

NOTES FROM FIFTH SEMINAR. ISSUES OF UNILATERAL ACTION

20 NOVEMBER 2013

Meeting Report

VENUE

McKinsey & Company, London.

CHAIR

Dr John Rhys, Oxford Institute for Energy Studies (OIES).

SPEAKERS

David Kennedy, CEO, CCC

Chris Allsopp, OIES

David Kennedy

David Kennedy began by reviewing the duties of the CCC and feasible UK pathways to attain its 2050 target of 80% reductions on 1990 levels, which required deep cuts in the 2020s. UK actions should not, strictly speaking, be regarded as unilateral, to the extent that they reflected what was considered an appropriate UK contribution to the pragmatic Stern Review estimates of acceptable average global emissions, as well as an important EU dimension.

Reviews of the state of climate science, and indeed the IPCC report itself, confirmed that there was no good case for relaxing ambitions and targets. A particular question was whether actions could be delayed for (say) 10 years, or much longer, with 2050 targets remaining achievable. This ignored both practical issues, such as the development of technologies and supply chains, and the fact that the essential emissions issue was not a single year target but the cumulative concentration of CO₂. Significant delay would render the achievement of targets, and overall success on climate policy, impossible.

There were a number of important issues. One was the power sector decarbonisation strategy, which could be seen currently as central to the 2050 target. Would the government commit to this or would they be tempted towards a new dash for gas? The issue would be reviewed in 2016. Its importance lay in the commitment necessary to get power sector investment.

Part of this question was whether shale gas was a game changer. Overall it was not. It was true that shale gas could with best practice have a carbon footprint similar to natural gas, and below that of LNG, but the evidence was that European shale gas was not going to be available in the quantities that would shift gas prices substantially. Shale gas did not change significantly the underlying narratives on affordability and growth. But UK shale gas should be welcomed if it made sense in terms of energy sovereignty, sound economics, jobs and Exchequer revenues.

It was also true that dispatching gas ahead of coal, in existing plant, would have a big immediate effect on UK emissions.

David devoted some time to particular issues of affordability and competitiveness. He pointed out that the effect of policy measures on consumer bills had so far been very small compared to the impact of gas prices, but this had not stopped the industry from placing a disproportionate weight on government policy, also conflated with aspects of social policy, as an explanatory factor.

Policies had had no discernible effect so far on industrial competitiveness, not least because energy intensive industries had had free allowances. There were potential risks going forward, with the focus on energy intensive industry (about 2% of GDP), and it had to be noted that the UK already had relatively high electricity prices within the EU.

UK objectives should also be set within an EU and a global context. This demonstrated that the UK policies were broadly consistent both with the EU and with international trends more widely. He noted that a significant proportion of emissions (c 20%) were now covered by carbon markets and an even higher proportion of vehicle emissions (c. 80%) by vehicle emission standards.

So overall there was nothing in the review of either the science or the international context that provided evidence for relaxing the budget. The effect of the Climate Act was that the carbon budget process was to some degree insulated from the risk of short termist or irrational pressures to abandon targets on the basis of spurious arguments.

One question posed to David was the argument that national policies generally (not just the UK) had undermined the EU ETS carbon price. David argued that the carbon price had been more affected by the recession than by national policies which were in principle supposed to be complementary. The UK had been a prime mover in EU policy towards climate.

In summary form recommendations were that:

- The UK's 2050 target of an 80% emissions reduction remains appropriate
- By 2030 the UK should aim for a 60% reduction on 1990, and a 37% reduction by 2020; this is a back ended path to 2050.
- Power sector decarbonisation remains an appropriate strategy given potential for shale gas
- Near term electricity price increases to avoid higher increases in future; scope for managing affordability and competitiveness impacts
- Policy implications: need new policies to drive step change in pace of underlying emissions reduction. Progress made – but more needed!

Overall the conclusion was that climate policies represented a small cost but the quality of life was unchanged. The future included

- Significant clean power generation - nuclear, CCS & renewables.
- Energy efficient homes and offices, building fabric and appliances
- More carbon friendly practice e.g. turning down air conditioning

- Change in balance of public / private transport and diet
- More efficient cars, plug in hybrids / full electric vehicles
- New jobs in green economy e.g. wind generation, electric cars.
- Cost was a price worth paying to secure a brighter future

Chris Allsopp

Chris Allsopp addressed the questions of unilateral action on energy and climate issues in a macro-economic context. There were several dimensions to the discussion, including the “prisoners dilemma” and “free-rider” models of collective action, the current and largely out of control debate over European competitiveness, the costs and financial impacts of climate policies in comparison with other factors and their consequences for growth, and comparison with closely related questions in trade and domestic pricing of oil and gas resources.

Was there a problem in unilateral action? Prima facie this appeared to be very obviously the traditional problem of the commons. But were there cases when it might make sense to take action even if others did not follow. The prisoner’s dilemma was the classic narrative, but in circumstances where the prisoners’ dilemma could be regarded as a repeated game then the dilemma tended to resolve itself. The WTO was a classic example and it was notable that trade or tariff wars had not been a feature of the current recession. With action on climate change, the position was not clear cut, but the evidence of widespread action could be interpreted that at least some degree of cooperation was in progress.

The general issue of justification for incurring costs necessary to action on climate change was, at least in global terms, very simple. If it was deemed good economics, or an essential expenditure to maintain an inhabitable planet or an acceptable environment, or to avoid excessive welfare losses or other economic costs, then the costs should be incurred irrespective of the particular economic circumstances prevailing at the time. But it was useful to put the quantities into perspective, especially when it was suggested that the costs were unaffordable,

and that they would disrupt normal economic activity or result in fundamental lifestyle changes.

