

EU Emissions Trading System

EUROFER's recommendations for a revision that delivers higher climate ambition, cost-efficiency, strengthened carbon leakage protection and faster industrial decarbonisation

Our key messages

- The higher 2030 target should be achieved in the most cost-efficient way: the one-off cancellation (rebasings) and strengthening of the Market Stability Reserve cause unnecessary additional costs for EU society that should be avoided
- Higher climate ambition and rising carbon costs require strengthened carbon leakage protection
 - Full benchmark based free allocation and indirect costs compensation need to remain on the basis of today's allocation rules also for CBAM sectors at least until 2030 to allow companies focussing on low carbon investment and to assess the effectiveness of the CBAM
 - Any subsequent phase out after 2030 should be conditional to a monitoring system assessing the effectiveness of the CBAM coupled with an emergency solution to strengthen carbon leakage protection if needed
 - The cross sectoral correction factor should be avoided by increasing the free allocation share and/or by using allowances from the Market Stability Reserve
 - Existing rules on benchmarks need to remain until 2030 to ensure legal predictability. Any possible modification of benchmark definitions to reward low carbon technologies should not reduce prematurely free allocation for existing installations
 - Free allocation should not become conditional to energy efficiency investments to avoid double regulation
 - Unrepresentative production volumes affected by covid pandemic in 2020 should not influence 2026-2030 free allocation
- The Innovation Fund needs to prioritise industrial projects, and auctioning revenues from traditional ETS sectors should not be diverted to new ETS sectors (transport and buildings)
- The legislation needs to recognise the benefits of all carbon capture and usage technologies
- A comprehensive and more realistic assessment of the combined effect of all provisions on carbon leakage risk is needed for a well-informed decision-making process

1. Introduction: legal predictability and a comprehensive impact assessment are essential for investment planning

The revision of the EU ETS, like all other pieces of legislation, should focus on those provisions that are necessary to achieve the higher 2030 target while preserving existing rules that do not affect the target and are essential to provide legal certainty and visibility to companies until 2030 in order to secure investment. As a result of the current legislation, EU companies already face a significant free allocation shortage (usually in the 20%-25% range). Important investment decisions have been made on the basis of the existing regulatory framework and require sufficient time for their full implementation, considering also the timeline of permitting procedures for large projects that often concern not only the steel installations themselves but also the energy infrastructure. Therefore, abrupt modifications of the legislation undermine legal predictability and reliability, and any further reduction in free allocation and overall carbon leakage protection before 2030 will undermine the financial ability to invest in technologies that are essential for the 2050 climate neutrality target.

The EU ETS Impact Assessment, contrary to the CBAM Impact Assessment, does not provide a comprehensive analysis of the impact of the final Commission proposal, since elements of the Directive (e.g. ambition, carbon leakage provisions, Innovation Fund, Market Stability Reserve) have been assessed only in isolation. In particular, it does not present a proper assessment of the impact of the legislation on sectors exposed to carbon leakage risk such as steel. Notably, indirect costs have not been assessed at all and direct costs have been largely underestimated due the following four key reasons:

- The carbon price used in the assumption (see table 45, Annex 4, page 90) starts at 42€ in 2021 and increases to 60€ only in 2030 (while it is above 60€ already now).
- Direct emissions have been underestimated, because the model assumes high reduction rates between 1% and 2% per year for all energy intensive sectors, which do not match the actual trend of the last years (see table 43, Annex 4, page 87). Moreover, investment costs for achieving such high abatement rates have not been estimated.
- Free allocation was overestimated because it was assumed taking into account the existing benchmark rates within the range 0.2%-1.6% (see Annex 4, section 9.2.1 page 82), while the Commission proposal increases the higher range from 1.6% to 2.5%.
- Free allocation was overestimated because it did not take into account the shift of 40 million free allowances to the Innovation Fund that is included in the Commission proposal.

In addition to the above shortcomings, the information concerning the cross sectoral correction factor provided in the Impact Assessment, table 11, page 83 provides only average figures for the period 2026-2030 (88%), while exact annual figures would provide a more transparent impact of the cross sectoral factor in the last years of the trading period. A comprehensive, transparent and

realistic analysis of the combined effect of all provisions on carbon leakage sectors is needed for a well-informed decision-making process.

Considering both the economic and environmental implications of the legislation, the overall priorities of the revision should be:

- Achieving the higher climate targets, including the 2050 climate neutrality, in the most cost-efficient way without unnecessary additional costs;
- Accelerating the implementation of low carbon technologies;
- Providing strengthened carbon leakage protection matching the higher climate ambition.

