



April 2010

Response to public consultation in preparation of an analytical report on the impact of the international climate negotiations on the situation of energy intensive sectors

Introduction

Sandbag is a not-for-profit organisation focused on the issue of emissions trading. We seek to analyse and report on how emissions trading policy is working on the ground and to secure improvements so that the policy operates efficiently and effectively to tackle climate change.

Emissions trading generates a large volume of information about participants in the scheme which can be used to assess how the policy is performing. It has been clear since the start of phase II that some installations, companies and sectors have been allocated emissions allowances in excess of recent historic emissions. For the first time, in 2009, overall emissions in the EU fell below the caps set on emissions. This is partly as a result of the recession which exacerbated the already uneven distribution of allowances between combustion and heavy industry sectors.

We strongly believe that in making any assessment of the risk of carbon leakage for industries in Europe, a comparison of allocations to actual emissions must be taken into account. The degree to which actors in this market are exposed to price impacts as a result of the trading scheme is heavily influenced by whether they are in a net buyer or net seller position. Such are the extent of some surpluses, many will be in a net seller position for many years to come.

We believe the threat of 'carbon leakage' has been overstated, with little corroborating evidence to support it, and become confused with other social policy objectives concerning job retention and industrial competitiveness.

Allocation of emissions allowances by auction is by far the most efficient and effective means of distribution. We believe the current proposals to exclude the majority of sectors from auctioning are based on a flawed methodology and support the work of CAN Europe and others who have challenged the basis on which carbon leakage assessments were undertaken.

We offer the following comments in response to the specific questions raised by the Commission in its consultation document.

Response to consultation questions

1. In your opinion, how have key indicators of the risk of carbon leakage (such as exposure to international trade, carbon prices etc.) for the EU energy intensive industry changed since the adoption of the climate change and energy package implementing the EU's unilateral 20% emission reduction target at the end of 2008?

The most significant change has been the projected balance of supply and demand of permits and the corresponding reduction in the carbon price. The rapid fall in emissions in Europe as a result of the recession has led to a far smaller demand for emissions allowances than was originally estimated. The distribution of the resulting surplus in emissions allowances is almost entirely located within industrial sectors with the power sector continuing to face shortfalls in allocations.

This imbalance between projected demand and actual demand has had a negative effect on the price of carbon in Phase II although the effect would have been far more pronounced if it had not been for the continued short in the power sector. The fact that surpluses can be banked will also impact on the balance of supply and demand, and resulting price, in Phase III.

Many analysts are still predicting high prices for Phase III as they expect demand to stay firm as power companies buy forward to cover their exposure in future years, however, the exposure to this price as a cost will be almost exclusively in the power sector where they are subject to challenging targets. The industrial sectors who have already built up sizeable cushions of surplus permits and who are, in addition, able to buy in CERs and swop them for EUAs¹, will not be universally exposed to this price as a cost but rather many will experience it as a receipt for sale of spare permits.

It is very likely that certain companies are actually receiving a subsidy from being in the scheme, which confers a competitive advantage over companies in the same sector in non-capped countries. The impact of the carry over of surplus permits from Phase II and the potential for profit taking from swapping CERs for EUAs should be included in a revised assessment of the exposure of sectors to carbon leakage risks.

DG Enterprise has compiled a data set combining NACE codes with all the installations in the EU ETS to assist in carbon leakage assessments. This data set should be used to determine the volume of surplus permits arising in 2008 and 09 and projected forward for the rest of the phase. The value of these surpluses should be taken into account in a revised assessment of the risk of carbon leakage.

The table below from Deutsche bank illustrates the extent of the surplus projected for the industrial sectors which, across the phase is projected to be so large as to more than make up for the shortfall in the power sector.

¹ Many companies are taking advantage of the lower costs of CERs and using them for compliance whilst banking their EUAs. This is the case even where installations have an over-supply of EUAs and do not need to make reductions relative to their allowances.

