

Response to Sandbag report “*Buckle Up!*”

Substance of a speech made by UK Steel Director, Ian Rodgers at Sandbag’s launch event on 6 July 2011

Facts

To put our response in context, we must first set out some facts about steel.

1. Carbon abatement opportunities in the steel industry are limited with current technology. The blast furnace is the most carbon intensive process on a steel site. In this process, carbon is used as a chemical reductant. There are limits on the extent to which carbon input can be reduced, and as a result of investments in recent decades the industry is fast reaching the point where no further reductions can be made. It is estimated that carbon emissions from other processes can perhaps be reduced by a further 1% per annum through to 2020, but the opportunities for abatement are becoming more difficult and costly.

The industry however recognises that it has a duty to reduce its emissions further and is pouring resources into researching new, break-through technologies. These technologies though – if successful - will not be available until the 2030s; and the investment then required to re-equip steelworks will be immense.

2. Steel is highly traded on global markets. In the test for carbon leakage set out in the EU ETS Directive, the Commission assessed steel’s trade intensity at 32.3% - above the 30% threshold at which a sector is deemed automatically to be at risk of carbon leakage regardless of its carbon intensity. Steel’s carbon intensity however is also high – assessed by the Commission at 12.7% of GVA.

These figures confirm many earlier independent assessments that place steel among the sectors at greatest risk of carbon leakage if the cost of carbon were to be internalised.

3. Steel is essential to civilisation and economic development. Globally, demand is rising by 6% a year as emerging economies develop. Steel also has a key role to play in the decarbonisation of the world economy. All low carbon technologies are reliant on steel. Steel is the most recycled and recyclable material on the planet. The industry is also playing its part through the development for example of low weight, high strength steels.

EU Emissions Trading Scheme

The EU ETS is in our view no longer fit for purpose – at least, not for internationally traded sectors. The UK steel industry argued long and hard for ETS allowances for such sectors to be allocated *ex post* – i.e. the actual volume of allowances issued should relate to actual output levels. Instead, green lobbyists and environment departments across Europe insisted that only an absolute cap would provide the

certainty of environmental outcome required, and that companies' allocations must therefore be fixed. The problem with this approach was that it made the market highly sensitive to changes in output.

Sandbag's report states: "*The ETS was never designed to encourage industries to to financially subsidise their economic growth or recovery*". But it was inevitable that when output fell, industries would receive excess allowances. This is a built in design feature of an absolute cap.

Paradoxically, our concern in the run in to Phase 2 was the opposite – we estimated that the allowances allocated to the UK steel industry were just adequate to meet business as usual requirements, but would act as a brake on growth for companies seeking to take advantage of booming world markets.

The recession of course changed the picture. The impact on steel was enormous. At the depth of the recession, UK steel output was 50% down on normal levels. Around 7,000 employees lost their jobs, thousands more were put on short time working. The misery continues in some parts of the industry, with the recent announcements of a further 1,500 job losses.

Steel companies were of course able to sell some of their allowances. This helped them survive the worst part of the recession, and as we slowly emerge has meant that companies have been able to start re-investing earlier than might otherwise have been the case. Sandbag complains of these "windfall" profits, apparently preferring that the pain should have been even worse. It is indeed ironic that the system we argued against helped us to survive, but it is illogical and insulting to demonise the sector for benefiting from it.

Set aside

The central proposition in Sandbag's report is that the surplus allowances built up in Phase 2 of the ETS will delay the achievement of the required Phase 3 emissions cuts. They therefore propose that 1.7GT of allowances should be withdrawn from the system.

This is total nonsense:

1. Phase 2 surpluses do not weaken the system. The Phase 3 cap has been calculated as being the traded sectors' contribution to the EU's emissions reduction target of 20% by 2020. That cap will be met. The total emissions in Phases 2 and 3 taken together will not, can not, exceed the total caps for those two phases. Thus the steel industry and other traded sectors will make our contribution to the environmental objective. The only change from the original plan is that the curve of emissions reduction will be different. Instead of a steady downward trend, we have experienced a very sharp reduction in emissions during the recession. This sharp reduction is now being followed by a gradual increase in emissions as economic activity picks up, but at some stage soon emissions will start trending down again as the Phase 3 cap starts biting.
2. The steel industry will be seriously short of allowances in Phase 3. The shortage has been estimated at some 350 to 400 million tonnes of CO₂. Every single steelmaker in the EU will be short of allowances, even though the Directive

stipulates that the level of allowances allocated should equal the needs of the best 10% of producers in each sector. This is because the benchmarks used to calculate companies' allocations have been poorly – perhaps illegally – calculated by the Commission. Depending on the speed of the recovery, the surpluses built up by the sector during the recession could be fully absorbed by around 2014.

