

Environmental Audit Committee Inquiry Pre-Budget 2006

Evidence from Friends of the Earth, January 2007

Introduction

We welcome the opportunity to give evidence to this inquiry.

The first part of our evidence covers the Stern Review and the Government's response to it so far. The rest of our evidence looks at the Committee's questions on aviation taxation, the Barker Review and companies' environmental reporting requirements.

1 Stern Review

We hope that the Stern Review will be a turning-point in the fight against climate change. The scientific case for action has been getting stronger with every passing year, however set against this has been the strong prevailing belief that action to stop climate change would be bad for the economy. This belief has been perhaps the biggest barrier to action. The Stern Review turns around this consensus by arguing very strongly that in fact it is far better for the economy to act now, rather than to wait. The costs of action are given as 1% of annual global GDP, with the costs of not acting 5-20% of annual GDP.

The Stern Review goes on to make four broad points

- **Urgent, strong action is needed now to prevent these costs** (eg p208).
- **There is not necessarily a conflict between tackling climate change and economic growth.** Indeed, the report states "*climate change is the pro-growth strategy*" (pviii)
- **A global response is needed, involving all countries**
- **To tackle climate change, Government intervention is needed - through taxes, trading, regulation, subsidy and information.** Climate change is described as the "*greatest market failure the world has ever seen*" – a wide range of policy interventions are needed to address it.

The Government seems to be using the Stern Review predominantly as ammunition in international climate negotiations. We welcome this, however the Stern Review also makes a strong economic case for domestic action. The Stern Review – in two detailed chapters (11 and 12) - sets out the case that although multilateral action is necessary, **unilateral action need not be bad, and can be good, for a country's economy**. This point is being downplayed by Treasury ministers, who are putting almost all emphasis on multilateral efforts. Chapters 11 and 12 make four broad points:

- The longer we wait, the more costly the economic transition will be
- There is very little macro-economic threat to the UK from moving more quickly.
- There are major opportunities in new markets from moving quicker

- There are major opportunities in rooting out economic inefficiencies; at a company level from being more efficient, and at a national level by removing inefficient subsidies.

The analysis in Stern is that action on climate change is a massive economic opportunity for the UK. Also, in addition to economic benefits around stimulating innovation, improving resource and energy productivity, and reducing the economic and social costs of future climate change, there are other ancillary benefits from reducing our dependence on fossil fuels, for example:

- Reducing the UK's vulnerability to the global volatility of oil markets and supplies
- Reducing the UK's balance of payments deficit
- Reducing dependence on energy supplies from unstable parts of the world
- Massive potential for job creation in renewable technologies and energy efficiency

In this respect, it has been very disappointing to see so little Government response to the Stern Review on national policy. In particular, there was very little action from the Chancellor in the December 2006 Pre-Budget Report, his first opportunity to respond to Stern. £5 on a cheap flight and an in-line with inflation rise in fuel duty were the limits of his ambition on green taxation – this is hardly the type of action that creates the economic incentives for a transition to a low carbon economy.

We hope that the Committee will ask the Chancellor – as a national response to the Stern Review – to implement a national climate change strategy to deliver a low carbon economy. We suggest that the main elements of a successful strategy would be:

- Set annual budgets for carbon, which fall year-on-year, driving emissions down
- Set up national carbon accounts, as a central part of the national accounts
- Use its range of policy instruments as part of a strategy to affect emissions in all sectors of the economy
- Have an annual review of policies to ensure that this budget is kept to, adapting policies accordingly.

Aside from the broad analysis of the net economic benefits of acting now on climate change, there are two other points in the Stern Review which should cause changes to Government policy.

1.1 Social Cost of Carbon (SCC)

The SCC is routinely used by Government to determine what level of carbon emissions to allow in specific policies and projects – for example the determination of appropriate Building Regulations; levels of recycling in the Waste Strategy; whether airport expansion is acceptable. The Government currently uses a figure of £70t/C, based on its 2002 literature review of climate impacts. Friends of the Earth has argued before that this figure is far too low – it is based on the use of a high discount rate, weak treatment of uncertainties, and narrow coverage of environmental impacts. The

Stern Review argues strongly that these issues deserve better coverage, and it recommends a figure for SCC of \$85 t/CO₂, which equates to £238 t/C – over three times the current figure. If implemented, this would have a major effect on policy appraisal across Government, and mean far greater likelihood of policies and projects which cut carbon emissions.

