BDI

Climate and Sustainable Development

Positioning of the BDI on the functionality and consistency of various instruments relevant to climate policy – especially the EU ETS

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Preamble:

German industry continues to actively support a comprehensive, legally binding global climate agreement to create a level playing field and make it possible to achieve the 2°C target set in Cancun. The international climate talks must lead to a fair distribution of climate protection burdens. A global carbon market is the precondition for investment in innovative technologies, installations and products where they will benefit climate the most. German industry is therefore committed to supporting political efforts to establish such a global carbon market.

However, European climate policy is not an isolated political area and cannot be regarded purely from the regional perspective. Thus the OECD[1] has noted that:

"Global GHG emissions are expected to grow by 50% between now and 2050, mostly driven by energy demand and economic growth in key emerging economies. […] Global greenhouse gas (GHG) emissions continue to increase, and in 2010 global energy-related carbon dioxide (CO_2) emissions reached an all-time high of 30.6 gigatonnes (Gt) despite the recent economic crisis. The Environmental Outlook Baseline scenario envisages that without more ambitious policies than those in force today, GHG emissions will increase by another 50% by 2050, primarily driven by a projected 70% growth in CO_2 emissions from energy use. This is primarily due to a projected 80% increase in global energy demand."

It thus becomes clear it will be crucial to focus on worldwide energy conversion and use as regards cutting greenhouse gas emissions. In contrast, in terms of its relevancy to combatting climate change, the focus of the EU (EU share of world emissions: approx. 10%) on only cutting emissions is increasingly limited.

Also the EU Roadmaps (Low Carbon Economy, Energy, Transport, Resource Efficiency) for which several Directorates General are responsible have not been coordinated despite their considerable conceptional overlaps and correlations. The European companies concerned are threatened with

[1] Source: "OECD ENVIRONMENTAL OUTLOOK TO 2050" (March 2012)

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double or even multiple burdens resulting in electricity and emissions trading costs, capital being siphoned off, investments being hindered, and thus in a massively adverse impact on world market competitiveness.

In view of the nuclear phase-out and the lack of social acceptance of CCS, Germany has little chance of achieving the EU long-term target of a largely climate-neutral energy supply. The remaining possibilities should be used as cost-efficiently as possible and be accepted by society.

It is about more than simply cutting emissions and combatting climate change in the EU, it is about making the European economies fit for the future in an increasingly globalized world.

Based on the increasingly heated debate on the way the EU ETS works and its capacity to function, various aspects of the current discussion will be addressed. The main problem is the lack of consistency between the various energy and climate policy targets and instruments.

1. Question:

How does the BDI view the current debate on low allowance prices and the ETS' capacity to function?

The comparatively low allowance prices are a result of the low demand for allowances, mainly due to the financial and debt crisis, and also due to enhanced energy efficiency and the expansion of renewable energies. The intended binding requirements to increase energy efficiency (the Energy Efficiency Directive is to be adopted in 2012) and the further uncontrolled development of renewable energies, in particular in Germany, will probably continue to put prices under pressure. Yet, at the same time increasing renewables capacities will probably lead to an increased burden on the final consumers.

Against this background is the ETS perhaps not developing according to plan? No, as the comparatively low carbon prices are inherent to the system. The ETS is not a price system but expressly a quantitative system. The system is therefore working perfectly in this context. The EU greenhouse gas reduction target for 2020 will be achieved. There is therefore no need to intervene in the system prior to the end of the third trading period (TP) in 2020.

On the contrary, after the recent inclusion of aviation activities a consolidation phase would be appropriate. Price developments from 1.1.2013 (beginning of the third TP) can also not be reliably predicted. In industry's view the new ambitious benchmarks will result in a greater demand for allowances and will indirectly lead to rising carbon prices. It cannot at present be excluded that the sum of the allocations applied for the third TP will exceed the cap. The cross-sectoral correction factor would then indirectly result in a greater demand for allowances.

If for overarching strategic political reasons (particularly the transformation towards a "low-carbon society") a stronger price signal would be considered necessary, discussions should focus on the fourth TP and those following. In this discussion on strengthening the ETS the question should also be answered how the competitiveness of the relevant installations could continue to be ensured as long as the international key trading partners are not also included in a management system for greenhouse gases. In other words not only scenarios with too low carbon prices should be discussed but precautions should also be taken to protect energy- and electricity-intensive industries against too high prices.

