

Report of the ad hoc meeting
of the EECF working group on emissions trading
on carbon leakage and auctioning

11 April 2008

Charlemagne, room Lord Jenkins, 170 Rue de la Loi, Brussels

Welcome and introduction

The Chairmen, Mr. Jos Delbeke (Deputy Director General, DG Environment) and Mr. Gert Jan Koopman (Director, DG Enterprise) welcomed the participants to the meeting.

Ongoing work and provisional timetable on carbon leakage analysis

Mr. Jos Delbeke introduced the overall objectives of the EU ETS review and its allocation principles. Harmonised allocation rules will ensure a level playing field across the EU. Auctioning is the basic principle for allocation. He emphasised the efficiency, simplicity and transparency of the ETS and the ability of auctioning to eliminate wind-fall profits. The draft Directive proposes partial free allocation to industry as a transitional measure.

The Commission is committed to addressing carbon leakage. For sectors exposed to a significant risk of carbon leakage free allocation is proposed up to 100% of their share. The sectors that are concerned will be determined by June 2010. The Commission will take into account numerous factors including the extent to which a sector can pass on the cost of allowances in product prices without significant loss of market share, the extent to which auctioning would lead to a substantial increase in production cost, market structure, relevant geographic and product market and the exposure of the sectors to international competition. In the light of the international negotiations the Commission will report on the risk of carbon leakage by June 2011 and make any appropriate proposals

Mr. Gert Jan Koopman introduced the ongoing work and provisional timetable on the carbon leakage analysis. DG Enterprise is currently collecting data and information in order to obtain a survey on the factors that may lead to carbon leakage in all sectors. He emphasised that the goals of this exercise is not to generate a list of sectors, but to enable a political decision to be taken based on rational data. Mr. Koopman underlined the cooperation between DG Environment and DG Enterprise on one side, and industry on the other side.

Ms. Doyle, Member of European Parliament for the EEP-ED group and rapporteur for the ETS proposal, was invited to say a few words on the preparations for the report on ETS. She emphasised the unprecedented cooperation across political groups that is currently taking place in order to prepare the EP report and gave an outline of the timetable for the ongoing preparations. The European Parliament aims to reach a first reading agreement with the Council in December. Ms Doyle underlined the importance of legal certainty for industry. She emphasised that she would respect the architecture of the Commission's draft proposal but that she would add political direction on carbon leakage, forestry, comitology and the

inclusion of maritime in the ETS. All participants were invited to a full day hearing on the ETS that will take place in the EP on 15 May.

Presentations from Member States

Ms Reinaud (International Energy Agency) presented a literature review of ex-ante and ex-post impact assessments and pass-through potential. According to the IEA, higher leakage rates are expected in the steel and aluminium sector even in case of free allocation. She underlined that a methodology to define (and track) the levels of carbon leakage should not only be based on pass-through potential, but also take into account profitability, trade flows and investment decisions. She urged participants not to speculate on carbon leakage, but to check theory against real observations.

Chris Holland (UK) presented the preliminary findings of a report from Climate Strategies. According to the report, the 20 sectors most sensitive to CO₂ price changes account for just over 1% of GDP. The report concludes that of those, only iron and steel, aluminium, cement and lime sectors are likely to be significantly affected. Deep dives into iron and steel, and cement show that there are important barriers to international competition and relocation that are likely to limit carbon leakage further.

According to a presentation of Mr Maurits Blanson Henkemans from the Dutch Ministry of Economic Affairs anorganic chemicals and aluminium are at risk from carbon leakage mainly due to indirect emissions (electricity price impacts).

Mr Pascal Dupuis (France) introduced a proposal for a Border Adjustment Mechanism (BAM). According to the proposal, importers have to surrender ETS allowances based on average emissions of that product in the EU, but reduced with the amount of free allowances handed out to EU producers. To avoid a de facto reduction of the cap, the allowances surrendered by importers should be auctioned in the following year. France stressed that any BAM should be considered as a last resort after trying to negotiate an international agreement and that WTO compliance can be secured.

Mr. Dirk Weinreich (Germany) gave a presentation emphasising the difference between direct and indirect induced CO₂ costs and the relationship between carbon leakage and pass-through potential. The German study aiming at a first test to identify sectors exposed to risk of carbon leakage is based on sector's exposure to direct and indirect induced CO₂ costs and the level of exposure to international competition. In Germany, basic iron and steel, fertilizers and nitrogen compounds were identified as sectors with high direct costs, while aluminium and aluminium products, paper and paperboard and other basic inorganic chemicals are sectors with high indirect costs. Germany stressed that a consensus on adequate criteria and an EU-wide analysis were necessary.

