

Strategic choices for EU ETS post-2020:

Free allocation principles, carbon leakage measures and competitiveness

QUESTIONNAIRE FOR ENERGY INTENSIVE INDUSTRIES

Answered by the 11 sectors present in the meeting with Commissioner Arias Cañete on

February 19th 2015

**CEFIC, CEMBUREAU, CEPI, CERAME-UNIE, EAA, EULA, EUROALLIAGES, EUROFER,
EUROMETAUX, FEVE, FUELSEUROPE.**

**With the aim to come to a well-functioning, fair and effective EU Emissions Trading
System**

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The European Commission is currently gathering the stakeholders' views on the key features of the revised EU ETS for the period post-2020¹, as an integral element of the EU's Energy Union with a forward-looking climate policy. In addition, and as a continuation of the discussions on 19 February 2015 with Commissioner Miguel Arias Cañete, this questionnaire aims to seek **a joint input of the energy-intensive industry associations** on the specific design features of the revised EU ETS carbon leakage system.

Please note that in case you will not be able to find a common position on a specific question, the "No common position" reply would also be an option.

¹ Consultation on revision of the EU Emission Trading System (EU ETS) Directive:
http://ec.europa.eu/clima/consultations/articles/0024_en.htm

Questions

- 1) In light of the gradually decreasing amount of free allocation, what are the key challenges to be addressed regarding the allocation methodology between phase 3 and phase 4, subject to the limit on the overall amount of free allocation for industry as determined by the European Council?

The limit on the total issuance of allowances in ETS sectors defined by Heads of State and governments covers both free allocation and auctioning. They did not impose a decrease of free allocation as such.

Energy Intensive Industries have developed sector roadmaps towards 2050 and all of our sectors are committed to further reducing their emissions and have done so in the past. However, the envisaged 2.2% Linear Reduction Factor after 2020 is challenging. Applying this Linear Reduction Factor to the Energy Intensive Industries would go beyond their technical and economic potential as breakthroughs needed in the manufacturing sectors will not be broadly available by 2030. Potential efficiency improvements have already been largely exhausted in Energy Intensive sectors whilst other segments of the economy still have large potential for cost-efficient GHG reductions.

Therefore, in order to avoid the incentive for re-location of production and EU deindustrialisation, the effectiveness of carbon leakage measures will be of paramount importance. This means that carbon leakage provisions should be improved in order to encourage carbon-efficient production and growth in Europe, and allocation must be guaranteed at the level of realistic benchmarks. Only predictable and effective carbon leakage measures will enable companies to invest in innovative solutions in Europe. Accordingly there should be no direct and indirect cost at the very least at the level of most efficient European installations in sectors at risk of carbon leakage.

The effect of the cross sectoral factor is that even the best performers cannot achieve these levels due to economic, technical or thermo-dynamical limits. Ignoring this turns the EU ETS into a penalty system rather than an incentivising system.

For that reason, all our sectors call for a deletion of the cross sectoral correction factor, in accordance with the European Council conclusions of 23-24 October 2014.

Benchmarking

2) **The benchmark values** are to be regularly updated, in order to reflect technological progress. How often should the update take place?

- Every year
- Every 2-3 years
- Every 4-5 years
- Once per trading period

Please motivate your answer.

The benchmarks should be updated maximum once, ahead of each trading period to provide planning certainty for participants, decrease the administrative burdens and provide an appropriate reward for those that have invested in emissions efficiency.

3) What would be the most appropriate method for update of the benchmark values, keeping in mind the levels of administrative effort for companies and authorities?

- Data collection from the companies
- Application of a flat-rate factor on all current benchmark values reflecting average technological progress across sectors
- Combined approach, e.g. in principle flat rate updates with less frequent updates based on full data collection

Please motivate your answer.

Benchmarks need to be technically and economically achievable throughout Europe. This means benchmarks have to be representative for the sectors and based on representative technologies that have been adopted by the European market.

The update of the benchmarks values should be based on data collection from the EU companies. The process of establishing benchmarks must be as transparent as possible. Sectors with a fall-back approach should also be properly treated. If in a sector no relevant changes in technology have taken place, such sector can request a simplified approach for data collection.

Over-ambitious benchmarks artificially increase costs to industry overall and de facto undermine the effectiveness of the carbon leakage provisions. The current rules are already very stringent, as benchmarks are set according to the average of the top 10% most efficient installations in the sector; hence, even without the cross sectoral correction factor, around 95% of the installations have to purchase allowances.

Update of production data

- 4) What adaptations to the allocation methodology regarding **production data** should be considered for phase 4? What is your view on the possibilities of achieving closer alignment between allocations and changing production levels, while minimizing the administrative burden for industry and public authorities, and preserving predictability and incentive to innovate for industry?

Please motivate your answer.

