

IndustriAll Europe position paper on the review of the EU Emissions Trading System

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Background

In the context of the European Green Deal, the EU has committed to become the first climate neutral continent by 2050. In order to put the EU on track to reach that objective, the European Commission has proposed to revise upwards its Greenhouse gas emission reduction target for 2030. The European Council of December 2020 endorsed the European Commission proposal for shifting the headline target from at least -40% to at least -55 % (compared to 1990 levels) and to include emissions due to “Land use, Land use change and forestry” (LULUCF) within the objective. The European Parliament is in favour of reducing the EU emissions by -60% by 2030, without including LULUCF. The negotiations are still ongoing and, despite the currently unknown nature of the final 2030 target, the revision of the EU headline emission reduction target entails a revision of the entire EU Climate legislation. To that end, the European Commission is expected to publish a “Fit to 55% package” by June 2021.

The EU Emission Trading System (ETS) which covers circa 40 % of the EU Greenhouse emissions from approximately 11 000 installations in all EU Member states, Norway, Iceland and Lichtenstein as well as from airlines operating within that group of countries is and will be among the cornerstones of the EU climate policy. Therefore, the upward revision of the EU 2030 emission reduction target requires to revise the ETS Directive accordingly. The two main proposals made by the European Commission when it comes to reforming the EU ETS in the context of the - 55 % are expanding it to building and road transport and reducing the cap.

In its Communication *“Stepping up Europe’s 2030 climate ambition. Investing in a climate-neutral future for the benefit of our people”*, the European Commission sees the extension of the ETS as a cost-efficient way to achieve the - 55% emission reduction objective as well as a way to increase revenues for state budgets that can be reinvested in the economy. The details of the ETS expansion proposal are not known yet but according to the European Commission, *“An expanded emissions trading system could be developed as an upstream trading system regulating at the point of fuel distributors or tax warehouses”*. In the same document, the Commission also identifies a series of challenges such as distributional impact or implementation issues.

As far as the strengthening of the cap is concerned, the -55% objective first triggers a discussion on the “Linear Reduction Factor” (LRF). Under the existing 2030 climate and energy package adopted in 2014, emissions covered by the EU ETS have to decrease by 43% by 2030 compared to 2005 levels. To fulfil that objective, the volume of emission allowances available in the system decreases by 2.2% every year. In the perspective of the “Fit to 55% package”, the European Commission has not

communicated any specific number regarding the revision of the ETS headline objective or the revision of the LRF even though both measures will be unavoidable. Complementary measures such as a one-off reduction of the revision of the “Market Stability Reserve” will be explored as well. It should be noted that from 2005 and 2019, emissions covered by the EU ETS have decreased by 35% (33% if only EU 27 is considered). This reduction is mainly driven by reduction in coal use for electricity production (See EEA, ETS 2020 report)¹.

The European Commission is currently preparing its legislative proposal to revise the EU ETS under the “Fit to 55% package”. The purpose of this document is to communicate the industriAll European Trade Union’s perspective on this important debate. We want to frame the discussion in a comprehensive way consistent with the EU industrial strategy and the Green Deal objective of transforming the EU industry to make it climate neutral by 2050².

From that perspective, we believe important to already stress the following elements of context:

- Sectors covered by the EU ETS represent altogether approximately 7,5 million jobs (5,9 million in Energy intensive industries and 1,5 million in energy sectors);
- Those sectors are also key suppliers of other sectors across the economy and are of strategic importance for the EU prosperity as well as for the EU “open strategic autonomy” that has been identified as a crucial policy objective in the aftermath of the outbreak of the pandemic;
- Decarbonisation will not happen in a vacuum and we are in the midst of the worst economic downturn (-6,3 % for the EU GDP in 2020 according to EC Feb 2021 data) which is impacting production levels as well as companies liquidities and investment capacities;
- Many sectors are struggling with competitiveness and trade issues such as dumping, overcapacity and lack or level playing field with main competitors from third countries;
- Breakthrough technologies fit with climate neutrality are looming but their industrial deployment will take some time and requires massive investment

1. A Climate neutral industrial package

The EU ETS does not make an industrial policy. The current cap and trade system is however the main element of the EU policy framework to decarbonise the industry. With other factors, it has been successful in reducing emissions in some sectors but not in others. Whereas emissions from electricity production have significantly decreased since 2005, emissions from other industrial installations have stagnated³. There are various reasons explaining those figures but obviously the current policy framework did not manage to roll out the breakthrough technologies that are needed to transform the EU industry to fit with the climate-neutral objective to be reached by 2050. Even though some

¹ During the same period, emissions from sectors covered by the “effort sharing decision” (Road transport, buildings, agriculture, small industrial installations, waste) have decreased by 10%.

