The EU: a hollow champion for the climate.

How the financial crisis (and intense lobbying) let polluting industry off the hook

The EU has cultivated an image of being a leader in the fight against climate change at UN climate summits. But as the UN talks in Copenhagen get underway, a closer look at the EU's climate policy reveals fundamental failings. The EU's flagship climate policy - the Emissions Trading Scheme (ETS) has been once more effectively undermined by industry lobbying for the right to pollute for free. The most polluting industries, including chemicals, cement and steel, have secured free permits to pollute for at least the next decade. This sends a dangerous signal to other countries about the need to regulate polluting industry, and undermines a major argument for emissions trading - that of putting a price on carbon.

According to the EU Commission, the ETS – a cap and trade system introduced in 2005 in which industry participants can buy and sell emissions allowances within an overall limit or "cap" - is the main way to achieve carbon dioxide (CO2) emissions reductions in the EU. The idea is that it reduces CO2 emissions and creates incentives for climate-friendly innovations and so moves industry onto a low carbon path. Yet, despite the claims, it has failed to do so. The main reasons have been that industry has been given more emissions permits than it needed, resulting in major falls in the carbon price, and it has been allowed to "offset", to get credits by investing in projects in third countries instead of reducing emissions at source. This has allowed industry to avoid making the structural changes needed and has in the case of the power sector, led to huge windfall profits, as a result of companies passing on the theoretical costs of emissions permits to consumers.

In 2007-08, the ETS was reviewed ahead of setting conditions for the third phase (from 2013 to 2020), which were to be included in the EU's so-called climate and energy package.

A crucial part of the proposal for the third phase was the introduction of auctioning - forcing industry to bid for emissions permits - and enlargement of the ETS to other sectors which had not previously been covered by the scheme. Until now, permits to

pollute have been handed out for free. For the period post-2012 the European Commission proposed full auctioning for the power sector and the gradual introduction of auctioning for the manufacturing sector, including the chemical industry, steel and other energy intensive industries. This ignited a fierce lobby campaign by the affected sectors. Refineries and the cement, steel and chemical industries were among the more vociferous in making their claims. They argued that auctioning permits would increase costs and threaten their survival, forcing them to relocate to countries with less strict regulations. According to them this would mean continued and even increasing CO2 emissions (so-called carbon leakage) as well as job losses in Europe.

Using EU access to information regulations, Corporate Europe Observatory has obtained evidence of the extensive lobbying that went on in numerous meetings and through correspondence between the energy intensive industries and the Commission, particularly DG Enterprise, DG Environment and to a lesser extent DG Transport and Energy and the Commission President Barroso. The cement industry, represented by Cembureau and individual companies including Lafarge and Holcim played a key role, as did the steel sector, represented by Eurofer and especially ArcelorMittal. Chemical companies such as BASF – and the lobby group CEFIC, were also actively involved.

The oil companies, represented by Europia were particularly effective - arguing against initial proposals to treat refineries in the same way as the power sector - which would mean they had to pay for all permits from 2013. They successfully lobbied to be put on a level with the manufacturing sector - claiming they would not survive competition from abroad.

These voices were also echoed by other groups with privileged access to decision makers, particularly the European employers' confederation Business Europe and others such as the European Roundtable for Industrialists (ERT), the Alliance of Energy Intensive Industries (AEII) or the EU Committee of the American Chamber of Commerce (AmCham).

Industry wanted a guarantee that they would get free allocations, but initially the Commission said it would not consider the risk of carbon leakage until after the Copenhagen climate summit to avoid influencing the outcome of the meeting. Industry wanted to know before then as is clear from a letter sent by Lafarge CEO

Bruno Lafont to Enterprise Commissioner Verheugen on 20 February 2008[1]. In it Lafont claims: “Indeed, we cannot wait until June 2011 to see this issue settled, as the resulting lack of predicatbility would dramatically impair our investment decisions.” The letter continues with the threat to move four planned investment projects worth 1 billion euro outside of the EU, saying he: “would like the Commission to be fully aware that the final environmental balance, if we were forced to invest outside of the EU, would be negative as a consequence of the resulting additional transportation of finished products.”