Geo-engineering was a possibly interesting contrast. Countries could engage in it unilaterally, but that would create new issues of governance.

Problems of economic adjustment. Stern had estimated necessary costs of adjustment in global terms at around 1% of GDP. The current consensus was that this might well be an underestimate, but not by an order of magnitude. Very approximate estimates of the scale of some of the more obvious carbon reduction measures could also be made. Significantly we could make direct comparisons with the effect of other comparable expenditure shifts in the energy and other sectors. The most obvious analogy was with the impact of the oil price shocks since the 1970s. The oil price shock could be most easily analysed as if it were just another indirect tax.

On each of these occasions the macro-economic impact of the oil price shocks had been equivalent to about 3% of GDP. This had had some very large distributional consequences, most obviously in terms of transfers to oil producers, but the world had not fallen apart and adjustments had been comparatively straightforward, not obviously damaging growth except when policy responses had been inappropriate. The sums involved in action on climate change were much smaller.

Health expenditure in the UK accounted for 9% of GDP but in the USA the figure was 18%. The effect of the recession induced by the financial crisis had put GDP 15% below trend. In this context the projected changes in the percentage of GDP devoted to energy were relatively small.

The real issue was the real resource cost implied by switching to a low carbon economy and the resulting differences in the costs of goods and services. Thus for the UK the cost of switching all coal generation to gas, a major measure, might be of the order of perhaps 0.25% of GDP (admittedly back of envelope calculation with simplifying assumptions). For a country like India however the cost of a comparable switch would be much more significant, at perhaps 5-7% of

GDP. Nevertheless in global terms at least the costs were not particularly large in a macro-economic context, and much lower than those of comparable shocks to the economic system, or significant changes in particular resource costs or terms of trade, associated with oil or other commodities.

We needed to distinguish the different phases of any change to a low carbon economy. Initially for example “Green” taxes such as a carbon tax could be recycled and were not per se a drain on the global economy. The real issue was how economic growth might be affected by a permanent upward shift in the real resource cost associated with energy production and delivery. This was hard to predict with any confidence but energy economists often appeared to have an exaggerated view of the “unique” importance of energy, redolent of a much earlier school of economists known as the Physiocrats, who attached a comparable significance to land.

Austerity and competitiveness.

One element of the argument against action on climate, for example at the EU level, had been that such policies were simply unaffordable at times of austerity. However there was plenty of capital available looking for secure investment opportunities and real interest rates were at an historic low. Failure to secure investment in what was perceived as an essential public good could only be construed as regulatory or policy failure – mainly the failure of government to fully commit to policies. It could be argued that this would lead to government taking more of such essential expenditure.

The competitiveness issue had been hugely inflated, and much of it, from a rational economic perspective, could be described as mercantilist nonsense. The Krugman position was that it was companies that were competitive, not countries. Even on a very short term analysis energy prices were demonstrably of much less importance than for example the exchange rate. Germany was not “competitive” and running a large surplus because it had low energy prices – actually they were among the highest in Europe- but because membership of the euro gave it a low effective exchange rate that it would not otherwise be able to sustain.

One of the best counter examples, on a longer term perspective, was the US motor industry which had long lobbied hard against gasoline taxes which would supposedly damage the US car industry. The outcome had been a huge competitive advantage to European and Asian producers who had produced far more efficient vehicles. Detroit was now a wasteland. A significant issue in long term “competitiveness” or innovation potential lay in “getting ahead of the game” and this was not fostered by policies that failed to recognise the direction in which global policy was moving.

A general conclusion might be that some of what were presented as key problems of emissions policies, in a macro-economic context, were essentially problems of adjustment, of distributional impacts and of local politics.

The EU ETS. The EU ETS had indeed been undermined. In large measure this could be attributed to the recession and euro-zone chaos. With hindsight a tax would have been better. Now the priority should be to get the system working better, so that it was capable of adjusting to changing circumstances. The UK floor price was one option. Another was to introduce the emissions equivalent of a central bank which could change allocations and caps.

Chairman’s Comments on the Proceedings

This seminar integrated a number of questions and observations, some of which had arisen earlier in the series.

David Kennedy reaffirmed the argument that the UK was not in fact adopting a purely altruistic but otherwise pointless unilateral approach, and was to a large extent just moving in line with many other countries. He also reminded us of the strength of the commitment to emissions targets that was provided by the Energy Act.

Chris Allsopp demolished a number of the myths surrounding the economic consequences of climate related policies, and around the particular issues of competitiveness. He also re-affirmed points made in the fourth and earlier seminars on the relative abundance of capital and historically low interest rates.

The EU ETS continues to be a key unresolved issue. EU policy ought to be of critical importance and the ETS ought to be an essential element both for the EU and the ETS. David Kennedy argued correctly that the recession had been a major factor in undermining the carbon price. However in my view there are several other factors, notably initial targets and caps that were too slack, timescales for the market that are too short to incentivise long lead time, long life investments, and inability to adjust caps to take account of additional policies. Arguably the scheme was built around the notion of meeting specific short term targets when the real task would have been more accurately defined as providing the underpinning for low carbon investment. The critical issue for the ETS is how it might be modified to be more responsive to exogenous factors such as the economy and other policy or technical developments.

One of David's important supporting points was recognition of the fundamental importance of focus on cumulative emissions and not just on remote targets. This is central to the urgency of the whole climate issue.

Chris also drew attention to the issue of the cost of climate policies. This is frequently exaggerated, but the identification of the underlying issues in relation to problems of adjustment and transition, and the distributional impacts, is clearly an area that is often neglected in the broad discussion. But it is one which may have a disproportionate impact on the politics.