

Peter Botschek, Cefic, speech at IFIEC Energy Forum, 12 June 2014

**“Structural ETS reform needed to prevent carbon leakage”**

Ladies and Gentlemen,

Cefic supports fully the EU policy objective to contribute to combating global climate change. As long as regional policies remain fragmented, EU policy measures must be strictly cost-efficient and proportionate whilst avoiding competitive disadvantages for the domestic economy. This may well require a review of EU’s energy and climate strategy away from unilateral, unconditional target setting.

Many sectors have qualified as exposed to a significant risk of carbon leakage and are therefore entitled to benchmark-based, free allocation. EU policies beyond 2020 require additional safeguards that effectively avoid carbon leakage, through setting realistic goals and allowing for industrial growth through carbon and energy efficient players.

“Carbon leakage” refers to a situation in which domestic or regional energy and climate policy costs drive production and investment towards other countries thereby leading to a degree of de-industrialisation. It is not easy to identify distinct incidents of “carbon leakage”. No business leader will admit to relocate production to other places in order to “pollute there more cheaply”. Loss of production in one place and relocation to, and new investment at another place will have multiple reasons:

- Many contemporary investments in energy-intensive industries such as the chemical industry are driven by local energy and feedstock costs (i.e. US, Middle East).
- Another reason for chemical industry investment is local market growth (e.g. China).
- While EU carbon costs are currently low, future significant, EU policy-driven cost increases are on the investors’ planning and decision horizon.

The EU Council has declared the objective to retain and grow manufacturing and employment in Europe. It has mandated the Commission to come up with measures preventing carbon leakage.

**Making the EU ETS more leakage-proof**

Cefic believes that production should be strengthened and encouraged to grow in Europe beyond 2020 whilst providing incentives to invest in even greater carbon and energy efficiency. For EU industries on the carbon leakage list, the incentive should be to invest in reducing emissions to the “benchmark” level:

**Undertakings meeting the benchmark should not have to bear any ETS costs (companies not meeting the benchmark should get free allowances up to the benchmark (as today) but have to purchase their needs beyond that).**

The EU ETS in its current structure has fundamental flaws:

- The current ‘frozen’ ex-ante allocation is requiring undertakings to purchase allowances if their output exceeds historic reference levels. This is also the case even for companies that meet the performance benchmarks (e.g. through the Cross-Sectoral Correction Factor or for growth and investment). This cost can achieve nothing more in terms of emissions efficiency – and imposes an unavoidable cost penalty on efficient EU producers (making them uncompetitive), is thus creating significant disincentives to investment.
- ‘Frozen’ ex-ante allocation will provide extra allowances to companies when they lower their output below their historic reference level production. This is a perverse incentive even rewarding relocation to outside Europe (unused allowances from relocating production to outside Europe can be sold to allowances market).
- The linear reduction factor (LRF) means that the number of free allowances to be allocated will fall by 1.74% per year up to 2020: and it is proposed that it should fall by 2.2% per year between 2020 and 2030. It pushes manufacturing companies into a bidding war with the power sector for an ever decreasing amount of emission allowances on the market. EU’s chemical industry is competing globally and cannot pass on the power sector’s low-carbon transition costs.
- The cross sectoral correction factor (CSCF) requires even the most efficient EU producers to purchase allowances in 2014: and needs to purchase will increase drastically (up to 30%) by 2030.
- EU chemical manufacturers already have a proud record of improving energy and carbon efficiency. But efficiency gains are not linear and further efficiency returns on investment are bound to decrease.

In order to avoid perverse incentives to carbon leakage or inhibit growth in Europe, a dynamic “ex post” system must be adopted.

### **Indirect costs**

Under the EU ETS electricity companies are required to purchase all allowances they need to submit for the carbon content of their electricity production.

- Power producers can pass on these carbon costs to their customers, the power consumers. Due to the electricity price formation, even ‘low-carbon’ power may bare carbon costs.
- While the ETS Directive gives member states the option to compensate exposed companies financially for indirect emission costs, only few countries have chosen to do so. Accordingly, i.e. electro-intensive companies are faced with indirect carbon costs weakening their competitiveness.

The above allocation principles must equally apply to compensation for costs passed on through the European carbon price.

### **Unconstrained production and growth for efficient manufacturing in Europe**

Instead of ex-ante planned emission economy, a “dynamic” flexible system based on benchmarks and actual production should be introduced after 2020. Companies will receive more allowances in times of growth or less allowances in times of reduced output (e.g. in a recession). The dynamic, company-specific allocation system (including ‘indirect’ allocation for carbon cost in electricity) would work for incumbents, greenfields, capacity changes, and (partial) cessations. Company output data are already available. Allocation rules must be plausible, reliable in view of long investment cycles, simple and harmonized.

**For efficient investment and growth, allocation perspectives for industry need to be plausible and credible: A reserve must be established to guarantee that sufficient free allowances are available to meet the needs of industry that is receiving free allocation up to and beyond 2030.**

- Such a reserve must be for manufacturing sectors and must contain enough allowances to ensure sufficient free allocations to fuel manufacturing growth (should be refilled in the event of unexpected high growth).
- The EU unilateral CSCF and the LRF to the “industry cap” should be abandoned to allow for EU’s energy intensive undertakings (in sectors on the carbon leakage list) to receive 100% free allocation of allowances provided they achieve the benchmark level of efficiency.
- No “free-riders”: Undertakings that do not meet the benchmarks would continue to be required to purchase the additional allowances (as today) thereby creating a continued incentive to invest in emissions abatement.
- Further reduction in emissions, beyond the current benchmarks, should be dependent on technological advances. The system should incentivize and reward pioneering innovators, not demotivate them by withdrawing their allowances.
- In case of no or insufficient global participation with equal or similar global burdens the EU must revisit its policy objectives and measures.

### **COM Market Stability Reserve proposal – in conflict with goals of re-industrialisation**

The proposed ‘Market Stability Reserve’ (MSR) - the only legal proposal in the COM 2030 framework Communication – is supposed to solve structural flaws of the ETS, namely to reduce an oversupply of allowances on the market.

- However, it implies a disproportionate approach by hoovering up any extra allowances from the market whilst inhibiting or limiting the back-feeding into the market: The MSR would step by step shrink of auctioning volume and only poorly replenish it once a low market volume (‘floor’) is reached.
- The COM proposal changes the ETS from a price-finding market tool with variable demand and a given allowances market volume (cap) into a high CO2 price tool by automatically reducing the market volume and by introducing high barriers preventing and limiting recirculation of allowances from of such a reserve.
- ‘Fixing’ the ETS under such conditions neither provides a timely accessible, functional reserve nor qualifies it as a robust carbon leakage measure.

- A reserve must be for manufacturing sectors and must contain enough allowances to ensure sufficient free allocations to fuel manufacturing growth (should be refilled in the event of unexpected high growth).
- If not revised, the proposed MSR mechanism bares the risk of pushing up EU carbon prices for manufacturing industries and consumers thereby even increasing the risk of carbon leakage.

Thank you for your attention!