

## EUROFER's response to the Consultation on structural options to strengthen the EU Emissions Trading System.

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On 7 December 2012 DG CLIMA launched a public consultation seeking to collect views from stakeholders and experts on the structural options and views reflected in the report "The State of the European Carbon Market in 2012". EUROFER welcomes this opportunity to express its opinion on the issue.

### Main message

EUROFER believes that the Commission's first Carbon Market Report is getting the wrong end of the stick. The carbon market is functioning and EU ETS operators have integrated carbon costs as a part of their production constraints. The EU mitigation target will be met and today's low carbon price just means that it will be met at a low cost for the entire economy.

Cost-effectiveness was a key-principle behind the development of market-based instruments under the Kyoto Protocol. In this context, the 6 options for structural measures put forward in the report constitute a U-turn.

Today's low carbon price is the consequence of a combination of factors:

- an enduring economic crisis
- the emission cap
- incoherent targets (impact of renewables and energy efficiency policy on the energy systems)
- energy efficiency improvements by energy users

The causes of the currently low carbon price are known. With the Carbon Report, the Commission misses an important opportunity to address them adequately.

EUROFER is opposed to any measure that would either increase the 2020 target and/or boost up carbon and power prices. Given the investments required and the corresponding lead times, the time horizon is too short for such measures to have meaningful effects on the steel sector. On the contrary, the proposals will drive up power prices and ETS compliance costs, consequently weakening the competitive position of the industry.

Climate policies made in isolation from the rest of the world and leading to unilateral cost increases will not put the EU economy on track towards a cost-effective decarbonisation.

Instead the EU should look forward and prepare a fundamental reform of the EU ETS as soon as possible with view to the period after 2020, which is just eight years from today. Until a comprehensive global agreement on climate change ensuring a level playing field is achieved, such a reform needs to be designed so as to protect the manufacturing value chains in Europe. It must rely on measures which are technically feasible and economically viable for the sectors involved.

## **Brief overview of the steel sector and the challenges it is facing**

This submission reflects the position of EUROFER which represents 100% of the European Iron and Steel industry.

Steel making is a carbon and energy intensive activity characterized by huge amounts of process emissions. It is worth recalling that the EU steel makers operate in a highly competitive global market (the EU is the first steel importing region in the world but also the third exporting one). EU steel makers managed to remain competitive, as well in terms of cost as in terms of quality, through a continuous process of investments in cutting-edge equipment, research and restructuring.

EU steel makers are leaders in their sector. Since 1970 the EU steel industry has reduced its emissions by about 50% per tonne of steel produced. The main drivers for this development were the improvement of processes and change of raw materials, material efficiency at all steps, and the increase of scrap recycling. At this point in time, the potential to further reduce material input, energy use and CO<sub>2</sub> emissions is tiny because the industry operates close to its physical limits. The data collection for the ETS benchmarking exercise has shown that the CO<sub>2</sub> mitigation potential for steel is, on average, only about 10 %. The effort required to meet even the 2030 Commission Roadmap milestone would already need the deployment of cost-intensive, yet unproven breakthrough technologies.

Against this background, EUROFER wishes to insist that any anticipated increase of the EU ETS 2020 emission target or increase in the carbon price would create an unjustified supplementary burden on the EU economy and in particular the steel industry.

**Impact of options a (increasing the EU reduction target to 30% in 2020), b (retiring a number of allowances in phase 3) and c (early revision of the of the annual linear reduction factor) on**

- **emission reductions**

Options a, b and c are equivalent to a reduction of the cap. EUROFER is opposed to such a decision. The 2020 Climate and Energy Package makes it clear that any strengthening of the target has to be conditional to similar efforts by third countries. It is unlikely that there will be any legally binding global agreement entering into force before 2020. Therefore globally distortive direct and indirect CO<sub>2</sub> costs will continue to weigh on energy-intensive industries until then. In these conditions, increasing the EU ETS cap either by changing the cap itself, the linear reduction factor or retiring allowances from the market will make the situation worse for our industry.

