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REFINING PRODUCTS FOR OUR EVERYDAY LIFE

Pass-through of carbon costs is not suitable as a criterion in the carbon leakage assessment for trade exposed industries

Cost pass-through is the process by which a producer or a manufacturer will offset increased costs by raising prices. These increased costs may be the consequence of several factors of the production process becoming more expensive (e.g. raw material, energy, labour, etc.); they may also result from specific legislation or taxes. This analysis will be the focus on the latter.

For example, electricity producers in Europe systematically pass through to their consumers the cost of carbon (i.e. the purchase cost of ETS allowances) incurred the production of electricity.

Cost pass-through requires specific conditions to apply

As a general principle, the ability of a domestic firm to pass-through additional costs to the final customers, depends on the ability of external competitors to access the same market. If, as in the example of electricity producers, there is no or very limited access to the EU market by non-EU competitors, offsetting the increased costs by raising consumer prices is a concrete possibility with no impact on competitiveness.

Conversely, in a market open to international competition any price increase put forward by the domestic producer would potentially undermine its competitiveness.

EU refining cannot pass-through costs to consumers without exposing itself to a competitive disadvantage

The EU refining industry is characterized by an extreme exposure to international competition. The refineries operate in an open, transparent and very liquid market for goods (commodities) that are easily traded and shipped at relatively low transport cost.

EU refiners are part of the ETS sectors and therefore exposed to carbon cost.

If they pass-through carbon costs to their customers, competitors not subject to ETS or other regulations resulting in carbon cost, would then benefit from a strong competitive advantage. In fact, the non-EU competitor may react:

- either by undercutting the market prices put forward by the EU refineries– thereby gaining market shares
- or by increasing their sales margin with respect to the EU refineries – thereby creating more value for their shareholders.

In both cases the competitiveness of the EU installations subject to ETS would be impaired, with the potential for a relocation of production activities and investment off-shore.

T +32 (0)2 566 91 00
Bd du Souverain 165 | 1160 Brussels | Belgium
contact@fuelseurope.eu
www.fuelseurope.eu
fuelseurope
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In contrast, if EU refineries do not pass-through these EU-only carbon costs, they have to face in the long run the erosion of their margins, making the EU less economically attractive to invest in upgrades of installations or in new capacity.

The competitive disadvantage of the EU refining sector, which has widened since the start of EU ETS Phase 3 in 2013, demonstrates the impossibility for EU refiners to pass through the cost of regulation without losing competitiveness.

In conclusion: theoretical assessments of the possibility for a sector heavily exposed to international competition – such as the refining industry - to pass-through carbon costs should not be used as a criterion to determine whether and to what extent such sector deserves Carbon Leakage protection.

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