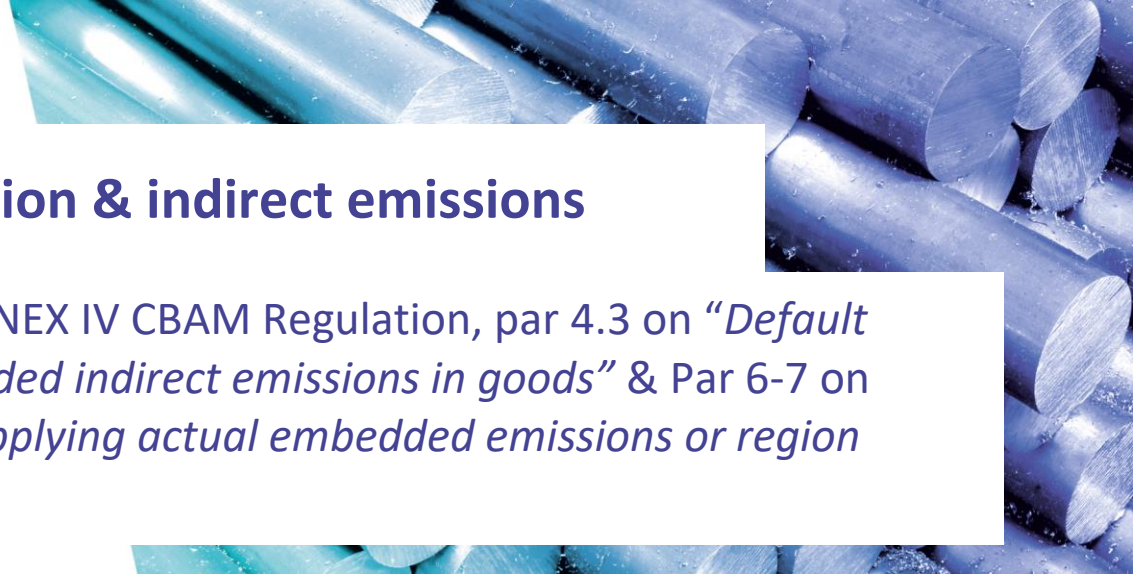

CBAM Regulation & indirect emissions

Comments to ANNEX IV CBAM Regulation, par 4.3 on "*Default values for embedded indirect emissions in goods*" & Par 6-7 on "*Conditions for applying actual embedded emissions or region specific values*"

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Contents

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European Aluminium
ANYTHING BUT BASIC

1. Introduction & summary of key policy recommendations

We support the EU's intention to prevent carbon leakage. Instruments like the CBAM, which intends to encourage decarbonisation globally by adding a carbon price for imported goods comparable to the costs paid by EU producers, represent a highly attractive idea in principle.

Unfortunately, independent analysis requested by European Aluminium has shown why the CBAM cannot yet be considered a suitable alternative to existing EU carbon leakage protection measures.

This is mainly because of the electro-intensive nature of primary aluminium production and the unique indirect carbon costs only European producers face in their power price. These are generated by the EU ETS and marginal pricing mechanism governing EU power markets, whereby it is always the most expensive power plant (fuel or gas) to set the price to be paid by consumers, even when they produce aluminium with 100% renewable based electricity (see a short explanation here). These costs will remain significant as long as the European grid is fully decarbonised, even when consuming decarbonised electricity or signing long-term power contracts[1].

> *To recall, there is no equivalent between indirect emissions and indirect emissions costs in Europe because of the EU ETS and the marginal pricing system governing the formation of electricity prices in EU power markets. The CBAM methodology focuses on indirect emissions, and the interplay between indirect emissions and costs has not yet been sufficiently assessed. Methodologies for calculating indirect emissions and designing carbon leakage measures must always keep in mind this aspect.*

Also, including indirect emissions in the CBAM increases the risk of circumvention and will not lead to a reduction in global emissions. Rather the opposite! Because low carbon aluminium producers outside Europe are not subject to indirect carbon costs, they will gain a competitive advantage and undercut EU based low carbon production, which will be forced to curtail production.

Moreover, including indirect emissions in the CBAM before the European power grid is fully decarbonized, creates an incentive to change trade patterns to the detriment of European Aluminium producers. This is because of the limited product scope of the CBAM where finished products are not included. Because of this, the manufacturer in Europe of finished products will be hit significantly.