Currently, the free allocation of allowances to installations eligible for free allocation is based on distant historic activity levels (2005-2008 or 2009-2010) for direct allocation, while indirect compensation is based on the average of 2005-2011 where a given year may be excluded.

Moving to an allocation methodology closely aligned with real/recent production levels would provide the required allowances at the level of the benchmark to companies expanding or restarting production to avoid undue costs, help prevent over- or under-allocation, stop rewarding ETS participants for moving production overseas and ensure simplified and fairer rules as regards new entrants, capacity increases or decreases, plant rationalisation and partial cessation. For example, the reference period could be the rolling year n-2.

The required production data are already available as verifiers have to ascertain the activity data needed for the allocation. The bureaucratic burden will be therefore minimal. Confidentiality issues can be solved e.g. through publication of aggregated data.

For installations covered by fall-back approaches as opposed to benchmarks, emission reductions resulting from efficiency measures should not result in a penalty.

Carbon leakage

- 5) What changes would you propose to the carbon leakage risk assessment criteria and thresholds for phase 4? How to achieve a more targeted system?

The carbon leakage risk assessment criteria were clearly defined in 2008 with the spirit of preserving the competitiveness of the EU manufacturing basis and of all energy-intensive industries in particular, this in the absence of an international agreement with equivalent efforts from competing industries in third countries.

Under Phase IV:

- It can currently not be expected that there will be a large breakthrough in negotiations at international level that would lead to climate policies, imposing equivalent carbon costs for industries located in competing regions;
- Meanwhile, the GHG reduction target will be increased to 43% for EU ETS sectors compared to 2005 levels and therefore the cap will be tightened;
- The Market Stability Reserve will result in rapid carbon price increases.

Therefore, the carbon leakage risk will not decrease and may well increase if the MSR results in a rapid price shift, as such all Energy Intensive Industries should receive full protection at the level of the benchmark. Consequently, the carbon leakage risk assessment criteria and assumptions as defined in 2008 remain fully valid and must remain unchanged. Finally, Energy Intensive Industries are characterised by long investment cycles. The carbon leakage list must only be updated at the beginning of each trading period.

- 6) Should the EU ETS retain the approach of two different groups in respect of risk of carbon leakage? Currently, one group is deemed exposed to a significant risk of carbon leakage and the other group not. Would additional differentiation be useful to better focus free allocation on sectors at highest risk of carbon leakage?
- Current system - one group of carbon leakage exposure
 - Two groups of carbon leakage exposure (reflecting a different degree of exposure)
 - Three or more groups of carbon leakage exposure

Please justify your answer and indicate percentage values for the different groups.

The current system should be kept. The risk of carbon and investment leakage remains as acute as ever for EU industry. Introducing differentiation in the level of protection will lead to unequal and incomplete protection for sectors at risk, and could have negative repercussions on EU industrial value/supply chains.

The concept of declining free allocation for industry is in contrast to the need for full protection against carbon leakage and should not serve as a justification to reduce protection.

- 7) How should the allocation rules address the differing degrees of sectors to pass on carbon costs to their customers in increased product prices?

EU Energy Intensive Industries compete on global markets and/or with global prices and have to carry a carbon cost while our competitors do not. In the absence of an effective global carbon cost, any attempt to pass through EU ETS carbon costs would result either in a loss of market share or increased attractiveness for investments in competitors outside EU.

There is no proven direct correlation between carbon prices and product prices evolution. The product prices are driven by many factors including market conditions, commodity prices, geographical specificities, taxation, etc. Models to quantify pass-through are depending on subjective choices and can be interpreted discretionally.

As the concept of cost pass-through by industry is a purely theoretical one, it is impossible to draw any conclusion from pass-through analysis that would be robust enough to enable policymakers to get a more granular view on the issue with a view to creating a complex system with different levels of exposure to leakage.

8) What are your views regarding the compensation for indirect costs? Please specify which measure would be proposed, and which sectors should be eligible.

The current implementation of carbon leakage measures to deal with indirect carbon costs has resulted in a fragmented approach as eligible sectors exposed to electricity price increases due to carbon costs may only receive from few Member States a partial financial compensation. This creates uneven playing field in the internal EU market, and creates a disadvantage for those installations that are not receiving any, or only partial, compensation, vis-à-vis extra-EU competitors.

While designing the new system, several measures/principles should apply:

- EU-wide harmonized system, which fully off-sets indirect costs (100% of the CO₂ cost-pass through in electricity prices) at the level of the most efficient installations in all Member States and reflects most recent production levels. Sectors with a fall-back approach should also be properly treated.
- Cost compensation could be assured using different complementary mechanisms (free allocation and/or harmonised financial compensation).
- Mechanisms should ensure predictability over the entire trading period by being described in the revised directive. The current system is unpredictable, as it relies on a state aid compensation assessment, and is granted annually, digressive and uncertain for future years.
- The eligibility assessment for such an EU-wide scheme should be based on a consistent methodology that identifies qualified sectors on the basis of their exposure to indirect carbon costs or their total electro-intensity.

