A Fair EU ETS Revision

REMOVING FAVOURITISM AND DISCRIMINATION FROM THE EU'S CARBON MARKET

Policy Briefing, June 2017

Executive Summary

The EU is currently finalizing the implementation of its 2030 climate framework. This work includes a revision of the EU's Emissions Trading System (EU ETS), the EU's flagship climate instrument. The European Parliament (EP) and the Council adopted their positions on the EU ETS revision earlier this year and are currently holding talks to reach an agreement on how to design the system for the 2021-2030 period.

A key issue yet to be resolved is the amount of free allowances the different industrial sectors will receive in the next trading period. Responding to the Parliament's concessions to award the lion's share of the overall available free pollution permits to the steel industry, a '*fair EU ETS*' alliance was established by the other industrial sectors that fear discrimination under the EU ETS. Other outstanding issues still negotiated by the Parliament and the Council are the size of the Innovation Fund, the introduction of a Just Transition Fund and the level of overcompensation to steel for energy production from its waste gases.

While the EU ETS must avoid unjust discrimination between the various sectors covered, the principle of fairness needs to be factored in from a much broader societal perspective, including the climate, citizens, workers and local communities, and innovators. From this perspective, the following recommendations aim to turn the EU ETS into an instrument that removes favouritism and discrimination from the EU's carbon market[1]:

- **Fair for the climate:** To bring the EU ETS in line with the Paris goals and make it a truly fair instrument for the climate, much steeper emission cuts are needed by increasing the LRF from 2.2% to 4.2% from 2021 onwards. The EU needs to reach net zero emissions by the year 2040, but at the current pace, this would happen only in the year 2058.

- **Fair for EU's citizens**: Divide the costs of the low-carbon transition more equally between citizens and industry, by limiting the amount of free allowances to industry in the 2021-2030 period and moving to full auctioning as soon as possible. The proposed overgenerous hand-out of free allowances to industry in the next period means that taxpayers could lose out on up to €175 billion in ETS revenues.

- **Fair for workers**: Up-skill workers for the low-carbon transition through a new Just Transition Fund to be financed from auctioning revenues. Corporations stand to make a €19 billion windfall from the EU ETS revision, while workers are left out from any compensation. The Parliament has proposed to correct this by introducing a Just Transition Fund after 2020, potentially raising €4 billion.

- **Fair for energy producers**: Remove discrimination between the industry and power sectors by eliminating unjust overcompensation to the steel sector for its energy production from waste gases, as proposed by the Parliament.

- **Fair for industry sectors**: Tailor carbon leakage approaches according to evidence of observed risks in industrial sectors, to avoid unjust treatment of sectors at lower risk, and introduce sector-specific approaches beyond free allocation, such as border taxes combined with full auctioning in the cement sector.

- **Fair for innovators**: Auction all allowances in the future and thereby increase the revenues for low-carbon innovations. In the 2021-2030 period, subsidies for industry pollution will be over ten times higher than support for industry innovators. This means industry's biggest polluters benefit from over-generous free allocation while frontrunners only receive limited financial support for their innovations. The Parliament slightly corrected for this imbalance by increasing the Innovation Fund from 450 to 650 million allowances.

1 All the calculations in this briefing assume an average carbon price of €25/tCO_2e in the 2021-2030 period, consistent with SWD(2015) 135

Introduction

In the context of the ongoing talks on the EU ETS revision, the word 'fairness' has become a popular reference point for certain outstanding decisions by many industry players. According to the Oxford dictionary, fair means the '*impartial and just treatment or behavior without favouritism or discrimination*'. This policy briefing takes stock of the fairness of the revision of the EU Emissions Trading System (EU ETS), taking into account the perspectives of the society at large, including the climate, European citizens, workers and local communities, and innovators. It concludes with recommendations to ensure that the EU ETS can be turned into a truly fair climate instrument ahead of its final adoption later this year.

A fair deal for the climate

Under the Paris Agreement, the EU has committed itself to pursuing efforts to limit global warming to 1.5°C. In terms of the EU ETS, this means that the EU needs to reach net zero emissions by the year 2040 according to climate scientists[1]. However, the pace put forward by the Parliament and the Council to reduce emissions under the EU ETS is too slow because the so called 2.2% Linear Reduction Factor (LRF) means that the decarbonization of the EU's power and industry sectors would happen only in the year 2058.

