7 September 2015

Response to the Commission's EU ETS reform proposal of 15 July 2015

Michiel Cornelissen (USG)

Response to the legislative proposal: COM(2015)337/F1: "Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments" https://ec.europa.eu/transparency/regdoc/?fuseaction=feedback&docId=3079130

1 Commission's proposal needs a significant upgrade

In line with the October 2014 European Council Conclusions[1], Carbon leakage prevention needs to be the first element of the ETS revision. It should be based on technically and economically achievable benchmarks, on actual production, and addressing both direct and indirect carbon costs. The most efficient European installations must be guaranteed access to enough free allowances in order to operate and even grow at no net carbon cost.

With the 15 July 2015 EU Commission's proposal for ETS reform, the competitiveness of EU industry would be severely undermined. Keeping the industry in Europe, as main economic driver and jobs source, needs a significant upgrade of this ETS reform proposal. Such upgrade should also ensure a healthy investment climate to enable industrial growth.

Companies that face international competition need to be compensated for carbon cost that their non-EU competitors don't have. These additional European costs influence production and investment decisions; with too high carbon costs, energy intensive industry cannot produce and invest in Europe.

In the current ETS scheme (2013-2020), support is given to those sectors that are at risk of losing competitiveness. This is done at an already strict benchmark level. Only few of those companies can meet that benchmark. Even these best performers are not fully compensated; this compensation is reduced with a reduction factor (CSCF).

With the proposed scheme, fewer sectors would be compensated and the benchmarks would be made even stricter: -1%/y from 2008, entailing for 2021-2030 -15% to -20%. This tightening of the benchmark is modified by + or - 0.5%/y if the annual reduction of a sector deviates by more than 1.5%/y or less than 0.5%/y, respectively. For most industries this is an unrealistic reduction rate that they cannot achieve. For many sectors the emissions are even unavoidable and the stricter benchmarks can therefore never be reached. On top of that, it would be quite likely that again some sort of reduction factor (CSCF) would be introduced. This would mean that even the best performers do have to bear carbon costs and face an unlevelled international playing field.

Constructive input has been given throughout the 2014 stakeholder consultations to the EU commission to effectively reconcile climate action and cost efficient decarbonisation while at the same time ensuring competitiveness and encouraging industrial growth in Europe. The current EU ETS reform proposal needs a significant upgrade to ensure that the energy intensive industry has a future in Europe.

[1] Quote from 23 October 2014 Council Conclusions: "The benchmarks for free allocations will be periodically reviewed in line with technological progress in the respective industry sectors. Both direct and indirect carbon costs will be taken into account, in line with the EU state aid rules so as to ensure a level-playing field. In order to maintain international competitiveness, the most efficient installations in these sectors should not face undue carbon costs leading to carbon leakage. Future allocations will ensure better alignment with changing production levels in different sectors. At the same time, incentives for industry to innovate will be fully preserved and administrative complexity will not be increased."

2 Main issues with Commission's proposal

"Free allowances" is the lifeline of European industry that is exposed to carbon leakage. Free allocation must be designed in such a way that carbon leakage can be avoided effectively and growth is not suppressed. This means sufficient allocation for the best performing manufacturers – namely those that produce at realistic, technical and economical achievable benchmark levels.

2.1 Fixed auctioning volume puts best performers at risk

The industry lifeline will get shorter every year, given the declining cap and the fixed shared of auctioning vs free allowances. Consequently, best industrial performers will not receive free allowances conform the stringent benchmark level, but these free allowances are further reduced with a reduction factor (currently CSCF). This allocation discount gives rise to carbon costs even for the best performers. These additional costs reduce EU industrial competitiveness even of the best performers and discourage investments.

The concept of declining free allocation for industry is in contrast with the October 2014 Council Conclusions that stressed the need for full protection against carbon leakage. In this statement of the Heads of State, the limit on allowance issuance covers combined "free allocation and auctioning". They did not impose a decrease of free allocation as such.

In our view, the calculation of the amount of allowances to be auctioned and their distribution has to be carried out only after the volumes of the free allocation have been determined which leaves free allocation without the need for a cross-sectoral correction factor[2].

2.2 Strict benchmarks

In the current (phase 3) scheme, compensation occurs already at a strict benchmark level. Only 5% of companies could meet that benchmark in 2008.

With the proposed scheme, the benchmarks would be made even stricter with an arbitrary factor: -1 %/y from 2008, entailing for 2021-2030 -15 % to -20% tightening of the benchmark relative to 2008. For most industries this is an unrealistic reduction rate that they cannot achieve. For many sectors, part of the emissions are even unavoidable and the stricter benchmarks would develop beyond the theoretical limits, hence can therefore never be reached.

There is no proper link between the compensation and technological progress as requested in Council Conclusions, except for an upwards or downwards 0.5% 'correction' of prescribed benchmark reduction, that is only granted in case the deviation is 0.5% or higher.

> *For example: If a sector could prove a -0.3% instead of -1% benchmark improvement, they would get a -0.5% benchmark. This means that in this sector the best performers would still remain 0.2% per year short.*

The proposed benchmark tightening scheme does not sufficiently consider technological progress of the different sectors including the fact that in some sectors part of the emissions are unavoidable.

2.3 Recent production based free allocation

The October 2014 Council Conclusions request a better alignment of free allocation with changing production levels.

