

## **Report of the ad-hoc stakeholders meeting of the ECCP Working Group on ETS on carbon leakage, 26 September 2008, Brussels**

### Welcome and introduction

Mr John Farnell (Director, DG Enterprise) and Mr. Jos Delbeke (acting Director General, DG Environment) and Gert-Jan Koopman (Director DG ECFIN) welcomed the participants to the meeting on behalf of DG Environment, DG Enterprise and DG Economic and Financial Affairs.

### Presentations

Following a presentation by Ms Yvon Slingenberg (Head of Unit, DG Environment) on the state of play in Council and European Parliament linked to carbon leakage, Mr Gert-Jan Koopman (Director, DG ECFIN) and Mr Manfred Bergmann (Head of Unit, DG Enterprise) introduced the Commission's approach for measuring the risk of carbon leakage.

They explained why the Commission shares the view that carbon leakage has to be avoided. It could lead to both negative environmental consequences at the global scale, as well as negative economic consequences within the EU. The methodology proposed will allow identifying the (sub)sectors exposed to such a risk.

In stage 1, a quantitative analysis will be performed, measuring the impact in terms of what product price increases would potentially be necessary to fully compensate for CO<sub>2</sub> related cost increases, as well as measuring the openness to international trade as a proxy for exposure to international competition. Stage 1 assessment will also include introducing threshold values for price increases and trade exposures beyond which the potential for cost-pass through will be deemed significantly reduced. Stage 1 assessment will then allocate each (sub)sector into one of four categories of risk of carbon leakage.

In stage 2 of the assessment, the quantitative analysis will be followed by a qualitative analysis which will take into account other market factors (such as relevant product and geographic market, market concentration, profit margins etc.). This analysis could lead to (sub)sectors being reclassified, thereby changing the category of risk of carbon leakage attributed to in stage 1.

Finally, a 3<sup>rd</sup> stage of the assessment will be conducted where the results of the two first stages will be assessed in the light of results from international negotiations on climate change. Results of that stage could again lead to a reclassification of (sub) sectors and would establish the final result of the assessment process.

It is important to note, that all energy intensive (sub)sectors covered by the ETS will be analysed in all stages of the assessment.

## Discussion

A large number of stakeholders expressed their appreciation for the work of the Commission and support the evidence-based approach, as well as the level of disaggregation proposed. However, some questions were raised concerning data requirements and transparency. While WWF and ETUC representatives emphasised the need for verified and public data, many industry organisations expressed concerns about confidentiality. BusinessEurope reminded that the approach and data needed should not impose excessive burden on businesses, particularly SMEs, associations or the Commission. Some participants were concerned about the high sensitivity of the results depending on the reliability of the data and assumptions made. Some others expressed concerns that the approach is too complex and technical.

In their interventions, a number of industry associations questioned relating the cost increase to product price. Instead, gross value added (GVA) was proposed as a more appropriate variable, as they believe that investment leakage is more closely related to operational cost and profitability than prices. The representative of Eurometaux noted that GVA is more appropriate as otherwise sectors refining costly raw materials would in their view be unfairly assessed. CEPI were positive about the fact that the profit margins would be taken into account in stage 2. Cerame-Unie stressed the importance of such qualitative criteria for the ceramic industry.

Several Member States were sceptical about assumptions on the cost-price mechanism for electricity and the choice of fuel mix. They also underlined differences between Member States. The cost increase should not be evaluated on average fuel mix but on marginal fuel mix and if possible be country specific.

A large number of representatives expressed support for the proposed inclusion of indirect cost in the analysis. They also called for defining measures to address the cost burden due to indirect emissions. Representatives of the glass and the tyres sectors indicated the need to include cost-increases of inputs other than electricity incurred from upstream production and its emissions.

Many participants raised concerns about the use of a static analysis and emphasised the need to look at future trade intensity. That level could change significantly over time, resulting in changes in sectors' exposure to the risk of carbon leakage. As the recent financial crisis has demonstrated, market conditions can change considerably in a short amount of time. Eurofer acknowledged the difficulty and limitations of making predictions and proposed to look at trade dynamics as an indicator in itself.

Several questions were raised concerning the use of export and import values as an indicator of the pass-through ability. Eurometaux noted that a sector can have low trade values, while having prices set at a global exchange. Cerame-Unie pointed out that a distinction should be made between the price on domestic market and the one on export markets. Eurofer questioned the definition of market size in the non-paper, which should rather be defined as domestic consumption.

Some representatives were interested if disaggregation at the level proposed would allow for taking into account the value chain.

The NGO representatives highlighted the importance of properly defining carbon leakage, which should only refer to situations where production relocates to less efficient installations outside the EU. In this context, they stressed the need to look at international data and comparing energy efficiency of installations.

