

*Brussels, 17 February 2016*

## Executive summary

- **ETRMA is particularly concerned by the Commission proposals' 'formula'** which will provide cut off criteria for carbon leakage sectors after 2020. We believe this 'equation' is imbalanced awarding carbon relief only to energy intensive industries. This disregards the situation of European manufacturing which must compete with a wave of imports from low cost regions, not submitted to the same climate regulation and constraints.  
**The entire proposal also fails to refer to the parameter most relevant to assess the risk of carbon leakage i.e. the ability to pass on carbon costs.**
- ETRMA believes that any sector which considers its market conditions justify carbon relief, should be able to apply for the qualitative assessment. We therefore **recommend the removal of the 0.18 threshold.**
- Whereas, **indirect carbon costs** are the main costs associated with ETS implementation for the tyre sector so far, they have never been properly compensated. The current proposal does nothing to improve the current situation which fails to deliver any relief.
- ETRMA would like further clarification on how the **Modernization and the Innovation funds** set up by this new proposal may help finance and develop certain energy efficiency projects in the industrial sector.

## Introduction

ETRMA members are committed to carbon reduction. We recognize the ETS is the keystone of EU climate policy and an efficient way to reduce carbon emissions in a cost effective manner.

This paper is the tyre industry's response to the Proposal which was released by the European Commission on 15 July 2015<sup>1</sup>, and which we believe has a number of shortcomings. Particularly, we believe it is crucial to ensure its consistency and long term coherence with other EU policies, notably, the EU industrial objective of increasing manufacturing's share of EU GDP: from 16% now to 20% by 2020<sup>2</sup>.

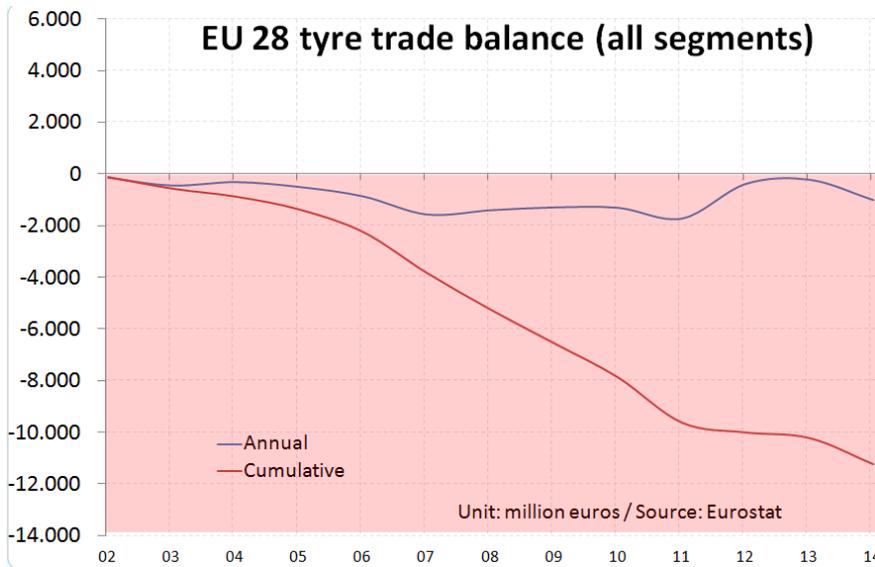
We look forward to being active participants in the legislative debate which will take place over the next few months to ensure the final law on the future of the ETS is fit for purpose.

<sup>1</sup> [2015/148 \(COD\)](#) Proposal amending Directive 2003/87/EC to enhance cost effective emission reductions and low carbon investments

<sup>2</sup> Industrial revolution brings industry back to Europe: [http://europa.eu/rapid/press-release MEMO-12-759\\_en.htm](http://europa.eu/rapid/press-release_MEMO-12-759_en.htm)

## I. Trade intensity should continue to be grounds for carbon cost relief

- The EU proposal favours Energy intensive industries at the expense of trade “exposed” sectors



ETRMA finds it surprising that all the carbon relief foreseen for the period after 2020 seems to be reserved for energy intensive industries. This is clear in the ETS Proposal’s Impact Assessment which overemphasizes the energy intensive sectors compared to trade intensive industries. The underrepresentation of trade intensive sectors is also blatantly obvious in the Impact Assessment attached to the Commission’s 2030

Climate and Energy package.

