European Commission's ETS proposal lacks essential elements to enhance EU competitiveness and investment security

AmCham EU's response to the draft law on the Emissions Trading System post-2020

Executive summary

The American Chamber of Commerce (AmCham EU) counts among its membership global companies producing and heavily invested in Europe. As other global companies, AmCham EU members carefully weigh the decision of where to invest, and look at the regulatory environment as an investment signal among others. It is from this perspective that AmCham EU wishes to contribute to the debate surrounding the proposal on the future of the European Union Emissions Trading System (ETS) post-2020. While an effective ETS needs to be predictable, trustworthy and send the right investment signals to global markets, the current state of the proposal fails to provide for these crucial elements.

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AmCham EU speaks for American companies committed to Europe on trade, investment and competitiveness issues. It aims to ensure a growth-orientated business and investment climate in Europe. AmCham EU facilitates the resolution of transatlantic issues that impact business and plays a role in creating better understanding of EU and US positions on business matters. Aggregate US investment in Europe totalled €2 trillion in 2014 and directly supports more than 4.3 million jobs in Europe.

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POSITION PAPER

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Introduction

AmCham EU members are global companies that produce and are heavily invested in Europe. As other global companies, whether headquartered in Europe, Asia or Latin America, AmCham EU members carefully weigh the decision of where to invest. AmCham EU is concerned that some EU legislation and regulatory constraints may contribute to a less attractive investment climate in Europe. It is from this perspective that AmCham EU wishes to contribute to the debate surrounding the proposal on the future of the EU Emissions Trading System (ETS) post-2020.

AmCham EU represents a diverse group of sectors and industries, all of which are impacted by the EU ETS. We are concerned that the current proposal, which is being debated by the EU legislators, might not send the right investment signal. Thus far, the ETS has not delivered on its promise to reduce carbon dioxide (CO_2) emissions in a cost-effective manner. It has increased the costs of a number of sectors, and failed to deliver the investment signal expected.

AmCham EU members are committed to carbon reduction, and continue to see the ETS as the keystone of EU climate policy that should help reduce carbon emissions. AmCham EU is eager to be a constructive partner in the legislative debate that will take place over the next few months to ensure an effective ETS post-2020.

Uncertainty around the Commission's proposal does not encourage global business to invest in Europe

A strengthened ETS should not lead to a slowdown in investment which would weaken the EU's industrial base. It is essential that EU climate policy remains consistent with the EU objective of raising the contribution of industry from the current 16% of EU gross domestic product (GDP), to 20% by 2020[1].

To invest, a company needs visibility on whether it will obtain a satisfactory return on its investment. In an increasingly open world, investment projects are assessed on a global scale. Europe is but one region where such projects may be located; therefore, it must offer investment conditions that are attractive compared to those in other regions. In this context, regulatory uncertainty can be perceived as an investment risk. In Europe's current economic environment of sluggish growth, this must be addressed.

As indicated in the Commission's latest report on competitiveness in the EU[2], the accumulated investment gap in Europe from 2009 to 2014 exceeded €1.2 trillion and the average investment rate remains below its pre-crisis level of 23.5%. This trend in European investment deviates with that in other regions of the world, especially the United States, where the investment rate has recovered from the crisis. Some manufacturing sectors, especially energy-intensive industries, seem to be most affected. This situation must be tackled soon, as decreased investment has adverse effects on competitiveness and

[1] European Commission, *Communication for A European Industrial Renaissance*, COM (2014) 14 final, January 2014.
[2] European Commission, *Single Market Integration and Competitiveness in the EU and its Member States Report*, 2015, p. 7-10.

innovation by, for example, delaying equipment upgrades and shrinking research and development budgets.

