Feedback 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"

Norsk Hydro ASA is a global aluminium company with production, sales and trading activities throughout the value chain, from bauxite, alumina and energy generation to the production of primary aluminium and rolled products as well as recycling. Based in Norway, the company is active in more than 50 countries worldwide but has a strong European presence. About two-thirds of our 13,000 employees work in Europe.

Aluminium production falls under the scope of the EU ETS since 2013.

Hydro is listed in the Transparency Register under the number 45060553191-59.

Introduction

The EU ETS is a key element to achieve the EU's ambitious climate targets. The ETS Directive shall create the necessary legal framework implementing the principles set out by the European Council in October 2014, including carbon leakage measures[1].

Hydro appreciates the intention of compensating the effects of the ETS to safeguard international competitiveness and avoid the carbon leakage risks it creates. Furthermore it is important to promote production growth, industrial innovation and investments. Through this submission, Hydro wishes to express serious concerns that the ETS proposal neither safeguard international competitiveness; nor provide for long term investments or satisfy the predictability, robustness and fairness principles. We will also demonstrate that it is possible to improve the Directive in such way that these targets are fulfilled.

Comments to the ETS Directive proposal

Carbon leakage is an unintended effect of the European emission trading scheme, where the carbon cost cannot be passed on in global product prices. Sectors that are exposed to carbon leakage should be compensated for this cost disadvantage until the carbon cost can be passed on into their product prices.

[1] Carbon leakage principles are set out in 1(2) *"…by further developing predictable robust and fair rules for free allocation of allowance to industry to address potential risk of carbon leakage in adequate manner. The proposed rules aim to safeguarding the international competitiveness of the EU energy intensive industries …… while carbon leakage rules mainly address the compensation for direct carbon costs, the proposal also addresses indirect carbon costs…."*

Furthermore, in the next phase of global climate agreement, Europe needs a straightforward and logical system that other countries may easily accept. Therefore, the system must protect European competitiveness in the global context, leading the way for other schemes to later adopt an ETS.

Primary aluminium metal is globally priced on the London Metal Exchange. European producers are price takers and thus cannot pass any carbon costs on to the aluminum price. At the same time, aluminium production is very electro intensive and the indirect carbon costs passed on into electricity prices by electricity producers, are 6-7 times higher than direct carbon costs.

Direct and indirect emission carbon costs are both a result of the EU ETS; they are equally harmful for competiveness and investments, but treated differently. Direct costs are compensated through free allowances, while the compensation for indirects remains optional (State Aid) and at the discretion of the Member States. Furthermore, both allocation of free allowances and possible State Aid for indirects are limited and thus, not sufficient to compensate up to realistic benchmark levels. Different treatment of direct versus indirect costs lacks any reasonable basis and is in direct contradiction to the aim of safeguarding the international competitiveness of EU energy intensive industries.

Therefore the Commission's proposal needs a significant upgrade to provide predictable, robust and fair compensation in order to safeguard the international competitiveness of European carbon leakage exposed industries and promote industrial growth and investments.

Considering the above, Hydro proposes the following:

1. Indirects compensation should be predictable and full, up to realistic benchmark levels
2. Not fixing the auctioning share at 57%, enabling increased availability of free allowances.
3. Compensation[2] should be based on actual production data
4. Benchmarks[2] should be based on actual data
5. Improve eligibility criteria for the carbon leakage list

1. Indirect compensation should be predictable and full, up to realistic benchmark levels

The carbon costs of the marginal producing technology is passed on into electricity prices (indirect carbon costs), thus creating windfall profits for emission free generation, while on the other hand, a number of sectors that are unable to pass on carbon costs into their product prices will have to carry these costs on their own balance sheet. Compensation for such indirect cost is insufficient, remains optional (State Aid) and at the discretion of the Member States.

Giving compensation for indirect emission costs as State Aid lacks a logical basis. State Aid law is designed to prevent distortion of the internal market by limiting the use of state funds to support certain business, while the purpose of compensation for

[2] Both for direct and indirect carbon costs

indirect emission costs is the opposite: to restore competitiveness of European energy intensive industry. Using State Aid to support businesses in certain sectors across the Union, is therefore not an appropriate measure. First of all, industry exposed to carbon leakage need to be compensated to upheld its international competitiveness. Second, in the case of the ETS, state aid will create an uneven playing field for the same industries across different Member States. In this case, state aid may introduces new distortions to the internal market instead of reducing those caused by the ETS. Industries in all Member States need compensation, but only industry in countries that can afford compensation will get it, and even then, only partial.