2. Achieving the higher 2030 target in the most cost-efficient way: avoid rebasing and strengthening of the Market Stability Reserve

The 2030 climate target is set by the total cap on EU emissions under the EU ETS in 2030. The EU ETS cap declines annually according to the linear reduction factor (LRF), which ensures that ETS sectors achieve the 2030 target.

The EU carbon price has already more than doubled since the end of last year as a result of speculative trading as well as expectations of the upcoming higher targets. The final legislative text needs to ensure that the new climate target is achieved in the most cost-efficient way without unnecessary additional costs that impact EU society. Furthermore, the distribution of the overall EU target between ETS and non ETS sectors needs to take into account also the carbon leakage risk of industrial sectors exposed to international competition as well as their recognised limited abatement potential by 2030. The currently proposed targets (61% for ETS sectors and 40% for non ETS sectors compared to 2005 levels) entail an uneven contribution from the two categories.

The one-off cancellation (rebasings) as well as the doubling of the intake rate of the Market Stability Reserve (i.e. 24% instead of 12% until 2030) and the new threshold for cancelling allowances in the reserve (i.e. 400 million instead of the auctioned allowances of the previous year) affect downwards the budget of allowances available during the trading period (i.e. the trajectory until 2030) in the form of disruptive ad-hoc interventions. The sole increase of the LRF until 2030 represents a less disruptive measure that would deliver the 2030 target (i.e. the end point of the trajectory) with a significantly lower impact on the overall trading period. For instance, the closest option to the Commission proposal with rebasing described in the Impact Assessment (option AMB2c) entails an ETS cap with 355 million allowances below the corresponding option without rebasing (AMB2a). This has also an impact on the total free allocation, which is more than 160 million lower than without rebasing; hence, it increases the magnitude of the cross sectoral correction factor.

It should be noted also that the introduction of the MSR as well as the doubled intake rate until 2023 were introduced to address the historical surplus from the previous trading period. Such

issue has been solved by those measures, and the phase 4 cap is being tightened due to the increased 2030 climate ambition; hence, a continued strengthening of the MSR until 2030 in the context of a much shorter carbon market is unjustified.

Therefore, all these measures increase artificially the carbon costs (for EU industry but also for households through higher electricity prices) for the same level of 2030 ambition, since they reduce the amount of available emissions during the trading period.

Furthermore, the inclusion in the existing ETS of another hard to abate sector such as maritime will create a further upward pressure on the carbon price. As indicated in the IA part 1, table 13, page 89, the projected emissions of this sector will be above the proposed extension of the ETS cap (by 28 million per year). Hence, the sector will need to purchase such allowances from the cap that would be available for the other sectors, thus increasing the carbon price.

The combined effect on the carbon price of the higher 2030 ambition, the rebasing, the doubled intake rate of the MSR and the new threshold for cancelling MSR allowances, and the inclusion of the maritime sector should be assessed in detail in order to provide a comprehensive assessment of the impact of the legislation. Since such measures are not strictly needed for the achievement of the new 2030 target, they should be withdrawn in order to avoid artificially higher costs. Furthermore, the revision of the legislation needs to address the increasing role of financial speculation in the EU carbon market and avoid its impacts on compliance operators exposed to international competition.

With regards the proposed technical adjustments to the functioning of the MSR, we support the inclusion of the aviation sector in the calculation of the TNAC (total number of allowances in circulation) since it reflects the actual situation of the carbon market as well as the more dynamic calculation of the intake rate when the TNAC is close to the 833 million threshold.

3. Strengthening rather than weakening carbon leakage protection to match the higher climate ambition and costs: full benchmark based free allocation and indirect costs compensation complemented by the CBAM

3.a. Full benchmark based free allocation and indirect costs compensation are essential measures to mitigate the carbon leakage risk and need to remain also for CBAM sectors

So far, free allocation and, where applied, indirect costs compensation have proved being effective in mitigating the carbon leakage risk to a large extent, although with carbon price levels that were much lower than the current ones.

Higher climate ambition will lead to higher unilateral costs for EU industry, since no comparable carbon constraint is envisaged for extra EU competitors, at least during the transition until 2030.

Therefore, higher climate ambition requires strengthened carbon leakage protection, at least until 2030, in order to secure both industrial competitiveness and environmental integrity. This

can be achieved if full benchmark based free allocation without cross sectoral correction factor and indirect costs compensation in all member states are complemented by an effective CBAM offsetting the remaining costs that only EU producers have to bear.

