Response to the Proposal for a Directive of the European Parliament and of the Council amending Directive 2003/87/EC to enhance cost-effective emissions reductions and low carbon investments

The Hanson UK is one of the UK's largest producers of aggregates, asphalt, cement and concrete. Hanson UK is part of the HeidelbergCement Group, the largest cement producer in Europe. Hanson operate 3 modern integrated cement plants and over 30 asphalt plants some of which are included in EUETS or the UK small emitters opt out scheme. Hanson is member of the Mineral Products Association and fully supports the response to this consultation submitted by MPA.

Summary

- Hanson UK welcomes the review of the EU ETS because as currently structured the allowance provision does not provide sufficient long-term protection against carbon leakage in the absence of an international agreement.
- The EU ETS must be revised whilst adhering to the following key principles:
  - Ensuring that emission reduction is achieved at the least cost.
  - The review must be consistent with EU growth ambitions and industrial policy.
  - The review should be carried out under the acknowledgement that the UNFCCC process has been sub-optimal in delivering carbon cost equalisation.
  - The revised Directive must ensure that the most efficient installations do not face undue costs, in line with the EU Council conclusions (October 2014).
  - Understanding that the current ETS with a linear cut by the cross sectoral correction factor for energy intensive industry will de-industrialise Europe before it decarbonizes European manufacturing.
  - Recognising that the cement manufacturing has technical limitations on reduction due to non-combustion source streams (process emissions).
  - The reduction effort for the cement and lime sectors must take into consideration the real reduction potential within the 2020-2030 timeframe, which lies in the reduction of emissions from combustion source streams.
  - Provision of support toward a low carbon economy by hypothecation (earmarking) of revenues from allowance auctions and direct innovation support to those sectors facing the greatest abatement challenges.
- In this regard the revised Directive proposal must be modified in the following areas to provide adequate protection for installations vulnerable to carbon leakage and avoid discouraging EU investment:
  - Removal or modification of the cross sectoral correction factor (CSCF) which is a feature of the EU ETS that is damaging to competitiveness and discourages investment in the EU
  - The benchmark revision must be scientifically driven and should not be based on the application of 'standard rate' reduction factors because these do not reflect abatement potential and so are likely to undermine carbon leakage protection.
  - To maintain industrial competitiveness the Commission should include flexibility in the amount of free allocation using a reserve or auction adjustment. This can be done whilst maintaining the environmental goal set by the overall cap on emissions.

- Strengthen the provision for the compensation of increasingly important indirect costs of EU ETS in electricity prices.
- The Directive should maintain a feature that allows carbon leakage exposure to be identified using a qualitative assessment.
- The production reference year update should include a feature which allows anomalous data to be excluded where a year's production data is unrepresentative.
- The Directive proposal must improve the clarity of the text on innovation and growth funding. In addition support mechanisms need to be available for switching unconventional/technologically challenging fuel use in industrial processes as well as the use of CO_2 from industrial carbon capture.

Without these modifications the current proposals provide inadequate protection from carbon leakage for the cement sector impacting EU investment, growth and jobs.

- The following detailed comments are preliminary based on our current understanding. To provide a full understanding a number of questions need to be answered, these are contained in ***Annex I***.

Detailed comments concerning the revised package

Removal and modification of the CSCF

Although the Commission Proposal overall is a step in the right direction, and does acknowledge the importance of a continued carbon leakage protection, this aim is completely undermined by the continued inclusion of the CSCF as a feature of the EU ETS. Even if the Commission claims its application will be minimized, the allocation to the best performer would be drastically reduced through the combined application of the CSCF with a flat percentage-based benchmark adjustment. The CSCF is a blunt and unsophisticated feature that impacts the greatest on those activities with the highest levels of non-combustion source stream emissions aka 'process emissions' (arguably those installations with the greatest technological abatement challenges). Removal of the CSCF and maintaining the overall EU ETS cap is possible and this is our preferred approach. If the CSCF does remain a feature of the EU ETS, then in the first instance the correction should be addressed using allowances from the Market Stability Reserve. Furthermore, should the CSCF apply as a last resort to installation free allocation then its correction should not apply to non-combustion source streams that are subject to much stricter technical limitations on their abatement or to sectors with a carbon leakage factor of >0.2 due to their high risk of carbon leakage.

