

UK response to the European Commission's consultation on assumptions to be used for new EU ETS carbon leakage list 2015-2019

30 August 2013

[To note: UK view is provided in black text with the European Commission's consultation questions in blue].

A. Registration

A.1. What is your profile?*

Business
Trade association representing businesses
Government institution/regulatory authority
Academic/research institution
Non-governmental organisation
Citizen
Other (please specify below)

A.2. Please enter the name of your business/organisation/association etc:*

UK Government

A.3. Please enter your contact details (address, telephone, email):*

EU ETS Team
Department of Energy and Climate Change
3 Whitehall Place
London
SW1A 2AW
UK
eu.ets@decc.gsi.gov.uk

A.4. If relevant, please state if the sector/industry you represent falls under the scope of the EU ETS:*

Yes
No
Not relevant (please explain below)

A.5. Please explain why the question above is not relevant in your case (max 500 characters)

A.6. If your sector/industry falls under the scope of EU ETS, does the sector/company you represent receive free allocation under the harmonised allocation rules?*

Yes

No

Not relevant (please explain below)

A.7. Please explain why the question above is not relevant in your case (max. 500 characters)

B. I. General: competitiveness, carbon leakage and the 2009-2014 carbon leakage list

The questions in this section are an opportunity for stakeholders to express their general and broader view on carbon leakage issues, the list valid for 2013 and 2014 and will be useful from a policy evaluation perspective.

B.1. As stipulated in the ETS Directive, the aim of the EU Emission Trading System is to promote reductions of greenhouse gas emissions in the most cost-effective and economically efficient manner. To address the risk that, for reasons of costs related to climate policies, relocation of companies to areas which have laxer constraints on greenhouse gas emissions could lead to an increase of carbon dioxide emissions, Commission Decision 2010/2/EU has established the list of sectors and subsectors which are deemed to be exposed to a significant risk of carbon leakage. This list is valid from 2009 to 2014 included, and is incorporated in the determination of free allocation for 2013 and 2014.

In your view, how has the risk of carbon leakage evolved since the adoption of the first carbon leakage list in 2009:*