DB projected aggregate net position of ETS sectors, 2008-12 (Mt)
before any seeling of surpluses from reserves

	Power sector	All other sectors combined	NET ETS position before unused NER allowances
Assumed net position in 2008	-180	+90	-90
Implied net position in 2009	-65	+200	+135
Implied net position in 2010	-130	+155	+25
Implied net position in 2011	-145	+144	-1
Implied net position in 2012	-140	+105	-35
TOTAL 2008-12	-660	+694	+34

Source: Deutsche Bank

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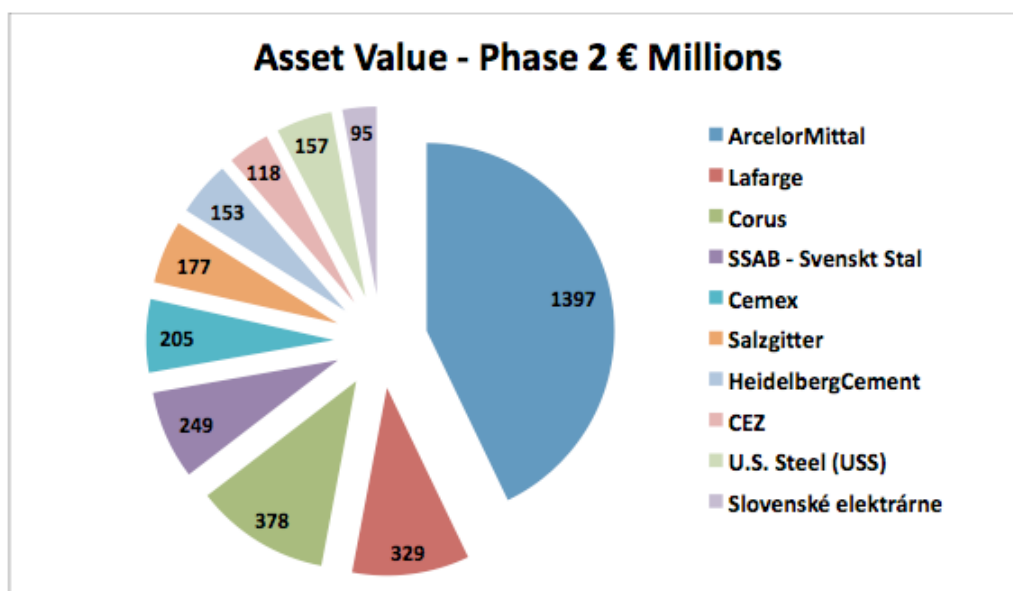
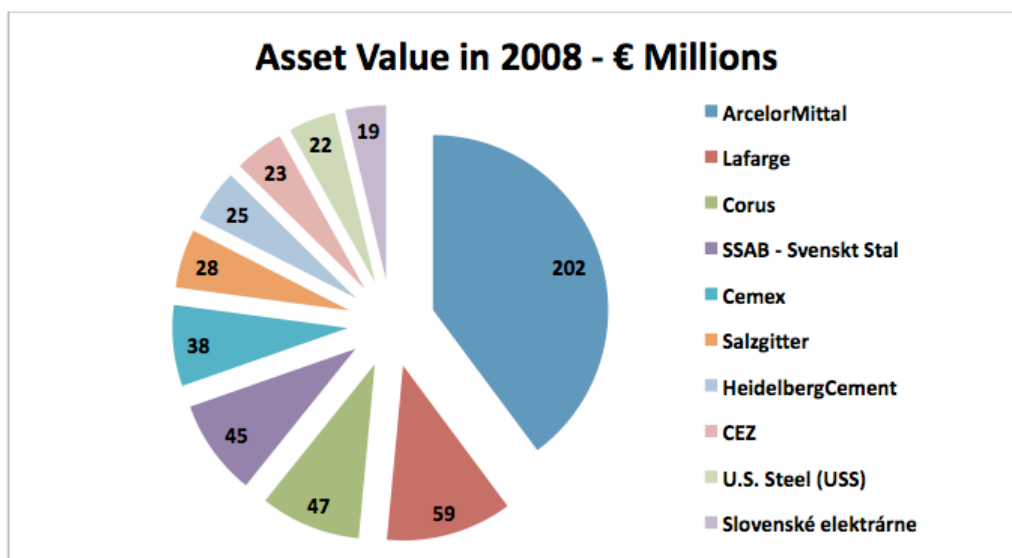
Deutsche Bank 

The table in Annex 1 of this document provides a breakdown of permit allocations compared to emissions in 2009 using the most recent emissions data release on April 1st 2010.

