EUROFER
The European Steel Association

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EUROFER's response to the consultation on review of the auction time profile for the EU Emissions Trading System.

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On 25 July 2012 the Commission launched a public consultation seeking to collect views from stakeholders and experts on a draft for a future amendment of the Commission Regulation (EU) 1031/2010 (Auctioning Regulation), including on the amounts of auctioned allowances which should be postponed towards the end of the third trading period (so called back-loading of allowances). EUROFER welcomes this opportunity to express its views on the issue as well as on the proposed modification of the EU ETS Directive.

Main messages:

- The purpose of the proposal is unclear (the notion of 'orderly functioning of the market' is vague) and the suggested measures are likely to be ineffective, bringing no benefit at all. On the contrary:
  - The proposal blatantly underestimates the effects of the measures on the industry and the power consumers in general. Rising electricity prices due to a higher carbon price will destroy value and hamper the economic recovery.
  - The proposal is against the fundamentals of the EU ETS Directive. Cost-effectiveness is at the core of the EU ETS and therefore low carbon prices should be supported as they make the scheme affordable for the industry.
  - Piecemeal intervention in the market will hamper predictability and not reinforce it. In that sense, the proposal infringes a core principle of the EU ETS Directive.
  - The political process could lead to the re-opening of other elements of the EU ETS which will create instability.
- The proposal may pave the way for a permanent set-aside of allowances. EUROFER is opposed to a change of the 2020 EU ETS target by cancelling phase III allowances or by any other means. Energy-intensive industries cannot adjust to more ambitious targets at short notice. The EU must stick to the 2008 Climate and Energy Package and the conditional 2020 targets.
- Instead the EU should look forward and base its post-2020 climate and energy policy on sectoral roadmaps relying on technical feasibility and economic viability. This must be done taking into consideration emissions reduction commitments by third countries so as to secure level playing field. Any unilateral action by the EU is ill-fated as it will destroy further the competitive position of the EU industry and have no impact whatsoever on global emission reductions.

Therefore any discretionary intervention by the Commission in the market must be banned and the EU ETS Directive should not be revised.

The declared purpose of the proposal (back-loading) is unclear

The EU ETS is facing a depressed demand in allowances because of the economic crisis. The Commission proposed to address this by i) putting forward a Decision to "clarify" the provisions of the Directive governing the EU Emissions Trading System (EU ETS) on the timing of allowance auctions and ii) proposing an amended version of the Auctioning Regulation with more flexibility on the timing of allowances. The alleged purpose is to reduce what is being understood as an imbalance between supply and demand by postponing the auctioning of a certain volume of allowances towards the end of the third trading period. Such a measure would in principle be meant to act on carbon prices although this intention is not explicitly mentioned by the Commission in the papers accompanying the proposal. This is rather strange as the amount of allowances which should be back-loaded would depend upon a pre-defined carbon price one has in mind (this would thus be like promoting a carbon price floor and have the character of a tax).

In this context, EUROFER is very surprised when the Commission says under Question 11 of the Q&A accompanying the proposal that "the purpose of back-loading is to improve the functioning of the carbon market, and not to increase the price", adding further that "market analysts confirm that any short-term price increases are expected to be rather limited if not accompanied by a structural measure".

Although should the objective of back-loading be to have a steady carbon price throughout the third trading period (which has some merit), EUROFER wishes to recall that hedging instruments (financial derivatives) have been developed to allow stakeholders to hedge their position and create a more stable environment for decision making. Piecemeal intervention by the Commission will on the contrary increase volatility and make market players more nervous.

Furthermore the proposed addition to the EU ETS Directive ("the Commission shall, where appropriate, adapt the timetable for each period so as to ensure an orderly functioning of the market") is all but clear. The notion of "not orderly functioning market" should have been defined. The existence of a carbon price means that demand meets supply and this condition only is sufficient for the carbon market to be deemed as functioning orderly. It is wrong to say there is an oversupply in allowances when supply meets demand.

With objectives which are not clearly defined and measures which seem ineffective on the one hand, and a market which is clearly well functioning, EUROFER believes that the proposal is ill-grounded and irrelevant.

The proposal goes against the fundamentals of the EU ETS

The EU ETS is a market-based instrument relying on the "make or buy" approach. Operators taking part to the EU ETS can either take measures to reduce their CO_2 emissions (by decreasing their fuel consumption through appropriate investments or by lowering their activity level) in order to avoid the cost relating to corresponding allowances or buy allowances to cover their CO_2 emissions. In theory, the allowance price corresponds to the lowest marginal abatement cost within the system and is determined by the total mitigation objective (21% CO_2 reduction between 2005 and 2020 for the ETS sector).