Increased substantially

Increased slightly

Remained the same

Decreased slightly

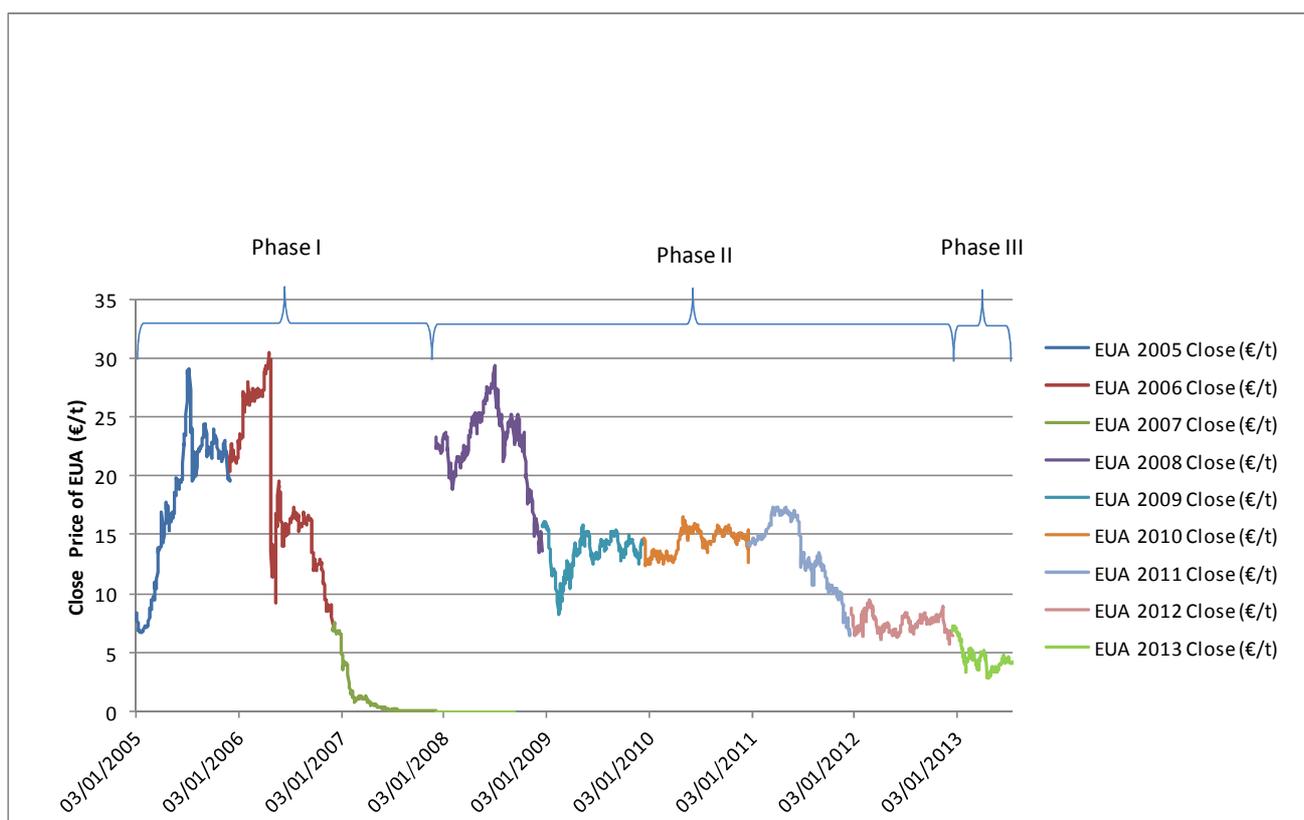
Decreased substantially

No opinion

B.2. If you wish, please motivate your answer (maximum 1000 characters)

The UK recognises the risk of carbon leakage and supports measures to minimise it. The risk of carbon leakage depends on a number of factors including the carbon intensity of production, carbon price, degree of international competition and cost pass through rates. All else being equal, a lower carbon price implies reduced carbon leakage risk. As demonstrated by the graph below since the adoption of the first carbon leakage list in 2009 EU ETS, and largely as a result of the recession, the price of EUAs has decreased substantially from approximately €30 in June 2008 to around €4 by July 2013, which indicates a substantial reduction in the risk of carbon leakage.

Figure 1: Price of EUA futures contracts 2005-2013 (source: Point Carbon)



However, we have little evidence of how other variables have changed over this period for example due to the recession. As a result we feel unable to provide a fully evidence based response to this question.

B.3. In your view, how adequate policy instruments are free allocation and the increased allocation for sectors on the carbon leakage list in particular in relation to the risk of carbon leakage?*

- Very adequate**
- Quite adequate
- Quite inadequate
- Very inadequate
- No opinion

B.4. If you wish, please motivate your answer (max. 1000 characters) (maximum 1000 characters)

The best way to address carbon leakage risk would be a legally binding international climate agreement. This would create a level playing field for industry inside and outside the EU.

We recognise the need to mitigate the risk of carbon leakage in the absence of such an agreement. In principle we support the free allocation of allowances as set out in the EU ETS Directive. The proportionate free allocation of allowances gives relief to

sectors at significant risk of carbon leakage, without raising barriers to international trade.

We welcome the Phase III rules put in place to adjust free allocation to companies whose installations have reduced activity levels or capacity. This will limit the potential for companies to generate allocation surpluses which are not a direct result of efforts to reduce greenhouse gas emissions.

However, the UK continues to be concerned by over allocation in the system which is in part driven by the economic slowdown and in part by low ambition in 2020 targets and is expected to persist until 2020 for a number of industrial sectors. Several studies indicate that some sectors have profited from the high levels of free allocation within the EU ETS (De Bruyn, Markowska, & Nelissen, 2010¹, Laing et al., 2013²).

