

Mr. José Manuel Barroso
President
BERL 13/057

Brussels, 11-21-06

Dear President,

Subject: Climate change, energy and competitiveness

In light of the upcoming college debate on the European policy in the area of energy and climate change, I would like to share with you my own thoughts as to how, as a College, we can genuinely promote environmental sustainability, a modern secure energy policy and competitiveness of European industry – in line with our Lisbon principles. Although these ideas are purely personal, they take into account recent discussions in the High Level Group on Competitiveness, Energy and Environment.

If we succeed with such an integrated approach, then we can show Europe's citizens how the European Union can add genuine value by addressing some of their essential concerns as regards the future of their jobs, protection of our environment and security of energy supply and availability of affordable energy.

This is a unique challenge for the Commission. We need mutually reinforcing principles that bind the strategy together and reconcile what may otherwise not be fully convergent objectives:

1. An ambitious and realistic approach towards targets for emission reductions *demonstrating environmental leadership* that offers *strong incentives for other big emitters* to also make significant contributions in a way that *does not undermine the competitiveness* of the European economy;
2. The Stern report underlined that we can make significant headway in addressing climate change, if we rely on *efficient instruments*. We need an instrument mix – both internationally and in Europe – that taps the potential for emission reductions where it is cheapest to do so while stimulating innovation.
3. We need to get serious about green technology development. Given the prevailing uncertainties and market failures, there is a clear need for public intervention. In other words, I would like to more aggressively promote *an industrial policy that will make Europe the frontrunner in environmental industries*. This must include a *differentiated approach for energy intensive companies, exposed to intense international competition* to ensure that they continue making real headway with environmental improvements in

the EU instead of moving production and related R&D to lower cost and less environmentally responsible locations outside the EU.

I believe that if we apply these principles we can integrate and indeed anchor this policy into our Growth and Jobs strategy. To do this, we need to translate these principles into substantive proposals for our January package. I believe that there are 10 inter-linked and mutually reinforcing action points flowing from this which are all necessary to develop a strategy that promotes environmental sustainability, improves security of energy supply and availability of affordable energy and bolsters competitiveness. They are summarized in the annex to this letter and consist of the following elements:

1. An ambitious and realistic approach to targets for reducing CO₂ emissions. In particular, I believe that we need to propose a realistic unilateral target for 2020 which we would further strengthen if other countries also commit to substantial actions to fight climate change. This target obviously needs to be consistent with our growth and jobs strategy, based on rigorous economic analysis in accordance with our Better Regulation principles.
2. Further action to develop the Clean Development Mechanism and Joint Implementation to have efficient international instruments for reducing emissions in a cost-effective manner and integrate other big emitters in the fight against climate change.
3. Bold action to complete the internal energy market and ensure that it functions efficiently. This requires, in particular, measures to guarantee effective unbundling, strengthen the role of regulators and ensure higher levels of interconnectivity.
4. All energy options must be kept open. We have to take a fresh look at the potential contribution of all energy resources, notably low carbon technologies, and carefully review our policies in this respect.
5. Further strengthen, harmonise and extend the European Emission Trading (ETS) system as a key element of our policy mix. This needs to be done through the Review of ETS to allow it to develop into a truly efficient "docking station" for trading systems across the globe.
6. Full exploitation of the potential of energy efficiency – in line with our recent Communication – and a framework to work with Member States to generate greater progress.
7. An ambitious industrial policy that will make Europe the frontrunner in environmental industries. Such a policy should aim at harnessing the experience, innovation potential, scientific capacity and responsibility of European companies and should be backed up by our Innovation policy. This implies taking a fresh look at the Joint European Technology Initiatives, the concept of lead markets, the CIP work programme as well as measures to promote innovation in the car industry;
8. A binding target for the share of renewables in the European energy mix coupled with a strong European framework for promoting renewables to create a genuine internal market for renewable production in Europe as Andris is striving to promote.
9. A framework for building the commitment of consumers and citizens to this agenda as an essential precondition for the success of this agenda.

10. A specific framework for energy intensive industries particularly exposed to international competition to cover the transition period in which Europe moves forward while other big emitting countries are not yet taking sufficient action. The objective must be to improve performance but avoid undue penalization compared to international competitors.

I believe that this ten point action plan would provide the EU with effective environmental leadership in a way that is consistent with our Lisbon objectives. Through efficient international and European co-operation we would be able to minimize any potential negative economic effects while equipping our industry with strength through innovation to prepare for the markets of the future. Significant decreases in the energy intensity of the EU economy coupled with increases in renewables production in the EU as well as a much stronger internal market with proper interconnections would better shield the EU economy from external supply shocks.

The action plan is a package from which one cannot pick and choose – the individual elements are designed to complement and reinforce each other. Selecting just a handful of its measures would inevitably weaken the strategy, either in its environmental, or security of supply or competitiveness dimensions.

