



## Paying the Polluters: EU emissions trading and the new corporate electricity subsidies

A new European Commission measure has opened the door to the granting of millions of Euros worth of subsidies to help the continent's largest corporate polluters with their electricity bills. This report shows how:

- A proposed reform to the European Commission's State Aid rules will allow member states to compensate industry for increases in electricity charges incurred as a result of the Emissions Trading System (ETS). Already, the UK Government has committed to covering these costs – as part of a £250 million (€300 million) commitment to “compensate key electricity-intensive businesses to help offset the indirect cost of the carbon price floor [a national initiative to set a minimum carbon price] and the EU Emissions Trading System.”<sup>1</sup>
- Some of the corporations that stand to benefit most from these new electricity subsidies have already profited massively from the ETS, most notably those in the steel sector. Eurofer, the European steel industry lobby group, has called for compensation despite over-allocations of pollution permits to the steel sector that could be worth billions of Euros.<sup>2</sup>
- The aluminium sector, represented by industry association Eurometaux, has also successfully lobbied for its compensation claims to be included in draft EU rules. Its submissions have massively overstated the impact of the ETS on the sector, while conveniently understating the real drivers of outsourced production, such as trade rules and cheap labour. In fact, much of the aluminium sector enjoys long-term contracts with private electricity suppliers at far lower rates than those paid by domestic consumers.
- The proposed reform of State Aid rules exposes significant flaws in how the Commission assesses “carbon leakage,” the perceived risk that caps on EU emissions could price business out of Europe and into less regulated markets, which would in turn contribute to an overall increase in greenhouse gas emissions. The price estimates lobbyists proposed to assess the risks are over five times the current or projected carbon price.



Photo: Thomas Guignard (flickr.com/photos/timtom)

From Aberdeen to Alicante, electricity prices have been rising across Europe – throwing millions of people into fuel poverty. Governments across the continent have frozen or scrapped benefits to cover electricity costs as austerity bites. For Europe’s most polluting industries, by contrast, the benefits keep rolling in. This report is about a new European Commission measure that has opened the door to the granting of millions of Euros worth of subsidies to help the continent’s largest corporate polluters with their electricity bills.<sup>3</sup>

New proposals to alter the European Commission’s State Aid rules would entitle some industries to receive subsidies towards their electricity bills – which are already, in most cases, far lower (per unit of electricity used) than those of ordinary consumers. In particular, the Commission wants to allow EU Member States to compensate companies exposed to “a significant risk of carbon leakage due to costs relating to greenhouse gas emissions passed on in electricity prices.” This would mean creating an exemption from the EU’s competition rules, which ban Member States from paying subsidies to corporations in most instances (see box: State Aid rules and emissions trading).

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On 21 December 2011, the Commission published draft proposals aimed at “enabling Member States to compensate under EU state aid rules for the risk of carbon leakage” resulting from the EU ETS.<sup>4</sup> As things stand, the proposed measure allows for compensation to aluminium, steel and other metal producers, as well as chemicals, paper and leather producers. These sectors have already been exempted from paying for their carbon emissions allowance, which they will be awarded for free (as long as these fall within an agreed benchmark). However, Germany has sought to extend compensation for electricity costs to up to 40 industrial sectors.<sup>5</sup>

Industry lobbying is now focused on two further demands. The first is to re-set the basis of the evaluation to look at “sub-sectors”, on the assumption that this would broaden the scope of the compensation claims.<sup>6</sup> For example, producers of glass for use in car production claim to be a trade exposed sector that loses out when classified with producers of glass windows in the building industry.<sup>7</sup> Secondly, industry is looking to increase the scope of potential compensation payments. The Commission is currently proposing compensation of up to 85 per cent of the costs that manufacturers claim to have incurred due to the ETS, falling to 75 per cent by 2020.<sup>8</sup> But the lobbyists are demanding more. “What we need is 100 percent,” Eurometeaux president Oliver Bell (an employee of Norwegian aluminium producer Norsk Hydro), told Reuters.<sup>9</sup> Business Europe weighed in with the same message in its response to DG Competition’s second consultation on the matter, held in January 2012.<sup>10</sup>

The Commission expects to adopt the new rules in the first quarter of 2012, in time for member states to introduce compensation related to the third phase of the ETS.<sup>11</sup> Although most countries will await the outcome of the consultation before granting subsidies, the UK government has already announced its intention to spend £250 million (€300 million) compensating industry for the “costs” of emissions trading, with at least £110 million (around €130 million) of this covering “indirect” electricity costs. EEF, the main British manufacturers’ lobby group, says that “In terms of eligibility, this goes further than we had hoped,” noting in particular the expectation that the scheme will include steelmakers.<sup>12</sup>

