



EU BRIEFING
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Competitiveness & climate policy: The ‘either-or’ fallacy

For well over a decade industry lobbyists have sought to undermine the EU Emissions Trading System (EU ETS). Despite the evidence proving them wrong, they repeatedly claim that cutting pollution by putting a price on greenhouse gas (GHG) emissions will make them less competitive. Their efforts are as counterproductive as they are ill-informed. A change of their strategy is needed or they will only lose out when Europe unavoidably progresses towards its comparative advantage in high tech, innovative, low-carbon technologies.

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3. Reformed to ensure that all pollution permits are auctioned – providing more funds for industrial clean-tech research;
4. Complemented by an Emissions Performance Standard to block the dirtiest power plant.

An EU ETS that works for polluters would be:

1. A rigged market that provides indirect subsidies to industry instead of incentivising low carbon investments;
2. Allowed to keep 2.6bn tonnes of surplus GHG allowances that undermine EU climate protection efforts;
3. Left with overly generous protections for unaffected sectors leading to more unused surpluses;
4. Able to continue giving away free pollution permits – breaching the application of the ‘polluters pay’ principle.

THE CONTEXT

Current government pledges will not keep global temperatures below the 2°C average increase that the international community has agreed will cause dangerous climate change. Strong political leadership is needed to cut carbon emissions further and faster, but in Brussels carbon intensive industries are working hard to prevent the adoption of the laws we need.

This is particularly the case with the EU ETS. A handful of energy-intensive industry lobbyists argue against adequate EU climate policies, claiming that their ‘international competitiveness’ will be negatively impacted. Their arguments are reinforced with a threat of moving production out of the EU.

However, these industry threats are losing credibility. More and more academic studies show EU climate policies have not been responsible for manufacturers leaving Europe. On the contrary, the evidence highlights the positive impacts of climate policies on EU industrial competitiveness.

Industry claim:

“Our competitiveness is highly at risk from a unilateral carbon cost. [...] If one major building block such as chlorine moves out of Europe, an entire value chain will follow resulting in tremendous losses of opportunity and jobs.” CEFIC, February 2009ⁱ

Reality check:

Chlorine production has not moved out of the EU. Net EU imports of chlorine – as with most chemicals did not increase from 2002 to 2012ⁱⁱ.

THE REAL ECONOMICS OF CLIMATE ACTION

Contrary to conventional assumptions, the claims of industry lobbyists are contradicted by leading economists. Nobel laureate Paul Krugman highlighted the “dangerous obsession” of allowing the concept of competitiveness to influence policymaking. National economic problems should not, according to Krugman, be attributed to a failure to compete in global marketsⁱⁱⁱ.

This economic theory is supported by those on the ground. Senior manufacturing executives from around the world recognize that energy policies are not a decisive factor in competitiveness. They rate i) an innovative and skilled workforce, ii) economic, trade, financial, and tax systems, iii) the cost and availability of labor and materials, iv) supplier networks, v) legal and regulatory systems, and vi) physical infrastructure as all being more important for competitiveness^{iv}.

Europe remains highly competitive because it excels in many of these areas. Europe sells more to the US than it buys from it. Europe benefits from comparative advantages in the innovation and high-tech manufacturing industries that drive the much-needed low carbon transition.

In reality, reducing energy use and freeing ourselves from fossil fuel import dependency will stabilise prices and reduce security of supply risks.

THE BOY WHO CRIED WOLF

Since 2003 the ETS has set a workable framework for long term industrial GHG cuts. However, the framework has not delivered because policy makers failed to set stringent enough reduction targets and approved the allocation of too many free allowances. Having failed to put enough pressure on the demand for allowances, policy makers exacerbated their mistake by allowing the use of international offset credits, which lead to massive oversupply.

EU policymakers have not corrected these initial failings despite nearly 10 years of operation. Continued, although less exaggerated, overallocation of emission allowances, a massive inflow of international offset credits, and the economic downturn, means the ETS market still suffers from oversupply and low prices. Even the cautious efforts by the European Commission to tackle the ETS' problems have been met by fierce resistance from some industry stakeholders, who claim, again, that higher carbon prices would hamper their international competitiveness.

