February 16

Consultation on revision of the EU Emission Trading System (EU ETS) Directive

Fields marked with * are mandatory.

Introduction

On 24 October 2014, the European Council agreed on the 2030 framework for climate and energy [1], including a binding domestic target for reducing greenhouse gas (GHG) emissions of at least 40% in 2030 as compared to 1990. To meet this target, the European Council agreed that the emissions in the EU Emission Trading System should be reduced, compared to 2005, by 43%. A reformed EU ETS remains the main instrument to achieve the emission reduction target. The cap will decline based on an annual linear reduction factor of 2.2% (instead of the current 1.74%) from 2021 onwards, to achieve the necessary emission reductions in the EU ETS. The European Council furthermore gave strategic guidance on several issues regarding the implementation of the emission reduction target, namely free allocation to industry, the establishment of a modernisation and an innovation fund, optional free allocation of allowances to modernise electricity generation in some Member States.

The strategic guidance given by European leaders on these elements will be translated into a legislative proposal to revise the EU ETS for the period post-2020. This constitutes an important part of the work on the achievement of a resilient Energy Union with a forward looking climate change policy, which has been identified as a key policy area in President Juncker's political guidelines for the new Commission.

The purpose of the present stakeholder consultation is to gather stakeholders' views on these elements. This consultation focuses on issues not yet addressed in the consultations recently conducted for the 2030 Impact Assessment[2], the Impact Assessment for the carbon leakage list for 2015-2019[3] and the consultation conducted on post-2020 carbon leakage provisions[4].

In order to take stock of the EU ETS (established by Directive 2003/87/EC) as a policy measure, this consultation also contains questions concerning the general evaluation of this policy measure. The questionnaire consists of 7 chapters. You are invited to answer questions on the chapters which are relevant to you.

Registration

0.1. What is your profile?*

- (●) Business
- ( ) A small and medium enterprise
- ( ) Trade association representing businesses
- ( ) SME business organisation
- ( ) Government institution/regulatory authority

- ○ Academic/research institution
- ○ Non-governmental organisation
- ○ Citizen
- ○ Other

0.2. Please enter the name of your business/organisation/association etc.:*

European Aluminium Association

0.3. Please enter your contact details (address, telephone, email):*

Erich Cuaz,

Director for Public Affairs and Communication

cuaz@eaa.be

+32 2 775 63 59

0.4. If relevant, please state if the sector/industry you represent falls under the scope of the EU ETS:*

- ◉ yes
- ○ no
- ○ not relevant

0.5. If relevant, please state what sector your represent:*

- ◉ Energy-intensive industry
- ○ Energy sector
- ○ Other

0.6. The results of this stakeholder consultation will be published unless stated otherwise. Can we include your replies in the publication?*

- ◉ yes
- ○ no
- ○ partially

0.7. Register ID number (if you/your organisation is registered in the Transparency register):

9224280267-20

1. Free allocation and addressing the risk of carbon leakage

The European Council has concluded that free allocation to prevent the risk of carbon leakage should not expire as foreseen in the current legislation, but should continue also after 2020 as long as there are no comparable efforts to reduce emissions in other major economies.

Extensive stakeholder consultation was already carried out on the post-2020 carbon leakage provisions, as well as on aspects related to innovation support. The process included three full-day stakeholder meetings (June, July and September 2014) and a written consultation conducted for 12 weeks (8 May – 31 July, 2014). The written consultation covered 23 multiple choice questions with space for motivations, and a question allowing respondents to bring up any other issue they felt was important or insufficiently covered.

The documents and minutes of the meetings, as well as the submissions and the analysis thereof in the case of the written consultation, are available on the Commission website.

Information from the stakeholder meetings:

http://ec.europa.eu/clima/events/articles/0090_en.htm

http://ec.europa.eu/clima/events/articles/0095_en.htm

http://ec.europa.eu/clima/events/articles/0097_en.htm

Replies and summary of the written consultation:

http://ec.europa.eu/clima/consultations/articles/0023_en.htm

The results of the above mentioned public consultation are being taken into account in the preparation of the legislative proposal. In order to reduce the administrative burden for stakeholders and the Commission, the present consultation focuses on issues not already covered in this recently finalised public consultation. Respondents are nevertheless invited to add to the replies provided in the earlier consultations if deemed necessary in the light of the conclusions of the European Council in this area.

