

LogicaCMG Emissions Trading Project – Draft White Paper V 13

1 Introduction

The Emissions Trading Scheme (ETS) has now been in operation for almost 6 months, with what are perceived to be varying levels of implementation and knowledge even amongst the most important sectors of the economy severely impacted by the regulations. The 2004 Pan European Emissions Trading Survey sponsored by LogicaCMG concluded:

“Overall about one half of these companies [impacted by the legislation] will not be ready when the regulations come into force and whilst some are clearly gambling on a delayed start others are either unaware of the impending situation, or prepared to live with the consequences in the short term.”

With the Scheme now in force for nearly 6 months LogicaCMG has sponsored a follow up survey to identify the extent to which companies have moved forward over the last 12 months and are now comfortable with the concept of ETS compliance – or not as the case may be. By now companies should have the right processes and procedures in place to report on emission activity and they should be a long way down the verification path. The following pages will shed light on some critical issues:

- How many companies have been investing to move towards compliance and in what areas?
- What is the wider impact of the regulations and what are companies doing to manage this impact – for example, through their trading activities. How many companies think that they can make money out of the ETS?
- With the end of the first year of the scheme approaching, how many companies are really ready for this? Have they set aside funds for any shortfall in allowances? How many truly understand the verification process and are ready for it? More importantly how many are aware of the consequences of not being ready!
- How important are the views of key stakeholders, including customers and shareholders?
- What concerns do big emitters have about the next phase of the scheme?
- In the UK, does industry think that further measures will be required, in addition to the ETS, in order to meet Kyoto requirements?

All these questions and more are answered in this report. The detailed study was undertaken by the independent firm, Coleman Parkes Research, a leading business to business marketing research company, based in the UK.

2 How the survey was conducted

200 carefully structured telephone interviews were carried out during April and May 2005, each lasting approximately 15 minutes. The companies contacted consisted of directors and senior managers in the largest CO₂ emitting companies in the UK and Germany. Filter questions were included at the beginning of the interview to ensure that respondents held responsibility for emissions control at that site. 100 interviews were carried out in the UK and 100 in Germany. Interviews were spread across power generation, refineries, cement manufacturers, iron and steel, heavy industries and the automotive sector – all deemed to be the largest emitters of CO₂ at present.

3 Executive overview

The main findings from the survey include:

- Only 15 per cent of UK firms and 17 per cent of German companies see the ETS as a means of potentially profitable trade.
- Two thirds of German companies compared with only half of UK companies claims to be completely ready for the ET now. But what is most worrying is that 28 per cent of UK firms do not know when they will be ready.
- German companies have a far more positive view on the organisational impact of the ETS, while UK companies remain unsure of the impact.
- 46 per cent of UK firms expect the financial impact of ETS to be negative, reflecting concerns about allowances, leading to the need to trade in a price volatile market.
- Verification remains a key issue in the market. Although so many German companies say they are ready for ETS, too few have appointed a verifier, a key ETS requirement. One third of companies in both countries remain unclear on some aspects of the verification process - a major issue given we are soon coming up to the first reporting and verification time.
- Around one third of both UK and German companies are concerned that market and price volatility makes it hard to plan and budget and a further 37 per cent of UK companies (compared with only 14 per cent in Germany where allowances are perceived to be more generous) worry that shortfalls in spare allowances will mean high prices.
- Too few companies in both countries have made sufficient financial provision for fines for non-compliance (which we feel are sure to materialise given the current levels of readiness for many companies) and last minute purchases of allowances to make up a shortfall.

- One quarter of UK companies report that they are unlikely to trade while many will be active buyers of allowances. In Germany, as many will buy as will sell. It is also clear that UK firms expect to trade as they fear they will have to manage to shortfalls in allowances.
- There are widespread concerns over Phase 2 as it will not include key major emitters and so the industries currently impacted by the ETS will again suffer more than most.

4 LogicaCMG and emissions management

LogicaCMG can help you to understand the impact of emissions trading schemes on your business and provide the solutions and know-how for you to comply cost-effectively. Our EMISSIONS logic solution, developed with our partner CarbonSim, supports cost-effective compliance with the EU ETS. We are also working with our clients to update their trading systems and other business processes affected by the EU ETS.

Working with national and state governments, we set up and operate emissions registries, including in New South Wales (Australia) and the Czech Republic.

5 The main findings in detail

5.1 ETS Aims and Principles are now widely recognised

Approaching two thirds of major emitters in both the UK and Germany see the EU Emissions Trading Scheme as a means of reducing CO₂ in the atmosphere, by far the most widely held view in both countries.

It would appear that most companies understand and support what the ETS is trying to do and its “green” principles, but it is also clear that few currently expect to profit from it as when questioned only 15 per cent in each country felt that the EU ETS would be a “potentially profitable trading activity”.

In addition around one quarter of major emitters in the UK and one fifth in Germany see the EU ETS as just unnecessary government compliance and bureaucracy. Finally, even though the figures are small, it is still very concerning that 6 per cent of major companies affected by the ETS still do not really understand what it is about and why it has been put in place!

