Energy Intensive Industries' recommendations to the EU Emission Trading Scheme reform

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Context

Ahead of the publication of the EC Proposal for the EU Emission Trading Scheme reform, expected on 14 July, we would like to present few considerations.

We support the objectives of the European Green Deal and the EU's ambition to accelerate significantly the transition towards the 2050 climate neutrality objective to ensure timely action by 2030, provide a balanced reduction pathway and redistribute in time efforts across the EU society. In this context, it is important to refine the current analysis on technology readiness and to understand the length of investment cycles in each sector of the economy, through a dedicated bottom up assessment.

The impact assessment accompanying the Commission communication on the "2030 Climate Target Plan" suggests a highly demanding reduction target for ETS emissions of -65% for 2030, while the current ETS level foresees a -21% reduction for 2020 and a -43% for 2030. Such a projection means a three-fold increase in reduction efforts required for EU industries under the future ETS Directive compared to the current level, to be achieved over a shorter timeframe of about 8 years. The same impact assessment confirms the high exposure of energy-intensive industries to the carbon leakage risk due to unilateral climate ambition (in Part 1, pages 79 and 86, tables 16 and 23, and Part 2, pages 111 and 113, tables 47 and 49).

To achieve the emission reduction goals and to protect the competitiveness of energy intensive industries, we have the following recommendations for the nextETS revision:

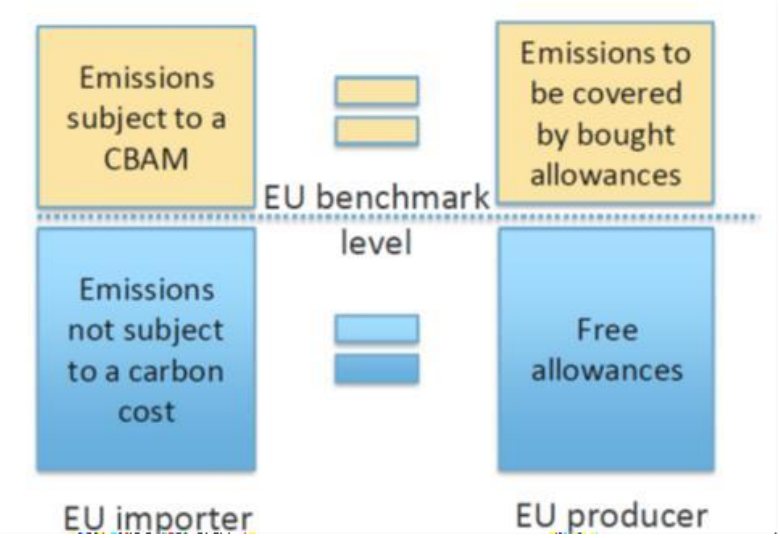
1. **Strengthened carbon leakage protection for EIIs and their value chains**

The replacement of European production by imports from foreign countries with lesser carbon constraints negatively affects both the Union climate action efforts worldwide and the competitiveness of its industrial basis. As long as competitors in third countries are not subject to equivalent carbon costs and constraints, carbon leakage is a major threat for many EU industries. For sectors exposed, it is then essential that the ETS system will be able to mitigate the risks of carbon leakage.

In particular, the following elements should be considered:

- Existing carbon leakage protection measures (free allocation and indirect costs compensation) mitigate carbon costs only partially, since they are set by strict performance benchmarks established on the basis of the average best 10% installations.
- According to the current rules, free allocation is digressive and cut even below the benchmark level by the cross sectoral correction factor when the top-down ETS cap is tightened. Yet, the power sector, whose historical emissions defined the auctioning share, have a much larger abatement potential (70%) compared to EIIs (22%) by 2030, as acknowledged by the Commission Impact Assessment on 2030 targets. Therefore, the cross sectoral correction factor can and should be avoided by increasing the free allocation share or by using allowances from the Market Stability Reserve.

- Furthermore, the current free allocation system is based on benchmarks which decrease in parallel with GHG reductions. The abatement costs of low carbon technologies is not reflected in carbon leakage measures based on GHG.
- Rules on free allocation and indirect costs compensation were defined in the recent revision of the EU ETS Directive and provide more legal certainty and visibility to EU producers compared to an untested and uncertain measure like the Carbon Border Adjustment Mechanism, whose effectiveness relies also on the robustness and reliability of data provided by third countries. Should any other instrument such as a CBAM be introduced, it should include a solution for exports and it should co-exist with the current system of free allocation, to provide certainty for low-carbon investments and avoid market distortions.
- On the contrary, removing existing carbon leakage measures with a CBAM exposes EU producers to the full compliance carbon costs, hence reducing their financial ability to invest in low carbon technologies when such costs cannot be recovered from the market due to international competition.
- In the absence of a rebate for exports, a CBAM limited to EU imports combined with full auctioning jeopardises the competitiveness of EU producers in export markets even more.
- Maintaining the current carbon leakage measures with a complementary CBAM instead of full auctioning mitigates the impact on downstream sectors and final consumers' prices since the carbon leakage measures limit the costs also for downstream sectors.
- Maintaining the current carbon leakage measures with a complementary CBAM (implemented as a border measure, consumption charge or excise duty) reduces the level of the border measure since the CBAM takes into account also the free allocation granted to EU industry (please see image below). Hence, while remaining WTO compliant, it could mitigate the impact on trade flows and facilitate international trade relations compared to a CBAM without existing carbon leakage measures which would apply the full carbon costs to traded products.
- Even with a complementary CBAM, EU installations still have an incentive to improve their performance and achieve (and where possible even over-achieve) the benchmarks, since they would save on their ETS compliance costs and have a better competitive position.