1.1 The European Council called for a periodic revision of benchmarks in line with technological progress. How could this be best achieved in your view and, in particular, which data could be used to this end? How frequently should benchmarks be updated, keeping in mind administrative feasibility?

EAA supports the allocation of allowances directly linked to realistic benchmarks and actual performance. For each industry, the baseline should then be set by realistic benchmark. The EU should not impose additional requirements that would further disadvantage aluminium producers versus global competitors. Benchmarks must be set at a realistic level as an over-ambitious benchmark will increase costs and disincentive investments, thus increasing the risk of carbon leakage. They must be defined bottom-up, starting from the real performance levels and be based on the 10% best performing installations in the EU.

Technically and economically achievable benchmarks will not only ensure that the most efficient installations in Europe will not face undue carbon costs, as requested by the European Council (2014 October's Council conclusions), but will also duly incentivize the installations to be as close as possible to such benchmarks. Full compensation when such benchmarks are met is absolutely necessary in order to

preserve the competitive position of Europe. Allocation should be linked to actual production, or actual activity levels where fall-back benchmarks apply, in order to provide an incentive for growth and to allow production flexibility through business cycles. Free allocation based on historical values doesn't comply with these objectives. Insufficient compensation reduces the operational margins and the incentive to keep the production equipment in good operational conditions and to invest in new and more efficient technology.

1.2 The European Council has defined guiding principles for the development of post-2020 free allocation rules which provide inter alia that "both direct and indirect costs will be taken into account, in line with the EU state aid rules" and that "the most efficient installations in these sectors should not face undue carbon costs leading to carbon leakage" while "incentives for industry to innovate will be fully preserved and administrative complexity will not be increased" and while "ensuring affordable energy prices". Do you have views how these principles should be reflected in the future free allocation rules?

Europe's market share for total aluminium demand is above 20%, and the world's demand is growing further, notably due to the climate and resource efficiency benefits of using aluminium compared to other materials. Despite this growth potential, Europe is facing a paradox as its production capacity is under threat and Europe's producers are not in the competitive position to accompany such growth in demand. Today, the dramatic decline of primary production (coupled with increasing exports of scrap towards non-EU countries) have made the EU dependent from exports (more than 50% of the metal needed to supply domestic demand). Full compensation for both direct and indirect costs, linked to actual performance and realistic benchmarks, is a sine qua non condition for addressing the risk of carbon – and investments - leakage.

No other industries are more electricity intensive than the primary aluminium industry, for which these costs can be up to 7 times higher than the direct ETS costs. Since aluminium prices are set globally at the London Metal Exchange (LME), the European aluminium producers cannot pass through the carbon costs incurred in Europe and are mostly exposed to the carbon cost passed through to the electricity prices (indirect effects). Until a significantly larger share of competitors will also fall under similar cap and trade schemes, there is a need for such accompanying measures.

Compensation of indirect costs should be granted through a harmonised EU-based scheme as for direct emissions, as it is currently not uniformly addressed throughout Europe. It is deemed to constitute State Aid which is unpredictable as it is exposed to budgetary constraints and annual decisions at Member States' level. Furthermore, the amount compensated is insufficient. This is valid both for direct costs, based on historical output – or activity levels where fall-back benchmarks apply - and reduction factors (free allowances are subject to an annual reduction of 5.73% in 2013 and 1.74% from 2014 onwards), and for indirect costs as the maximum aid is capped, starting at 85% in 2013 and decreasing to 75% in 2020.
To ensure that the most efficient installations do not face undue carbon costs leading to carbon leakage – as requested by the European Council October 2014 – the compensation for indirect must be more predictable and the parameters deciding the compensation (direct and indirect) shall be amended:

Post-2020 level of compensation should be based on the following principles:

1. **Realistic benchmarks**: keeping the present system based on the 10% best performing installations in the EU is necessary for the preservation of the environmental and energy efficiency incentives to both new and old capacity.
2. **Actual output (or actual activity levels where fall-back benchmarks apply):** in order to provide an incentive for growth and to allow optimal production flexibility through economic business cycles. Full compensation per unit of increased production is a precondition for investment in new technology and for increasing production at present capacity.
    a. Allocation based on historical values prevents rewarding installations for "capacity creep": Gradual increase in output from a given unit through improved operational procedures and small modifications. The present approach to compensation creates opportunities for windfall profit if output is reduced below certain production volumes.
    b. However, if historical production continues, it should include updated production values and be frequently reviewed.
3. **No further annual reduction; either through cross sectorial reduction factor (CSRF) or capping mechanisms.** Insufficient compensation reduces the operational margins and will ultimately reduce the financial capability to keep the production equipment in good operational condition and to invest in new and more efficient technology.
4. **Use of marginal producer's electricity emission pass through factor (for compensation of indirect costs):**

    The European electricity market prices are set by the marginal producer's price. Even though a higher share of renewable production is being achieved, electro-intensive industries will face pass- through of the marginal producer's emission allowance cost. By using electricity market models, the marginal price setter technology can be determined ex post, and this can serve to more properly determine the actual marginal pass-through cost.

1.3 Should free allocation be given from 2021 to 2030 to compensate those carbon costs which sectors pass through to customers? How could free allocation be best determined in order to avoid windfall profits?

Pass-through of emission allowance cost into customer prices should be seen as an intended effect of the ETS system which is necessary for the optimal functioning of a global emission trading scheme. However, as long as the European ETS remains geographically isolated and primary aluminium prices are set globally at the London Metal Exchange, the European aluminium producers lose market share in favour of other regions with no emission trading scheme, as they cannot pass through any carbon costs to its customers. Thus, the aluminium industry does not make any windfall profit from any compensation system

To avoid windfall profits the carbon leakage list should be based on the industries' level of exposure to global competition (ability to pass- through cost to customers) and on the total direct and indirect carbon costs exposure. Installations meeting both criteria at significant levels would fall in the *most exposed category* of the carbon leakage list and therefore must be treated especially due to their degree of global competitive risk exposure.

Using actual production/energy consumption instead of historical output/energy input as the basis for allocation/compensation would also eliminate the risk of windfall profits, and would allow the right

matching with an installation's needs to avoid carbon leakage. This would also be in line with the European Council's conclusions asking that "Future allocation will ensure better alignment with changing production levels in different sectors".

The present compensation of indirect cost effects, through State Aid provided by Member States, has several drawbacks (see answer above to Q.1.2.). To obtain predictability and provide effective incentives to long-term investments, compensation for indirect costs should be treated equally to the direct emission costs and be financed through the EU ETS directive. Indirect emission costs may easily be converted to a number of allowances per year independently of the allowance price. Free allocation should be provided to compensate carbon costs which are passed through to the customers.

1.4 Are there any complementary aspects you would like to add to the replies given to the previous written consultation in the light of the European Council conclusions?

Aluminium prices are set globally while electricity prices are set locally. Due to the CO2 component in the electricity price in Europe the indirect emission costs for the aluminium industry are 6-7 times higher than direct emission costs. A more adequate compensation scheme is urgently needed, also in the light of the expected rise of CO2 costs and the introduction of the Market Stability Reserve mechanism (MSR).

The cost of indirects compensation will also increase due to the phase-out of the remaining historic electricity supply contracts around 2020 and in particular if allowance prices are increased as foreseen by the Commission with introduction of MSR. It is hard to see how such large amounts of compensation can be fit into Member State budgets. Financing mitigation of carbon leakage by using free allowances or auctioning income would eliminate this uncertainty.

A binding international agreement leading to global pricing of emissions and more equal CO2 cost situation, with no further distorting of global international competition for different sectors, is further away than previously expected. In this situation, compensation for direct and indirect effects should be maintained until a global level playing field, meaning until a critical mass of industry competing with European industry is exposed to a similar climate cost level.

