ENERGY AND CLIMATE TRANSITION: HOW TO STRENGTHEN THE EU'S COMPETITIVENESS

The energy policy and industrial landscape in Europe is at a critical juncture. The recent energy crisis exposed significant vulnerabilities in the European energy supply and led to a sharp increase in energy costs for European businesses.

BusinessEurope commissioned Compass Lexecon to assess how Europe can achieve its climate and energy targets in a cost-effective way, while being internationally competitive. One message is clear from the report's findings: **a strategic review of EU energy and climate policies is needed to achieve this outcome**.

The report, published alongside this position paper, finds that a massive scale-up of renewable and low-carbon capacity is needed to reduce the energy price gap between the EU and third countries and reach climate neutrality.

It also projects that energy prices could remain substantially higher in Europe compared to our international competitors. Therefore, additional policy measures will be needed to secure the competitiveness of European industry, supported by a conducive regulatory framework and a scale-up of private and public investments.

While there are major challenges ahead, this analysis demonstrates that a competitive energy and climate transition is still possible if the right policy decisions are made in time. Building on the report's conclusions, **we call on EU policymakers to urgently take the following seven actions during the next political cycle**.

1. MASSIVELY INCREASE THE DEPLOYMENT AND INTEGRATION OF ALL RENEWABLE AND LOW-CARBON ENERGY SOURCES, AND THE NECESSARY INFRASTRUCTURES

According to the report's findings, reaching climate neutrality by 2050 requires a deep electrification of our economy. At the same time, the 2050 energy mix will rely on a combination of different energy carriers such as wind and solar, hydrogen, biomethane and biomass products, and nuclear. **European energy policy must therefore focus on ensuring a sufficient supply of all generation sources and infrastructure. In this context, guaranteeing technology neutrality at EU level is key**, where we recognise the need for diverse and complementary means of reaching Net-Zero.

More broadly, EU energy policy needs to move towards a fully comprehensive and coherent policy framework. This should cover all the key elements which are needed to make the energy system more cost-effective, modern and robust, including: the supply of renewable and low-carbon energy, energy storage, efficiency measures and demand-side management, energy infrastructure, carbon capture and storage, flexible capacity, and interconnections.

Supporting the development of renewables and low-carbon resources along with the necessary infrastructure will not only enhance the security of Europe's energy system but should also help reduce the overall cost of the energy and climate transition. **The report finds that when renewables are developed in the least-costly locations and the roadblocks to their development are lifted, including on interconnections, this could lower wholesale power prices by almost 40%.**

A well-integrated energy market will play a key role in incentivising investments in the energy system, ensuring a stronger convergence of energy prices within the EU and guaranteeing long-term security of supply and lower prices for consumers.

Further action is needed to implement the Electricity Market Design agreement and scrutinise any existing barriers to signing long-term agreements, such as corporate Power Purchase Agreements and Contracts for Difference.

These contracts contribute to the establishment of long-term price signals and ensure visibility and stability for both electricity consumers and producers. They are also important in encouraging new investments in renewable and low-carbon power generation of all types, as well as investments in demand flexibility tools.

Likewise, the Commission should carefully monitor the implementation of the 2023 Hydrogen and Decarbonised Gas Market Package, to ensure the timely and efficient development of markets for renewable gases and hydrogen. It is key to drive investment in production and transport of those energy carriers. In this context, it is crucial to complete the internal European gas market to strengthen the EU's security of supply[1].

[1]For this, existing regulatory, operational, and commercial barriers need to be removed. In places where the entry-exit zones are relatively small and the transits cross several borders, gas flows are being charged exit and entry fees each time, leading to a pancaking effect for users. See BusinessEurope reply to the 'gas networks' consultation.

2. CLOSE THE INVESTMENT GAP

Europe's ability to mobilise more private investments in necessary production capacity and essential infrastructure will be central to reaching the Net-Zero target. Measures that improve framework conditions for investments in general are fundamental and need to be the primary focus.

Next to private financing, targeted public funding will be crucial to de-risk and trigger some of the investments needed to massively increase the deployment of energy capacities and infrastructures. Projects receiving public funding should strive towards market-based dynamics as soon as possible.

The development of an efficient energy system should be supported by increased EU funding. This can be done either through increasing the funding for existing facilities (CEF-E, Innovation Fund, etc.) or setting up new facilities based on competition and excellence. These facilities may consider time-limited support for operational (OPEX) and capital (CAPEX) expenditures to incentivise private investments in climate-friendly production methods, where market conditions fail to do so, as illustrated in the steel and ammonia case studies. In addition, the Hydrogen Bank could serve as a useful model, utilising an auction design mechanism as the guiding principle for the swift and cost-effective deployment of EU funds.