This new proposed figure is in essence down to three changes:

- It is based on more up-to-date science
- It is based on a lower discount rate. We note that this is not a “scientific” issue, but an “ethical” one. Stern states that the lower rate used reflects “*the view that this rate should be based largely on the probability that future generations exist, rather than their having some more lowly ethical status*”.
- It covers a broader range of impacts. The 2002 review was based on a literature review of studies which only cover a small range of the total impacts of climate change

There still remain difficulties with using SCC – not least that it institutionalises the trade-off of different policy objectives, which is conflict with the Government’s Sustainable Development strategy that policy objectives should be integrated. However, this higher SCC gives a more accurate reflection of the actual damage from climate change, and is far more appropriate than the current £70tC figure.

So far, it is not clear what the process is for determining whether a new SCC figure should be put in place. A parliamentary answer from John Healy MP from 18th December 2006 said that Government was “*in the process of reviewing*” the social cost of carbon– we advocate that this should be resolved before Budget 2007, used for policy and project appraisal at Budget 2007 and beyond, and applied retrospectively to major policy areas to determine whether policy review is needed.

1.2 Policy instruments

The Stern Review is very clear that climate change is a problem caused by market failure. It argues strongly that a range of policy instruments – from market measures like tradable permits and taxes, through to Government spending, use of regulations and better information – will all be needed to tackle climate change. In other words, Government intervention is essential to tackle climate change. The Stern Review states that tackling climate change is the pro-growth strategy. So the clear inference is that to get a strong economy, Government intervention is required. This is at odds with the Government’s current deregulatory focus – where for example stronger building regulations are dismissed as “unnecessary gold-plating”, the land-use planning system is attacked (through the Barker Review) as an inefficient and bureaucratic hindrance to growth, and interventions generally – whether regulatory or fiscal – have an unwarranted taint of being ‘bad for competitiveness and UK plc’. This is writ large into the Cabinet Office’s Better Regulation agenda – for example in the Autumn 2006 consultation on Regulatory Impact Assessment where it says that “*the new impact assessment is aimed at focussing on whether regulation will impose an unnecessary burden on the private, public or third sectors*”.

In fact what Stern is saying is that free-markets failures are the cause of problems which will have major negative impacts on the economy. Markets have a central role in all economies, but these markets must be managed well. There is a strong central role for Government intervention to tackle climate change and deliver strong economies. We hope that the Stern Review starts to signal the end of the erroneous belief that generally interventions are bad and to be avoided. On the contrary, it is Government inaction, and letting the free-market rip, which is the problem.

2 Aviation Taxation

The Chancellor's increase in Air Passenger Duty (APD) is too small to deliver much environmental benefit.

The increases only restore the lowest level of APD to 2000 levels (ie lower in real terms than in 2000). The increases will not even stabilise emissions (as the EAC recommended), let alone reduce them. APD will still bring in only £2 billion a year, compared with the £10 billion annual tax exemptions (from VAT and fuel duty exemptions). This year's increase (the first in 6 years) does recognise that APD increases can deliver environmental benefit, and would be welcome if it was to be followed up in Budget 2007 by a commitment to an APD escalator, to curb the demand growth for flights. This is particularly necessary now as ETS is not due until 2011 and even then will only slightly reduce passenger growth, and because it is crucial to stop "air dependency culture" before it becomes entrenched. We also advocate that the rise in APD is explicitly linked to a combination of tax cuts in other areas (for example employment taxes) and to environmental spending – for example providing grants for people wanting to cut carbon emissions in their homes. APD rises could provide the funds for a major push for households in helping them cut their carbon emissions at home.

We do not support the use of APD revenues to provide a fund for R&D for new aviation technologies as some have suggested – giving this revenue back to the aviation industry would be against the Government's "polluter pays principle". The industry is quite capable of funding its own research programme. In this respect, reform of APD so that it reflects environmental damage more, would create an incentive for the aviation industry to step-up its R&D effort. We note however that new technologies will take decades to diffuse through the fleet, so that other action – in the form of slowing demand growth – is essential.

Other reforms of APD – such as charging per plane to encourage better load factors, and extension to cover air freight (not currently covered) would all be beneficial, but the main area needed is for the Chancellor to commit to an APD escalator as part of a overall climate change strategy.

On other areas of aviation policy, it was disappointing that there was:

- No commitment to remove the (Government recognised) anomaly of fuel tax exemptions for domestic flights. The UK has the greatest number of domestic flights in the EU, despite being a small country.