The allowance price is set when supply meets demand, regardless of its level. However it has to be acknowledged that a lower carbon price makes the system more affordable, the mitigation objective being met at a cheaper cost. Cost-effectiveness being a key-feature of the EU ETS, provisions were introduced in the EU ETS Directive to cater with high carbon prices (art 29a gives a definition of a high allowance price and suggests measures to bring it down). EUROFER believes that the proposed addition to the EU ETS Directive ("the Commission shall, where appropriate, adapt the timetable for each period so as to ensure an orderly functioning of the market") is in contradiction with the spirit of the directive and will undermine the application of article 29a, a low carbon price being an implicit objective of the EU ETS Directive.

It is also worth stressing that as highlighted by art 10.4 of the EU ETS Directive predictability is a prerequisite for the proper functioning of the market. Predictability means that the amounts of allowances auctioned and the timing of the auctions are known in advance. Interventions by the Commission in the carbon market will be in conflict with this requirement.

The proposed addition to the ETS Directive will also be in conflict with its Article 9 which provides for a linear decrease in the quantity of allowances issued each year: "The Community-wide quantity of allowances issued each year starting in 2013 shall decrease in a linear manner beginning from the mid-point of the period from 2008 to 2012.The quantity shall decrease by a linear factor of 1,74 % compared to the average annual total quantity of allowances issued by Member States in accordance with the Commission Decisions on their national allocation plans for the period from 2008 to 2012."

Moreover, the fact that the carbon price remains at low levels is not only a consequence of the economic crisis and the subsequent decrease in industrial production but it is also due to the bleak economic outlook. Given the wide variety of parameters impacting the carbon price and keeping in mind that the carbon price signal is just one among many parameters in investment decisions (like e.g. energy efficiency improvements, market conditions, fuel price forecasts,…) an intervention in the market to address any imbalance seems highly presumptuous. Again hedging instruments (financial derivatives) are here to help operators hedge their carbon costs. On the contrary repeated interventions of the

authorities to prop up carbon prices and costs will inevitably result in a loss of confidence in a system which is supposed to get us to the target at the lowest cost for the economy.

In this context, the legality of the Commission proposal is highly questionable.

The proposal underestimates the impact on the industry

By stating in Question 11 of the Q&A that "*not only does the change in the auction time profile not affect the total amount of allowances to be auctioned (it only affects the timing of auctioning), it would not impact the amounts of free allocation to industry. Furthermore, many industries actually have a surplus of allowances allocated for free which would alleviate also part of any cost impacts*" the Commission overlooks the consequences of such measure on the industry:

- Higher carbon prices will inevitably result in higher power prices. This will damage the competitiveness of electricity-intensive industries (in particular the EAF steelmaking route based on steel recycling) and increase their exposure to carbon leakage.
- Free allocation covers only a part of the operators needs because they are based on benchmarks. In principle under a BAU scenario 95% of the operators will face a shortfall in allowances because benchmarks are set at the average of the best 10% of the benchmarking curve. Furthermore it's worth recalling that the methodology used by the Commission to set the integrated route benchmarks makes them technically unachievable (natural gas equivalent subtracted from the waste gases carbon intensity).
- Surpluses 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 is way below of the cost of the crisis. As matter of fact, the cost of the crisis has to be added to the value of the surplus. Higher carbon prices will deteriorate the overall position of industrial players.
- 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.

The Commission statement is also misleading in that it implies that the power sector will be the only sector affected by the proposal. On the contrary their ability to pass on indirect CO2 costs will at worst leave them unaffected. Due the power price setting mechanism, many utilities will enjoy higher profits from a higher carbon price.

Back-loading will bring no benefit

The objective of the ETS is to meet the CO2 emission target at the lowest cost for the economy. In this regard, the back-loading of allowances towards the end of the period will bring no environmental benefit since the emissions are capped.

On the contrary, as mentioned above, increasing scarcity in the beginning of the third trading period will increase the impact of direct and indirect CO2 costs on the industry, in particular energy-intensive industries, which may result – depending on a number of factors – in carbon leakage.

Recent studies have shown that the quantity of carbon embedded in imports has increased dramatically over the last years, exceeding by far the reduction in domestic emissions. By increasing the carbon leakage risk, this trend will be exacerbated, leading to more global emissions.

A debate on the post-2020 policy framework would be more productive than proposing new structural measures

The Commission will publish later this year a report on the functioning of the EU ETS and finalise the options for long-term structural measures. EUROFER understands that by doing so the Commission acknowledges that back-loading measures might not be enough and intends withdrawing allowances definitively from the system by cancelling them. If this is proved to be the case, then the back-loading of allowances would just be a means to buy time and 'freeze' allowances before cancelling them in a later stage.