The risk of carbon leakage may go up or down in the future, depending on internal (e.g. carbon price) or external (e.g. action by other countries) factors and we believe it will be key to continue to monitor it carefully using robust and transparent processes. We view the Ecofys study (2010), commissioned and published by the European Commission, as a helpful addition to the evidence base but further analysis is needed to build a picture of carbon leakage risk over time.

In the longer term the UK intends to assess the effectiveness of the free allocation mechanism in reducing the risk of carbon leakage and considering alternative approaches. As part of this work, we have commissioned Vivid Economics to carry out a carbon leakage research project that is due to report in the Autumn.

B.5. Currently 154 sectors and 16 sub-sectors are on the carbon leakage list valid for 2009-2014. In your view, how adequate is the coverage of sectors and sub-sectors in the current carbon leakage list?*

- The carbon leakage list is too short
- The carbon leakage list is of adequate length
- The carbon leakage list is too long**
- No opinion

B.6. If you wish, please motivate your answer (maximum 1000 characters)

We recognise concerns around competitiveness and carbon leakage, and reiterate the need for assessments to be based on sound analysis of the risk.

As highlighted by Ecofys's (2010) literature review, "...political compromises may have resulted in a list of sectors that is too long". We consider that only a few sectors are likely to be at high risk of carbon leakage. This view is supported by a range of research, including Climate Strategies³, the Oko Institute⁴ and CE Delft⁵.

¹ De Bruyn, S., Markowska, A., & Nelissen, D. (2010). Will the energy-intensive industry profit from EU ETS under Phase 3? *CE Delft Report*.

² Laing, T., Sato, M., Grubb, M., & Comberti, C. (2013). Assessing the effectiveness of the EU Emissions Trading System. *Centre for Climate Change Economics and Policy, Grantham Research Institute Report*.

³ Climate Strategies (UK) Reports (2007 – 2009) on: Tackling Leakage in a world of unequal carbon prices

In our view compensation should be focused on those where the evidence demonstrates most risk of carbon leakage. The UK is concerned that those most at risk may not be compensated sufficiently in the future if current EU ETS rules are not reformed, due to the reduction in the total amount of allowances available for free allocation as the overall EU ETS cap declines.

We continue to monitor and evaluate the risk of carbon leakage and have recently commissioned a carbon leakage research project that will report later this year.

B.A. II. Methodology for new carbon leakage list 2015-2019: options to be discussed in the Impact Assessment

Based on Article 10(a)18a of the ETS Directive, if third countries have firmly committed to reducing emissions in an extent comparable to the one of the ETS, it can be considered whether the trade between EU and these countries shall be treated the same way as intra-EU trade because there would be no risk of carbon leakage to such countries.

B.A.1. In your view, is there an increase of the ambition of domestic climate policies undertaken in countries outside the EU/EEA since 2009?*

Yes, a significant increase

Yes, some increase

No change since 2009

No, there is even some decrease

No, there is even a significant decrease

No opinion

B.A.2. If you wish, please motivate your answer (maximum 1000 characters)

A number of countries have increased their domestic climate ambition, including through development of trading schemes. However, much of this work is in the early stages and it is therefore difficult to judge the impact to date.

B.A.3. How do you see the climate policies of the following countries outside the EU-28 and EEA EFTA states, with which there are decisions or on-going discussions to implement ETS systems?

Fully comparable to the ETS

Partially comparable to the ETS

Not comparable to the ETS

No opinion

<http://www.climatestrategies.org/research/our-reports/category/32.html>

Hourcade et al (2007) Differentiation and Dynamics of EU ETS Industrial Competitiveness Impacts, *Climate Strategies* <http://www.climatestrategies.org/research/our-reports/category/6/37.html>

⁴ Öko-Institut, Fraunhofer ISI, DIW (September 2008) Impacts of the EU Emissions Trading Scheme on the industrial competitiveness in Germany

<http://www.umweltdaten.de/publikationen/fpdf-l/3625.pdf>

⁵ CE Delft (2013) Carbon leakage and the future of the EU ETS market-

http://www.cedelft.eu/art/uploads/CE_Delft_7917_Carbon_leakage_future_EU_ETS_market_Final.pdf

