

Comments of voestalpine on the Commission's report COM(2012)652 on „The state of the European carbon market in 2012”

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In its conclusions the Market Report clearly spells out that

- “imbalances ..between supply and demand ... will ... affect the ability of the EU ETS to meet the ETS target in future phases” and that
- “a solution ... would require a structural measure affecting ... the balance between supply and demand”.

Contrary to this view, voestalpine understands that the biggest risk to the Emissions Trading System is not an oversupply with allowances but the current determination of the Commission to use the emissions trading system primarily as a tool for applying an ever increasing CO₂-price on all activities regardless of their actual susceptibility towards CO₂-pricing.

voestalpine agrees with the Commission that a structural reform of the Emissions Trading System is necessary. But contrary to the Commission, voestalpine suggests not to narrow a structural reform down to reducing allowance volumes but to

- **refrain from interference before 2020;**
- preferably already in 2013 discuss and agree on a structural reform which would **come into effect after 2020;**
- base such a structural reform on differentiated regimes according to the specific ability of a CO₂ price to act as an incentive in **different sectors or activities;**

The continuation of European based operations of the energy and resource intensive industries of the EU are not only indispensable for the envisioned transformation of the European Union until 2050, but these industries are also willing and determined to play an active role. For this, the boundary conditions set by politics thus must create a supportive environment. Generally applied CO₂-pricing alone can not provide this.

The recommendations made above rest on the following more detailed analysis of the Market Report:

Articles 10.5 and 29 oblige the Commission to report on the **functioning of the carbon market**^[1] and in case of evidence that it is not functioning properly and if appropriate, to accompany this with proposals to increase its transparency and functioning^[2]. The Commission takes the position that “with the surplus already at almost a billion allowances in 2011, there is a real risk of seriously undermining the orderly functioning of the carbon market by causing excessive price fluctuation due to the additional short-term over-supply of allowances”¹. It is highly questionable, if price fluctuations in themselves can be considered as sufficient a proof for a non-functioning market, even if they are “excessive”. Usually, it is understood that an overly large volume of goods (allowances in this case) supplying a market may impose unwanted downward pressure on market prices but does not impact on the orderly functioning of this market. In other words: The effects the market should generate cannot be achieved but the market itself does function well. Thus, only direct interference with the market mechanisms would qualify as a risk for undermining its orderly functioning. In this respect it is also useful to recall the positions of the institutions during the legislative procedure for the revision of the Emissions Trading Directive in 2008. Already in the proposal for a revised directive the Commission stated that carbon price adjustments in response to an oversupply with

¹ COM(2012)652; page 6; Chapter 3; second paragraph

certificates are a sign of a “working market”^[3]. Why an analogous situation some years afterwards should suddenly qualify as a market the orderly functioning of which is undermined is not obvious and in need of a detailed justification. Furthermore, it should be taken into consideration that in the only reference the European Parliament made to the issue of carbon market surveillance was by the opinion of ITRE. Therein, the “functioning of the carbon market” is linked to the “elimination of windfall profits”, equal treatment of incumbents and new entrants as well as to a delivery of the benefits promised by auctioning, namely to be the “simplest and generally considered to be the most economically efficient system”^[4].

In the introduction to the report COM(2012)652 (the “Market Report”) the Commission explains that **CO2-pricing** is the European Unions’ instrument of choice to initiate and drive the desired transition to a low-carbon economy by 2050^[5]. This statement is not true and it is highly advisable that it does not become so in the future. Article 1 of the Emissions Trading Directive is the place where respective programmatic provisions can be found^[6]. However, the wording of this article does not point towards a certain function of emissions trading, because cost-efficiency and economic efficiency can be achieved by a variety of means and not necessarily by CO2-pricing only. If the experience with the European Unions Emissions Trading System has resulted in one insight it is this: In the absence of a comprehensive, enforceable and enforced international agreement a unilateral CO2-price may to some extent be supportive to investment and technology change in the power sector but exerts detrimental effects on the manufacturing industry. This is the case because the level of the CO2-price needed to initiate and maintain the transition is too high to be borne unilaterally by the European Unions’ manufacturing industry and at the same time to allow it to remain globally competitive. Since a globally competitive manufacturing industry is needed to operate on European Union soil to provide the materials, the technologies and the value added to finance the transition to a low-carbon economy, the whole concept of the priority of CO2-pricing is actually impeding any progress in said transition. Consequently and with a view to the prospects of concluding a comprehensive, enforceable and enforced international agreement, the CO2-price-focused Emissions Trading System of today can never play “an increased role in the transition to a low-carbon economy by 2050”.