- No commitment to work to remove the anomaly of fuel tax exemptions on international flights between UK and 2nd countries in renegotiated bi-lateral air service agreements
- ETS proposals are only for 10% auctioning from 2011, with gradual increases in future. This is well short of the Stern recommendations for greater use of auctioning.

3 Carbon from buildings and the Barker Review

3.1 Overview

Planning and building regulation can make a major contribution to CO₂ reduction. These are powerful and complementary measures. While some of the actions announced by DCLG on using these mechanisms are welcome, more effective delivery in shorter timescales is possible. The final Barker Report will significantly restrict the ability of planning to deliver on climate because its recommendations will give more emphasis to business interests and deregulate important planning functions.

3.2 Building regulations

Building regulations have the capability to ensure that new housing is built to carbon zero standards through detailed regulations on energy efficiency and micro energy generation. The Code for Sustainable Homes published in December 2006 was announced as a voluntary initiative which signalled the direction of travel for building regulations so that the most demanding code standards (Carbon zero) would be incorporated into building regulation in 10 years. Friends of the Earth is concerned that this timescale does not meet the challenges set out by climate science for greater and faster CO₂ reduction (See Tyndall Centre Research 2006). We regret that the code is voluntary and that it fails to tackle the reform of standards for commercial and public sector development.

3.3 New planning guidance

The proposed new Planning Policy Statement: Planning and Climate Change supplement goes some way to maximising the potential of the planning system to deal with climate change. The document contains a framework for estimating CO₂ emissions from new development and for setting bench marks for reductions in the built environment. The policy is also actively supportive of renewables projects. The policy sees regional and local spatial strategies as shaping “the framework for energy supply in their area” (para 1.11, Introduction). In addition “*development plan documents (DPDs) will set policies on the provision of low carbon and renewable sources of energy to provide the platform necessary for securing and complementing the increasingly high levels of energy efficiency required by Building Regulations*” (para 1.11, Introduction). The extent of the planning authority’s ability to enforce these policies is clearly stated as “*where proposals are inconsistent with the policies in this PPS, consideration should be given to how they could be amended to make them acceptable or, where this is not practicable, to refusing planning permission.*” (para 28).

3.4 The impact of the Barker Report

The policy framework put forward by the Planning and Climate Change supplement, and the Code for Sustainable Homes are undermined by the recommendations of the Barker Review. A more detailed assessment of Barker available on request. In short the recommendations of the final report (and the analysis in the body of the report – see para 1.15) are for a presumption in favour of development outside of the plan (recommendation 1), and an emphasis on economic factors (recommendation 2) and including price signals (see Box 1.1 on page 24), removing the needs test for retail development, and emphasising cost and benefit analysis (recommendation 4). They are therefore directly contrary to making decisions based upon carbon emissions reductions and sustainable development criteria, as they emphasise economic growth over other environmental considerations.

One example of how the recommendations would weaken the planning frameworks ability to deliver carbon reduction is in relation to Sustainability Appraisal. The Planning and Climate Change supplement to PPS1 envisages Sustainability Appraisal as important, particularly in encouraging “*regional planning bodies as part of their approach to managing performance on carbon emissions, to produce regional trajectories for the expected carbon performance of new residential and commercial development*” (para 1.7, Introduction). The Barker Review however in Recommendation 15 suggests “*streamlining of Sustainability Assessment (SA) process including removing or reducing requirements where a related higher tier policy has already been subject to SA and exploring how SA requirements can be streamlined for Supplementary Planning Documents;*” a move which removes important environmental safeguards and will not be effective in assessing whether policies and decision-making on applications for development will actually result in the reduction of carbon emissions from development or retrofit.

4 Companies’ environmental reporting requirements

4.1 Background

In our written evidence submitted to the Environmental Audit Committee’s inquiry into the 2005 Pre-Budget Report, Friends of the Earth highlighted our disappointment at the Government’s decision to abolish the requirement for listed UK companies to publish an Operating and Financial Review (OFR). Introduced in March 2005, the OFR regulations would have required companies to annually disclose non-financial information on company performance, including on environmental and social issues where these were material to the company’s business.

As we highlighted in last year’s submission, the OFR would have constituted a major step forward in terms of corporate transparency and accountability in relation to environmental impacts. Although the primary audience for the reports was existing company shareholders, the reporting requirements would have helped to make a company’s board and its wider stakeholders – including employees, consumers, and potential investors – more aware of any negative environmental and social impacts associated with its activities, thereby increasing the likelihood that companies would take steps to improve their performance in these areas.

