

Ad-hoc ECCP stakeholder meeting of 17/3

Consultation questions on the analytical report in light of the international negotiations

Climate Strategies' 2009 paper authored by Susanne Droege, *"Tackling Leakage in a World of Unequal Carbon Prices"* offers a comprehensive analysis of the issue of carbon leakage. This, and a later report produced on behalf of The Carbon Trust (UK) are available to download at www.climatestrategies.org.

The views expressed in this document are based on the insights and recommendations coming out of this research.

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?

At the end of 2008 the world economy was confronted with a major collapse of international financial markets. The financial crisis translated into a recession in 2009 with a recovery emerging in the second half of 2009. The economic slump affected the energy-intensive industries in two respects: a massive decrease in global demand and falling prices, and a lack of financial capacity to follow up on (re)investment plans. In 2010 sectors still have to deal with over-capacity and with pressures to save costs and restructure. For the EU's indicators on risk of leakage this will translate into lower trade intensity, while the carbon price decrease following lower production will have lifted cost pressures. Both effects translate into a lower risk of carbon leakage. However, the EU's two indicators are not sufficient to identify the individual sectoral components making industry pass-through the carbon cost, investing in cleaner technologies or closing down and leaving the EU. Thus, these two key indicators can only serve as a screening device, and sector specific assessment is necessary to identify industries that are really at risk of leakage. In particular, the investment and reinvestment decisions in the light of the EU's future carbon pricing under the EU ETS need to be illuminated.

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?

The pledges made under the Copenhagen Accord include all major EU trade partner countries. The Accord follows a voluntary and unbinding approach; still the pledges are made on the basis of actual national aims, partly already incorporated in national programmes, for improving the GHG performances. In order to translate the targets into GHG emission reductions comparable to each other, the EU needs to invest capacity in making this translation. For most countries, the underlying measures address energy production and energy-intensive industries as they are the main contributors to GHG emissions (e.g. China or India). An

analysis of the economic downturn's impact on energy-intensive industries¹ (see answer to question 1), and the evaluation of trade partners' national climate policies to achieve the international pledges needs to be undertaken in order to review the EU list. To achieve this, sectoral studies for the top trade partner countries could be useful focusing on the main sectors that contribute to the GHG emissions capped under the EU ETS. However, this exercise cannot be finalised in the short term, but requires a longer-term investment in evaluation methods, data availability and networking with third countries.

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?

Climate Strategies is unable to offer an opinion here

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?

Free allowances should be viewed as one of a number of measures available to limit the risk of emissions leakage from carbon pricing. In the case of full auctioning, alternative measures should also be considered so that for each sector identified as being at risk of carbon leakage a tailored, efficient remedial policy option is applied.

At a sector level, free allocation dilutes the incentives, created by a carbon price, to introduce mitigation actions and decarbonise over time. Climate Strategies' 2009 paper authored by Susanne Droege, "*Tackling Leakage in a World of Unequal Carbon Prices*" offers a comprehensive analysis of the major challenges and trade-offs of solely using free allocation. It is available to download at <http://climatestrategies.org/our-reports/category/32/153.html>². Widespread free allocation would significantly reduce the number of participants in auctions for EUAs (to be introduced gradually in Phase III of the EU ETS) and reduce the potential revenue that could be generated to finance mitigation, adaptation and low-carbon technologies both within Europe and as part of any financing initiatives at the international level such as those proposed in the Copenhagen Accord.

Relying on free allocation as the sole remedial policy option for all 164 sectors identified at risk by the European Commission may also prove difficult because of Article 21 in the Directive: decreasing the percentage of free allowances as a proportion of overall Community-wide emissions from 80% in 2013 to 30% at the end of Phase III in 2020. This reduction in the absolute amount of free allocation available over time is another driver for considering alternative policy measures.

Border levelling, equalising carbon costs with international competitors by ensuring that products consumed in the EU pay a carbon price irrespective of where they have come from, is one such alternative. The European cement sector was identified as a strong candidate for this policy measure in a recent Carbon Trust report (Carbon Trust 2010, based on Droege 2009). If the cement sector was to receive free allowances, there is a risk of windfall profits, as there is a strong incentive for installations to sell the free allowances and import clinker – the most carbon intensive part of the cement production process. The Carbon Trust report also identified the most appropriate sector-specific policy responses for the European aluminium and steel sectors based on each industry's characteristics. For both these sectors, it suggests using a combination of policies e.g. an investment study in the aluminium sector to provide the basis for possible border levelling later in

¹ Climate Strategies will explore the impact of the economic downturn on energy intensive industries in the report, Bowen et al (forthcoming), "*Emission trends and commitments to 2020-30: the impact of financial crisis and business cycles*", a working paper in the 2010 project, "Interpreting and comparing post-Copenhagen mitigation targets and mechanisms"

² In addition, Climate Strategies' 2008 project, "Differentiation and Dynamics of Competitiveness Impacts" includes a number of papers which explores the incentives and impacts of free allocation in particular sectors of the economy and also analyses the legal issues that they pose. These papers are available at <http://www.climatestrategies.org/our-reports/category/6.html>

Phase III, which would assist with the sector's transition phase to become low carbon. More detail can be found in the report, but the core lesson from the paper is that the portfolio of policy options for effectively addressing leakage in all 164 sectors identified as being at risk by the European Commission needs to be expanded beyond just free allocation alone. By introducing sector-wide policies, suitably aligned with industry cost structures and likely channels of leakage, border levelling is one such alternative policy that could be used as a non-discriminatory tool to ensure all installations in a sector face the same carbon costs.

Border levelling should be clearly distinguished from the wider debate on the use of border adjustments as a way of creating incentives for other countries to do more. Levelling is what it says: ensuring that energy-intensive products consumed in the EU pay a carbon price equal to the price faced by domestic producers, irrespective of where they have come from, to avoid discriminating against domestic production. As such, it can in principle be entirely compatible with World Trade law – unlike proposals to discriminate between products and sectors based on the climate policies of their country of origin.



Climate Strategies aims to assist governments in solving the collective action problem of climate change. We connect leading applied research on international climate change issues to the policy process and to public debate, raising the quality and coherence of advice provided on policy formation.

Our programmes convene international groups of experts to provide rigorous fact-based and independent assessment on international climate change policy.

Secretariat – Climate Strategies c/o University of Cambridge,
13-14 Trumpington Street Cambridge, CB2 1QA, UK
+44 (0) 1223 748812; www.climatestrategies.org

Climate Strategies is grateful for funding from the government of **Australia**, Agence de l'environnement et de la maîtrise de l'énergie (ADEME) in **France**, Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) in **Germany**, Ministry of Foreign Affairs (MFA) in **Norway**, Swedish Energy Agency (SEA) **Sweden**, Department for Environment, Food and Rural Affairs (DEFRA), the Office of Climate Change (OCC), Department of Energy and Climate Change (DECC), Department for International Development (DFID) in the **UK**, The Carbon Trust, Nordic COP15 Group, Corus, Center for International Public Policy Studies (CIPPS) in **Japan**, European Climate Foundation (ECF) in The **Netherlands**, and the German Marshall Fund of the **United States**.