5.2 Many companies are completely ready now – but too many still have work to do!

Companies in Germany appear better prepared to implement the ETS than those in the UK, or at least they think they are. 70 per cent of German companies believe they are completely ready now compared with just half of those in the UK. But looking back at the results from last year highlights an element of over-optimism within the markets. In 2004, 58 per cent of UK based firms expected to be ready within 6 months of the introduction of the ETS, and now only 49 per cent are actually in that position and a

further 10 per cent need a further 6 months before they will be ready. So many may have underestimated the amount of work required to meet the compliance needs. .

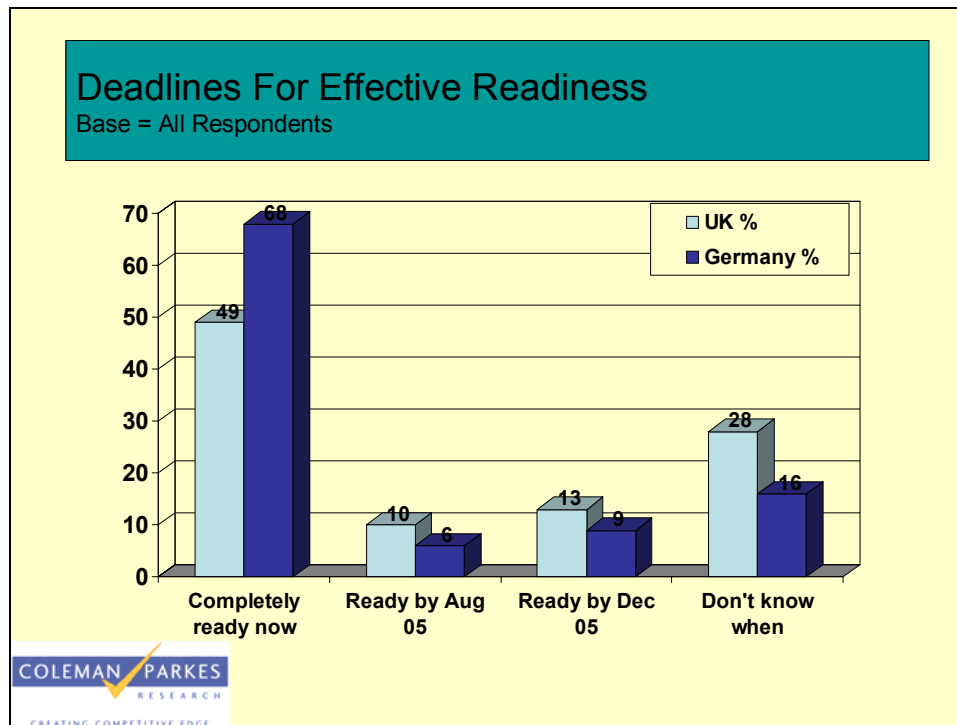


Figure 1

It is therefore clear that companies last year over-estimated their ability to get ready for the ETS and some of those who said they would take longer are still not in a position to say they are really prepared for the impact that the ETS will have.

Staggeringly, nearly one third of UK companies admit that they don't know when they'll be ready, even after all of this time and promotion of the scheme. 16 per cent of those companies in Germany contacted also said they did not know when they would be ready, which is also a concerning figure, showing a high degree of either apathy or concern about the real costs and actions needed to be ready for the ETS.

5.3 Positive views about the ETS grow in Germany, but not in the UK

Companies in Germany are far more upbeat about the organisational impact of the ETS on the efficiency of their operational activities with two thirds predicting a positive impact in this way compared with only one fifth of those in the UK.

One third of all UK companies expect a negative organisational impact on their business compared with only 19 per cent of German companies, again a possible reflection of the approach being taken to the entire ETS programme and the difference in the levels of understanding.

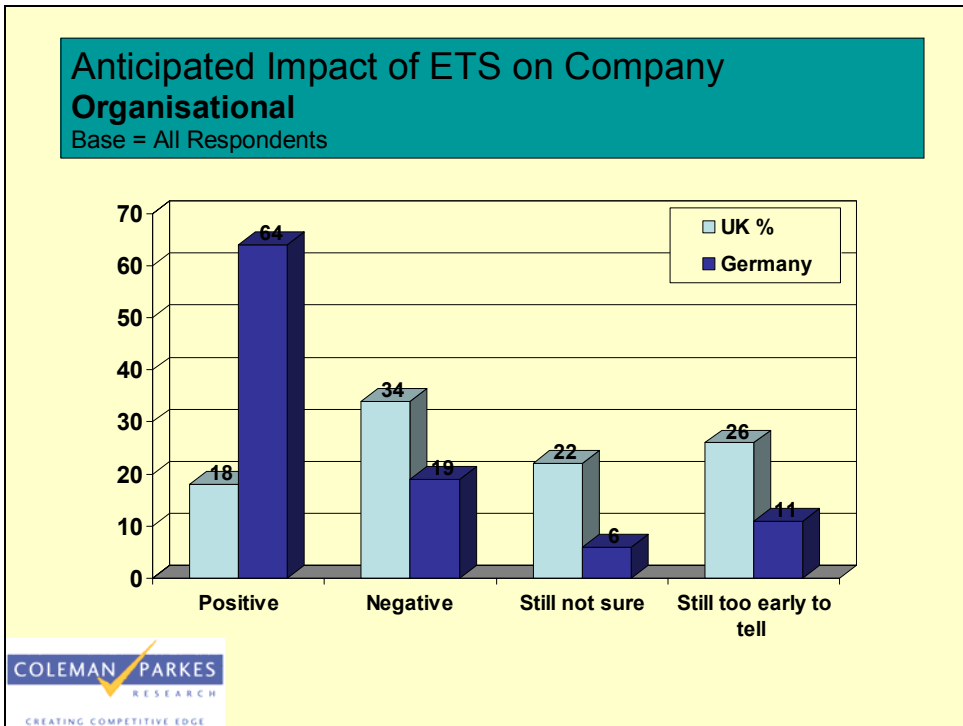


Figure 2

It is still worrying that 6 months into the programme one fifth of UK companies are still unsure of the potential organisational impact on their business. This can only reflect a lack of focus on getting to grips with the organisational issues surrounding good compliant ETS activity.