Their claims stand in stark contrast with to real-life experience. Repeated studies^{vii,viii}, reports^{ix,x}, and analyses^{xi,xii} show no evidence of carbon leakage as defined by the ETS Directive^{xiii}. Some sectors saw increasing imports or decreasing exports, but these changes were driven mainly by global demand developments and input price differences. Even in energy-intensive sectors, EU carbon pricing has not led to measurable carbon leakage. This empirical evidence is even confirmed by shareholders in some energy intensive companies who concede that the ETS has not been a significant factor in the context of competitiveness concerns^{xiv}, even while prices were as high as 25€/ton CO₂.

Industry claim

“There is currently an extraordinary increase in the volumes of cement and clinker being imported to European ports [...] from countries which do not bear the burden of carbon constraints. [...] it is clear that there is not only a very real risk of carbon leakage in our industry, but that carbon leakage is already occurring.” CEMBUREAU reaction to publication of EU Commission proposal for 2020 climate and energy package, January 2008^v

Reality check

The EU shifted from a net exporter of cement and a net importer of clinker before 2009 to a net exporter of both products. Cement company executives now confirm that import flows have so far not been driven by carbon prices^{vi}.

PROVISIONS TO COUNTER CARBON LEAKAGE: NOT FIT FOR A DOUBTFUL PURPOSE

Despite the evidence to the contrary, a handful of influential big polluters have repeatedly convinced EU policymakers that they need generous exemptions to the carbon price signal, including the free allocation of emissions allowances and the potential for state-aid compensation by Member States.

Those “*deemed to be exposed to a significant risk of carbon leakage*”^{xv} are placed on a list of exempted industrial sectors. Once on the so-called ‘carbon leakage list’, exempted sectors are awarded free pollution permits on the basis of efficiency benchmarks. These free permits represent a transfer of wealth from Member State budgets to industry. In 2013 this hand-out amounted to about 840 million^{xvi} free allowances, worth nearly €4 billion. Both the value involved and the list’s impact on GHG cuts mean that criteria for inclusion must be carefully drawn.

In reality, this never happened. The parameters used to assess potential carbon leakage are very generous and overestimate the risk of relocation abroad:

- Firstly, the impact of emissions pricing was over-estimated because the calculations use an assumed price of 30€/ton CO₂, between 3 and 6 times more than the Commission’s own reference scenario price forecast up to 2020^{xvii}.
- Secondly, the carbon leakage list covers sectors trading with any non-EU country, regardless of whether those countries have comparable carbon pricing policies. This means the carbon leakage list ‘protects’ EU players who are actually competing with some rivals who are on a level playing field. In the context of the UNFCCC negotiations, where the EU is expecting other countries to show more climate ambition before 2020, such generosity could backfire.

The result of the over-generous acceptance policy of the carbon leakage list is that 60% of industrial sectors, representing 95% of EU industrial GHG emissions now qualify for free pollution permits^{xviii}. Across trading phases, the sectors concerned will continue to have a net surplus of emission allowances until after 2020^{xix}.

This is particularly worrying, given the evidence of unintended consequences from the current policy design:

- Between 2005 and 2012 some companies have passed through at least part of the costs of emissions pricing – despite not having to actually pay that cost themselves. During the first two phases of EU ETS, the chemical, oil and steel sectors alone may have made windfall profits of some 14 billion €^{xx}.
- In the cement sector, companies have intentionally spread production over several installations in order to maximise free allowances^{xxi}. This has led to overproduction of cement in Southern Europe, which then had to be exported – leaving the ETS to subsidise additional pollution, and overproduction^{xxii}.

It is therefore no surprise these sectors are extremely keen to remain on the carbon leakage list since the short term economic benefits are very tangible.

However, the public benefits of abolishing the carbon leakage exemptions are equally clear. A recent FTI Consulting^{xxiii} report showed that closing exemptions would deliver more benefits than costs; including overall net GDP gains of €13-16bn and 137,000-234,000 more jobs. A large proportion of these society-wide benefits can be attributed to the recycling of ETS auctioning revenues into the economy. Reinvestments of these revenues into renewable and energy saving technologies can create a virtuous cycle where application of the ‘polluter pays’ principle can support investments in the tools needed for further decarbonisation.

