

Guest commentary***The EU should focus on windfall profits instead of carbon leakage***

By Sander de Bruyn, senior economist, CE Delft

One of the more confused debates in the design of the third phase of the EU emissions trading scheme (ETS) has been the alleged fear of carbon leakage due to unilateral climate policies in the EU.

Carbon leakage occurs by an increase of imports (or decrease of exports) in energy intensive products due to a deterioration in the competitive position of EU industries as the consequence of EU climate change policies.

Carbon leakage results in a loss of jobs and prosperity. However, it also undermines the effectiveness of EU ETS as an instrument in international climate policies. If the cars manufactured in the EU no longer contain EU-produced steel but use steel from countries where CO₂ emissions are not capped, global CO₂ emissions will rise.

Therefore carbon leakage should matter for economists and environmentalists equally.

The fear of carbon leakage steered last year's discussion on the allocation of emission allowances for the third ETS phase (2013-2020). Although auctioning was perceived as a superior allocation method with respect to economic efficiency, free allocation was believed to have less impact on carbon leakage.

The European commission settled this discussion by defining two criteria along which it was decided if sectors would be deemed for free allocation: trade intensity and value at stake (additional costs over gross value added). Using these criteria it appears that over 90 per cent of industrial ETS emissions would qualify for free allocation.

However, the amended EU ETS directive allows for the provision to re-discuss this large-scale free allocation once an international post-2012 climate agreement has been reached.

There are two important considerations that play a role in an eventual re-discussion of the carbon leakage issue after the UN-led Copenhagen summit next month.

First, the very nature of carbon leakage assumes that emission intensive production within the EU is being replaced by production outside the EU where climate emissions are not being "capped" by binding reductions.

This latter condition is crucial. Only if emissions relocate from the EU to a country that does not have a ceiling on its CO₂ emissions, will global CO₂ emissions increase. However, if the production moves to countries that do have a ceiling on their CO₂ emissions, global emissions of CO₂ would

stay the same.

If the Copenhagen outcome would be that more countries accept binding ceilings on their CO₂ emissions, the possibilities for carbon leakage diminish by definition. Only trade with countries where CO₂ emissions are not being capped can formally result in carbon leakage.

One logical adaption to the EU ETS directive would therefore be to adjust the criterion of high trade intensities qualifying for free allocation by classifying only trade with countries without CO₂ emission ceilings as relevant for that criterion. The more countries then adhering to binding CO₂ reductions, the less free allocation will be the result.

The second consideration is the question whether free allocation is the right medicine to combat carbon leakage.

Economists assume that companies put forward the marginal costs in their product prices including the opportunity costs. As free allowances constitute opportunity costs to companies, the price increase from EU ETS should be similar for auctioning and free allocation. The only difference is that free allocation spurs windfall profits while auctioning spurs governmental revenues.

If governments recycle revenues to consumers to compensate for the higher costs and to companies as investment subsidies to prevent carbon leakage through investments, auctioning has in the end less economic impacts than free allocation while minimising eventual carbon leakage impacts through investments.

Alternative measures like border tax adjustments on EU imports, may be considered as better solutions to carbon leakage than free allocation. For the discussion on the allocation mechanisms, it may be more sound to focus on windfall profits instead of carbon leakage. One of the main reasons for putting the power sector under auctioning from 2013 has been the proof of windfall profits from the first phase of the EU ETS.

It is remarkable that so little research has been devoted to eventual windfall profits in other economic sectors. If it could be proved that companies in these sectors indeed passed through the costs of their freely obtained allowances in the prices, it would make sense to consider auctioning in these sectors as well.

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