Two examples:

- An imported aluminium plate or sheet used for the manufacturing of automotive body sheets should be exposed to a potential high CBAM charge if embedded indirect emissions in products are included and the calculation is done correctly. However, the import of automotive components, typically under CN codes 87.07 and 87.08 which are currently outside the CBAM scope (outside tariff code 76.06) will gain a significant competitive advantage compared to European aluminium manufacturers[2].
    - As a result: Producers of automotive parts in Europe based on aluminium will have increased costs when free allowances are removed due to CBAM. There will be an economic incentive to move production of certain products under the CN code heading 87 out of the EU. This illustrates a major concern we have with the CBAM that needs to be assessed as soon as possible: instead of developing production inside the EU, companies will be incentivized to perform fabrication outside the EU to the point where the products finally entering the European marketplace is no longer covered by CN code 76[3]. Other examples of specific end-products outside CN code 76 to be potentially affected by such practice are 8712 (Bikes), 8716 (Trailers) and cables (8544).

[1] For further explanations about why the CBAM cannot mirror the unique indirect carbon costs European producers face in Europe, please read here our detailed position paper (October 2021)

[2] For more detail, see ERSCT study « *The aluminium value chain and implications for CBAM design », June 2021*

[3] See here the updated Council Regulation on the tariff and statistical nomenclature and on the Common Customs Tariff, January 2023

  - Also, certain products that are 100% made of aluminium should be added to avoid carbon leakage: Aluminium wheels under CN Code 8708 70 50 for example are currently missing from the product scope and should be included.

- The significant risk of circumvention (legally or not) is evident: an importer can claim that the product is made of scrap or based on primary material where electricity used is based on renewables. In both incidents there will be no/limited CBAM charge for the product on the attributed embedded indirect emissions while European producers will still have to pay for their raw material used with ETS costs embedded or the indirect ETS carbon costs embedded in the electricity price even when consuming decarbonised electricity.

The two cases above show the detrimental effects of a too early inclusion of indirect emissions for European industries and increased imports, with no gain in competitiveness for the European industry nor reduction in global emissions.

We thus urge the Commission and all involved stakeholders to address the following design elements as we move towards the implementation of the CBAM Regulation:

- *The inclusion of indirect emissions in imported aluminium CBAM products should be considered only once the EU electricity grid is completely emission-free and all circumvention risks and downstream impacts have been assessed across the entire European aluminium value chain.*

- *The Commission should carry out as soon as possible a detailed assessment on the consequences of the inclusion or exclusion of more Aluminium products upstream or downstream, including precursors such as alumina (see our paper about why alumina should not be included in the CBAM product scope here). This assessment should be reviewed regularly as the CBAM is gradually phased in.*

- *During the transitional period, all importers should refer to emission factors internationally accepted such as the IEA Electricity Emission factors when submitting their quarterly CBAM reports. Third countries' national grid mix should be the one and only value to be used as default values for reporting indirect emissions. This would avoid diverging reporting practices and ensure consistency for developing a sound methodology.*

- *For the definitive period, the emission factor of the country-of-origin electricity grid (based for example on IEA electricity generation data sets) should be the emission factor to be used for the default values to be applied. This would best incentivise grid decarbonisation in third countries, ensure data reliability, and reduce circumvention.*

- *Exemptions to default values should be limited as much as possible and allowed under very strict conditions. The Commission should first better understand the functioning of electricity markets in third countries and to what extent they are comparable (e.g. with indirect carbon costs) to the one we have in Europe because of the EU ETS and the marginal pricing system.*

- *Related to the point above, for reporting embedded indirect emissions in imported aluminium CBAM products, the use of Renewable Energy Certificates like for example Guarantees of Origin (GoOs) should not be allowed. This is because if there is not a transparent and well-regulated global market with adequate safeguards, there will be circumvention[4].*

- *Because of the challenges in designing a methodology for the CBAM capable of fully mirroring the unique indirect carbon costs European producers face, European Aluminium reiterates its request to exclude indirect emissions from the CBAM for aluminium goods until the European electricity grid is fully decarbonised.*

[4] See Article here explaining the risks of Renewable Energy Certificates for electricity in Europe : « *How Iceland sold the same Green Electricity twice* », May 2023

- *Meanwhile, for developing the methodology for CBAM products where the CBAM will apply on both direct and indirect emissions starting from 2026 (e.g. cement and fertilisers products listed in annex I of the Regulation) we would recommend the Commission to initially introduce a minimum indirect CBAM cost. Such value should be designed in a way to provide an incentive to declare emission by third country producers while also being sufficiently high so as to protect European producers against the unique indirect carbon costs they face in the power price, even when producing CBAM products with decarbonised electricity.*

In this paper we:

- Reiterate our support the final agreement on the CBAM which initially excludes the application of the CBAM on indirect emissions for sectors today eligible to ETS indirect costs compensation under EU state aid rules.