Furthermore, in the instance of an increased scarcity of allowances, the corresponding reduction of emissions is unlikely to take place in our sector by means other than companies abandoning market shares to foreign competition. As a matter of fact, as pointed out in the previous section, a lot has been done in the past, potentials left are scarce and new technologies are needed. 2020 is around the corner and only incremental changes are expected to take place.

In May 2010, the European Commission presented an analysis of the costs, benefits and options for moving beyond the EU's greenhouse gas reduction target for 2020 from 20% below 1990 levels to 30% and concluded that the conditions to strengthen the target had not been met. In the meantime, nothing happened that would justify increasing the effort. There is no global climate agreement and the economic crisis has dramatically deepened.

In the persistence of asymmetric carbon costs the EU must stick to the 2008 agreement and leave the 2020 target unchanged.

- **ability of the EU ETS to meet the EU long-term target of an 80-95% reduction in a cost-effective manner**

The current emission reduction potential of the EU steel industry is around 10 % with the existing technologies (specific energy consumption and CO<sub>2</sub> emissions have decreased sharply over the past four decades and the improvement potential left is limited as the sector is getting closer to the processes' physical limits). Going further than this will require breakthrough technologies (e.g. the technologies developed under the ULCOS project) possibly combined with CCS. A recent study by the Joint Research Centre<sup>1</sup> estimated the reduction potential of specific CO<sub>2</sub> emissions in the EU steel industry between 2010 and 2030 as ranging from 15% to 19% under respectively a 100€ and 200€ allowance price scenario, and this assuming that CCS is available as from 2020. It can therefore be concluded that:

- it is technically not feasible for the sector to meet the current pathway enshrined in the EU ETS of 21% CO<sub>2</sub> reduction by 2020 and of 34 to 40% by 2030 (meaning 43-48% CO<sub>2</sub> reduction by 2030 for the ETS sector<sup>2</sup>) even if the ULCOS technologies and CCS proved to be viable and rapidly deployed on a broad industrial scale
- carbon pricing will not drive the huge investment needed to decarbonise the sector
- in the context of increasing global competition and ever decreasing profit margins, such technologies are unaffordable

In other words the technologies involved under too ambitious reduction targets will demand huge and sustained risky investments while at the same time increasing operating costs without giving any competitive advantage to industry, should the EU adopt such targets unilaterally. Unlike investments in energy efficient technologies or process control which can be paid back after a limited period of time, the breakthrough technologies under consideration for the steel sector will, if implemented, deteriorate the competitive position of the EU steel industry.

Although carbon pricing could lead to substantial low carbon investments in the power sector where alternative technologies are available without entailing global competition issues, it is unlikely to give comparable results for steel. Instead sound and coherent long-term climate, energy and industrial policies are needed to address the huge challenges the 2050 objective would incur. These policies should be based on sectoral bottom-up assessments in order to best address the technical-economical capabilities and competition challenges the industry sectors are facing.

- **the steel industry's activities, including estimated changes in compliance and administrative cost**

EUROFER doesn't see the 6 options under consideration having any significant impact on administrative costs (which are mainly stemming from the monitoring and reporting obligation).

As far as compliance costs are concerned, benchmarks-based free allocation will cover only a part of the operators needs. In principle under a BAU scenario 95% of the operators will face a

<sup>1</sup> <http://publications.jrc.ec.europa.eu/repository/handle/111111111/26669>

<sup>2</sup> See Table 9 of the proportionate Impact Assessment accompanying the Communication on the Roadmap for moving to a Competitive Low Carbon Economy by 2050.

shortfall in allowances because benchmarks are set at the average of the best 10% of the benchmarking curve. It's worth stressing that the benchmarks for the integrated route as set out in Commission decision COM 2011/278/EU are technically unachievable, meaning that contrary to what was intended by the EU ETS Directive, the level of free allocation derived from the benchmarks will create a structural deficit of allowances in the sector even for best performers. Any measure meant to drive up the carbon price will make the situation worse for our sector. Measures potentially affecting the level of free allocation through the cross-sectoral reduction factor will decrease the amount of free allocation and therefore increase compliance costs (options a and c).