² IndustriAll Europe has adopted a comprehensive position on the 2050 Climate neutrality objective in November 2019: <https://news.industrialall-europe.eu/p/position-papers>

³ EEA, “The EU Emissions Trading System in 2020: trends and projections », <https://www.eea.europa.eu/publications/the-eu-emissions-trading-system-1>

reforms of the EU ETS will have a role to play (see below) a reform of the ETS must be enshrined into a broader industrial strategy that would provide all the key enabling elements that are needed to trigger the necessary transformative action.

In November 2020, industriAll Europe adopted a position on the revision of the EU 2030 climate target that provides the broader picture within which the reform of the ETS should take place⁴. In order to avoid disruptive changes that would threaten industrial value chains and the related jobs, the EU must set up a credible pathway towards the revised 2030 emission reduction. The EU 2030 climate policy framework must be transformative and not disruptive. It must mainly:

- Be based on in-depth sectoral impact assessments to avoid unrealistic 2030 objectives that would undermine the EU industrial basis⁵ ;
- Provide sectoral 2050 “climate neutrality” roadmaps that will identify what industry concretely needs to cope with the 2050 objective and the intermediate revised targets in terms of technology development, infrastructures and skills;
- Strengthen the EU industrial leadership in leading technologies and value chains that are strategic to reach the 2050 objectives as well as to fully tap its job potential;
- Support the uptake of low-carbon industrial products by developing viable business models and by creating lead markets;
- Bridge the investment gap in order to accelerate the roll-out of the required technologies and infrastructures;
- Relax EU State aid rules to allow public authorities to better support the transformation of the industries;
- Ensure a level playing field between EU producers and their competitors;
- Support regions and sectors that are the hardest hit thanks to increased resources for the “Just transition fund”;
- Involve trade unions in the preparation of the review of the EU climate policy and promote workers participation to deal with its consequences for workers at national, regional, sectoral and company level

In 2019, the High Level Group on Energy Intensive industries published its “Masterplan for a competitive transformation of EU energy-intensive industries enabling a climate-neutral, circular economy by 2050”. Among other key industrial stakeholders, industriAll Europe has been actively involved in the preparation of this report that should be used as a basis to design this strategy and notably to create lead markets for low-carbon products through appropriate measures (e.g. Public procurements, Contract for differences), to develop further the necessary infrastructures (e.g.

⁴ See industriAll Europe position “Europe’s Green Deal: mapping the route to 2030”: https://news.industrial-europe.eu/content/documents/upload/2020/11/637418363805326269_EN%20-%20Green%20Deal%20-%20Europe's%20Green%20Deal%20mapping%20the%20route%20to%202030.pdf

⁵ The 2018 European Commission “In-depth analysis” in support of the “*Clean Planet for All*” Communication stressed for instance when it comes to the steel sector that “Most of the technologies discussed in this section for deep decarbonisation have a low technology readiness level (TRL)” and will lead to a very significant increase of electricity consumption. See pp. 345-46 : https://ec.europa.eu/clima/sites/default/files/docs/pages/com_2018_733_analysis_in_support_en_0.pdf

Electricity grid, energy and transport infrastructures) or to boost innovation through additional support.

2. ETS emission reduction target and Linear Reduction Factor

The review of the EU climate legislation related to the move to 55 % must be based on 2030 in-depth sectoral impact assessments in order to identify what is achievable in the coming decade in the sectors at stake. It should be kept in mind that many industrial sectors cannot follow a linear emission reduction pathway with current technologies in use. Those sectors will require the roll out of breakthrough technologies to be decarbonized. In the same way, the heavy investments that are needed to transform installations in these sectors require a high level of confidence in technologies that are not often mature yet and 2030 is less than an investment cycle away from now. Hence, any revision of the regulatory instruments impacting a sector should first clarify the readiness level of the possible breakthrough technologies to decarbonize the sector at stake as well as the time and the investment needed to spread their use. The decarbonisation of many sectors will also require massive investment in low-carbon electricity production and related infrastructures. Deciding on the revision of the EU 2030 EU climate instruments without having a clear picture of what is possible in the different sectors might put at risk industrial value chains and the related jobs. Such an approach would be a major strategic mistake that would undermine the EU Industrial strategy.

The EU ETS has a role to play, certainly to further decarbonize power production, but it cannot be seen as the main driver of emission reductions, especially for Energy-intensive industries. Betting on the theoretical assumption that a strengthened ETS would trigger investment through a much higher carbon price, completely overlooks the variety of situations across sectors. According to available studies, putting the EU ETS in line with the 55% scenario would mean bringing the annual reduction of emissions from 2,2 % to 3,7%. Such a brutal modification raises a lot of fundamental questions for energy intensive industries. industriAll Europe will not accept purely ideologic measures that would lead to an ETS disconnected from the reality of many industrial sectors. The EU ETS must be reformed in a way that will avoid disruptive changes for the industry and that will take duly into account the impact of the current economic downturn as well as the already existing competitiveness challenges (overcapacity on global markets, and competition distortion on the EU market due to state-owned enterprises from third countries and foreign subsidies). Time wise, any revision of the EU ETS that would increase the carbon price must be simultaneously accompanied by all the necessary measures to avoid carbon leakage, including a Carbon Border Adjustment Mechanism (CBAM, *see below*).