More as a side-note: It is not obvious why the Commission states that the Market Report “responds to a call of the European Parliament and the Council made in the context of the Energy Efficiency Directive”². The respective wording, which is cited in the Market Report^[7], appears not to originate from the European Parliament nor the Council but rather to have been taken from a “Draft Commission statement in relation to EU ETS” attached to the European Parliament legislative resolution on the Energy Efficiency Directive³ and a respective Commission statement attached to the Council Conclusions on this directive from the 2nd October 2012⁴.

Based on the Commission’s analysis on the functioning of the carbon market (which voestalpine contests, see above) the measure of choice for the Commission is a proposal to “backload” some of the allowances earmarked for auctioning in the 3rd trading period. The objective of this “**backloading proposal**” appears to aim to “rebalance supply and demand in the EU ETS market into the transition into phase 3 and reduce volatility caused by the rapid build-up of surplus allowances”⁵. In itself this is

² COM(2012)652; Introduction; page 3; fifth paragraph

³ P7_TA-PROV(2012)0306 ; page 177

⁴ Council document 13917/12 ADD 1 REV 3; page 2

⁵ COM(2012)652; Chapter 3; page 6; fifth paragraph

a legitimate task. As explained above, there is, however a problem with this approach and this is rooted in the Commission's claim that backloading will address market failures. As argued above, for three reasons this is not the case. First, because price volatility in itself is not a market failure. Second, because actual market failures cannot be successfully addressed by something like backloading. Third, the Market Report itself mentions that the surplus expected for trading period 3 is of a structural nature⁶. Consequently, "backloading" does not appear to be a potent measure to address the structural influences the Commission herself has identified. It should be carefully analysed, if it would not be more efficient instead of backloading immediately to start a discussion on a structural reform of the Emissions Trading System with the objective to adjust it to the long term climate policy objectives of the European Union as from after 2020. A respective political agreement during 2013 would also support the carbon market of today and in a more sustainable way. With respect to the issue of the orderly functioning of the market it should also be taken into account that suitable measures are not related to anything like backloading and that respective powers should rather be placed in the hands of an independent market regulator than to rest with the Commission.

The Market Report does not only intend to provide explanation and justification for the so called "backloading proposal" but also proposes to introduce "structural measures"^[8]. The Commission reasons that backloading in itself cannot correct the assumed oversupply with certificates but that structural measures can be applied to this end. This line of reasoning introduces an interesting **contradiction** with the starting point of the Market Report, namely that the market is not functioning properly. Because, if structural measures are needed, then, obviously, there must be a problem related to the structure of the Emissions Trading System and not to the orderly functioning of the market.

The Chapter 4 of the Market Report is entirely devoted to the **Commission's list of options for a structural reform** of the Emissions Trading System. Since the starting point of the Market report is the role of the Emissions Trading System as the main tool to set a certain CO₂-price level it is not surprising that also the list of structural measures consists entirely of those whose only aim is to reduce the amount and number of allowances available in the Emissions Trading System. Three of these measures (Option b, Option e, Option f) are intended by the Commission primarily to reduce the number of allowances available in the third trading period, whilst another three (Option a, Option c, Option d) are in addition deemed suitable to align the pressure on the economy with the 2050 objectives. Because voestalpine contests the case of CO₂-pricing as the pivotal driver for transition to a low-carbon economy, voestalpine also deems these six options as not being advisable.

