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BUSINESSEUROPE response to the consultation on the revision of the EU ETS Directive

This paper outlines BUSINESSEUROPE response to the public consultation on the revision of the European Emissions Trading Scheme (EU ETS) Directive. BUSINESSEUROPE has consistently advocated for a thorough reform of the EU ETS which should remain the main tool to reduce industrial emissions at the lowest cost and to promote investments in low carbon technologies. It should provide a common regulatory framework for both the power sector and covered energy intensive sectors. However, as long as there is no global level playing field, the EU ETS must also address the loss of competitiveness of energy-intensive and trade-exposed industries through evidence-based effective measures for carbon leakage protection. BUSINESSEUROPE vision for a reformed EU ETS encompasses the redefinition of carbon leakage, the introduction of a more dynamic allocation system and the elimination of the C-factor, harmonized compensation for indirect costs as well as consistent funding for innovation.

1. Redefining carbon leakage

The European Council conclusions of October 2014 have clearly laid out that carbon leakage measures should not expire as foreseen in the current legislation, but should continue after 2020 as long as there are no comparable efforts to reduce emissions in other major economies. BUSINESSEUROPE has also previously provided its input to the EC consultation on carbon leakage measures post-2020.¹ The following points aim to provide guidance on how the principles enshrined in the Council conclusions should be reflected in the future.

The current carbon leakage definition has proved insufficient to address industry's competitiveness exposed to international competition. A strengthened approach to what is meant by displacement due to asymmetrical climate policies should encompass the broader notion of investment leakage. There is **clear evidence that investment in the EU is falling** particularly in the energy-intensive sectors. For the whole, EU average annual investments by energy-intensive industries have decreased decisively more compared to other sectors in relation to pre-crisis levels. This has to be seen in the context of growing investments of energy intensive sectors in other regions of the

¹ BUSINESSEUROPE response to the consultation on ETS post-2020 carbon leakage provisions, 31 July 2014



world. In Germany, for instance, energy-intensive industries have pulled back domestic investments between 1995 and 2011, where investment has decreased 11% while other industries have increased 5%.² There is also evidence that the chemical industry in the Netherlands and Belgium has seen investment leakage with a negative impact on the value chain.³ In comparison with other world regions, there is a growing focus on the US with many EU companies turning to North American markets instead.⁴ This is inextricably linked with the high energy prices industrial consumers are facing in the EU. These facts, coupled with the future impact of the Market Stability Reserve (MSR) on carbon prices call for urgent measures for shielding European industry from serious competitive disadvantages and loss of competitiveness.

In addition, as provided by the new Environmental and Energy Aid Guidelines, carbon leakage must also go beyond the carbon price by factoring other elements in the definition such as the cost impact of overlapping energy and climate measures, notably subsidies to renewable energy and energy efficiency policies.

2. Introducing dynamic allocation

A more accurate model for carbon leakage measures will make the ETS more fit for purpose, by being more adaptable to sudden changes in the economy. The lack of European industry policy and the increasing production costs generated by the energy and climate policy have contributed to an investment leakage. For sectors at risk of carbon and / or investment leakage, **full compensation through free allocation** based on feasible benchmarks must allow the most efficient European companies to be globally competitive without being penalized by direct carbon costs. The existing allocation system based on historical production has proven to be too rigid and distortive. **Real / recent production levels** – combined with economically and technically feasible benchmarks – **should be considered as an option for the allocation of free allowances** in order to provide better protection against carbon leakage and to avoid problems deriving from over or under allocation.

Therefore, a dynamic allocation model based on realistic benchmarks and actual production should be introduced. In the absence of an international agreement, allocation based on historical production and the application of the cross-sectoral correction factor harm competitiveness and encourage production and investment to take place outside the EU.