Finally, this strategy would demonstrate to our citizens, enterprises and the world that we have a coherent plan of action to address the pressing global challenges of our age through a coherent set of concrete actions. We would be doing this by exploiting the real advantages that the European Union brings in terms of its internal market, research and industrial policies as well as the external dimension that cannot be achieved by Member States acting in isolation.

I guarantee you my full support in designing a European policy that responds to our key challenges of protecting the environment, securing the energy supply and maintaining jobs and growth in Europe.

We know that Europe's citizens expect us to act, we must not disappoint them.

*Yours sincerely
Günter Verheugen*

Cc: All Commissioners

Annex

A 10 point action plan for fighting climate change, promoting security of supply and bolstering competitiveness

Environmental leadership

1. We need a **twin track approach to target setting for reducing Greenhouse Gas Emissions**. A first set of targets would represent the EU's **unilateral** commitments over time (e.g. 2020, 2035, 2050) – highlighting our willingness to fight against climate change as part of our vision of a sustainable Europe prepared to accept its global responsibilities. These targets would become more ambitious over time and encompass efforts which we should in any event make to promote energy efficiency at low cost and protect our security of supply. At the same time, we would underline our willingness to take on a second, more ambitious, set of targets through international agreements if the other main emitters are willing to equally take substantial commitments to act against climate change. I believe that this twin track approach is to be preferred to a "single shot" approach to target setting that provides no incentives to other parties to join us in a common effort to meet the global challenge of climate change. At the same time this will help avoid potentially seriously damage to Europe's competitiveness. We need to demonstrate environmental leadership, but there is no point in doing so if we have no followers – especially if this comes at significant cost to the EU economy.

Clearly, the unilateral set of targets must be based on rigorous economic analysis – in line with our Better Regulation principles. We must take account of investment cycles and the time it will invariably take to reap the benefits of the industrial policy that will make Europe the frontrunner in environmental industries that I am proposing. Unrealistic targets for the near future (e.g. 2020) could come at a significant cost because they do not take account of the rigidities of the energy system and the lifetimes of installed capacities. The tentative empirical work undertaken by my services suggests that 2020 unilateral targets of more than 15% off 1990 levels could imply significant costs. Targets between 10% and 15% would already imply electricity price increases in Europe of some 10% and prices of CO₂/tonne of up to 30€. Our growth and jobs priority must not be endangered at a time when it is beginning to generate real results. On the other hand, with an ambitious industrial policy that boosts environmental industries, we should be prepared to set much more ambitious targets for the longer run, taking full account of investment cycles and experience of the new measures. I believe that this should enable us to consider progressively more constraining targets for the period after 2020.

Efficient international and European Instruments

2. Europe's share of global CO₂ emissions is 14% and it is falling rapidly. China will overtake the US as the world's biggest emitter of CO₂ in less than a decade. Our new post-2012 strategy will have to address these realities. This requires a very ambitious approach to the so-called flexible Kyoto instruments that allow emission reductions in fast growing economies to be financed. We need, therefore, to resolve the institutional and practical barriers that are still holding back **the full use of the Clean Development Mechanism (CDM) as well as Joint Implementation**. We should also work with financial institutions to see whether we could not set up a significant European CDM Investment Fund that would allow these markets to really take

off. The Kyoto flexible instruments provide our best hope for developing global markets in CO2 emission abatement and generating real progress across the globe. They should, therefore, be strongly promoted and we should avoid policies that unnecessarily restrict their use. If we are successful then we will be able to develop huge markets in China and India for clean technologies which will be of great interest for European industry. I believe, in this context, that Europe's development policies could play an important role in assisting the third world to manage the necessary transitions in their economies. A greater use, and possible earmarking, of development assistance would clearly be desirable.

3. **An efficiently functioning Internal Energy Market** is key to all three objectives we are pursuing: competitiveness, security of supply and environmental sustainability. A fully integrated internal market will reduce inefficiencies, promote investment where it is most needed and, therefore, strengthen our competitiveness. The analysis carried out by Andris's and Neelie's services clearly demonstrates the scale of the problems we are facing today with the functioning of this market. We need to be very bold in resolving this and how we can do this. The energy package should contain proposals to ensure effective unbundling, measures to safeguard the independence of regulators whilst providing incentives to work together at a European scale and effective measures to build interconnection capacity. Our high level of environmental ambition implies that we must also have a high level of ambition when it comes to completing the internal energy market.

4. **All energy options will need to be kept open.** We cannot meet our triple challenge if we constrain the energy system further by blocking certain technologies over the next twenty years. Given the lead times and investment cycles involved with bringing renewables on stream, we will need all our domestic low CO2 emission options – certainly until 2020 and even beyond. Without prejudice to political decisions by individual Member States, this implies a fresh look at the economic effects of all available low carbon energy sources and it also means that we should carefully review our own policies in this respect.

