportunity to reduce the risks faced by renewable-energy power generators, for example, by encouraging long-term contracts for the supply of renewable energy and making grid connection easier (without removing all the commercial risks, many of which firms are better placed than government to manage). Given the ‘public good’ nature of basic research, it is also desirable to increase public spending on R&D for low-carbon technologies, preferably focusing on areas in which the United Kingdom has a comparative advantage at the margin and (to avoid free-riding) in the context of international co-ordination of research efforts across technologies. Such spending would need to be consistent with overall fiscal consolidation plans.

Box 3. Price versus quantity instruments to promote renewable energy

Several empirical studies have investigated the relative merits of price- and quantity-based instruments (such as feed-in tariffs (FITs) and the UK Renewables Obligation respectively) as means of promoting renewable energy for electricity generation. On the whole, they have found that price-based instruments have been the more effective. For example, the European Commission (2005, 2008) compared the costs of renewable energy support schemes with the proportion of the potential renewable energy supply share achieved, concluding in both years that “well-adapted feed-in tariff regimes are generally the most efficient and effective support schemes for promoting renewable electricity.” Despite the United Kingdom being below the EU-27 average on the Commission measures of both the effectiveness of its support for onshore wind power over 1998-2006 and the trend in effectiveness in 2006, the expected profit per kWh for UK generators using renewable energy was one of the highest¹⁶. Ragwitz *et al* (2007) also found that in 2004 and 2006, the Spanish and German FITs were the most effective and the UK quota system was much less so. Lipp (2007) compared UK experience unfavourably with that of Denmark and Germany, writing that “not only has the United Kingdom avoided picking winners, but it would also seem it has not chosen a policy winner either.” Ofgem (2007) argued that the price of electricity including the cost of the Renewable Obligation was above that necessary to make renewable energy technologies viable. Similarly, Jacobsson *et al* (2009) concluded that UK renewables support had generated excess profits for the wind power sector (primarily owned by the established utilities).

The evidence is not, however, entirely in favour of price-based over tradable-certificate systems. For example, Jamasb *et al* (2008) noted that German FITs had encouraged inefficient wind generation in low-wind areas. Newbery (2010) observed that FITs had originally been set too high for solar PV power in Spain and Germany, raising prices excessively high; the solar PV industry was then undermined when the pricing regime was amended. The two key issues are the incidence of risk and the generation of intramarginal rents on more mature renewables technologies, rather than the debate over price-based versus tradable-certificate systems.

Potential renewable-energy suppliers face several types of risk. Mitchell *et al* (2006) compared the Renewable Obligation in England and Wales with the FIT system in Germany, showing how in the former renewables generators have faced considerably more risks. But many of those risks reflected the absence of long-term contracts and the way in which the electricity grid has been regulated, and are not intrinsic to tradable-certificate schemes. Tradable certificate systems have tended to be more effective in promoting renewable energy where long-term contracts have been used (Agnolucci, 2007). That has reduced the risks associated with the short-run volatility of certificate prices,

16. However, it is not clear that all the costs of the FIT schemes (*e.g.* those falling on national grids) were taken into consideration.

which have been easier for large incumbent firms than new market entrants to manage. In the United Kingdom, long-term contracting has been uncommon. Introducing compulsory long-term certificates would help encourage new entrants (Mitchell, 2006). It would be unwise in any case to try to remove all sources of risk facing renewables suppliers. Klessman *et al.* (2008) drew attention to how risks facing renewables suppliers have often been reduced at the cost of reducing incentives for them to respond to long-run relative cost developments and shorter-run fluctuations in market demand and grid balancing requirements.

Among the reasons suggested for the superiority of some price-based systems has been that they have allowed the differentiation of price according to the renewables technology used. However, it is possible to differentiate among technologies under certificate trading schemes where this is deemed appropriate to reduce rents, as recent revisions to the UK Renewables Obligation system illustrate. The point of differentiation has been to prevent excessive profits being made by the users of more mature technologies, while ensuring that an appropriately broad portfolio of technologies is initially encouraged (Kramer and Haigh, 2009; Foxon and Pearson, 2007) There is, however, a danger of setting prices so that even technologies with very poor prospects are profitable at the margin. That can be avoided if the premium for any particular technology starts at broadly the same level and declines after initial commercial deployment at the same rate.