EU climate policy should not be perceived as an investment risk, and this is especially difficult in a global context, where costs associated with climate policies are highly asymmetrical between regions. Looking at cumulative costs generated by regulation, EU ETS and energy together represent the largest share of the overall costs burden of the manufacturing sectors in Europe. For the metal sector it represents as much as 87% of the costs, with 46% for the ETS alone. This adds €60 per ton of production.[3]

One example of the legal uncertainty embedded in the ETS proposal is that the new carbon leakage list is only due to be released by 31 December 2019[4] – at the earliest. This means that industries that are close to the cut-off criteria will have little ability to plan to better absorb increased costs and assess the return on investment of their projects. The list should be published at an earlier stage to enable sectors to plan accordingly. So far, the EU ETS has not provided companies with sufficient visibility on direct or indirect carbon costs to drive investment either.

Furthermore, while the Commission has long argued that a strong price signal is needed for the ETS to drive low-carbon transformation, a credible carbon price trajectory is still missing. The backloading and Market Stability Reserve (MSR) decisions were proposed by the Commission with exactly this goal in mind. But the lack of a public assessment of the carbon price trajectory in the ETS impact assessment and proposal is a fundamental flaw[5], leaving investors and the public without any clear visibility to assess the cost of low carbon transformation.

Providing an adequate protection against the risk of carbon leakage

The system does not reward best performers

AmCham EU members understand that the EU ETS should support the efforts of the best performers. This is the very reason we question the proposed revision of the benchmarks and the reintroduction of the cross-sectorial correction factor (CSCF or C-factor).

To efficiently encourage innovation and investment in low-carbon technologies, it is essential that benchmarks take into account technological improvements, and not be based on a fixed annual 1% flat-rate reduction across all sectors. A flat-rate reduction does not reflect the reality of all the industries covered by the EU ETS. The risk here is that unrealistic benchmarks would undermine investments in new processes and technologies rather than encourage them. Benchmarks should instead be based on actual data to reflect the improvement potential of each sector.

Strict benchmarks may acts as a covert cross-sectorial correction factor (C-factor) but will not necessarily ensure that the C-factor will not be reintroduced in the future. The Centre for European Policy Studies report entitled *The EU ETS structural reform for Phase 4: views on the European*

[3] *Ibid*., p. 10.
[4] European Commission, *Proposal amending Directive 2003/87/EC to enhance cost-effective emission reductions and low carbon investments*, COM (2015) 337 final, July 2015, p. 20, article 10b (4).
[5] This is especially needed, since the 2030 Climate and Energy impact assessment was based on oil prices between $60-100 a barrel, which is far from the case today.

Commission proposal is enlightening in this regard[6]. It explains that the Commission, in choosing for the ETS to continue functioning with a set of fixed auctioned shares, had to reintroduce the C-factor: 'it became inevitable that the Commission retained the Cross-sectoral Correction Factor, as found in Art. 10a (5) of the Commission proposal.'

AmCham EU members feel that the C-factor will be counter-productive and contrary to the very philosophy underlining the EU ETS, as it cuts free allowances for all sectors, including the best performers and therefore might not provide the necessary incentives for investment in low-carbon technologies.

Carbon relief should be allocated fairly

The impact assessment attached to the Commission proposal defines carbon leakage as a '[...] situation that may occur if, for reasons of costs related to climate policies, businesses transferred production to other countries which have laxer constraints on greenhouse gas emissions. This could lead to an increase in their total emissions [...]'[7]. This definition includes both the notion of the cost burden on industries whose energy cost are very heavy, but also the notion that the European market demand for a given good could be satisfied by imports instead of local production, thereby exporting Europe's carbon emissions, while disrupting its own EU manufacturing capacity.

The Commission's proposal aims to do away with this approach. Although trade intensity will continue to be assessed, it will cease to be a standalone criterion, which is sufficient grounds for relief. This means that trade-intensive sectors are set to lose most of their carbon relief post-2020, and that they will represent the bulk of the 100 sectors which are due to be removed from the carbon leakage list.