5. **The European Emissions Trading (ETS) system is a key element of our policy mix that will need to be further strengthened and extended.** ETS is the main market based instrument we have and, as such, it holds out the potential for an efficient approach to CO2 emission abatement. In particular, the review that Stavros is presently preparing provides a unique opportunity to fix some of the problems we have identified already. First and foremost, we need a level playing field to be achieved by more harmonization to ensure that the system generates real benefits without distorting competition in the internal market. In particular, I believe we need European rules on the allocation of emission rights as well as the treatment of new entrants and closures. Secondly, we need to extend the system to bring in other sectors – e.g. cars – as well as other gases. There is no justification for excluding these from the ETS – we must avoid the proliferation of stand alone schemes or alternative outdated "command and control" approaches. The logical point in time to really make this bold step is 2012 when the Kyoto trading period expires. ETS should be the "docking station" for trading systems across the globe allowing the emergence of a genuinely efficient global carbon trading system. These measures are also vital to realize the real take off of the Clean Development Mechanism I argue for above.

6. We need to **fully exploit the energy efficiency possibilities** – in line with our recent Communication on this matter. Energy efficiency and, where possible, energy conservation, can really make a key contribution to promoting sustainability and competitiveness. We must fully use the provisions of the Energy Using Products (EUP) directive which Andris and I co-manage. New standards and minimum requirements could do much to stimulate progress. At the same time, we should propose that Member States put in place the necessary advisory services and incentive schemes to tap the cost-effective potential in buildings and to support SMEs in contributing to our aims. A framework for generating greater progress to this end is clearly needed.

Technology development: an ambitious industrial policy fostering environmental industries

7. The above instruments have the potential of efficiently exploiting existing technologies and possibilities for reducing emissions. But these technologies alone will not be sufficient to achieve the deep cuts in emissions that will be needed. While a (global) carbon price will, of course, give incentives to technology development, there are nevertheless many barriers and market failures that hold back this development. Moreover, many of the incentives are dispersed across the EU while some of the technologies require a European scale for deployment. I strongly believe, therefore, that we should develop an **ambitious industrial policy** boosting environmental industries and technology development beneficial for the environment. This implies that we need to take a fresh look at the Joint European Technology Initiatives to see whether we have got the priorities right. I am also reviewing our work programme for the Competitiveness and Innovation Programme (CIP) from a similar perspective and the same needs to be done with regard to our lead market initiative. Our innovation policy can then help bring supply and demand closer. Finally, while I believe that the inclusion of automobiles in ETS is the right approach to reap efficiencies across the economy in the short to medium run, it will not suffice to generate the technology breakthroughs that we patently need in this field. I would, therefore, consider that additional technology push measures are also required.

8. We have made good progress with developing a renewables policy in Europe through an approach that consisted of setting targets for individual technologies. This has allowed us to kick-start technology development from a very low base and, as such, has served a very useful purpose. But, clearly, given the need to make genuine progress on a much larger scale, I believe that we now have to **create a truly internal market for renewables in the EU**. Naturally, we should not fall in the trap of attempting to "pick the winner" and we should, therefore, provide incentives, in a technology neutral fashion, based on the environmental benefits of different renewables. A promising approach would be to set a binding European target for all renewables with a sharing out amongst Member States within the context of a strong European framework. In this context, we should consider linking existing schemes such as the green and white certificates to ETS to ensure coherence.

9. For this industrial policy driving forward environmental industries to succeed, we will need to get the **commitment of consumers and citizens**. Life style choices and attitudes will have to equally change to embrace the new agenda and to use the new technologies. This will require a real effort on the part of Member State governments as well as other stakeholders – including social partners, the research and development community, transport and the world of

education. Member State governments and the Commission will need to work together to develop policy frameworks that promote this new agenda, e.g. through taxation, transport and land use planning, housing (both existing buildings and new construction) etc. I would propose that we take an initiative to develop a framework for taking this forward as part of our Lisbon strategy.

Managing the transition: a differentiated approach

10. We have to recognize that, during the transitional period where Europe moves forward but other big emitting countries are not yet taking sufficient action, our environmental leadership could significantly undermine the international competitiveness of part of Europe's energy intensive industries and worsen global environmental performance by redirecting production to parts of the world with lower environment standards. This is a *specific* problem that needs to be addressed through a *specific* solution if our strategy is to make economic and environmental sense. We, therefore, need to develop a **specific framework for energy intensive industries particularly exposed to international competition**. This framework should ensure that the incentives to improve performance are maintained, but that those companies that lead by example in terms of sustainability are not unduly penalized compared to their international competitors. I believe that we need to urgently launch a reflection on how we can best bring forward proposals to achieve this. Possibilities that need to be explored include binding international sectoral agreements, trade policy measures such as, for example, border tax adjustments and a dedicated state aid framework. I propose that we urgently set up a task force to develop appropriate proposals by early next year.