The BDI wants to maintain an EU-wide harmonised and well-functioning EU ETS as a guarantee for cost-efficient climate protection. Instead of short-term market intervention with almost unforeseeable consequences, fundamentally enhancing the EU ETS should therefore be considered to make the system less prone to unforeseeable events such as the financial and debt crisis. Internationalisation of the EU ETS should also be expedited.

The greatly discussed "set-aside" (temporary, permanent[2]) is rejected as setting a precedent for politically motivated market manipulation. Politically motivated market intervention in the EU ETS would mean negating the system's fundamental way of functioning and degrading it to the role of a money-maker for policy-makers. From the climate protection perspective, the effect would even be counterproductive: interventions to govern the economy would create an environment of unpredictability for potential investors and companies and would be likely to hinder investment in climate-friendly technologies in Europe. From the point of view of business, what would prevent policy-makers from intervening in the system again should framework conditions change in the future and not seem politically opportune? Policy-makers often underestimate the sensitiveness of the markets as regards political intervention. Anyway, as regards impending investment decisions, future carbon prices resulting from the medium and long-term climate policy ambition levels, as well as the general energy cost developments, are much more important than current carbon prices.

In its "Roadmap for Moving to a Competitive Low-Carbon Economy in 2050" the EU Commission proposed reducing greenhouse gas emissions by up to 40% as an intermediate target for 2030, entailing a reduction obligation for the ETS sector of up to - 48%. According to the Commission's analyses, these requirements would be in accordance with cost-efficiently achieving the EU target for 2050 (- 80% to - 95% based on 1990). The caps for the 4th and following trading periods can therefore also be expected to be of this magnitude.

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[2] Temporary set-aside: Shifting certain quantities of allowances to be auctioned from 2013 towards the end of the 3rd trading period (could be implemented at relatively short notice). Impact on the market unclear as the allowances are only made available later, however would not be cancelled.
Permanent set-aside: Concomitantly with the temporary set-aside amending the ETS Directive would begin (time-consuming) so that the allowances set aside could then be permanently removed from the market.

Reduction as compared to **2005**	2020	2030	2050
Total	- 14%	- 35% - 40%	- 77% - 81%
ETS	**- 21%**	**- 43% - 48%**	**- 88% - 92%**
Non-ETS	- 10%	- 24% - 36%	- 66% - 71%

The Commission further assumes that by enhancing energy efficiency, energy consumption will fall by more than 8% up to 2030; energy consumption should even fall by up to 28% by 2050. Over the next 40 years approx. EUR 270 billion per annum would have to be invested, in addition to ongoing and anticipated "business-as-usual" investment plans.

From 2020 to 2030 the reduction target for the ETS sector should therefore more than double. What this would mean in terms of the "energy turnaround" (Energiewende) in Germany for 2030 is not clear. However, it can be assumed that carbon prices will increase substantially. Should these targets be pursued seriously, i.e. with a good chance of being realised, it would provide a positive incentive for the necessary investment. Investors require a clear, predictable and dependable framework **now**. This applies not only to the EU ETS but also to the structured expansion of renewable energies and energy efficiency requirements. The EU ETS is an isolated European solution, requirements for renewables and efficiency are strongly dominated by the Member States. In particular the question how to ensure that the funds needed to restructure the energy systems in the Member States are invested **in Europe** also needs to be answered convincingly. In other words, how can energy-intensive installations in particular also be maintained in Europe after 2020, i.e. how can the risk of "carbon and job leakage" which rises with the level of ambition be resolved? How to ensure that the levels of ambition can be achieved cost-effectively and technically? Which role will offsets (CDM credits etc.) play in the future? Is the envisaged "burden sharing" between ETS and non-ETS sectors really cost-efficient? What are the remaining framework conditions like, how can the overall burden on companies (imposed by energy taxes, cost for expanding renewables (EEG-Umlage), more stringent environmental legislation etc.) be kept within tolerable limits so that international competitiveness will not be undermined?

German industries would like to discuss these and other urgent issues with policy-makers as soon as possible.