2. Innovation fund

The European Council has concluded that 400 million allowances in 2021 to 2030 should be dedicated for setting up an innovation fund to support demonstration projects of innovative renewable energy technologies, carbon capture and storage (CCS) as well as low carbon innovation in industrial sectors. To make this fund operational, a legal basis has to be created in the EU ETS Directive while further implementation modalities can be set out in secondary legislation. The work can build on the experience with the existing "NER300" programme which made available 300 million allowances for CCS and innovative renewable energy technologies[1].

With regard to establishing a legal basis for the innovation fund as part of the revision of the EU ETS Directive, the Commission seeks feedback on the following questions:

2.1 Do you see reasons to modify the existing modalities applied in the first two calls of the NER300? Are there any modalities governing the NER 300 programme which could be simplified in the design of the innovation fund? If you see the need for changes, please be specific what aspects you would like to see changed and why.

The aluminium industry is a strong supporter of innovation programs, but these cannot replace a proactive industrial policy agenda nor the adequate compensation measures that are needed to avoid an uneven global playing field. Income from the sale of emission allowances should primarily be used to the mitigation of undesirable effects of emission trading. Once appropriate mitigation has been achieved, the remaining income should be used to fund low-carbon innovation, but not in the same way as until now. Most of the funds have been geared so far towards CO2 free power generation (in particular CCS). It is now of paramount importance to support the energy-intensive industry in its shift towards CO2 free processes. These investments are possible only with the adequate predictability and therefore the adequate mitigation tools. Industry exposed to carbon leakage risk will not have the financial strength to invest in production capacity and innovate, therefore revenues should be earmarked firstly to compensate for indirect and direct costs, secondly to innovation purposes and thirdly into national budgets. Therefore, innovation support should not counteract carbon leakage protection measures. Innovation clusters are closely linked with production and therefore we need measures to both keep production cluster in Europe and promote research and development.

The income from the auctioning of a given number of emission allowances is a particularly ill-suited source for co-financing of innovative low-carbon energy demonstration projects, like the NER 300. Firstly, the availability of funds will be linked to the price of emission allowances (EUAs) and thus will be very volatile, depending on the success of the EU's climate policy. Secondly, the need for co-financing of such projects depends on the competitive position of low-carbon energy in the market, which is mainly linked to the cost of carbon emissions. That means that the need for support is high when availability of funds is low and vice versa.

2.2 Do you consider that for the extended scope of supporting low-carbon innovation in industrial sectors the modalities should be the same as for CCS and innovative renewable energy technologies or is certain tailoring needed, e.g. pre-defined amounts, specific selection criteria? If possible, please provide specific examples of tailored modalities.

Industry exposed to carbon leakage risk will not have the financial strength to invest or innovate without predictable efficient carbon leakage prevention; therefore revenues should be earmarked firstly to compensate for indirect and direct costs, secondly to innovation purposes and thirdly (if any left) into national budgets. Innovation support should not counteract carbon leakage protection measures.

2.3 Are there any complementary aspects regarding innovation funding you would like to add to the replies given to the previous written consultation in the light of the European Council conclusions?

Low-carbon innovation should not be financed through auctioning incomes as explained above.

3. Modernisation fund

The European Council has concluded that 2% of the total EU ETS allowances in 2021 to 2030 should be dedicated to address the particularly high investment needs for Member States with GDP per capita below 60% of the EU average. The aim is to improve energy efficiency and to modernise the energy systems of the benefitting Member States. The fund should be managed by the beneficiary Member States, with the involvement of the European Investment Bank (EIB) in the selection of projects. To make this fund operational, a legal basis has to be created (in the EU ETS Directive), while further implementation modalities can be set out in secondary legislation.

With regard to establishing a legal basis for the modernisation fund as part of the revision of the EU ETS Directive, the Commission seeks feedback on the following questions:

3.1 Implementation of the modernization fund requires a governance structure: What is the right balance between the responsibilities of eligible Member States, the EIB and other institutions to ensure an effective and transparent management?

No comment

3.2 Regarding the investments, what types of projects should be financed by the modernisation fund to ensure the attainment of its goals? Should certain types of projects be ineligible for support?

No comment

3.3 Should there be concrete criteria [e.g. cost-per-unit performance, clean energy produced, energy saved, etc.] guiding the selection of projects?

