

Required EU ETS upgrades for European manufacturing industry to realise Carbon Neutral Future

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A secure legal and economic framework with effective and adequate carbon leakage protection are crucial for the energy-intensive industry to maintain international competitiveness and at the same time enable the transformation towards a carbon neutral economy.

The main target of the green deal is to pave the way to reach carbon neutrality by 2050. The EU shall focus on the reduction of the European carbon footprint while avoiding carbon leakage that would increase the worldwide GHG emissions. Carbon leakage protection should be effective. Thus, the current measures that address the risk of carbon leakage should be not only maintained but as they will be not sufficient, also complemented by an additional protection scheme. It must be ensured that the planned reform of emissions trading does not lead to additional cost increase for industrial installations in Europe, and thus to a decrease in competitiveness of the European industry.

The main upgrades needed in the ETS Directive revision:

1	Manufacturing industry needs to remain globally competitive	2
1.1	ETS should be predictable and not an attractive speculative market.....	2
1.2	Avoid cap rebasing since it reduces industry's ability to act.....	2
1.3	MSR needs to accommodate economic upswings and support innovation	2
1.4	Decouple carbon leakage level protection from the overall ETS cap	3
1.5	Perform in-depth impact assessment of carbon leakage risk.....	3
1.6	Benchmarks should reflect reality.....	3
1.7	Perform accurate activity level change to adjust allocation	3
1.8	New entrants should not be deterred by using the LRF	4
1.9	Avoid ETS scope extension to sectors with higher abatement costs and no international competition	4
1.10	Thorough impact assessment needed	5
2	Support the transition to low carbon technologies	5
2.1	ETS should support low carbon energy usage.....	5
2.2	Ensure indirect CO2 costs compensation.....	5
3	Incentivise low carbon innovation	6
3.1	Incentivise Carbon Capture and Usage	6
3.2	Allocate ETS revenues to support industrial decarbonisation	6

1 Manufacturing industry needs to remain globally competitive

To meet possible increased greenhouse gas targets, the **EU needs a competitive energy-intensive industry to drive the transition** and that continues to develop sustainable innovation, products and jobs in Europe. It must be ensured that the planned reform of emissions trading does not lead to additional cost increase for industrial installations in Europe, and thus to a decrease in competitiveness of the European industry in worldwide competition. This is a delicate balance, driving required transition to low carbon manufacturing without departure of production facilities to non-European countries, so-called carbon leakage.

It is highly **important that carbon leakage protection for European industry is continued**, especially with increased climate ambitions. In this context, existing measures such as the free EU ETS allowances and indirect cost compensation should remain and even be reinforced in line with the new climate targets. To achieve the planned increase in the EU's climate targets related to greenhouse gas emissions by 2030, the linear reduction factor together with the level of carbon leakage protection might be modified. This option for a more rapidly shortage of allowances will lead to an increase in CO2 prices, which will put additional pressure on the competitiveness of European industries. As global competitors do not incur these costs, the risk of carbon leakage increases.

1.1 ETS should be predictable and not an attractive speculative market

With increasing ambitions and additional measures to push prices artificially up, the EU ETS has become an interesting market for speculators. This drives scarcity and prices up, reduces predictability and add to the costs and uncertainty for European manufacturing industry. **Measures need to be put in place to reduce interests from speculative investors from the market.**

1.2 Avoid cap rebasing since it reduces industry's ability to act

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). European industry needs time to develop and implement decarbonation projects. For some activities, research and innovation are necessary to find breakthrough technologies. It is the reason why cap rebasing (i.e. one-off cancellation of allowances) not the appropriate manners to proceed. **Cap rebasing artificially increases the costs for the same level of climate ambition, without providing enough time to act.**

1.3 MSR needs to accommodate economic upswings and support innovation

It must be stressed that reliable legal and economic framework conditions are of the utmost importance for the energy-intensive industry in order to maintain international competitiveness while at the same time enabling investment in climate-friendly technologies.

In order to make the ETS better fit for economic cycles, **the outflow rate of the MSR needs to be increased. And, instead of invalidating allowances in the MSR, it must be considered to use them for innovation and avoiding a CSCF.**

Since 2021 exchange of EUA between ETS installation and aviation is possible. The current calculation of the total number of allowances in circulation (TNAC), which determines the in- and out-take of EUA to the MSR, doesn't take the EUA demand from aviation in account. This could lead to an overestimation of the surplus. **Therefor TNAC calculation needs to include the EUA demand from aviation.**

1.4 Decouple carbon leakage level protection from the overall ETS cap

The current ETS provisions for fixing the available free allocation volume to the overall combined cap of industry and power sector should be revised.