The governance and long-term credibility of climate-change policies

An analogy can be drawn between climate-change, fiscal and monetary policies. Governments may be tempted to relax policies (*e.g.* lower the carbon price, tax rates or the interest rate) in the present for short-term political gain, with adverse consequences for the long-term goal (*e.g.* long-run emissions reductions, debt reduction or price stability). Time consistency of behaviour and credible commitments to future actions are important but need appropriate institutions to help deliver them. One problem with climate-change policies is that the impact of GHG emissions is very long-lasting, so that the costs of mitigation are likely to be front-loaded relative to the benefits. That introduces a risk that governments may relax measures to reduce burdens on consumers and industry in the short term, especially in response to adverse macroeconomic shocks. Knowing this, firms and consumers are less likely to change their investment and consumption patterns. For example, the electricity supply industry may fear that, once it has invested heavily in renewable energy, so that the private costs of transforming the capital stock have been incurred, governments will no longer wish to impose the carbon price that made the investments appear profitable in the first place.

One way of combating this problem is for policy-makers to make public commitments, backed up by legislation, to a course of action that can be easily monitored by the electorate, creating a political cost of renegeing¹⁷. The CCC and the system of UK carbon budgets can be seen in this light. The Government has set medium-term and long-term objectives for specific percentage GHG emission reductions by 2020 and 2050. These are now embodied in statute. The CCC lays out what those targets are likely to entail in the near future, gives public advice about how government policies can help, proposes five-year carbon budgets and monitors progress towards meeting those budgets once adopted.

The arrangements are similar to those set up by the new Government for fiscal policy, with the creation of the Office for Budget Responsibility. They are also analogous to arrangements for monetary policy in the mid-1990s, when the Bank of England had a mandate to offer advice monthly but the Chancellor of the Exchequer was not bound to accept it. The Bank in that period also presented its analysis of the economy and the prospects for inflation, given the official interest rate, in its quarterly Inflation Report¹⁸. This raises the question of whether the Government should go further in pursuing the analogy between emissions targetry and inflation targetry by granting the CCC constrained ‘instrument independence’ – powers to adjust the settings of some key climate-policy instruments such as the CCL and

17. There is, of course, an enormous literature on these issues in the context of monetary policy; among the key references are Kydland and Prescott (1977), Barro and Gordon (1983) and Rogoff (1985).

18. The current climate-policy arrangements are actually stronger, because of their statutory footing.

RO target, just as the Monetary Policy Committee has, since 1997, been able to set Bank Rate (while the Chancellor still sets the inflation target). Such an arrangement would devolve limited tax-setting powers to an independent agency, but the taxes would still be received by HM Treasury and would not need to be earmarked in any way.

Proposals along these lines have been aired before (*e.g.* Helm, 1992; Helm, 2003; Helm *et al*, 2005)¹⁹ and warrant further consideration. The innovation would be easier to implement if the current CCL, CCA, CRC EES, hydrocarbon fuel duties and other transport- and climate-related charges were simplified and unified as suggested above. That would also facilitate a greater focus on how the various instruments interact. As well as improving policy credibility and combating the risks of time-inconsistent behaviour, the independent control of a simplified set of instruments in pursuit of a limited number of clear targets set by the Government would lessen the danger of rent-seeking. It is perhaps instructive that the Bank of England does not attempt to differentiate Bank Rate by sector to compensate for the differing sector exposures to variations in borrowing costs and exchange rates.

Sector-specific policies

There are several UK government policies more narrowly focused on reducing emissions in particular sectors. These have tended to concentrate on improving energy efficiency, increasing the use of renewable energy and promoting low-carbon innovation, but with the mix depending on the sector.