Industrial sectors, which are constantly and increasingly competing on an uneven playing field with low-cost imports from outside the EU, should not be left without support and almost overlooked by the Commission proposal.

The crisis and its aftermath have led to a dramatic change in the trade balance of some product manufactured in Europe. The tyre industry is a good example of this trend as exemplified by the graph above. Since 2002, the EU tyre industry has registered a cumulative trade deficit of over €10 bn. vs. the rest of the world<sup>3</sup>. This situation means that since 2002, European consumers are increasingly purchasing tyres made outside the EU, in plants which are more energy intensive than in Europe, and have been exporting their carbon emissions. Removing carbon relief for industries in this situation would exacerbate this trend.

This economic reality means that, although we take note of the interesting Member State non-paper on a ‘Tiered Carbon Leakage list in Phase IV of EU ETS<sup>4</sup>’, we disagree with the authors’ generalization that ‘Where sectors have very high trade intensity but minimal carbon costs, these costs should not have significant implications for their international competitiveness.’<sup>5</sup>

- Underestimating trade exposure opens door to investment leakage

The Impact Assessment attached to the Commission proposal defines Carbon leakage as a “[...] situation that may occur if, for reasons of costs related to climate policies, businesses transferred production to other countries which have laxer constraints on greenhouse gas emissions. This could lead to an increase in their total emissions<sup>6</sup>[...]”. This definition includes both a notion of the cost burden of industries whose energy costs are very heavy, but also the notion that the European market demand for a given good could be satisfied by imports instead of local

<sup>3</sup> [Impact Assessment](#) Accompanying the document Proposal for a Directive of the European Parliament and of the Council amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments, (SWD(2015) 135 final), p.96

<sup>4</sup> Authored by the Czech Republic, France, Slovakia and the United Kingdom

<sup>5</sup> Member State non-paper on ‘Tiered Carbon Leakage list in Phase IV of EU ETS, p.3

<sup>6</sup> Impact Assessment, p.96

production, thereby exporting Europe's carbon emissions, while disrupting its own EU manufacturing capacity.

This is why, until now, both factors were taken into account to assess whether a sector deserved carbon relief. Each was ground, in its own right, for a sector to qualify for the carbon leakage list.

However, the new proposal (amendment to article 10b), no longer recognizes trade intensity on its own as grounds for carbon cost relief in the form of free allowances.

We believe that the example of the tyre industry, weakened by multiple crisis factors, is illustrative of the fact that certain trade intensive industries will continue to need support after 2020<sup>7</sup>.

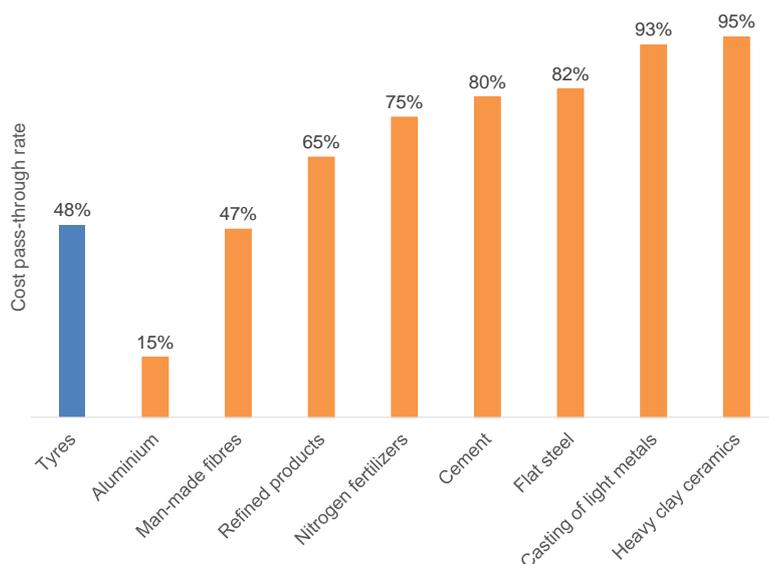
What the Commission proposes for the EU ETS after 2020 would exacerbate this trend by giving foreign imports an additional competitive advantage compared to local EU based production.