IndustriAll Europe supports measures reducing price volatility in order to secure a meaningful incentive to invest in technologies that reduce emissions when prices are going down, while avoiding disruptive chocks for the industries covered while prices are dramatically increasing in a short period of time. The review of the Market Stability Reserve should be envisaged in priority to fix this volatility problem since it might make other measures unnecessary. From that perspective, a Carbon price corridor would be an interesting fall-back option to be considered to deal with a too low or too high carbon price but it would make more sense at EU level to ensure a level playing field across Member states and avoid the fragmentation of the system.

3. ETS scope

IndustriAll Europe is not in favour of extending the EU ETS to other sectors as proposed by the European Commission. Carbon pricing can provide an additional incentive to decarbonise sectors such as road transport and building but the EU ETS is not the best vehicle to achieve that objective.

Bringing too many sectors, with completely different features, under the EU ETS might undermine its efficiency (risk of loopholes, lack of clarity on carbon price and cap). Keeping in mind that it has taken 15 years and four reforms to build the current system and that phase IV has only started in January 2021, IAE does not think appropriate to completely revamp it by bringing new sectors that are so different than the ones already in it.

The extension of the ETS could be detrimental to some sectors. Triggering transformative change in sectors such as road transport would require a carbon price at such a high level that it would threaten sectors struggling with tiny profit margins and a fierce competition such as steel and basic metals.

For the sectors to be included into an extended ETS, such as road transport, there is already a set of existing instruments (CO₂ standards, Euro VI, RED to some extent) and bringing ETS on top of them might lead to coherence challenges.

Including road transport and building (and therefore heating) in the ETS will entail distributional consequences detrimental to low-income households, especially in the poorest regions of Europe.

Even though setting up a separate ETS system specific to road transport and building is a sound decarbonisation option that makes more sense than the simple ETS extension, it would require regional differentiation since carbon pricing cannot be the same across the EU given the different contexts and level of prosperity. An affordable energy (especially for lighting and heating) is a key condition of social cohesion and the same is true for mobility. An EU-wide ETS covering road transport and building would increase inequalities whereas some regions are already struggling with high level of energy poverty.

All these reasons are advocating for leaving national authorities taking the lead on carbon pricing for road transport and buildings. The Energy Taxation Directive can provide the basis for a minimum carbon taxation across Europe as well as for the necessary coordination to avoid practices that would be against the well-functioning of the EU internal market.

When it comes to bringing maritime, there is currently no credible alternative to its inclusion into the ETS given the lack of significant progress at international level to provide for a global framework (IMO and UNFCCC) to tackle emissions from the sector. But there is a need to further work on an industrial policy for the ship building sector in order to be able to produce the zero emission vessels and the related fuels that will be needed to reach climate neutrality on time. There is also a need to ensure that it will not be detrimental to the international value chains that require the shipping of goods.

4. Auctioning revenues

ETS auctioning have generated EUR 57 bn from 2012 to 2020, and more than EUR 14 bn in 2019⁶.

Use of revenues should provide additional support for climate action, including for investment to transform the installations in the sectors covered by the ETS. Any reform of the ETS should increase the resources of the Innovation Fund and the Modernisation Fund. The access to those funds must be conditional to commitment to invest and maintain jobs in Europe. In the same way, access to these funds should be in line with the EU initiative to tackle the problems identified in the 2020 European Commission White Paper on “*Foreign Subsidies in the Single Market*”⁷.

Measures to support workers from regions impacted by decarbonisation should also be a priority as well. The ETS reform should lead to earmark auctioning revenues to complement the limited resources of the Just Transition Fund (EUR 17,5 bn for 2021-2027).

The ETS funds must have a role to play to create lead markets for low-carbon products, for instance through the financing of Contract for difference for low-carbon products.

ETS revenues should not be considered as an important own resource for the EU budget or for the repayment of NGEU. ETS must be designed to drive investments towards the cleanest technologies in the concerned sectors and not to generate financial resources that will fill the gap of EU budget. IndustriAll Europe supports other options when it comes to the EU own resources or to promoting a fair taxation across Europe⁸.