However, industry's claims were not backed up by solid evidence. The bulk of academic and scientific studies[2] showed that auctioning did not pose a major risk to the competitiveness of EU industry - a position argued by civil society groups and the Greens in the European Parliament. Indeed when the European Parliament voted on the proposals in autumn 2008, it rejected many of industry's demands. These had been put forward by a few MEPs who appeared to be working hand in hand with corporate lobby groups. In particular German MEP Karl Heinz Florenz and Finnish MEP Eija-Riitta Korhola from the conservative group (EPP) put forward amendments echoing industry's demands. Indeed, according to Terhi Lehtonen, an advisor to the Greens, inspection of Florenz's amendments, revealed that they had actually been written by Eurofer, the steel industry lobby group.

Following the failure in Parliament, companies turned to member state governments for support, and indeed some of them, most notably Germany, were already pushing for free allocations to protect the competitiveness of their home industries (the chemical industry for example clearly influenced German chancellor Angela Merkel's position). According to Avril Doyle, the former Irish MEP who was rapporteur for the ETS review in the European Parliament, the German chemical industry, along with German coal, has been the most effective lobbyist for Phase Three of the ETS[3].

Some governments (German, Dutch, Swedish, UK) had looked at the risk of carbon leakage from auctioning and had concluded that it would have a small impact on the economy. However, as the extent of the economic crisis became apparent, their position changed. Facing a recession, many governments became more sympathetic to industry's claims.

The EU presidency was at this point held by the French. Nicolas Sarkozy had made a personal pledge to have the climate and energy package approved during his

tenure. The package was contentious - including regulations not only on the ETS review but also EU targets for renewable energy and CO2 reductions, burden sharing, regulations on car emissions and policy on carbon capture and storage. In order to avoid getting bogged down in endless negotiations, Sarkozy moved the issue from the Environmental Council (which requires qualified majority voting) to the European Council (which requires unanimity, therefore giving the right of veto to any country which is not happy with the deal). This allowed governments to in effect become lobbyists for their own industry sectors. The Finnish finance minister, for example, was quoted in Finnish media saying that the prime minister would not leave the European Council until he got free allocations for the Finnish paper and pulp industry.

The approved directive[4] set thresholds to identify the sectors at risk of carbon leakage, which will be entitled to some free permits until at least 2020[5] . The thresholds - based on the increases in production costs and the level of trade with third countries were set low enough to allow most sectors to be included.

This was the political price to pay for governments approving the deal.

Importantly, the directive also moved forward the date by which the Commission would decide the final list of sectors deemed at risk of carbon leakage. The final list will be approved by the end of 2009, but the draft list was published in the summer and has already been approved by member states, the Commission and the Parliament's Environment Committee - making the Parliament's final approval a formality[6]. Even the Commission had been pushing for this to be delayed until after the Copenhagen climate talks. Other countries could see it as a protectionist move, and it also sets a dangerous precedent for dealing with polluting industries elsewhere. Lobby pressure from industry supported by national governments has significantly reduced the chances of making industry change course.

The sectors included on the list were decided via a stakeholder process, led by DG Enterprise working with DG Environment. Through access to information requests Corporate Europe Observatory has obtained evidence of intense lobbying by energy intensive sectors, including chemicals, steel and cement, showing numerous meetings with both DGs, emails and letters, claiming the cost pressures that would lead them to relocate (carbon leakage).

The steel sector, for example, had close to 20 meetings on the subject of carbon leakage with DG Enterprise Commissioner Verheugen and other officials between January 2008 and May 2009 dealing with carbon leakage.

As a result, industry has managed to persuade EU member states not only to adopt low thresholds, but also to allow the thresholds to be based on flawed calculations. The directive introduces gradual auctioning (so they would not have to pay for 100% of permits until 2020.) but the calculations to see how much the costs would rise if industries paid for permits assumed 100% auctioning from the start. This means that industry costs were inflated.

The final result was that 164 sectors representing 77% of the EU's manufacturing industry were considered at risk of carbon leakage. To rub salt into the wound, the list will be reviewed every five years, providing an opportunity to add new sectors. Politically, it will be practically impossible to remove sectors.