THE EU IS NOT ALONE

As stated above, the EU is not the only country or region implementing an emissions trading system and/or other climate related energy policies. In 66 countries, together responsible for around 88% of global greenhouse gas emissions, almost 500 climate laws have been passed. Developing countries and emerging markets are advancing climate change regulation at the fastest pace^{xxiv}. From 2005 to 2015, the share of global emissions covered by an ETS will have increased by more than 70 percent^{xxv}. Governments around the world have realised that green strategies play a vital role in unlocking synergies between economic growth, environmental protection and poverty reduction^{xxvi}.

Business and industry stakeholders claiming that the EU should not act as a ‘lone frontrunner’ should take note. As should European policy makers. Even if the false claims of emissions pricing unfairly adding to costs are accepted, no action is required if other countries are also applying similar costs to polluting sectors.

EU policy makers and industry alike would benefit from working to persuade all countries to take adequate climate action, rather than trying to avoid their own responsibilities. This is particularly the case for energy intensive industries. Under a European Commission scenario^{xxviii} in which all countries take the action required to limit average temperature increases below 2°C, and the EU cuts emissions in 2030 by 50% (40% domestically and 10% through international offsets) the impact on production in EU energy intensive industries is positive – with up to 8.7% growth.

Unfortunately, the same sectors that scaremonger about carbon leakage in EU are actively undermining climate pricing policies globally, as shown by evidence the US^{xxix}, Japan^{xxx}, Korea^{xxxi}, Australia^{xxxii} and South Africa. Rather than aiming for the ceiling, they promote a race to the bottom.

Industry strategy: undermine international action

“[we are] hoping to qualify for higher exemptions and [...] engage with the government on proposals currently on the table”

ArcelorMittal, requesting to be exempted from the introduction of a carbon tax in South Africa, April 2013^{xxvii}

THE WAY FORWARD

Energy-intensive industries are an important part of the EU economy, which are currently operating under economically unfavourable circumstances. These sectors are suffering from weak demand due to the poor economy, aggravated in the longer term by structural overcapacity, the changing nature of global comparative advantage in richer economies and competition from emerging markets^{xxxiii}. Even if EU climate and energy policy were written exactly to their liking, they would still face difficult decisions about asset rationalization and industrial structure and practices. Their strategy to aim for delay of climate policy decisions is therefore a potentially self-defeating distraction.

European society cannot afford such distractions from efforts to maintain and grow a sustainable industrial base in Europe by focusing on the region's comparative advantage. The most recent European Competitiveness Report^{xxxiv} confirmed that for the EU economy as a whole, increasing productivity is more relevant than protecting competitiveness. In particular, it suggests a long-term industrial policy targeted at the development of 'clean' products and technologies could form the basis of a major industrial policy initiative. The EU ETS offers an excellent opportunity to mainstream climate policy into industrial policy to build a cleaner, more innovative and competitive future^{xxxv}.

The upcoming 2030 climate and energy package should therefore be seen as an opportunity rather than a threat. Four in five EU voters agree that fighting climate change and using energy more efficiently can boost the economy and jobs in the EU^{xxxvi}. A stronger EU carbon price and accelerated rate of clean investments will play an important role in stimulating innovation and boosting demand for sustainable products from industrial sectors. Moreover, contrary to some industries' claims, a wide range of technological options is still available to reduce emissions in energy-intensive sectors, both in the short and long term^{xxxvii,xxxviii,xxxix}.

The focus should be on improvements in total factor productivity through skills development, research, and innovation in renewable energy and energy saving technologies. A portion of auctioning revenues from the fully reformed EU ETS should be centrally earmarked for this purpose. Now is the time to shape a European carbon market that delivers long-term benefits for society and the environment.

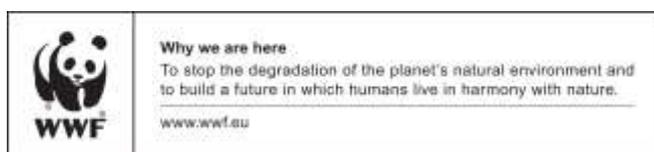
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