Bring the EU ETS emissions reduction trajectory in line with the 1.5 degrees Celsius objective

In the context of the 2018 Facilitative Dialogue, the ambition level of the EU ETS needs to be increased to align it with the Paris Agreement objectives. To bring the EU ETS in line with the Paris goals and make it a truly fair instrument for the climate, much steeper emission cuts and an LRF of 4.2% from 2021 onwards is needed.

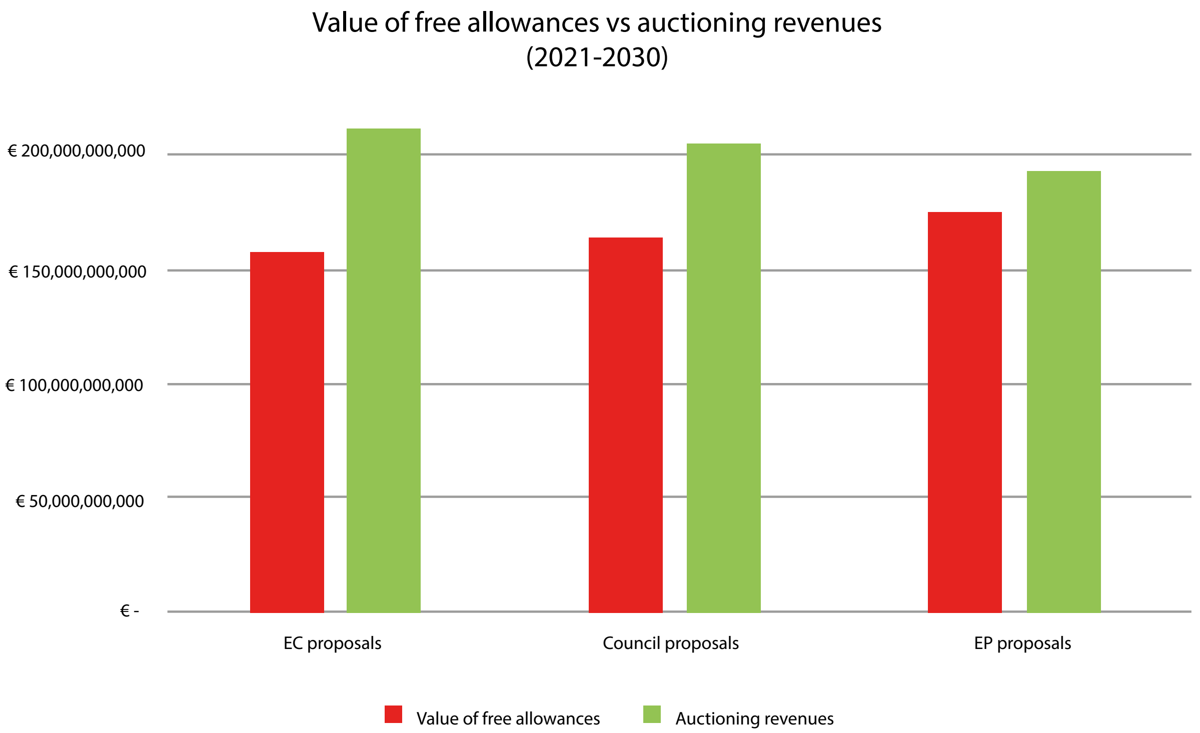
A fair deal for EU's citizens

The EU ETS provides free allowances to industrial sectors that are considered to be at risk of moving their production to countries with less stringent climate policies. However, to date there has been no evidence that EU's climate policies are forcing companies to move abroad even with a complete phase-out of free pollution permits.[2] Yet, over 94% of industry emissions receive a 100% free allocation, which means that only few allowances are auctioned. This therefore reduces the potential auctioning revenues that EU governments could generate and invest in the low-carbon transition of the European society.

The Commission's proposal for the EU ETS revision suggests to hand out 6.3 billion free allowances to counter potential 'carbon leakage'. The Council and the Parliament want to increase this amount by up to 300 and 750 million respectively. If these allowances were auctioned by governments, rather than given away for free to industry, an additional €160 billion (Commission proposal) up to €175 billion (EP proposal) could be mobilized and earmarked to benefit European citizens. Moreover, it is worth noting that the favouritsm of handing out free allowances only applies to industry sectors under the EU ETS. Power companies, by contrast, need to buy all their emission allowances at auctions.