Ms. Ola Hansén presented a report published by the Swedish Energy Agency focussing on the impact of direct and indirect costs (due to increased electricity prices as a result from the EU ETS) on competitiveness. According to the report, indirect effects were dominating the costs in the period 2005-2007 for Swedish industry, while the costs for direct effects were relatively small. After 2012, direct effects will probably dominate in emission intensive sectors (like cement, lime, iron & steel and refineries) and indirect effects will dominate in power intensive sectors (like paper and pulp, chemistry, iron & steel and aluminium), leading to an increase of

total operating expenses with several percentages. The ability for Swedish industry to pass increased costs through to prices is difficult to assess.

Discussion

Many questions were raised concerning the impact of the French BAM proposal on the international negotiations and its WTO compatibility. The French delegation responded that it is not its intention to hamper the international negotiations and that it believes a BAM proposal can be compatible with WTO rules. The proposal does not cover the issue of indirect effects.

In their interventions, several industry organisations were sceptical about the BAM proposal mentioning the risks for higher input costs for industry and trade retaliation. The lime and cement sector showed a more positive attitude towards the proposal. Ms Doyle noted that even though a BAM is not in the current proposal, Europe should keep it in mind as a policy option, but only in case the international agreement fails.

A number of industry representatives raised concerns about the use of static import and export data and emphasised that factors like profitability and investment decisions should have more weight in future studies on carbon leakage. ETUC underlined the importance of investment figures and trends and of expenditures for research and development. The UK noted its reservations against the use of profitability as an indicator for carbon leakage.

Other delegations consider the studies that were presented by Member States as not being representative for all countries and emphasise that more attention should be paid to regional differentiation.

A number of other issues were mentioned. The ceramics industry raised concerns with regard to the administrative costs related to data gathering. The European Carbon and Graphite Association emphasised the difficulties of data gathering for small industry sectors.

A representative of the steel sector warned other delegations not to continue looking for the perfect modelling approach, because it might not exist. The data that are available at this moment should be analysed as soon as possible in order to create legal certainty for industry.

Greenpeace underlined that most presentations lack a proper definition of carbon leakage and that developing new capacity outside the EU does not necessarily have a negative environmental impact.

Poland and Estonia underlined the risk of carbon leakage in the power sector to neighbouring countries, while Ireland raised the issue of carbon leakage in the agricultural sector in the light of the effort-sharing decision. Poland also emphasised the importance of the inclusion of the heat sector in the ETS.

Conclusions

In concluding the discussions, the Chairmen highlighted the following points:

1. The realisation of an international agreement is a first priority.

2. The introduction of BAM is already mentioned as an option in the ETS proposal. In case Europe decides to go in this direction it is of utmost importance that WTO compatibility is ensured. Furthermore, the impacts of BAM on trade and on the international negotiations must be clearly assessed. The ETS should provide for the right incentives towards a low carbon economy.
3. The concept of carbon leakage is not clearly defined and no agreement has been reached yet on how to measure carbon leakage. It is worrying that power, heat and agriculture also claim to be affected by carbon leakage.
4. There are difficulties concerning the gathering of data in the various industrial sectors. There is no agreement on how far sub-sectors should be taken into account.
5. The analysis on the risk for carbon leakage should preferably not develop into a modelling exercise. It is better to study existing data.

Presentations from industry and NGOs

According to the presentation given by Mr Wolfgang Gerhardt (CEFIC) the European chemical industry is highly energy intensive and highly integrated. The sector is competing on a global market and is at risk for delocalisation and carbon leakage. It is not possible to pass on unilateral costs. The chemical industry prefers to stay close to its main clients in Europe and therefore supports a performance-based free allocation in the ETS.

Ms Wyart-Remy (European Lime Association) presented the results from a collection of data by an independent party concerning the exposure to carbon leakage for the lime industry. The lime sector is a small sector which was identified as the most carbon-exposed industry. Currently, costs are not passed through to consumers. According to her, carbon leakage in the lime sector is closely related to the gap between production costs within the EU including CO₂ costs and costs of products imported from outside the EU including transportation costs.

In his presentation on carbon leakage impacts, Mr Kyte (Eurelectric) stressed that the electricity sector is energy intensive and trade exposed. He accepts auctioning but emphasised the need for clear rules in this field and free allocation. Certainty is needed with regard to the total amount of allowances that is available and the system also after 2020. Allowances for the electricity sector must relate to 2005 emissions. Mr Kyte underlined that especially in border regions carbon leakage is a major concern.

