Industry protests new emissions trading regime

The new emissions trading proposals presented by the European Commission on January 23rd, threaten to seriously hamper the competitiveness of European industry in the global market, according to industry organizations. They demand radical changes in the way Brussels allocates emission allowances. 'Auctioning of allowances, as the Commission proposes, will drive industry and employment out of Europe.'

by Jan Berends and Vianney Schyns

On the 23rd of January the European Commission presented its provisional proposal for the new Directive on the EU Emissions Trading Scheme (EU ETS) for greenhouse gases in the third trading period (2013-2020). These proposals are in some ways an improvement on the failed methods used in the first (2005-2007) and second (2008-2012) trading periods, but they still contain serious flaws that will have highly negative economic consequences for the European Union.

In the first two periods, the Commission allocated allowances on the basis of what is called historical grandfathering. The allocation of each installation was based on historical emissions minus a correction factor to create scarcity of emission allowances. This method suffers many shortcomings that caused – and are still causing – serious economic distortions. For example, a company that reduces emissions gets fewer allowances in the next trading period – clearly a disincentive to become more efficient. Allowances given to new entrants based on expected emissions favour coal-fired power plants rather than low carbon technologies. The transfer and closure rules that are applied lead to market concentration, as an operator can close a plant on a site with several plants, keep all allowances of that site and apply for allowances for a new plant. Newcomers have no old plant to close. Last but not least historical grandfathering generates economic rents for electricity producers – windfall profits – at the detriment of electricity consumers paying the bill. The European Commission has admitted these shortcomings – which in itself is a remarkable development – and has decided that allocation in the third period will be based on auctioning and partially on benchmarking.

The Commission proposes to move to 100% auctioning for electricity producers and a gradual phase-in for industry starting with 20% auctioning in 2013 and full auctioning in 2020. The remaining free allocation to industry will be based on EU-wide benchmarks based on performance, namely CO_2 emissions per unit of product. A benchmark requires a production quantity and the Commission proposes to derive this quantity from historical production figures. An important point is that the Commission proposes that for industrial sectors or sub-sectors exposed to global competition, free, benchmark-based allocation up to 100% will remain possible or 'border adjustments' will be put in place. Such adjustments are, in effect, import tariffs on products made outside the EU by manufacturers who are not subject to emission limits. Importers will need to buy allowances, while exporters will get a refund. Which sectors are considered 'exposed' will be decided upon around 2011.

Competitiveness

European industry has made it clear that it is against auctioning because of the loss of competitiveness on global markets. This has been expressed in countless communications

and letters from industry organizations. For example, Jeroen van der Veer, ceo of Shell, and Martin Broughton, ceo of British Airways, said in a letter of January 17th to the Commission on behalf of the European Round Table of Industrialists, representing about 50 top EU business leaders: 'Any such removal of capital would slow down the necessary investment in more CO_2 efficient technologies and projects to the detriment of the environment in the long term.' The heads of Business Europe, the Confederation of European Business and ten sector federations declared: 'European citizens need a low carbon strategy that delivers success, not a carbon ideology that damages Europe's competitiveness! '(...) 'The prime condition for this is free allocation of CO_2 certificates to our industries, in particular energy-intensive industries, as long as there is no international agreement ensuring that the developing economies with which we compete commit to targets equivalent to ours'. The fact that the Commission will not decide which sectors are 'exposed' before mid-2011, causes investment uncertainty for at least four years, the major part of the trading period 2008-2012.

Photo Malcolm Hanes/Etsa/Corbis

There are some studies – notably by DG Ecfin (which is not published yet) and the network Climate Strategies – that suggest that competitiveness of European industry will not be seriously harmed by the emissions trading scheme as proposed by the Commission. These studies are flawed, however. Ecfin surmises that inclusion of the CO_2-cost into product prices is possible, provided there will be a sufficient lead-time, e.g. 10 years. The reasoning that a patient can bear heavy pain provided it comes slowly is not supported by scientific evidence.

Photo: Charles O'Rear/Corbis

Climate Strategies claims that for 99% of economic activity the cost increases from emissions trading, even with full auctioning of allowances, will be insignificant relative to other cost components, and thus raise no concern. At the same time, it admits that for cement, basic steel and aluminium the cost increases are high, and thus could result in leakage of production and emissions outside Europe.