- **Response to the carbon price:** Not all sectors can respond positively to a carbon price. This has already been acknowledged to some extent by the introduction of benchmarks into the Emissions Trading System. However, the protection that these benchmarks can provide against undue impacts of CO₂-prices on the manufacturing sectors of the European Union is limited to the extent of the 20%-objective of 2020. A tightening of the allowance supply without specific additional measures for the manufacturing industries to avoid negative CO₂-price impacts would thus not strengthen the Emissions Trading System with a view to proceed towards the 2050 objective.
- **Competition distortion:** The Emissions Trading System has introduced unjustified different treatment of comparable industrial activities throughout the European Union,

⁶ COM(2012)652; Chapter 2; page 5; second and third paragraph

which gives rise to competition distortion. The reason for this is that the supply of industrial activities with cost free certificates is not a function of their carbon efficiency but of historical coincidences and its historical production volumes. Perversely, the less economically competitive a company to which an activity belongs is today, the higher is its chance of receiving a comparatively larger share of cost free allowances. Since in energy and resource intensive industries carbon efficiency is an important success condition for global competitiveness, the Emissions Trading System of today subtly procrastinates economic restructuring processes of the European Union and thus does not promote reductions of greenhouse gas emissions in a cost-effective and economically efficient manner. A tightening of the allowance supply would only aggravate this situation.

- **Energy prices:** Especially in Northern America today's energy prices are significantly lower than those in the European Union. With a view to the global competitiveness of the European Union's energy intensive industries and the value adding chains extending from these such a situation cannot be sustained for a longer period of time. A CO₂-price can only add to the cost of fuels and energy. This applies also to renewable and CO₂-lean energy sources because if they can become competitive within the European Union only by applying a CO₂ price, the energy price level in the European Union would inevitably rise to the extend of this CO₂-price increase compared to other global regions. As a result the European Union would have introduced a measure to widen the energy price gap with other regions of the world instead of making an effort to close it.
- **Materials needed and creation of values:** All the Commission's scenarios on how to approach the 2050 objective rely on new technologies, renewed transport fleets and new infrastructures. The large amounts of materials needed must be developed and produced by those energy intensive industries whose global competitiveness will be impacted most by a CO₂-price (and in cooperation with the technology developers). The material providing industries, amongst which the steel industry, as the "interface" to the natural resources are inevitably resource and energy intensive. However, without being competitive on international level, these sectors will not be able to invest in respective developments and production facilities and eventually the European Union would be forced to purchase the technologies needed for the transformation from abroad but might find that it cannot afford to do so. Therefore, the material providing industries need to be a pivotal element of the EU strategies. To do so, effects of the value chains, recyclability, by-products and product's life-cycles have to be taken into account.

Negligence of these four important influences and their interaction will result in a kind of downward spiral, which would make the 2050 objective and the development goals behind it an ever more elusive task. In addition, the transformation towards a low-carbon society requires considerable resources, which have to be assessed and provided for before agreeing on targets or trajectories.

**Responses of voestalpine to the questions the Commission tabled with her
“Consultation on structural options to strengthen the EU Emissions Trading
System”** (http://ec.europa.eu/clima/consultations/0017/index_en.htm)

Questions posed by the Commission:

“In order to assist the Commission in its evaluation of your contributions, it would be appreciated if you could maintain the numbering of the options, when commenting on the options in the report. Please indicate the expected impact of individual structural options, including on:

- emission reductions;
- ability of the EU ETS to meet the EU long-term target of an 80-95% reduction in a cost-effective manner;
- your activities or the activities of the business under your jurisdiction, including estimated changes in compliance and administrative cost;
- employment and households.

Please also state the reasoning behind your comments and any evidence supporting it.”

	Expected impact on emission reductions
Option a	Any generally applied increase in the reduction target will rise CO ₂ -prices. This may support investments to reduce emission in the power sector but, without a comprehensive, enforceable and enforced international agreement, will hinder such investments in the manufacturing sector, especially due to the energy intensive industries loss of international competitiveness. Consequently, emissions in the EU will fall but rise globally. Eventually, there is no net emission reduction but only a loss of economic activity in the EU.
Option b	See answer to Option a.
Option c	See answer to Option a.
Option d	An emissions trading system can either be designed to introduce a CO ₂ price or to foster technological development. It cannot deliver both results at the same time nor be applied on all actors. Thus already today, but surely in the long term, sectors which respond positively to a CO ₂ -price should be differentiated from those sectors which do not. That this differentiation is missing today, already places huge strain on the system and impairs its ability to actually reduce emissions. Consequently, adding new sectors to this scheme as it is, will only increase this strain and hamper actual emission abatements further. This observation does not exclude extensions of the scope, but conditions on a restructuring of the scheme. The inclusion of aviation already points in this way.
Option e	The use of credits in principle strengthens the ability of the ETS to deliver real emission reductions. Thus, limiting access as such should not be the main aspect of this Option e, but instead a harmonisation of credit use across the Member States. This could go hand in hand with a strengthening of UNFCCC rules to avoid unwanted effects in project host countries.
Option f	voestalpine is convinced that the intention to apply a steadily rising CO ₂ price on all activities regardless of their ability to respond positively is the real threat to the effectiveness of the Emissions Trading System. Consequently, price management mechanisms will only improve the functioning of the Emissions Trading System if designed and implemented very carefully and thus do not deliver emission reductions on their own.