1 Information taken from a presentation by Bert Metz, ECF fellow and former co-chair of the IPCC Working Group Mitigation, on 27 April 2016 in the EP.

2 Carbon Market Watch (2015), Carbon leakage myth buster, see here



Limit the amount of free allowances to industry in the 2021-2030 period and move to full auctioning as soon as possible

To remove discrimination of European citizens and the power sector, the EU ETS needs to swiftly move to full auctioning as soon as possible. This would not only divide the burden of mobilizing the financial resources needed for the climate challenge between industry and citizens, it would also internalize the pollution caused by the industry sectors in the carbon price. Limiting free allocation in the 2021-2030 period should be a key priority in the EU ETS reform, since taxpayers could lose out on up to €175 billion in ETS revenues.

A fair deal for workers and local communities

The current draft EU ETS suggests that several carbon-intensive industries that are not at genuine risk of carbon leakage, such as cement or refineries, will still be receiving all of their allowances for free after 2020. Numerous studies have found that companies pass through at least part of hypothetical, non-existent 'costs' of carbon pricing to consumers[3]. Since the pollution permits were received for free, this means that several corporations stand to make enormous windfall profits.

This risk has even been highlighted by the European Commission that has underlined that '*all sectors analysed would be expected to gain windfall profits*', and that corporations from the steel, cement, refineries, and chemicals sectors will be able to pass through all their compliance costs to their customers and even make €19 billion from the EU ETS in the 2021-2030 period[4].

At the same time, the prospect for local communities and workers is not as bright: in the short-term some communities are likely to be negatively impacted by the low-carbon transition, especially workers in the coal sector who could face job losses and threats to their livelihoods without proper training to enable their transition towards the rapidly growing green job sector. To counter these potential consequences, the Parliament has introduced the establishment of a Just Transition Fund. By pooling 2% of the auctioning revenues, the Fund could make available €4 billion to

3 See for example SWD (2015) 135, Impact Assessment accompanying the EU ETS revision, p. 202 table 33

4 SWD (2015) 135, Impact Assessment accompanying the EU ETS revision

support lower-income regions that have a high share of workers in carbon-intensive sectors, e.g. to finance education and training initiatives to re- or up-skill workers.

Introduce a Just Transition Fund to assist local communities and workers in the low-carbon transition

At the moment, the EU ETS reform will mostly benefit large industry corporations that stand to make a €19 billion windfall, while their workers are left out from any compensation. The Parliament has proposed to correct this by introducing a Just Transition Fund after 2020, potentially raising €4 billion to assist lower-income regions that have a high share of workers in carbon-intensive sectors. This proposal should be adopted for the EU ETS to become a fair instrument to respond to the needs of workers and local communities, although it only represents 20% of the amount that industrial corporations are expected to gain from the EU ETS reform.

Steel sector set to make the biggest gains

The distribution of free allowances between industrial sectors is a hotly debated issue. As the cap on the total amount of emission allowances under the EU ETS reduces over time, there is a limited and decreasing amount of free allowances to give away to industrial sectors. The sector to receive most free allowances compared to others is by far the steel sector.

Following intense lobbying, the Parliament adopted proposals to increase the amount of free allowances to the steel sector after 2020. An analysis of the current EU ETS proposal by Carbon Market Watch shows that the steel industry will receive 2 - 2.1 billion free allowances in the 2021-2030 period[5]. This represents around 30% of the total available free allowances and is worth around €49-53 billion. Moreover, the steel sector managed to push through a Parliament amendment to receive overcompensation in the form of free allowances for its waste gases which will lead to market distortions with power producers and goes against a recent court verdict that opposed such preferential treatment. Any Member State compensation for indirect costs (e.g. higher electricity bills) will come on top of this.