Homes

Improving energy efficiency in homes and encouraging low-carbon ‘micro-generation’ (small-scale generation of heat and power by individuals, small businesses and communities) are important, because the residential building sector accounts for a large share of emissions and these have grown strongly over recent decades. UK households account for over 20% of total UK GHG emissions (Figure 3). The Carbon Emissions Reduction Target (CERT) has been the cornerstone of government policy in this area. It places an obligation on the main gas and electricity suppliers to deliver a household energy saving target by December 2012²⁰. It has been complemented by a range of policies to help finance energy-saving measures and encourage micro-production of renewable energy (Box 2). The Government’s Energy Bill includes provisions for implementing a ‘Green Deal’ and a new Energy Company Obligation to replace the CERT and the Community Energy Saving Programme (CESP); both of the latter expire in 2012. This will be complemented by policies such as the Renewable Heat Incentive, the Feed-In-Tariff scheme and smart meter roll-out. This combination of policies is an important step towards the more comprehensive approach needed to tackle the wide range of market failures afflicting household energy choice, including lack of information about energy use and technological opportunities, low innovation in the building industry, capital market imperfections in the market for small loans and misaligned incentives between landlords and tenants. For example, under a more comprehensive approach, households could each be offered an energy-efficiency package tailored to the individual property and improved feedback to energy users (*e.g.* by including smart metering), complemented by tailored finance facilities, but with delivery organised on a large scale, street-by-street.

The ‘Green Deal’ is a central element of the new policy regime, designed to overcome market failures, especially in the provision of finance, and deliver a more comprehensive approach to household energy efficiency and micro-generation. Although final details of the ‘Green Deal’ are not yet available,

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19. Andrew Sentance of the Bank of England Monetary Policy Committee has also discussed parallels between climate-change and monetary policy (Sentance, 2008).
20. Ofgem indicates that suppliers had met 80% of the original target by March 2010, the end of the second year of the CERT.

there are several outstanding policy questions. A central question is how households will be incentivised to take part in the 'Green Deal'. A range of measures from subsidies to penalties have been suggested but the Government has not yet announced details. However, measures that directly address market failures in this area, *e.g.*, provision of quality information to households, are likely to be needed in addition to financial incentives or penalties. Smith (2010) raises a number of further issues with the 'Green Deal,' concerning how interest payments on loans will be set and at what level, to whom repayments will be made, enforcement of default, landlord/tenant issues and the ability of finance providers refuse loans to households. Holmes (2011) raises further issues, including that demand for the Green Deal will be low given the economics of energy efficiency retrofits at current energy prices. And it is not clear yet how onerous the imposition of the so-called 'golden rule' will be; this rule requires that repayments for energy efficiency measures should not exceed projected cost savings on the average energy bill over the life of the financing agreement. This may limit the range of measures that are feasible under a 'Green Deal', possibly to basic cavity and loft insulation alone. However, estimating which measures will obey the 'golden rule' is problematic as there is insufficient information about the costs of energy efficiency measures and likely energy savings.

The government appears aware of these limitations, especially around the 'golden rule', and aims to alleviate them through the integration of a new Energy Company Obligation (ECO) into the Green Deal. The ECO will provide additional support for lower income and vulnerable households, and provide support for hard-to-treat homes that do not meet the 'golden rule'. This is designed to enable action beyond basic cavity and loft insulations. Further consultations on the details of the ECO will be undertaken in Autumn 2011. (See DECC, 2011.)

The Government has also initiated a Call for Evidence about the costs and benefits of a wide range of energy efficiency measures, which is welcome. Results from this Call for Evidence are currently being examined. Existing research suggests that actual energy savings from the installation of home insulation are often much less than predicted. Sanders and Philipson (2006), for example, found that cavity and loft insulation was around half as effective as predicted. Part of the problem is the so-called 'rebound effect,' whereby energy-efficiency improvements, by reducing costs per unit of energy, lead to increases in consumption. This effect is more pronounced in low-income households; for further discussion of the rebound effect, see Barker *et al* (2009), UKERC (2007) and DECC (2010a, 2011a). Under the 'Green Deal,' if energy cost savings are not achieved, which is more likely in low-income households who may decide to take energy savings in the form of more warmth, Green Deal financing may not be viable. The government will address this risk with support through the Energy Company Obligation.

Any rebound effect would be reduced if improvements were accompanied by stronger carbon pricing. While there has been much focus on policies to encourage deployment of energy efficiency measures, there has been less emphasis on ensuring that households face an appropriate carbon price. The lower VAT rate on household energy should be abolished to achieve more uniform carbon taxation, with more targeted tools being used to ameliorate the distributional consequences, such as that proposed through the new Energy Company Obligation.