Furthermore certain sectors that should be entitled to free allocation on the grounds of the new formula are being treated differently and this situation should be normalised. For example, sectors that generate electricity offshore by oil and gas platforms for their own use (as they are unable to connect to the grid due to distance) do not receive the free allowances granted to land-based electricity generation facilities (which can pass costs through to customers).

Sectors exposed to the risk of carbon leakage should be entitled to present their arguments

The Commission's proposal mentions the opportunity for a few sectors to go through a qualitative assessment process provided they reach a threshold set at 0.18 through the carbon leakage list formula calculations. The Commission has not yet explained the rationale of this threshold or how this assessment will be made.

Any sector that believes its market conditions justify carbon relief should be able to reach out to authorities and present its argumentation, without having to first qualify through what seems to be an arbitrary cut off point. For the sake of transparency and predictability, the qualitative assessment parameters should be clarified as they are not sufficiently described in the proposal.

[6]'Centre for European Policy Studies, *The EU ETS structural reform for Phase 4: views on the European Commission proposal*, August 2015, p. 6.
[7] European Commission, *Impact assessment accompanying the document Proposal for a Directive of the European Parliament and of the Council amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments*, (SWD(2015) 135 final), July 2015, p. 96.

Compensation of indirect ETS costs is absent from the proposal

AmCham EU has been consistent in calling for the compensation of ETS indirect costs[8] in phase IV of ETS. As such, we are disappointed by the Commission's proposal which goes no further than the current, ineffective, status quo of using state aid mechanisms. This means the compensation of such costs depends on the will and or ability of national governments to support their industries. This results, on the one hand, in the ineffective protection of exposed industries and, on the other, in competitive distortions across the EU.

It is instead necessary to create a system to ensure the effective and full compensation of indirect costs at the level of best performers. The request to consider providing compensation for those costs was also put forward by the European Council[9]. However, the Commission's proposal fails to provide a legal framework to do so, which is problematic for the sectors in which indirect costs far exceed direct emissions costs.

Furthermore, the State Aid Guidelines, which the compensation of indirect costs refers to, will expire in 2020. This creates additional legal uncertainty, as well as the potential for market distortions. To prevent these, and to ensure compensation happens in a harmonised way, it would be preferable to define the compensation for indirect costs in the ETS directive itself, and to fund it via the recycling of auctioning revenues or other budget sources if necessary.

Further increases in energy costs would penalise EU based industries

There is already clear evidence that energy costs are significantly higher in Europe than in other regions of the world. For instance, European electricity costs are more than twice of those of the US and Russia, and are 20% higher than in China.[10] By 2035, electricity prices in the EU are projected to become the highest among leading industrial countries[11]. This situation already penalises EU-based production, a fact that has been eloquently outlined in the International Energy Agency's (IEA) World Energy Outlook 2013[12]. The IEA projects that over the next two decades Europe (and Japan which is also heavily dependent on energy imports) will lose one-third of its energy intensive export market. Another increase of those costs because of the EU ETS will only accelerate this trend.

Wholesale energy prices are set on global markets and this is especially true for oil. Therefore, the discrepancies in terms of retail prices can only be explained by distorting schemes, public interventions and tax levies on energy. EU institutions and national governments therefore have their role to play in addressing this discrepancy in energy costs among the great regions of the world and providing long-term predictability.

Against this backdrop, AmCham EU members in Europe have already significantly reduced their energy intensity. European manufacturing is already the least energy intensive, and therefore most energy efficient in the world[13]. However, the price gap is such that 'the reduction was not large enough to offset

[8] European Commission, *Proposal amending Directive 2003/87/EC*, COM (2015) 337, July 2015, p. 19, article 10 a (6).
[9] General Secretariat of the Council, *European Council's Conclusions*, 24 October 2014, paragraph 2.4, p. 2.
[10] European Commission, *Communication on Energy prices and costs in Europe*, COM (2014) 21/2, January 2014, p. 12.
[11] European Commission, *European Competitiveness Report 2014*, p. 190.
[12] International Energy Agency, *World Energy Outlook*, 2013.
[13] European Commission, *European Competitiveness Report 2014*, p. 198. Figures do not include NACE Rev. 1 23 coke, refined petroleum and nuclear fuel.