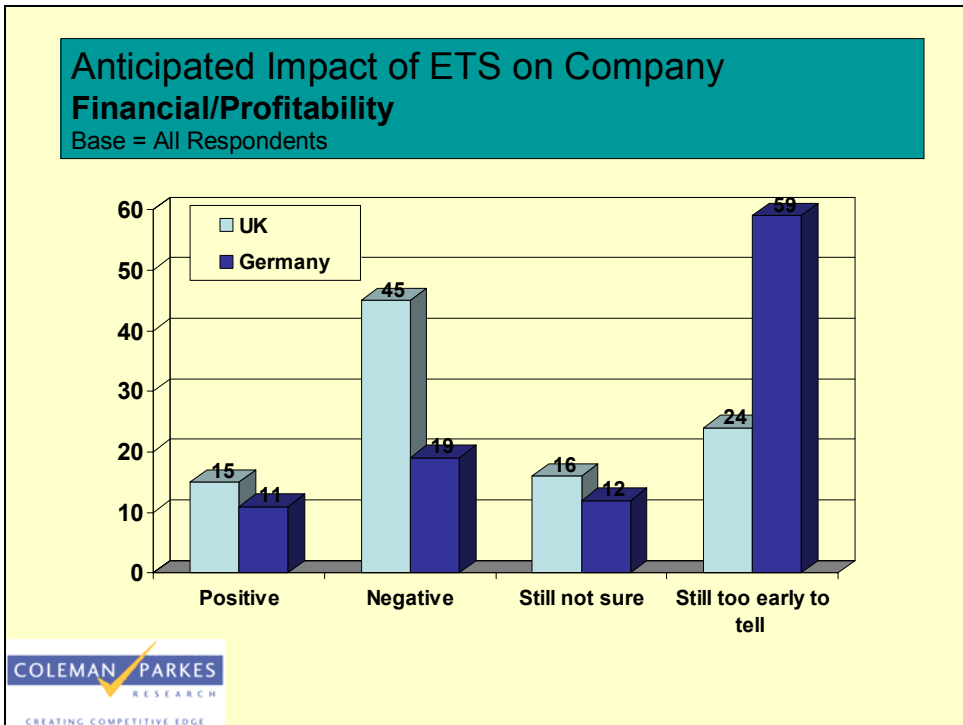


Figure 3

Few companies in either country expect to see a positive impact on profits, the implication being that the cost of compliance will be significant. It may also be the case that companies do not yet really understand the costs of compliance and so there is a fear that they will be higher than expected and make profitability hard to attain. In the UK there is certainly concern over a perceived shortage of allowances which will contribute towards this overall feeling.

Over the last 12 months there has been a significant change in Germany in terms of both the effect of the ETS on organisational efficiency, with companies predicting a positive impact up from one fifth last year to two thirds this year, and to a lesser extent in terms of impact on profitability where far fewer anticipate a negative impact and 7 out of 10 are unsure or feel it is too early to tell.

Unfortunately, there has been no such positive shift in the UK. Indeed, movement has been in the opposite direction, with many more companies now believing that there will be a negative impact on profits.

5.4 Verification – at last a key focus but is it enough?

Verification is a key issue with the ETS, as companies can be fined if they do not provide independently verified figures on their emissions and trading activities. Whilst three quarters of companies in the UK and half of those in Germany have invested in verification procedures and activities so far, a worrying proportion still have not and appear to be leaving it rather late! There is a strong argument to say that a verifier should by now have been appointed as it will get more difficult to secure their services as the year draws to a close. Failure to provide verified figures in time will lead to significant fines for many companies.

In addition, over one third of companies in both countries remain unclear on at least some areas of the verification process and requirement even at this late stage of the adoption process.

In some respects it is encouraging to see that approaching three quarters of German companies and two thirds of those in the UK have already appointed a verifier. But given that we are 6 months into the programme, there is a strong argument to say that all should have made an appointment or each company runs the real risk of being fined in the coming year.