## State Aid rules and emissions trading

Membership of the European Union formally prohibits the 27 member states from providing subsidies (“State Aid”) to their national industries, with the aim of preventing “distortions” of free trade and competition.<sup>13</sup> The European Commission’s Directorate General for Competition is responsible for policing State Aid, and adjudicating complaints between companies and member states. It also sets guidelines on a wide range of exemptions to the State Aid rules. These allow subsidies to correct for some of the excesses of the free market but, with significant sums of money at stake, corporate lobbyists often target DG Competition with demands for rules that favour their interests.

In setting up the ETS, the Commission foresaw the contradiction between the granting of free emissions allowances and State Aid rules and granted a general exemption via Guidelines on Environmental Aid, issued in 2001 and revised in 2008.<sup>14</sup> These exemptions persist despite considerable evidence that the allocations result in industrial subsidies and windfall profits.

Changes to the EU Emissions Trading Directive, secured by lobbying, have led to further challenges to the State Aid rules, resulting in the new guidelines, including a review of the sectors “deemed to be exposed to a significant risk of carbon leakage due to EU ETS allowance costs passed on in electricity prices”.<sup>15</sup>

DG Competition has the sole legal competence for enforcing and revising the State Aid rules, although it is then up to member states to decide whether or not to grant subsidies, with money drawn from national budgets. This does not prevent lobbying via member states, however. This can take rather crude forms – for example, the Bulgarian government’s submission to the DG Competition consultation on State Aid rule changes consisted solely of a letter and lobby briefing sent by the International Zinc Association.<sup>16</sup> In the case of the German government, a more concerted effort has been undertaken to call for subsidies in a broad range of industrial sectors.<sup>17</sup>

## The “leakage” lobby

Since 2006, corporate lobbyists have mounted a concerted campaign to ensure that energy-intensive industries can benefit from lucrative subsidies related to the ETS, while at the same time avoiding obligations to reduce their greenhouse gases. This involved framing “carbon leakage” (see box: “The carbon leakage myth”) as a key problem with the scheme, which included the claim that the cost of carbon permits passed on via electricity prices was harming international competitiveness. The initial lobby strategy focused on stopping auctioning and weakening EU climate targets.

By contrast, the idea that companies should be compensated for their electricity costs only emerged as a fall-back position for some industries – notably, the chemicals sector and aluminium smelters – that were trying to exempt themselves from inclusion in the ETS to start with.<sup>18</sup> The compensation suggestion was first formally tabled in May 2007 at a consultation of the European Climate Change Programme Working Group which was consulting on revisions to the third phase of the ETS. At that meeting, Alistair Steel, Executive Director of EuroChlor (the European federation of European Chlor-Alkali producers), proposed “compensation for the energy intensive industry in the form of free-of-charge allowances taken from electricity generators.”<sup>19</sup>

The proposal received the support of “some industrial representatives” at the ECCP Working Group, and was raised in the context of a CEFIC (European Chemical Industry Council) lobby presentation to DG Enterprise in May 2008, but it only really gained traction as the broader energy-intensive industry lobby for free emissions permits reached its endgame.<sup>20</sup>

By November 2008, while reaffirming its call for 100 per cent free permit allocations for energy-intensive industry, BusinessEurope also stressed the “utmost importance to find a solution for alleviating the additional burden on electricity intensive industries caused by the increasing power prices.”<sup>21</sup> The proposal that member states should be allowed to compensate companies for “indirect” costs passed on through electricity prices was levered into the revised Directive at this point, as part of the last minute scramble to agree a deal.

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## The Carbon Leakage Myth

“Carbon leakage” is the risk that capping emissions in the EU could lead to net increases in emissions.<sup>22</sup> If industry decides to relocate from the EU to countries like India and China where there is no cap – so the argument runs – the net effect will be to increase emissions, since the energy intensity of industrial production in those countries tends to be higher.

There is remarkably little evidence that this is happening, however. The fact that carbon leakage has come to enjoy a status akin to self-evident truth has more to do with the frequency with which the claim is made, and the bargaining power of those making it, rather than its veracity. Although leakage could happen in a theoretical future (with carbon prices far higher than those projected for the next decade), it remains a marginal factor in relation to industrial outsourcing decisions.

