BRITISH ceramic CONFEDERATION

Federation House, Station Road, Stoke-on-Trent. ST4 2SA
Tel: (01782) 744631 Fax: (01782) 744102
E-mail: bcc@ceramfed.co.uk
www.ceramfed.co.uk

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to: European Commission Feedback on Legislative Proposals
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

from: Dr Andrew McDermott, Technical Director, British Ceramic Confederation
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British Ceramic Confederation Initial Response to the European Commission's EU ETS Phase 4 Legislative Proposal COM(2015)337

I am writing with regards to the British Ceramic Confederation's (BCC) initial thoughts on the European Commission's legislative proposal for EU ETS phase 4[1]. Whilst BCC welcomes the Commission's focus on carbon leakage protection and recognition of the key role that Energy Intensive Industries (EIIs) play in the European economy, we believe the proposal falls short of adequately protecting the UK ceramic sector against the risks of carbon, investment and job leakage. Our main comments regarding the proposal are:

- We support the retention of the binary (i.e. pass / fail) approach to carbon leakage assessment. The introduction of a tiered / differentiated approach would lead to unequal and incomplete protection for sectors at risk of carbon leakage and would introduce major competitive distortions in the EU internal market between sectors on the list and not on the list.
- For sectors at risk of carbon leakage, the mitigation level outlined in the proposal will be incomplete leading to higher costs and increased leakage risks.
- We strongly welcome the retention of qualitative carbon leakage assessments, but are deeply concerned about the introduction of a qualification threshold (at "0.18"). We advocate the removal of this threshold such that the option of a qualitative assessment is open to all sectors and subsectors that do not meet the quantitative threshold of "0.2". In such cases, the risk of carbon leakage would need to be demonstrated by a qualitative assessment of the sector / subsector in question.
- The carbon leakage assessment must not be limited to evaluations at 4-digit (NACE) code level and instead should continue to be made at a higher level of disaggregation where appropriate to do so.
- Free allocation should be based on more recent production levels to reflect real industry performance.
- Fall-back benchmarks should be maintained for sectors with a large range of heterogeneous products.
- We support the development of small emitter opt-out schemes for phase 4 and advocate an increase in the annual emissions threshold from 25,000 to 50,000 tCO_2e.
- We welcome the extension of the NER400 fund to cover industrial innovation and the increase in the co-funding level up to 60%, but further measures are required to support low-carbon innovation.
- Eligibility for financial compensation for indirect costs should be based on total electro-intensity as in the Environmental and Energy State Aid Guidelines (EEAG).

These comments are further elaborated:

[1] COM(2015) 337: 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
http://ec.europa.eu/clima/policies/ets/revision/documentation_en.htm

Ceramic Sector and the EU ETS

The review of the EU ETS Directive is of crucial concern to the ceramic sector. Across Europe, more than 1,200 ceramic installations participate in EU ETS phase 3, representing around 10% of the total number of EU ETS installations, but less than 1% of the total EU ETS emissions. Ceramic sectors in the scheme include manufacturers of clay construction products (bricks, clay roof tiles, and clay drainage pipes), refractories, floor / wall tiles, sanitaryware and other ceramic products. Unlike many other Energy Intensive Industries (EIIs) in the scheme, the ceramic sector is characterised by a high proportion of small emitters and SMEs.

In the UK, there are 54 ceramic sector installations[2] from a range of sectors and subsectors in the main EU ETS scheme or the UK Small Emitter and Hospital Opt-out Scheme. In total, these installations represent around 5,000 jobs.

The global economic downturn resulted in extremely difficult operating conditions and a significant reduction in customer demand across almost all major markets in the ceramic sector. In particular, construction activity and consumer markets slowed dramatically, impacting the production of heavy clay construction products (bricks, roof tiles and drainage pipes) and whitewares (including floor / wall tiles). Indeed between 2008 and 2013, 26 UK heavy clay sites closed permanently (i.e. a fall of over a quarter). The UK recovery started in 2013, especially for those making products used in house building. Heavy clay production increased and a handful of plants were un-mothballed. In recent years, we have seen bricks and clay roof tile imports escalate rapidly to meet rising UK demand. Brick imports are now at unprecedented levels, reaching 22% of total sales in 2014 and still increasing. More investment in new UK manufacturing capacity is now needed at this critical time in the recovery. However, it remains difficult to justify investment in the UK, given the plethora of energy and climate-related issues and costs. The recovery in other subsectors (e.g. refractories) has been much more subdued.