B.A.3.1. Australia*

Partially comparable to the ETS

B.A.3.2. Switzerland*

Partially comparable to the ETS

B.A.4. If you wish, please motivate your answer (maximum 1000 characters)

With both planning to link to the EU ETS, we would expect that both will change to become fully compatible with the EU ETS. Currently, Switzerland and Australia's (planned) ETSs will only be partially aligned with the EU ETS. Before linking can be finalised, both Switzerland and Australia will need to amend their ETSs to align with the EU ETS with regards to monitoring reporting, verification, compliance and enforcement, use of international credits, sectoral coverage, banking and borrowing rules, price control mechanisms, and ambition. As a result, in our view there will need to be an evidence based assessment to demonstrate the success of the linking prior to using them to guide the European principles of carbon leakage compensation.

B.A.5. How do you see the climate policies of countries or regions outside the EU-28 and EEA EFTA states?

Fully comparable to the ETS

Partially comparable to the ETS

Not comparable to the ETS

No opinion

B.A.5.1. China*

Partially comparable to the ETS

B.A.5.2. South Korea*

Partially comparable to the ETS

B.A.5.3. New Zealand*

Partially comparable to the ETS

B.A.5.4. USA*

Partially comparable to the ETS

B.A.5.5. Brazil*

Not comparable to the ETS

B.A.5.6. Russian Federation*

Not comparable to the ETS

B.A.5.7. Middle Eastern countries*

No opinion

B.A.5.8. Other country (please specify below)

B.A.6. If you wish, please motivate your answer (maximum 2000 characters)

China has committed to reduce emissions intensity per unit of GDP by 40-45% by 2020 compared to 2005 levels. China announced its intention to launch a national Emissions Trading Scheme by 2020. They are launching seven ETS pilots this year, with Shenzhen launching the first pilot system in June 2013. Although it is too early to make a definitive judgement, depending on the design of the scheme, this could align with the EU ETS in the future.

The Republic of Korea aims to reduce emissions by 30% from BAU by 2020. They are launching an ETS in 2015 but specific design is yet to be confirmed. Details are expected to be completed within 9 months. There are currently 3 phases: 2015-17; 2018-20; 2021-25, free allocation starts at 100%, 97% up to 90% respectively. Use of international offsets will not be allowed during Phases I & II (up to 2020). Companies will be allowed to use domestic offsets for up to 10% of emission allowances. Certified Emissions Reduction credits (CERs) created through projects in Korea will be eligible, many of these projects involve HFC23 and NO2 gases. This system partially aligns with the EU ETS.

New Zealand is committed to reducing GHG emission by 10 -20% below 1990 levels by 2020, but will not participate in the second commitment period of the Kyoto Protocol. New Zealand established an ETS in 2008 covering 50% of national emissions with an aim to achieving emission reductions of 10 to 20% below 1990 levels, if there is a comprehensive global agreement. This is partially aligned with the EU ETS.

The USA has pledged to reduce their emissions by 17% by 2020 compared to 2005 levels. California launched their ETS in January 2013 with a target to achieve 1990 baseline carbon neutrality by 2020 and 80% below 1990 levels by 2050, and will formally link systems with Quebec in 2014. Elsewhere, 9 states form the Regional Greenhouse Gas Initiative (RGGI), in an effort to reduce power sector emissions. This scheme aims to stabilise emissions until 2015, reduce emissions annually from 2015 by 2.5%, and achieve a total reduction through 2018 of 10%.

B.A.7. The ETS Directive requires the use of the Eurostat NACE classification (Statistical Classification of Economic Activities in the European Community) for the definition of sectors to be assessed for potential [1] inclusion in the carbon leakage list. In your view, what should be the starting point for the analysis of sectors, taking into consideration both feasibility and the structure of European industry?
[1] http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-RA-07-015/EN/KS-RA-07-015-EN.PDF*

NACE- 3

NACE- 4

No opinion

B.A.8. If you wish, please motivate your answer (maximum 1000 characters)

We continue to believe the carbon leakage assessment should be based on sound analysis of the risk and therefore the best available data. We would support the carbon leakage assessment starting at the NACE 4 level in order to accurately assess leakage risk between different sub-sectors.

