

Revision of the EU Emissions Trading System

Recommendations for a revision that supports low-carbon investments and ensures carbon leakage protection and cost efficiency

Key messages

- Setting a fairer burden sharing between ETS and non-ETS sectors
 - The distribution in the Commission's Impact Assessment envisages a disproportionate target on ETS sectors (-65% emissions reduction vs. 2005 by 2030) compared to non ETS (only -39% vs. 2005)
- Ensuring cost efficiency within the ETS
 - The climate ambition of the EU ETS is defined by the stricter 2030 cap; rebasing (i.e. one off cancellation of allowances) and strengthening of the Market Stability Reserve (i.e. putting more allowances in the reserve) are not needed as they artificially increase the costs for the same level of climate ambition
- Increasing the free allocation share to avoid the cross sectoral correction factor
 - Higher 2030 climate ambition reduces the ETS cap. Yet, the decarbonisation of the power sector (which is the reference of the auctioning share) leaves the room for increasing the free allocation share and avoiding the cross sectoral correction factor
- Effective carbon leakage protection with benchmark based free allocation and indirect costs compensation complemented by an effective carbon border measure
 - Higher climate ambition requires strengthened carbon leakage protection. Even with benchmark based free allocation and indirect costs compensation, EU producers bear unilateral carbon costs, which requires a complementary and effective carbon border measure to address such a gap
- Avoiding undue impact of breakthrough technologies on current benchmarks
 - The application of breakthrough technologies at industrial scale level should not reduce benchmarks to avoid undermining carbon leakage protection for the entire sector
- Indirect cost compensation at benchmark level in all Member States
 - All activities in the steel value chain (including iron ores and industrial gases) need indirect costs compensation in all member states due to the high carbon leakage exposure
- Using the Market Stability Reserve to avoid the application of the cross sectoral correction factor
- Avoiding the integration of transport and buildings into the existing ETS
 - Transport and buildings have much higher carbon abatement costs (up to 250€/t CO₂) and are not exposed to international competition; hence, they require dedicated, separate policy instruments
- Focusing ETS revenues on industrial decarbonisation technologies
 - ETS revenues should fund the development and roll out of low carbon technologies in industry
- Strengthening the Innovation Fund with more allowances from the auctioning share to support industry's decarbonisation
- Introducing a *force majeure* clause to avoid undue impact of external events, such as the COVID pandemic, on free allocation
 - Production reductions related to the COVID-19 outbreak should not lead to undue reduction of post-2020 free allocation

Introduction

The European steel industry is committed to contributing to the objectives of the EU Green Deal. Deep emissions reductions in the steel sector are possible through a combination of technological pathways, including steel recycling, carbon capture utilisation and storage, process integration, and electricity/hydrogen-based metallurgy.

At the same time, the steel sector is the most exposed to carbon leakage among all energy intensive industries, as confirmed also in the Commission's Impact Assessment on 2030 targets (in Part 1, pages 79 and 86, tables 16 and 23, and Part 2, pages 111 and 113, tables 47 and 49).

The transformation of the steel industry will require significant investment in the technologies required to decarbonise, but the sector must be able to remain competitive throughout the entire transition and beyond. External factors outside of the sector's direct control have a large impact. One of the most notable of these factors is access to low-carbon energy/electricity and feedstock, as well as CO₂ storage capacity, where available and relevant, at affordable prices.

Considering the additional time required for market uptake, it is essential that the most promising breakthrough technologies are implemented at industrial scale as soon as possible in the coming decade.

At the same time – and in the absence of equivalent carbon reductions and costs by competitors in third countries – higher EU climate ambition should be accompanied by a strengthened mechanism to protect against carbon and investment leakage in sectors that cannot pass on unilateral carbon costs without losing market shares such as steel.

In this context, the EU needs a stable and predictable policy framework that delivers on the climate objectives and preserves the competitiveness of its industrial basis while providing security for planning and investment.

The revision of the EU ETS for the fourth trading period, which was reviewed very recently and just entered into force, is only one element of a mix of instruments that should support a competitive transformation of the European industry with a dedicated industrial strategy. The central objectives of the ETS revision should be to support low carbon investment in industry, carbon leakage protection, and cost-efficient progress towards meeting the agreed climate ambition.

Q1: Setting a fairer burden sharing between ETS (less than 65%) and non ETS sectors (more than 39%)

The 65% target proposed for ETS sectors in the Commission Impact Assessment (IA) entails a relative increase of more than 50% compared to the existing 43%, while the non ETS target would be only 39% (a relative increase of just 30%).

This split results from macroeconomic models (PRIMES-GAINS) that consider the EU economy in isolation, with a focus on coal phase-out in power but no assessment on the carbon leakage risk for Energy Intensive Industries (EIIs). Yet, other models (JRC-GEM-E3) (tables 16-23) do indicate carbon leakage with fragmented policy in such sectors, and steel in particular.