Transport

Several strategies and delivery plans are in place to decarbonise the transport sector, including a Renewable Fuels Transport Obligation. EU policies, such as the EU Renewable Energy Directive and vehicle fleet emission standards, are also likely to have a major influence. And the most important instruments in the United Kingdom are hydrocarbon duties, as they impose an implicit price on carbon.

Fullerton *et al* (2010) examine transport taxes, arguing that several policy instruments are needed to tackle efficiently the multiple externalities associated with road transport. Hydrocarbon duties can be

argued to serve several purposes, including pure revenue-raising, greenhouse gas abatement, a charge for road users reflecting wear and tear on the transport infrastructure and congestion charging. Until the relevant objectives are quantified, it will not be clear whether the carbon-pricing element is sufficient. Also, vehicle running costs may not provide a sufficiently strong signal. One option is to set more ambitious standards for new vehicle emissions and fleet average emissions. The problem is that such standards provide little incentive to outperform the given standards or to equalise marginal abatement costs across firms. The academic literature evaluating Corporate Average Fuel Efficiency Standards in the United States tends to find that increased fuel duties are a more cost-effective way of reducing emissions (*e.g.* Parry *et al.*, 2007).

Electric vehicles also have great potential to reduce average vehicle fleet emissions, but network economies in the provision of charging facilities make it unlikely that carbon pricing alone will be adequate to provide the appropriate incentives. More generally, the infrastructure requirements of transport systems complicate the challenge for policy-makers. The UK government has committed around £400 million to address these challenges. This funding includes the Plug-In car grant, a 25% grant towards the cost of a low-emissions vehicle, up to a maximum of £5,000, and the Plugged-In places scheme, which provides matched support for the installation of electric vehicle charging infrastructure. It also involves research and development support for low-emissions vehicles via a range of schemes including The Low Carbon Vehicles Innovation Platform, designed to accelerate the introduction of low-emission vehicles, and The Ultra Low Carbon Vehicle Demonstration Project, designed to facilitate learning about the use and performance of electric vehicles.

The interaction of transport demand and land-use planning has not received adequate attention across OECD countries (Garnaut Review, 2008). Planning regulations in the United Kingdom should be reviewed to ensure that either new developments are located in areas already serviced by low-carbon public/private transport infrastructure or new infrastructure is provided.

Agriculture

The Government supports a voluntary industry-led approach to reducing emissions in agriculture (where non-CO₂ greenhouse gases are more important than CO₂), rather than a mandatory market-based approach. The industry's Greenhouse Gas Action Plan aims to increase the efficiency of resource use through improved nitrogen use, better livestock management and more efficient use of fuels. There are also other policies to tackle other market failures, including underinvestment in R&D and deployment of new agricultural technologies and crops (due to the disincentives to privately funded innovation discussed previously), credit market failures, inertia, search costs, information failures and high transaction costs at the level of the individual farm (information on government programmes is available at <http://www.defra.gov.uk/food-farm/land-manage/>).

Despite government assistance and the impact of reforms of the EU's Common Agricultural Policy, it is unclear if the voluntary approach will achieve the emission reduction potential of this sector. The Government will review progress in 2012. Market-based policies can provide a clearer economic incentive and deliver more cost-efficient and equitable emission reductions. The UK Committee on Climate Change suggests that policy options from cap-and-trade schemes to grants, subsidies and taxes could be considered by policy-makers. If such options were to be introduced, issues around the measurement and reporting of agricultural emissions, administrative costs, and competitiveness concerns would need to be tackled. A report on market mechanisms prepared for Defra suggested that most cap-and-trade schemes in this sector would probably fail a cost-benefit test, because of administrative and compliance costs (NERA, 2007). However, specific project-based schemes – for example, to reduce fertiliser use, improve dairy yields, increase forest coverage or introduce new crop varieties – may prove more effective. Afforestation, in

particular, may offer substantial low-cost mitigation opportunities (Pearce, 2005b). Additional research into the feasibility of market-based approaches is warranted.

Adaptation to climate change

Climate-change policy in the United Kingdom should increasingly consider adaptation in addition to mitigation. The world is already committed to some climate change due to past emissions, and emissions over the coming decades, which will lead to further increases of concentrations of greenhouse gases in the atmosphere, will contribute to further changes in climate. Failure to reach agreement to restrain emissions across nations may also lead to high emissions in the future. Therefore the United Kingdom must prepare to adapt.