B.A.9. In your view, the auctioning factor (an estimation concerning the share of allowances to be acquired if not on the carbon leakage list) should be:*

All industrial installations in the ETS receive free allowances based on benchmarks, according to the Benchmarking Decision (2011/278/EU). The amount of free allowances received per year if they are not deemed to be exposed to carbon leakage declines from 80% of the benchmark value in 2013 to 30% of the benchmark value in 2020. To assess direct costs, it is necessary to take into account the amount of allowances a sector would need to acquire if were not deemed to be exposed to carbon leakage. This assessment, referred to as 'auctioning factor' is expressed as a percentage and is used alongside actual levels of allocation in the calculation of the direct costs a sector may be facing under ETS.

- Uniform for all sectors
- Sectorial at NACE-2 level,
- Sectorial at NACE-3 level,
- Sectorial at NACE-4 level,**
- Other (please specify below)
- No opinion

B.A.10. If you wish, please motivate your answer (maximum 1000 characters)

Where data and evidence is available, the UK considers that the auctioning factor should be applied at a NACE level consistent with the starting point of the analysis of sectors.

B.A.11. The current carbon leakage list, applied for free allocation in 2013 and 2014, is based on a carbon price of €30. In your view, is this an adequate carbon price to be used for the new carbon leakage list for the period 2015-2019?*

- Yes
- No**
- No opinion

B.A.12. Please motivate your answer (maximum 1000 characters)

The UK believes the carbon leakage assessment should be based on best available evidence of what the carbon price is likely to be over the period. A carbon price assumption of €30 does not sit well with this principle and arguably does not reflect the likely position within Phase III unless structural reform were to be implemented ahead of 2020. Any revision of the carbon price assumption should consider market forecasts of carbon prices over time as well as the impact of the Phase II surplus and current growth projections.

B.A.13. In your view, which is the most adequate CO2 emission factor that should be used for the calculation of indirect costs?*

Average emission intensity of the whole electricity generation mix

Average emission intensity of the fossil fuel electricity generation mix

Emission intensity of marginal electricity generation in the current system

No opinion

B.A.14. If you wish, please motivate your answer (maximum 1000 characters)

Conceptually a marginal emissions factor might be considered most appropriate as it would, in a functioning market, measure the carbon content of a marginal price-setting plant, which would accurately reflect the extent to which carbon costs are passed through to consumers through electricity prices. However, this approach would entail considerable difficulties due to data limitations, the different types of electricity market across the EU, levels of uncertainty in determining the marginal producer over the time period and across the EU, and the need to take into account long term and base load contracts, regulated tariffs, and special deals.

We believe that an average emission intensity of the whole electricity generation mix is most appropriate in light of the practical difficulties around estimating a marginal factor. The factor would take account of all forms of electricity generation in the mix, including renewables and low carbon technologies.

B.A.15. On a scale from 1 to 5, where 1- the least, and 5- the most, what is your view on the following indicator for the qualitative assessment of the risk of carbon leakage: possibility of individual installations within a sector to reduce emissions

a: 1

b: 2

c: 3

d: 4

e: 5

f: No opinion

a b c d e f

B.A.15.1. Measurable*

B.A.15.2. Relevant*

B.A.15.3. Important*

B.A.16. On a scale from 1 to 5, where 1- the least, and 5- the most, what is your view on the indicator for the qualitative assessment of the risk of carbon leakage listed below: current and projected market characteristics

- a: 1
 - b: 2
 - c: 3
 - d: 4
 - e: 5
 - f: No opinion
- a b c d e f

B.A.16.1. Measurable*

B.A.16.2. Relevant*

B.A.16.3. Important*

B.A.17. On a scale from 1 to 5, where 1- the least, and 5- the most, what is your view on the indicator for the qualitative assessment of the risk of carbon leakage listed below: profit margins