Carbon Leakage Mitigation

Unilateral climate and energy policies create costs for EU / UK industry thereby leading to a risk of relocation to countries with less ambitious (or no) climate policy. The resulting loss of manufacturing not only costs EU / UK jobs but could also give rise to an increase in global energy use and emissions through the use of inferior production processes, more carbon-intensive electricity and greater transportation of goods. In the absence of a binding international agreement, with truly comparable efforts from competing countries (in terms of emission reductions, timescale and enforcement), it is essential that adequate mitigation measures for industry are maintained. Ceramic producers compete in global markets, meaning manufacturers cannot pass through higher unilateral energy or carbon costs without damaging their international competitiveness. We must ensure that the UK is not simply decarbonising by deindustrialising.

The European Commission's legislative proposal introduces a new quantitative carbon leakage indicator[3] with three and ultimately two outcomes[4]. We strongly welcome the Commission's retention of the binary (pass / fail) approach to the leakage assessment. Introducing a tiered / differentiated approach would lead

[2] In EU ETS phase 3, 54 UK ceramic sector installations are in EU ETS:
- Regulated activity = manufacture of ceramic products by firing:
  - 1x NACE 23.20 refractory products.
  - 2x NACE 23.31 wall / floor tiles.
  - 47x NACE 23.32 heavy clay construction products (bricks, clay roof tiles and clay drainage pipes).
  - 2x NACE 23.49 other ceramic products.
  - 1x PRODCOM 23991920 expanded clays and similar expanded mineral materials.
- Regulated activity = combustion of fuels in installations with a total rated thermal input exceeding 20 MW:
  - 1x CPA 081221 kaolin and other kaolinic clays.

[3] Obtained by multiplying together trade intensity and emission intensity.

[4] Indicator exceeds 0.2: sector deemed to be at risk of carbon leakage (i.e. pass)
Indicator between 0.18 - 0.2: sector eligible for a qualitative assessment to determine risk of carbon leakage (ultimately pass or fail).
Indicator below 0.18: sector deemed not be at risk of carbon leakage (i.e. fail)

to incomplete carbon leakage protection for many industrial sectors. In addition, the unequal levels of protection would also distort fair competition in the EU internal market (for example between competing construction product materials); an outcome which would paradoxically favour those sectors with higher carbon emissions.

Provisional estimates indicate that some ceramic sectors (including refractories, sanitaryware and floor / wall tiles) are likely to meet the 0.2 quantitative threshold. However, under the proposal, free allocation to such sectors would be severely limited and declining. Mitigation would be incomplete, leading to operators facing significantly higher carbon costs and hence increased leakage risks. Even the most carbon-efficient installations would be exposed. This raises serious concerns about the ability of such sectors to remain internationally competitive and attract investment to UK operations.

We believe post-2020 carbon leakage mitigation measures should be in line with the adopted level of ambition. The more stringent 2030 climate targets (-43% vs. 2005 levels for EU ETS sectors), steeper emissions reduction pathway (-2.2% annual cap reduction), the existence of the Market Stability Reserve and foreseeably higher energy, carbon and other environmental costs (such as complying with the Industrial Emissions Directive) will all intensify leakage risks, necessitating the need for stronger carbon leakage mitigation measures. The -43% headline target exceeds what we believe is technically possible in the ceramic sector even after making favourable assumptions on major technology breakthroughs and available funds for implementation. This is echoed by the trajectories in the recent UK Government / ceramic industry decarbonisation roadmap[5]. In common with other industrial sectors, we call for all EIIs to receive full protection at level of realistic benchmarks.

BCC strongly welcome the retention of qualitative risk assessment in the European Commission's proposal. Quantitative criteria are too narrow and do not take into account all the factors that can contribute to the risk of carbon leakage. As such, they do not enable a comprehensive picture of the complex market situation for a given sector to be established. For instance, they do not take into account the technological limits of the sector, its ability to pass-through carbon costs or of profit margins which act as a potential indicator of investment capacity. Furthermore, quantitative assessments are solely backward looking, whereas qualitative analysis can add the necessary forward looking elements.

