

Discussion paper on reform of the Carbon Leakage measures

Intelligence gathered from recent meetings indicates that DG CLIMA are already well advanced in their thinking as to how to reform the carbon leakage arrangements. It would appear that there are three elements to this:

1. DG CLIMA are seeing to revise the carbon leakage list in three ways:

- They are proposing to drop sectors from the list that only qualify by virtue of the >30% trade intensity rule. There don't seem to be any big emitters in this group.
- They would like to drop sectors on the list by virtue of the >30% costs rule. This group includes big emitters, but DG CLIMA expects Member States to oppose the dropping of these sectors (so they may remain).
- For the rest, under the >5% GVA + >10% trade intensity rule, there will be a grading, with sectors deemed to be more vulnerable receiving more allowances and those deemed less vulnerable receiving less.

2. DG CLIMA are, apparently, calculating new more restrictive benchmarks

3. DG CLIMA are considering a shift in the baseline for ex ante allocation:

Instead of basing the "ex ante" calculation on 2008-2010 they would reset the system and base historical allocation on something like 2018-2020.

Implications

1. Big emitters are likely to remain on the carbon leakage list for political reasons: Thus shortening the list by the exclusion of minor emitters will have limited effect on the COMs alleged dilemma of having to distribute fewer allowances ('shrinking industry cap').
Therefore the main threat in the COMs 'fixes' will be for sectors and subsectors on the list to be deemed 'less vulnerable' (by using qualifying indicators or factors): and so to be allocated only a proportion of their required allowances.
2. Effect of tightening the benchmarks:

Proponents of tighter benchmarks often claim that thereby this would increase the financial incentive for an ETS company to invest in GHG reducing techniques. This is an erroneous claim:

- Company A with strict benchmark (few free allowances): when reducing X tonCO₂, this company needs to buy X ton CO₂ less.
- Company B with 'less stringent' benchmark (lots of free allowances): when reducing X ton CO₂, this company can sell X ton CO₂ more.

For both companies, the financial incentive (monetary value of emission reduction) remains the same!
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So, more stringent benchmarks do not create any greater incentive to increase carbon efficiency. But they would reduce the number of allowances to be allocated, thus increase the costs for an undertaking in the EU, making it less competitive against non-EU competition. **Stricter benchmarks result in an incentive for carbon leakage, not in a greater incentive to improve.**

3. Effect of shifting the ex-ante baseline:

Companies that have reduced emissions over the intervening years by more than the linear reduction factor would receive less free allocations in future. Companies that reduced production to get windfall profits would lose the spare allowances: but **companies that have increased efficiency would lose theirs too and with it the pay back of their investment.**

The above proposals, if adopted, are likely to substantially reduce the level of carbon leakage protection available to the industry. The effect may vary from sector to sector – but none of it looks good.

The logic underlying these proposals is that the number of allowances available is limited and declining: and therefore the number that can be allocated free has to be restricted. This is the “cake getting smaller” argument based on a linearly declining emission cap to EU’s manufacturing sectors. The Commission is seeking to drive a wedge between different sectors in the energy intensive industries: a divide and rule strategy which would leave them free to push the above proposals through the system.

This approach flatly contradicts the EU’s goal of economic recovery and growth.

Carbon leakage protection – a fresh approach

The above approach is based on the existing criteria for estimating the risk of carbon leakage. It seeks to keep the focus on a narrow definition of “carbon leakage” (for which DG CLIMA sees no evidence) and to ignore the clear evidence of “investment leakage”.

The impact of the ETS on investment decisions is part and parcel of “carbon leakage” and the EU’s industrial energy users need effective measures to prevent investment leakage. *The current arrangements result from the political will of EU Member States to protect their industrial base. It would be wrong to change the criteria as an arbitrary means of reducing the number of eligible sectors (e.g. through gradients meaning that sectors currently assessed as ‘vulnerable’ would be deprived of protection).*

This paper suggests an alternative approach. It argues that the discussion on the “carbon leakage list” and the calculation as to who is at risk, and who is not, is an empty debate. It serves little purpose to argue over a notional calculation about vulnerabilities to carbon leakage when Europe is losing industrial investment while seeking an industrial renaissance.

Instead, we suggest that the EU should move away from these arbitrary criteria, and recognise the need for the ETS to apply differently as between energy producers and energy intensive users. To that end, the current “carbon leakage” arrangements should cover all energy intensive industrial users.

For energy users, the basic purpose of the ETS, ie to encourage industries to become more carbon efficient, would continue to be met by establishing benchmark standards of carbon efficiency. In any sector:

- Undertakings that do not meet those standards would have to buy carbon allowances (and so would be encouraged to invest in meeting the standards).
- Undertakings that meet the standards would have an incentive to improve even further, as they would then have free allowances that could be sold. *[nb Under the ex post system (below) this would differ from the current windfall profit: in that the free allowances would be a reward for greater efficiency and not a reward for reducing production].*

This approach should apply to all energy intensive manufacturing sectors, obviating the need to try and estimate which sector is more and which may be less, exposed to the risk of carbon leakage.

Availability of allowances

Under the current “cake getting smaller” approach this could mean fewer allowances available for any one sector. However, we are proposing this approach in conjunction with the introduction of an “ex post” allocation system that uses the MSR as a dynamic reserve for growth. Under the existing ETS total cap there should be no separate, absolute limit on the available allowances for manufacturing industries (thus also no parallel linear reduction factor under the total ETS cap). This also eliminates any need for a cross-sectoral correction factor (CSCF - currently subject to close to 900 legal complaints throughout Europe!) which forces perversely even best EU industry performers to buy increasing amounts of allowances to cover their compliance needs. The so-called “excess allowances” in the market as suggested by the EU Commission, including backloaded and “unused” allowances should be put in this flexible reserve for growth.

Indirect emissions

Corresponding changes should also be made to the system permitting Member States to provide compensation for indirect emissions, which should be preplaced by a harmonised EU mechanism to ensure that energy efficient undertakings do not bear indirect carbon costs that are not borne by their international competitors.

Concluding remarks

The current reform process is an opportunity to reform the existing carbon leakage arrangements and to make them fit for purpose. The measures that are apparently being developed within DG CLIMA do not do so: and, if fact, they would make matters considerably worse.

It is essential that full and effective investment leakage protection is in place before any measures to reform the ETS come into effect: and the above ideas are presented as a set of arguments that could help us to present and to achieve that goal.