- Provide a set of design recommendations to the Commission when looking into the methodology for reporting indirect emissions in CBAM products and for designing the CBAM charge when the system will begin to apply to indirect emissions to initially non-compensated sectors.

2. Reporting indirect emissions during the transitional period (Article 35)

Article 35 Par 3 foresees that importers (or indirect customs representatives) must include in the CBAM quarterly report to be submitted no later than one month after the end of the given reporting period under consideration information of embedded indirect emissions in CBAM goods.

Such information should include:

- The quantity of electricity used for the production of the goods;
- Country of origin of the electricity.
- Electricity generation source;
- Electricity emission factors.

As per above, the CBAM Regulations appears to grant a lot of flexibility to importers and third country producers for reporting the embedded indirect emissions in aluminium products. Furthermore, the requirement to include "electricity generation" appears to be redundant: If country national grid mixes are used, there will be a mix of different sources reported.

Clarifications are therefore urgently needed to ensure there is no fragmentation among importers when reporting indirect emissions in CBAM products and the methodology is as sound as possible to protect European producers from ETS indirect carbon costs, which are unique to Europe because of the higher climate ambition under the EU reformed ETS.

This is crucial because the data reported during the transitional period will not be subject to third party verification. If the methodology for possibly extending the emissions scope and applying the CBAM to indirect emissions will be based on data collected during 2022-2025, the lack of third-party verification and diverging reporting practices, will lead to inaccurate data and incorrect impact assessment study results.

We are very much concerned that inaccurate reporting of emissions data could then be used to determine the methodology to be initially applied to sectors currently not eligible to ETS indirect cost compensation, namely cement and fertilisers products under the CBAM.

EU producers of cement and fertilisers are less exposed to ETS indirect carbon costs in their electricity costs' share as they are less electro-intensive and not global price takers on international markets: Aluminium is a global commodity priced on the London Metal Exchange (LME). As such, aluminium producers have no control over their product's sale price. They are "*price takers*" and they are unable to pass-on additional local costs to their customers. This is why the Aluminium sector is on the list of eligible sectors to ETS indirect costs compensation and why preserving such framework is crucial for preserving the full value chain in Europe.

We would therefore recommend during the transitional period that:

- All importers refer to emission factors internationally accepted such as the IEA Electricity Emission factors[5].
- Third countries' national grid mix should be the one and only value to be used as default values for reporting indirect emissions.

3. Methodology for default values indirect emissions during the Definitive period (Article 7, Par 4 & Annex IV Par. 4.3)

5 See IEA Emissions Factors 2022 data base here.

Annex IV foresees default values are the rule for calculating indirect emissions, while actual embedded emissions and alternative default values represent exceptions (Par 6 & 7).

The following three options will be considered by the Commission for the development of the methodology:

1. Average of either the emission factor of the EU electricity grid;
2. **The emission factor of the country-of-origin electricity grid;**
3. The CO2 emission factor of price-setting sources in the country of origin, of the electricity used for the production of this good.

Of the three options above, we would recommend **option 2** for the following reasons:

- Average of the EU electricity grid (option 1) would lead to an unjustifiable low default value as the European electricity grid is closer to decarbonisation compared to our global competitors producing aluminium. It would underestimate the indirect emissions attributable to imported products and would provide no incentive to declare or reduce electricity emissions.
- Outside Europe there is no comparable electricity market with similar or equivalent carbon costs electro intensive consumers face because of a carbon pricing scheme on generated emissions. Policy makers have tried to integrate in legislation what we have in Europe, but the reality is that presently there is no comparable electricity market nor ETS in third countries. Furthermore, the price setting source (Option 3) could be arbitrarily decided, and it would be very difficult to verify. This will lead to circumvention.
- The need to have a system as harmonized as possible globally and limit exemptions.

