A Competitive EU ETS for Industrial Decarbonisation

Key priorities for an ETS that allows industry to invest, decarbonise and remain in Europe

Europe's energy-intensive industries (EIIs) remain committed to contribute to the transition towards climate neutrality.

EIIs are fundamental for the EU's industrial economy and values chains in terms of production and employment and are crucial to secure strategic independence in critical industries in Europe. Nevertheless, they are now facing increasing competitive pressure, primarily due to increased energy costs, unfair trading practices, severe global trade disruptions, and higher carbon costs in Europe compared to its international competitors without the ability to recover those additional costs from the products they produce. Deindustrialisation in the EU has already started and is likely to accelerate without dedicated policies.[i]

Investment in decarbonisation requires a credible business case to materialise, with supportive enabling conditions. The EU ETS must therefore support frontrunners and early investment by preserving effective carbon leakage protection, including for small emitters and ensuring enabling conditions for transformation. The ETS framework must allow companies to invest, decarbonise and continue producing in Europe.

While some elements of the Commission's proposal, such as the adjustment of the ETS trajectory and other flexibility measures, represent a step in the right direction, the adopted version must better reflect industrial realities and provide the predictability needed for long-term investment.

Preserve effective carbon leakage protection through unconditional free allocation

No conditionality should be imposed. Companies make decarbonization investments when enabling and market conditions are there to support them. Forcing such investments without a business case will not succeed. It will only lead to loss of free allocation, the main purpose of which is to protect European production from carbon leakage when international competitors do not face comparable carbon costs. Today, benchmark-based allocation links the level of free allocation directly to performance against the 10% least emitting installations, already encouraging to reduce emissions. Additional conditionality therefore jeopardizes its main purpose, adds complexity and administrative burden without strengthening the incentives already embedded in the system. It also undermines parity between CBAM and ETS, as new conditionality applies only to European companies, and reduces companies' capacity to invest outside of decarbonisation projects.

Free allocation is not an investment subsidy, but a carbon leakage protection mechanism. Making free allocation conditional on investment would remove carbon leakage protection, precisely where investment cannot yet proceed for reasons beyond companies' control.

The priority should be to create conditions that enable investment, such as CO_2 and energy infrastructure, permitting, technology readiness, financing and market demand, that are not yet in place.

Avoid the triggering of the cross-sectoral correction factor

The EU ETS must avoid the triggering of the cross-sectoral correction factor (CSCF), which undermines carbon leakage protection by reducing free allocation below already top performing benchmark levels across industrial installations.[ii] A steep reduction in free allocation, as presented in the Commission's impact assessment, seriously undermines the competitiveness and investment capacity of EU energy-intensive industries at the very moment they are expected to deliver the deepest transformation.

The current balance between free allocation and auctioning is based on outdated, pre-2013, emissions patterns and no longer reflects the respective decarbonisation pathways of the power sector and industry, particularly given the declining share of power-sector emissions. Avoiding the triggering of the CSCF will therefore require, among others, changing the ratio and increasing the buffer between free allocation and auctioning, to ensure adequate allocation for industry, and maintain confidence in the long-term policy and investment framework required for industrial decarbonisation.

Improve the benchmarking methodology to reflect the industry's real decarbonisation potential

The EU ETS review is a chance to improve the benchmarking methodology to ensure that the ETS benchmark values are technologically achievable and economically viable. For that, it is essential that all the parameters impacting the benchmarks are representative of the decarbonisation transitions of the relevant sectors, taking into account local specificities across the EU.

Deliver an Effective CBAM, including for exports

The Carbon Border Adjustment Mechanism (CBAM) must provide effective carbon leakage protection for entire value chains both in the EU and in third countries' markets. The phase-out of free allocation for CBAM sectors must be based on a realistic transition pathway, provided that the CBAM is watertight and provides a level playing field between EU and third-country producers not facing comparable carbon costs. This must be accompanied by a permanent solution to preserve the competitiveness of the EU exports and downstream production.

Reinvest ETS Revenues in Industrial Decarbonisation of ETS 1 industry

To date, only 5% of ETS revenues has been channelled back to energy-intensive industries. Auction revenues generated by ETS1 covered installations, including those channelled through funding instruments, should be fully used to support the decarbonisation of existing ETS 1 installation in a technology neutral way, including ongoing and new investments in technologies, materials, processes, and projects that deliver industrial decarbonisation and climate-mitigation solutions deployed in those installations.

Need of markets for renewable and low-carbon products

Dedicated measures are needed to develop lead-markets and strengthen demand for renewable and low-carbon products. Europe's energy-intensive industries stand ready to work with policymakers to deliver industrial transformation, protect high-quality jobs, and secure Europe's competitiveness. EU policy must now provide the conditions that allow energy-intensive industries' investments to happen.

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[i] As highlighted by the Draghi Report, *''declining competitiveness has been reflected in output losses and an increased reliance on imports. During the past years, the competitiveness of the EU's EIIs has deteriorated sharply. Cost gaps with other world regions have widened. As a result, domestic production has contracted sharply, while total manufacturing remained robust by comparison. In parallel, trade intensity has trended upwards and reliance on domestic supply has declined, implying more reliance on imports to serve domestic demand.''*

[ii] According to the Commission's estimates, free allocation could be reduced by up to 70% by 2040 through the CSCF.