In order to avoid the application of the cross sectoral factor, the free allocation share should be increased. The existing distribution between auctioning and free allocation (i.e. 57% and around 41%) were based on the historical shares of emissions of power and industry sectors respectively. However, the impact assessment on the 2030 targets indicates clearly that the abatement in the power sector (70% by 2030 vs. 2015) is far larger than in energy intensive industries (22%). This leaves the room for increasing the free allocation share. Similarly, unused allowances in the Market Stability Reserve should be exploited to avoid the cross sectoral correction factor.

The proposal to phase out free allocation for CBAM sectors as of 2026 weakens the carbon leakage protection when such protection is mostly needed due to the increasing carbon price and the required massive investment in low carbon technologies.

Free allocation is already partial and digressive, as it is based on tight benchmarks set by the average of the best 10% installations and further reduced by the cross sectoral correction factor when the ETS cap is too strict.

Even with 100% benchmark based free allocation according to the EU ETS rules before the ongoing revision, the EU steel industry will have an allowance shortage of 600 million tonnes in the period 2021 to 2030 resulting in a cost burden of € 36 billion at a carbon price of €60, or € 55 billion if the carbon price increases linearly to € 100 by 2030. During the transition, and at least until 2030, the CBAM needs to complement 100% benchmark based free allocation instead of the gradual and irreversible phase out mechanism proposed by the Commission. Any subsequent phase out after 2030 should be conditional to a monitoring system assessing the effectiveness of the CBAM coupled with an emergency solution to strengthen carbon leakage protection if needed. This is essential for the following reasons:

- The effectiveness and WTO conformity of the CBAM needs to be fully tested and ensured before reducing irreversibly the existing measures, even gradually. With the Commission proposal, the CBAM entails financial costs for EU importers only as of 2026, when the free allocation phase out starts. Furthermore, major elements of the design (default values, boundaries of embedded emissions, etc.) will be set only at a later stage in secondary legislation. Finally, the proposal does not provide any solution for circumvention risks like resource shuffling and costs absorption. Hence, there is no possibility to assess the actual impact of the CBAM before reducing the free allocation.
- The transition towards low carbon technologies will be gradual and most of the promising low carbon projects are expected to deliver significant emissions reductions around 2030. If free allocation is reduced significantly before 2030, and considering also the increased

carbon price, EU steel producers will be exposed to much higher compliance carbon costs, which will be extremely difficult to recover from the product prices due to the uncertain ability of the CBAM in delivering a truly level playing field. For instance, increased EU steel prices resulting from higher carbon costs will also create new business opportunities for importers that are currently not competitive in the EU market due to their cost structure and the EU market price. In such a situation, the financial ability of EU producers to invest in low carbon technologies will be undermined exactly when it is needed the most. On the contrary, once low carbon projects in the EU will have delivered significant emissions reductions, the exposure of EU producers to carbon costs will diminish and the free allocation phase out will have a less disruptive impact.

- In the absence of a solution for exports, as the Commission proposal stands, the phase out of free allocation would be a major threat to exports' competitiveness.
- The free allocation phase out for CBAM products exposes inevitably downstream sectors to increasing costs and distorts competition with sectors that are not subject to the CBAM.
- It is clearly possible to design a WTO compliant carbon border measure that complements full benchmark based free allocation in a transition period; hence, there is no WTO legal obligation to reduce or phase out free allowances.
- A CBAM complementing full benchmark based free allocation at least until 2030 would also reduce the direct impact on trade flows because importers would have to pay a lower levy. This would mitigate trade tensions as it would provide a longer transition for negotiations with international partners to align climate ambition.

3.b. Existing rules on benchmarks need to remain until 2030 to ensure legal predictability

The overall framework needs to balance properly the two objectives of securing carbon leakage protection and incentivising low carbon technologies. Both objectives should be prioritised, ensuring that the one does not undermine the other.

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

The proposal to modify product benchmarks (e.g. possible inclusion of low carbon technologies) in secondary legislation without more precise legal provisions in the Directive creates major uncertainty. This is also because such changes would take effect in 2026 (with a likely significant downward impact on free allocation levels) but would be set very shortly before (around 2025). Such timeline is counterproductive for investment planning since it overlaps with long investment cycles, some of which have been launched very recently.

In particular, if new technologies are included too quickly in the existing product benchmarks and the maximum reduction rate (1.6%) is increased to 2.5% as proposed by the Commission, benchmarks and free allocation would decrease sharply for the entire sector (50%) when such technologies represent still a minor percentage of the market (because benchmarks are set by the lowest 10% emitting installations -which is a very limited number of installations, e.g. in the case of primary steel around 2.5 installations out of 25). This would reduce prematurely carbon leakage protection for the entire sector and increase the risk of higher imports from third countries more than incentivising such technologies in the EU.