Our research highlights the case of international steel manufacturers Arcelor Mittal who are in the process of accruing large surpluses of permits. After taking into account the transfer of permits for the combustion of flue gases we still estimate that over the course of the second phase they will amass permits worth in the region of €1.4 bn though this was before taking into account emissions data recently released for 2009.

Lafarge have recently confirmed that in 2008 they made €140 million from the sale of spare permits.

The charts below show the value of permits held by the top 10 over allocated companies in the EU ETS. Chart 1 shows information for 2008 while chart 2 below illustrates the value of a projected surplus for the whole of phase II. We are grateful for Carbon Market Data for helping us to compile this list which we will be updating with 2009 data in due course.



For more information about the methodology used to compile these charts please refer to our full Carbon Rich List report:

http://sandbag.org.uk/files/sandbag.org.uk/carbon_fat_cats_march2010.pdf

2. *Do you think that the outcome of Copenhagen, including the Copenhagen Accord and its pledges by relevant competitors of European energy-intensive industry, will translate into additional greenhouse gas emission reductions sufficient to review the list of sectors deemed to be exposed to a significant risk of carbon leakage? If so, how and why?*

Prior to Copenhagen there were few targets on the table, since Copenhagen, 75 countries covering more than 80% of global emissions have now signed up to the

Copenhagen Accord in which emissions reduction targets for 2020 are recorded. All major economies have now adopted emissions reduction targets and many are in the process of implementing policies and measures to deliver on these targets. The EU is no longer on its own in terms of taking action to combat climate change through domestic policy.

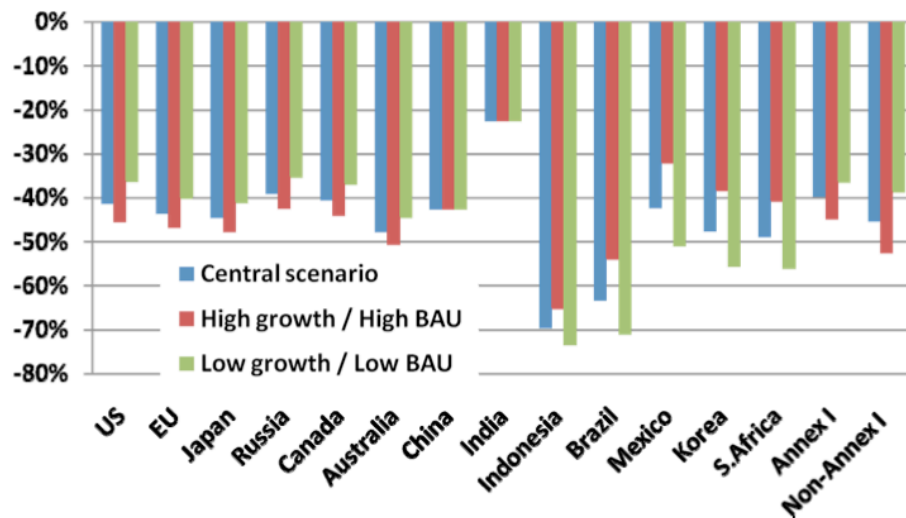
The concept of ‘carbon leakage’ arises from the contention that sectors subject to caps will relocate operations to countries without equivalent constraints on carbon. In a report commissioned by the Commission² and published in July 2009, independent consultants TNO concluded that it was impossible to determine with any degree of accuracy whether this risk was in fact real, since each case of potential relocation would need to be assessed according to individual circumstances. In many cases a move from country with a high carbon intensity to a country with a lower carbon intensity would result in emissions savings. As would the increased efficiency of newly built plant compared to the older less efficient stock in Europe.

The fact that this study is inconclusive is important as it fails to make a convincing case for carbon leakage as a result of the introduction of the ETS. The EU’s climate policy may have negative impacts on the competitiveness of some EU based industries but this is not the same issue as carbon leakage which purports to be concerned with the overall net *environmental* impact of the policy. The economic health or otherwise of European industry must be addressed through industrial policy not environmental policy.