No comment

3.4 How do you see the interaction of the modernisation fund with other sources of funding available for the same type of projects, in particular under the optional free allocation for modernisation of electricity generation (see section 4 below)? Would accumulation rules be appropriate?

No comment

3.5 Do you have views how the assessment of the projects should be reflected in the forthcoming 2030 governance process (e.g. national climate programmes, and plans for renewable energy and energy efficiency)?

No comment

3.6 Should the level of funding be contingent on concrete performance criteria?

No comment

4. Free allocation to promote investments for modernising the energy sector

The conclusions of the European Council provide for the continuation after 2020 of the mechanism foreseen in Article 10c of the EU ETS Directive, which allows some Member States to opt to hand out free allowances to power plants in order to promote investments for modernising the energy sector. The current Article 10c modalities, including transparency, should be improved to promote investments modernising the energy sector, while avoiding distortions of the internal energy market.

With a view to reviewing and improving the current modalities as part of the revisions to the EU ETS Directive, the Commission seeks feedback on the following questions:

4.1 How can it be ensured that investments have an added value in terms of modernising the energy sector? Should there be common criteria for the selection of projects?

No comment

4.2 How do you see the interaction of the free allocation to energy sector with other sources of funding available for the same type of projects, e.g. EU co-financing that should be made available for the projects of common interest under the 2030 climate and energy framework? Would accumulation rules be appropriate?

No comment

4.3 Do you have any views how the assessment of the projects should be reflected in the forthcoming 2030 governance process (e.g. as regards improving transparency)?

No comment

4.4 The maximum amount of allowances handed out for free under this option is limited. Do you think eligible Member States should use the allowances for a period of time specified in advance (e.g. per year), or freely distribute them over the 2021-2030 period? (Please explain your motivation.)

No comment

4.5 Should there be priorities guiding the Member States in the selection of areas to be supported?

- yes
- no

4.6 How can improved transparency be ensured with regard to the selection and implementation of investments related to free allocation for modernisation of energy? In particular regarding the implementation of investments, should allowances be added to auctioning volumes after a certain time period has lapsed in case the investment is not carried out within the agreed timeframe?

No comment

5. SMEs / regulatory fees / other

In order to allow taking stock of the EU ETS aspects beyond those examined by the European Council, respondents are also invited to provide feedback on certain other questions.

The Commission ensures that better regulation principles govern all of the policy work, including that the specificities of small and medium sized enterprise (SMEs) are taken into due consideration. Member States can exclude certain small installations from the EU ETS in the current trading period (2013-2020) if taxation or other equivalent measures are in place that will cut their emissions. If such a possibility was to be reviewed, a legal basis would have to be created in the EU ETS Directive.

The accurate accounting of all emission allowances issued is assured by a single Union Registry with strong security measures. The operations were centralised in a single Registry operated by the Commission, following a revision of the ETS Directive in 2009. This has replaced Member States' national Registries. Despite the considerable resources from the EU budget required for maintaining the EU Registry, as does supporting work on auctioning, the Commission does not have the possibility to charge any fees. However, Member States administrators may still charge Registry fees to account holders administered by them. There are discrepancies in fees across different Member States.

5.1 Are there any EU ETS administrative requirements which you consider can be simplified? Do you see scope to reduce transaction costs, in particular for SMEs? If yes, please explain in detail.

No comment

5.2 Member States had the possibility to exclude small emitting installations from the EU ETS until 2020. Should this possibility be continued? If so, what should be the modalities for opt-out installations to contribute to emission

reductions in a cost-effective and economically efficient manner? Should these be harmonised at EU level?

No comment

5.3 How do you rate the importance of a high level of security and user-friendliness of the Union Registry? Do you think the costs for providing these services should be covered via Registry fees?

No comment

5.4 Do you consider discrepancies in Registry fees in different Member States justified? Should Registry fees be aligned at EU level?

No comment

5.5 Under the current EU ETS Directive, at least 50% of the revenues generated from the auctioning of allowances should be used by Member States for climate-related purposes. For the calendar year 2013 Member States have reported to have used or to plan to use 87 % on average to support domestic investments in climate and energy. Do you consider the current provisions regarding the use of the revenues adequate for financing climate action? If not, please explain why?