- a: 1
 - b: 2
 - c: 3
 - d: 4
 - e: 5
 - f: No opinion
- a b c d e f

B.A.17.1. Measurable*

B.A.17.2. Relevant*

B.A.17.3. Important*

B.A.18. If you wish, please motivate your answer (maximum 1000 characters)

The UK has not responded to the question above (question B. A .15-17) as we believe decisions on indicators of carbon leakage need to be based on firm evidence and we not feel this question provides sufficient evidence.

However in our view, independently these indicators would not provide a sufficient level of detail to enable a qualitative assessment of carbon leakage risk. These indicators are required at the sector/ sub-sector level to provide a sufficient indication of carbon leakage risk for a sector/ sub-sector if it is deemed that a qualitative assessment is warranted. In addition, the relevance and importance of the indicator would also depend largely on the approach used to measure it.

B.A.19. On a scale from 1 to 5, where 1- the least, and 5- the most, what is your view on a framework for qualitative assessment, such as the one proposed in the study made for DG Climate Action and published on DG Climate website ? [1]

[1]http://ec.europa.eu/clima/policies/ets/cap/leakage/docs/carbon_leakage_list_en.pdf

- a: 1
 - b: 2
 - c: 3
 - d: 4
 - e: 5
 - f: No opinion
- a b c d e f

B.A.19.1. Complete*

B.A.19.2. Adequate*

B.A.19.3. Comparable across sectors*

B.A.19.4. Transparent*

B.A.19.5. Well-structured*

B.A.19.6. Clear and understandable*

B.A.20. If you wish, please motivate your answer: (maximum 1000 characters)

Within the current carbon leakage assessment framework, we support the principle of a qualitative element of the assessment. Our view is that this qualitative element should be focused on circumstances where the quantitative element is not appropriate. We would support the European Commission in making the qualitative assessment more harmonised, structured, robust and transparent.

The UK has not responded to the question above (question B. A .19) as we believe decisions on indicators of carbon leakage should to be based on firm evidence and do not feel this question provides sufficient information on the European Commission's preferred approach. To aid transparency and foster a greater understanding of the qualitative assessment, the UK requests that the European Commission publish:

- their preferred approach for the qualitative assessment for stakeholder consideration and comment, including methodologies and data requirements for each indicator; and
- reports detailing the evidence to support the outcome of any qualitative assessments with commercially confidential information redacted if necessary.

B.A.21. In the context of qualitative assessment, after considering the indicators listed in the study, do you consider that other indicators/variables should be taken into account when gathering basic evidence? Please explain (maximum 2000 characters)

The UK would support consideration of demand growth for products at the sector/ sub-sector level to the extent this is not captured by the indicators listed in the study. This could provide an insight into whether the impact of carbon price might be due to a general market trend of the product rather than carbon leakage risk.

In addition, the European Commission may wish to consider the infrastructure investment horizons for the sectors or sub-sectors. This could provide an indication of the risk of a sector moving production, investment and/ or physically.

B.A.22. If you wish, please provide any general comments on the questionnaire (maximum 1000 characters)

The UK welcomes the opportunity to contribute views on the assumptions to be used for the 2014 carbon leakage review and looks forward to further opportunities over the course of the Review.

With regards to broader concerns and in reference to our response to Q B.4, whilst the UK recognises the European Commission is taking steps to address the ETS surplus we believe urgent reforms are necessary to strengthen the EU ETS in order to better align the cap with long term climate goals. Long term reform of the system should be aimed at minimising the need to intervene in the market and providing more investor certainty while guaranteeing ambitious emissions reductions. In addition, support to reduce the risk of carbon leakage should be targeted at those sectors which evidence shows are most at risk of carbon leakage. An agreement now would minimise uncertainty and distortions, and promote investment. We continue to call on the European Commission to bring forward legislative proposals by the end of this year.