The overall cap decreases based on the esteemed potential for reduction of both the energy-intensive and the power sector. Since both sectors have highly differing estimations of potentials (25% for energy intensive industries vs. 70% for the power sector), the carbon leakage protection level is decreasing much quicker than energy intensive sector's emissions can be reduced.

The **level of carbon leakage protection needs to be decoupled from the overall ETS cap** and to match it to the economic protection needs of the energy-intensive sectors.

1.5 Perform in-depth impact assessment of carbon leakage risk

Since carbon leakage risks assessment is basis for granting carbon leakage protection, this needs to be performed in an in-depth and correct way. The current parameters to determine carbon leakage risk of a (sub)sector focus on trade intensity and emission intensity combined. To have an accurate view on carbon leakage risk the carbon leakage risk across the entire value chain needs to be considered. In addition, it should be noted that data on sector level does not always give a good representation of specific products, therefore assessment on prodcom level should be allowed.

Over a 10-year period (2021-2030), the economic context can change significantly and impact trade intensity as well as emission intensity of sectors. Therefore, it is necessary that a sector or subsector can prove its exposure when new data is available or change with substantial impact on (sub)sector occurred.

1.6 Benchmarks should reflect reality

The current free allocation system is based on benchmarks which decrease in parallel with GHG reductions. However for the ETS phase 2021-2030, with the new methodology applied to update the benchmark values (extrapolation till the medium of the following ETS period by using the annual improvement rate observed during the previous years, assuming that the past performance improvement can be replicate in the future), even the best performers won't receive an amount of free allocations sufficient to compensate their CO₂ costs. **Unrealistic tightening of the benchmarks leads to insufficient carbon leakage protection and should therefore be avoided.** It is the reason why benchmarks values should reflect actual performances. To provide predictability to ETS operators, the current safeguard measures to limit at 1.6 % per year the decrease of the benchmark values must be kept. In addition, the cost of low carbon technologies is not reflected in carbon leakage measures based on GHG and should be taken into account when defining carbon leakage protection measures.

The recent updated fallback benchmarks are based on a new methodology and includes not widely available resource (e.g. biomass or exothermic heat) with zero GHG emissions. This methodology drives the resulting heat benchmark to unrealistically low levels ("10% best") which other ETS companies can't reach due the limited amount of these heat sources. Not widely available heat (e.g. biomass or exothermic heat) sources should be excluded from the heat benchmark curve.

1.7 Perform accurate activity level change to adjust allocation

It is positive that the level of free allocation is based on the production levels, however the threshold of 15% is too high to accurately follow the changes in production level. The **threshold needs to decrease** to a low level which will not significantly increase the administrative burden.

Energy efficiency should be incentivised. For the **Heat/Fuel benchmark, improvement of energy efficiency should not be punished with removal of free allowances.**

1.8 New entrants should not be deterred by using the LRF

New entrants should not be subjected to an LRF. Correct allocation is crucial to safeguard the investment climate in Europe. **By applying a linear reduction factor on new installations, the level playing field between old and new installations is distorted.** LRF on allocation during the period, will result in an allocation of 22% below benchmarks that already reflect technological evolutions.

1.9 Avoid ETS scope extension to sectors with higher abatement costs and no international competition

The inclusion of other major emitting sectors into the ETS should not disturb the logic of CO₂ abatement costs and price elasticity. Any inclusion should not unbalance the existing ETS carbon market. It is the reason why if it was decided to include other sectors in an ETS scheme, only sectors with similar CO₂ abatement costs and price elasticity might be potentially included in the ETS of industrial sector. The other sectors should be included in a dedicated ETS fully separated from the current ETS.

Similarly, with regard to the potential option of extending emission trading to the 'buildings' and 'road transport' sectors, it must be noted that this may pose a risk to the EU ETS-sector. While a significant reduction in CO₂ emissions has already been achieved in the EU ETS-sector over an extended period of time, transport and building sectors fall behind the targets. Low price elasticities in the building and transport sectors, together with long investment cycles, indicate that market-based climate protection instruments such as carbon pricing are likely to have less impact than in other sectors and not to the same extent as in the existing ETS. This would lead to a delay in emission reduction for non-ETS sectors on the one hand, but also to a disproportional increase of financial burden for the ETS sector on the other hand. The consequence will be a significant imbalance in CO₂ costs and avoidance measures and a further distortion of competition.

Achieving more ambitious emission reduction targets by 2030 requires reductions in all sectors of the economy. All the key economic sectors should play their part in achieving the EU global GHG reduction of - 55 %. The reduction obligations between sectors need to be balanced appropriately based on the reduction potential of each sector. EU ETS sector is already significantly contributing to the reduction of the EU emissions. The future contribution of the current ETS sectors should be carefully defined based on detailed analysis of the sources of GHG reduction of each ETS sub-sectors and should not go beyond the potential for cost-effective emissions.