- **Give cost pass through the importance it deserves in the carbon leakage assessment**

The EU Commission formula which decides which sectors will continue to be eligible for carbon relief after 2020 is also questionable because it does not assess certain criteria which are essential to ascertain whether a sector is at risk of carbon leakage. ETRMA particularly believes that the ability to pass on carbon costs, should be more important in this assessment.

The Commission proposal itself states that: '*Sectors deemed to be exposed to a risk of carbon leakage will continue to receive a higher allocation than others who have a higher ability to pass on relevant costs in product prices.*'<sup>8</sup> However, cost pass through is not one of the variables in the equation which decides which sectors are eligible for relief to date.

Indeed, artificially classifying sectors into energy-intensive or trade-intensive does not adequately reflect a sector's ability to bear and pass on additional costs. Cost pass through reflects essential market characteristics more accurately such as trade exposure, supply and demand elasticity<sup>9</sup> all of which are simply discounted in the Commission's proposed assessment criteria.



We believe cost pass through is an essential dimension of this assessment, and **should therefore be fully reflected**. After all, cost pass through has a direct influence on two key elements of any sector's competitiveness: profit margins and market shares.

<sup>7</sup> [ETRMA contribution to the regulatory discussion on the future of EU ETS after 2020: Better understanding the importance of trade intensity for shaping the future of the EU carbon leakage list \(12 June 2015\)](#), p.4

<sup>8</sup> [Commission proposal](#) ( COM(2015) 337 final ) amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments p.10

<sup>9</sup> As indicated in the EU impact assessment accompanying the proposal, p. 195

A recent study<sup>10</sup> (see Annex) commissioned by ETRMA to Vivid Economics<sup>11</sup> shows that "***The tyre industry is able to pass-through approximately half of ETS cost, a lower rate than several other energy intensive trade exposed sectors. The low cost pass-through rate implies a higher proportion of ETS cost absorbed by the EU tyre manufacturing sector compared with these other sectors.***" With a cost pass through rate sets at 48%, this means that for every one Euro of EU ETS cost of direct and indirect emissions, the tyre sector bears 52 cents. This will significantly impact the tyre industry's revenue, which may fall by €640 million each year by 2030..

- **Increase legal certainty around the qualitative assessment**

Given the formula which provides the cut off point for relief leaves much to be desired, it is essential that the new ETS law should clarify the parameters of the qualitative assessment. At the moment these parameters are barely described in the proposal.

We also believe that the qualitative assessment should remain open to all sectors, and not be open only industries which pass an arbitrary cut off level. A sector which believes its market conditions justify carbon relief, should be able to reach out to authorities and present its argumentation.

Arbitrary cut off criteria and uncertainty around what the qualitative assessment will entail means there is enormous legal uncertainty for the 100 sectors which will lose most of their carbon relief in 2020. The new carbon leakage list is only due to be released in 2018 (at the earliest), this gives industries which are close to the cut off criteria and uncertain little ability to plan for their increased costs. This is very damaging for Europe's attractiveness to foreign investment over the next few years.

## **II. Compensation mechanisms should be improved to limit the energy price gap with international economies**

- **Improve compensation for indirect costs**

ETRMA has been consistent in calling for the EU to address the need to compensate ETS indirect costs<sup>12</sup> in the ETS' Phase IV. As such, we are disappointed by the Commission's proposal goes no further than the current, ineffective status quo.<sup>13</sup> These costs have a major impact on European manufacturing industries, and leaving their compensation to the will/ability of national governments will not only be ineffective but opens the door to unequal treatment.

After all, for many industries indirect costs are the principle cost associated with ETS implementation so far. For the tyre industry, for example, these costs represent 63% of costs associated with ETS<sup>14</sup>. This means free allocation alone is not sufficient to protect industrial sectors from the loss of competitiveness associated with carbon costs passed through their energy consumption. This has resulted in an ineffective protection of exposed industries and competitive distortions across the EU.