price increase', as recognised by the Commission in its Competitiveness Report 2014[14]. If the profit margins are not high enough to offset additional cost increases, there is a direct negative impact on competitiveness. In the same document, the Commission even indicates that 'caution is needed in using prices as a policy instrument to induce energy savings: the increase of energy prices created a real burden that most European firms were not able to fully compensate for', meaning the Commission calls for a careful study of the impact of energy cost on EU industry competitiveness[15].

Taking those points into consideration, AmCham EU members encourage policymakers to consider other effective and meaningful levers to promote decarbonisation, in addition to the ETS, without EU industry bearing a burden that would be detrimental to its competitiveness on a global scale. For instance, since the implementation of EU ETS, the CO_2 price is passed into power generation costs that impact EU electricity prices. However, local decision-makers have the ability to directly influence these energy costs through taxes and levies. The difference in electricity prices in Europe for the first half of 2015, with or without taxes and levies, was around 50% for all 28 countries[16]. Europe and its regulators at all levels should therefore seriously consider decreasing taxes and levies to improve Europe's competitiveness while at the same time meeting the EU's decarbonisation targets. This work should happen in parallel to a meaningful implementation of the ETS, with appropriate protection to all sectors at risk of carbon leakage.

Industry needs greater clarity on what the new Modernisation and Innovation Funds may entail

Modernisation Fund

AmCham EU takes note of the Commission's new Modernisation Fund, which is a result of the October 2014 Council conclusion on the 2030 Climate and Energy Package[17]. Many AmCham EU members have a large manufacturing presence in Central and Eastern Europe and could benefit from further investment in their low carbon infrastructure. However, for the moment, it is still unclear how the Fund will be governed and whether it will support industry projects in addition to electricity generation projects. We welcome additional information and look forward to being involved in future discussions concerning the Fund's scope and governance.

We believe that the use of the Modernisation Fund needs to be consistent with the EU's 2050 decarbonisation ambitions. For this reason, eligibility criteria should be clearly defined in advance. The governance structure will play a crucial role in ensuring its successful implementation. As indicated in the proposal, the European Investment Bank (EIB) should play a prominent role, especially when it comes to selection criteria and project selection.

In addition, as for all funding which is due to advance investment in Europe's future low carbon economy, we recommend complete transparency around the use of these funds and that this ETS-derived revenue is earmarked for low carbon investments. The types of investments that could benefit from this fund should be clearly defined, and not too open to interpretation. However the tender process itself should be technologically neutral and not overly prescriptive.

[14] European Commission, *European Competitiveness Report – Energy costs and EU industrial competitiveness fact sheet*, 2014.
[15] *Ibid*.
[16] Eurostat data, available at: http://ec.europa.eu/eurostat/web/energy/data/database.
[17] General Secretariat of the Council, *European Council's Conclusions*, 24 October 2014.

Innovation Fund

AmCham EU welcomes the proposal to broaden the scope of the Innovation Fund, to finance industry projects with high carbon abatement potential, but notes that the timeframe for a return on investment may be hard to justify in a business context.

We find it encouraging that the Commission has recognised that some of its co-financing requirements were so strict that it limited the number of applications for EU low carbon funding, and that the proposal places a greater emphasis on the flexibility of co-financing requirements, and provides more of the funding up front, which is essential for certain projects. We also welcome the proposal to increase the maximum funding rate, which we believe should be up to 75%, as suggested in the impact assessment accompanying the legislative proposal. We believe that this funding, derived from revenues generated by ETS income, should go to projects selected first and foremost on the basis of their carbon abatement potential.