Benchmark review

The benchmark revision must be scientifically driven and should not be based on the application of 'standard rate' reduction factors because these do not reflect abatement potential and so are likely to undermine carbon leakage protection. The guidance given by the European Council in October 2014 clearly demands that the most efficient installations in energy-intensive sectors should not face undue carbon costs leading to carbon leakage. This guidance must be upheld but the current proposal undermines this principle. It was clearly the intention of Heads of State and Government to incentivise industry to invest in low carbon technologies while maintaining growth and jobs in Europe. To this end, the production benchmarks should be achievable by all of the EU market participants insofar as they should not be dependent on geography or local special circumstances, such as the access to a particular raw material (in the case of non combustion emissions).

Furthermore, the fundamentals of the benchmark principles of ETD article 10a(1) and 10a(2) should be maintained. For that purpose; the benchmark should be set on the basis of real data collection of the best performers once per period. Benchmarks should be set on the basis of robust and verified data collection and should not be arbitrarily reduced by a standard factor. The benchmark review should consider the abatement potential over the period 2021-2030 which may be quite different to the technological progress over the past decade. In this regard, assumptions on future linear trends are likely to be inappropriate for sectors that have taken early action and those with a significant share of non-combustion source stream (process emissions). The information to complete a proper technical review of the benchmark will be readily available for the cement industry in data provided in annual emission reports, an approach which is far more rigorous than the proposed arbitrary 1% reduction per year.

For the current benchmarked cement plant the non-combustion CO_2 represents around 70% of the total (540kgCO_2 process emissions vs 766kgCO_2 benchmark). Technological options to significantly reduce non-combustion CO_2 are unlikely to be viable until post 2030. An adjustment to the whole benchmark of 10% actually requires 34% effort on the combustion emissions to achieve. This makes the Commission proposal to ratchet down the 2007-2008 benchmarks by 1% (±0.5%) per year unachievable. The Commission proposal would place all European cement in the unrealistic position of having to be manufactured almost exclusively with carbon neutral fuel. ***Annex II*** illustrates this graphically. It shows that as early as 2023 the benchmarked allocation for cement could hit the 'technological floor', beyond which only major technological breakthroughs can assist in decarbonisation. It also illustrates that the current average plant would need to nearly half its emissions by the end of Phase IV with a 1% benchmark ratchet and the use of the CSCF.

In summary, sectors need a benchmark based on technological feasibility, such that best performers receive full free allocation to provide protection from carbon leakage and enable further investment. The benchmark review must therefore be scientific.

Furthermore, when setting the benchmark and in order to ensure a level playing field in the waste market, emissions from co-incineration should be accounted with a zero emission factor (the only alternative being the removal of the exclusion for waste incineration from the combustion activity in Annex I of the Directive).

Flexible free allocation

To maintain industrial competitiveness the Commission should include flexibility in the amount of free allocation using a reserve or auction adjustment. To ensure that free allocation plus auction amounts do not exceed the overall EU trading system cap an adjustment may be necessary, however it can be done without damaging industrial competiveness. The adjustment could be made by either introducing flexibility between free allocation and the auctioning amount or implementing an allocation reserve as suggested by Ecofys in June 2014. Such a reserve could be fed using the MSR/NER surplus and/or from the allowances not allocated when free allocation is below the free allocation proportion of the EU ETS cap.

The Commission's proposal to fix the amount of auctioning is based on what is, in our view, an incorrect reading of Article 2.9 of the European Council Conclusions of 23 October 2014. Based

on two legal opinions received, we contend that the Member States intended to give priority, in paragraphs 2.4 to 2.8 of the same Conclusions, to the need for free allowances to ensure that the best performers were not subject to undue carbon costs for both direct and indirect emissions. In our interpretation, there is a cap on the overall amount of allowances but NOT on the amount of free allowances. By assuming an approach with a fixed amount of auctioning, the Commission concludes that the number of free allowances is limited and must be reduced through a combined application of the cross-sectoral correction factor, a percentage-based reduction of the benchmarks and updating the HAL. This approach creates legal uncertainty for EU industries as it is contradicting the European Council's request that the best performer should not bear undue carbon costs. Implementing a fixed 57% for auctioning and a fixed remaining 43% for free allocation contradicts the benchmark principle of ETD article 10a(1) and 10a(2) for the best performers. In fact the twofold linear limitation of the required carbon leakage protection (benchmark ratchet and CSCF), imposes additional cost even for best performers.