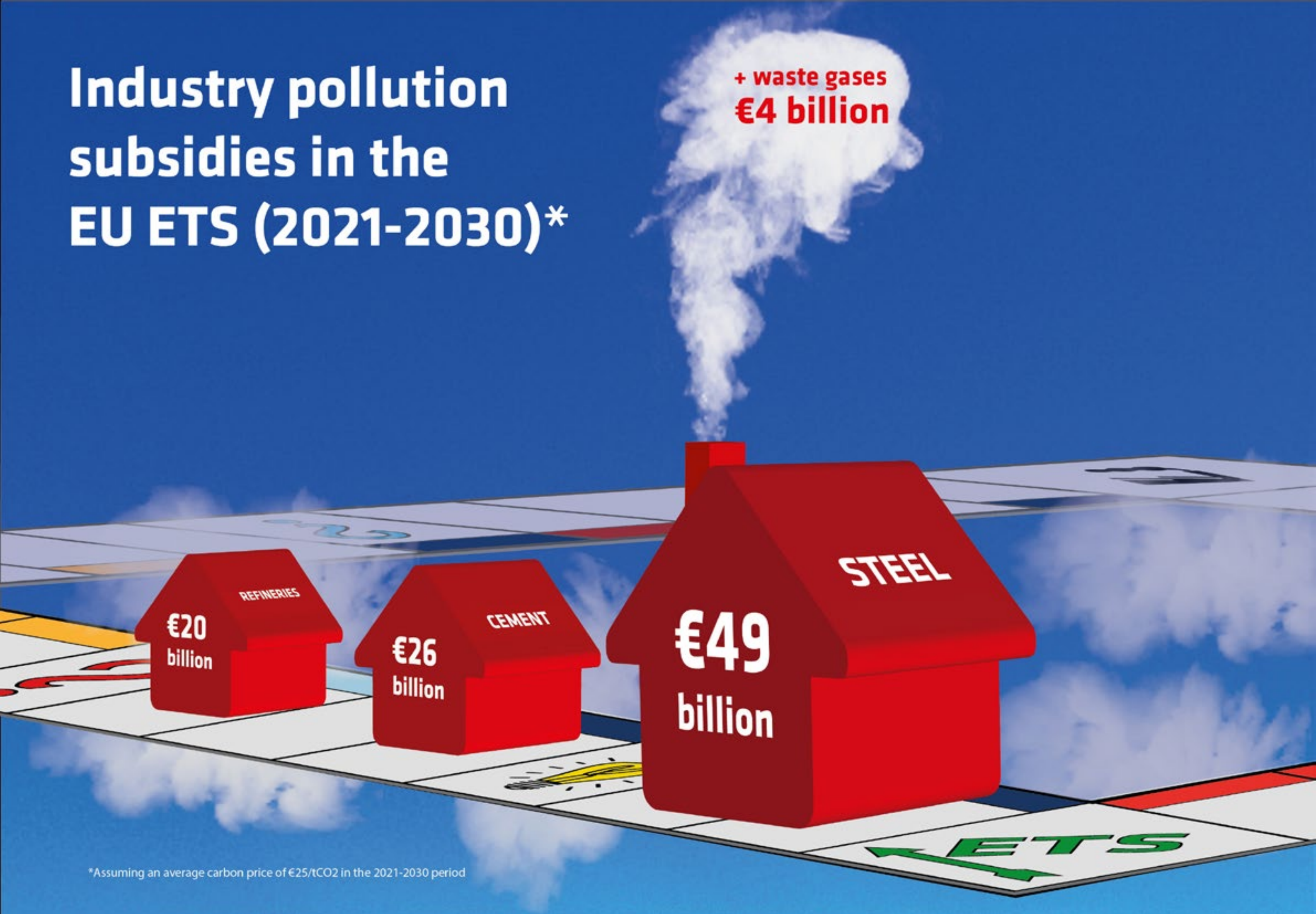
This major lobby win has upset other industrial sectors who have responded by establishing a '*Fair EU ETS Alliance*' calling for a rejection of any approach that discriminates between industrial sectors[6]. While unjust preferential treatment should be avoided under the EU ETS, discrimination is not necessarily unfair as the risk of 'carbon leakage' varies greatly between industrial sectors.

Tailor carbon leakage approaches according to the evidence of observed risks in industrial sectors

The risk of competitive distortions due to the EU ETS varies greatly between the different industrial sectors. Any approach to counter such 'carbon leakage' risks should in the future be tailored to each sector based on the observed carbon cost pass-through rates so windfall profits can be avoided. Sector-specific approaches beyond free allocation should be introduced, such as border taxes combined with full auctioning in the cement sector, in order to ensure a carbon price signal to industry.