Similarly, the proposal to increase the maximum annual reduction rate of benchmarks from 1.6% to 2.5% (i.e. by 50% instead of 32% for the period 2026-2030) would reduce drastically carbon leakage protection in sectors that are still highly exposed to the carbon leakage risk but show decreasing benchmark values due to specific circumstances that are not directly connected to technological improvement within the sector, notably: the fall back fuel benchmark, where some installations in some sectors have access to biomass which is restricted for all other installations, as well as the exchangeable benchmarks like the electric arc furnace steel benchmarks, where the reduction of the benchmark value is due to the decarbonisation of the power sector rather than to the technological improvement within the steel industry.

Therefore, existing rules on benchmarks definitions and update should be maintained until 2030. If any modification of benchmark definitions is introduced to reward low carbon technologies, this should not reduce prematurely free allocation for existing installations included in the benchmark curves.

3.c. Free allocation should not become conditional to energy efficiency investments to avoid double regulation

The proposal to make free allocation conditional to energy efficiency investment may have counterproductive effects, both on industrial competitiveness and environmental integrity.

Firstly, free allocation is already subject to very strict rules, since it is set at the level of the average best 10% installations, thus creating a strong incentive to reduce emissions on the entire sector. Secondly, making free allocation conditional to further investments is not consistent with its essential objective (i.e. avoiding carbon leakage). If now free allocation is made conditional to additional measures to be taken by the company (i.e. investments in energy efficiency), de facto it is not anymore a (partial) mitigation of unilateral carbon costs because it requires additional expenditure to the company. As the eligible sectors are acknowledged as being at risk of carbon leakage, the missed allocation would create the conditions for the materialisation of such risk, leading to an increase in global emissions.

Thirdly, the requirement focused on energy efficiency investments in existing installations may be inconsistent with the pathway towards climate neutrality, which in some cases requires the

conversion of the site to breakthrough technologies rather than incremental efficiency gains of existing ones. Fourthly, a consistent regulatory framework should avoid any overlapping between different pieces of legislation, such as the EU ETS and the Energy Efficiency Directives.

3.d. Unrepresentative production volumes affected by covid pandemic in 2020 should not influence 2026-2030 free allocation

The revision of the Directive offers also the opportunity to adjust specific provisions of the secondary legislation that risk having unintended effects. According to the current rules, free allocation for the period 2026-2030 will be based on the average production levels in the period 2019-2023. This will penalise EU companies which had unrepresentatively low production in 2020 due to covid pandemic. A targeted clause should be introduced so that 2020 production does not impact the calculation. Furthermore, existing rules on activity level changes for exchangeable benchmarks should avoid unintended downwards effects on free allocation of energy and/or carbon efficiency measures.

4. Promoting low carbon technologies with ETS revenues

The proposals to increase the funding rate up to 100% of eligible costs and to introduce contracts for difference are welcomed steps. Yet, the increased size of the Fund should be financed fully from the auctioning share rather than free allocation in order to avoid undermining the effectiveness of carbon leakage measures. Contracts for Difference should be more substantiated in the Directive as an integrated measure to incentivize investments in the EU, e.g. by introducing a provision which would provide that CCfD funding will actually close any gap between the full production cost (CAPEX and OPEX) and what the market is willing and able to bear.

Since the innovation Fund is also extended to the transport and buildings sectors, it should be ensured that auctioning revenues from traditional ETS sectors such as industry are allocated to them rather than being diverted to new sectors.

Furthermore, if any free allocation is removed from CBAM sectors -which we object to- and allocated to the Innovation Fund, it should be used to finance only projects in such sectors, unless there are not sufficient projects.

In order to ensure legal certainty and investment planning, any modification of eligibility rules should not have retroactive effect on projects that have been recognised as eligible for EU funding.

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. This shows that much more financial resources should be mobilised to support the transformation of hard to abate industrial sectors in order to reach carbon neutrality. Therefore, in addition to the Innovation Fund, all revenues raised from the EU ETS should be reinvested in ETS sectors, in particular in

hard to abate industrial sectors. Other financial mechanisms might also be developed to tackle the challenges of industrial decarbonisation.

5. Recognising the benefits of all carbon capture and usage technologies in the legislation

The proposal exempts from the surrendering obligation only GHG emissions that are captured and utilised to be permanently chemically bound in a product. Other CCU applications would remain subject to the surrendering obligation. The overall environmental benefits of capturing and re-using carbon should be acknowledged and thus the compliance obligation should be on the operator finally realising emissions rather than on the industrial installation capturing them.