Civil society groups have warned of the negative consequences of handing out free allocation to a high number of the most polluting industries, but the Commission and industry argue that because the cap remains the same, total emissions will still be reduced. Benchmarking[7], they argue, will ensure that only the most efficient manufacturers get all permits for free. Not only is the setting of the benchmark open to heavy lobbying, but giving free permits to the worst polluters kills the rationale behind the emissions trading scheme. It removes the incentive for climate-friendly innovation. The idea is that putting a price on carbon effectively redirects the economy towards low carbon products and technologies. When industry gets permits without paying for them, they either pass the costs to consumers and make a windfall profit, or they ignore the costs removing any carbon price signal at all. This means there is no incentive to introduce low carbon products or manufacturing processes.

The cap is there, but there are also loopholes. In the first two phases of the ETS, more emission permits were allocated than needed, and as a result of industry pressure, these spare permits can be banked for future use[8]. What is more, industry is allowed to offset up to 50% of their carbon emissions - effectively allowing industry to claim reductions by paying through offsetting schemes under the Kyoto Protocol (the clean development mechanism and joint implementation)[9].

The exact number of permits allocated will be decided in 2011 based on a benchmark decided next year. This means industry is still actively lobbying to obtain as many permits out of the total of 2,000 million allowances as possible, which is worth a huge sum of money.

And this is just one of the problems of relying on cap and trade as the way to achieve emission reductions. It is permeable to industry lobbying and they have been allowed a major say in its design and implementation.

The impacts of the EU ETS extend well beyond its borders, as it is being used as a model for other cap and trade systems, such as Australia or the US. Yet the EU's flagship climate policy is clearly flawed. It is time to change course and enforce binding regulations to reduce emissions at source, with no offsetting, no trading and no get-out clause.

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7 December 2009

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[1] Letter sent by Bruno Lafont to Günter Verheugen on 20 February 2008, filed at Corporate Europe Observatory, obtained through access to information regulation.

[2]See fi European Parliament, study, “Competitive distortions in a world of different carbon prices. Trade, competitiveness and employment challenges when meeting the post-2012 climate commitments in the European Union”, July 2008, http://www.europarl.europa.eu/activities/committees/studies/download.do?file=21551; “Issues behind Competitiveness and Carbon Leakage. Focus on Heavy Industry”, OECD/IEA, Paris, October 2008 http://www.iea.org/papers/2008/Competitiveness_and_Carbon_Leakage.pdf; “Climate Policy and Industrial Competitiveness: ten insights from Europe on the EU Emissions Trading System”, by Michael Grubb, Thomas L. Brewer, Misato Sato, Robert Heilmayr, Dora Fazekas, August 2009 http://www.climatestrategies.org/our-reports/category/17/204.html;

[3]Avril Doyle speaking at a session during the World Business Summit on Climate Change which took place 24-26 May 2009 in Copenhagen.

[4] Directive 2009/29/EC of the European Parliament and of the Council of 23 April 2009 amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading scheme of the Community. http://register.consilium.europa.eu/pdf/en/08/st03/st03737.en08.pdf

[5] These will be allocated in relation to a benchmark for the best performing installations - with the best-performers receiving 100% free permits

[6]http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:140:0063:0087:EN:PDF

[7]The idea is that only the best 10% performers of every sector get 100% free allocation, but the design of the benchmarks are being decided in 2010 and therefore open to the influence of industry, which has already started actively lobbying for the most favourable arrangements.

[8]An analysis by Sandbag concludes that the bankablility of permits and credits means that nearly 40% of phase 3 targets could be met be carry-over from phase 2. See “EU ETS S.O.S: Why the flagship ´EU Emissions Trading Policy´needs rescuing”, Anna Pearson and Bryony Worthington, Sandbag, London, July 2009.
[9]Calculations by NGO FERN based on EU data showed that the actual emission reductions to be achieved in the EU in phase 3 of the ETS is just 3.9% compared to 2005 levels and 60% of this will come through offsetting. “Reducing Emissions or Playing with Numbers?”, EU Forest Watch, FERN, March 2009. According to a study by Ecofys, “the remaining abatement effort in phase-3 of the EU-ETS could to a large extent (65%) be achieved through the use of CDM/JI-credits”, “EU climate policy impact in 2020. With a focus on the effectiveness of emissions trading policy in an economic recession scenario”, Ecofys, June 2009. http://www.ecofys.com/com/publications/documents/Ecofys_EUclimatepolicyimpactin2020_new.pdf