Adaptation requires a very different set of policy responses from mitigation. The UK Climate Change Act 2008 encouraged a step change in adaptation activities required, proposing:

- the introduction of Climate Change Risk Assessments (CCRAs), at five-yearly intervals from 2012, to provide assessments about the risks faced by the UK from climate change;
- a National Adaptation Programme, to be produced following the first risk assessment in 2012 and reviewed every five years, which will address the most important opportunities and risks;
- an Adaptation Sub-Committee (ASC) to provide advice to government on the risk assessments, to assess progress towards the implementation of the Government's National Adaptation Programme, and to provide advice when requested on adaptation; and
- the Adaptation Reporting Power, which enables the Secretary of State to direct authorities with public or statutory functions to prepare reports on their proposed adaptation actions.

Other measures outside the Act include the requirement for government departments to prepare Departmental Adaptation Plans and local authorities to report their progress on adaptation.

A review by the Environmental Audit Committee (EAC 2010) concludes that "The UK's adaptation policy framework compares well with arrangements put in place in other countries. The Climate Change Act 2008 has, however, introduced a complicated assessment and reporting regime. Its complexity has been increased by the introduction of Departmental Adaptation Plans." Furthermore, while action on adaptation has increased in recent years, especially since the 2008 Act, the UK Committee on Climate Change has reported that the United Kingdom remains inadequately prepared for the changes in climate that may occur over the coming decades. Current action involves building adaptation capacity through the provision of advice. But there is little evidence that climate impacts are being incorporated into local decision-making and actions that reduce risks (CCC 2010e).

The Environmental Audit Committee review (EAC 2010) recommended that the new Government should review the regime if it fails to deliver the necessary step-change in adaptation planning and action. The Government has responded, arguing that the framework is robust and that it is committed to reducing any unnecessary complexity and bureaucracy should it arise.

A number of factors have hampered progress on adaptation: insufficient climate risk information, undeveloped risk-assessment frameworks, little incorporation of adaptation across government policy, and poorly developed metrics for monitoring and evaluation; Pidgeon and Butler (2009) provide a detailed review of the benefits and limitations of risk-based approaches to climate-change adaptation. However, the

United Kingdom has made strong progress in overcoming barriers to adaptation in recent years²¹. The forthcoming risk assessments should provide high-quality risk information, and the quality of risk-assessment frameworks, such as the guidance offered by the Supplementary Green Book, has also increased. The Government has also recently introduced the Climate Resilience Toolkit, which will provide a business with a detailed report on where it is at risk and opportunities from climate change. While there is more work to be done on measuring and monitoring adaptation, progress is being made on many fronts²². It will be important to resolve tensions between the use of process-based tools and outcome-based metrics for monitoring and evaluation. The United Kingdom has also started incorporating adaptation into policy, for example, in the building regulations and in heat-wave plans that will assist preparations for more frequent heat-waves²³.

Going forward, the Government should establish a process for defining what level of risk is acceptable, assist in the delivery of adaptation outcomes, and consider adaptation measures in policy reform (CCC, 2010e). The sub-Committee also recommends that the United Kingdom should focus early adaptation efforts where further adaptation to present-day climate variability is desirable and where decisions have long-lasting consequences. The latter include investment in long-lived assets (for example, buildings and infrastructure), decisions that may cause irreversible changes (for example loss of biodiversity), and decisions that may have systemic and far-reaching effects (for example development in one part of the floodplain with knock-on effects downstream). Five adaptation priorities are proposed, including a strategic approach to land-use planning, provision of national infrastructure, design and renovation of buildings, management of natural resource sustainability, and effective emergency planning. Focus on these areas will provide ‘low-regrets’ investment options that provide immediate benefits and reduce risks.

The UK Government is already active in these five areas. For example, the United Kingdom committed more than £2 billion over the 2010 Spending Review period to flood and coastal erosion adaptation. This funding should remain a priority as recent events suggest that the United Kingdom is not adequately equipped to cope with extreme local flooding, despite better information about risks in this area. In addition, various government departments are undertaking work to build capacity and move adaptation planning and action forward²⁴. The authorities should take incremental actions to protect against near-term climate threats that are better understood, allowing flexibility and retaining options as risks and the knowledge base evolve over coming decades. They should continue to focus on the appropriate provision of public goods, including information, better risk-assessment frameworks, and more advanced metrics for monitoring and evaluation.