5. Carbon leakage

For industriAll Europe, the implementation of a CBAM must accompany the revision of EU climate framework in the context of the fit to 55% package. IAE supports a CBAM that would be WTO compatible and that would ensure a level playing field between EU domestic producers and their competitors on EU and global markets. Linking the CBAM with the ETS Directive revision would be IAE first option since it would give more certainty to deliver on time than options relying on taxation decision making procedures that require unanimity among Member States. CBAM should focus in priority on sectors that are really in need of such a system to limit the risk of carbon leakage. Making a full list would require an in-depth assessment of sectorial business models but sectors with high emissions – energy or process related - and exposed to a fierce competition on EU and global markets should be a priority. Sectors such as steel and basic metal, cement, fertilizers, electricity⁹ would be the most obvious sectors to be covered by the CBAM, without prejudging what the final list might look like. To cope with technological, regulatory and market change, the CBAM should be dynamic and its scope should be regularly reviewed.

⁶ https://ec.europa.eu/clima/sites/clima/files/news/docs/com_2020_740_en.pdf

⁷ https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1070

⁸ See industriAll Europe Manifesto for the 2019 European elections

⁹ The aim is here to avoid the import of electricity produced in third countries from carbon-intensive sources.

To limit the risk of delocalisation of manufacturing activities downstream the value chain, CBAM should also apply to intermediate and finished products. A CBAM that would lead to off shore assembly or finishing industrial activities would be an unacceptable threat to employment in industries and would be in conflict with the EU Industrial Strategy. To reduce administrative cost and keep the system manageable, regarding those goods, the CBAM should only focus on components with a high carbon footprint.

The CBAM should complement existing measures to reduce the risk of carbon leakage. Free allocation of allowances and state aids to compensate the indirect cost of ETS on electro-intensive industries must be kept as long as climate neutral industrial products are not available and competitive. There is a need to know what the CBAM will look like and see what its impact will be in the real world before to decide of a possible system change.

Options to combine CBAM and existing carbon leakage mechanisms should be also explored. If based on similar product benchmarks than the ETS, CBAM can be compatible with a system of free allocation. If importers reaching the benchmark of the 10% best performers are exempted of CBAM and if the other importers must pay an amount equivalent to what domestic producers with similar CO₂ performance would have paid to acquire emission allowances, both EU producers and importers are on an equal footing when it comes to carbon pricing.

It must also be stressed that the system of Free allocation provides some sectoral flexibility to the system since the 52 +2 benchmarks, calculated on the basis of sectoral best performers, adapt the system to the specificities of the various sectors. Phasing out free allocation would end that element of sectoral differentiation. Moreover, the free allocation cushion the impact of the ETS on the competitiveness of downstream industries. Phasing out free allocation means that companies would have to buy through auctioning all their allowances and CBAM would allow them to pass the cost through their customers. With a rising carbon price, a rapid phase out of free allocation would have disruptive impact on the EU industry competitiveness beyond the scope of the EU ETS.

Before changing the carbon leakage protection framework, the impact of the various options on the EU exporting industries must be carefully assessed. The competitiveness of the most important goods exported by the EU (such as Machinery and equipment, Motor vehicles, Pharmaceutical products, or Chemical Products) could be significantly undermined by a brutal end of the free allocation system combined with a sudden increase of the carbon price on the EU ETS.

However, even if a protection against carbon leakage is required, it should not be designed in a way that would undermine the incentive for companies to invest in cleaner technologies. The review of the EU ETS should explore how to make free allocation of allowances and State aids conditional to investment to roll out climate neutral technologies in the EU. Free allocation and state aids must be seen as support provided by public authorities and financed with public money and they should not be granted for free to companies. There should be a counterpart in terms of investment in transforming European industrial facilities to make them fit to climate neutrality as well as in terms of employment guarantees. This should be done in a way that will take into account the variety of

contexts across the EU countries and regions in order to avoid disruptive change in regions and sectors where investment is more difficult to trigger.

Indirect cost compensation must be seen in a broader context than the CBAM debate. Affordable, reliable, and decarbonised energy is crucial for European industries competitiveness. Whatever the drivers of cost increases, member states should be allowed to compensate them, while respecting State aid rules and avoiding fragmentation of the internal market. Electricity prices for industries have increased on average of 9,3% (nominal terms) in EU from 2009 to 2019, with significant differences among member states.¹⁰

IndustriAll Europe requests to design the Carbon leakage framework in a way that will ensure a level playing field and allow for transformative action in the EU and its trade partners. In particular, industriAll Europe opposes solutions that would entail desindustrialisation and job losses in non-EU European Countries. industriAll Europe does not support protectionist measures that would put workers against each other. industriAll Europe supports a fair and regulated trade as well as a climate policy based on just transition aiming at transforming industries while leaving no one behind, in Europe and beyond.

¹⁰ See ACER, MMR 2019 P.18

https://www.acer.europa.eu/Official_documents/Acts_of_the_Agency/Publication/ACER%20Market%20Monitoring%20Report%202019%20-%20Energy%20Retail%20and%20Consumer%20Protection%20Volume.pdf)