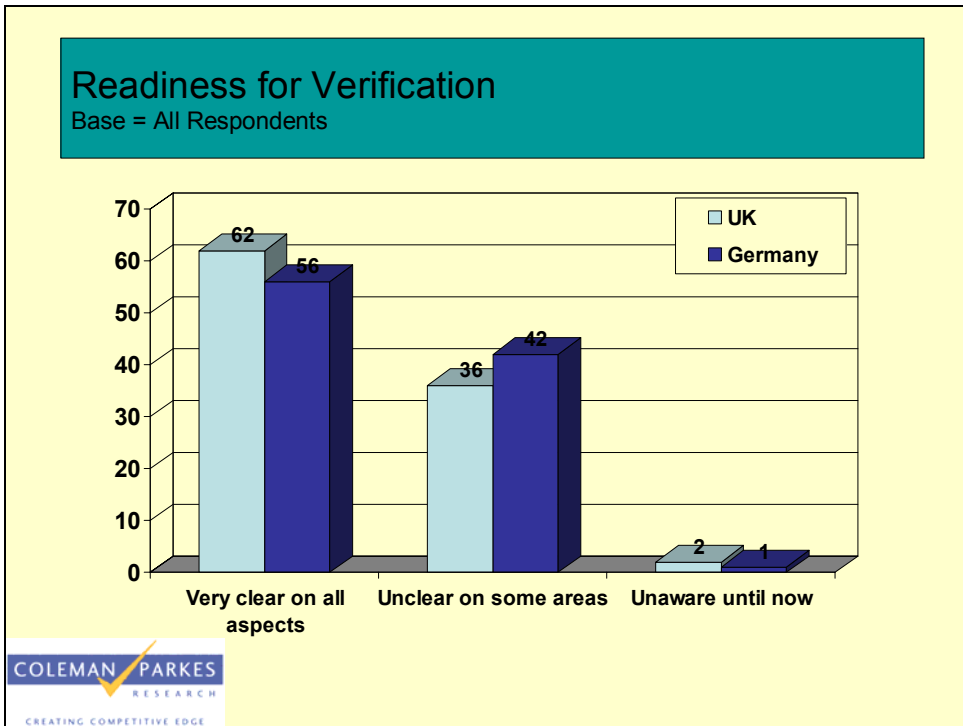


Figure 4

It is really concerning to see that 18 per cent of UK companies and 14 per cent of those in Germany will “get around to appointing a verifier next year” by which time it may be too late to avoid any penalties.

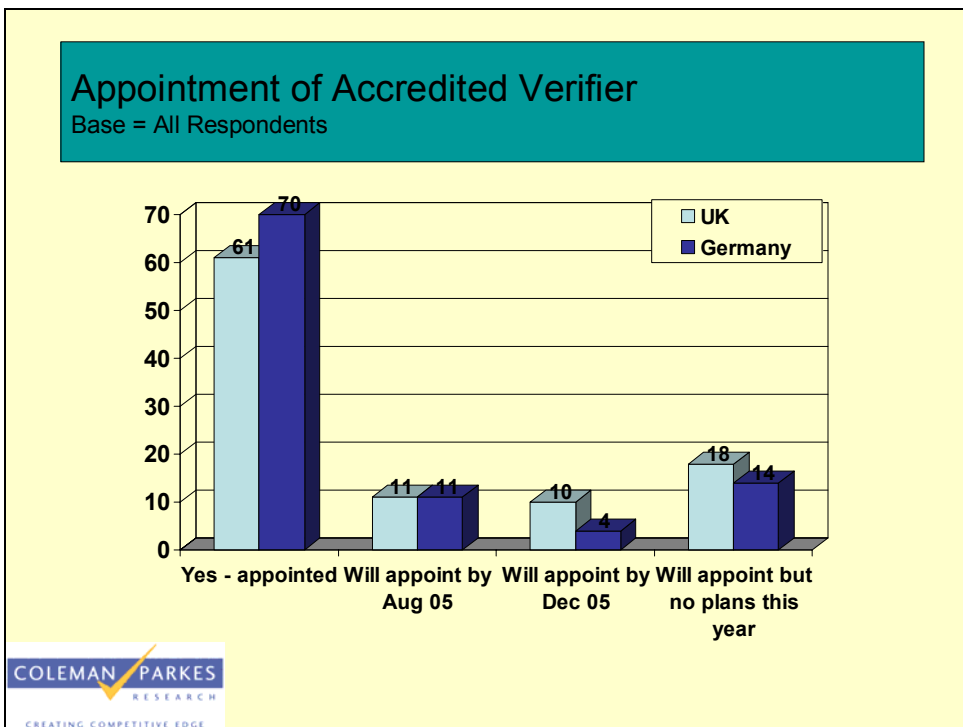


Figure 5

5.5 Levels of investment made in meeting ETS requirements

It would appear that over the year UK companies have been playing a game of catch up compared with their German counterparts in terms of investing in the right area to meet the ETS requirements. In most areas where investment has been measured, UK companies have been more active than their German counterparts, but we already know that too few UK companies are really ready for the ETS. The conclusion may be that the UK is investing now as a means to catch up and put in place all of the required processes and approaches. For example, almost three quarters of UK companies compared with only half of German companies have been investing in verification, and we have already seen that many UK companies are not yet fully versed with what verification actually involves.

In addition, 42 per cent of UK companies have been investing in trading, which may reflect a key issue within the UK regarding allowances, as too many UK firms believe the allowances are insufficient and so they will have to trade. In Germany, where allowances are perceived to be more generous, trading has not been an area of significant investment activity. Around one third of all companies in each country have been investing in IT systems to assist in the ETS implementation and management. It is interesting to note that around one third of all German firms have made no investment to date in the areas covered by the survey, which may reflect the fact that German companies feel that they have the procedures in place already to meet the ETS requirements or that they are simply falling behind and are under-estimating what is required. With so many already saying that they are completely ready now, they should have made some form of investment in core areas.