However, we are deeply concerned about the introduction of a threshold (at 0.18) to qualify for a qualitative assessment. This issue is of acute concern to the heavy clay sector (the largest UK ceramic sector in EU ETS)[2]. Using data for 2009-11 (the period used to compile the second carbon leakage list), the quantitative indicator for the heavy clay sector is 0.17 (i.e. just below the qualitative threshold). The required data for 2012 is not completely available in Eurostat yet and so the calculation for 2010-12 is not possible. However an early indication suggests that metric could be around 0.22 (i.e. just above the quantitative threshold). Industrial sectors will not know definitively if they are on the carbon leakage list until the Commission finalises it at the end of 2019, using data from the three most recent calendar years available.

In the meantime, the closeness of the heavy clay sector to the proposed thresholds means there is a very high degree of uncertainty on the outcome. If carbon leakage status is lost, this would have a serious impact on business survival before 2030, let alone the impacts on growth, investment and the competitive distortion in the EU internal market between sectors on / not on the list. BCC estimate that carbon costs to UK heavy clay manufacturers could be around €20 to €70 million per annum by 2030[6]. Such costs would put most UK heavy clay producers in EU ETS out of business. This is stopping the low-carbon investment

[5] Industrial Decarbonisation & Energy Efficiency Roadmaps to 2050: Ceramic Sector https://www.gov.uk/government/publications/industrial-decarbonisation-and-energy-efficiency-roadmaps-to-2050

[6] Assumptions:
- 2030 reference year.
- Current phase 3 installations in EU ETS and UK small emitter opt-out scheme
- Current output rising by 1% per year, resulting in total annual emissions of 835 $ktCO_2e$ in 2030.
- Carbon prices of between €30 and €100 per tCO_2e (later based on a carbon price of £77.66 (real 2014 terms) taken from: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/360277/Updated_short-term_traded_carbon_values_used_for_UK_policy_appraisal__2014_.pdf)
- Installations receive free allocation to cover 15% of total emissions (125 $ktCO_2e$) due to a combination of: i) free allocation at 30% of benchmark, ii) tougher benchmarks, iii) most installations have emissions in excess of the benchmark level and iv) the existence of some form of cross-sectoral reduction factor in phase 4.

required in the UK to generate jobs and extra manufacturing capacity at this critical time in the economic recovery. Meanwhile, it is clear that significant investments are taking place in neighbouring countries outside the EU, particularly in Russia and North Africa. The retention of full carbon leakage status for the heavy clay sector is thus a business-critical issue.

We consider a qualification threshold of 0.18 for qualitative carbon leakage assessments to be unnecessary. Instead, we advocate the removal of the 0.18 threshold; such that the option of a qualitative assessment is open to all sectors and subsectors that do not meet the quantitative threshold of 0.2. In such cases, the risk of carbon leakage would need to be demonstrated by the sector / subsector in question by means of a qualitative assessment. Furthermore, the ability to annually add sectors onto the carbon leakage list should also be maintained to reflect changing market characteristics for borderline sectors.

The Commission's proposal indicates that qualitative assessments should evaluate three criteria: a) extent to which it is possible for individual installations to reduce emission levels / electricity consumption, b) current / projected market characteristics and c) profit margins as a potential indicator of long-term investment or relocation decisions. For a comprehensive assessment, all indicators must be evaluated simultaneously, with no hierarchy between the three components.

In the qualitative assessment, it is imperative that investment leakage is evaluated since this will provide a longer-term, forward looking estimate of carbon leakage. Carbon leakage studies invariably focus on analysing production levels and trade flow patterns retrospectively. However, the impact of EU ETS on EU / UK competitiveness is much broader since it also impacts on decisions for new investments. Consequently, for investments made today, the impact on production levels and trade flow patterns will not become evident until the future.

For some time, BCC and Cerame-Unie (our European ceramic industry association) have been asserting that Gross Value Added (GVA) is not an appropriate indicator to reflect the impact of carbon costs on the competitiveness of a sector, since it comprises of both labour costs and the Gross Operating Surplus (GOS). Average labour costs can represent up to 70% of the GVA for some ceramic sectors and therefore using GVA underestimates the impact. A more representative indication can be obtained by replacing GVA with GOS in the emission intensity calculation. Like GVA, GOS data can also be readily obtained from Eurostat. In the UK, the introduction of the national living wage for over-25s will exaggerate this distortion further. We believe that GOS should be used in the quantitative assessments. At the very least, we call for GOS to be used in qualitative assessments.

