

Carbon Leakage Rebuttal



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“Dynamic allocation” – an industry model for windfall profits from free emission allowances at the expense of taxpayers

The EU Emission Trading System (EU ETS) covers just over 40% of the EU's greenhouse gas emissions from the industry and power sector. After each year, companies participating in the system must surrender enough allowances to cover all of their emissions. For the 3rd trading phase from 2012 to 2020 companies are supposed to purchase their emission allowances under the EU ETS through auctioning as the default allocation method. However, the production from European industrial sectors that is deemed to be exposed to a significant risk of “carbon leakage”¹ is getting protection by receiving their allowances to emit CO₂ for free. This concept has been adopted during the revision of the EU ETS and is valid for the 2020 climate package from 2013 to 2020.

Questions over how the potential risk of carbon leakage will be addressed in the 2030 climate and energy framework have recently gained importance. Earlier this year, the European Commission launched a stakeholder consultation process on the post-2020 carbon leakage provisions. Dynamic allocation, in combination with an industry fund, has been proposed by recent papers prepared by the chemical company BASF² and Ecofys commissioned by Dutch industry³ as an option to tackle carbon leakage concerns post-2020.

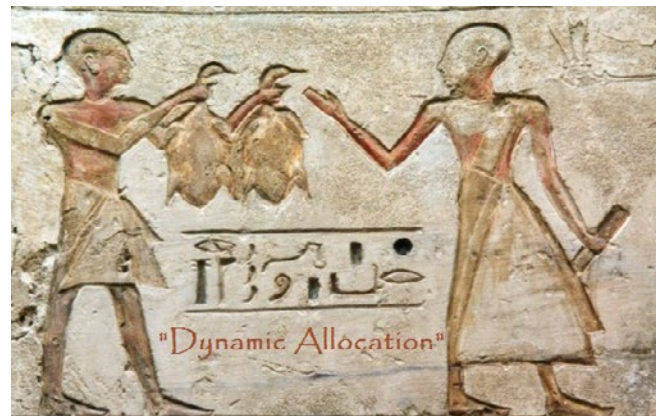
These papers shows that the main objective of the proposal for dynamic allocation is to keep the door open for windfall profits while failing to incentivize industry to modernize their production facilities. This rebuttal recommends that auctioning of emission allowances should be the default allocation method for all sectors to reward efficiency and low-carbon solutions and keep low-carbon investments in Europe.

Current practice: free allocation of emission allowances to industry

- Since the year 2013, all power generators buy their CO₂ allowances at auction. However, manufacturing industries that have been deemed at risk of carbon leakage receive their emission allocation (benchmark⁴) for free. The total allocation of free allowances to industry is capped to a certain limit. Currently, 164 sectors, representing more than 95% of industrial emissions, are deemed to be at risk of carbon leakage (based on their carbon costs and/or their trade intensity with third countries) and receive **free pollution permits**.
- As a result of the overgenerous allocation of free allowances and the low carbon price, European companies are currently not receiving a sufficient price signal to produce more efficiently or invest in innovative technologies that reduce CO₂. **European industry is therefore at risk of falling behind** in deploying low-carbon and state-of-the-art technologies compared to their competitors abroad. Currently, the most efficient cement production occurs in Asia, particularly in India and China. Also in the steel sector, the European installations often perform worse than the global average.⁵
- Up to now, **industrial sectors have received more free pollution permits than needed**. During 2008-2011, the steel sector was able to build up a surplus of more than 300 million CO₂ excess allowances, while the cement sector received 200 million

allowances more than needed⁶.

- Windfall profits occur when companies pass through the opportunity cost of the CO₂ permits to their consumers, while receiving these permits for free. During 2005-2008, carbon-intensive industry gained **windfall profits** in the order of 14 billion euros⁷, which implies a huge transfer of money from taxpayers to industry.



Industry's proposal for post-2020:

“dynamic” allocation of free emission allowances (= letting the polluter cash-in)

- Under the industry proposal, industrial sectors are compensated for both their direct and indirect carbon costs by allocating free allocation of emission allowances based on actual production. While in the current framework, the total allocation of free allowances to industry is capped, the industry proposal is that the number of **free allowances to industry is not capped to any limit** anymore. This means that industry will not need to reduce their emissions in line with the rest of the economy. Since the industry's emissions are not capped anymore, an industry fund is necessary to ensure that enough free emission allowances are available even when industry's emissions grow.
- It assumes a **significant transfer of wealth from taxpayers to industry** because the auctioning revenues of Member States will be reduced. More allowances will be given for free to industry which means that less allowances are available for Member States to auction. Under the Ecofys proposal for example, industry's subsidy will be increased by around **€130 billion** during 2021-2030⁸ compared to their current subsidy. This is because industry will receive almost 5 billion extra emission allowances for free compared to the current practice.
- The proposals include **no incentives for industry to innovate**

or modernize their production facilities. In the Ecofys report, industry's effort is ten times less than the other sectors of the economy after 2020⁹ even when receiving the huge subsidy. In the BASF paper, the industry's emissions "may allow for slight growth up to 2030" as under this proposal, industry's effort will be "distinctly lower" than that of the other sectors of the economy. This is not in line with the 2011 Low Carbon Roadmap which indicates that industry is required to reduce its emissions by 34-40% by 2030 compared to 1990 levels¹⁰.