Not addressing this issue, which is one of the main shortcoming of the current ETS system, will further decrease the competitiveness of European manufacturing. EU climate policy feeds the

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<sup>10</sup> Vivid Economics "Cost pass-through in the EU tyre industry" – Policy brief – February 2016

<sup>11</sup> Vivid Economics is an economic consultancy, which previously performed with Ecofys a similar study "Carbon Leakage Prospects under the EU ETS" for the UK DECC (Department for Energy and Climate Change) by December 2013

<sup>12</sup> Commission proposal, article 10 a (6), p.18

<sup>13</sup> Commission proposal, article 1 (5) d, p.19

<sup>14</sup> Electricity costs (54%) and Steam consumption (9%)

growing discrepancies in energy costs between Europe and other regions of the global economy<sup>15</sup>. European electricity costs are already more than double those of the US and Russia, and are 20% higher than in China.<sup>16</sup>

This critical situation has been eloquently laid out in the International Energy Agency's World Energy Outlook 2013<sup>17</sup>. The IEA projects that over the next two decades Europe (and Japan which is also dependent on energy imports) will lose one third of its market in energy intensive exports.

Therefore ETRMA asks for a better compensation of indirect costs through an EU harmonised approach allowing for solutions either through financial compensation or receiving additional free allowances.

- **Incentivise energy efficiency investments**

ETRMA would like further clarification on how the Modernization and the Innovation funds set up by this new proposal may help finance and develop certain energy efficiency projects in the industrial sector.

We particularly hope that the NER 400 fund will not be too prescriptive in choosing which technologies and projects are eligible for this funding and will also help finance industrial projects with high carbon abatement potential and a longer or low return on investment such as process improvements. It could be instrumental in reaching the EU target of increasing energy efficiency by 27% in 2030. As stated by the Communication on the Energy Union, it is time to “fundamentally rethink energy efficiency and treat it as an energy source in its own right”<sup>18</sup>.

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<sup>15</sup> [Commission working document](#) (SWD(2014) 330 final/3) In-depth study of European Energy Security

<sup>16</sup> [Communication](#) (COM(2014) 21 /2) Energy prices and costs in Europe p.12

<sup>17</sup> [IEA World Energy Outlook 2013](#) p261: The EU and Japan are expected to see a combined loss of one third of their market share in energy intensive products. See also Pilita Clark [FT article on Europe's energy gap with the US](#), 28 January 2014:

<sup>18</sup> [Communication](#) (COM(2015) 80 final) Energy Union Package, p. 12

## Cost pass-through in the EU tyre industry

8<sup>th</sup> February 2016

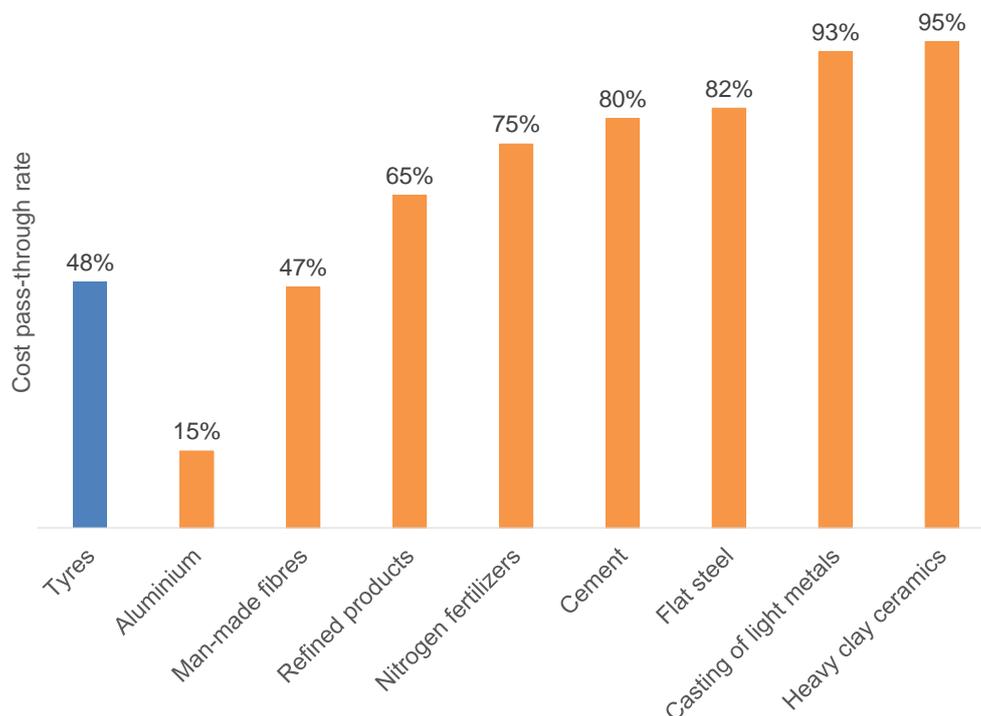
### The work estimates the cost pass-through rate in the EU tyre manufacturing sector.