2. Question:

From the BDI perspective, what are the most urgent fields of action regarding climate policy?

a.) At national level

The impact of new European requirements on the concrete German situa-

tion should be analysed in detail (correlation with the national - 40% target? Additional costs involved to achieve the target?):

Greenhouse gases, based on **1990**	By 2020	By 2030	By 2040	By 2050
EU Low Carbon Roadmap 2050	- 20%	- 40%	- 60%	- 80%
D Energy Concept	- 40%	- 55%	- 70%	- 80%/- 95%

In Germany the question is currently being discussed whether, with the massive and generally uncontrolled development of renewables (PV in particular), the second or even third step has been taken before the first step as there is a broad consensus that energy-efficiency enhancement measures provide a far better cost-benefit ratio ("more climate protection per Euro spent"). The expansion is controlled by subsidies and is still practically unstructured. It is neither geared to regional requirements nor to infrastructure development. There has been no European optimisation of the development of renewable energies at appropriate geographic locations. In 2010 energy losses have increased by more than 70% compared to 2009 as more renewable energy installations had to be down-regulated (Bundesnetzagentur, 2011 Annual Report). This reflects the continually growing challenges which grids are already facing due to the rapid increase in renewables and this will remain so during the coming years. The best locations EU-wide should be used to develop renewable energies as efficiently as possible. However, in contradiction to this idea many German Bundesländer have set up their own support schemes to attract investors – in addition to the federal feed-in law (EEG).

b.) <u>At European level</u>

The Energy Roadmap lacks a discussion on an appropriate instrument-mix to achieve the extremely ambitious targets for 2030 and 2050. Current experiences show that a varied collection of uncoordinated measures and support schemes to cut carbon emissions, to develop renewable energies and to enhance energy efficiency are tending to prove counterproductive, with the danger of multiple burdens for companies as the addressees of all these regulations. Moreover, separate objectives for certain sectors or branches are quite onerous and should therefore be dismissed.

Absolute energy-saving requirements compete with greenhouse gas reduction targets (approx. 80% of the greenhouse gases consist of carbon emissions from the combustion of fossil energy sources). It is not at all clear how the EU ETS and simultaneous implementation of the Energy Efficiency Directive (in particular if it is an "Energy Consumption Reduction Directive") could be coordinated. The required systematic enhancement of the EU ETS need to be brought into line with the targets for renewables and energy-efficiency on a clear and consistent basis. Particularly bearing in mind longer operating lives of new investments, sectors at risk of carbon leakage need effective protection as long as there are not even approximately internationally comparable competitive conditions for European and German companies as regards climate policy. Reliable and consistent long-term "rules of the game" for the carbon markets are crucial. In view of the very ambitious expansion targets for regenerative energy sources their integra-

tion into the internal market, that is, into competition becomes more and more urgent. The rapid expansion of regenerative production and the legally required connection with the grid together with the obligation of the Transmission System Operators (TSO) to accept the fed-in electricity irrespective of whether there is demand for it, means the TSO faces major challenges. The EU has to deal with these problems efficiently and successfully before new ambitious targets are to be set for the period after 2020.

c.) <u>At international level</u>
The course pursued in Durban towards an international climate agreement to be negotiated by 2015 and to take effect from 2020 and to be implemented by all signatory states should now be continued particularly with the right focus. The most difficult tasks still lie ahead, namely determining the material conditions that are actually crucial to such an agreement. This applies particularly to the level of the reduction targets of individual countries, the strength of commitment and the manner in which the market mechanisms are to be developed further under the Convention and the Kyoto Protocol. However, also as regards technology transfer and climate finance acceptable solutions have to be found for donor and recipient countries. In terms of harmonising global competitive conditions, international emissions trading should be expanded by linking existing emissions trading systems with emissions trading systems under construction. Effective protection against carbon and job leakage should be kept up until there are measurable appropriate efforts to combat climate change in all countries. To distribute the reduction burdens more fairly, sectors such as transport and agriculture should be included more in the world-wide reduction efforts. To distribute burdens more fairly also means providing more impetus for developing and emerging countries and helping them put their economies on a low-emission course by implementing their own instruments and measures.

3. Question:

What does the BDI want European and German policy-makers to do as regards climate policy?