In addition, the carbon leakage assessment must not be limited to evaluations at 4-digit (NACE) code level. The NACE-4 classification system has not been drawn up to reflect the characteristics relevant for determining carbon leakage risks. As a result NACE-4 classifications can contain products with vastly different energy and carbon emission characteristics. Limiting the assessment to NACE-4 would discriminate against smaller subsectors, exposing them to the risk of carbon leakage, hampering their competitiveness and introducing business distortion within the EU. The carbon leakage assessment must continue be made at a higher level of disaggregation (i.e. 6-digit Classification of Products by Activity (CPA) code level or 8-digit Prodcom code level) where subsectors can demonstrate different characteristics exist than for its broader NACE-4 classification. Kaolin and expanded clay producers are adversely affected by the proposals as their current leakage assessment is based on a 6- or 8-digit code level evaluation.

Activity Levels

For phase 4, the free allocation methodology should be based on more recent production levels to reflect real industry performance. This would: i) allow companies expanding or restarting production to avoid an allowance shortage, ii) help prevent over-allocation in the case of recession, iii) help prevent under-allocation during economic recovery, iv) stop rewarding EU ETS participants for moving production overseas and v) ensure simplified and fairer rules with respect to new entrants, capacity increases, capacity decreases, plant rationalisation and partial cessation.

Therefore we welcome the Commission's proposal to move somewhat in that direction by setting free allocation for five years at a time (i.e. 2021-25 and 2026-30) to better align free allocation with actual production levels. The accompanying impact assessment indicates that the production level to be used in the two periods will be based on historic production in 2013-17 and 2018-22 respectively. We would welcome further clarity on the base year periods which will be used for determining production levels.

We note the Commission's proposal allows installations to obtain additional free allowances (from the new entrants' reserve) for significant production increases (which contrasts to the current rules where an increase in allocation can only be obtained if new physical capacity is built). However, whilst we strongly support the principle of a reserve for growth, we anticipate little benefit from the Commission's proposal since a minimum production increase of 50% would be required. In order to deliver genuine benefits to industry, a lower minimum threshold should be considered.

Benchmarks

With regards to the benchmark updates, we are surprised that the Commission's proposal makes no mention of the fall-back approach to free allocation. The fall-back approach is required for those processes not covered by a product-specific benchmark.

The ceramic sector uses numerous raw materials, firing temperatures, firing times, kiln sizes, kiln types and energy sources in order to produces a diverse range of products for a multitude applications, markets and customers. As a result, products can exhibit significant variations in their carbon intensity, even within the same industrial classification code. Consequently, the fall-back approach to benchmarks is required for the more heterogeneous facets of the ceramic sector, such as refractory and wall / floor tile manufacturing. It is essential that the fall-back approach is maintained where it is technically inappropriate to use product-specific benchmarks, since an inappropriate treatment will dramatically raise the risk of carbon leakage. We would welcome urgent clarification to confirm that the fall-back approach to free allocation will be maintained in EU ETS phase 4.

Furthermore, for installations utilising the fall-back approach, it is important that the use of more recent production data does not penalise installations that implement energy / carbon efficiency measures.

Small Emitters

As noted above, the ceramic sector is characterised by a high proportion of small emitters and SMEs. In the UK, of the 54 installations within the scheme, 39 were eligible and 27 actually participate in the current small emitter opt-out scheme (i.e. half of the total EU ETS installations).

Naturally, we welcome the Commission's proposal that continues the Member State option to offer smaller emitters the possibility to opt out of the main EU ETS scheme and into national measures with an equivalent level of emission reduction. We believe it is essential to develop simplified methods for monitoring, reporting and verification for small emitters to ensure that the regulatory and cost burdens are not disproportionate. Furthermore, we believe that additional simplification is possible over and above that which exists under the existing scheme.

In order to ensure that all small emitters and SMEs have the opportunity to participate in the small emitter opt-out scheme, we support a widening of the annual emission qualification threshold from 25,000 up to 50,000 tCO_2e. This would ensure that all EU ETS category A installations are treated as small emitters. This approach would be entirely consistent with the new Commission's objective of reducing EU bureaucracy and focusing only on the bigger priorities. According to 2013 data, around 13,540 installations reported emissions below this threshold. They represented around 84% of the total number of ETS installations (16,200) but only 5% of total emissions (95m tonnes vs. 1.75bn tonnes). Therefore, extending the opt-out possibility to such installations would allow the administrative burden to be significantly reduced without undermining the overall environmental objective

A harmonised EU-wide small emitter opt-out scheme has many attractions, primarily the avoidance of disproportionate costs and administrative burdens for all small emitters across all Member States. However, should this not be possible, BCC would be content with a national level opt-out scheme, providing this offered genuine benefits to UK small emitters.