Other EU instruments such as Important Projects of Common European Interest (IPCEIs) should be further developed to stimulate additional research, support first industrial development, and 'Europeanise' investments in decarbonised energy technologies and infrastructures.

However, IPCEIs are often considered too burdensome and lengthy. To accelerate the transition and deployment of strategic ecosystems through IPCEIs, a 4-month ceiling for the review period should be enforced. A simplified procedure should also be put in place for SMEs' involvement in IPCEIs.

When State aid measures are implemented to supplement EU funding, they should be targeted, time-limited and carefully monitored to mitigate distortions of competition and preserve a level playing field in the single market.

3. SECURE THE HYDROGEN VALUE CHAIN

The report's projections show hydrogen plays a key role in the path to net-zero emissions, especially to decarbonise certain European industrial sectors. The share of hydrogen in final energy consumption could grow up to 15 to 25% by 2050 depending on the scenario, with demand being met through both domestic production and imports.

The study results indicate that by 2030, green hydrogen produced via electrolysis is projected to remain significantly more expensive than both grey and blue hydrogen. Thus, the EU must adopt

a dual approach going forward: **investment certainty and industrial demand for green hydrogen must be safeguarded, as it remains the vital hydrogen source for achieving a decarbonised economy by 2050**.

In the short to medium term, public support will be necessary to ensure that investments around green hydrogen can accelerate, and that Europe can start producing decarbonised products that are competitive both internationally and compared to fossil fuel-based production methods.

In the long term, scale and learning effects, higher CO2 pricing and the build-up of EU's renewable energy production are expected to enhance the competitiveness of green hydrogen and achieve a faster deployment.

In parallel to the green hydrogen ramp up, low-carbon hydrogen will have to play an important role in facilitating a switch to lower emission techniques and therefore supporting the development of the European hydrogen market in the coming years.

Incorporating low-carbon hydrogen into the EU policy framework requires the prompt adoption of the delegated act defining low-carbon fuels (covering H2 and H2 derivatives), as mandated by Article 9 of the revised Gas Directive. It will be vital for the forthcoming delegated act to establish criteria that facilitate the import and production of low-carbon hydrogen.

Furthermore, a targeted evaluation of the industrial RFNBO quota in Art. 22a of RED III is needed to ensure that additional use of low-carbon H2 is not (indirectly) penalised through an inflation of the denominator, which currently encompasses all forms of hydrogen, including low-carbon hydrogen.

4. CONTINUE SPEEDING-UP AND STREAMLINING PERMITTING PROCEDURES

Long permitting procedures undermine the business case for investing in innovative technology across Europe. The root cause of these long procedures is a complex and fragmented approach to permitting policy at the EU level[2].

Building on the initial improvements brought about by the Net-Zero Industry Act, a more systemic approach to streamline permitting procedures needs to be undertaken to ensure (i) stronger policy coherence between different EU policies and already existing legislations in Member States that together affect the prerequisites for Member State's permitting processes and (ii) faster procedures.

The current patchwork of permitting rules has neither been successful in addressing challenges with long and inefficient permitting procedures nor in managing the trade-offs between environmental and climate impacts. Instead, the lack of policy coherence, as well as the gap between the ambition of fast-tracking permitting for decarbonisation projects and the reality of implementing certain environmental rules, remains.

[2]See BusinessEurope' survey "Licence to transform: SWOT analysis of industrial permitting in Europe"

An integrated, cross-sectoral approach to permitting, covering environment, climate and energy policies is urgently needed. One step in this direction would be to revise the Strategic Environmental Assessment Directive to ensure Member States' large-scale planning strikes the right balance between environmental, climate and economic goals. It is also essential to introduce a time-limit on Environmental Impact Assessments under the Environmental Impact Assessment Directive, without lowering the environmental standards.

5. TACKLE THE CARBON-COST DIFFERENTIAL AND ENSURE EFFECTIVE IMPLEMENTATION OF CBAM

The case studies focusing on the steel and ammonia sectors indicate that energy intensive industries in Europe will not be cost-competitive in 2030 compared to production in the US or China.

CBAM, if adjusted appropriately and implemented effectively without circumvention, could help to absorb part of the competitiveness gap associated with carbon costs. However, it is not designed to address the gap associated with energy prices.