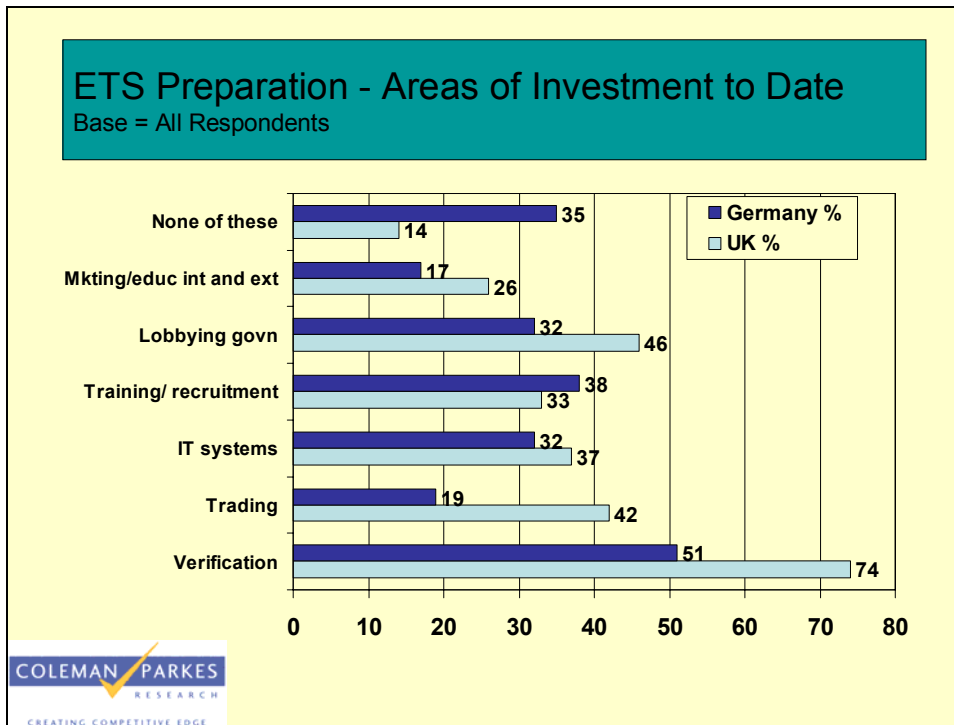


Figure 6

Table 1 Concerns about Trading Emissions Allowances
Base = All Companies

Concern	UK %	Germany %
Market volatility makes it hard to plan and budget	39	36
Shortfall in spares allowances will mean high prices	37	14
Generous allowances will mean more sellers, pushing down prices	15	6
Fear of incurring trading losses	18	2
The trading component is superfluous to the aim of reducing emissions – an unnecessary complication	22	9
None of the above	25	48

The greater degree of nervousness in the UK than in Germany about the ETS is again reflected in the fact that about half of companies in Germany have no real concerns around the trading of emissions allowances compared with only one quarter of UK companies. This may again reflect the fact the allowances in Germany are more generous (in the eyes of UK companies) and UK companies fear that they will have to do a lot more trading than they first thought. With a perceived lack of allowances for UK firms, there is a clear need to trade more actively which in itself creates an ongoing concern but also has an impact on the price volatility in the market. With demand for trading being higher, then prices will be more volatile, a key concern for UK companies.

In both countries market volatility and associated planning and budgeting difficulties is the biggest concern when it comes to trading emission allowances (mentioned by around 4 out of 10 in each country). However, potential shortfalls in spare allowances leading to higher prices is almost as important a concerns in the UK (37%) but much less so in Germany (14%), giving a clear insight into the differing position of each country. This reflects the greater feeling amongst UK companies, than those in Germany, that they will be net buyers of emissions allowances as does the much greater fear in the UK of incurring trading losses (18%) than in Germany (just 2%). These fears may have been exacerbated by the steep rise in the price of allowances in the first six months of the scheme.

5.6 Levels of Readiness are too low – and complacency too high!

We have already seen from the survey that many companies in both countries are playing catch up on verification procedures and processes, but that is not the only area where problems are being stored up through a lack of proactive management.

As we found in the survey in 2004, most companies in the UK and Germany have not allocated a specific budget for ETS compliance, but investment is clearly required. Additionally, around 8 out of 10 companies in both the UK and Germany have not made financial provision for non-compliance or for last minute purchases of allowances to make up a shortfall.