5 The calculations are done using aggregated production data from the Commission, the Benchmark Decision 2011/287/EU, own estimates for bench mark updates and production growth rates from Ecofys

6 April 2017, 'No trade-off on Fairness: Recommendations from the Alliance for a fair ETS" see here



Over-compensating electricity production from waste gases in steel production

Waste gases are secondary products of iron and steel activities. These gases are degraded fuels with high carbon content and can be recovered for the production of heat or electricity. The European Parliament put forward a provision that would ensure 100% free allocation for the production of electricity from waste gases. This provision is problematic for the following four reasons:

1. **It would lead to over-compensation**. Steel producers in most cases are already fully compensated for their emissions through free allocation and state aid for indirect costs. Analysis of EU Transition Log data shows that the best performing steel installations will not face any costs from the EU ETS revision in the 2021-2030 period. This is because steel producers already receive free allowances for 85% of the emissions from waste gases, regardless how the waste gases are used. Where the waste gases are used for heat production, the steel company receives the remaining 15% as an additional free allocation. When the waste gases are used in electricity production, the steel installation can receive state aid for the cost of carbon passed through the price of the electricity it consumes (indirect cost compensation).
2. **It would lead to market distortions**. Free allocation for the full carbon content of waste gases used in the production of electricity would create an exemption from the principle that electricity generation receives no free allocation. It would hence create market distortions in the power sector, as electricity generation from other sources than waste gases does not receive free allowances. Other sectors that produce some of their own electricity (refining, chemicals) would also not receive this special treatment.
3. **It would disincentivize efficient use of resources.** Once the full carbon content of waste gases is included in the benchmark, there is no longer an incentive to use waste gases for heat recovery instead of flaring them.
4. **It would increase the free allocation to steel by 150 Mt CO_2.** The free allocation for the iron and steel sectors in the 2021-2030 period will be around 2 billion allowances. If the steel industry would receive 100% free allocation for waste gases, this amount would be increased by another 150 million allowances. In comparison, the cumulated surplus of allowances in the steel sector is reported to be in the order of 500 million allowances by 2020.

The European Court of Justice on 8 September 2016 moreover rejected the steel industry's claim for additional free allowances for its waste gases and confirmed the current methodology for compensating the steel industry for energy recovery from waste gases. Any additional compensation, as proposed by the Parliament, would go against this court verdict.

Do not overcompensate the steel sector for energy recovery from its waste gases

Discrimination between the industry and power sectors should be removed by eliminating unjust overcompensation to the steel sector for its energy production from waste gases. The European Parliament adopted a provision to allocate 100% free allowances for electricity production from waste gases, even though the current system already ensures full compensation for waste gases through free allocation and state aid for indirect costs.
The EP proposal is problematic as it would lead to over-compensation and market distortions with other electricity sources that do not receive free allowances. A recent court verdict moreover ruled against such additional subsidies.

A fair deal for innovators

Industrial emissions have barely been reduced to date: in 2016, they fell by just 0.2% and since 2012, they have been cut by only 1%[1]. Projections by Member States show that this trend will continue as emissions from industrial sectors are not expected to decline up to 2030[2].

This slow pace of industrial emission reductions is not due to a lack of solutions: there is a lot of potential to achieve deep emission reductions while enhancing the competitiveness of European industry[3] with options ranging from shifting to a bio-based, circular economy, to increasing the use of recycled scrap for secondary steelmaking and clinker substitution in the cement sector. For example, the most efficient cement production occurs in Asia[4] and Indian cement production is 20% more energy efficient than European production.

To ensure that Europe does not fall behind in the global low-carbon transition, the EU ETS needs to move to an instrument that provides incentives to reduce industrial emissions, encourage efficiency improvements through carbon pricing and invest auctioning revenues in breakthrough technologies in carbon-intensive sectors.

Under the EU ETS reform, a new Innovation Fund will be established to support industrial breakthrough technologies. The Commission and the Council want to set up this fund with an endowment of 450 million allowances. The Parliament has proposed to increase the fund to 650 million allowances, or around €16 billion.

While in principle an excellent idea, the concept of free allocation undermines the objectives of the fund because it shields European industrial companies from receiving a sufficient price signal to produce more efficiently. In other words, the EU ETS proposal foresees to hand out between 6.3 – 7 billion allowances for free to industry, which ultimately subsidizes pollution, while it foresees an endowment of 450-650 million allowances for the Innovation Fund. The pay-outs to industry in the form of free pollution permits will hence be over 10 times more than the amount that the EU plans to spend on supporting innovators.