EUROFER is opposed to such tactics which would bypass the 2008 Climate and Energy Package objectives and change the EU ETS 2020 target through the backdoor without addressing the non-ETS sector.

EUROFER believes that incentives for emission reductions must come from transparent and explicit political agreements on the overall cap on emissions, and not from repeated interventions in the carbon market. Repeated attempts to alter temporarily or permanently the 2020 target would reduce predictability for industry and the credibility of the EU ETS.

If the problem, as pointed out by some stakeholders, is that the current carbon price is too low to incentivise investments in low carbon technologies and thus risks to lock the EU into carbon-intensive infrastructures for the decades to come, then the whole policy framework has to be revised because long-term investments need a long-term policy framework (with the possibility to bank allowances from one period to the next one). Tinkering with the EU ETS and especially the timing of auctions will prove useless (given the mismatch between the proposal timeframe and time when such investments will become effective, it will have little or no impact at all on decisions for low carbon investment in the power sector or manufacturing industry).

Steel, as many other energy intensive industries, has very long life-cycle investments, often spreading over several decades. In this context, 2020 is already too close to envisage being able to meet a more ambitious target in such a tight time-frame, and in the absence of economically viable alternative technologies. The investments needed to meet EU's post 2020 objectives are not likely to be driven by a short-term carbon price, let alone an artificially manipulated carbon price. High carbon prices could also in certain circumstances prevent investments because of the deterioration of the global competitive position and the resulting pressure on profit margins. **Therefore the EU must stick to its commitment to go beyond its overall 20% reduction target only in case of an effective global agreement on climate change.**

For these reasons EUROFER believes that the debate should instead move to the post-2020 climate and energy policy framework. CO2 mitigation challenges for our industry must be tackled in a **long-term perspective**, taking into consideration **technical feasibility and economic viability** in conjunction with **third countries' commitments** to effectively reduce CO2 emissions in a comparable way so as to maintain **level playing field towards** third countries.

The linking of the EU ETS with other national schemes brings more complexity

The recent announcement that the EU ETS will be linked with the forthcoming Australian ETS raises a number of questions. While linking the EU ETS with third parties' schemes should in general be supported as a means to promote effective global mitigation efforts and reduce carbon costs-related competition distortions, the consequences of linking schemes which rely on a different set of targets and rules should be carefully assessed. In view of the differences in allocation methodology, cap setting principles and marginal mitigation costs, the first visible consequence of the recent arrangement between the EU and Australia is likely to be an increase in EU allowances demand driven by Australian companies entering the market to cash in on the allowance price difference. This will in reality reduce the number of allowances available for the EU operators, indirectly decreasing the EU cap and driving the EU carbon price up, with all the detrimental consequences on the EU business listed above.

Furthermore, the linking also implies that decisions made about the Australian ETS which have an effect on the operators' position (like e.g. the stringency of the cap which in Australia is adjusted yearly 5 years in advance or the free allocation rules) will have an impact on the EU ETS carbon price.

This clearly adds another layer of complexity to a very complicated issue and we can hardly see how the backloading proposal could bring anything positive to that. As a matter of fact, in the perspective of a linking of the EU ETS with the Australian one, the impact on the demand in allowances makes the discussion initiated by the Commission in the Working Staff Document on the 'supply-side' of the EU ETS market totally irrelevant.

A preliminary assessment of the linking shows that linking schemes is not addressing the issue on a fair basis since differentiated targets cohabit. In order to avoid increasing carbon-costs related competition distortions (reinforced by the linkage) the ETS rules for sectors competing on global markets (leakage sectors) need to be aligned.

EUROFER comments on the functioning of the EU ETS

EUROFER 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 have to face. It's worth stressing that:

- The total direct EU CO2 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 CO2 is being emitted outside the EU as a consequence of relocation of production and growth.
- Despite all the efforts made, the EU did not manage to secure a global deal which would ensure all regions in the world take part to the CO2 mitigation efforts. Even worse, global CO2 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 CO2 costs, CO2 costs passed on power prices, costs of the renewable policies) are jeopardizing the competitiveness of the EU industry. So far the EU has failed setting up appropriate remediation measures (the financial compensation scheme will at best alleviate partially indirect CO2 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.

These major flaws need to be addressed. If not, they will be exacerbated in the future as mitigation objectives will get more and more aggressive. 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 CO2 mitigation and in which timeframe. To be successful the EU post-2020 climate and energy policy should be based on such bottom-up approaches which, contrary to 'blind' economic models, best capture the reality and specificities of the industrial sectors. Ambitious long-term objectives require a drastic change of philosophy and reconsider – sectorwise – the place of the EU ETS in the EU's climate and energy arsenal.

Cost-effectiveness was a driving principle of the EU ETS. It must remain at the core of the EU policy.