The surpluses, which reflect the harmful consequences of an enduring crisis, could have a cushioning effect. However they may vary significantly from one operator to the other, depending on which market he supplies and how it is being affected by the economic crisis. In any case, the value of the surpluses only partly offsets the cost of the crisis and should in no way be perceived as a profit. Since the so-called oversupply in allowances is due to the economic crisis, it would be unwise to respond to it with a measure jeopardizing the competitiveness of the industry.

Higher carbon prices will inevitably result in higher power prices. This will damage the competitiveness of electricity-intensive industries (in particular the Electric Arc Furnace steelmaking route based on steel recycling) and increase their exposure to carbon leakage.

- **employment and households**

The effect of the proposed measures on the households' budget will have an impact on final consumption. Higher carbon prices will be passed on power prices and affect the final user's ability to buy goods. This will in turn slow the economy further down. The same effect on industries exposed to foreign competition will be more pronounced and lead to decreased activity and lay-offs. The order of magnitude of these effects is very difficult to estimate. The measures put forward in the report will come on top of other elements - most notably higher energy prices compared to our competitors - explaining why the EU production in energy intensive products is already leaking abroad together with the corresponding CO<sub>2</sub> emissions<sup>3</sup>.

It is incomprehensible that this perspective is not really being addressed in the current political debate, just as if high carbon prices were more important than the fight against energy poverty and more generally unemployment.

### **Comments on option d: Extension of the scope of the EU ETS to other sectors**

In principle, broadening the scope of the EU ETS to other sectors would decrease the overall abatement costs (provided that any regulatory overlap is avoided). However including in the scheme sectors resilient to carbon abatement measures will just drive the allowance price up. So extending the scope of the EU ETS to this end only is quite questionable. The same can be said about the linking with emission trading schemes in third countries.

### **Comments on option e: Use access to international credits**

International credits have delivered substantial CO<sub>2</sub> reductions in countries with no carbon constraints. They constitute a good means to spread the low carbon culture and involve in the fight against climate change countries that would otherwise only do little in terms of mitigation

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<sup>3</sup> A. Brinkley, S. Iess (October 2010), Carbon Omissions, Policy Exchange, research note,

action. It should also be noted that the linking of the EU ETS to similar schemes in other regions could also result in allowances being imported or exported depending on the carbon price difference. What really matters in the end is concrete and effective mitigation action made at the lowest cost. It was on this premise that market-based instruments were developed under the Kyoto Protocol.

Restricting the use of such credits in the EU ETS would give the wrong signal to the countries hosting the projects and put the CERs market at risk, substituting one problem with another.

EUROFER acknowledges that international crediting schemes raise a number of questions, in particular as regards competition issues (they could be used to finance competition in third countries beyond the mere CO<sub>2</sub> mitigation goals) and that they should be improved, most notably in terms of transparency and integrity.

To conclude, international credits should be used for what they were initially meant: broadening the fight against climate change and cut global emissions by tapping cheap CO<sub>2</sub> emission reduction potentials in non-carbon constrained economies. There is more to lose by abandoning this very important feature than there is to gain from a higher EU ETS carbon price.

### **Comments on option f: Discretionary price management mechanism**

EUROFER accepted the EU ETS on the grounds that it could potentially be a cost-effective way to meet an emission reduction target without distorting too much competition because of asymmetric CO<sub>2</sub> policies. However as pointed out earlier in this paper<sup>4</sup> the EU ETS has failed to fully deliver on domestic CO<sub>2</sub> reduction as 'CO<sub>2</sub> imports' have continued to rise since its implementation.

The introduction of a carbon price management mechanism or a carbon price management reserve would alter dramatically the very nature of the EU ETS. Setting an explicit carbon price objective - obviously above what it should really be - will no longer make the system cost effective (the carbon price should reflect the lowest marginal abatement cost of the economy).