This estimate can be part of an assessment of whether the sector meets the proposed European Commission criterion for classification as facing a significant carbon leakage risk, according to the proposed amendments to Directive 2003/87/EC.

**The tyre industry is able to pass-through approximately half of ETS cost, a lower rate than several other energy intensive trade exposed sectors.** The low cost pass-through rate implies a higher proportion of ETS cost absorbed by the EU tyre manufacturing sector compared with these other sectors.

**Cost pass-through in the European tyre sector is estimated at 48 per cent.** This means that for every one Euro of EU ETS cost of direct and indirect emissions, the tyre sector bears 52 cents and 48 cents is passed on to consumers as a price increase. As shown in Figure 1, this estimate of cost pass-through is lower than the estimates for several other candidates for the carbon leakage list.

Figure 1. Approximately half of the EU ETS cost is passed through in the tyre sector in 2015



Note: Cost pass-through estimates are for EU markets, not the UK markets only.

Source: Vivid Economics based calculations for ETRMA and Vivid Economics (2013)

**Increased competition from importers in the future could further lower the cost pass-through rate.** The cost pass-through rate is sensitive to the number of importers and also to margins. The number of importers is not known exactly but based on interview evidence and an assumption of similar plant capacity to EU-based plant, the figure is estimated at 75. It could plausibly be higher or lower. The estimate of the cost pass-through rate could be as low as 33 per cent if the number of importing plant is as high as 150.

**Cost pass-through is approximately constant between today and 2030 as overall tyre sales are projected to change only slightly.** Market projections by LMC show a cumulative increase in tyre sales in Europe of 11 per cent from 2015 to 2020 at a 2 per cent compound annual growth rate (CAGR) and cumulative 23 per cent from 2015 to 2030, at a 1.5 per cent CAGR, with an approximately constant share of imports. As a consequence of the constant import market share, the model estimates no significant changes in cost pass-through rate between 2015 and 2030. However, interview evidence with tyre companies indicates that importers might continue their efforts to expand market share in the replacement tyre market and might also push into the OEM and premium tyre segments. Therefore the fact that LMC does not project increases in import market share in the future should not be taken as demonstration that there will not be such increases.

**This cost pass-through rate suggests significant impacts on revenue, which may fall by €640 million per year by 2030.** The cost pass-through rate implies a decrease in profits of approximately €90 million per year by 2030 and reduces emissions from the NACE 22.11 sector by 102 ktCO<sub>2</sub>/year by 2030 for the EUA reference price in the EU 2050 roadmap<sup>19</sup> of €35/tCO<sub>2</sub>.

**Interviews with tyre manufacturing companies indicate that imports are likely to grow and may affect not only budget tyres but also the medium and premium price segments as importers improve their product quality over time.** Currently, most of the medium and premium segment in the European tyre market is held by tyre companies manufacturing in Europe. Importers compete with European manufacturers on price in the lower budget sector and those importers have access to lower costs of labour and energy. The expected future increase in imports in both the budget and medium price segments would increase the intensity of competition in this market. If this happens, it will lead to a lower cost pass-through rate for manufacturers located in the EU.

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<sup>19</sup> European Commission DG Energy. (2013). *Energy trends up to 2050*.