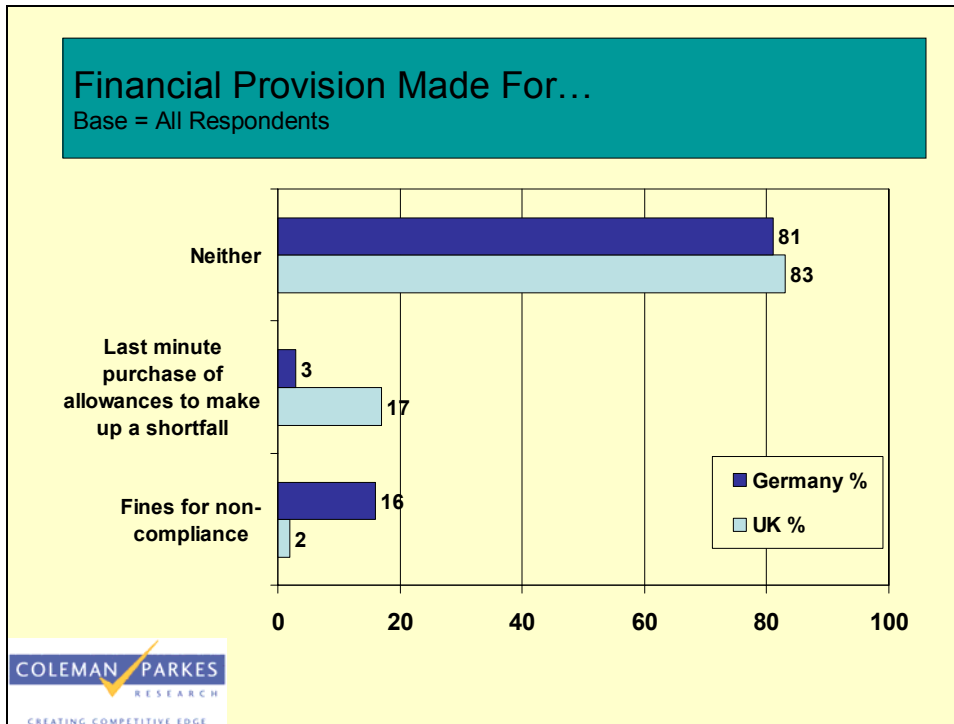


Figure 7

16 per cent of German firms are already making allowances for fines compared with only 2 per cent of UK firms, but it is the latter that should be making the largest provision as they are the companies who seem least prepared overall, many do not yet have a verifier in place and too many are likely to have to be the most active traders!

Similarly, in both countries many companies have not yet agreed with their accounts department how to represent emissions related assets and liabilities on the company balance sheet. Around one third of German firms have still to tackle this issue compared with 44 per cent of UK based firms. So it would appear that for many they will be unable to track and report on the ongoing financial position and could be in for a number of relatively nasty surprises as they move to end of year accounting.

Many would argue that companies need expect assistance to fully understand, and manage the impact of this scheme which could have far reaching implications for their business operational structure and performance. But as many as 4 out of 10 companies in both the UK and Germany have not yet, and will not in the future, employ external assistance to help them achieve full compliance. Given that practically all companies say they intend to comply this shows either a very high level of confidence in their own internal resources, massive complacency or a fear of the costs that may be incurred in using third party assistance. It is also very much at odds with the high levels of nervousness about the ETS and Phase 2 in the UK.

Encouragingly, 15 per cent of UK based firms who are not yet using any third party assistance will do so in the next year compared with only 5 per cent of German firms, the implication being that German firms have already made the decision on how they are going to move towards compliance.

What is also interesting, given that there is a concern in the UK that they will have to trade more frequently than others, is that only 2 per cent of UK companies expect to appoint a broker, the implication being that they will carry out the trading activity in-house using internal expertise.

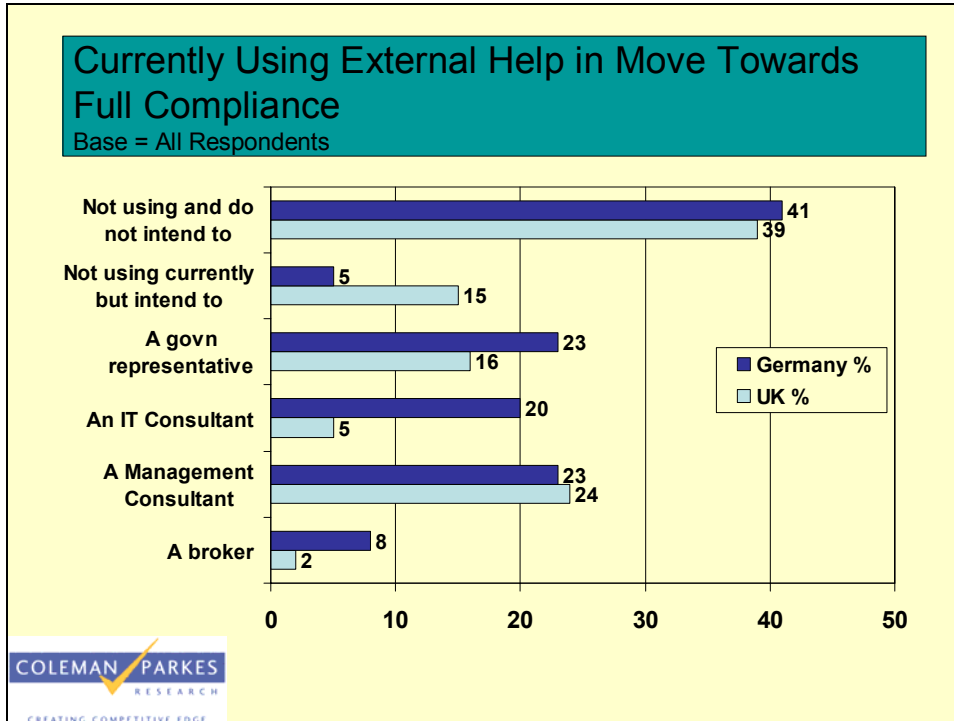


Figure 8

5.7 How many will trade and why?

Only one quarter of companies in both countries, marginally more in the UK than Germany, say they are unlikely to trade.

