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IS CONTINUED FREE ALLOCATION TO INDUSTRY DEFENSIBLE?

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The long-awaited proposal to implement the 2007 European Council decisions on the integrated climate and energy policy, notably the sharing out among member states of the greenhouse gas reduction and renewable energy target, is finally due to be published today. With various drafts leaked so widely beforehand, there should be few surprises.

Interestingly, in the run-up to the publication of the proposal, most attention has focused on the review of the EU emissions trading scheme (ETS), which logically is autonomous from the greenhouse gas and renewable target decisions. Practically, however, they have to be linked because clarity on the ETS cap and its methodology is a crucial precondition for settling all 'effort-sharing', as it is now being called. Europe's industry has been mounting a high-profile campaign to avoid large-scale auctioning of allowances, i.e. the sale of the allowances by member states to emitters. Their objections are understandable. A rough back-of-the-envelope calculation reveals that the difference between auctioning and free allocation for the industrial sector is around €22 billion annually. This assumes a price of €30 per tonne of CO_2 and a reduction of around 20% until 2020 compared to 2005 verified emissions, which would bring the average total number of allowances for the industrial sector to around 750 million annually. Most would agree that it is worth fighting over whether €22 billion end up in state coffers or on companies' balance sheets. This is even true for a sum half that amount, as most leaked drafts have not foreseen more than 50% of all allowances to be auctioned to the industrial sector.

EU energy-intensive industry has been arguing that due to the global pricing of its commodities, it cannot pass on its additional carbon costs stemming from the ETS. A number of studies, by e.g. the UK Carbon Trust, International Energy Agency, McKinsey & Ecofys and Climate Strategies, showed that pass-through capacity depends on the sector and even the commodity in question. Those industries that receive free allowances while being able to pass through carbon costs gain a windfall profit. The European Commission services, member states and the European Parliament remain deeply divided over this issue. And indeed, the empirical evidence is inconclusive.

Rather than opting for border measures, whereby importers are forced to pay a carbon surcharge, or putting their faith in the as yet vague concept of global sectoral approaches for industry – among the hottest topics in Bali and on the agenda of the first 2008 meeting of the Major Economies – the European Commission has settled on free allocation for the industrial sector. Clearly, free allocation is a subsidy to industry, if

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industry can pass on the cost of carbon, but also one that we can never prove, as we simply do not know exactly to what degree the carbon cost can be passed through. Industry has a point when it argues that it will need this subsidy to compensate for higher electricity costs as a result of the ETS. Studies are inconclusive as to how much power prices will increase.

Some will argue that this will damage the climate. Perhaps it will. But all studies show that the real mitigation potential under the ETS lies with the power sector. The International Energy Agency in Paris has identified a need of over 650 gigawatts of new capacity in Europe between now and 2030, which is a bit more than current installed capacity in Europe. Two-thirds of the existing thermal power plants (i.e. coal and gas) will need to be replaced in that period. This clearly demonstrates that the key for meeting EU and global climate change target is first-off to shift investment patterns towards low-carbon technologies in the power sector. Economists tell us that auctioning in the power sector will accelerate this shift. Therefore, full auctioning to the power sector has always been less controversial and is therefore still in the Commission's proposal.

But even under full free allocation, industry will not be a total free-rider. It will feel the heat in the form of increased power prices as a result of the ETS, at least in the short term. And an allowance price of €30 per tonne of CO_2 will continue to provide incentives to industry to make energy savings. The writing is clearly on the wall that there will be auctioning in the future. The proposal says that as soon as an international agreement is agreed that puts a carbon constraint on the EU industry's competitors, the EU will move quickly towards auctioning. Indeed, under such a scenario, there will no longer be a case for continued free allocation. But the real beauty of free allocation to the industry is that it does away with the talk about imposing border measures, as the EU will find it impossible to demonstrate that its industry is at a disadvantage if a subsidy in the form of free allocation is given. In this respect, it could well prove that free allocation may offer a way out of this potentially divisive internal debate.