Open statement by energy intensive industries on the trilogues for the Fit for 55 package

September 2022

ETS and CBAM trilogue: Last chance to make legislation fit for purpose to achieve industrial transformation, to make the energy transition and to ensure environmental integrity by enabling EU industries to remain competitive in global markets.

The Alliance of Energy Intensive Industries (AEII) brings together the sectors which provide direct employment to around 2.6 million people and make products which are the foundations of critical and strategic value chains for the EU economy and society. We support the objectives of the European Green Deal. Companies in our sectors are investing in concrete projects across a range of technological pathways to deliver deep emission reductions and are switching to alternative energy sources and feedstocks. Yet all these new technologies come with significant additional costs and industry will have to substantially increase their investments to implement them. This represents a tremendous challenge which should not be underestimated but also a unique opportunity to get on track for climate neutrality.

As the trilogues on the Fit for 55 package are starting, the AEII wants to share recommendations for the revision of the Emission Trading Directive (ETS) and the introduction of a Carbon Border Adjustment Mechanism (CBAM).

These negotiations take place in a turbulent geopolitical context. The European Energy Intensive Industries need urgent support to face the energy crisis which will have long-lasting consequences. In the last months, the European industries have experienced uncertainties in energy supply, sky-rocketing energy prices, high inflation, very high direct and indirect carbon costs (at levels which are largely above the price expected by 2030 in the ETS Impact Assessment from the EC) and raw materials shortages. This crisis results in significant production curtailments and business closures and will cause further disruptions in the near future and for years to come. European products are being replaced by imports of often more carbon-intensive products leading to a significant increase in global emissions. High electricity prices are also a major barrier for direct and indirect

electrification as one of the key solutions for transforming the EU industry towards the climate neutrality target.
These developments will jeopardise the UN's climate goals and will increase European import dependency on raw materials and goods.

<u>The trilogues should propose measures that tackle climate change globally by preventing carbon leakage and giving our industries predictability and stability; this is essential to attract investments in decarbonisation and to proceed and succeed with the energy transition, ensuring that EU manufacturing companies would stay in operation and tackle climate change.</u> Measures against carbon leakage are essential until competitors outside the EU face the same conditions and obligations across global markets.

We would also like to stress the importance of ensuring full coherence between the different pieces of legislation in the Fit For 55 package. It is key to carefully analyse the impact of the current crisis, of the inconsistencies between the different legal requirements of the energy and climate related regulations and develop appropriate measures that support effective solutions for emissions in hard to abate sectors.

Against this background, we urge EU institutions to focus on the following elements in view of the upcoming trilogues:

1) **Ensuring the co-existence of an effective CBAM with the current free allocation based on the 10% best performers for those sectors covered by CBAM.** <u>CBAM is a new instrument whose effectiveness in terms of protecting companies from carbon leakage is largely unknown</u>. When the CBAM is introduced, it should co-exist with the current system of full benchmark-based free allocation in a testing period at least until 2030 to evaluate its effectiveness, focus companies' financial resources on low carbon investments, and avoid market disruptions across value chains. As already proposed by the Commission, the CBAM to be paid by importers will be reduced to take into account emissions covered by the free allocation granted to EU industry. Such a system presents the advantage of avoiding any double protection. An abrupt phasing out of free allowances could undermine EU producers' market positions and have disastrous consequences for ETS installations.

   <u>Recommendations:</u>
   1) **Maintain the free allocation at the level of realistic benchmarks at least until 2030 and assess the CBAM effectiveness until then. If it proves effective against carbon leakage, a phase-out of free allowances for EU market production can be envisaged.**
   2) **As a fall-back option, the Council proposal establishing the phasing out of free allowances between 2026 and 2035 with a slower reduction pace at the beginning, although insufficient and challenging, is the most reasonable one on the trilogue table.**

2) **Providing a carbon leakage solution for export and across the value chain for EU industries to remain competitive in global markets**. The CBAM as proposed by the Commission in July 2021 addresses only the "import" side of carbon leakage by striving to equalize carbon costs between products manufactured in the EU (which bear an additional carbon cost, especially when free allocation will disappear) and products imported into the EU.
   <u>However, CBAM as currently proposed completely fails to address the "export" side of carbon leakage</u>. As EU products will become more expensive due to additional carbon costs, their exports will be seriously jeopardised. As a result, EU products will often be replaced on

export markets by more carbon-intensive goods from competing origins with lower climate ambitions, directly undermining the declared objective of CBAM to reduce emissions also outside the EU. To be acceptable, any CBAM proposal must proactively and concretely address the issue of exports.

The Commission claims that any solution for exports that have been proposed so far would be WTO incompatible, but several legal analyses tend to prove otherwise (see e.g. Aegis Europe legal opinion on the subject)[1].

The Council and the Parliament have acknowledged that exports are an issue to address. The Council proposed solution is to ask the Commission to issue a report every two years after 2026. There is a risk that such an assessment would be conducted too little too late. It would essentially be a "post-mortem assessment" rather than a real solution.

Rather, the Parliament proposal to keep free allocation for the share of production exported outside the EU is more suitable. However, the idea of limiting, after some time, the free allocation to only the 10% best performers in a sector needs to be rejected. By doing so, it would mean that 90% of installations would be at a major disadvantage when exporting their products, with disastrous consequences on the EU climate policy, on the EU trade balance, on jobs and economic prosperity and on global emissions.

