

EMISSIONS TRADING SYSTEM

EUROFER RESPONSE TO RECENT CE DELFT STUDY

A recent study by the consultancy CE Delft commissioned by Carbon Market Watch purports to have detected large windfall profits emerging from the European Union Emissions Trading System (EU ETS). This response from the European steel industry seeks to determine how these conclusions were reached and to react to the claims.

Unfortunately, the study (and those on which it is based) has a number of methodological flaws. These include the omission of indirect costs in the calculation, the use of implausible data proxies and the underestimation of the impact of carbon costs. For these reasons, the study results in misleading conclusions which should be dismissed.

More generally, the study provides a picture of the EU steel industry which is at odds with the everyday-reality of a sector which is highly exposed to an uneven international playing field and suffers from unfair practises, such as dumping and global overcapacity. These factors have led to job losses, decreasing prices and very low or negative profitability. Such reality clearly contradicts the claims of the study on cost pass through ability and windfall profits.

The European steel industry is committed to contributing fairly to EU climate and energy targets, taking into account also the exposure to fierce international competition and the need for a global playing field. We are committed to sustainable production and sale of high quality steels in Europe while ensuring high level job, but to continue to do this, there needs to be an open, fact-based discussion on the right regulatory regime and impact assessments.

Elements of the study

The study claims that the steel industry made around €9 billion of windfall profits as a result of EU ETS over the period 2008-2014. These profits are alleged to have been generated by the pass-through of carbon costs in steel prices, the historical overallocation of free allowances compared to real emissions and the use of International Credits.

The study does not deal with indirect carbon costs passed through in electricity prices, despite the fact that these have a major impact on the cost-benefit analysis of the EU ETS.

Responding to the study

Cost pass-through

The largest share of the alleged windfall profits – €7.5 billion out of €9.3 billion for the European steel industry - relies on the cost pass-through rate derived from an earlier, European Commission-funded study, also by CE Delft (November 2015). That study

estimated the cost pass through rate using the production costs of a single *Japanese* plant in 2015 (accessed from a [public website](#)) as a proxy for European prices, and comparing this to an average carbon price in Europe between 2008 and 2014. This is peculiar as it is comparing different regions in different time-periods, producing results which cannot be considered methodologically robust. The resultant 55%-100% rate of cost pass-through is then used in the new (March 2016) CE Delft study on windfall profits.

This is important as suggesting that the industry is able to pass on 55% of its carbon costs is then used to claim that the industry is profiting by 55% on the market value of its emissions allowances. This is an absurd and misleading claim especially when lined up against a backdrop of booming third-country imports, collapsing prices and job losses.

A comprehensive analysis of shortcomings of this study and other existing literature was published recently by NERA Consulting for EUROFER and is available [here](#). Among other elements, the review shows that existing literature does not consider the relationship between cost pass through and the potential impact on market share, contrary to the provisions of the ETS Directive.

Indirect costs

The CE Delft study fails to deal in any way with indirect costs energy-intensive industries suffer from. Indirect costs refer to the carbon costs passed-through to steel producers by electricity providers. In contrast to steel – which due to its market structure cannot pass on carbon costs without losing market share – the energy sector can pass on its carbon costs. This is because energy suppliers are not exposed to international competition.

These indirect costs are very significant, and were not compensated for at all until the second trading phase (2008-2012) and are only partially compensated for in the third phase (as very few member states are doing that). If one considers also uncompensated indirect costs, the total (direct and indirect) costs generated by the ETS are certainly much higher than the possible benefits.

Administrative compliance costs are not considered as well by CE Delft.

Historical overallocation

That there is a surplus Emissions Allowances from the second EU ETS trading period (2008-2012) is mainly the result of the massive crisis that occurred in those years. During the peak crisis period demand fell by 25% and capacity was reduced substantially. This affected also the financial performance of companies, which reported major economic losses. This situation is not taken into account in the findings of the study. The *ex-ante* EU ETS system was not designed with sufficient flexibility to cope with an unexpected demand-side shock.

However, the surplus is being used to supplement the free allocation in the present trading period because this is already too low to cover the industry's needs due to unrealistically

low benchmarks. This surplus will run out by the end of the third trading period, so it will not affect the post-2020 period which is currently under discussion.

The CE Delft study is therefore incomplete because it only looks at the period from 2008-2014– the industry will not make any windfall profit over the entirety of the trading period, even if one considers only direct costs and ignores indirect costs.

Furthermore, the study downplays the direct costs of the steel sector because it underestimates significantly the emissions from waste gases which on the contrary are a major source. It also neglects the significant investments in energy efficiency that were made by the European steel companies during the period under investigation. Finally, it includes in the findings also the data from companies that have permanently closed their sites and ceased activity.

International credits

The study considers the purchase of offset-certificates for international emissions reduction projects as an additional source of revenues. However, these certificates were not allocated for free, but purchased as part of a trading operation. Such financial instruments were introduced as a tool to promote the integration of carbon markets and to encourage the participation of the private sector to the financing of global emissions reduction efforts. In this context, international instruments represented also an opportunity for European operators to reduce their compliance costs. Therefore, it is not appropriate to consider such a lawful practice as a source of windfall profits.

Final comments

Regarding the revision of the EU ETS for the fourth trading period, the Commission proposal must not lead to direct or indirect costs, at least at the level of the 10% best performing European steel plants.

A recent ECOFYS study commissioned by EUROFER calculated that in its current form, the Commission proposal would cost the industry up to €34 billion – almost €30 per tonne of steel produced. Given that the EBITDA of European steel has fluctuated at around €35 over the past few years, the EU ETS proposal as it stands today would wipe out the industry's economic viability.

It is vital to reiterate that the European steel industry is dedicated to sustainable production in Europe. We are in the business of making and selling steel, and our business supports around direct 320,000 jobs in Europe and millions more indirectly in the value chains. Our commitment to environmental protection is clear, and can be seen in the 50% drop in energy use and CO₂ emissions per tonne of steel produced since 1970. At the forefront of technical innovation at both product and process level, the industry needs sound regulatory policy making based on facts and methodologically sound research.