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Initial views on the European Commission's proposal for reform of the EU Emissions Trading System

The proposal for reform of the EU Emissions Trading System (ETS) published by the European Commission in mid-July recognises many of the steel industry's concerns about the scheme's approach to carbon leakage. Unfortunately, it also fails to address them.

As a result, UK steelmakers fear even the most efficient plants will continue to receive insufficient free ETS allowances to cover their operations during the next 2021-30 phase of the scheme. This will make it increasingly hard to compete with plants overseas not facing the same compliance costs and to justify future investment in UK assets, especially when the industry is facing the converging impacts of high energy costs, business rates and environmental compliance costs, a strong pound and global overcapacity.

The Commission has clearly failed to deliver the European Council's demand for leakage provisions that provide "appropriate levels of support for sectors at risk of losing international competitiveness" and ensure the most efficient installations in at-risk sectors do not face "undue carbon costs".[1]

This paper sets out our initial reaction to a number of elements of the proposal, and suggestions as to the type of modifications member states and MEPs should consider investigating. We will be making more detailed recommendations as more data and analysis becomes available.

Uncertain impact

The explanatory memorandum at the start of the Commission's legislative proposal says its rules on free allocation are "predictable, robust and fair" but none of these adjectives seem particularly appropriate.

It will be impossible to know the final effect of the plans on our sector until new production data has been collected for the 2013-17 period, an updated carbon leakage list drawn up (due by the end of 2019) and revised benchmarks published for each of the sectors

[1] European Council conclusions on the 2030 Climate and Energy Policy Framework, October 2014

included, and the resulting cross-sectoral correction factor calculated and published.[2] By that time, it will be too late to change the rules, and even that will only give certainty for the period to 2025.

One of the main causes of uncertainty, and our gravest concern about the proposal, is the continuing cap on free allocation. The Commission's impact assessment suggests a significant cross-sectoral correction factor will still be required in the next phase to keep free allocation within this cap, potentially cutting every installation's allocation by 30% a year by 2030.[3] A system requiring this scale of correction hardly seems robust and is definitely not fair on those sectors more at risk of carbon leakage. It is also unfair on industry as a whole given the power sector has more options for reducing emissions, is not at risk of carbon leakage and has received far more government support for decarbonisation.

While the timing of data collection makes it inevitable the detailed effect of any changes will not be obvious until nearer 2021, we would urge policymakers to refine the European Commission's proposals to ensure the most efficient plants in higher risk sectors can be certain they will receive all the allowances they need.

The carbon leakage proposals in more detail

Cap on free allocation

As discussed above, we are very concerned by the Commission's retention of the cap on free allocation. As in the current phase of the ETS, this would prevent plants at risk of carbon leakage from receiving the level of protection they need and that EU leaders acknowledge is required.

We would question the reference in the Council conclusions used to justify the cap, but also the level at which it is set. It is illogical to require the same emissions trajectories from electricity generators and industry given their differing capacity to reduce emissions. The EU risks overburdening and potentially losing sectors that have fewer mitigation opportunities than power producers and are facing more competition from overseas.

There are also questionable aspects of the method proposed by the Commission to decide what proportion of allowances will be auctioned (57%) and therefore also the cap on free allocation. The 57% figure is based on the share of allowances the Commission says will be auctioned in phase 3, but the rules used to calculate it are not consistent. It is not fair that allowances set aside for free allocation to industry but ultimately unused are considered to be part of the auctioned share, while allowances given for free to electricity generators in some Eastern European states are not attributed to the freely allocated portion. This

[2] A cross-sectoral correction factor is currently applied after all the other elements of free allocation are calculated to ensure that the total number of allowances given away for free stays within a set limit. It is retained in the new proposal

[3] This is based on the impact assessment's baseline scenario as this assumes an average 1%/year cut in benchmarks, a largely unchanged carbon leakage list and 100% compensation for sectors on the list

calculation should either be based on policymakers' original intentions for each allowance or the actual method by which it will be distributed.