The emissions cap and environmental objective for the EU ETS can be met by introducing flexibility in the auction and free allocation amounts by the creation of a reserve (or using the MSR) so that the environmental goal is maintained. By not reducing free allocations to installations below the attributed benchmark, the Commission can ensure that the operators in the EU ETS with the greatest ability to pass through the cost of carbon take the greatest burden. The benefits of this approach are two fold; firstly it ensures that the cost of meeting the climate change targets is spread as wide as possible via electricity prices which ensures that all areas of the economy make a contribution; secondly it allows the EU to meet its growth objectives by encouraging manufacturing to remain in the EU rather than relocating to lower carbon constrained economies.

Identification and compensation of indirect costs

Hanson welcomes that the proposed revision which indicates that Member States proceeds from the EU ETS should be used for compensation of indirect carbon costs. However, this doesn't go far enough to protect business from these costs and there is a need to strengthen the provision for the compensation of increasingly important indirect costs of EU ETS in electricity prices. Hanson disagrees that the partial compensation offered by State Aid should be limited to those activities and sectors which are on the current State Aid guidelines. In this regard Hanson calls for a review or expansion of the existing State Aid guidelines for indirect EU ETS CO_2 costs in electricity. This is particularly relevant for sectors/activities facing a high level of carbon leakage exposure due to their cumulative burden of direct and indirect as identified by the Article 10a(13) carbon leakage list.

Carbon leakage test

Hanson welcomes the efforts made by the European Commission to recognise that energy intensive industries are at risk of carbon leakage and the proposal to reduce the provision of free allocation to those sectors with a lower carbon intensity/trade intensity coefficient to reduce the influence of the CSCF on those industries most exposed. MPA's analysis indicates that the 0.2 coefficient referred to in the Article 10b proposal is about the right number as

initial estimates indicate that cement and lime would qualify for 100% of the benchmark allocation to 2030.
The removal of the link to an assumed carbon price in the leakage tests appears appropriate because it is carbon intensity that is the most important criterion i.e. those activities with the highest carbon intensity are the most exposed to an increasing EUA price.
However, in the advent of anomalies arising from the leakage test criteria (e.g. borderline results or unrepresentative data) Hanson insist that the Directive maintains the feature of a qualitative analysis when needed because Hanson strongly disagrees with the Commission's assessment of the cement industry cost pass through capacity (contained in the Impact Assessment) which currently erroneously leads to the conclusion that cement producers would not face undue carbon cost.

Production reference review
Hanson agree that the production reference years should to be more closely aligned to recent activity levels. However, Hanson are concerned that using only 3 production reference years referred to Article 10b(4) that unusual operating conditions may not be sufficiently taken into account. Indeed during phase 3 Hanson's allowances at one site were reduced as a result of the significant capacity change rules even though 3 years data of post change were available.

Innovation and growth support
There is lack of clarity on how the NER and Innovation and Growth funds will be primed and how many allowances are available for these purposes in total. Hanson believes that the NER and Innovation and Growth Funds should be primed using excess Phase III or MSR allowances only so that the level of benchmarked free allocation is not reduced further.
The Commission's proposal appears to restrict support for innovation to carbon capture and storage, Hanson suggests that this is extended to cover the use of CO_2 from industrial carbon capture carbon capture and use. In addition support mechanisms need to be available for switching to unconventional/technologically challenging fuel use in industrial processes particularly as more expensive fuel sources (driven by tighter benchmarks and other limiting factors in the Directive) adds to production cost and therefore increases the carbon leakage threat at high levels of fuel switching.

Annex I
Questions for clarification

Cap distribution

1. What is the anticipated allocation cap and what is the cap trajectory? Please provide absolute numbers for each year
2. Please confirm that the Modernisation Fund is 2% of the total allowance cap?
3. Please confirm that the Modernisation Fund is drawn only from the auction allocation?
4. Please confirm that the full 43% of the total allowances will be available for free allocation?
5. Please confirm that the initial allocation to the New Entrant Reserve and the Innovation Fund will come from unallocated allowances from Phase 3, and not from the Phase 4 free allocation – albeit that the New Entrant Reserve is 'topped-up' with unallocated free allowances (from ceased operations, partial cessations and significant capacity reduction according to paragraphs 19 and 20) throughout Phase 4.
6. Please confirm that a total of 450 million allowances in total will be available for the New Entrant Reserve and the Innovation Fund in combination? OR Are 400 million allowances allocated to the New Entrant Reserve and a further 450 million allowances allocated to the Innovation Fund?
7. Please confirm that 250 million allowances will be ring-fenced for new entrants and business growth?