But, in addition, 27 per cent of companies in Germany compared with only 18 per cent in the UK have yet to decide on whether they will trade or not. In both the UK and Germany proportions of companies expecting to trade emissions allowances have increased significantly from about one third in each country last year to half in the UK and 6 out of 10 in Germany this year. So it would appear as though companies have taken a detailed look at their planned activities and allowances and have been able to make the decision on how they will trade.

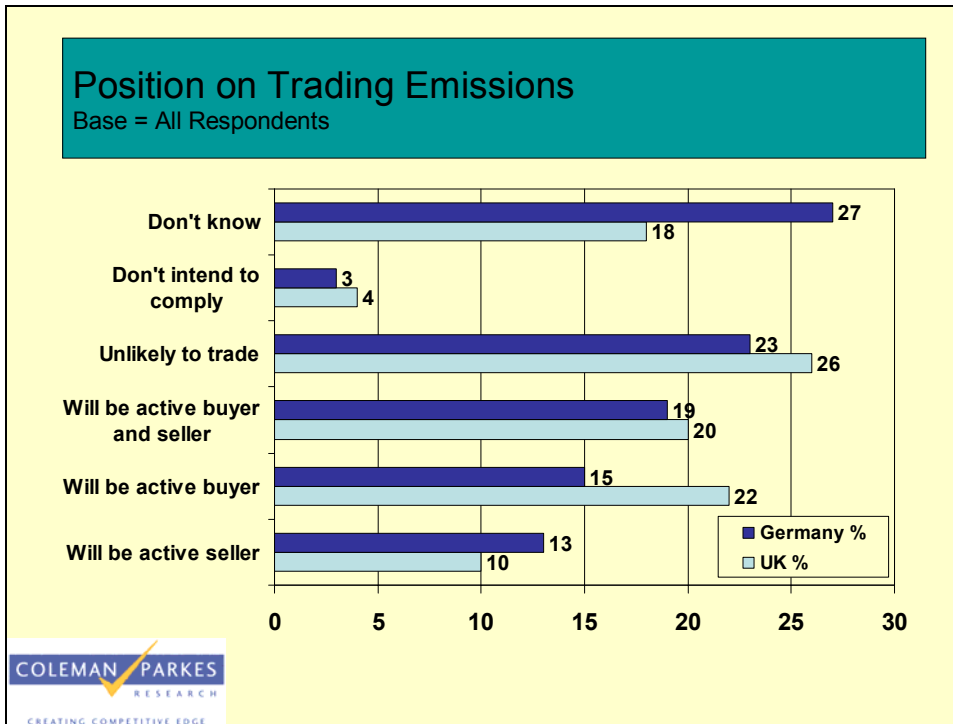


Figure 9

It is not surprising to see more companies in the UK feeling they will be active buyers as there is the ongoing concern about the number of allowances, not to mention that they are the least prepared out of the two countries.

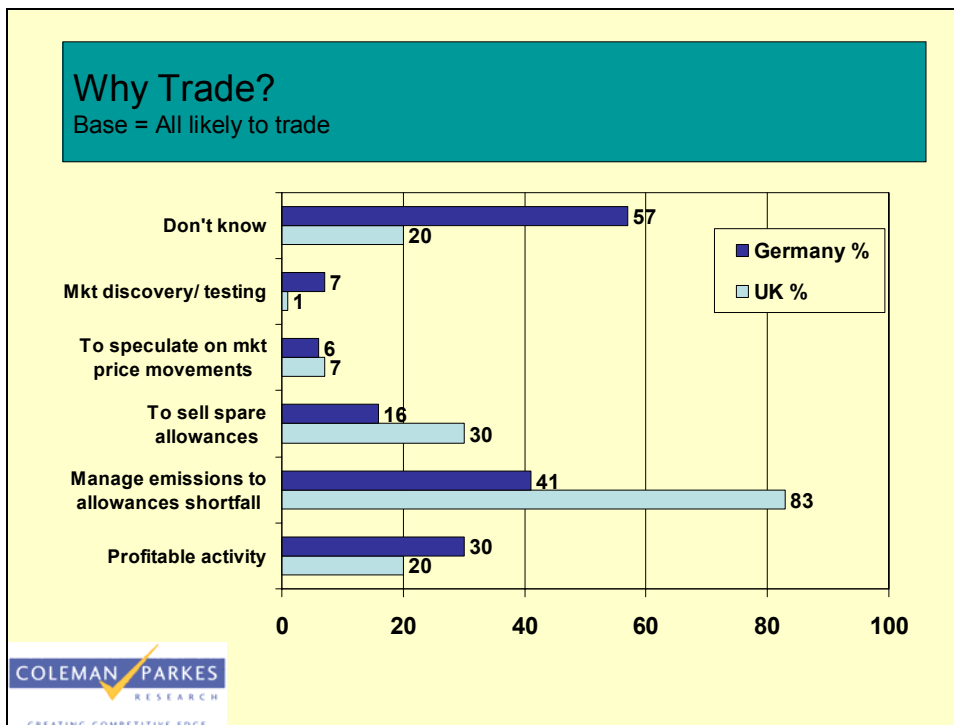


Figure 10

Whilst the proportions likely to trade are similar in both the UK and Germany (but showing growth on the figures from last year), taken as a whole, the reasons for trading are very different by country. That many companies in the UK expect to be under pressure from the ETS is confirmed by the fact that over 80% of UK companies that plan to trade will do so to help manage shortfalls between their emissions levels and their allowances. Only one fifth of UK companies see it as a potentially profitable activity. The picture is very different in Germany where only 4 out of 10 would trade to help manage allowance shortfalls and nearly one third will trade to make a profit.

