BIAC Discussion Note

OECD Competition Committee WP2 Roundtable on Emission Permits and Competition

25 October 2010

BIAC welcomes the opportunity to provide its views to the Competition Committee WP2 Roundtable on Emission Permit Trading and Competition. Despite its highly specific technical content, it is a subject worthy of the competition agencies’ interest as it raises serious issues of competition, which is reflected in the fact that all industries do not have a unified approach to the existing systems.

The purpose of emission trading is to provide a cost-effective greenhouse gas (GHG) abatement instrument. By setting a cap on economy-wide emissions that decreases over time, governments are seeking to reach certain emission reduction objectives at a set point in time. A carbon market where emission permits are traded then allows covered entities to implement the cheapest abatement possibilities before more expensive low-carbon investments are undertaken. In this way, governments aim to reach climate goals without the deadweight losses experienced with over (or under-) taxation/subsidies, rigid emission controls or voluntary agreements which could lead to expensive adjustment processes if targets are not met in time. Offering low cost reduction flexibility coupled with the added assurance of firmly reaching specified emission targets has made emissions trading policy the mechanism of choice for many policy makers, and this instrument has received support from many stakeholders across industrial sectors. Of course for this mechanism to be effective, the assumption is that it should be designed and implemented globally.

However, in practice this instrument is not without side effects on competition, and it has a cost which is inevitably borne by the end-users, especially in the form of higher electricity prices. The cost variations resulting for electricity producers\(^1\) from the trade emission market’s mechanism are passed through to industrial users, who operate in already highly differentiated pricing systems, some with long-term bilateral power contracts and some based on marginal costs. Only a widespread carbon market, in which all major industrial sectors are subject to comparable stringent rules, would completely erase competition concerns in relation to the direct cost impacts. Unfortunately, the development of a distinctly

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1 Electricity producers are the most important carbon-emitting sector, receiving approximately half the emission permits.
A harmonized market approach is currently not a realistic scenario as sovereign nations have unique issues and concerns that need to be addressed prior to standardization. Moreover, the established historic concept of ‘common but differentiated responsibility’ would make it impossible to submit industry sectors in developing nations to the same emission abatement target as industry sectors in OECD countries. A more realistic option, the linking of regional/national or sub-national trading schemes, is further discussed below.

Climate change is a global phenomenon that cannot be addressed by capping emissions solely in one region. The aim must remain to establish a global climate regime which covers all major emission sources. Some economic sectors are highly interconnected, where prices for commodities are determined in a global market. Passing on the costs of a locally-implemented abatement policy into a global market is not possible for sectors exposed to international competition. Therefore, all major emitting countries should be encouraged to introduce similar national trade schemes to allow for a level-playing field where industry is able to compete on a global scale even if, locally, additional costs have to be assumed in the early development of a global programme. Unless all main competitors face similar costs, free allocation of allowances represents a necessary transitory mechanism that balances the regulatory regime at a time when first-movers take action and protects jobs in those jurisdictions. Industry therefore welcomes a more active role by competition authorities in the carbon market debate, particularly to deal constructively with these sectors where global pricing systems apply.

The linking of regional markets could reduce the overall costs of abatement and would create a more liquid and robust market, thereby enhancing price signals for low-carbon investments. Indeed, we see more and more countries introducing or contemplating the introduction of domestic emissions trading schemes. OECD countries are not the only ones considering cap and trade policy; discussion on emission markets is underway in China, Russia, India, Brazil, Ukraine and elsewhere.

Linkage is the direct or indirect connection among tradable allowance systems that permit emissions reduction efforts to be redistributed across systems to take advantage of the lowest cost abatement opportunities. Larger and more liquid markets are inherently more efficient, reducing transaction costs and providing capital to a larger pool of opportunities for low cost abatement. Larger markets are more robust, reducing concerns about the market power of actors, and reducing total price volatility. Crucially, links between emissions trading systems (ETS) results in a more united, globally-recognized price for greenhouse gases. To develop the more complex form of two-way, direct linkage between systems, technical barriers will not normally be the limiting element. To minimize regulatory arbitrage, policy makers must minimize price interference, accept differentiated reduction efforts, require consistent, reliable monitoring, reporting and verification systems and ensure that tradeable units are of comparable emission denomination.

