Subject: Public consultation in preparation of an analytical report on the impact of the international climate negotiations on the situation of energy intensive sectors

Dear Sir or Madam,

Having undertaken considerable academic research on the impact of the EU ETS on business over the past year we would like to take the opportunity to respond to your recent public consultation on the allocation of permits within the post-2012 EU ETS.

From July to November 2009 we conducted telephone interviews with managers in almost 800 manufacturing businesses in Europe. Based on these we constructed scores measuring a business' risk of downsizing or closure due to climate change policy. Enclosed with this letter please find a policy brief providing further details.[1]

On the basis of this evidence we come to the following conclusions regarding carbon leakage and permit allocations.

The risk of carbon leakage does not appear to be dramatic. The average risk score suggests that there is not a single sector of the economy for which closure in response to climate policy is likely. We can only identify very few sectors with a moderately heightened potential impact of climate policy. These include Fuels, Glass, Ceramics, Other Minerals, Iron & Steel.

We analyse in detail the sectoral trade and carbon intensity criteria recently proposed by the EU Commission to determine which sectors should be exempted from auctioning of permits. Our risk score shows that the carbon intensity criterion is a good predictor of downsizing risk, whereas trade intensity does not appear to be related to downsizing risk at all.

Taking into account the thresholds for exemptions from auctioning proposed by the EU Commission we identify several sub-groups within the exempted sectors; e.g. sectors that are exempted because of the trade intensity criterion only, sectors that are exempted because of the carbon intensity criterion only, and so on. We find that only sectors with high carbon intensity and sectors with high trade and intermediate carbon intensity are at increased risk of downsizing due to climate policy.

[1] A background paper describing a range of additional results emerging from our survey will be released soon.

On these grounds, we propose – as a short run measure – to allow only sectors with carbon intensity higher than 30% as well as sectors with trade intensity higher than 30% and carbon intensity higher than 5% to be exempt from auctioning. Compared to the current proposal, we estimate that these changes could raise additional revenue for EU governments on the order of €7 billion per year and improve the efficiency of the EU ETS without increasing the risk of carbon leakage.

In the medium and long run we suggest that the Commission explore more adequate criteria to capture the risk of downsizing and leakage such as, for example, a more sophisticated version of the trade intensity criterion based on import intensity only and taking into account the origin of imports. Importantly, we recommend that the suitability of any new criteria for assessing the risk of carbon leakage be carefully evaluated prior to making them the basis of policy design.

In light of this we provide the following answers to the specific questions posed in the public consultation call.

"*1. In your opinion, how have key indicators of the risk of carbon leakage (such as exposure to international trade, carbon prices etc.) for the EU energy intensive industry changed since the adoption of the climate change and energy package implementing the EU's unilateral 20% emission reduction target at the end of 2008?"*

The key event since the end of 2008 has been the worldwide economic recession which is likely to have affected exposure to international trade and to carbon prices for different sectors in different ways. However, the interview responses provide little indication that the recent economic fluctuations have changed the structural factors that determine which sectors are at risk of carbon leakage. If anything, firms find it easier to comply with their permit allocations because they produce less output and thus have lower emission levels. Consequently, we think that it would be wrong to make the exemption rules more generous in response to the recession. In fact, there is no need to do so because the permit price moves counter-cyclically. That is, when the economy is bad, the permit demand is low and hence permits are cheap.

"*2. Do you think that the outcome of Copenhagen, including the Copenhagen Accord and its pledges by relevant competitors of European energy-intensive industry, will translate into additional greenhouse gas emission reductions sufficient to review the list of sectors deemed to be exposed to a significant risk of carbon leakage? If so, how and why?"*

and

"*3. In your view, what would be a compelling new general economic or other factor which would require a change of the level of free allocation to sectors deemed to be exposed to a significant risk of carbon leakage?"*

Based on our results we argue that changes should be made regarding the thresholds for free permit allocations. However, this is not so much because of new economic factors or a changed situation in the wake of Copenhagen, but because the current criteria to establish carbon leakage risk are too generous.

“*4. Do you consider free allocation of allowances as sufficient measure to address the risk of carbon leakage, or do you see a need for alternative or additional measures?*”

Our research indicates that free permit allocation at the scale currently envisaged by the Commission is not necessary because the risk of carbon leakage is much lower in many sectors than is suggested by the trade intensity criterion. Furthermore, firm closure or complete relocation is unlikely to occur even in the sectors most affected by carbon leakage. By granting emission allowances for free, the EU Commission effectively transfers the scarcity rent associated with the right-to-pollute from European taxpayers to energy-intensive industries. This is a very generous measure to support a relatively small set of industries at the expense of the general public, and it ensures that the profit impact of the ETS for the benchmark firm in exempted industries is zero. Additional measures would thus appear excessive.

We hope you find our remarks useful. Please to do not hesitate to contact us for further clarification or additional questions.

With kind regards,

Ralf Martin, Centre for Economic Performance (CEP) and Centre for Climate Change Economics and Policy, London School of Economics (r.martin@lse.ac.uk)

Mirabelle Muûls, Grantham Institute for Climate Change, Imperial College London and CEP (m.muuls@imperial.ac.uk)

Ulrich Wagner, Department of Economics, Universidad Carlos III de Madrid and CEP (uwagner@eco.uc3m.es)