Both Climate Strategies and Ecfin assume a price of €20/tonnes CO_2 while most analysts predict much higher prices, e.g. Deutsche Bank €35/tonnes already for the second trading period and CBI/McKinsey between €60/tonnes and €90/tonnes by 2020. In its impact assessment published on January 23 the Commission concludes that prices will be at least €30/tonnes, while other scenarios indicate prices above €40/tonnes. Recent modelling by Fortis resulted in a CO_2-price of €48/tonnes.

'With full auctioning the windfall profits will not go with the wind'

All in all the analyses are ambiguous and a shaky ground to base such important policy on. Results from the recent past concerning imports and exports, gross value added and profits are no guarantee whatsoever for the long future from now to 2020. Judgment will always be based on arbitrary assumptions of the future. It speaks volumes that in the Commission the refinery sector was initially considered as not exposed, but finally came into the league of possibly exposed sectors. On what evidence?

The 'border adjustments' proposed by the Commission could lead to trade wars with our major trading partners. It should be noted that not a few products are at stake here but all value chains of related products. Literally tens of thousands of products, intermediary up to final consumer goods such as cars, electronics, household articles, leisure – all with different accumulated CO_2-costs – are produced from enabling materials such as primary steel, aluminium, other metals, polymers and chemicals, etc. Even when the added value of a sector is relatively high, companies will produce intermediate or final products where manufacturing plus transport to market is cheapest.

Benchmarks

The Commission proposes to use EU-wide benchmarks in cases where free allocation is applicable. This is in itself a step in the right direction, but the production volume will be based on historical production as remote as 2006. A study by consultant Nera on behalf of the UK government showed significant variations of production of individual sites in

a period of just 5 years, 1998-2003. The average variation of all sectors was 28% with 48% for the power sector. It is no surprise that production from the past is no indicator for the future. Moreover, in a sound ETS, efficient producers should be encouraged to win market share to lower overall emissions, but allocation based on the past will achieve the opposite.

In 2007 ten legal cases were started at the European Court of First Instance against the decisions of the EU Commission on proposed National Allocation Plans: Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Hungary, Bulgaria, Rumania and Malta. These member states claim that their economy is strongly expanding. Their historical productions and emissions have little meaning for the period until 2012, let alone until 2020. This means that distortions will not disappear with EU-wide benchmarks and historical production. It would be a second "historic" mistake, after two trading periods with historical grandfathering.

In the electricity market the Commission has acknowledged two major flaws: economic rents – windfall profits – and enhancement of market concentration. With the intended remedy of full auctioning for electricity companies, the windfall profits will not go with the wind, they will remain for nuclear and hydropower. Coal-fired and gas-fired power plants are the marginal plants determining the market price. Since they will incorporate the CO_2-price fully in the market price, the nuclear and hydropower producers will profit – at no extra cost. At a conservatively assumed CO_2-price of €35/tonnes, IFIEC Europe calculated the total price effect in the EU on €82 billion/year.

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Solid alternative

The European Commission declared in November 2006: 'Three major alternatives exist, which are equally legitimate: investing in emissions reductions and selling freed allowances, reducing production volume and selling freed allowances or maintaining/expanding production volume while buying additional allowances needed'. The key European federations in the meetings on the review of the EU ETS, being Cefic (chemicals), Cembureau (cement), Cepi (paper and pulp), Cerame-Unie (ceramics), CPIV (glass), Eula (lime), Eurochlor (chlorine), Eurofer (steel), Eurometaux (non-ferro metals) and IFIEC (International Federation of Industrial Energy Consumers) lambasted this 'incentive to shrink' and 'disincentive for growth' in a joint statement. Lower emissions in the European Union do not contribute to a better climate when equal or even higher emissions elsewhere are disregarded, they argued.

In their joint statement, the industry organizations proposed a 'solid alternative' to the Commission's proposals, namely 'performance-based allocation of allowances based on actual production'. In other words, a system of allocation based on benchmarking, but benchmarking geared to actual rather than historical production. The benchmarks to be established must be geared to products, not to technology, age or capacity of the production plants. In this way the incentive with benchmarks is the same as under auctioning.
Some policymakers expressed concern that industry will not be able to agree on benchmarks. The remedy is simple. Industry must be made responsible for the derivation of benchmarks whereas the EU sets the total cap and the requirements.

Given the choice, benchmarking related to actual production with a guaranteed cap is the only alternative that will Europe in business. Industrial stakeholders support this approach; they have to deliver the emissions reductions.
President Barroso of the Commission joined the statement of Commissioner Verheugen that nobody wants 'export of pollution and import of unemployment'. It seems about time for the European Parliament and member states to act upon that excellent intention, before the second trading period is also lost because of great uncertainties. ■