The OFR regulations had been due to be incorporated into the Companies Bill (previously the Company Law Reform Bill), along with similar but less stringent non-financial reporting requirements required under EU law. The latter – originating from the EU Accounts Modernisation Directive – required quoted companies to include non-financial information in a Business Review as part of their annual Directors' Report. However, the reporting requirements of the Business Review were significantly weaker than those of the OFR in a number of key areas, including in relation to the provision of information on environmental matters, reporting standards, and auditing requirements.

4.2 Progress on Environmental Reporting in 2006

– Two steps backwards, one step forward

With the passage of the Companies Bill through Parliament in 2006, some progress was made in strengthening the non-financial reporting requirements in the Business Review to fill the gap left by the OFR. Following Friends of the Earth's launch of Judicial Review proceedings into the decision to abolish the OFR¹, and a major campaign to strengthen the environmental and social provisions in the Bill by two civil society coalitions, the Corporate Responsibility (CORE) Coalition and the Trade Justice Movement, the Government brought forward amendments to the Companies Bill to expand the range of issues on which companies will have to report in their Business Reviews.

The Companies Act 2006, which received Royal Assent on 8 November 2006, requires that quoted companies annually disclose information on environmental matters (including the impact of the company's business on the environment) to the extent necessary for an understanding of the development, performance or position of the company's business. It also requires companies to disclose information on:

- Their policies in relation to environmental matters;
- The effectiveness of those policies; and
- Persons with whom the company has contractual or other arrangements that are essential to the business of the company (except where 'disclosure would, in the opinion of the directors, be seriously prejudicial to that person and contrary to the public interest').

4.3 Key Outstanding Issues

The audit requirements for the Business Review remain weaker than those for the OFR, with no requirement in place for auditors to consider whether any other matters had come to their attention during the course of the audit that were inconsistent with the information provided in the Business Review.

Furthermore, there is no statutory reporting guidance for the Business Review. Mandatory reporting standards ease compliance with narrative reporting requirements by providing guidance and clarity for companies on what information to include.

¹ This legal action was settled out of court following a commitment by the Government to reopen and widen the consultation on the reporting requirements in the Companies Bill:
http://www.foe.co.uk/resource/press_releases/friends_of_the_earth_force_02022006.html

They also help to ensure comparability of reports and facilitate assessment by interested parties of a company's relative environmental performance vis-à-vis its competitors, and its own progress in this area year-on-year.

However, despite calls from a diverse range of stakeholders for the Government to provide mandatory reporting standards for the Business Review, none are included in the Companies Act 2006. The Government has committed to review the need for a mandatory reporting standard 2 years after the new non-financial reporting regulations come into force, but this is still disappointing given that the OFR regulations were accompanied by a mandatory reporting standard issued by the Accounting Standards Board (ASB).

Overall, it is regrettable that the Government did not take greater advantage of last year's major reform of UK company law to put stronger regulations in place in relation to the transparency, accountability and responsibility of UK companies for their environmental and social impacts. Despite the improvements to the Companies Bill, which as a whole represented an important step in the right direction for UK corporate accountability, the environmental reporting requirements on UK companies are still weaker than they were under the OFR regulations.

4.4 Recommendations

Friends of the Earth believes that mandatory environmental reporting is one of the essential first steps to ensuring improved environmental performance by UK companies. In order to provide a **level playing field across business** and sufficient incentives for all companies to take their environmental responsibilities seriously, we believe that the following progress on environmental reporting requirements is essential:

- Extension of reporting requirements to cover all large and medium-sized public and private companies (with reporting to be consistent with the size and complexity of a company's business operations).
- Introduction of mandatory reporting standards for the Business Review through the publication of statutory guidance developed in consultation with all interested stakeholders.
- Removal of materiality requirements so that information on environmental impacts, including carbon emissions, is not limited to that which is considered to be material to the company's business (as is the case with the Business Review).
- Introduction of stronger audit requirements for information on environmental impacts in order to ensure the accuracy of the information provided by companies in their non-financial reports.

5 Other aspects of environmental tax and incentive policy

We were disappointed that the PBR contained so few new initiatives, particularly given the Government's failure to bring carbon emissions down over the last ten years. In particular, there was a major opportunity missed to use new tax revenues to make it cheaper and easier for individuals to take the greener option. We attach below as an appendix our December 2006 summary of the PBR's environmental measures.

