

27 June 2008

## **BUSINESSEUROPE POSITION ON THE ISSUE OF “CARBON LEAKAGE”**

### **Executive Summary**

The EU ETS directive proposal in its current form will lead to a loss of competitiveness and, eventually, carbon leakage<sup>1</sup>, if no countermeasures are taken. This is due to the fact that production of manufacturing industry within the EU will be less profitable than production outside the EU as long as competitors outside the EU are not facing an equivalent burden.

European business regards relocation of production, investment and emissions outside Europe resulting from EU legislation as unacceptable from a socio-economic and environmental perspective. BUSINESSEUROPE therefore insists that manufacturing industries exposed to international competition must receive 100 per cent free allocations against independently scrutinized technology or efficiency benchmarks unless and until there is an international agreement with equivalent burdens for industry outside Europe.

This paper offers a general business point of view on the issue of carbon leakage criteria - cross-cutting all sectors and addressing both direct and indirect effects. However, BUSINESSEUROPE also supports the work already started to address specific sectors that are threatened by relocation and carbon leakage, since the way various sectors are impacted by the ETS varies from sector to sector and product to product.

BUSINESSEUROPE raises a number of issues we would like to see being taken into consideration when analysing carbon leakage and exposure to international competition. Firstly, we address some concerns about the way the Commission and others have chosen to analyse carbon leakage so far. Concerns are raised about the scope of the work programme, the focus on cost analysis and the conclusions concerning the impact of transport costs. Secondly, we highlight some issues which we find imperative to be taken into consideration when analysing carbon leakage, in particular the need to analyse profitability of investments within energy-intensive industry in the EU as compared to investments outside the EU. These issues are further elaborated upon in the text below.

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<sup>1</sup> i.e; the increase of production outside the EU resulting in higher overall greenhouse gas emissions

## **General comments**

The EU Emission Trading Scheme (ETS) imposes extra costs to European business which competitors outside the EU are not facing as long as non-EU competitors do not share an equivalent burden. To safeguard EU business competitiveness it is therefore imperative to ensure that the EU ETS after 2012 is designed and implemented in such a way that the risk of carbon leakage is eliminated.

EU industry, and in particular energy-intensive industry (EII), is holding back investments already, simply because the existence of carbon constraints and the price of emitting CO<sub>2</sub> within the EU reduce profitability of investments within EII already today.

To be aligned with the Lisbon Strategy, EU ETS should neither lead to relocation of production outside the EU, nor should it lead to significant windfall gains for EU producers.

BUSINESSEUROPE strongly emphasises that EU EII's competitiveness will suffer significantly if non EU producers do not face similar and verifiable carbon constraints. In this context, the directive proposal's scope for defining carbon leakage is not complete<sup>2</sup>: it needs to be extended to "all competing installations outside the EU not having an equivalent burden that is monitorable, verifiable, subject to mandatory enforcement arrangements and which internalise the cost of carbon". This also means that the geographical scope of an international agreement is of key importance. In the absence of a suitable international agreement, free allowances will rebalance EU EIIs competitiveness.

In the absence of a suitable international agreement, considerations of border adjustment measures raise concern with BUSINESSEUROPE. The competitive distortion of the EU ETS cannot be solved through mechanisms which will simply introduce different measures of competitive distortion, high risk of WTO incompatibility with risk of retaliation, and significant administrative burden to the companies involved.

BUSINESSEUROPE therefore insists that manufacturing industries exposed to international competition must receive 100 per cent free allocations against independently scrutinized technology or efficiency benchmarks unless and until there is an international agreement with equivalent burdens for industry outside Europe.

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<sup>2</sup> (art. 10a, 9. ...installations in sectors exposed to a significant risk of carbon leakage .....shall take into account the extent to which it is possible ....to pass on costs...without loss of market share to less carbon efficient installations outside the Community...).

BUSINESSEUROPE welcomes an open and transparent process to establish facts in order to come to a timely decision on which sectors are at risk of carbon leakage due to the additional direct and indirect cost imposed by the EU energy and climate package.

The competitiveness of all EII must be safeguarded as long as there is a risk of carbon leakage. According to the current draft of the legislative text, however, the exceptions for sectors at risk of carbon leakage would cease automatically either in 2020 or “once an international agreement is concluded”. However, BUSINESSEUROPE emphasises that all EIIs are at risk of carbon leakage as long as other regions do not put equivalent burdens on their companies’ emissions.