² Deutsche Bank Research, Carbon Leakage: *Ein schleichender Prozess*, 18 December 2013

³ Contribution to a future oriented energy strategy for the chemical industry, *Impact of energy and feedstock costs on the competitiveness of the chemical industry in the ARA-cluster*, 6 May 2014 https://www.vnci.nl/Content/Files/file/Downloads/Finaal_%20Report_essenscia-VNCI_140507.pdf

⁴ BASF: http://www.nytimes.com/2014/10/25/business/international/basf-an-industrial-pillar-in-germany-leans-abroad.html?_r=0



For that purpose, an allocation supply reserve should be considered allowing for allocation based on actual production. This reserve should be funded up-front with allowances that are to be taken out of the current market supply. This allocation supply reserve can also operate alongside the MSR; because of their different purposes and triggers, they can act independently. The MSR has been created to improve supply-demand balance and is triggered by surplus while an allocation supply reserve would be meant to prevent carbon leakage and would be triggered by economic cycles.

3. Compensating for indirect costs

It is of equal importance to handle the indirect effects, occurring from the pass-through cost of carbon into the electricity price. Compensation must be given in relation to actual costs passed-through before and beyond 2020. The current framework only sets maximum compensation levels allowed through state aid guidelines for a list of industrial sectors different from the direct emissions carbon leakage list, and it is voluntary for each Member State to give this compensation. The current guidelines generate competition distortions among member states (by singular political decision in favour of compensation) and sectors (by arbitrating fuel against electricity). It is therefore necessary to **set mandatory and harmonised EU compensation measures** and to review the list of eligible sectors to achieve full offsetting of indirect costs in all Member States and to insure technological neutrality. Especially in the case of an increasing EU carbon price, this should be developed through a harmonised EU approach using specific mechanisms, such as the use of auctioning revenues or additional free allocation rather than through state aid rules.

4. Eliminating the C-factor

The current cross-sectoral correction factor constitutes a disruptive element for already committed investments in industry, as well as a source of uncertainty for investments going beyond 2020. The C-factor elimination stems from the need to provide for an effective carbon and investment leakage protection. The current free allocation system of allowances based on benchmarks combines the need for competitiveness (free allowances) and for incentives in reducing GHG emissions (benchmarks). For the future, post-2020, **European industrial growth will be best supported if there will only be the overall ETS cap and free allowances volumes are based on actual production rather than on historical data.** This could be supported for example through a more dynamic allocation model.

If the current ETS rules are maintained up to 2030, the C-factor would have as consequence that even the most CO₂-efficient companies would be up to 40% short yearly on their needs for emission allowances.

5. Funding for innovative technologies

The European Council conclusions provide for the renewal of the existing NER300 fund with an initial endowment increased to 400 million allowances, to be extended beyond carbon capture and storage and renewables, to also cover low carbon innovation in industrial sectors. As the EU ETS has been primarily designed as an emissions' reductions tool, it is necessary to seize the reform of the ETS Directive to create a legal basis to unleash these credits for innovation. Taking stock of the current NER300, it is evident that the red tape criteria made it difficult for projects to be eligible for funding. A more flexible fund with an improved design should succeed NER300.

All ETS auctioning revenues should be used more cost-effectively and efficiently to assist the decarbonisation of European industry without impairing its international competitiveness. Half of auctioning revenues should be re-used to decarbonise the ETS sector. This has not been the case so far, a missed opportunity to pursue an active industrial policy. The other half should be used, (in a coherent EU-wide approach on compensation for indirect costs) to prevent carbon leakage.

BUSINESSEUROPE welcomes in particular the creation of an innovation fund in the MSR. However, taking into account the political support for an early start, BUSINESSEUROPE considers this must be accompanied by consequent measures. By boosting the carbon price, the MSR is of high relevance to the competitiveness of EU companies. Thus, the earlier it starts, the earlier the MSR will impact on carbon and electricity prices. Therefore any anticipation of the start date should be clearly coupled with strong provisions on carbon leakage both for direct and indirect costs. In particular, the resources provided by the MSR must be used to earmark backloaded and unallocated allowances for innovation as well as for dedicated carbon leakage purposes.

It is necessary to ensure that these innovation schemes are structured in a consistent way to provide the missing element in the climate package.

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