We also consider that this Fund could be instrumental in reaching the EU target of increasing energy efficiency by 27% in 2030. As stated by the Communication on the Energy Union, it is time to 'fundamentally rethink energy efficiency and treat it as an energy source in its own right' [18].

Compatibility across funds

Low carbon technology projects require the mobilisation of considerable amount of funding. This is why the Innovation and Modernisation Funds should be combined wherever possible and allowed to be supplemented by other European and national funding programmes. We recommend that the terms and conditions as well as the timelines for awards of the funds are matched. We also believe that more clarity is needed as to align support of Member States with state aid rules.

EU competitiveness also depends on developments in other regions of the world

To date, the mechanisms to reduce CO_2 emissions and mitigate climate change throughout the world remain patchy and asymmetric compared to EU commitments. Much work remains to be done to ensure the burden becomes equally shared with other parts of the world. The EU ETS remains by far the largest carbon market. In its impact assessment[19], the Commission mentions that ETS-like systems are developing quickly worldwide. However, it is recognised that 'their approaches, design features and levels of ambition are heterogeneous'. They are mostly on a sub-national scale (city or regional) like in Quebec and California, or when they are national, they are implemented in countries that do not have a strong industrial base, such as Kazakhstan, New Zealand, South Korea and Switzerland. It is has been announced that the Chinese mechanism, launched in 2014, is to be extended nationwide next year. Nevertheless, this announcement can only be considered a game changer upon further information about the new scheme, its implementation and scope. To date, the two systems are hardly comparable: the

[18] European Commission, *Communication on A Framework Strategy for a Resilient Energy Union with a Forward-Looking Climate Change Policy*, COM (2015) 80 final, February 2015, p. 12.
[19] As acknowledged by the impact assessment itself 'their approaches, design, features and levels of ambition are heterogeneous, making it difficult to quality the impact.' European Commission, *Impact assessment accompanying the Proposal*, (SWD (2015) 135 final), 2015, p. 33.

Chinese scheme covers the equivalent of 14 million tons of greenhouse gas emissions only against more than 8,300 million tons for the EU ETS[20].

The issue at stake is not so much comparing the features of different carbon pricing emissions but to ensure first that a global challenge is addressed at the appropriate level, and that the EU ETS fits in this global scheme, so that efforts are shared evenly.

The COP21 agreement has been celebrated as a significant step towards an international commitment in addressing climate change as a global challenge, setting long-term goals limiting the overall increase of temperatures below 2 degrees Celsius and possibly even 1.5 degrees Celsius. This agreement recognised the need to revisit commitments every five years to reflect the new technologies and opportunities that arise and to ensure policies are on track. Regularly scheduled stock taking exercises can make it easier to match the trajectory for decarbonisation indicated by climate science in a cost effective manner.

However, the essential question of how the agreement will be implemented remains unanswered to date. Business needs a stronger and more consistent economic visibility on targets and timelines, combined with a carbon price that can effectively underpin its decarbonisation efforts and provide finance to support the development of new technologies. Once again, the key question is how to ensure a clear governance to initiate and sustain efforts at the right level, while sharing the burden appropriately. EU emissions account for less than 10% of global emissions and this share is projected to be even lower by 2030 while the emissions of China and other major emerging economies will increase. Against this backdrop, it is essential to ensure that sectors covered by the EU ETS, which will be at the forefront of decarbonisation, should be encouraged and supported with the appropriate regulatory framework.

Conclusion

In this paper, AmCham EU members have highlighted what they find encourgaing, and what leaves unanswered questions in the Commission draft law on the future of the ETS. We hope that by raising awarness of these oustanding questions, and the doubts their raise for eventual investors into the European economy, these will be discussed and addressed in the months to come while the legislators negotiate and define what the ETS will look like in the near future.

As always, AmCham EU intends to be an active particpant in the debates to come, and is eager to share its expertise with the regulators.

[20] *Ibid*., p. 15. Figures from Bloomberg, quoted in the document.