	Expected impact on the ability of the EU ETS to meet the EU long-term target of an 80-95% reduction in a cost-effective manner
Option a	Any generally applied increase in the reduction target will rise CO ₂ -prices. This may support investments to reduce emission in the power sector but, without a comprehensive, enforceable and enforced international agreement, will hinder such investments in the manufacturing sector, especially due to the energy intensive industries loss of international competitiveness. The 80%-95% reduction target is only achievable by investment in new infrastructures, transport fleets and technologies. Without a globally competitive EU-based manufacturing and especially energy intensive industry these developments and investments are not feasible and said targets cannot be met.
Option b	See Option a. The Option b has one theoretical benefit compared to Option a, namely that it could be feasible not to retire all backloaded allowances but to allocate some of these in annual ex-post allocations to installations with growing production (compared to the reference period) and to the extent of benchmark values. This could be seen as a first step towards a differentiation between the power sector and the manufacturing sector, which is absolutely needed with a view to progressing towards the 80%-95% reduction target. However, such a scenario is impossible, if it would not be accompanied by full compensation for CO ₂ -cost in energy prices for energy intensive industries.
Option c	See answer to Option a.
Option d	Option d could have a positive effect only, if it were a part of a more fundamental structural reform, which allows for differentiation of ETS-rules in line with sectors capability to respond positively to CO ₂ -pricing.
Option e	Very little, because progress towards the 80%-95% reduction target entirely depends on technology development and implementation within the European Union itself.
Option f	voestalpine is convinced that the intention to apply a steadily rising CO ₂ price on all activities regardless of their ability to respond positively is the real threat to the effectiveness of the Emissions Trading System. This negative effect is not very visible at the emission reduction targets agreed for 2020 but will become ever more prominent with rising targets. Consequently, price management mechanisms will not enable the Emissions Trading System to deliver the 80%-95% reduction target on their own.

	Expected impact on your activities or the activities of the business under your jurisdiction, including estimated changes in compliance and administrative cost
Option a	Already in Trading Phase Two voestalpine was short of allowances. This is not because of low carbon efficiencies in the production, but because of production growth, very strict rationing of allowances by the Austrian government and a relatively tight national credit use framework. If reports on oversupplies for direct competitors are true, voestalpine is already suffering from competition distortion due to the structure of the ETS both within the European Union as well as with competitors from outside the European Union. For Trading phase three a significantly increased shortage is expected for the existing 2020 targets and thus the competition distortion will increase. Any generally applied increase in the reduction target for 2020 will increase the competition distortion even more.
Option b	See Option a. The Option b has one theoretical benefit compared to Option a, namely that it could be feasible not to retire all backloaded allowances but to allocate some of these in annual ex-post allocations to installations with growing production (compared to the reference period) and to the extent of benchmark values. This could be seen as a first step towards a differentiation between the power sector and the manufacturing sector, which is absolutely needed with a view

	to progressing towards the 80%-95% reduction target. However, such a scenario is impossible, if it would not be accompanied by full compensation for CO2-cost in energy prices for energy intensive industries. For voestalpine this would allow to remove some part of the probably existing competition distortion introduced by the rigid ex-post allocation mechanism (see the answers to the other questions on Option b).
Option c	See answer to Option a.
Option d	Although the sectors which are subject to emissions trading are the ones most suited the administrative costs are already very high.. Any new sectors will be even more difficult to administrate and thus the specific CO2-costs for such activities will be significantly higher. For this reason the Option d needs careful analysis in this respect and should only be applied if the costs are not disproportionately high.
Option e	voestalpine actively uses the credit mechanisms to hedge its ETS risks. Most important would be harmonised rules across the European Union to reduce competition distortion and legal certainty on the validity of credits from different project phases for compliance.
Option f	This Option f will not contribute anything to address and alleviate the negative effects the current design of the Emissions Trading System has on voestalpine: Competition distortion within the steel sector in the European Union, competition distortion with global competitors, disincentive for technology development and deployment.

