The «green» race. How can Ukraine prevent losing access to the EU market?

SUMMARY

The EU's Green New Deal forces Ukraine's industries to decisively cut carbon emissions, or lose competitiveness in EU markets. For this, Ukrainian companies need coherent, substantial government support – as EU member states support their national industries.

Ukraine must make much more ambitious commitments to cut carbon emissions to help tackle climate change.

This is also an economic imperative: The EU will within its New Green Deal to achieve climate neutrality by 2050 put up import restrictions for products violating EU emission standards.

Ukrainian key industries like metallurgy and agriculture's access to EU markets can be severely limited.

While the EU and its member states' governments combine tough standards and substantive carbon taxes with generous state support for industries' ecological transformation – Ukraine has done nothing.

The only existing piece of legislation to stimulate industry transformation, the green metallurgy norm, has been stuck in bureaucracy for over six monts since its adoption.

Initiatives and conversations with the EU are underways. But what is lacking is: clear and ambitious action to make carbon emissions costly, and simultaneously green transformation attractive, and access to its financing easy, for Ukrainian companies.

If Ukraine fails to act now, this shuts the door to an economic future of integration with EU markets in a green European economy.

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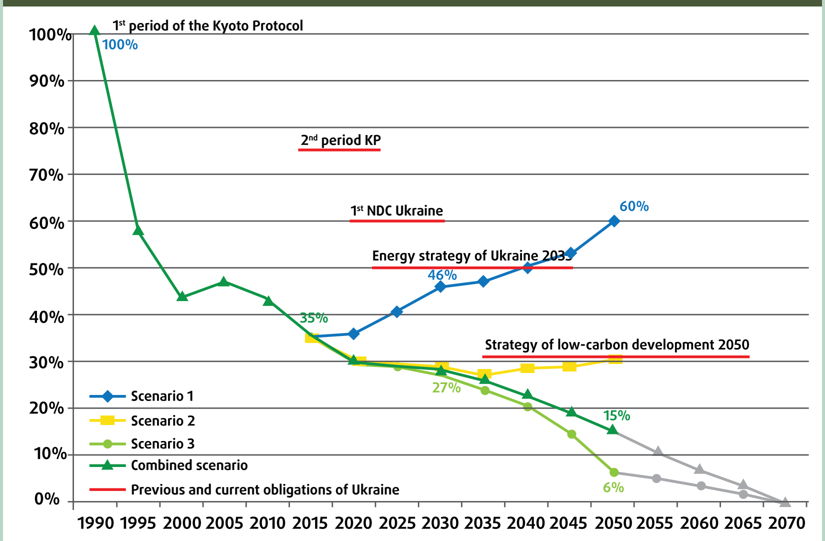
THE «GREEN» RACE. HOW CAN UKRAINE PREVENT LOSING ACCESS TO THE EU MARKET?

In 2015, Ukraine approved its first Nationally Determined Contribution (NDC) commitment to reduce greenhouse gas emissions: a reduction to 60% compared to 1990 by 2030.

For Ukraine, 1990 is an ideal comparison year for beautiful statements – and no practical efforts. With industry's steep decline when the USSR collapsed, carbon emissions fell proportionally. When Ukraine committed to 60% compared to 1990 in 2015, its emissions were 35% of 1990. To achieve 60%, Ukraine can not just do nothing. It can even almost double emissions.

GHG emission targets and scenarios in Ukraine



Think tank Climate Action Tracker calls Ukraine's contributions to reaching the Paris Agreement goals critically insufficient: They «require virtually no effort to achieve them».

«GREEN» INTENTIONS OF UKRAINE

This year, Ukraine will decide its second Nationally Determined Contribution (NDC2). In the coming months, the government must define its commited volume of CO2 emissions cuts.

In December 2020, President Volodymyr Zelensky said Ukraine could cut its emissions to 36-42% of 1992 levels. Minister of Ecology and Natural Resources of Ukraine Roman Abramovsky said the aim was a consensus solution for an even more ambitious goal.

A working group was set up in January to find a «green course» for Ukraine balancing economic growth, emission cuts, and implementation of commitments. And a month earlier, Ukraine had sent a position paper to the EU on its participation in the implementation of the Green Deal.

The NDC2 working group presented several decarbonization scenarios in 2020. The baseline scenario is amending current legislation, but no structural changes in the energy sector and the economy - to reduce emissions by 54% by 2030. It requires 168 billion euros of investment.

European Green Deal in Ukraine

The ecologically most ambitious scenario is to achieve a climate-neutral economy by cutting emissions by 73% by 2030. It would require 256 billion euros of investment.

At the same time, total capital investments in Ukraine from 2004 to 2019 were 318 billion euros. Only a fraction of this went to energy efficiency and infrastructure projects reducing emissions.

WHERE UKRAINE CAN GET MONEY FROM?

So obviously, before setting ambitious NDC2 goals, Ukraine must decide on mechanisms for financing them. As of now, no sectoral policy provides sources of funding for industry decarbonization.

Ideas are being floated. However, one thing is clear: Ukraine has no direct budget funding for ecological modernization.