The challenge of decision-making under uncertainty at the local level remains, as does the need to maintain flexibility and options as new information becomes available. Much of the adaptation decision-making will be carried out at the local and regional levels and this will increasingly be the case as responsibility for many central government policies is decentralised. The implications of the recent Government decision to abolish the Regional Development Agencies and Government Offices for the Regions need to be carefully considered to avoid the loss of critical regional information. However, the Environment Agency, the body responsible for much adaptation planning and oversight, operates on a regional basis, with implementation largely falling on local government. It should be possible, therefore, to maintain progress on adaptation despite the administrative changes. Flexibility implies focusing on

21. (see <http://ukclimateprojections.defra.gov.uk/content/view/12/689/>).

22. (see, for example, www.defra.gov.uk/environment/climate/documents/adaptation-guidance.pdf).

23. (see www.environment-agency.gov.uk/research/library/consultations/106100.aspx).

24. (for a summary of government adaptation action, see ww2.defra.gov.uk/environment/climate/government/).

mitigation before large-scale spending on adaptation, long-lived infrastructure investments excepted. Defra, the relevant government department, recommends this approach for government appraisals, emphasising the need to maintain flexibility as risks evolve²⁵.

Conclusions

Given the Government's ambitious emission-reduction targets, it should seek a higher, more consistent, less volatile carbon price at the international level through tighter quotas within the EU emission trading system (EU ETS) and the adoption of a binding 30% EU emissions reduction target by 2020. The EU ETS should also be used to strengthen the long-term carbon price signal and its sectoral scope should be extended to reduce distortions in carbon pricing across the economy. That would reduce the overall cost of any given emission reductions.

EU emission allowances may not provide sufficient price signals to achieve the UK's major emission-reduction objectives. Higher and more uniform domestic carbon prices across the economy should therefore be sought in a cost-effective way. The Government should also assess more thoroughly how policy instruments overlap and interact, so that the effective carbon price becomes more uniform across industry sectors and different stages of production. Specifically, it should:

- Adjust the Climate Change Levy (CCL) and hydrocarbon fuel duties to reflect more closely carbon content and the content of other pollutants.
- Merge the CCL and the Carbon Reduction Commitment Energy Efficiency Scheme and stop making Climate Change Agreements which reduce the implied carbon tax rate.
- Raise the VAT rate on domestic energy use over time from 5% to the standard rate of 20% to promote consistency in climate change policies and enhance efficiency of taxation. Relevant distributional concerns could be more efficiently addressed through targeted support.
- Consider ways of giving firms greater certainty about the trajectory of the carbon price they face (*e.g.* by means of long-term contracts that transfer some risk around EU ETS carbon prices from firms to the government), including by implementing proposals in the current energy market reform consultations. The proposed carbon price floor should help (although its implications for the variation in the effective carbon price across the economy as a whole will need to be considered).
- Speed up the development and deployment of low-carbon technologies, focusing on correcting the inadequate private market incentives for innovation. Increased public spending on R&D for new low-carbon technologies could be warranted, while taking account of fiscal constraints.

The Government plans to reform the regulation of the electricity market, an opportunity that should be used to review support for renewable-energy power generators. The objectives should be to

- Focus support so as to remedy market failures in the generation and dissemination of innovations;
- Encourage longer-term renewable-energy contracts;
- Reduce the burdens placed on renewable-energy power generators by grid connection rules;

25. (see www.environment-agency.gov.uk/research/library/consultations/106100.aspx).

- Simplify and accelerate planning procedures.

The proposed Green Investment Bank should be able to subsidise projects where a low social discount rate is appropriate. But it can also contribute by helping to reduce private-sector investment risk and overcome other obstacles to long-term project finance – not least, by signifying the Government’s long-term commitment to aggressive climate-change policies. To increase leverage, the Bank should be allowed to borrow in debt markets, while taking into account fiscal constraints.

The Government should continue to build adaptive capacity across the UK economy, with a focus on reducing market failures such as the appropriate provision of public goods, including information, better risk-assessment frameworks and more advanced metrics for monitoring and evaluation. Immediate action should focus on near-term climate threats that are better understood.

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