No comment

6. General evaluation

6.1 How well do the objectives of the EU ETS Directive correspond to the EU climate policy objectives?
How well is the EU ETS Directive adapted to subsequent technological or scientific changes?

Europe is the first region in the world to implement carbon constraints policies in such a comprehensive way. The aluminium industry still supports such an approach on the condition that the ETS Directive is revised to provide adequate mechanisms to prevent carbon leakage until a critical mass of industry competing with the European industry is exposed to a similar climate cost level.

European demand for aluminium is expected to increase considerably due to the significant benefits inherent to the aluminium properties in terms of climate and resource efficiency when used in cars, packaging, building and engineering. Considering the industry's ability to deliver solutions, it is therefore a paradox that Europe's import of primary aluminium is increasing substantially from countries without carbon regulations.

The retention of our industry in Europe offers the biggest potential – not only in terms of economic growth and jobs' creation – but also in terms of emissions' reduction at global level, especially for energy-intensive sectors. The most exposed industries have to be protected from unfair international competition until fair conditions are restored by an international climate agreement. Without a comprehensive international agreement including harmonised rules and similar cost, the cost of carbon leakage mitigation will be more or less stable, whereas the number of allowances to cover this cost will gradually diminish. This is a cost that is directly attributable to emission trading and should therefore be covered by the ETS system itself. On top, the carbon footprint of primary aluminium varies mainly according to the energy source, and new capacity is coming from countries with carbon footprint far above the average level in the EU. Today we face an uneven world with regards to climate regulation. Approx. 95% of total primary aluminium production is produced in countries with no CO2 impact on electricity prices.

6.2 What are the strengths and weaknesses of the EU ETS Directive? To what extent has the EU ETS Directive been successful in achieving its objectives to promote emission reductions in a cost-effective manner compared to alternatives, e.g. regulatory standards, taxation?

The EU ETS Directive was successful in steering the emission reductions but for some highly exposed sectors such as aluminium, it generated a significant regulatory cost burden as demonstrated by the Commission's Cumulative costs assessment on the impact of regulation on the EU aluminium industry.

ETS does not deliver a clear price signal to drive decarbonisation investments or to decide disinvestments. The uncertainties on future carbon price and the lack of clarity on price trajectories that the EU targets make impossible to effectively factor CO2 price into investment decisions but are most often considered as an underlying risk for productive investments.

Current compensation of direct and indirect effects on manufacturing industry is inadequate (keeping benchmark exposed to costs and not relating to actual production) and unpredictable for indirect costs. It therefore hinders new investments, leading to carbon leakage.

Today's carbon leakage list, setting one size of compensation for all sectors, should be better structured and focused, to differentiate the level of compensation based upon the different level of exposure to the carbon leakage risk.

6.3 To what extent are the costs resulting from the implementation of the EU ETS Directive proportionate to the results/benefits that have been achieved, including secondary impacts on financing/support mechanisms for low carbon technologies, administrative cost, employment impacts etc.? If there are significant differences in costs (or benefits) between Member States, what is causing them?

No comment

6.4 How well does the EU ETS Directive fit with other relevant EU legislation?

Lack of adequate and predictable compensation does not correspond to European targets for industrial growth. Further, it could have a reverse effect and worsen Europe's total carbon footprint due to increased imports of goods from countries with substantially higher carbon footprint. Last but not least, the whole aluminium value chain is affected by the loss of competitiveness of some of its segments and the dependency from an easier access to raw materials.

6.5 What is the EU value-added of the EU ETS Directive? To what extent could the changes brought by the EU ETS Directive have been achieved by national measures only?

Energy intensive industry has an innate incentive to become more energy efficient due to high energy cost, independently of the extra cost arising from ETS. Improvements however require investments, either in upgrading existing capacity or in developing new plants. Because of insufficient compensation of extra climate policy costs the EU ETS actually reduce the margins of the industry, thereby reducing its ability to invest and eventually to become more energy efficient.

6.6 Do you have any other comment on the revision of the EU ETS Directive that you would like to share?

No comment