> «Unfortunately, now there really are not many financial instruments that would stimulate modernization at Ukrainian enterprises. We advocate that environmental funds be used for their intended purpose. We have a concept that we need to establish a separate foundation as a separate legal entity, and not just an article in the budget, so that it can adopt various programs for such stimulation needs and raise some international funds», said Iryna Stavchuk, Deputy Minister of Ecology and Natural Resources of Ukraine.

She suggests cooperation with banks:

> «Funds will be distributed according to certain criteria for modernization programs through a credit granting system, coverage of the principal amount of the loan or the interest. This is the most efficient and the fastest mechanism», said the Deputy Minister.

Ukraine provides no financial incentives to modernize industry plants to reduce emissions.

For now, the only initiative for a financial incentive is the «green electrometallurgy» regulation. It exempts low-emission iron and steel plants from additional payments which the government introduced to finance subsidies for renewable energy producers. Similar approaches are used in the EU, e.g. with Germany exempting industrial enterprises which implement decarbonization, from environmental taxes raised to subsidize «green» electricity producers.

But while for example Berlin turns these norms into action, Kyiv's bureaucracy six months after the «green electrometallurgy» norm's adoption has not yet moved to implement it. Ukrainian steel plants that already comply with the requirements of the European Green Deal, have to subsidize the renewable energy sector just as the «dirty» businesses of the industry.

DECARBONIZATION OF THE EU INDUSTRY: THE CARROT AND THE STICK APPROACH

To achieve CO2 emissions, the EU on the one hand sets strict rules and incentives for the industry, and on the other hand allocates considerable funds for modernization.

EU countries have much higher carbon taxes than Ukraine. On average, 30 euros per ton, in some countries much more. Sweden leads with relevant tax reaches 140 euros per ton. Such high taxes make it financially attractive to invest into the modernization of an enterprise. Moreover, a flexible lending system and state support for green transition allow financing on favorable terms.

Taxes on CO2 emissions are used in a targeted way to finance combating climate change, for example in Finland, Denmark, Great Britain, and Sweden.

Ukraine also has a carbon emission tax. But the money is not used for its intended purpose - it falls instead into the general state budget. And the tax is tens if times lower than in EU countries: Until 2019, the rate in Ukraine was UAH 0.41 per ton. From January 1, 2019, it grew to UAH 10 per ton. Revenues per year are now UAH 0.9 billion.

«There is a draft law to increase it by UAH 10 every year and bring it to UAH 30 by 2024, but it has not yet been submitted to the Verkhovna Rada for its consideration. At present, the CO2 emission tax is rather a fiscal fundraising tool than one that creates preconditions for modernizing enterprises to curtail their payments. In the EU countries, environmental taxes are formed in such a way that it is more profitable for a company to modernize than to pay a tax», Iryna Stavchuk said.

In the EU, enterprises get grants to partially compensate their expenses for energy-efficient equipment or optimization of technological processes.

In addition, countries allocate funds from the state budget for the environmental transformation of their industries. For instance, the German Government has allocated 2 billion euros to implement the European Green Deal initiative. According to Minister of the Environment, Nature Conservation and Nuclear Safety Svenja Schulze, the money will be allocated through the State Energy and Climate Fund. It will be used for a decisive reduction of greenhouse gas emissions by metallurgical, cement, lime, and chemical industry companies, which are the largest consumers of electricity in the country. For example, as part of this initiative, Germany's second-largest steelmaker, Salzgitter AG, has received a 5 million euro grant from the federal government to upgrade its blast furnace workshop to use hydrogen for iron smelting instead of coke.

From 2013 to 2020, EU countries implemented the Steel Action Plan – a large-scale program to modernize the iron and steel industry. Steelmakers had access to low interest credits, as well as to the Government support. They revamped obsolete plants and increased their efficiency considerably. In some cases, the high CO2 emission tax made shutting down production facilities the only cost-effective solution.

EU steelmakers must already take environmental requirements into consideration in their strategies. For instance, because of the European Green Deal, the Swedish SSAB refused to buy the metallurgical plant IJmuiden in the Netherlands – high cost of the «green transition» of the blast furnace production was the stumbling block.

BETWEEN ELECTRICITY AND HYDROGEN

Interpipe Steel mill

Metallurgy, one of the industries with highest carbon emissions, has two options to modernize to comply with EU standards: to use hydrogen for steelmaking, or electricity.

In the last few years, hydrogen has become an environmental trend in Europe. A number of companies have already announced their intention to switch from using fossil energy sources (coal, oil, and natural gas) to hydrogen to achieve climate neutrality.

The use of hydrogen instead of fossil minerals is a long-term perspective. A current technology in line with the norms of Green Deal is electric steelmaking. It uses scrap metal as a raw material.

> «The value of scrap metal as a more environmentally friendly raw material for steel production will grow both in Ukraine and abroad in connection with the European Union's desire to achieve carbon neutrality by 2050», said Ukrainian MP Dmytro Kysylevskiy.