WBCSD was interested in why the approach gives more weight to actual competition as reflected in trade intensity than to potential competition which may result from the cost increase. WWF stressed that trade intensity must be the paramount indicator, followed by market structure, whereas product cost increase is only of secondary importance.

A number of industry representatives as well as ETUC called for early setting of the list of exposed sectors in order to provide certainty. IFIEC expressed concerns about the continuous revision, which could prolong the uncertainty.

Some stakeholders questioned the carbon price of €30 used in the calculations and argued that such an assumption did not reflect some of the forecasts given by certain analysts. Euroalliances was interested if the Commission looked at possible implications that the cap will have on the carbon price. The Italian representative expressed concerns about potential inflationary pressures where sectors are able to pass through the costs.

T&E highlighted that potential for emission reduction should be given more weight in the analysis, as well as possible profitability gains resulting from such reductions. As experience has shown, negative effects should not be automatically assumed. Similarly, ETUC noted that abatement potential needs to be taken into account, as it is of key importance for having a competitive EU industry.

A number of other issues were raised. Italian representative emphasized the importance of finding generally applicable criteria. As defining the four categories will be difficult politically, they prefer their own proposal in this respect. The Italian paper proposes assigning both quantitative criteria equal weight and adding them up into a single "leakage index". Ireland expressed concerns about the focus of the analysis on energy intensive sectors only.

The Commission representatives took note of the comments and responded to the questions, first of all observing that there is general support for the Commission approach. The participants recognised the importance of an evidence-based approach, as well as disaggregation and differentiation of compensation. The Commission will now look at the issues raised and continue to work on the other sectors speedily, investing sufficient resources needed for the analysis.

The Commission representatives acknowledged the need to address indirect costs. However, they reminded that the objective of the meeting is to define an objective

methodology for applying the criteria first. The analysis will take into account indirect cost, while the measures will be determined at a later stage. The Commission also reminded that under the conditions of an emissions cap, like in the EU ETS, any leakage would result in higher global emissions, irrespective of the efficiency of the installations to which leakage would occur.

Although there are four categories, their definition requires only two thresholds, which should be politically manageable. The analysis is looking at sectors covered by the ETS, while the others fall under the effort-sharing agreement. The analysis is sector-specific and conducted at an EU level. The aim is to have a method that is applicable to all sectors, verifiable, workable, and can provide answers as soon as possible. The goal is to identify the (sub)sectors at risk of carbon leakage across the EU, thus it does not take into account differences at installation level or in country-specific fuel mixes. The approach is as precise and provides as much certainty as possible, given the always changing external developments and market forces.

As regards the carbon price the Commission has based the work on the Package Impact Assessment, where the central scenario results in a carbon price of around €30. The Commission has also undertaken a sensitivity analysis on different carbon prices (€20 and €40) in the ECFIN study, of which sectoral chapters were sent to corresponding industry associations. The review of the list of exposed (sub)sectors every three years allows to take into account actual carbon price dynamics in the third trading period.

According to the Commission, the cost increase should be related to product prices, because carbon leakage is mainly driven by price differences. Moreover, one needs to be cautious about quality of data on GVA, which is not comparable to data on product prices. In addition, data on GVA at the degree of disaggregation needed for this analysis has proven to be insufficient.

Impact on profit margins, as well as many other issues raised, will be examined in the qualitative assessment in stage 2. Similarly, the issue of indirect emissions stemming from other sources than electricity is related to value chain characteristics, which will also be addressed in qualitative assessment.

The speakers acknowledged that accounting for future trade intensity would be desirable. However, it is very difficult to make accurate predictions about its values. To take into account future developments, the Commission proposal foresees a 3-yearly revision of the list.

Particular importance is given to trade intensity, as this is what brings about the risk of asymmetric cost. However, the weight of the two quantitative criteria will ultimately depend on the thresholds set.

The exposure to international competition was broken down to exposure to international trade in Stage 1 and traditional competition indicators, such as market concentration, in

Stage 2. The Commission is willing to also consider other better evidence-based indicators that the stakeholders would propose.

The Commission has been working closely with industry to gather quality data, and is confident it can obtain all key figures for applying the methodology. However, it needs to be recognised that data is never perfect. The data used will be published to ensure maximum transparency. The industry has previously ensured that it is possible to work around confidentiality issues through third party verification. In addition, the Commission is working with Eurostat in order to overcome the problem of unpublished data. Data on global production are excluded from the analysis, as already gathering robust data for EU is a difficult task.

### Views from the Presidency

Mr Francois Gave (Presidency) presented the presidency views on the carbon leakage discussion. He reaffirmed that the Presidency takes the issue very seriously. The EU should not rush into adopting bad policy. The reason why we need an agreement on carbon leakage and the Energy and Climate Package in general is not only to deal with EU environmental issues, but also because we desperately need an agreement in Copenhagen negotiations. If the EU does not get its house in order, it will weaken its position.