4. Conditions for applying actual embedded emissions or region-specific adaptations to default values (Annex IV Par. 6 & 7)

Annex IV, Par. 6 & 7 allows third country producers to apply actual values or adjust the default values for indirect emissions instead under the following circumstances:

- They can *"demonstrate a direct technical link between the installation in which the imported good is produced and the electricity generation source or*
- *If the operator of that installation has concluded a power purchase agreement with a producer of electricity located in a third country for an amount of electricity that is equivalent to the amount for which the use of a specific value is claimed"* (Annex IV, Par 6).
- Regarding regional exemptions:
    - Default values can be adapted to specific regions "*where specific characteristics prevail in terms of objective emission factors. When data adapted to those specific local characteristics are available and more targeted default values can be determined, the latter may be used;*
    - *"Declarants for goods originating in a third country, a group of third countries or a region within a third country can demonstrate, on the basis of reliable data, that alternative region-specific adaptations of default values are lower than the default values determined by the Commission, such region-specific adaptations can be used" (Annex IV, Par. 7)*

European Aluminium believes these exemptions should be limited as much as possible because:

- In Europe, European Aluminium producers cannot choose not to pay ETS costs because they are reflected in the electricity price set by the marginal plant (gas or fuel). Even if they sign a PPA procuring low carbon electricity, an indirect carbon cost will always affect the power price they pay.
- If we were to mirror the European system, it should be default values only with no possibility to go for a lower value. In Europe producers cannot choose not to pay indirect carbon costs, even if they consume decarbonised electricity. Why should we give third country producers the option?

Moreover:

- The possibility to have a lower value for a country or group of countries or a region in a given third country based on the price setting source can be a source of circumvention: in China, in the Yunan province for example there is a lot of hydro generated power. Therefore, this exemption could be used to source-shift low carbon aluminium to Europe while European low carbon producers would continue to face indirect carbon costs in their power price, even when signing a PPA and thus actively contributing to decarbonising the European grid.
- If unbundled GoOs are allowed for PPAs and there is not a transparent and well-regulated market with adequate safeguards, there will be circumvention. Producers in third countries would simply be able to purchase the required volume of GoOs (which tend to be extremely cheap) in order to export their products to Europe as 'low carbon' products, even if they continue to consume high-carbon electricity. Therefore, the use of GoOs should not be allowed for demonstrating the indirect emissions linked to imported products.
- If we allow third country producers to choose a lower value, there should be reciprocity in Europe and we should take power generation out of the EU ETS, which would eliminate indirect carbon costs.

Therefore, the possibility to go for a lower default value by claiming a PPA or direct connection should only be allowed under very strict conditions that minimise the risk of circumvention, such as an island not connected to the grid or a direct and exclusive physical link between the electricity producer and the aluminium smelter with no market for trading Guarantees of Origin.

Furthermore, the Commission should first better understand the functioning of electricity markets in third countries and to what extent they are comparable (e.g. with indirect carbon costs) to the one we have in Europe because of the EU ETS and the marginal pricing system. A detailed assessment should be done on functioning of third countries' electricity markets and how they compare to the EU with EU ETS and marginal pricing system (e.g. indirect carbon cost).

5. Proposal for a minimum indirect carbon cost

Because of the challenges in designing a methodology for the CBAM capable of fully mirroring the unique indirect carbon costs European producers face, European Aluminium reiterates its request to exclude indirect emissions from the CBAM for aluminium goods until the European electricity grid is fully decarbonised.

Meanwhile, as the CBAM is gradually phased in, the European Commission should first carefully assess existing allegedly similar or nominal carbon pricing schemes in third countries and evaluate to what extent the costs applied to industrial installations consuming electricity for the production of CBAM products are comparable to the ones European producers face. Data in this regard would be collected during the first decade of the CBAM once the system is in place.

If further to such assessment, the conclusion is that there is no comparable electricity market and indirect carbon costs equivalent to the ones we have in Europe, ***the Commission should initially introduce a minimum indirect CBAM cost to be paid.***

Such value should be designed in a way to provide an incentive to declare emission by third country producers while also being sufficiently high so as to protect European producers against the unique indirect carbon costs they face in the power price, even when producing CBAM products with decarbonised electricity.

For the purpose of introducing a minimum carbon cost on the indirect emission declared in imported goods, Article 7 could be used as a legal basis because it allows for the use of default values *"to be adapted to particular areas or regions to take into account specific objective factors that affect emissions, such as prevailing energy sources or industrial processes".*

For example, the existence of subsidized over-capacity in third countries is a legitimate reason to set a higher default value and apply such minimum indirect carbon cost. The value to be applied could be for instance based on the global average for a given sector or the share of coal-based electricity used for the production process in a given country.

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