Electric steel plants emit much less CO2 than blast furnaces and open-hearth furnaces. The most powerful Ukrainian such plant – Interpipe Steel, a one-billion-US-dollar investment, decreased CO2 emissions by 10 times and gas consumption by 8 times. Already now, the CO2 level is lower than the rate that EU intends to reach by 2050. The city of Dnipro could shut down the «dirty» open-hearth furnace facility.

However, electrometallurgy in Ukraine is still under-developed, with a share of only 5.5% of steel production in 2020.

UKRAINE IS ON A TIGHTROPE OF BECOMING UNCOMPETITIVE AT THE EUROPEAN MARKETS

The EU is carbon-neutral by 2050 – that is the ambitious goal of the European Commission's Green New Deal. The program contains several economic instruments to stimulate decarbonization in EU countries and those who have economic cooperation with the EU.

Now, to protect their manufacturers and stimulate emission cuts for producers exporting to the EU, the EU considers a carbon border adjustment mechanism (CBAM) for imported products.

The EU announced more details on this mechanism at the end of the first half of 2021. But whatever the details – for sure the

The purpose of this is clear: to prevent so-called "carbon leakage", when climate-damaging production capacities are transferred from the EU to countries that cut emissions less strictly. The mechanism will protect EU industries' competitiveness and encourage such countries to decarbonize their economies.

CBAM will affect the main sectors of Ukrainian exports and sources of foreign exchange earnings – iron and steel industry and agriculture.

Ukraine's government directly states that such an EU policy is a potential barrier to Ukraine's exports. The government intends to hold a dialogue to gain time and better conditions.

"The Association Agreement has been designed from the outset in such a way that it enables the provision of a level playing field for open trade and protection from climate change. Accordingly, there is neither the need nor the expediency to introduce any additional instruments, such as CBAM, in the trade between Ukraine and the EU. We have to hold a dialogue on that with the European Commission in the coming months before the draft of such a mechanism is presented," said Ihor Petrashko, Minister for Development of Economy, Trade, and Agriculture of Ukraine.

However, the mood in the EU among the supporters of the «green» course is very decisive. For example, on February 5, the European Parliament's Environment Committee passed a tough resolution, according to which almost 94% of Europe's imports making emissions with the territory of Europe, will be subject to a carbon tax.

In this case, along with imports from such carbon-intensive industries as power generation, metallurgy, cement, and chemical businesses, CBAM will also cover oil refining, wood pulp and paper industry, and aluminum companies.

«There is a great risk that «dirty» industrial manufacturing from European countries may be transferred to such countries as Ukraine, Georgia, Albania, and others. That is why the EU is already considering the introduction of a mechanism, the essence of which provides for various economic and customs barriers for our industry, if we do not meet the criteria of energy efficiency and carbon emission norms», said the former interim Chairman of the State Environmental Inspectorate Yegor Firsov.

As a result, Ukrainian industry will have to change to comply with European norms and directives, or look for other markets.

It is noteworthy that the Vice-President of the European Commission Frans Timmermans called the introduction of CBAM «a matter of life and death» for European industry. The European Parliament is expected to consider the resolution on March 8-11. In case of a positive vote, it will call on the European Commission to adopt a tough variant of the carbon tax.

«Formation of the European mechanism is currently underway. We are in active negotiations with the EU in order to understand their plans and visions, to prepare as much as possible, and to protect our exporters. The main goal of the Ukrainian Government is to discuss such conditions with the European side, which has the lowest impact on business, perhaps only in some exceptional situations. There are several scenarios. If we still have to pay the CBAM tax, we want these funds to remain in the country and be channeled for the modernization of national enterprises. We also discussed a scenario, when Ukraine will introduce a comparable rate of this tax», Iryna Stavchuk said.

In 2019, exports of ferrous metals to the EU, according to DiXi Group, amounted to 3.145 billion dollars, or 15.2% of total Ukrainian exports to the EU. Therefore, the loss of competitiveness at this key commodity market can fundamentally affect Ukraines's economy.

A significant part of enterprises in our country use coal as a source of energy. Such enterprises will not be able to compete with EU competitors if an environmental export tax is introduced.

One measure of state support for industry may can be to channel income from the CO2 emission tax not to the general budget fund, but to improving energy efficiency of enterprises.

Last year the Ministry of Energy, together with the State Agency on Energy Efficiency and Energy Saving and the Ukrainian-Danish Energy Center, developed a law draft, which provides for amendments to the Budget Code of Ukraine to implement such a mechanism.

While maintaining the rate of CO2 emission tax, this will raise approximately UAH 1 billion for energy modernization of enterprises. The amount is not that large, if compared with the funds that EU countries use to prepare for the «green» transition, but it is better than nothing.

Another step could be to introduce incentives for companies to raise funds for eco-modernization on their own. For example, that could be fiscal incentives, or lower energy resources' costs for businesses that cut down their CO2 emissions.

Without decisive government measures Ukrainian industry will sooner or later loose competitiveness in the EU and be left with the Ukrainian market – which is shrinking every year.

European Green
Deal in Ukraine