2. Cost-efficient achievement of the ETS target without rebasing and MSR strengthening

The climate ambition of the EU ETS will be defined by the stricter 2030 cap. This needs to be achieved in the most efficient way to reduce costs for compliance operators as well as the whole EU society (through higher indirect costs passed on in the electricity price). Rebasing (i.e. one-off cancellation of allowances) and strengthening of the Market Stability Reserve (i.e. putting more allowances in the reserve) are not needed as they artificially increase the costs for the same level of climate ambition. Instead of invalidating allowances in the MSR, it must be considered to use them for innovation and to avoid a CSCF.

3. Contribution of EU ETS and non-ETS sectors (i.e. burden-sharing)

Achieving more ambitious emission reduction targets by 2030 requires reductions in all sectors of the economy. Since 2005, that EU ETS sectors have kept reducing their emissions at a faster pace than ESR sectors.

The abovementioned Commission impact assessment continues to foresee marked differences in the reduction targets as well for 2030. The projections show -65/-69% in each of the scenarios for ETS-sectors and -39/-41% for non-ETS (in Part 1, table 28, page 129). This threatens the current functioning of the ETS system and the competitiveness of industry. The sole -65% GHG reduction target is expected to decrease the cap level by 2 billion allowances, in turn translating into a decrease of 800 million free allowances.

This imbalance in the distribution of the 2030 target would be to the detriment of a smooth transition towards the 2050 climate neutrality objective. Hence, sectors currently covered by the Effort Sharing Regulation need to step up their contribution to emissions reductions in order to deliver a fair burden share.

4. Avoiding extension of the ETS scope to non-ETS sectors with higher abatement costs and no international competition

The building and transport sectors have different CO_2 abatement costs, elasticities and risks of carbon leakage as well as limited or no exposure to international competition compared to energy-intensive industries. Their inclusion in the ETS system is, therefore, expected to drive carbon prices up substantially. This would exacerbate carbon costs and carbon leakage risks for sectors exposed to international competition.

The Alliance sees the need for fairer burden-sharing and appropriate GHG reduction measures in these sectors. However, the Alliance is not in favour of the inclusion of any of those sectors in the EU ETS. Should the Commission consider making these sectors subject to a European carbon market, this should be done through dedicated and separate cap-and-trade systems, without any links to the existing ETS as long as relative abatements costs do not converge.

5. The allocation of ETS revenues to support industrial decarbonisation

For the revised ETS system to meet its emission reduction targets sustainably, it is of utmost importance to increase the financial support and enabling framework for the development and market uptake of low-carbon technologies in line with the technology neutrality principle. The EU ETS revision could be an opportunity, amongst other policies and measures, to allow the development of new applications based on carbon circularity. As acknowledged by the Commission inception impact assessment on 2030 climate targets, "*the carbon price alone will at the levels estimated for this decade – not sufficiently trigger the demonstration and deployment of clean technologies both in the transport and industry sector at scale […]"* (in Part 1, page. 121). The current debate on filling the EU budget via the ETS auction revenues risks undermining the potential of industrial decarbonisation:

The Commission 2018 Clean Planet Strategy attached particular importance to electrification as one of the key routes for decarbonisation. With increased carbon prices, indirect carbon costs for the industry will increase and thus, it is essential that adequate state aid for indirect carbon costs is provided. If these revenues instead go to the EU budget, then, fewer resources would be available to provide compensation.

6. Addressing the impact of the COVID pandemic on free allocation

While a comprehensive assessment of this unprecedented and unforeseeable crisis will be possible only in the near future, the coronavirus outbreak could likely have a disruptive effect on production volumes.

According to the existing rules, after affecting the emissions/free allocation balance in 2020, this situation would impact post-2020 free allocation both in the first sub-trading period (as a result of the 2-year rolling average's adjustments in 2021 and 2022) and in the second sub-trading period (as a result of the reference historical activity level based on the average of the period 2019-2023).

As soon as comprehensive data on the full impact of the outbreak become available, we urge the Commission to take the necessary initiatives to ensure that production and emissions reductions related to the COVID-19 outbreak will not unduly reduce the amount of post-2020 free allocation.