The comprehensive coverage of countries signed up to carbon abatement targets under the Copenhagen Accord makes the risk of carbon leakage even more unlikely since all the targets on the table will require policy interventions to be achieved. Comparing targets in relation to the level of reduction in carbon intensity required to meet the targets illustrates just how close in terms of effort the targets in the Copenhagen Accord now are:

² ‘Greenhouse gas efficiency of industrial activities in EU and Non-EU’ **TNO-034-UT-2009-01420_RPT-ML**, July 2009

Emissions intensity Targeted change, % from 2005 to 2020



For mid-point of target ranges where applicable.

www.crawford.anu.edu.au

Source: Frank Jotzo, Asia-Pacific Programme, Crawford School Australia

3. *In your view, what would be a compelling new general economic or other factor which would require a change of the level of free allocation to sectors deemed to be exposed to a significant risk of carbon leakage?*

The caps set in the EU ETS Directive are not in line with the contribution the EU should be expected to make to global emissions savings. In addition, free allocations have resulted in windfall profits removing or reducing the incentive to invest in emissions reductions. In this context, the recent economic down turn and sudden reduction in emissions arising from the recession is a sufficiently compelling factor to change the level of free allocations. Companies and installations in the EU ETS will not start phase III with a blank sheet. Many will have accrued large volumes of banked permits arising from the deep cut in emissions in this phase. In 2008 emissions fell by 6% in a single year and in 2009 fell again by over 11% in a single year. The spare permits such dramatic declines generate will insulate many participants in the scheme from having to make reductions and will significantly reduce the risk of 'carbon leakage'. This was not taken into account in the initial assessments and this should be corrected.

A further compelling factor is the existence of new updated economic modeling, using the PRIMES model, taking into account recent historic emissions and revised future growth projections. These new figures have been used by the Commission to argue in favour of a reduced allocations to accession countries should they be required to re-open their NAPs. This same logic can be applied to the review of sectors exposed to carbon leakage.

4. Do you consider free allocation of allowances as sufficient measure to address the risk of carbon leakage, or do you see a need for alternative or additional measures?

The most effective way to eliminate the risk of carbon leakage would be for sectoral agreements to be negotiated in the small number of sectors genuinely exposed to competition as a result of participating in a genuinely international commodity market.

In the absence of this, the continued allocation of free allowances simply serves to undermine the economic efficiency of the EU ETS. It would therefore be far better to auction permits but to explore the provision in the Directive that allows inclusion of importers of capped products into the trading scheme, requiring them to buy permits equivalent to the requirements on manufacturers in the EU ETS.

Alternatively in order to improve the efficiency of the scheme as a whole it might be appropriate to temporarily suspend genuinely exposed sectors from the scheme, removing the ‘hot air’ surpluses that they hold from the market. These sectors should then be regulated using energy efficiency benchmark regulations designed to improve overall efficiency and productivity.

Finally, the use of international offsets in the ETS potentially distorts competition increasing any risk of carbon leakage. While manufacturers in the EU are subject to caps, manufacturers of potential competing products are able to generate emissions reductions credits for sale into the EU ETS via the CDM. For example, an energy efficiency project at a Chinese steel works to improve the productivity of the site may be profiting from the sale of credits, while some EU steel manufacturers could in the future face a deficit of permits. The fact that industry lobby groups have not been more vocal about this issue raises a question about how genuinely concerned industry is about competitive distortions. It may be that for some multi-national companies the potential to sell credits into the EU ETS is seen as more profitable than the downside of the caps they have been given. Or others may be more concerned with maintaining access to high volumes of cheap credits than addressing this competitive distortion.

We suggest that before any action is taken to address the perceived risk of carbon leakage, work to assess the effect of the subsidies being received by competing industries outside the EU via the CDM ought to be a priority. Recommendations should be made for the exclusion of CDM projects which distort competition, from the list of eligible projects for use in the ETS.

For more information about Sandbag please visit <http://sandbag.org.uk> or email bryony@sandbag.org.uk