Innovation Fund

As demonstrated in the Ceramic Industry Roadmap 2050[7] and the recent UK Government / ceramic industry decarbonisation roadmap[5], the contribution of the sector to ambitious long-term emission reductions is critically dependent on the availability of breakthrough technologies that increase industrial energy and carbon efficiency at affordable implementation costs. The high risks associated with investing in unproven technologies, the high level of resources required and the long timescales involved mean that individual companies or sectors are highly unlikely to act in isolation. Tangible EU / UK support to incentivise more-difficult technological breakthroughs is essential, including funding (or co-funding) for industrial research, development and demonstration of pre-commercial technologies. There is a need for breakthrough technologies to come to market very quickly given the need to attain long-term decarbonisation targets, coupled with the long lifetime of ceramic plants (typically 40 years).

BCC therefore strongly support the extension of the NER400 programme to cover low-carbon innovation in industrial sectors (in addition to power-generation CCS and innovative renewables which are currently covered). For industrial innovation, the NER400 fund should be technology-neutral and be used for developing a portfolio of decarbonisation technologies, including those identified in the Roadmaps. Support for industrial low-carbon innovation must stretch beyond CCS.

Furthermore, we welcome the Commission's proposal to increase the level of co-funding from 50% to 60% and the extension of funding allocation to pre-determined project milestones other than verified emissions reduction. To maximise emissions reductions and buy-in from industrial sectors, further increases in the level of co-funding should be considered.

Given industry already contributes significant revenues through EU ETS auctioned allowances, increased electricity prices and other environmental taxation, there is a role for (at least) some degree of revenue recycling to support low-carbon development in energy intensive sectors.

Indirect Cost Compensation

Regarding indirect carbon costs (which arise due to carbon costs being passed on in the price of electricity) the Commission's proposal leaves the phase 3 approach largely unchanged. Member States have the choice to provide partial financial compensation to a very limited number of sectors / sub-sectors defined in Annex II of the EU ETS State Aid Guidelines[8]. The UK Government has committed to compensate the listed sectors for the indirect costs of EU ETS (and the unilateral UK Carbon Price Support) until 2019-20. However, the Annex II list (which is based on trade and indirect carbon intensity) does not include any ceramic sectors. The sector has some unique, highly electro-intensive processes, such as those making technical ceramics and refractories in electric arc and induction furnaces at over 2000 °C, but the sectors do not qualify as a whole. Whilst these sites are not in the EU ETS, they are subject to rising EU ETS indirect costs on their electricity bills. BCC has already identified several highly electro-intensive ceramic businesses that have recently relocated some operations outside the UK, with the loss of several hundred highly skilled jobs, in order to benefit from significantly lower electricity costs elsewhere in Europe (such France and Germany). Over next number of years, the impact of carbon costs on their electricity prices will escalate dramatically as power generation sector decarbonises. This anomaly must be urgently addressed.

7 Paving the Way to 205: The Ceramic Industry Roadmap
http://www.cerameunie.eu/en/news/the-ceramic-industry-roadmap-to-2050

8 Guidelines on certain State aid measures in the context of the greenhouse gas emission allowance trading scheme post-2012
http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52012XC0605(01)

The eligibility assessment for financial compensation for indirect costs 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. We propose that eligibility should be based on total electro-intensity as in the Environmental and Energy State Aid Guidelines (EEAG) in order to extend the list to cover all sectors and sites susceptible to carbon leakage due to indirect emissions costs.

Furthermore, there also needs to be ongoing assessment of sector eligibility for indirect compensation throughout phase 4, otherwise this strongly disincentives high temperature sectors to move away from fossil fuel derived heating to low-carbon electric heating.

The above views are the UK ceramic sector's initial response to the Commission's proposal. We would welcome continued dialogue on this critical topic as we proceed with a more in-depth analysis, wider member engagement and as the EU ETS reform debate develops over the coming months. Please feel free to contact me if you require clarification on any of the above information.

Dr Andrew McDermott
Technical Director
andrewm@ceramfed.co.uk