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2 Direct linkage requires that at least one ETS recognizes the other’s allowances for compliance. This may be one-way (unilateral) or two-way (bilateral).
3 Indirect linkage occurs when the supply and demand for allowances in one ETS is able to influence supply and demand in another ETS through direct links with a common system, e.g. UN offsets.
Experience with emission trading and the Clean Development Mechanism (CDM) has shown that carbon markets lead to the transfer of clean technologies from developed to developing countries as well as from developing to developing countries. Just as importantly, they also lead to the more widespread diffusion of technologies that are currently available in-country but are under-utilized. Credits from the Kyoto flexible mechanisms are playing an important role in the development of cost-efficient reduction strategies for companies in Annex I countries and currently represent the only mechanism that transfers private finance and technology to developing countries. The use of offset credits in major emission trading systems should therefore be encouraged and further developed.

The clearest benefit for developing countries to engage with carbon markets is the generation of new, additional finance for investment in low carbon activities. The development of offset projects leads to money being spent in-country on clean technology, raw materials, and on salaries for local staff, thus creating jobs and alleviating poverty. The creation and linking of ETS around the world could significantly increase foreign direct investment into developing countries.

A number of issues have however been identified in relation to the functioning of the CDM, including its cost and its potential effects on competition as it can be viewed as a form of subsidy. The future of the CDM beyond 2012, the end of the Kyoto commitment period, needs to be clarified as soon as possible so that all players can determine their strategies. In particular, new offset mechanisms, e.g. programmatic CDM or sectoral crediting, are welcome with a view to scaling up mitigation efforts and should be developed in parallel without, however, impinging on the use of offsets from, and function of the CDM.

Sectors that do face larger production costs in one country and cannot pass them on to customers risk disinvesting and moving production factors abroad. This is particularly the case for sectors that have a global pricing system. This will not only result in job losses but also deprives the affected country of key input factors, technology and know-how which might reduce industrial agglomerations as well as high-tech centres. Moreover, the phenomenon of carbon leakage as emissions move abroad is reducing the effectiveness of the policy to the detriment of the wider goal of combating climate change.

Free allowances based on achievable product-based benchmarks could prevent carbon leakage and still incentivize long-term investments in low carbon technologies. Given the lack of comparable, comprehensive carbon-reduction policies in other major economies, industries within a “cap and trade” scheme should receive a maximum amount of free allowances.

Competitive concerns also arise through indirect costs related to electricity price increases. Power generators, in a liberalized market, pass on marginal production costs to their customers. Each emission permit they have to purchase will be reflected in the wholesale

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4 The “flexibility” mechanism introduced by the Kyoto Protocol to the United Nations Framework Convention on Climate Change (UNFCCC), allowing the “Annex I countries” (i.e. the industrialized countries) to meet part of their caps using “Certified Emission Reductions” from CDM emission reduction projects in developing countries.
and retail electricity price. Through appropriate hedging, the power sector manages price volatility, however if carbon prices increase, indirect costs of production also increase. This is in particular a concern for electricity-intensive industries such as steel, chlorine and aluminium. Moreover, additional costs could be imposed by mandatory policies for the phase-in of renewable or energy efficiency programmes. Governments must allow for appropriate compensation measures to take away the carbon leakage risk originating from higher electricity costs. On average, electricity in Europe is 21% more expensive than in the USA and 197% more expensive than in China:

![Bar chart showing benchmark costs of electricity](chart_image)

Source: BusinessEurope

* Based on the 2007 IEA data, the chart above displays the benchmarks of the levelised costs of electricity (LCOE) with a discount rate of 10%. The electricity cost presented here is calculated on a weighted average mix of nuclear, coal and gas.

Given governments’ efforts to mitigate emissions via domestic climate policy, and the varying levels of environmental regulation around the world, it is desirable to design climate policy in a way that alleviates both competitiveness and carbon leakage concerns. However, proposals to do so have created political and economic tensions between the developed and developing world.

