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BUSINESSEUROPE response to the consultation on ETS post-2020 carbon leakage provisions

1. Introduction

This paper outlines BUSINESSEUROPE response to the public consultation on post-2020 carbon leakage provisions under the EU Emissions Trading Scheme (ETS). As BUSINESSEUROPE believes a coherent reform of the EU ETS post-2020 is needed, this paper addresses not only carbon leakage measures, but it also comments on other elements such as the Market Stability Reserve (MSR) and the role of the ETS in the wider climate and energy framework. Further information about BUSINESSEUROPE positions regarding the 2030 climate and energy package is available on our dedicated web pages.

European businesses have consistently called for a stable and predictable legislative framework that effectively combines EU climate ambition and EU industrial competitiveness, indispensable for investments. In March 2014, EU leaders have called on industrial competitiveness to be systematically mainstreamed across all EU policies in view of getting a stronger industrial base in the EU. This competitiveness mainstreaming must be a predominant objective for the reform of the ETS post-2020 as long as no comparable efforts are undertaken in other major economies.

2. Making decisions in the right order

Instead of a piecemeal approach, a genuine reform of the EU ETS with an improved carbon leakage support must take effect post-2020. Since the future of the ETS and international competitiveness are closely interconnected, BUSINESSEUROPE believes the MSR proposal should be finalised, in conjunction with a legislative proposal containing new compensation measures for direct and indirect costs, in light of the outcome of the 2015 Climate Conference in Paris. Only then should Europe be able to make a final decision on the level of ambition for the 2030 GHG emissions reduction target and particularly for the 43% ETS target. Non-ETS sectors, which make up for more than half of current emissions, should be addressed more systematically in order to further improve the functioning of EU's efforts.¹

¹ Agriculture in particular could mitigate up to a third of current EU GHG emissions (e.g.: through agroforestry techniques). Additionally, a large share of energy efficiency and GHG reductions potentials are also untapped in the buildings sector.

BUSINESSEUROPE favors an EU-wide market-based approach with a strong ETS as the main instrument to reduce emissions for industry and other covered sectors and to promote investments in low carbon technologies.

In order to make the EU ETS 'fit-for-purpose' from 2020, industry remains convinced that rather than tweaking the system, a bottom-up structural reform is required. Notably, in the absence of a global level playing field for business activities in terms of direct and indirect carbon expenditures, stronger measures will have to be taken at EU level to safeguard industrial competitiveness and avoid investment leakage.

3. Scaling-up carbon leakage provisions

Addressing carbon leakage is inextricably linked to the EU ETS reform and is crucial for the growth of EU business. For this reason, reforming the ETS must not be seen as a stand-alone piece of legislation but needs to be carefully weighed against the need to ensure industrial competitiveness while avoiding carbon and investment leakage, as long as no global level playing field is achieved with a binding global agreement providing comparable efforts.

Review carbon leakage list

BUSINESSEUROPE welcomes the Commission decision to maintain the current carbon leakage list up to 2020. However the current definition of carbon leakage has proved insufficient to address industry's competitiveness exposed to international competition. A strengthened approach to what is meant by displacement due to asymmetrical climate policies should encompass the broader notion of investment leakage. As agreed in the new Environmental and Energy Aids Guidelines, it should go beyond the carbon price by factoring other elements in the definition such as the cost impact of overlapping climate measures, notably subsidies to renewable energy and energy efficiency policies.

Compensation for direct costs

For sectors at risk of carbon and / or investment leakage, full compensation through free allocation based on benchmarks must allow the most efficient European companies to be globally competitive without being penalized by direct carbon costs. The existing allocation system based on historical production has proven to be too inflexible. Real/recent production levels – combined with economically and technically feasible benchmarks – should be considered as an option for the allocation of free allowances in order to provide better protection against carbon leakage and to avoid problems deriving from over or under allocation.

Therefore, a "dynamic allocation model" based on realistic benchmarks and actual production should be further explored. In the absence of an international agreement,

allocation based on historical production and the application of the cross-sectoral correction factor harm competitiveness and encourage production and investment to take place outside the EU.