Our reading of the Commission proposal is that an alignment with changing production levels would only happen once every 5 years and with a time shift of 3 years (i.e. 2021-2025 activity level fixed on

[2] See legal opinion on article 2.9 by Luther of April 2015

2013-2017 figures)[3]. Furthermore, this alignment is conditional. The Commission's proposal has the following deficits in meeting the Council Conclusion's demand:

The time gap between allocation and the considered production is still significant and will not reflect the real dynamics of economic development.

With a threshold to adjust allocation downwards, there is still an incentive to reduce production levels in the EU ETS sectors up to that threshold, leading to windfall profits and replacement of European production.

The high upward threshold (kept same as in ETS 2013-2020) is unwanted and cannot be met by manufacturing industries by creep or debottleneck their normal operations. This will suppress efficient production growth in the EU.

Setting of the rules in a delegated act by the Commission brings a lot of uncertainties concerning transparency and consideration of Member States' voices for these highly important system issues. Participation of EP, Council and stakeholders should be safeguarded.

2.4 Carbon leakage criteria are arbitrary

The arbitrary thresholds for both quantitative (0.2) and qualitative assessment (0.18) should be adequately justified and adjusted in order to provide appropriate levels of support for sectors at risk of losing international competitiveness. For qualitative assessment, in particular, there should be NO threshold.

The effect of the measures proposed by the commission on the emissions volume is negligible (a few percent of the total free allocation) : just for reducing administrative burden for authorities is not a good enough reason for kicking sectors off the list and exposing them and entire value chains to the risk of carbon leakage. Other options such as removing minor emitters from the ETS scope should be considered.

2.5 Access to reserve for growth should not be limited

The creation of a "reserve for growth" is welcomed. The reserve should be accessible and should give companies predictability for many years ahead through clear rules and provisions in the revised ETS Directive. Access should not be limited to large production expansions only, therefor the high thresholds of the actual ETS 2013-2020 need to be adjusted. The reserve should also be used for free allocation at benchmark levels according to most recent output (dynamic). It should enable economic growth and recovery and avoid undue carbon costs for most efficient production – in full compliance with October 2014 European Council Conclusions.

The IA is lacking an analysis if the 250 million allowances from the MSR would be sufficient to safeguard the intended EU industry growth. In our view, also the abt. 700 million[4] unallocated allowances should be available for growth related allocations.

[3] July 15, 2015 Commission proposal (8): "A list of installations covered by this Directive for the five years beginning on 1 January 2021 shall be submitted by 30 September 2018, and lists for the subsequent five years shall be submitted every five years thereafter. Each list shall include information on production activity, transfers of heat and gases, electricity production and emissions at sub-installation level over the five calendar years preceding its submission. Free allocations shall only be given to installations where such information is provided."

[4] Answer on Question 8 in July 15 'Commission Fact Sheet, Q&A: "The recent agreement on the Market Stability Reserve (MSR) enables unallocated allowances to be transferred to the MSR in 2020. Under this rule, analysts estimate that some 550 to 700 million allowances may be transferred into the MSR in 2020. Following a request by the Parliament and Council to consider the use of unallocated allowances after 2020, the Commission proposes to use 250 million unallocated allowances from 2013-2020 to establish a reserve for new and growing installations."

2.6 No harmonized compensation for indirect costs

The compensation remains optional and at the discretion of the Member States. Along with the Council, a harmonised solution is requested either through financial compensation and/or free allocation – without disadvantaging existing solutions in Member States.

2.7 Innovation funding

The extension of the NER400 to industrial projects is welcome. Implementing measures need to explain better the eligibility criteria and the projects selection process. Carbon capture and reuse need also to be eligible for such funding.

2.8 Impact assessment does not match proposal

The impact assessment should cover the impact of the combined set of parameters that are put forward in the proposal. Next to that, the impact of the MSR should be taken into account.

3 Significant upgrade needed to protect best performers

The following upgrades of the ETS reform proposal are needed to truly take into account the European Council Conclusions[1]:

1. Best performers should receive 100% of the benchmark; so no reduction factors (like CSCF). This can be resolved by interpreting the Council Conclusions in the proper way by not-fixing the auctioning share. An alternative solution is to supplement the free allowances from the MSR. Both options will ensure no undue carbon costs for industries' best performers;

2. There need to be realistic benchmarks for both product-specific as well as fall-back (heat) benchmarks. Proper benchmark levels shall ensure that the best performers do not face a carbon cost, which implies that theoretical lower limits are respected. In case the benchmarks are updated, this should be done based on actual technological progress of the sector and hence on actual data (no arbitrary benchmark updating factor).

3. Free allocation should be based on actual recent production data, without any thresholds;

4. All sectors at risk for carbon leakage need to be included into the carbon leakage list, including sectors that have fall-back benchmarks. The arbitrary threshold for quantitative (0.2) should be adequately justified and adjusted in order to provide appropriate levels of support for sectors at risk of losing international competitiveness. For qualitative assessment, in particular, there should be no threshold at all;

5. There needs to be an adequate EU-wide compensation system for indirect costs, which fully off-sets CO2 costs pass through in electricity prices at the level of the most efficient installations;

6. Project eligibility criteria need to be clearer for the NER400. Carbon capture and reuse need also to be eligible for such funding;

7. A proper impact assessment should be made for the complete and correct reform package, including impacts of the MSR.

"Free allowances" is the lifeline of European industry. Free allocation must be designed in such a way that carbon leakage can be avoided effectively and growth is not suppressed. This means sufficient allocation for the most efficient manufacturers – namely those that produce at realistic, technical and economical achievable benchmark levels.