Dr. Patricio Barrios (European Copper Institute) presented the views of the copper sector. The global LME copper price is not a relevant criterion to assess the energy intensity of European primary, secondary and copper processing sectors, as copper sector's income are related with the processing fees and these are independent of the copper LME prices. So, recognised global processing fees should be used. As copper price is globally fixed at the LME, the European copper industry does not have the possibility to pass through costs to consumers and will be unsustainable with additional EU ETS costs.

In his presentation, Mr. Sanjeev Kumar from WWF questioned the validity and accuracy of industry claims concerning carbon leakage and in particular outlined the case for the cement sector to start with 100% auctioning in 2013. WWF recommended that any assessment should

be based on independently verified data. Trade intensity, market structure and concentration, and historic investment data on installation level against company and sector trends should be applied as assessment criteria to allow for a true discussion about alleged competitiveness impacts. WWF supports full auctioning and has yet to see robust arguments against this as a means of a cost-effective initial allocation of permits to companies.

Mr. Jos Dings from the European Federation for Transport and Environment gave a presentation on the inclusion of aviation in the ETS. According to him, the aviation industry will not suffer significant negative impacts because it is geographically bound and there is no risk of relocating activities outside the EU. Furthermore, it is expected that aircraft operators will pass on most of the compliance costs to consumers.

Discussion

The European pulp and paper industry noted that it is against border measures and in favour of the inclusion of forestry in the ETS. Furthermore it urged other industrial sectors to be cautious with moving towards analysis based on many sub-sectors.

In a reaction to the claims from industry organisations, that production in Europe is becoming more expensive, WWF asked for the rationale behind their decision to stay in Europe until now. CEFIC replied that there is a historical proximity to the customer, but if the attractiveness decreases further, the sector will consider moving outside Europe. Lime industry argued that production in the EU allows them to be close to the resource base, but that this could change in the future.

Conclusion

The Chairman concluded that industries seem to be in different stages as regards data availability.

Presentations on auctioning techniques

Eurelectric supports auctioning as the principle allocation method. All sectors should be treated in an equitable manner and all electricity production must be treated in the same way. The auction process should not distort the market price for carbon nor the power market. Key principles to reach this objective are predictability, fair and equal access, efficiency and transparency.

Kate Hampton from Carbon Investors made a presentation on auctioning modalities and the criteria for good design. According to her, auctioning is a well studied area where an abundance of academic literature is available based on empirical evidence. Use should be made of the experience gathered by government debt management authorities and existing auction software. The European Central Bank could be involved to keep oversight over the auctioning process.

According to Michela Beltracchi (IETA), greenhouse gases are not a difficult commodity to auction. Three key issues should be taken into account. Auctions should not be a tool to manage the market and therefore government intervention has to be limited as much as possible. Efficiency is more important than maximizing revenue. Finally, auctioning should be conducted with the greatest possible degree of transparency, fairness and simplicity.

Discussion

During the discussion the risk of speculators, or even political intervention, was considered an important issue. It was argued that capitalistic speculators are not a risk for the market, as their behaviour is easy to predict and therefore easy to create appropriate rules for. For the intervention of sovereign wealth funds there might be a need for some stricter regulation. Germany underlined that it is already auctioning via the state owned investment bank KfW and that it works fine.

A representative from COGEN did not request that ETS should support cogeneration, but feared that that the ETS would hinder its development. Mr. Delbeke replied that the aim is that ETS should not hinder the development of cogeneration, since it is a useful tool towards a low-carbon economy. However, the Commission must avoid creating a market distortion by favouring one sort of electricity over the other.

AOB

Several industry representatives showed concerns about the misuse of auction's revenues by Member States. According to MEP Doyle, the European Parliament considers earmarking an important part of the Directive and will pressure Member States to their promises as regards use of funds.

ETUC questioned if there are criteria for a good international agreement and requested whether the ECFIN economic paper would be released soon. According to Mr. Delbeke, the criteria for an international agreement are rapidly maturing but it is too early to provide a precise reply. The ECFIN economic paper would hopefully be released within a few weeks.

Concluding remarks

Chairman Mr. Delbeke concluded the meeting by saying there will most likely be a follow-up meeting. It may be before or after summer. This is depending on the availability of material to discuss and on the state of the negotiations in the Council and the European Parliament.