5.8 Widespread concern exists over Phase 2

It is no real surprise to find that UK companies are more worried about the introduction of Phase 2 than companies in Germany but, this said, the level of concern in Germany is still significant, and real. Nearly all UK companies have concerns about Phase 2 compared with 7 out of 10 German companies.

Table 2 Issues around Phase 2 and its Impact on a Company
Base = All Sites

Issue	UK %	Germany %
I am nervous about Phase 2 of the ETS because it won't involve industries that are large emitters such as aviation and transport	63	69
I'm nervous about Phase 2 of the ETS because I expect allowances to decrease further	74	43
I worry the advent of Phase 2 will see European companies penalised compared with other regions that do not have an ETS	77	72
I have no concerns about the introduction of Phase 2	9	29

These results are very much in line with much recent and ongoing debate. With aviation and transport accounting for much of the growth in emissions, some have been pushing for them to be included in phase 2. Otherwise, the burden will continue to fall on energy and industry. But some perceive that it may be too late to do this in time for the start of phase 2, though including them half way through the scheme has not been ruled out. Similarly, many European organisations have expressed, privately or publicly, their concern that they will be treated unfairly compared with other regions without an ETS. It will be interesting to see whether this stimulates a greater interest in overseas investment to take advantage of the clean development mechanism.

Not surprisingly a much higher proportion of UK companies (three quarters) than of German companies (less than half) fear that Phase 2 will bring a further decrease in allowances reflecting the ongoing concern about allowances and provisions for UK companies.

5.9 The Role and influence of the customer

In both countries feelings are very mixed in terms of the impact of emissions management on the customer. In the UK only half of organisations think customers would prefer to buy from an environmentally friendly company. In Germany nearly all companies feel that emissions management would impact perceptions of a company. However, only 4 out of 10 believe that when it comes to actual purchase decisions, customers care about this. Perhaps because, in Germany, it is expected that a company will be green and this is no longer a differentiator.

The situation now is very similar to last year, where half of companies felt that customers would not care about buying from an emissions compliant company. This may reflect the fact that companies have failed to get across to customers the importance of being emissions compliant.

**Table 3 Perceptions of the Importance of Emissions Management to Customers
Base = All Sites**

Issue	UK %	Germany %
Customers would prefer to purchase from a company that was environmentally friendly	48	35
Customers might buy more because efficient emissions management could help lower prices	21	10
Emissions management would not impact a customers perception of a company or purchasing decisions	23	9
Customers would rather purchase from a non compliant company because the scheme will increase prices for the customer	6	6
Customers don't care if they purchase goods/services from a company that is environmentally friendly	24	38

The main reason companies hold such mixed views about customers' reaction to emission management is that they do not believe customers would tolerate any price increase being passed onto them as a result of the scheme. 6 out of 10 companies in Germany said this and 4 out of 10 in the UK.

When looking at stakeholders and shareholders, one quarter of Germany companies compared with only 7 per cent of UK firms report a strong correlation between the share value and good management of emissions. 40 per cent of UK firms and 36 per cent of German companies also some correlation between share value and good emissions management, indicating that there are significant external benefits to being complaint to the ETS.

5.10 UK and Kyoto

There is common agreement amongst those UK firms questioned (German firms did not take part in this section of the study) that the ETS scheme is not sufficient for the UK to meet its Kyoto targets. To meet better the targets, companies agreed that the UK Government would need to:

- | | |
|--|-------|
| Step up the programme of developing more renewable power sources | (71%) |
| Construct more nuclear power stations to reduce reliance on fossil fuels | (58%) |
| Increase investment in small scale (domestic) power generation as envisaged in the Energy Act 2004 | (48%) |
| Impose additional taxes on personal air and/or road travel | (48%) |

Only half of UK companies are aware of Certified Emissions Reductions (CERs) and of those that are aware of them, the majority do not expect to need to use them in the foreseeable future.

6 Conclusion

The 2005 Emissions Trading Survey has highlighted some major changes from 2004 but also some worrying consistencies in terms of the lack of preparedness amongst certain key companies, which is not industry specific. There are also some major differences between the UK and Germany, many of which reflect the cultural difference in terms of attitudes to green issues and the Government in general and other reflect a more progressive approach.

What is clear is that there is still more work to be done even though we are now 6 months into the scheme and plans for Phase 2 are well advanced. Companies must focus on

- Getting the verification process correct and in place otherwise they will leave themselves open to fines.
- Get the trading approach right – a key issue for UK companies who feel they will be net buyers of allowances.
- Move to being completely ready and programme compliant as soon as possible. Here the use of third party suppliers can expedite the moves very cost effectively.
- Ensure the right level of investment is being put in place to meet the exact needs of the ETS.

Ends