ENDS

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Appendix one – summary of PBR measures:

Friends of the Earth's critique of the Chancellor's Pre Budget measures:

TRANSPORT

Fuel Duty

The Chancellor announced an immediate rise in duty of 1.25p, in line with inflation, but ruled out a real terms increase and reinstating the fuel duty escalator.

The cost of motoring continues to fall, while the costs of alternatives like bus and rail continues to rise. The 1.25p rise – merely in line with inflation, ie real price staying still - will have almost no effect. A real terms increase would also have allowed investment of the funds raised into improving public transport, as promised in his 1999 report, but there are now no funds for this.

Vehicle Excise Duty

Nothing.

The Government accepts that varying the cost of the tax disc by pollution levels has great potential to shift buying habits towards greener cars. However the current £20 difference between F and G bands for example is no incentive at all.

Air Passenger Duty

Rates have doubled – from £5 to £10 for intra-EU flights, and £20 to £40 for longer flights. Business rates have also doubled from £10 to £20 (intra-EU), and £40 to £80 (rest of the world)

Air Passenger Duty has been frozen (and falling in real terms) since 2000. Today's announcement brings the £5 rate back to its 2000 level of £10. This increase is welcome in that the Government has recognised that interim measures are needed to tackle aviation's emissions while an international agreement is negotiated. It is also welcome that the Government accepts that APD rises will have an environmental effect, and that demand management is necessary. However, the increases are not sufficient to tackle aviation's emissions– larger increases are needed, and an commitment to year on year increases to prevent the continuing falls in the overall

cost of flying. These falling costs are driving massive airport expansion programmes across the UK.

Biofuels

The Chancellor announced a number of policies designed to increase the support for and uptake of biofuels.

Biofuels could potentially have a part to play in tackling climate change, but it is essential that there are strong environmental and social criteria attached to new biofuels projects, otherwise biofuels could encourage deforestation (monoculture plantations replacing rainforests) threatening biodiversity and adding to climate change. The Government's current sustainability criteria are nowhere near strong enough, and it is a major concern that it is helping this technology expand before ensuring high quality standards are in place.

HOMES

Energy efficiency

No measures anything near the scale of the challenge in the domestic sector. £7.5 million extra for better coordination of the Warm Front and Energy Efficiency Commitment.

Almost no new measures here, despite it being a huge source of emissions. Households need financial help with capital costs for installing energy efficiency measures and new technologies such as solar panels. This would save people money, create jobs and reduce emissions. An investment of billions is the order of change needed – to help millions of householders improve the efficiency of their homes. Tiny micro-measures are not what are required here.

Micro-generations

**No increase in the Low Carbon Buildings Programme (LCBP).
No measures to ensure a fair price for power generated and sold to the grid.
The sale of power to the grid is now not subject to income tax.**

The income tax measure is welcome but small. The overwhelming priority to get these technologies taken up is help for householders with capital costs. The existing LCBP needs to be massively boosted. Countries like Germany have a package of strong measures to support micro-generation, and it is taking off. The UK is already falling way behind in these future technologies.

New homes

All new homes to be zero-carbon by 2016.

This is welcome, but the date of 2016 is far too unambitious. Also, a far greater

priority is the existing stock – each year new houses contribute just 1% to the overall stock. The overwhelming priority is measures for 99% of houses now, not 1% of houses in 10 years time.

Zero stamp duty on new zero-carbon homes

This is a useful but minor measure.

Landfill tax

A £3 a year increase, in line with existing policy of a £3 a year escalator.

David Miliband has said that a much higher escalator is needed to reduce landfill and its adverse environmental impacts. A commitment to “consider” steeper increases is not progress.

Climate Change Levy (CCL)

Nothing. Continuing with in-line with inflation rise announced in Budget 2006.

The CCL has been a success, but frozen in recent years. A real-terms increase would have helped businesses increase efficiency, cut emissions and boosted the further uptake of renewable energy.

Carbon capture and storage

The Government is going to subsidise a demonstration plant.

Emissions Trading

The Government continues to place great hope in the EUETS scheme and its potential future expansion. The “protecting the environment” chapter of the pre-budget report focuses heavily on it. However it is not a panacea, and is working very badly at the moment – for example the UK power generators made £800 million windfall profits in the first year of its operation. The Stern Report is clear that other mechanisms including taxes, spending and regulation are all essential. It is also clear that action at the UK level will be, with well designed packages of policies, good for the economy as well as the environment. There is not a penalty from unilateral action, and indeed we are not moving faster than many countries in any case.