I have been requested by the CCC to conduct a short peer review into their work program on competitiveness. In particular, I have been asked to focus on the approach taken to determining pass-through rates as these are a particularly difficult area of the assessment.

I come at this review from the perspective of business, rather than an academic viewpoint, given my longstanding experience of industry and as an adviser focusing on the steel sector:

- Senior Adviser, European Bank of Reconstruction and Development, with a special focus on the steel sector
- Formerly, Adviser, British Steel Corporation (1976-81)
- 15 years in UK merchant banking (including corporate finance).

The views below are submitted in a personal capacity.

Regarding pass-through rates, I understand that the CCC are taking an approach that looks at qualitative information on key sectors and empirical estimates of historical discount rates. Given the uncertainty around future pass-through rates, the CCC are modeling a scenario where costs are fully absorbed (i.e. pass-through rates equal zero) and a scenario that is aligned with historical estimates. As a starting-point this seems like an adequate approach that covers a range of possibilities.

However, my conclusion from this is that this analysis is only a first stage in establishing a basis for analysing competitiveness and designing compensation. If the analysis remained at this fairly crude level, then policies will be too crude, and are likely to lead to under- or over-compensation. Further, more detailed analysis is required in order to design specific policies and provide support to affected industries.

The pass-through argument is, of course, related to the value in use, and the EU industrial base. For example in the iron and steel sector, many grades of iron and steel are low-value, have low pass-through, and, like cement, their sourcing is hardly critical to EU prosperity. The argument for compensation here is really about fairness: why should companies in South Wales close, when the competitive advantage of non-EU competition is based on absence from EU ETS? But in higher value sectors, where pass through should be higher, the threat to the EU industrial structure is much more serious. This is well understood in

Germany. This requires an analysis based on tipping-points. It is hard to estimate pass-through, but there must come a point of danger when certain activities become uneconomic in the EU.

As the steel sector is my area of expertise, I also add some specific points about this sector.

The first well-known elementary point is that the iron and steel sector consists of two different processes, Basic Oxygen (BOS) and Electric Arc (EAF). Electricity costs are more important in EAF, although they can be significant in BOS, but less than iron ore and coking coal costs; BOS. of course, is much more directly affected by CO2 pricing. The processes compete: thus Tata Steel Europe Scunthorpe (BOS) largely competes against EAF producers. Within the EAF sector there are two broad businesses – (a) low value (eg rebar, merchant bar, commodity wire rod), and (b) high value (eg engineering steels for automotive-structural, aerospace). Competition in low value steels will be intense, and pass through levels low; competition in high value steels will be less intense, especially in EU markets, because these are in ICF's words "not perfectly competitive", that is they are the sort of high value-added product, serving high-value sectors, in which OECD countries hope to compete internationally. Within the BOS sector there is also a range of products, some commodity, some higher value (eg for automotive-body). I would therefore strongly endorse the ICF statement in section 5.3 about sector "inputs into downstream competitiveness", and the desirability of "conducting in depth sector analyses to understand the risk faced by each industry", as long as this includes "each industry and its principal EU customers". This also relates to the ICF suggestion (Section 5.4) that the Australian system of "a separate compensation fund" may be necessary.

The UK steel sector is intensely competitive, with 30% imports but with the threat of imports well beyond this. You can see the effect of this in Tata Steel Europe's very marginal results – little profit at the EBITDA level, let alone EBIT level. Tata Steel Europe is able to maintain its relatively high market share because at any given price of steel TSE has a transport and logistics advantage. But this is strictly limited. When there is too much competitive steel around it can bankrupt UK operators as happened with Allied Steel and Wire in Cardiff in 2001/02.

Today, most of the EU iron and steel industry is suffering severe stress, due to the recession. What is hard is distinguishing between cyclical factors and structural

factors. It is generally agreed that, at about 200mt, there is 25% overcapacity. However, the Chairman of Eurofer (and of VoestAlpine), Wolfgang Eder, has stated that the EU steel industry should reduce capacity by 2030 to between 50-70mt, and make way for competition in commodity steels from Russia, Ukraine and Turkey; this is strongly disputed by most other members of Eurofer. The most successful parts of the industry target higher value markets (eg VoestAlpine, ThyssenKrupp Europe, parts of ArcelorMittal and TSE). Much of it is kept going by political constraints, or by the very long-term view taken by some eg Tata Steel, certain family companies. Negative publicity about the EU ETS will make investor sentiment worse. But since steel assets are long-lived, evidence of actual carbon leakage is always hard to find.

In the qualitative description of this sector the statement is made that “the outlook for UK steel production in the short term looks relatively positive”. For those who believe that the UK gave up its steel industry years ago, this would be true. And TSE is certainly investing eg at Port Talbot. But this should be related to the latest EBITDA for TSE, which suggests a grim picture on profitability, and to the latest Eurofer projections for the EU steel industry (Feb 2013), which describe the EU market outlook for 2013 as “bleak”.

IN CONCLUSION, the steel sector is important and sensitive enough to require further sector-specific analysis, which would take an impartial view both of the dynamics and vulnerabilities of the sector itself, and of its place within the UK/EU value-chain.

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