The primary concern must be ensuring there are enough allowances available to properly protect industries at risk of carbon leakage.

Leakage list

Given the cap on free allocation proposed, it is essential the leakage list is targeted particularly on the most at-risk sectors that score highly on both the carbon-intensity and trade-intensity criteria.

Integrated steelworks are also very concerned about the status of sinter. Sinter production is an integral step in their production process but for statistical reasons is considered to be in the mining sector about which there is limited data making qualification for the leakage list less likely. There needs to be some kind of process allowing anomalies such as this to be ironed out.

Benchmarks

Benchmarks should be based on what is really being achieved at EU plants and not generalised assumptions. This is a particular concern for the integrated steel benchmark which is still being challenged through various member state courts. Taking a proper evidence-based approach would require more administrative work than simply reducing the existing 2007/8 benchmarks by one percent per year as the Commission proposes. However it would ensure they accurately capture the mitigation capacity of each sector and avoid becoming another arbitrary correction factor.

The Commission has proposed an improvement rate of 0.5 percent a year for sectors that have found it particularly hard to reduce emissions and 1.5 percent a year for those that have seen much more rapid emissions reductions. This fails to address the complexities of EU industry. Furthermore, it is not clear how easy it will be to choose an appropriate figure from the data available, especially for sectors using multiple benchmarks, and a fresh data collection exercise may be needed anyway.

We would also like an explanation of the approach intended for fall-back benchmarks. Decisions on issues like this should be included in the revision of the directive where they can be debated fully, not left to secondary legislation.

Additionally, we believe the benchmarks should be retained over the whole phase, not updated midway through. This would improve predictability and ensure the best performers in each sector have some time to benefit from their investments.

Link to production levels

The steel sector believes the production figures used to calculate free allocation to each installation should be recalculated annually and based on much more recent data than is currently the case, or proposed by the Commission. The improved accuracy of this approach would more than compensate for any additional administrative burden.

The Commission's proposal to update production figures slightly more often and provide extra allowances from the New Entrant Reserve for year-to-year increases in production over a certain threshold at least represents a step in the right direction. However, if the change is to have any impact, the threshold should be set during the revision of the ETS Directive to enable a proper debate about its level, not via a delegated act as proposed. We would urge policymakers to ensure it is low enough for companies to be able to genuinely take advantage of the new flexibility, and is well below the 50% threshold currently used in the partial cessation rules. This is essential if the ETS is not to act as a brake on growth.

Unused allowances

Ringfencing unused industry allowances from phase 3 for industry's use in phase 4 is a fair and sensible approach. However, we would rather these allowances were available to all plants at risk of carbon leakage to help mitigate the effect of the industry cap rather than being placed in the New Entrant Reserve where they can only be accessed by those fortunate enough to be growing. It is also essential that in future any allowances intended for industry but unused because of closures, partial closures or lower than expected levels of new entrants are kept for industry.

Innovation fund

We do not agree on principle with the annexation of parts of the ETS cap for other goals as this undermines its market-based rationale and removes allowances that might be used to reduce the risk of carbon leakage.

However if allowances are to continue being removed and used to support innovation, it is only fair that access to this support is extended to industry as the Commission proposes. We also appreciate the changes the Commission has proposed to the fund's rules to try and ensure it works for industry, and will be assessing these more fully in the coming months.

Simplification

Every effort should be made to simplify the ETS where this will not impact on carbon leakage risk. This would help balance any additional complexity required in the carbon leakage rules.

With this in mind, we would like to see the small emitter opt-out extended, which would help ease administrative burdens for smaller companies and regulators. We believe the threshold for the opt-out should be raised to include installations with annual emissions below 50,000 tonnes CO2e/year and qualification ought to be based entirely on a site's emissions, not its thermal input which might be a historic legacy and irrelevant to current operations. Ideally,

the very smallest emitters should be removed from the ETS entirely as the current opt-out rules still impose a substantial burden.

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