Producers of steel, cement and aluminium are among those lobbying most heavily on the leakage question, yet a 2008 International Energy Agency study found that “[t]he EU emissions trading scheme (EU-ETS) has not, so far, triggered observable carbon leakage” in these sectors.<sup>23</sup> This finding was backed up by a further study of the first phase of the EU ETS, which found no evidence “demonstrating a correlation between European carbon prices and a loss of competitiveness” in the cement, refining, iron and steel, paper and pulp, petrochemicals, glass, or aluminium sectors.<sup>24</sup> Such a pattern is likely to continue, since carbon prices remain a relatively marginal factor in infrastructure investment decisions.<sup>25</sup>

While there has been a long-term trend towards relocating industry from the EU to the Global South, this has been driven by the liberalisation of international trade, and reductions in the marginal cost of international aviation and shipping.<sup>26</sup>

The main function of the leakage argument, by contrast, has been to enable heavy industry to gain free emissions allowances and punch holes in the stringency of ETS caps. An Analysis of options to move beyond 20 per cent greenhouse gas emission reductions and assessing the risk of carbon leakage presented to the European Parliament by Green MEP Bas Eickhout in February 2011 noted that energy-intensive industry sectors are likely to have a considerable surplus of emissions allowances. As the European financial crisis deepens this surplus continues to grow – with a leaked Commission report suggesting that the figure could reach 2.4 billion surplus permits.<sup>27</sup> The largest share of this surplus is held by energy-intensive industry.

## Corporate Electricity Subsidies: from principle to policy

Having established the principle of compensating energy-intensive industry for electricity payments (in article 10(a)6 of the revised directive), the lobby process changed gear. On March 2009, BusinessEurope’s director general Philippe De Buck wrote to Competition Commissioner Nelle Kroes calling for an early start to the process of revising State Aid rules to allow compensation payments to energy-intensive sectors, and to consider carbon leakage risks in relation to a “worst-case cost scenario” of a carbon price of €30 to €47 per tonne.<sup>28</sup> At that time, carbon prices had just crashed from a high of €31 to around €11, and were showing few signs of recovery.<sup>29</sup> The European Roundtable of Industrialists followed suit in May 2009, arguing that the Commissions should assume a carbon price of €39 or more whilst making its assessments, and demanding a system of ex-ante (upfront) compensation payments for “indirect costs” of electricity.<sup>30</sup>

**Since 2006, corporate lobbyists have mounted a concerted campaign to ensure that energy-intensive industries can benefit from lucrative subsidies related to the ETS, while at the same time avoiding obligations to reduce their greenhouse gases.**

The lobby agenda was then taken up by various industry associations. In May 2010, the International Federation of Industrial Energy Consumers (IFIEC) brought lobbyists from the copper, chemicals and paper sectors to a meeting with DG Competition,<sup>31</sup> and returned the favour by hosting speakers from DG Competition, DG Enterprise and DG Climate Action at its “Energy Forum” in June 2011.<sup>32</sup> In October 2010, Euro Chlor, Eurofer, Eurometaux, Euroalliances and ESTA sent a joint letter to Competition Commissioner Almunia calling for a framework for financial compensation for energy-intensive industry to proceed immediately, “independently of any quantitative leakage risk assessment.”<sup>33</sup>

Finally, from March to May 2011, the European Commission opened a public consultation on the question of “future Commission Guidelines for State aid in the context of the amended EU Emissions Trading Scheme.”<sup>34</sup> More than two-thirds of the 145 responses came from industry lobbyists, the majority of which were from energy-intensive industries demanding a generous interpretation of the ETS Directive’s provision to compensate companies for their electricity costs. The steel and aluminium sectors were amongst the most active of these lobbyists.

## Heavy metal lobbying: steel and aluminium

In a presentation to DG Competition in March 2010, Eurofer (the European steel industry lobby association) claimed that the price of “the additional annual cost for the secondary producers due to CO<sub>2</sub>-cost pass through in electricity prices will be around 1.1 Billion € (and 2 Billion € per year in case of 50 € / t CO<sub>2</sub>).”<sup>35</sup> EUA prices at the time were €13 /t CO<sub>2</sub>, and have since fallen.<sup>36</sup> Yet Eurofer conspicuously failed to mention the windfall profits that the steel sector stands to make from its surplus permits, the value of which runs to several billions.<sup>37</sup>