The impact assessment recognises a widely divergent abatement potential in power ($\pm 70\%$) and industry ($\pm 20\%$) by 2030. Hence, a 65% target for all current ETS sectors is disproportionate and should not be applied to all current ETS sectors. Furthermore, it sharply increases the likelihood of the Cross Sectoral Correction Factor (CSCF), which would undermine the effectiveness carbon leakage measures since it reduces free allocation below the benchmarks level.

Also, the electrification in buildings, transport and industry will likely increase power's emissions under ETS. Most importantly, the limited increased target for non ETS sectors does not provide a fair incentive on such ETS sectors, since it overlooks the impact of upcoming initiatives in buildings and transport (renovation wave and mobility strategy) and the need to accelerate emission reductions in these sectors (which have been lagging behind in the last decades) in view of decarbonising them by 2050.

Accordingly, the implementation of climate targets needs to be based on a holistic, transparent and reliable planning taking international competition fully into account.

Q2: Ensuring cost efficiency within the ETS (avoiding rebasing and MSR strengthening)

The higher 2030 ambition should focus on non-ETS sectors, which are not exposed to international competition and have been lagging behind in recent decades and need to accelerate their emission reductions by 2030 in view of their decarbonisation by 2050.

If a strengthened ETS is agreed, the decision should prioritise the option that minimises overall direct and indirect ETS costs (on industry but also on households through higher electricity prices) and the impact on sectors highly exposed to global competition such as steel. This decision should consider the effect on the available free allocation (which is the key tool to avoid carbon leakage) and on the carbon price (which is a key indicator to assess the cost efficiency of the decarbonisation path).

One-off cancellation (rebasings) should be avoided because it causes the highest disruptive impact, since it entails higher direct and indirect costs in carbon and electricity prices for industry and households (through a reduced supply of allowances), and raises the likelihood of the application of the CSCF, as confirmed in the upcoming DG CLIMA study on carbon leakage.

This rebasing would therefore work against the cost efficiency of the ETS market, as it increases the carbon costs for the same level of climate ambition (i.e. the ETS cap in 2030 is the same but the available allowances throughout the phase 4 are reduced by the rebasing, which increases the carbon price).

The option of strengthening the Market Stability Reserve (MSR) after 2023 has a similar effect, since it removes allowances from the market and places them in the reserve before cancelling them. More details on the MSR are provided in the relevant paragraph below. If a higher Linear Reduction Factor (LRF) is applied, it should be clearly defined as a temporary measure until 2030 only (and not prolonged after that) and be accompanied by an increase of the free allocation share to avoid the CSCF.

Q3: Increasing the free allocation share to avoid the cross sectoral correction factor (CSCF)

The auction share should be reduced on the basis of more recent emission levels and of the highly divergent 2030 abatement potential between the power sector ($\pm 70\%$) and industry ($\pm 20\%$).

The current 57% auction share was based on the historical share of emissions of the power sector in the total ETS cap, originally defined with 2005-2007 data. Due to the faster decarbonisation of the power sector, their share of emissions in the total ETS cap is declining very rapidly. As an order of magnitude, the 2030 impact assessment (page 48, table 39, annex) indicates that the power sector would represent only around 40% of the ETS cap in 2030. Accordingly, the free allocation share should increase to avoid the application of the CSCF.

Hence, a decrease in the auction cap is justified (since the power sector will need much fewer allowances from auctions) and necessary to ensure effective carbon leakage protection (no CSCF) to energy intensive industries that have much lower abatement potential and high exposure to international competition.

Q4: Effective carbon leakage protection with benchmark-based free allocation and indirect costs compensation complemented by an effective carbon border measure

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

This requires: firstly, free allocation and indirect costs compensation at the full level of realistic benchmarks (i.e. without CSCF and any further reduction). Free allocation should not be conditional, since it is already based on very strict benchmarks and because it is meant to avoid the carbon leakage risk. If not granted (because the possible conditions are not fulfilled), it would mean that such risk will materialise.

Secondly, the rapid implementation of an effective carbon border measure complementing the existing carbon leakage measures is needed to tackle emissions linked to international trade, taking into account also the possible long-term limitations on free allocation due to a declining ETS cap. Even with benchmark based free allocation and indirect costs compensation, EU producers bear unilateral carbon costs, which requires a complementary and effective carbon border measure to address such a gap. A carbon border measure with full auctioning would have a disruptive impact on the EU steel industry and the related value chains, as it would expose EU steel producers and downstream sectors to the full carbon costs, undermining the financial ability

to invest in low carbon technologies and jeopardising the competitiveness of EU exports. More details are available in the EUROFER paper on carbon border measures.

Thirdly, the integration of new measures, such as contracts for difference, to upscale and roll out low carbon technologies is urgently needed to de-risk such large scale investments.

Q5: Avoiding undue impact of breakthrough technologies on current benchmarks

Higher climate ambition requires strengthened carbon leakage protection and more measures to incentivise low carbon value chains.

Benchmark rules, which have been revised very recently, need to take into account that the transition to new technologies, which is highly dependent on externalities (e.g. energy, H₂, input materials, logistics and storage, etc.). This change will be gradual and will require sufficient time.