Compensation for indirect costs

It is of equal importance to handle the indirect effects, occurring from the pass-through cost of carbon into the electricity price. Compensation must be given in relation to actual costs passed-through before and beyond 2020. The current framework only sets maximum compensation levels allowed through state aids guidelines, and it is voluntary for each Member State to give this compensation generating competition distortions. It is therefore necessary to set mandatory EU compensation measures to achieve full offsetting of indirect costs in all Member States. Especially in the case of an increasing EU carbon price, this should be developed through a harmonised EU approach using specific mechanisms, such as the use of auctioning revenues or additional free allocation rather than through state aids rules.

Avoid the Correction-factor (C-factor)

The current free allocation system of allowances based on benchmarks combines the need for competitiveness (free allowances) and for incentives in reducing GHG emissions (benchmarks). For the future, post-2020, European industrial growth will be best supported if there will only be the overall ETS cap and free allowances volumes are based on actual production rather than on historical data. In other words, if from 2020, there is no C-Factor as now, which applies in addition to the overall ETS cap. This could be done for example through dynamic allocation.

If the current ETS rules were maintained up to 2030, the C-factor would have as consequence that even the most CO₂-efficient companies would be up to 40% short yearly on their needs for emission allowances. This would prevent the sustainable growth of manufacturing industry in Europe and the achievement of the industrial renaissance goals.

4. Addressing carbon price volatility

While the proposed MSR under the EU ETS opens the debate on possible measures to deal with the volatility of EU emission allowances prices post-2020, it exclusively aims at tackling this particular challenge. The ETS cap should provide an incentive to drive emissions down rather than the prospect of a high carbon price. Any mechanism to address carbon price volatility must constitute the most cost-effective solution and provide enough predictability on the responsibilities of decision-makers to minimize the risk of politicisation of the carbon market and on the impact of the reserve on the carbon price. Regarding the proposal at hand, evidence that this reserve constitutes the most cost-efficient option to address carbon price volatility needs to be

indisputable. In addition, several aspects of the mechanism design need to be further considered, notably:

- The percentage to withdraw and release allowances from the reserve;
- The number of allowances proposed as a threshold for oversupply;
- The lack of flexibility of the reserve to react to market changes;
- The feasibility of co-existing with an allocation supply reserve.

5. Using the EU ETS as an innovation driver

All ETS auctioning revenues should be used more cost-effectively and efficiently to assist the decarbonisation of European industry without impairing its international competitiveness. The ETS directive states that half of auctioning revenues should be spent on decarbonisation measures. This has not been the case so far, a missed opportunity to pursue an active industrial policy. The other half should be used, in a coherent EU-wide approach (see section 3 on compensation for indirect costs) to prevent carbon leakage.

Both Member States and the European Commission should go beyond Horizon 2020 and assess a breakthrough technology programme for innovation in energy intensive industry, partly funded by the revenues from the EU ETS. Creating innovation programmes in a structured way around industrial sectors would create a necessary missing element in the climate package. In the 2030 Communication, the Commission announced the concept of an expanded NER300 scheme that should be explored as a means of directing revenues from the ETS towards the demonstration of innovative low carbon technologies in the industry. An improved successor to the NER300 needs to be followed up in the framework of an EU ETS reform.

However, the EU ETS has been primarily designed as a tool to reduce emissions in the most cost-effective way and should not be considered as the *only* innovation driver. Policy-makers should refrain from raising the costs of decarbonisation policies in order to increase revenues that would otherwise be needed to addressing those costs. A more targeted use of all financial instruments at EU level and a more industry-focused low carbon technology R&D programme are essential to drive innovation. Therefore it will be indispensable to identify and open up other sources of public funding and support, which are utterly independent from the EU ETS, in order to provide the resources and predictability required for meaningful R&D&I investments in low-carbon technologies and the transition towards a low-carbon society.

BUSINESSEUROPE looks forward to working constructively with the European institutions to build on these comments to improve the EU ETS resilience while ensuring that industrial competitiveness and growth become a policy imperative for the incoming EU political cycle.

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