- The system for dynamic allocation is extremely complex. It entails a large administrative burden for the Commission and Member States, which is why it has been called "the **perfect example of red tape**".
- There is **no stimulus for product or material substitution** anymore, like building cars with less steel or changing from concrete to steel buildings, under dynamic allocation. This is in stark contrast with the current allocation rules based on historic production in which companies have an incentive to produce less product, because the carbon price signal is present in additional production.



The much needed proposal for post-2020: auctioning of emission allowances (= letting the polluter pay)

- As part of the 2030 climate and energy proposals, European policymakers should ensure that the polluter pays while supporting the frontrunners who invest in efficiency and renewable technologies.
- **Full auctioning of pollution permits** reflects the polluter-pays-principle and rewards efficiency and low-carbon investments. Full auctioning should replace free allocation of emission allowances as free allocation shields industrial sectors for any carbon price and therefore reduces their incentive to invest in innovative, low-carbon technologies in Europe.
- Instead of subsidizing the least efficient industries to continue polluting, the EU could provide support to the frontrunners that want to invest in low-carbon innovation in Europe. Innovation support helps to leverage investments in efficient, clean and pioneering industrial and renewable technologies in the EU. A portion of the ETS auctioning revenues could replenish **an industrial innovation fund dedicated to energy savings and renewable production processes** (e.g. magnesium-based cement production, coke-free steel production).

Summary

- **Until 2020, industrial sectors deemed to be at risk of carbon leakage will receive their emission allowances for free.** This weakens the incentive for reducing emissions and leads to a substantial transfer of money from taxpayers to industry in the order of billions of euros.
- **The industry has recently proposed to "dynamically allocate" even more free emission allowances to industry after 2020.** Under this proposal, the free allowances given to industry are not subject to a cap anymore, removing the incentives for industry to reduce their emissions. Not requiring any effort from industry to decarbonize post-2020, as industry proposes, risks bringing Europe on a 4°C pathway to dangerous climate change. Taxpayers will be picking up the bill as the transfer of money from taxpayers to industry would be further increased by more than one hundred billion euros.
- **After 2020, industry should not be subsidized for its pollution through free allocation. Instead, auctioning of emission allowances should be the default allocation method for all sectors to properly reward efficiency and low-carbon solutions.** A climate fund which is replenished by a portion of the ETS auctioning revenues could support the development of breakthrough technologies that are necessary to achieve deep emission reductions and helps ensure the survival and the sustainability of Europe's manufacturing base. These proposals should be part of the ETS revision to implement the 2030 package.

1. Carbon leakage is the situation in which, as a result of stringent climate policies, companies move their production abroad to countries with less ambitious climate measures to lower their production costs. This can lead to a rise in global greenhouse gas emissions. A recent study ordered by the European Commission found that during 2005-2012 there were no occurrences of carbon leakage.
2. BASF (2014), The "Dynamic Industry Fund proposal" (DIF) – safeguarding future growth of industry
3. Ecofys (2014), Dynamic allocation for the EU Emissions Trading System ([see here](#))
4. IV The benchmark is the threshold for what an installation gets for free. The starting point for setting the benchmark values is the average performance of the 10% most efficient installations in the (sub)sector. The benchmark (ton CO2 per ton product) is then multiplied by the average historical production during 2005-2009 to get to the amount of free allocation the installation receives.
5. Climate Strategies (2014), Staying with the Leaders: Europe's Path to a Successful Low-Carbon Economy ([see here](#))
6. EC (2012), Impact Assessment accompanying the Backloading proposal ([see here](#))
7. CE Delft (2010), Does the energy intensive industry obtain windfall profits through the EU ETS? ([see here](#))
8. The Ecofys report indicates that industry will be entitled to the 900 million backloaded allowances, that were due to return to the market in 2019 and 2020. Assuming a carbon price of €10/tCO₂, this is equal to a €9 billion subsidy. On top of that, in the 2021-2030 period, each year 400 million allowances more will be given to industry for free than under the current carbon leakage rules, so in total 4 billion. Assuming an average carbon price of €30/tCO₂ during that time, this is equal to a €120 billion subsidy. In total: €129 billion.
9. The Ecofys report indicates that the amount of free pollution permits given to industry is reduced by 0.17% annually, while the other sectors of the economy need to reduce their emissions by more than 2% each year.
10. EC (2011), COM(2011) 112 final, A Roadmap for moving to a competitive low carbon economy in 2050



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