FEDIL note on the EU ETS reform and the introduction of a Carbon Border Adjustment Mechanism (CBAM)

September 20th, 2021

FEDIL is glad to share its views on the European Commission's proposals to reform the European Emissions Trading System (ETS) and on the proposal to introduce the Carbon Border Adjustment Mechanism (CBAM).

A life cycle consideration makes it all clear

In the first ten years since introducing the EU ETS system in 2005, the energy-intensive industry, one of the ETS system's target groups, reduced its direct CO2 emissions by over 25%[1]. Moreover, those direct reductions are further leveraged by indirect CO2 reductions that many products of the energy-intensive industry facilitate throughout their lifecycles in many different value chains of the economy.

Let's consider the example of flat glass. Over its life cycle of 40-50 years in a window, high-performance flat glass helps its building reach higher energy efficiencies and avoid heating and cooling emissions. A study by Glass Europe shows that the CO2 emitted to produce an energy-efficient double-glazing window is offset by its energy savings within 6 to 20 months. For the remaining decades of its lifecycle, it generates a more than positive carbon footprint.

The same is valid for steel and concrete. Both materials are essential to the energy transition. Wind turbines, hydropower plants, heat storage systems, renewable energy generation, transmission, and distribution systems that all play a vital role in the energy transition are dependent on high-performance materials delivered by the energy-intensive industry.

At the end of their life cycles, steel, concrete, and glass can be recycled. In a subsequent cycle, they can continue to find use in the same sectors or other ones, such as mobility, construction or renovation. The latter three sectors are currently undergoing considerable changes in their fight against climate change. Those changes are made possible through the energy-intensive industry's products.

The life cycle consideration of the energy-intensive industry's products makes it all clear: The energy-intensive industry is essential to reach carbon neutrality. Therefore, we need to continue producing its products in Europe profitably while gradually transitioning towards carbon neutrality. Carbon leakage protection and the preservation of their global competitiveness, by all means, must thus be our very first priority in reforming the ETS system and the CBAM.

The following paragraphs present ten propositions for the reform of the EU ETS system; it also includes our primary concern regarding the CBAM.

[1] Tomas Wyns et al, Industrial Value Chains, 2019

a. Achieve the climate targets cost-effectively without high additional costs

1. **Ensure cost efficiency within the EU ETS design: no need for rebasing or strengthening the MSR.** A one-off cancellation (rebasing) as suggested by the Commission should be avoided. It will cause the highest possible disruptive impact to the ETS system resulting in higher direct and indirect EUA and electricity prices for the industry and households (through a reduced supply of allowances).

   Rebasing, therefore, works against the cost efficiency of the ETS market. The same goes for strengthening the Market Stability Reserve (MSR) to 24% until 2030; it removes allowances from the market and places them in reserve. Both rebasing and strengthening the MSR increase the carbon costs for the same level of climate ambition, i.e. the ETS cap in 2030 is the same. However, the available allowances throughout phase 4 are reduced. As a result, E.U. manufacturer's competitiveness further deteriorates without direct gains for the climate ambitions.

   The faster and the higher the carbon price increases, the higher the risks of rendering parts of the capital stock (in the energy, transport, manufacturing and building sector) economically obsolete. In the industry, this means that production equipment will be discarded before reaching the end of its economic life. In the short term, potential industrial output will thus decline. At a constant level of demand, inflation will be the consequence; labour will need to be reallocated to different jobs and different places. Such a scenario can be avoided if the carbon price rises slowly and only as high as it is cost-effective to reduce carbon emissions.

b. Protect against carbon leakage to maintain the competitiveness in a global trade

Higher climate ambitions need to be accompanied by strengthened carbon leakage protection and further measures to incentivise low carbon technologies, both by 2030 and beyond.

2. **Adapt the auction share to the decarbonisation progress made in the power sector.** The current 57% auction share is based on the historical share of emissions from the power sector in the total ETS cap. It was defined with data from 2005-2007. Due to the faster than expected decarbonisation of the power sector, their share of emissions in the total ETS cap is, however, declining rapidly.

   As the Commission proposes to leave the (nominal) auction share unchanged at 57% even though the power sector does not need it, the increase in ambition alone (not accounting for other effects such as reduction due to CBAM) will lead to a decrease of ca. 15% of the total amount of free allocation from 2021 – 2030 when compared to the current scenario.

3. **Maintain benchmark-based free allocations and indirect costs compensation as long as Carbon Border Adjustment Mechanism (CBAM) has proven effective.** Free allocations are the tool that addresses the risk of carbon leakage; CBAM is the tool that preserves E.U. companies' international competitiveness while tackling the energy transition.

CBAM effectively addresses emissions embedded in *imports* and incentivises third countries to join EU ETS or introduce their own carbon pricing system. It would help close the competitiveness gap and reach global climate objectives faster. However, at least until CBAM is fully effective, free allocations and the compensation of indirect costs shall continue unchanged to take pressure off E.U. manufacturers who are now facing the E.U.'s higher climate ambitions. The proposal to phase out free allocations for CBAM sectors as of 2026 goes in the opposite direction; it weakens the carbon leakage protection when the effectiveness of the CBAM is still unclear. Both instruments, free allocations, and CBAM are complementary and need to co-exist to help the E.U. industry stay in business while managing the transition.

