

UK Briefing note - EU ETS Market Stability Reserve (MSR) and Carbon Leakage

- The UK remains **committed to ensuring energy intensive industries remain competitive** and therefore supports for Phase IV (2020-2030) the continuation and improvement of mechanisms to protect those industries genuinely at risk from carbon leakage due to climate policy.
- **We do not believe amendments to pre-2020 carbon leakage rules are needed.**
- Carbon leakage is a serious risk, and there would be no purpose – either in economic or environmental terms – in a system which forced industry to relocate outside of the EU. It is therefore important that sufficient measures are in place to mitigate carbon leakage risk as a result of the EU ETS.
- October's European Council conclusions confirm that carbon leakage prevention through the free allocation of allowances to industries at risk will continue into Phase IV. The Commission has stated that proposals for the period 2020 to 2030 will be published after the MSR is agreed. The UK supports this approach.

Carbon Leakage and the MSR

- The current MSR negotiations do not directly relate to carbon leakage policy, which is largely fixed until 2020. The proposed MSR will affect the number of allowances auctioned in the System, rather than the amount of allowances available for free allocation.
- The current mechanisms to address carbon leakage risk were designed with significantly higher prices (€30/t) than currently seen or likely under an MSR pre-2020. Our analysis shows these mechanisms are sufficiently robust to deal with carbon leakage risks to 2020 even with a strengthened MSR.
- In addition, hasty redesign of carbon leakage policy at this stage could damage the functioning of the carbon market and undermine our ability to fully consider the implications of changes to post-2020 rules to ensure that those sectors most at risk continue to receive adequate protections as the cap reduces.

Studies have found no evidence of carbon leakage as a result of the EU ETS

- There have been numerous empirical studies of carbon leakage from the EU ETS, falling into two categories: econometric measures of trade flows since the introduction of the EU ETS, and industry surveys covering relocation of plants and changes in investment decisions as a result of the System. Neither type of study has detected carbon leakage from the EU ETS¹.

¹ *Carbon leakage prospects under Phase III of the EU ETS and beyond*, Vivid Economics, June 2014

- Indeed, studies show that, by passing through some of the costs of the EU ETS while selling their free allowances, some firms have been generating windfall profits in the range of €1-9bn a year².

Even in theoretical studies, carbon leakage only occurs at much higher prices than seen currently

- Theoretical work on the likelihood of carbon leakage has been undertaken in order to ascertain what rate of carbon leakage would be likely at various carbon price levels. Studies which do not take into account free allocation and use significantly higher prices than currently seen in the EU carbon market still predict only moderate carbon leakage:
- One study predicts that, with no free allocation, at a carbon price of €14/t, there would be a 10% carbon leakage rate³ from the EU⁴.
- A study by Cambridge Econometrics predicted that, at a carbon price of €14/t and with no free allocation, most sectors in the EU would see a decline in production of less than 1.5%⁵

Why has the carbon leakage predicted in theoretical models not occurred in EU ETS?

- Most theoretical studies of carbon leakage are not based on real-world emissions trading schemes; they do not take into account the protections that governments put in place to prevent carbon leakage, such as the free allocation scheme used by the EU ETS and numerous other cap-and-trade schemes.
- The EU carbon leakage list uses a carbon price of €30/t to determine carbon leakage protection – this is significantly higher than the actual price that industry face, around €7/t.

How much does the EU ETS really cost various sectors?

Increasing the carbon price would have a relatively small impact on final product price. The main driver of high energy prices in Europe compared to economies such as the US is the higher cost of fuel acquisition, not taxation or renewables policy⁶.

² *Will the energy-intensive industry benefit from EU ETS in Phase 3*, CE Delft 2010; *Assessing the effectiveness of the EU Emissions Trading System*, Centre for Climate Change Economics and Policy 2013

³ The carbon leakage rate is the ratio between increases in emissions in unregulated regions and decreases in emissions in regulated regions.

⁴ *Tackling leakage in a world of uneven carbon prices* Droge et al. 2009

⁵ *An Assessment of the degree of carbon leakage in light of an international deal on climate change* Cambridge Econometrics, August 2010

⁶ *European electricity prices and their components*, Ecofys

Oil Refining

In a world without free allocation, an increase in the carbon price to €30/t before 2020 would result in a 0.5% increase in product price, reflecting a 68% cost pass-through rate⁷.

Steel

With no free allocation, a carbon price of €15/t would result in just a 0.3% increase in product price⁸. In 2012, the average EU steel producer paid €73/MWh for electricity; of this, the indirect costs of the EU ETS represented around €4/MWh⁹.

Ceramics

The ceramics industry has a very high cost pass-through rate – 93% at a €15/t carbon price – which would result in a 3% price increase if the ceramics industry received no free allowances¹⁰.

What effects could an MSR have on carbon leakage?

- As we have seen, carbon leakage from the EU ETS has not occurred under prices seen so far in Phase III and with the carbon leakage prevention measures in place in the EU ETS, which are designed to work with much higher carbon prices than currently exist.
- The MSR will not create any significant risk of carbon leakage pre-2020. A number of market analysts have considered the impact of introducing the MSR on carbon prices. While prices will increase overtime, **no market analyst is forecasting prices before 2020 under an MSR that are above the €30/t used to assess carbon leakage risk**. This remains true even if the MSR is strengthened by introducing it earlier and placing backloaded allowances directly into the reserve.
- Discussion has begun on rules to provide adequate carbon leakage protection post-2020.

⁷ *Case studies for sectors investigated in detail*, Vivid Economics, June 2014

⁸ *Case studies for sectors investigated in detail*, Vivid Economics, June 2014

⁹ *The steel industry in the European Union: composition and drivers of energy prices and costs* Centre for European Policy Studies, December 2013

¹⁰ *Case studies for sectors investigated in detail*, Vivid Economics, June 2014

Industry will benefit from a reformed EU ETS

- The EU ETS is the most economically efficient way to guarantee long term certainty over emissions reductions while letting the carbon price adjust in the market. The EU ETS provides flexibility to business to make their own choices about carbon abatement or purchasing allowances, secures abatement at least cost, and is strongly supported by the business community.
- However, the EU ETS market currently has a surplus of around 2 billion allowances¹¹ which, if not tackled, is expected to depress the signal for low-carbon investment for at least a decade¹² and is likely to increase the overall costs of meeting our future targets. Without reform, the credibility of emissions trading is being undermined risking a shift away from efficient, market-based emissions reduction to fragmented and regulation-centric approaches across the EU that could increase costs further and undermine the single energy market.
- Once in place, the MSR will reduce uncertainty for industry, providing a mechanism to allow supply to adjust to changing circumstances, as supply does in other ordinary markets and most other ETS's. It will substantially reduce the risk of ad hoc interventions such as backloading in the future. The operation of the MSR is determined by clear and transparent rules, and as such is predictable to the market.
- The System recognises EII sectors will need support for investment in energy efficiency improvements. The European Council agreed on a new "innovation fund" NER400 which will help support innovation for industrial sectors.
- Please click [here](#) for more information on the UK's position on the MSR legislative proposal.

¹¹ Equivalent to a year's worth of allowances under the EU ETS cap.

¹² DECC analysis shows even with a tightened cap in Phase IV to deliver a 40% GHG target in 2030, the surplus will reduce slowly and will remain significant in 2030. This is similar to results from Commission analysis:

http://ec.europa.eu/clima/policies/ets/reform/docs/swd_2014_17_en.pdf Any further access to project credits within the cap will prolong the surplus.