Our deep concern is that before the end of Phase 3, perhaps around 2018, steel companies will run out of allowances. With abatement opportunities very limited, they will have two choices: either to buy allowances, which could increase their costs by up to 10% and result in severe loss of market share, or to stop production for the rest of the phase. This is the inevitable result of a fixed cap system with less than full allocation going to internationally traded sectors, and why we contend that the current system is not fit for purpose.

Setting aside “surplus” allowances from Phase 2 as Sandbag proposes will merely lock in to the system recessionary output levels and bring forward the point at which steel companies run out of allowances.

Other issues

There are many other inaccuracies and misleading assertions in Sandbag's report, but three which need instantly addressing are:

Waste gases

Sandbag suggests that the steel industry is engaged in some heinous, Machiavellian plot to hide the true level of surpluses by somehow obfuscating actual emission levels through the transfer of waste gases.

In fact, the reality is very simple. The sensible approach to calculating steel plant emissions is to take the volume of carbon being put into the iron and steelmaking process (mainly coal) and deduct from it the carbon contained in the products leaving the plant (such as steel). The difference must by definition be the amount of carbon emitted from the total process area. This was the approach generally used by Member States to calculate steel companies' allocations in Phase 2.

Within an integrated steel plant, several processes generate bi-product gases, which are then used elsewhere for heat, steam or electricity generation. This maximises energy efficiency and is something that steelmakers have been doing for decades. The alternative would be to flare the gases on safety grounds.

Thus emissions from the combustion of waste gases are included within the total steel plant allocation.

A problem tended to arise however with electricity generation. Some steel companies, instead of building their own power plant on site, decided to collaborate with an independent power company to build an adjacent power plant, using their waste gases. The electricity generated is generally sold back to the steel plant for internal use. In some Member States the emissions arising from the combustion of waste gases by the power generator have been accounted for separately – attributed to the power generator - so steel companies have had to transfer the relevant allowances.

There is thus no mystery about steel “waste gases”: it is just an accounting quirk.

The report identifies the UK as one of the countries where these transfers are “more pronounced”. In fact, they do not happen here at all. Here the power plants are owned by steelmakers and are on the steelmakers’ sites.

Carbon offsets

Sandbag is outraged that some steel companies in Europe have been using offsets bought from competitors in developing countries. Sandbag regards this as steel companies subsidising their competitors’ activities. They have demanded a ban on the use of offsets from competitors.

This also is nonsense.

- If offset credits are bought on the open market, companies have no visibility of the source of those credits.
- A ban would in any case be pointless. A steel company could buy offsets from a cement company, and vice versa. This would make no difference to the availability of offsets to overseas projects.

Furthermore, we dispute the hypothesis underlying Sandbag’s analysis that overseas companies derive a competitive advantage from the sale of offsets. Provided the UN’s rules on additionality are observed, the sale of carbon credits merely gives the overseas company the ability to invest in carbon reduction equipment that would not otherwise have been cost effective. The overseas company does not enjoy reduced costs, it merely get its increased costs offset.

The key is therefore strict application of the UN rules, not arbitrary tinkering with companies’ legal rights within the EU.

The carbon price

There is an abiding obsession, which also features in Sandbag’s report, that the EU carbon price is too low. This misunderstands the purpose of the ETS. The purpose is not to deliver a given level of carbon cost internalisation, but to deliver a fixed level of emissions reduction. The theory of emissions trading is that it will facilitate cost effective abatement, and according to this theory, the lower the carbon price, the more effective the trading scheme.

If the carbon price is deemed to be too low to stimulate investment in favoured technologies (it is debatable whether the carbon price will ever be high enough to stimulate investment in expensive renewables), then other measures are needed. This has been recognised by the UK government with their Carbon Price Floor and Electricity Market Reform proposals (though we dispute that both are needed). It would be a distortion of the system to tighten the cap merely to get a higher carbon price.

Conclusion

The Sandbag report contains the following paragraph:

“The profit making opportunities in the ETS make it the preferred regulatory instrument of industry despite their protestations. If they continue to block progress an alternative strategy would be to remove the most vocal sectors from the system altogether and instead imposing (sic) direct regulatory controls on emissions or introduce a carbon tax. This threat would, we suspect, lead to industry lobbying in favour of emissions trading once more.”

We are prepared to call Sandbag’s bluff. We in the UK steel industry would welcome a dialogue with government on an intelligent alternative to ETS as the means to incentivise carbon abatement in our sector.

Ian Rodgers
6 July 2011