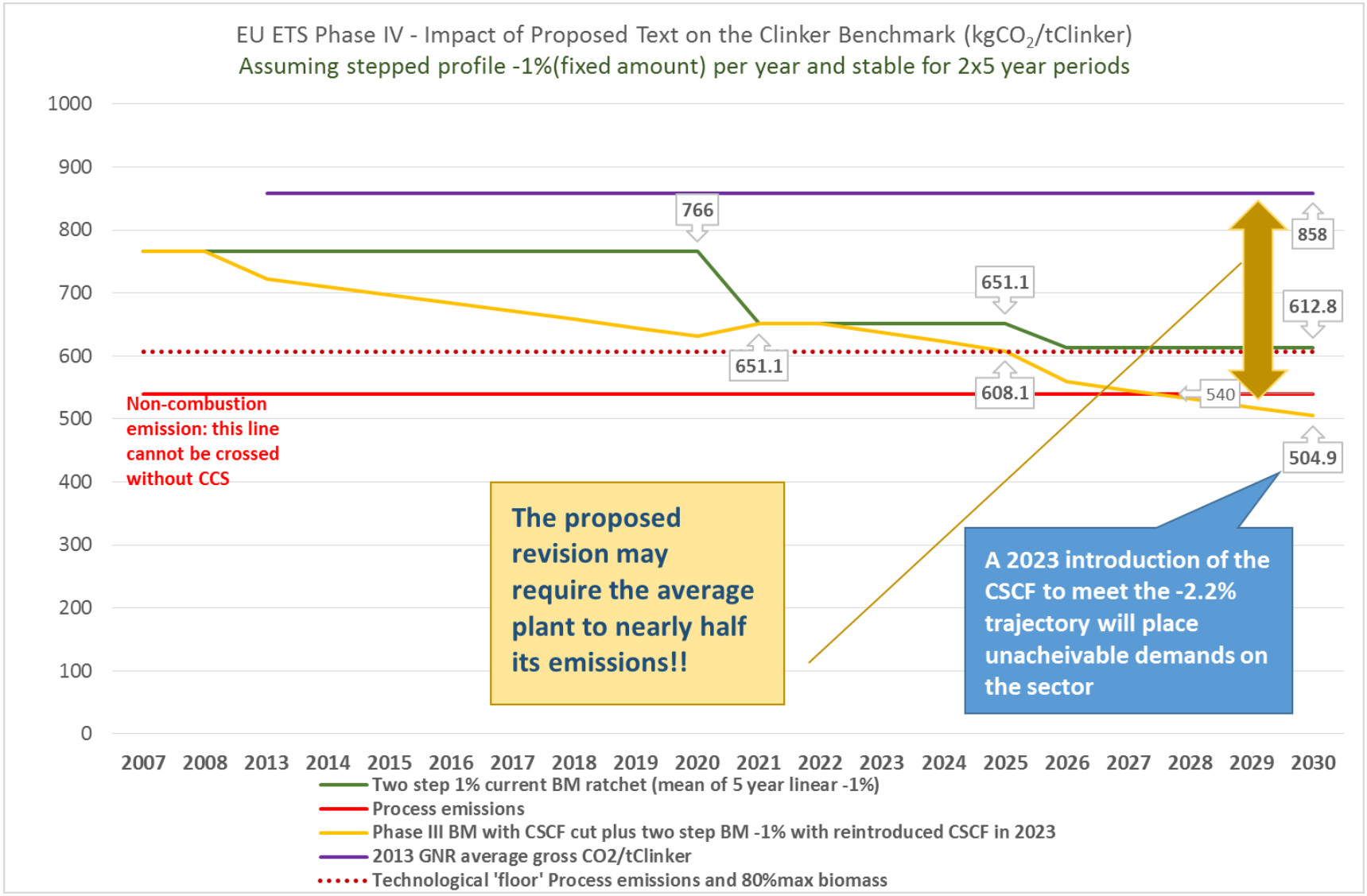
Benchmark review

8. Please could you confirm that the revised benchmark value for each year within the period 2021-2025 will be the same value for each year?
9. In calculating the 'observed average improvement'. Is the improvement taken from the top 10% benchmark plants or all plants in the sector?

HAL determination

10. Please could you give some clarification on which years the HAL will be determined? What impact will it have on the CSCF?

CSCF

11. Please clarify where and how the remaining allowances in the years where the sum of free allocations does not reach the maximum level that respects the Member State auctioning share will be used?

Annex II - Impact of a 1% Clinker Benchmark Ratchet