High levels of energy efficiency constitute the basis for economic success and are therefore in the companies' own best interest. This is why the BDI considers high energy efficiency crucial to the energy target triangle of security of energy supplies – environmental and climate protection – competitiveness. During the last six decades German industries increased their production processes' energy efficiency more than four-fold. German companies are not only among the most efficient world-wide, they are also among the major providers of modern technologies and help enhance energy efficiency in all industrial and commercial sectors, from the producing industry via the energy industry, the building sector, the transport sector, up to and including the service-providing sector. Nevertheless, achieving ambitious climate targets comes at a price, whereby each Euro can only be spent once. So it is all the more important to enhance the cost efficiency of all the measures. Not only should the numerous different climate policy targets

and instruments therefore be better coordinated but also be assessed in view of their cost-benefit (i.e. climate protection) ratios.

Over the long term cutting greenhouse gases should be established as a **key objective** and the market-based **ETS as a key instrument**. This requires a deeper discussion which should include a number of additional aspects such as carbon and job leakage, energy taxes, "energy turnaround" etc. Renewables and energy-efficiency targets should then be merged into the EU ETS over the medium term. For the idea of the "key instrument" means that the ETS cap should be so ambitious that developing renewables and enhancing efficiency should be stimulated and controlled through the ETS. In return, the support for renewables and command and control with respect to energy efficiency (by the exclusion of those subject to the EU ETS and a much more differentiated approach to the non-ETS sectors) should be substantially cut back.

Investment decisions in favour of certain technologies are geared to the respective current legal and political requirements. If these requirements are not clear it could lead to so-called "technology lock-in" effects. Subsequent, different, or more precise, requirements could then generally no longer be adequately addressed, as changing the situation that has resulted from the earlier investment decisions would involve prohibitive costs. Either way, unclear and unpredictable political requirements lead to wrong economic decisions and welfare losses. To avoid "technology lock-in" as regards impending investment, clear and consistent political statements on trajectories up to 2050, including interim targets, are therefore needed as soon as possible.

As regards the ETS, the following applies: If the EU ETS is to stimulate investment in long-life low-carbon technologies, then investors need much more stable and predictable framework conditions. The EU Commission should therefore pay far greater attention to the **consistency of the energy and climate policy instruments** (ETS, expanding renewables, enhancing energy efficiency etc.). Counterproductive interactions between the instruments which result in multiple and additional burdens on companies should be avoided.

The BDI has with concern been observing the introduction of Bundesland-**specific climate protection legislation** with own targets in individual federal states. This is a development in the completely wrong direction – instead of the absolutely necessary internationalision of climate protection it is now being inefficiently regionalized. Export-oriented German companies are active across *Länder* and state borders. They are being confronted with an increasing number of different objectives, processes and measures in the climate and energy sector which often make excessive demands of what is possible in practical terms, particularly for small and medium-sized enterprises. A harmonized approach at EU level with the objective of participation in an ambitious international climate protection agreement, announced for 2020 in Durban, would be the right way forward. Parallel fragmented additional measures particularly weaken those industries in Germany which could play a major role in combating worldwide climate change with their technologies and innovations.

4. Question:

How do the German "energy turnaround" and European climate policy influence each other?

German industries supported the "energy turnaround" from the outset. However, in view of the technical and financial challenges the ambitious restructuring of the energy system will not happen automatically. Expanding renewable energies, fossil-fuel power plants and grids as well as energy research and efficiency should be better interlinked. Only supporting the development of individual technologies would not solve the problem. Integration into the overall system will be crucial. Industry therefore calls for a distinct control system and comprehensive, market-oriented and solid management of the "energy turnaround" project.

What the EU 2050 climate target and the German "energy turnaround" have in common is that they are both not only linked as regards the content but both need very prompt, clear and predictable implementation processes. Aligning these processes will be of greatest importance, particularly for Germany with its particular energy policy position, as both targets may well otherwise not be achieved.

In Germany the entire ETS auctioning revenues go to the Energy and Climate Fund (EKF). Of these revenues, funds totalling up to EUR 500 million/annum are earmarked to compensate ETS-related electricity price increases. Electro-mobility and the modernization of the building stock are also financed by ECF funds. At the time of the political commitment one assumed the allowances would cost around 17 €/t. Reliably and continuously financing important elements of the energy turnaround through a fund with, by definition, fluctuating revenues (auctioning/EU ETS) is extremely problematic. If the prices remain relatively low (at present approx. 7 €/t) or if they fall even further, limited funds would be available from the ECF. However, the policy-makers agreed on the funding for electro-mobility and renovating buildings independently of the ECF, and funding should therefore on principle not be linked to the ETS auctioning revenues.