As indirect costs arise from the price setting mechanism prevailing in the power sector (marginal price setting), an EU-wide compensation scheme should be in place without delay.

For the longer term, the Commission should also assess the possibility of redesigning the electricity market in a way that prevents carbon cost pass through in electricity prices to sectors at risk of carbon leakage.

Innovation fund

9) The European Council foresees an innovation fund for low carbon technology that also covers industry. How could such a fund support most effectively demonstration projects in industry? In this context, how do you foresee the industry's sectoral 2050 roadmaps for competitive low-carbon economy contributing to the aim of supporting innovation and new technology?

The extension of innovation support to industrial projects is welcome. However, it should not happen at the detriment of carbon leakage protection by reducing or limiting the amount of free allocation. Industry exposed to carbon leakage risk will struggle to invest or innovate without predictable efficient carbon leakage protection.

The revenues from auctioning should be reinvested for low carbon technology support, as foreseen in the ETS Directive, or energy efficiency but more importantly they should be used by Member States to stimulate economic growth and relevant R&D investments.

Innovation funding under the EU ETS should be allocated to Energy Intensive sectors appointed in Annex 1 of the Directive. The NER 300 fund currently in place and run by EIB was dedicated to CCS and renewables. The NER 400 should be technology-neutral and refer instead to R&D and deployment of new technologies for Annex 1 sectors.

Public incentives should acknowledge the technical risks involved and provide financing for the development stage without coupling the actual payment to a successful outcome. Currently, the EU Emissions Trading Directive makes the awarding of allowances from the NER 300 dependent upon the "verified avoidance of CO2 emissions". This not only requires the project to be successful (i.e. excluding any risks) but also makes funding available only at the end of the project.

In order to achieve a realistic policy and to allow for effective reduction of emissions, there is a need to identify the abatement possibilities in the industry. Some sectors have already developed 2050 decarbonisation roadmaps, in which transformation technologies are mentioned. A dedicated fund taking into consideration these abatement possibilities will bring innovative technologies (e.g. Industrial breakthrough technologies, including CCS and CCU for industry) forward and secure buy-in of industry sectors.

10) Any other joint suggestion/comment?

Today, expectations on performance of the Directive have risen significantly and to a level which very likely exceeds the potential of this system. Some other stakeholders expect the ETS to establish and maintain a high CO₂-price signal, to generate significant income for EU governments, to support the 2030 GHG emission reduction objective and to simultaneously initiate investments required for a speedy and deep transformation of very different sectors (aviation, manufacturing industry and the power sector) with very different abatement potentials (due to technological, thermo-dynamic and physical/chemical limits that cannot be overcome due to feedstock, process emissions and lack of breakthrough technologies) and operating under very different market conditions.

It is unlikely that all this can be delivered with the same efficiency and effectiveness as initially envisaged without increasing the overall costs for the EU society. Therefore, the highest priority should continue to be laid on the reduction of GHG emissions at least cost, for the society as a whole as well as for every group of GHG emitters.

The system should also have a predictable outcome in terms of emissions reductions and ensure certainty for the participants. It should reward and stimulate low-carbon technologies and should work in coordination with other EU policies. This is needed in order to create an effective environment for growth and investment in Europe.

The current scheme is complex and is not being used as a blueprint by other nations in the world. A fairer, more dynamic and cost-efficient scheme as suggested by the EU Energy-Intensive Industries is much more likely to be adopted outside of the EU. This would open up the possibility to make the EU ETS compatible and linkable – a key condition for a desirable future global carbon approach.

For Energy Intensive Industries carbon leakage protection needs to be a key element of the ETS revision. To ensure sufficient availability of allowances for free allocation for industry for direct and indirect effects, a reserve for growth would be needed. This reserve for growth would act as a buffer to ensure predictable access to both free allocation and auctioned allowances.

There are several ways to operate this proposed reserve for growth:

- It can be filled with unused free allowances due to lower production in phase III, back-loaded allowances, un-allocated allowances from New Entrants Reserve. Then it can provide allowances for growth in case of higher production.
- In addition, the Market Stability Reserve could also be used as the source for granting such allowances, if it would be designed as a sink for unused allowances from which allowances could be released for said purpose.

We would like to stress that, in light of the better regulation policy of the new Commission, an objective impact assessment on the different European energy intensive industries is crucial, taking into account their ability to reduce emissions (low carbon roadmaps). Otherwise, any flawed impact assessment could lead to wrong policy decisions for the energy intensive industries in Europe.