Since 2005, EU ETS sectors and non-ETS sectors (covered by the Effort Sharing Regulation) have been reducing CO₂ emissions at significantly different rates, with ETS-sectors compelled to strive towards a -43% reduction target against the -30% for ESR sectors compared to 2005. It is noteworthy 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.

Hence, the Effort Sharing Regulation and the ETS Directive need to address sectors currently covered by the Effort Sharing to deliver a fair share of emission reductions.

1.10 Thorough impact assessment needed

A thorough and substantiated assessment of the economic impact by revising the ETS Directive, not only on a macroeconomic level but in-depth per sector, is needed. As explained above, the costs for energy-intensive industries are likely to rise. This will be reflected in higher CO₂-costs, as well as in higher total energy costs (driven by energy prices, grid tariffs and taxation). In the Inception Impact Assessment, the Commission claims that this initiative would likely to contribute to higher investment and growth in the ETS, improve energy security and reduce the energy imports bill. But the Impact Assessment does not include any substantiation. Positive sectoral impacts are highly dependable on global action. As for the energy import bill, a total assessment of the expected total final energy demand (including technologies leading to more energy demand) was not done. Sufficient, secure, and affordable low carbon energy sources need to be available for energy-intensive companies to successfully invest in CO₂ avoidance. This requires infrastructure development and likely imports into the EU at a large scale.

2 Support the transition to low carbon technologies

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.

More fundamentally, the current system of contradictory regulations, like:

- incentivising electrification, but punishing by removal of free allowances;
- increasing electricity prices due to pass-on of CO₂ costs, but reducing/removal of indirect compensation;

needs to be revised to really support transition of industry.

2.1 ETS should support low carbon energy usage

The European industrial strategy for moving towards a carbon neutral future is largely based on using low carbon energy/electricity sources. It is therefore important that:

- a. **Switching manufacturing to low carbon electricity is not punished by removing free allowances.**
- b. **Enough affordable low carbon energy/electricity needs to be available.**

2.2 Ensure indirect CO₂ costs compensation

Electrification is seen as one of the promising routes to decarbonize the European industry. Some activity within sectors could switch from fossil fuel to electricity and could become more electro-intensive in the future. **The guidelines on financial compensation of indirect CO₂ costs need to be reviewed** to take into account such changes. In particular the list of eligible sectors shall be regularly reviewed to update the electro-intensity of each sector.

To ensure an adequate carbon leakage protection, an aid intensity currently limited to 75 % and fall-back electricity benchmark currently set at 80 % needs to be increased. Member states need to be persuaded to provide compensation.

Because of the increasing importance of indirect cost compensation and to avoid competitive distortions within Europe, **this compensation should be handled on European level with a dedicated EU fund.**

3 Incentivise low carbon innovation

The EU needs a competitive energy-intensive industry to drive the transition and that continues to develop sustainable innovations, products, and jobs in Europe. It must be ensured that the planned reform of emissions trading does lead to the implementation of schemes that **support financially innovation and modernisation of the European industry.**

This is also acknowledged by the Commission's 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).

3.1 Incentivise Carbon Capture and Usage

A robust and consistent GHG accounting is necessary. Therefore, ETS should be adapted to **recognize the avoided emissions by implementation of CCU and the created sinks by storing biogenic CO₂.**

Carbon Capture and Usage (CCU) is recognised as a new low carbon technology, that will contribute to climate neutrality. The update of the MRR provides a perfect opportunity to recognise avoided CO₂ emissions and to support CCU by providing a consistent accounting framework. The MRR rules don't contain consistent accounting rules as avoided CO₂ emissions are reported as if they were emitted (this would be double counting).

Two types of CCU products exist:

- CCU products where the CO₂ remains chemically bound in the use phase (CCU-Materials) and
- CCU-products where the CO₂ will be emitted during use phase (CCU-fuels).

Adaption of the MRR for these two types can be done following two CCU cases already implemented in the MRR (precipitated calcium carbonate (e.g. example CCU material) and urea (e.g. example CCU fuels) and safeguarding following principles

1. The avoided CO₂ emissions should be recognised in the MRR for phase 4 (2021-2030) to adequately support CCU.
2. All CO₂ emission should be accounted for consistently and only once.
3. Storage of CO₂ originating from biomass should be recognised as a net sink of CO₂.

3.2 Allocate 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.

About IFIEC Europe

IFIEC Europe represents 13 national European associations that comprise - on a cross-sectoral level - those industrial sectors for which energy is a significant component of production costs. IFIEC's membership represents a diverse set of industries including: aluminium, automobile, brewing, cement, chemical, copper, fertilizer, food, glass, industrial gases, metals, paper, pharmaceutical, plastics and steel.

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