	Expected impact on employment and households
Option a	In spite of the visible endeavours of politics to make the true costs of climate policy invisible to the households, eventually it will be the households which will have to shoulder the costs, either by higher energy prices, by increased consumer product prices or by rising unemployment. Most likely, all three effects will appear simultaneously. This will be more and more felt with rising reduction targets. If technological solutions to reduce emissions with low costs are not available rather soon then social tension will rise and eventually bring down the whole climate change policy of the European Union. Consequently, the objectives, policies and instruments for the period beyond 2020 should not rely on carbon pricing as the main tool anymore but focus on developing and picking-up of cost-effective technologies and the relevant new infrastructures which both also need to offer increased customer service.
Option b	See answer to Option a.
Option c	See answer to Option a.
Option d	See answer to Option a.
Option e	See answer to Option a.
Option f	See answer to Option a.

- [1] Emissions Trading Directive Article 10.5: "The Commission shall monitor the functioning of the European carbon market. Each year, it shall submit a report to the European Parliament and to the Council on the functioning of the carbon market including the implementation of the auctions, liquidity and the volumes traded."
- [2] Emissions Trading Directive Article 10.5: "If, on the basis of the regular reports on the carbon market referred to in Article 10(5), the Commission has evidence that the carbon market is not functioning properly, it shall submit a report to the European Parliament and to the Council. The report may be accompanied, if appropriate, by proposals aiming at increasing transparency of the carbon market and addressing measures to improve its functioning."
- [3] COM(2008) 16 final; Explanatory Memorandum; Introduction: "However, the environmental outcome of the 1st phase of the EU ETS could have been more significant but was limited due to excessive allocation of allowances in some Member States and some sectors, which must mainly be attributed to reliance on projections and a lack of verified emission data. Once such data became available, it swiftly corrected the market price of allowances demonstrating convincingly that the carbon market is working."
- [4] Opinion of the Committee on Industry, Research and Energy for the Committee on the Environment, Public Health and Food Safety; PE404.749v02-00; 15.9.2008; Amendment 10: "(13) The additional effort to be made by the European economy requires inter alia that the revised Community scheme operate with the highest possible degree of economic efficiency and on the basis of fully harmonised conditions of allocation within the Community. Auctioning **will** therefore be the basic principle for allocation, as it is the simplest and generally considered to be the most economically efficient system. This should also eliminate windfall profits and put new entrants and fast growing economies on the same competitive footing as existing installations. **The Commission should monitor auctioning and the subsequent functioning of the carbon market to ensure that these two objectives are being achieved. To ensure a common and consistent approach to auctioning throughout the Union, auctioning should be administered by the Commission or a competent authority designated by the Commission. This would also ensure that auction revenues can be pooled and used more efficiently and effectively.** Justification: In order to minimise uncertainty for business, move further towards harmonisation and maximise efficiencies, auctioning should be administered centrally. In addition, the Commission should monitor the impact of auctioning, to ensure that it is delivering the benefits promised."
- [5] COM(2012)652; Introduction; page 3, paragraph 3: "The ETS will be critical in driving investments in a wide range of low carbon technologies. It is designed to be technology neutral, cost-effective and fully compatible with the internal energy market. The ETS will need to play an increased role in the transition to a low-carbon economy by 2050. Since the start of the second trading period in 2008, emissions are down by more than 10 % but while the carbon price signal of the EU ETS has certainly contributed to this, the economic crisis is clearly the major cause of these strong emission reductions."
- [6] Directive 2003/87/EC; Article 1; Subject matter: " This Directive establishes a scheme for greenhouse gas emission allowance trading within the Community (hereinafter referred to as the 'Community scheme') in order to promote reductions of greenhouse gas emissions in a cost-effective and economically efficient manner."
- [7] COM(2012)652; Introduction; page 3; paragraph 6: - "to examine in this report options, including among others permanent withholding of the necessary amount of allowances, for action with a view to adopting as soon as possible further appropriate structural measures to strengthen the ETS during phase 3, and make it more effective."
- [8] COM(2012)652; Chapter 3; page 7; paragraph 2: "A structural measure could correct this over-supply, thereby limiting its longer-term effects."