In common with others using the “leakage” argument, Eurofer’s account distorted the key determinants of production shifts in the industry. The EU’s own evidence suggests that “the economics of blast furnace operation [favour] production close to where raw materials are situated”.<sup>38</sup> Insofar as there have been shifts in production, these have tended to favour port locations for cheaper access to materials mined in the South, rather than a shift to facilities outside of Europe itself.<sup>39</sup>

A similar story of distortions and evasion characterises the aluminium industry lobby on the issue of compensating electricity costs. In April 2009, DG Competition held meetings with Eurometaux, Rio Tinto, Alcoa, Hydro (all of which are major aluminium smelters) and others from the “non-ferrous metals” sector to “hear their views on the need to compensate CO<sub>2</sub> costs passed on in electricity prices (ETS indirect emissions) to avoid carbon leakage.”<sup>40</sup> They urged the Commission to act swiftly, claiming that “All investments are currently put on hold due to uncertainty – even investments in energy savings” in advance of the Commission’s decision, and arguing that “compensation for CO<sub>2</sub> costs is needed immediately and not only from 2013.”<sup>41</sup>

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On 10 January 2010, the Chair and Vice-Chair of Eurometaux wrote to Commissioner Kroes reinforcing this message, and claiming that modification of the State Aid guidelines was “of critical importance for the survival of the non-ferrous metals industry in Europe.”<sup>42</sup>

This was followed by a further meeting involving Eurometaux, Rio Tinto, Alcoa and Hydro, DG Competition officials and the Cabinet of Commissioner Almunia on 22 March 2010, at which Eurometaux claimed in its presentation that “smelters are closing due to EU specific CO<sub>2</sub> costs.”<sup>43</sup>

The DG Commission minutes of the meeting draw attention to the industry’s same key lobby point: “Compensation should be allowed now, as long as carbon leakage risk exists.”<sup>44</sup>

This message was reinforced in Eurometaux’ response to the Commission consultation on the changes to state aid rules. It notes that aluminium, and indeed “all non-ferrous metals sectors are exposed to a significant risk of Carbon Leakage” according to the Commission’s rules, meaning that they are eligible for free emissions permits in the third phase of the ETS (as long as they comply with an agreed benchmark).<sup>45</sup> In common with submissions from other industries, Eurometaux argued that the assessment of eligibility for compensation payments should include an analysis of sub-sectors, with the aim being to maximise the number of installations eligible. It claimed that the industry “cannot cope” with the “huge costs” of emissions permits, as a result of which “some smelters have closed and the remaining smelters are hanging on in the expectation of financial compensation.”<sup>46</sup>



It is worth contrasting this with the real world economics of aluminium, which is a booming international market. A European Commission report found a two per cent growth rate in primary aluminium production in the EU-25 between 2000 and 2004.<sup>47</sup> Although production dipped during the 2008-2009 recession, it grew by seven per cent in 2010.<sup>48</sup> While it is true that imports are increasing, a study by the International Energy Agency (IEA) points out that “this was already the situation in 1999, prior to the introduction of a carbon cost in the EU.”<sup>49</sup> The IEA study concludes that

*“Statistical analysis of 1999-2006 trade data does not confirm that CO2 prices affected EU primary aluminium trade flows. At the same time, growing demand in Europe has not triggered investment in local primary smelting capacity. The region is obviously less attractive for new capacity than regions that guarantee lower energy costs.”*

While “only 35% of the aluminium consumed in Europe is actually produced within the EU ETS zone,” the key to the rise in imports is “lower operating costs” outside of Europe “irrespective of the cost of carbon.”<sup>50</sup> Moreover, the same firms that complain of the outsourcing risk - including Rio Tinto Alcan and Alcoa - are benefitting from a boom in imports to Europe, as well as from the bauxite mining and alumina processing needed to produce aluminium in the first place.<sup>51</sup>

The EU’s responsibility for emissions from aluminium production continues to grow, “increasing consumption, not carbon leakage” are key to this process.<sup>52</sup> The rapid growth in imports, moreover, is accounted for by shipping prices, global commodities prices and a trade regime that fosters outsourcing and a race to the bottom in labour standards. Put simply, the aluminium industry’s special pleading for electricity price compensation is a blackmail strategy for extracting subsidies, but is unrelated to the actual drivers of European smelters’ competitiveness.

## What’s wrong with compensation payments anyway?

The basic argument used by energy-intensive industries is that the ETS punished them by imposing higher electricity prices, which they cannot pass through to their own consumers since this will damage their ability to compete with other firms in global markets. This mis-states the situation in several ways, however.