It is worth stressing that a low carbon price makes the EU ETS an affordable mitigation tool for the economy (the EU ETS is by far more acceptable to most with a low carbon price than with a high one). The introduction of a minimum carbon price objective will leave the EU ETS with all the negative features of a tax, just what it was supposed not to be. Furthermore there is abundant literature demonstrating on the contrary that price floors lead to a mismatch between demand and supply, making such a measure not fit for purpose.

The EU ETS can only be cost-effective if market forces do the work. Any carbon price resulting from a political decision will be counter-productive.

### **EUROFER comments on the functioning of the EU ETS**

Repeated piecemeal intervention discredits the EU ETS and turn away investors. The industry needs planning certainty. EUROFER therefore calls for an open and encompassing debate on the post-2020 policy framework in order to best address the environmental and competition challenges the EU economy will be facing. Long-term structural measures for the period after 2020 are required. They should imperatively reconcile the sustainability objectives of the EU

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<sup>4</sup> Glen P. Peters, Jan C. Minx, Christopher L. Weber and Ottmar Edenhofer (2010), Growth in emission transfers via international trade from 1990 to 2008 (PNAS)

with the need to protect its industrial competitiveness on a global scale. In this regard, EUROFER would like to point out that:

- ✓ The total direct EU CO<sub>2</sub> emissions have decreased and the EU is on its way to meet its Kyoto commitments. However various studies showed at the same time that this decrease in emission has been more than offset by the emissions relating to imports. In other words, even more CO<sub>2</sub> is being emitted outside the EU as a consequence of relocation of production and growth.
- ✓ Despite all the efforts made, the EU has not yet managed to secure a global deal which would ensure all major regions in the world take part to the CO<sub>2</sub> mitigation efforts. Even worse, global CO<sub>2</sub> emissions are increasing and projections show they won't peak anytime soon whilst ever more pressure is put on the EU industry.
- ✓ Higher power prices which are a consequence of the EU's Climate Change policy (direct CO<sub>2</sub> costs, CO<sub>2</sub> costs passed on power prices, costs of the renewable policies) are jeopardizing the competitiveness of the EU industry and weighing on final power consumers. So far the EU has failed setting up appropriate remediation measures (the financial compensation scheme will at best alleviate partially indirect CO<sub>2</sub> costs for some sectors).
- ✓ The linkage of the EU ETS with third countries' schemes might undermine the consistency of the EU Climate and Energy policy as long as there is no equal treatment between installations.
- ✓ In times of economic downturn the ETS cap leads to allowances surpluses and depressed carbon prices. Responding with even more ambitious targets unfairly puts under pressure industrial sectors which have to struggle with adverse economic conditions and at the same time counter attempts to raise the carbon price and accusations of profiting from the system.

These major flaws need to be addressed. If not, they will be exacerbated in the future as mitigation objectives will get more and more harsh. The EU prosperity relies on a strong, competitive, energy and resource efficient industrial base. That's why EUROFER is convinced that an unbiased re-cast of the EU climate and energy policy is required in order to meet long-term ambitious mitigation objectives whilst maintaining at the same time a decent level of competitiveness of our economy. A quick fix to the EU ETS is not the answer. It's not just all about the EU ETS.

The work initiated with the Roadmap to a Low Carbon Economy by 2050 has to be complemented by sectoral roadmaps: such roadmaps must determine what is technically feasible in an economically viable way in terms of CO<sub>2</sub> mitigation and in which timeframe. To be successful the EU post-2020 climate and energy policy must build on such bottom-up approaches which best capture the reality and specificities of the industrial sectors. The current carbon price level reflects the poor state the EU economy is in. It also reflects the increasing investments in renewable energy the costs of which are mainly borne by energy users. Ambitious long-term objectives require a drastic change of philosophy and the broad support of industrial sectors facing different challenges and with varying emission reduction potentials. A successful climate and energy policy is an affordable one.

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*Represented by EUROFER, the European steel industry is a world leader in its sector with a turnover of EUR 170 billion and direct employment of 360 thousand highly skilled people, producing on average 190 million tonnes of steel per year.*

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*Contact: D. Valenti, [D.Valenti@eurofer.be](mailto:D.Valenti@eurofer.be), +32 (0)2 738 79 33*