An in-depth monitoring of the CBAM implementation is crucial to ensure that it will prevent carbon leakage. In addition, there is an urgent need to accelerate the work on CBAM's critical parameters, in particular:

- the definition of a WTO-compatible exports support scheme, which is crucial to maintain the competitiveness of European products in third markets. One such measure could be maintaining full free allocation for that part of the production which is destined for export;
- the prevention of the risk of circumvention and resource shuffling;
- preserving the framework for indirect cost compensation under the EU ETS including for CBAM sectors beyond 2030, considering that a CBAM on indirect emissions would not reflect the indirect carbon costs passed on to European consumers through electricity prices;
- the impacts of CBAM on downstream production in the EU, in light of input materials becoming more expensive;
- ensuring an efficient and well-functioning reporting system[3].

By December 2024, the Commission is mandated to assess carbon leakage risks linked to exports as part of its annual ETS report. It is crucial that it dedicates sufficient resources, time and expertise, along with consulting with relevant stakeholders at this stage to assess these risks, rather than waiting until 2028 when the assessment is due to be undertaken under CBAM.

Should CBAM prove to be ineffective in preventing carbon leakage, it will be important to reconsider the phase-out of free allowances early enough to ensure effective carbon leakage protection, and until other appropriate instruments are found that can reliably provide such assurance.

[3]See BusinessEurope' paper "CBAM Implementation - BusinessEurope Survey"

At the same time, efforts to progress the long-term goal of establishing a global and consistent framework for carbon pricing and carbon mitigation approaches should be accelerated, as this remains the ideal solution to the problem of carbon leakage. The EU has a key role to play on the global stage to promote further cooperation and convergence of ambitions.

Lastly, there should be a more significant redistribution of EU ETS revenues towards industry to support its decarbonisation efforts, thus enabling the EU's future green industrial policies.

6. INTRODUCE MEASURES TO CLOSE THE ENERGY COMPETITIVENESS GAP

Addressing the carbon cost differential alone will not be sufficient to prevent the risk of relocation and investment leakage if the gap in total energy system costs remains excessively high, as the report's projections show. **Hence, it will be crucial to introduce additional measures to mitigate energy costs for industries at risk of carbon and investment leakage**.

The following measures should be considered at EU level to close the energy competitiveness gap between EU-based industrial consumers and major competitors from outside the EU, while also supporting the transition to a net-zero economy:

- broaden the scope of industries considered at risk of investment and carbon leakage as well as factors considered to contribute to such leakage, to encompass factors such as CO2 pricing, energy and infrastructure costs, along with international competition;
- urging Member States to fully implement the schemes for indirect cost compensation under the EU ETS while transitioning towards renewable and low-carbon energy sources;
- develop recommendations on reducing the exposure of industrial consumers to rising costs for energy infrastructures, for instance through exemptions from network charges in the respect of fair cost allocation and avoiding distortions of competition in the internal market. This will become increasingly important in the years to come, as investments in energy infrastructure are expected to increase;
- support an efficient implementation of the Electricity Market Design agreement to enhance companies' ability to sign long-term contracts, which can provide them with significant hedging opportunities, reducing the impact of gas price fluctuations on consumer prices and contributing to the overall stability of the system.

Additional measures can also be taken at the Member State level such as tax credits or economic support for large-scale industrial investments, that support the transition to a net-zero economy. They should, however, be introduced with due care so as not to distort the pan-European level-playing field.

7. FOSTER INDUSTRIAL DECARBONISATION THROUGH EFFECTIVE DEMAND-SIDE MEASURES

Europe must ground its business case for its comparative advantage in terms of emissions and compliance with sustainability criteria. At the moment, however, without additional measures to stimulate demand for decarbonised goods, the competitiveness gap with third countries could make it more attractive to locate production elsewhere, threatening the business case for a European production of green products. The production and demand for decarbonised goods in the EU thus need to increase at the same pace.

One of the key levers in that respect is public procurement, which represents around 15% of EU GDP. **Implementing sustainability criteria for public procurement in all Member States would stimulate demand for clean tech and decarbonised products in Europe**.

Many consumers are still hesitant or unable to pay 'green premiums' for decarbonised products. Therefore, additional efforts to create markets for these products are needed, and should specifically include:

- introducing sustainability criteria in EU public procurement legislations, alongside existing sectoral EU legislation, like the Net-Zero Industry Act;
- advancing product-specific sustainability requirements such as those to be developed under the Ecodesign for Sustainable Products Regulation;
- implementing environmental scoring systems to incentive the purchase products (e.g. cars), which consider the environmental impact throughout the product's life cycle.

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