Making free allocations conditional: Prescribing such conditions seems incoherent and even counterproductive with regards to the ETS and Fit-for-55 objective:

- Incoherent: when considering that free allocations are designed to avoid carbon leakage in the concerned energy-intensive industries. These industries are fighting against losing international competitiveness as they face the additional costs of the EU ETS. Tying the present aid to conditions deprives companies of freely allocating resources most efficiently against losing competitiveness. In other words, conditions tend to neutralise the free allocations' aim of preventing carbon leakage.
- Counterproductive: it may prove to be counterproductive to prescribe energy efficiency (E.E.) measures to achieve the goals of the ETS system. ETS focuses on reducing carbon emissions. In many industries, energy efficiency measures tend to yield only limited emission reductions. Many years of E.E. efforts made those industries already operating on a very high level of efficiency. Significant CO2 reductions as required by the Fit-for-55 are the kind of reduction that usually cannot be found in incremental E.E. measures. Much more radical measures such as switches to low carbon fuels, carbon capture or electrification of heat are required. A condition that would oblige companies to invest in incremental E.E. measures would thus reduce the budgets necessary to invest in more radical CO2 reduction measures.

We conclude that in the absence of a level playing field and the unproven CBAM, it is premature to significantly tighten the ETS, i.e. increasing the LRF while still rebasing the cap and strengthening the MSR. Furthermore, reducing the support by free allocations and making them conditional will significantly increase the exposure of E.U. manufacturers while undermining the objective of Fit-for-55.

4. **Avoid the disproportionate impact of breakthrough technologies on current benchmarks.** The market diffusion of new technologies, in particular radical ones, depends on many external factors. For example, prices and availabilities of low carbon energy such as H2 or other input materials, logistics and storage capacities determine whether and how fast new technology can be deployed in an installation. As a result, their development is gradual and requires time.
Suppose new, low-carbon technologies are included too rapidly in the existing product benchmarks. It could make the maximum reduction rate (1.6%) increase to 2.5% as suggested by the Commission, benchmarks and free allocation could decrease sharply while the diffusion of new technologies is still low. This would reduce carbon leakage protection significantly for conventional processes and weaken incentives to invest in such technologies.

5. **Maintain current rules for indirect cost compensation in all Member States and**

extend it to a larger number of sectors. Like direct costs, indirect costs create a high risk of carbon leakage in sectors exposed to international competition. Thus, like free allocations for direct costs, indirect costs shall be fully offset via harmonised and unconditional rules in all member states.
In the wake of the currently exploding electricity prices, indirect cost compensation should be envisaged not only for currently electricity-intensive sectors. The electrification of heat bears some of the industry's most significant emission reduction potentials to reach the net-zero vision in 2050. The list of sectors able to benefit from indirect cost compensation should thus be extended to those currently relying on natural gas.

6. **Avoid the application of the cross-sectoral correction factor (Use the Market Stability Reserve).** If the number of free allowances changes throughout the period (due to fewer auctioned allowances or production and capacity adjustments) beyond the thresholds fixed in the harmonised allocation rules, it is essential to leave the free allowances in the system. The MSR could be triggered but with the option to reinject allowances in case of higher needs during economic uptake.

7. FEDIL welcomes the Commission's proposal **not to integrate the transport and building sectors into the existing ETS system** but to include them into a separate scheme with different trajectories. The transport and building sectors have different CO_2 abatement costs, price elasticities, and exposure to carbon leakage due to limited or no international competition compared to energy-intensive industries. Therefore, the Commission should not aim to merge those sectors into the industry's ETS system in the future but instead continue to manage them side by side.

8. **Introduce a force majeure clause to avoid the disproportionate impact of external events on free allocation.** The COVID-19 year 2020 affected the emissions and free allocation balance. This situation will impact post-2020 free allocations, both in the first sub-trading period (because the 2-year rolling average adjusted in 2021 and 2022) and in the second sub-trading period (because of the reference to historical activity levels that are based on the average of the period 2019-2023).

c. Support low-carbon investment (R&D, CAPEX, OPEX) into industrial-scale technologies

9. **FEDIL applauds the Commission's proposal to strengthen the Innovation Fund (IF).** The proposals to increase the funding rate up to 100% of eligible costs and introduce contracts for difference are welcome. Yet, to avoid undermining the effectiveness of carbon leakage measures, the increased size of the IF should be financed fully from the auctioning share rather than free allocation.
Furthermore, suppose any free allocation is removed from CBAM sectors and allocated to the Innovation Fund. In that case, it should be used to finance only projects in such sectors, unless there are not sufficient projects in that sector.
Given that the IF's scope is extended to road transport & buildings, distribution should be proportionate to the contribution of each ETS sector.

10. For the majority of the E.U. manufacturing industries, achieving the Fit-for-55 targets are incredibly challenging. This means that relying only on incremental emission reduction measures such as energy efficiency, the substitution of raw materials, circular economy, or even switching to biomass is not enough. An evidence-based

analysis[2] shows that such incremental measures will yield emission reductions between 15-25% by 2050 in most industrial sectors. This leaves a considerable gap to reach the 2030 goals of -55%, let alone climate neutrality in 2050.
The gap can only be filled effectively by deploying, on a massive scale, radically new technologies such as low carbon gases, carbon capture and above all, broad electrification of heat. Governments across the E.U. must succeed in mobilising colossal capital investments in all industrial sectors to kick off this transition. In addition, they must be willing to absorb significant parts of the increasing operational costs that will follow the transition. A significant reform of E.U. state aid rules is thus necessary. It must incentivise investments in the electrification of heat and the introduction of other radical technologies and compensate for their extra operational costs. Therefore, Luxembourg must seek like-minded allies among the Member States to introduce a significant reform to revise the Energy and Environmental State aid guidelines (EEAG). Without a reform of the state aid guidelines, the ambitions of the Fit-for-55 packages might be very hard to materialise.

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[2] Benelux-Business-Round table expert workshop, 2021