### **Comments related to choice of analytical method**

With specific reference to the “Work Programme of DG ENTR EII-Taskforce”<sup>3</sup>:

#### *1. EII and the sectoral scope of the project:*

The choice of sectors often seems to build on the idea that those sectors facing the largest cost impact of the ETS are the only ones relevant to the leakage issue. However, a wider definition of sectors - potentially harmed by the cost of the ETS - is needed. The current definition of “energy-intensive” industries is too narrow and should be broadened to consider also the indirect effects on downstream parts of sectors, where ETS will be an extra cost which competitors outside the EU do not have. These sectors must therefore also be covered by the scope of sectors to be analysed.

Though the scope of the analysis only reflects carbon leakage outside the EU, it is worth notifying that the ETS must be developed in such a way that market distortions and increased greenhouse gas emissions are avoided, no matter whether this comes in the shape of leakage to non EU competitors or whether leakage takes place inside the EU.

#### *2. Pass-through of carbon costs and price elasticity analysis:*

The Commission puts much focus on analysing the cost impact of the ETS on companies and their capacity to pass-through these costs to the market. An analysis of price-elasticities could help clarify the expected short term impacts of the EU ETS on companies. However, such an analysis is made more difficult where either threshold effects in CO<sub>2</sub> prices or cumulative effects concerning the combined energy and CO<sub>2</sub> price impact are at play,

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<sup>3</sup> Document accompanying the Commission’s data gathering exercise with European sector federations in February/March 2008.

which will mean that there are "price jumps" which cannot be reflected in a price elasticity analysis.

Furthermore, when looking at how costs are passed through to consumer prices, it is very important to understand that marginal cost considerations are not equal to total cost considerations. This has an impact on how the free allocation must take place to prevent carbon leakage, including how new entrants are defined and given free allowances. Relocation can only be prevented by benchmark allocation which will preserve the marginal costs.

If companies have already implemented energy investment to a level of high efficiency, with limited scope for further improvement on an economic basis, further cost constraints on such industries will likely lead to carbon leakage.

We believe that due to both conceptual and empirical limitations, complementary indicators will be needed to validate results. In this regard, an analysis of export market share developments seems inappropriate to capture a sector's ability to maintain competitiveness on a sustainable basis after the imposition of higher unilateral carbon constraints in Europe. It is essential to focus instead on the impact of the EU ETS on companies' relative profitability within a sector. Though BUSINESSEUROPE realises that information on profitability will be difficult to obtain due to the confidential nature of such information. For instance, in some sectors an extra cost of only 2 to 4 per cent of gross value added could annihilate profit margins. Using concrete price examples at company and product level would help illustrate this issue and would complement the costs analysis. Measures of substitutability between domestic and foreign production should also be refined.

### 3. *Transport costs:*

The geographic areas which are in competition with European industry vary from sector and product to sector and product. However, producers in any part of the EU compete with non-EU producers just outside the regional borders. Analysis linking the impact of various prices per ton of CO<sub>2</sub> to transport costs by sea and land can demonstrate how all regional EU markets can be covered by import from non-EU producers depending on the price of carbon emissions.

### 4. *Investment decisions*

As mentioned above, BUSINESSEUROPE would like to see the analysis expanded to focus on the impact which the ETS will have on investment decision due to changes in relative profitability. Some thoughts on this issue are reflected below.

The static and short term impact on EII of the EU ETS are referred to in the Commission's project as well as in other analytical work, though dynamic and medium to long term impacts are absent in these analyses. This is a significant weakness in the analysis, in particular since changes in market share may only occur after long term investments. It is therefore imperative to include the impact which the ETS will have on investment decisions. Factors that influence the return on investment of a company must be taken into account, such as profitability, operational costs and marginal costs. A unilateral EU regulation, increasing costs of emitting CO<sub>2</sub> only within the EU and not in similar ways outside the EU, will make investments in EII less profitable when located within the EU. While there is an important existing capital stock in Europe, lower profitability on marginal investments will lead to a gradual process of relocation and reduced incentives to technological upgrades. In turn, weaker productivity growth would further contribute to downgrading international competitiveness of EU EIIs and accelerate relocation. Although difficult to demonstrate statistically, these dynamic processes should be further investigated.

It is possible that the analysis and estimations just mentioned have already been carried out. The impact assessment of the energy and climate package from 23 January 2008 contain some estimations based on GEM-E3 which indicates that the model has been run (p. 114-116 in staff working document, Impact Assessment). This may indicate that the analysis described above has already been completed. If not, readjusting an existing analysis on these dynamic factors made by the Commission as background study to the EU Communication from Feb. 2005, *Winning the Battle Against Global Climate Change* (2005-IPTS study), should be considered. BUSINESSEUROPE would suggest a Steering Committee involving business to discuss the assumptions made when doing such further analysis. A possibility would be to use the GEM-E3 model to demonstrate impacts on production, trade patterns and regional investment patterns. This would illuminate the dynamic impact of the EU ETS and the risk of carbon leakage in a situation where other regions do not implement similar regulation.

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