Recommendations:
Introduce a sustained mechanism in the CBAM so that EU industries are provided with legal certainty and can remain competitive in global markets, for instance by maintaining free allocation at full benchmark levels for exports (this should not be conditional nor limited in time and always apply to all ETS installations and not be limited to only to the 10% best performers).

3) **Extending the CBAM scope very carefully**: any further extension of the CBAM scope should be done carefully as CBAM might not be the suitable solution for all sectors, depending on their trade flows and the specificities of their value chains. In the case of extending the CBAM scope, an ordinary legislative procedure (co-decision) should be applied. This cannot be done on the basis of a Delegated Acts. Therefore, a full impact assessment should be conducted prior to adding any new sector to the CBAM. The sectors in question should be duly consulted. Regarding the co-existence of free allocation and CBAM, sectors added at a later stage should benefit from the same transitional period as the first sectors. An ordinary legislative procedure (co-decision) should be applied.

Recommendations:
1) **Don't add new sectors in the CBAM without a proper impact assessment on export and value chain and consultation with the sectors.**
2) **Regarding the co-existence of free allocation and CBAM, sectors added at a later stage should benefit from the same transitional period as the first sectors.**

4) **Ensuring realistic benchmarks.** Benchmarks are already very strict, since they are based on the average of the best 10% performers and extrapolated into the future. They should remain economically and technically achievable, taking into account the unavoidable CO2 process emissions. Therefore, the update of product and fall-back benchmarks needs to reflect the gradual transformation of sectors and take into account EU-wide availability of

[1] In this context, it is important to note that free allowances are not a subsidy within the meaning of the WTO SCM Agreement (cf. European Commission's legal arguments in US anti-subsidy investigation on Forged Steel Fluid End Blocks).

technologies, resources (e.g. biomass, electricity and hydrogen) and related infrastructure both for industrial energy needs and CO2 transport and storage. Unrealistic reductions of benchmark values in 2026 should be avoided, considering that alternative technologies and/or underlying energy sources and feedstock are still very limited. The position of the European Parliament is very helpful when it comes to the exclusion of some of the newest installations from driving down benchmarks: in the majority of cases, these plants are outliers, and their performance cannot be realistically reached by other installations (due to a lack of renewable power, green hydrogen, or other inputs and energy and transport infrastructure). Transformation of hard to abate industry needs to be incentivized by promoting new technologies and not penalize them.

Recommendations:

1) **Ensure realistic benchmarks and avoid abrupt changes to the benchmarks and maintain the benchmark update rates at the levels decided at the start of the fourth trading period, namely min 0.2%/year and max 1.6%/year**
2) **support the Parliament solution to address the consequence of potential changes in the definition and system boundaries of existing benchmarks.**
3) **Support the development of appropriate energy and transport infrastructure to enable energy intensive sectors to meet those benchmarks.**

5) **Rejecting any additional conditionality to free allocation**. Free allocation protects the European installations against the risk of carbon leakage and is already conditional to meeting many specific requirements in terms of trade intensity and carbon intensity. Industry is also equally incentivised to reduce its CO2 emissions through the average of the 10% best performers benchmark system. Adding additional conditions, such as implementing recommendations from energy audits (as described in the Energy Efficiency Directive) and/or decarbonisation plans, undermine the reliability of the existing carbon leakage protection measures. Additional conditionality is unnecessary, undermine core ETS market-based functioning, unlevel the intra-EU playing field and would add red tape to an already complex system, making compliance even more complicated for authorities and companies. The Council's position to delete any additional conditionality regarding free allocation should be endorsed in the trilogue negotiations.

Recommendations:

1) **Reject any additional conditionality regarding free allocation and support the Council's position.**

6) **Avoiding the application of the Cross-Sectoral Correction Factor (CSCF).** As already widely recognised, industry needs sufficient legal predictability to invest in the climate transition. The application of the Cross Sectoral Correction Factor should therefore be avoided since it reduces free allocation for all sectors below the benchmark level of the 10% best performers. The CSCF could be avoided by increasing the 3% flexibility between auctioning and free allocation shares to 5% (or beyond if required), and/or by using allowances from the Market Stability Reserve (MSR).

Recommendations:

Avoid the CSCF by increasing the buffer between the free allocation share and the auctioning share from 3% to 5% (or beyond if required) and/or using allowances from the MSR.

7) **Preventing stricter rules of the Market Stability Reserve (MSR) and rebasing**: the climate ambition of the EU ETS has already been defined by the stricter 2030 cap through an increased linear reduction factor. A cancellation of allowances (rebasing) and stricter rules of the Market Stability Reserve is therefore unnecessary and should be avoided as they create artificial shortage inflating further carbon and electricity costs for businesses and households. On the contrary the MSR should be used to mitigate the enormous cost increase for ETS installations. Following the European Securities and Markets Authority (ESMA) report on the carbon market, appropriate measures should be investigated to improve transparency and address excessive carbon prices and undue financial speculation.

Recommendations:
Restrain from rebasing the cap and from increasing carbon costs further through the MSR. Rather use the MSR to avoid shortages and relieve pressure on carbon and energy costs. In case rebasing is maintained, dividing the one-time reduction of the cap between 2023 and 2026 as proposed by the Parliament may help reducing the external supply shock to the carbon market.

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