### Possible future technology breakthroughs for emission reductions

Mr Jose-Lorenzo Valles (Head of Unit, DG Research and technological development) gave a presentation on current research underway to achieve emission reductions. He stressed the role of ETS as a driver for sustainable development as it provides incentive for technological excellence. There is evidence for potential to improve energy savings and reduce carbon emissions, as presented in examples from the Research Framework Programmes 6 and 7 for the steel, cement and pulp and paper sectors.

### Carbon leakage studies made for Member States

Mr Felix Matthes (Öko-Institute) and Mr Sander de Bruyn (CE Delft) presented studies they made for Germany and the Netherlands respectively.

### Discussion

A number of industry organisations raised reservations about the findings for their respective sectors. For the NL study, Mr de Bruyn responded that many objections about conclusions can be put down to data availability limitations for certain sectors at NACE 4-digit level and beyond.

Several were sceptical about Mr Matthes' observation that (using different thresholds) the switch between the use of product price or GVA does not lead to significant differences in results as regards the ranking of sectors. Mr Matthes replied that GVA is probably

indeed a better indicator of impact on profitability but it is much more difficult to establish a flat rate threshold. Moreover, it is problematic in practice e.g. for power production in industrial installations. Such an approach will be undermined by behaviour of business and gaming. When moving from prices to GVA any threshold values would need to be adapted.

NL was interested whether quality data exists for regional power markets that could form a basis for compensation. Mr Matthes responded that if we assume that relocation within the EU is not carbon leakage, then there should be no differentiation for indirect effects across the EU.

ETUC was interested in speakers' views on border adjustment measures (BAMs) and whether free allocation constitutes a subsidy considering the closure rules. Mr Koopman (DG ECFIN) asked the speakers to elaborate on their statement there would be inefficiencies regardless of allocation methods due to higher carbon prices. Mr Matthes believes that this is a complicated issue and its extent depends on how the measures would be tailored to cases where carbon leakage could occur, the more tailored they are, the less inefficiencies there are. This is the reason why it is too soon to discuss the measures.

Mr de Bruyn said that the question of allocation methods is in essence a distributional one – who is going to pay: EII, consumers or, in tight labour markets, labour intensive industries (in a tight labour market, consumers will be able to put higher salary demands on businesses to cover their increased costs). Nevertheless, free allocation could be labelled as an implicit subsidy. If BAMs were implemented for imports, they would have to be complemented by export subsidies. However, in practice it would be very difficult to determine the correct level of measures. Furthermore, the industry itself is not supportive, as they realise that it could easily lead to retaliation by other countries. However, it is not excluded that the US will consider putting such a mechanism in place.

WWF highlighted significant differences between low cement prices in Germany and high prices in UK and France as an indication that the producers are able to pass through the cost. WWF also invited Germany to present their proposal for the criteria. The German representative responded that the work and discussions in the government to flesh out the details are still ongoing, and would therefore not like to comment further at this stage.

#### Preliminary results of benchmarking study made for Commission (info point)

Mr Maarten Neelis (Ecofys) presented some initial findings on benchmark criteria for free allocation, partly based on experience with the use of benchmarking by Member States in the ETS so far. The main conclusions are that benchmarks should be based on most GHG-efficient technology applied at industrial scale and that there should be no corrections for plant size and age, or raw material quality. However, separate benchmarks for intermediate products that are traded between installations are required.

#### Discussion

A number of participants agreed with the messages. Europaia supported the application of best GHG-technology as a basis in order to provide proper incentives. EULA was interested in how the speakers proposed to deal with differences in availability of fuels, as well as energy policy and security implications. Similarly, CPIV did not agree with treatment of inputs, e.g. recycled materials. WWF commented that it may be more advantageous to set benchmarks at a global level.

The speaker explained that in order to provide incentive for fuel switch, the benchmark should not be fuel-specific or corrected for material inputs. However, he agreed that the former may have some political implications. He also agreed that it would be best to set global benchmarks in the longterm. Nevertheless, having EU benchmarks makes the EU well-prepared for international climate negotiations in which sector benchmarks might play a role.

### Main conclusions

1. There seems to be a good understanding of the approach and broad support for it as a workable, evidence-based method. The Commission will look at the issues raised by the stakeholders. Most of these are already taken into account in the qualitative assessment in Stage 2. An important outstanding issue remains about the request to use GVA (instead of product price). This could be problematic due to lack of data availability.
2. It is necessary to provide sufficient level of disaggregation in the analysis of (sub)sectors and differentiation in the level of compensation.
3. There is a need to address indirect effects. It is very helpful that they are recognised in the analysis.
4. It is very important that results are published and that the approach is consistent across the sectors.
5. The Commission is committed to the exercise. Its main task at this point is to rapidly process the data of the remaining sectors. It will invest sufficient efforts and resources, and continue to work closely with the industry to gather any missing data.