Increase support to industry innovators through a larger Innovation Fund

Under the EU ETS reform, subsidies for industry pollution will be over ten times higher than support to industry innovators. To slightly correct for this imbalance and reward industry innovation, the Parliament proposed to increase the Innovation Fund from 450 to 650 million allowances. This would make available an additional €5 billion for frontrunners that want to invest in breakthrough technologies. If all allowances are auctioned in the future, more revenues can be invested in low-carbon innovations to make the EU ETS a fair instrument for industrial frontrunners.

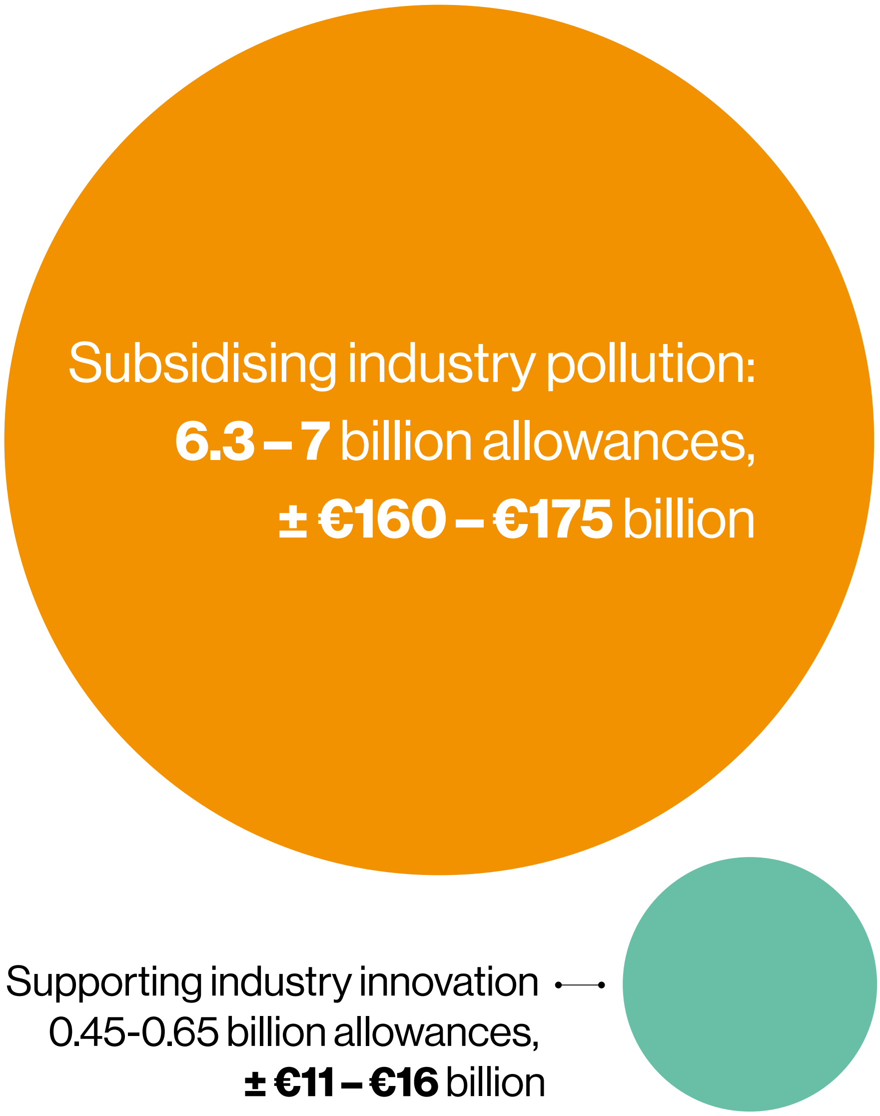
1 Sandbag (2017), NEW DATA: European coal emissions plummet by 11% in 2016, here.

2 EEA (2016), Trends and projections in the EU ETS in 2016 - The EU Emissions Trading System in numbers, here.

3 Institute for European Studies (2016), The final Frontier – Decarbonising Europe's energy intensive industries

4 Climate Strategies (2014), Staying with the Leaders: Europe's path to a successful low-carbon economy

Subsidies for industry pollution versus support for industry innovation in the EU ETS (2021-2030)



**Assuming an average carbon price of €25/tCO2 in the 2021 - 2030 period*

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