**More than two-thirds of the 145 responses to a European Commission public consultation on the ETS and state aid rules came from industry lobbyists, the majority of which were from energy-intensive industries demanding compensation for their electricity costs.**

First, there is evidence that manufacturing companies covered by the scheme already pass on the costs of the EU ETS to their consumers. Econometric analysis by CE Delft found that fossil fuel refineries and the iron and steel sectors routinely passed on the entire notional “cost” of emissions permits - which they received for free - to consumers. The windfall profits received by these sectors in the first phase of the ETS (from 2005-2007) were worth an estimated €14 billion.<sup>53</sup> By passing on non-existent costs to consumers in this way, the whole exercise resulted in a transfer of income from citizens to business.<sup>54</sup>

Second, the logic of compensation payments undermines the stated purpose of the emissions trading scheme itself. In theory, carbon trading is supposed to force companies to put a price on their greenhouse gas emissions, paying for pollution that was previously kept off the balance sheet. The resulting cost is supposed to encourage a shift to a cleaner model of production. In practice, the vast majority of emissions allowances have been handed out for free - and this will remain the case for over 75 per cent of the manufacturing sector until at least 2020.<sup>55</sup> Combined with the windfall profits made by companies, the incentives offered encourage business-as-usual, delaying much-needed shifts in how goods are produced.

While compensating for “indirect emissions” contradicts the theory of carbon trading, however, it is consistent with the pattern of how such schemes work in practice. Carbon markets are unusual in that the commodity being traded depends upon government fiat and regulation. As a result, decision-making by the European Commission and member state governments plays a significant role in determining supply and demand - making the whole scheme particularly susceptible to lobbying.<sup>56</sup>

In the case of carbon leakage assessments, this problem is exacerbated by the fact that a significant part of the data upon which decisions are made is reliant on projections and data provided by the companies, an information asymmetry between regulator and regulated that has opened the door to “opportunistic and rent-seeking behaviour.”<sup>57</sup>

Corporations have consistently over-stated the potential impact of carbon permit on their electricity costs. While the lobbyists put forward projections of carbon prices at up to €50 per permit, the markets were moving in the opposite direction. Prices now stand at just over €8 per permit.

Finally, the impact of carbon permit prices on firms’ electricity costs has been consistently over-stated. While the lobbyists put forward projections of carbon rising to up to €50 per ton, the markets were moving in the opposite direction. Prices now stand at just over €8 per EUA (European Union Allowance), with projections that they could fall as low as €3 per allowance.<sup>58</sup> Even using the lobbyists’ own assumptions, prices at these levels would pose little threat to industry – as well as doing nothing to encourage the shift to cleaner production that the ETS is, in theory, supposed to stimulate. But even at higher prices, the impact of “carbon leakage” misrepresents the real drivers of industrial outsourcing.

## Conclusion: putting polluters before people

The risks of carbon leakage have been consistently over-stated by lobbyists in order to weaken EU targets, gain free emissions allowances and now – with proposed revisions to state aid rules – to gain electricity rebates for key industrial sectors.

The initial lobby efforts concentrated on framing “leakage” as the key issue, and were accompanied by manoeuvring within the Commission with DG Industry and Enterprise seeking a greater sway over the rules governing the ETS. This process led to significant concessions in the revised ETS.

Subsequent lobbying has shifted attention to the policy details of how leakage is addressed. But the technical complexity of industry’s submissions in response to DG Competition’s consultations on State Aid rule changes belies a rather simple story: industry has seen an opportunity to receive subsidies and has grasped it with both hands. As things stand, the steel sector stands to supplement its windfall profit from over-allocated ETS permits with electricity price compensation.

The aluminium sector has also succeeded in making its case for electricity price compensation, even though the companies that are leading the lobby charge in Europe are enjoying considerable growth in global markets, outsourcing production (for reasons unrelated to EU climate policy), and then benefiting from increased imports into the EU.

With the financial crisis resulting in ever lower carbon prices and an ever increasing surplus of permits, the claims that “leakage” constitutes a genuine risk look further from the truth than ever. Yet the proposal for compensation payments has provided a useful wedge for corporations seeking government subsidies, and offer another case of how the ETS provides fertile ground for subsidy-seeking corporations to influence EU climate and energy policy. At a time when many of the continent’s poorest people are losing benefits and winter fuel payments, some of the continent’s most polluting companies are lining up to gain subsidies for their electricity bills.

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[www.corporateeurope.org](http://www.corporateeurope.org)

[www.carbontradewatch.org](http://www.carbontradewatch.org)

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