If new technologies are included too quickly in the existing product benchmarks and the maximum reduction rate (1.6%) is removed, benchmarks and free allocation would decrease sharply, reducing both carbon leakage protection for conventional processes and incentives to invest in such technologies.

Due to the declining ETS cap, free allocation is a transitional measure by nature that will not be appropriate to incentivise low carbon investment that have a long timeframe. Other measures, such as contracts for difference, are required to bridge the funding gap. While retaining business confidential information, we support transparency on benchmarks.

Q6: Indirect cost compensation at benchmark level in all member states

Like direct costs, also indirect costs create a high risk of carbon leakage in sectors highly exposed to international competition such as steel.

Therefore, like with free allocation for direct costs, also indirect costs shall be fully off-set at benchmark level via harmonised rules in all member states. Under no circumstances, harmonisation at EU level shall lead to a further reduction of the maximum compensation level allowed by the recently revised EU ETS State aid guidelines.

On the contrary, it should ensure that all activities of the steel value chain (including also iron ores and industrial gases) receive compensation at the maximum allowed level fully addressing the risk of carbon leakage.

Q8-11: Avoiding the integration of transport and buildings in the current ETS

It is important to focus any possible additional measures on non ETS sectors like buildings and transport. The details of such measures for these sectors need to be optimised for the desired level of ambition.

We do not support the proposal to include in the existing EU ETS sectors resilient to carbon abatement such as transport since they would easily purchase allowances with a limited effect on their emissions, if any. This would complicate their decarbonisation by 2050 and drive up the

ETS carbon price, with a major impact also on sectors exposed to international competition and carbon leakage risk.

Such sectors have very high abatement costs (around 145-250 €/t CO₂ for buildings and around 250 for road transport¹) while they are not exposed to international competition. If it were decided to include them in a cap and trading system in order to increase their effort and regulate them more easily at European level, this should be done with a separate trading system.

Q16-21: MSR as a reserve to avoid the CSCF

The MSR is not meant nor should be used as a proxy for price-support or for climate ambition. Its objective is a proper functioning of the ETS market. It should not be an instrument to artificially increase the carbon price, since that would undermine the cost efficiency of the system, and increase direct and indirect carbon costs as well as electricity prices for the EU society.

The resilience of the carbon price in these months of COVID crisis already indicates the impact of existing MSR as well as the expected increase in climate ambition. Furthermore, the MSR removes allowances from the market regardless of the cause (economic crisis, overlapping policies, emissions reductions, etc.). For these reasons, we do not support a strengthening of this instrument.

The MSR entered into force in 2019 and was agreed in the context of the 40% target by 2030. Any change of the rules would be premature and not based on sufficient evidence. Any assessment needs to take into account not only the possible change in hedging behaviour by the power sector, but also of energy intensive industries, which are exposed to declining free allocation due to reductions of benchmarks.

If any change is taken into consideration, it should be the relaxation of the rules on releasing allowances from the MSR, which could be an instrument to counterbalance the possible increase of carbon prices due to climate ambition, in the challenging context of the COVID crisis that undermines the financial ability of energy intensive industries exposed to global competition such as steel. At the same time, the allowances retained in the MSR should be used as a reserve to avoid the application of the CSCF. Finally, the MSR rules should prevent price increase due to financial speculation.

Q22-23: Focusing ETS revenues on industrial decarbonisation technologies

Considering that renewable electricity technologies are reaching market maturity and that they are already supported by dedicated schemes, ETS revenues should prioritise low-carbon technologies in industry, in order to enable and accelerate their development as well as the roll out and market uptake.

¹ https://www.boell.de/sites/default/files/2020-07/Der-Preis-auf-CO2_Web.pdf

Q24-25: Strengthening the Innovation Fund with more allowances from the auctioning share to support industry's decarbonisation

Due to the sharp decline of emissions in the power sector (which essentially define the auctioning share), the auctioning share can be decreased at the benefit of free allocation and the Innovation Fund. The first call of the Innovation Fund for large scale projects registered applications that required financial support which was 22 times higher than the available budget, which shows that much more financial resources should be mobilised to support low carbon technologies in ETS sectors, and industry in particular. Due to the high technological and economic risks, the current maximum funding rate (60% of eligible costs) is not sufficient to de-risk large scale projects. Hence, it should be significantly increased and the combination of different funding instruments should be better supported by the legal framework.

Q29: Introducing a force majeure clause to avoid undue impact of external events, such as the COVID pandemic, on free allocation

While a comprehensive assessment of this unprecedented and unforeseeable crisis will be possible only in the near future, the coronavirus outbreak could likely have a disruptive effect on production volumes.

According to the existing rules, after affecting the emissions/free allocation balance in 2020, this situation would impact post 2020 free allocation both in the first sub-trading period (as a result of the 2-year rolling average's adjustments in 2021 and 2022) and in the second sub-trading period (as a result of the reference historical activity level based on the average of the period 2019-2023).

As soon as comprehensive data on the full impact of the outbreak become available, we urge the Commission to take the necessary initiatives to ensure that production and emissions reductions related to the COVID-19 outbreak will not unduly reduce the amount of post-2020 free allocation.