In late June 2009, the U.S. House of Representatives passed the Clean Energy and Security Act, which calls for a U.S. cap-and-trade scheme to be implemented by 2012. To ensure the competitiveness of trade-exposed and energy-intensive sectors, the legislation called for emission allowance rebates to cover the costs of compliance as well as “carbon equalization” provisions which would involve raising tariffs on imports from countries without climate policies in place.

Similarly, competitiveness provisions are supported by some major developed economies that have strict climate legislation already in place. In particular, some European member countries that participate in the EU ETS, in particular France and Italy, have increasingly started to call for competitiveness provisions. While competitiveness proposals by the governments of the U.S., France and Italy are designed to ensure the continued competitiveness of energy-intensive and import-competing sectors, also the governments of developing or emerging countries, notably India and China, vehemently oppose what they view as a form of “green protectionism”.

![Chart showing benchmark costs of electricity](chart_image)
Despite these divergent economic interests it remains to be determined if either side of the debate has any legal weight in the context of the World Trade Organization (WTO). While there is no precedent as of yet—that is, no complaints have been submitted for WTO dispute settlement—international trade experts believe that it is possible to implement competitiveness provisions in climate policy without violating the General Agreement of Tariffs and Trade (GATT), and the WTO does not seem to rule out their eventual existence.

Given today’s dependency on open markets and a rules-based international trading system, companies oppose unilateral trade measures to enforce non-trade objectives. Proposals to impose “border adjustment measures” for carbon-intensive imports cannot solve the carbon leakage problem for sectors with value chains and tradable end-products. Recent studies have shown that, while indirect impacts via increased electricity prices have been high, cap and trade regimes have thus far imposed limited real costs to major direct emitters within the scheme, thereby reducing the perceived threat of carbon leakage and limiting the necessity for border carbon measures. Even if made compatible with WTO rules such border carbon measures may fail to address competitiveness concerns for most industrial sectors.

Market manipulation or insider trading can distort the price signal for carbon mitigation strategies and thereby reduce the cost-effectiveness of emission trading. It is important to have appropriate rules in place to prevent market abuse in both carbon derivatives and spot trading whether through exchanges, trading facilities or bilaterally (OTC).

The carbon market is different from other (commodity or financial) markets as (i) it is a regulated market, i.e. entities covered have a legal obligation to participate and allowances are produced and allocated by governments; (ii) it is a young market; (iii) it has many smaller participants; and (iv) its transactions are mostly traded on exchange or cleared. However, carbon trading is essentially similar to trading in markets for other commodities. Therefore, carbon market oversight measures should be coordinated with other commodity markets, in particular energy markets.

A comprehensive market abuse framework would have to encompass both auctions of emission allowances and trade in spot and derivative carbon contracts via exchanges, multilateral trading facilities (MTF) and over-the-counter (OTC). This is important because derivatives transactions – i.e. futures - account for the vast majority of volumes but serve essentially a function of forward ‘physical’ delivery (in other words, there is a continuum between the spot and the derivatives markets, the only difference being the delivery date). If an abuse of market dominance is being detected, anti-trust laws and competition authorities should be responsible.

Oversight/enforcement should be left to the relevant market operator, with support from financial and energy regulators, combined with effective communication and coordination between all relevant bodies.

Position reporting on derivatives transactions can provide a useful tool for regulators in identifying concentrations of risk in a particular instrument or market. It should be limited to
large positions. However, position limits can hinder the ability of producers/manufacturers to hedge effectively or expose these firms to a detrimental regulatory and commercial risk. In the same vein, a framework that provides robust disclosure of all OTC transactions to the regulator and preserves access to OTC markets for regulated entities can achieve the same degree of transparency to the regulator and market as forcing all transactions onto exchanges, and it does so at much lower cost to the economy and individual ratepayers.

Finally, to allow a market to develop, it is important not to restrict participation only to compliance entities. Prohibiting financial institutions or other sectors from participating would make the market less liquid, less efficient, more volatile and more expensive. Limiting market participation unnecessarily increases overall compliance costs and limits the market’s ability to produce a forward price signal. However, it is important to submit parties in the trading system to a ‘due diligence’ check to prevent fraudsters from abusing the system.

BIAC respectfully asks the competition agencies to take in consideration the above points when they have the opportunity to participate in the framing of the next developments in the world greenhouse gas abatement strategy.