The fact that the generation mix vary across the Union, is no proper reason for giving compensation for indirect emission costs as State Aid. European electricity markets are more and more interconnected leading to increasing regional pricing and carbon costs effects. This can easily be handled in an EU-wide compensation scheme.

To obtain equal predictability and equal treatment within Europe, such as for the compensation of direct costs (free allowances), an adequate EU-wide compensation system for indirect emission costs should be introduced through the ETS Directive, fully off-setting those costs for the most efficient installations.

2. No fixing of auctioning share (57%)

The costs of compensating for the direct and indirect effects of the EU ETS should be covered by free allocation or use of auction income before other allocation or use of auction funds. Today, the fiscal element of the EU ETS for Member States is prioritised[3], which is not the intention of the ETS. Maximum free allocation is arbitrarily set as a fixed share of the total cap, and reduced annually by a fixed percentage. The risk of such downscaling due to economic growth etc. may have a very strong effect on the willingness to invest in innovation and technology.

The concept of limiting and declining free allocation for industry is in contrast with the October 2014 Council Conclusions that stressed the need for full protection against carbon leakage. There is not a sufficient amount of free allowances to ensure full compensation up to benchmark level with the proposed fixed share of auctioning volumes. It is moreover contradictory to limit economic growth by limiting the amount of free allocation, while millions of allowances are put into a reserve.

The system for free allocation must be designed in such a way that there is sufficient allocation up to benchmark level without any limitations. The allowances must be divided differently; firstly protecting the most carbon leakage exposed sectors through free allowances and auction revenues, and secondly granting the residual of the annual cap for auction purposes. Furthermore, allowances put into the MSR could be used for compensating indirect and direct carbon costs.

3. Compensation should be based on actual production data

The October 2014 European Council Conclusions request a better alignment of free allocation with changing production levels. The Commission proposal is that an alignment with changing production levels would only happen once every 5 years and with a long time-lag (i.e. 2021-2025 activity level fixed on 2013-2017 data). The time-

[3] the ETS directive page 8 no **4. BUDGETARY IMPLICATIONS** The EU ETS generates significant revenues for Member States' budgets

lag between relevant production and compensation is significant and will not reflect the real dynamics of economic development.

Since production may be reduced without reducing compensation downwards, the ETS system is leading to creation of windfall profits. Furthermore, the incentive to improve efficiency by gradually increasing production, is lost.

In existing aluminium plants, there is a continuous process of reducing unit cost and improving efficiency through investments and improved operational procedures. The production steps created by such “creep” investments will not meet the proposed thresholds.

Producers also need to reduce output when global product prices are low, in particular in high cost plants. Lack of flexibility to adapt capacity or output will accelerate closures. Compensation based on historic production distorts operational incentives in this regard and is thus ineffective in preventing carbon leakage.

The Directive should be improved to avoid windfall profits and give incentives to investments. Compensation should be based on actual recent production data, without any thresholds for production increases/decreases, and without any annual reduction factors.

4. Benchmarks should be realistic, based on actual data.

The aluminium industry is continuously improving performance and agrees that the benchmarks in the current scheme should be updated. However the Commission’s proposal[4] is theoretical and does not reflect reality. The proposed benchmark scheme does not consider the technological progress in the different sectors, including the fact that in some sectors part of the emissions are unavoidable. It might lead to windfall profit for sectors with potential to improve more than 1,5% p.a.

The update of benchmarks should be revised periodically based on actual performance data. Mechanical or automatic reductions should be avoided.

5. Improve eligibility criteria for the carbon leakage list

The proposal regarding the carbon leakage groups keeps the main part of industry emissions eligible for compensation (94% of industrial emissions vs 97% in current phase) will not fulfil the Commission’s target to achieve more targeted carbon leakage measures. The eligibility criteria only partly consider industries’ ability to pass on carbon costs to their customers. Industries facing global pricing mechanism, have no ability to pass on carbon costs into their product prices.

Therefore, the main criterion for eligibility to carbon leakage protection should be the sector’s emission/electricity intensity and its ability to pass on costs into product prices.

[4] 1% yearly decrease as default value from 2008, where 0,5%p.a and 1,5%p.a.might be possible depending on technological development.