Preliminary Assessment

Draft Regulation on the introduction of an EU Carbon Border Adjustment Mechanism

7 October 2021

EUROPEAN ALUMINIUM

INTRODUCTION

The European aluminium industry welcomes the Commission's *Fit for 55* package. We share the ambition of creating a more sustainable economy and welcome the Commission's determination to combat carbon leakage. While we appreciate that the Commission has recognised the lack of appropriateness of a Carbon Border Adjustment Mechanism (CBAM) to deal with complex issues such as indirect emissions and only foresees a gradual transition towards the new system, the proposal still misses a significant amount of detail. Important improvements to function as an effective, future-proof carbon leakage tool are needed, for the sake of sustainability and Europe's industrial viability.

To achieve sustainable growth, we must have a global level playing field for industry. Carbon leakage is a reality in our sector: up to 1/3 of our primary smelting capacity has been closed and replaced by capacity outside Europe, most of it with a higher carbon footprint. With today's price on CO2 emissions, carbon leakage will increase even more in the years to come. Production losses in Europe have been replaced almost exclusively by Chinese firms, covering now all the incremental global demand for aluminium (which has more than doubled over the past twenty years[1]). Today, China accounts for almost 60% of the global primary aluminium production (up from just over 10% in 2000)[2]. While Europe lost significant shares to the Chinese (unfair) competition, European aluminium demand has been under constant growth over the past decades, because of its pivotal role aluminium plays in the EU's green transition[3].

Higher cost stemming from a tightened ETS cap will affect the competitiveness of European producers across the entire value chain, starting from the alumina refining and the primary segment all the way down the value chain, encompassing producers of semi-manufactured products and recyclers of aluminium products. If the CBAM will be the alternative carbon leakage measure for the years to come, it will have to be carefully designed to fully protect our industry's competitiveness while accelerating the decarbonisation of the value chain in Europe and globally. While we appreciate the EU's efforts to find new tools to combat carbon leakage, we do not think that the CBAM, as proposed today, can deliver over on its intended objectives.

In this paper, we outline our initial thoughts on how to design an effective CBAM for the European aluminium industry, based on the European Commission's draft Regulation released on 14 July 2021.

KEY MESSAGES

While we are relieved that indirect emissions are not included in the initial scope of the proposal and appreciate that the Commission has recognised the lack of appropriateness of a CBAM to deal with indirect emissions and indirect costs, and the hazards of including them, **aluminium should not have been part of the CBAM proposal, which is not fit for the aluminium-specific climate and competitiveness challenges we face in Europe and globally.**

In the recitals of the draft proposal, the European Commission recognized that aluminium is mainly included because of steel.

European Aluminium is fully committed to working closely with the European Parliament, the Council and the European Commission, as well as broader stakeholders, on designing effective measures to provide the required level of carbon leakage protection and achieve the EU's ambitious targets under the fit for 55% package. **This includes improvements to the CBAM to eventually become a suitable measure for the European aluminium value chain. Most importantly**

[1] World Aluminium, 2020. Primary Aluminium Production
[2] Ibid, 2020
[3] See European Aluminium Vision 2050 Report here, 2019

though, the Regulation must recognise that the CBAM is untested. It is highly uncertain whether it will work. Therefore, **review mechanisms must be included** in the Regulation, with the possibility to pause further implementation in case the CBAM does not live up to its intentions.

Seven main steps to improve the CBAM:

1. **For aluminium, the CBAM must be tested initially on direct emissions:** The CBAM cost should apply only to direct emissions, in line with the Commission proposal. ETS indirect compensation must remain until 2030 and beyond, as correctly recognised by the Commission in the ETS revision impact assessment. Including indirect emissions and pricing them in the CBAM should be done only when the mismatch between ETS indirect costs and emissions is reduced to the minimum, as the national/regional/EU electricity grid decarbonises.

2. **Review mechanisms after the transition period to ensure the proper application of CBAM:** The CBAM proposal details a gradual phase-out of free allocation from 2026 to 2035 and an initial monitoring, reporting and verification (MRV) phase to test the system. The assessment at the end of the initial stage in 2025 to consider the quality of the emissions data collected over the first three years should also evaluate the effectiveness of the system. If the assessment shows that CBAM does not comply with its objective of mitigating carbon leakage, the CBAM on aluminium should be suspended, and phase-ins of new sectors (and phase-out of free allocation) must be paused until the EU can introduce a reliable solution meeting its intentions.

3. **We need a solution for the reduced global competitiveness of exported products due to higher ETS compliance costs:** We suggest that exporters get refunded the ETS compliance costs each supplier faces above the benchmark level on their exported products. Otherwise, CBAM represents a significant threat to European export industries.

4. **Anti-circumvention measures need to be strengthened:** As proposed, there are concrete risks of source-shifting of low-carbon aluminium to Europe and free-riding via false declarations. In this respect, a **solution must be found for the problem of cost absorption:** A CBAM applied to products that a third-country producer sends to Europe does not and cannot reflect the cost borne by an EU producer across its entire production chain.

5. **Full complementarity of CBAM and free allocation:** The CBAM must come on top of existing free allocation and be complementary to it. Free allocation should not be phased out until the system is fully tested and robust. If CBAM will replace free allocation in the long run, it is crucial that the included sectors have their general ETS risk exposure reduced. Further, there is the need to align different CN & NACE codes for products under the CBAM.

6

The status of smelter grade alumina is unclear in the draft Regulation: Alumina is a key input of the primary smelting process. It can also be produced in a stand-alone refinery without being situated in the same location.

7

Product scope should be broadened: Many imported products fall outside the CBAM. By importing downstream products, third countries can further circumvent the obligations. By adding more downstream products to the scope, the possibility of carbon leakage for the manufacturing industry decreases significantly.

Aluminium in the CBAM: A risky choice

From the recitals, explanatory memorandum, and impact assessment of the proposal, the choice of including aluminium appears to be justified by the fact that the material is in direct competition with others, and the system is expected to be extended to cover indirect emissions in the future. The European Commission believes that ETS sectors exposed to carbon leakage are eager to be included in the CBAM, considering the parallel revision of the ETS Directive and strengthening of the cap.

However, the impact assessment provides no analysis of how the CBAM can effectively incentivise the reduction of CO2 emissions in third countries. There is no analysis of the benefits in terms of carbon leakage protection and competitiveness for aluminium producers. Also, given the lack of detail in the proposed Regulation, it is currently very difficult to come to the Commission's same conclusion, considering that the rules do not specify what will happen to free allocation for sectors and installations not under the CBAM.

Based on our preliminary analysis of the proposal, we can only expect that the CBAM will have a diverse impact across the aluminium value chain. This is because different ETS benchmarks[4] apply to the aluminium product covered by the European Commission proposal, and because of the limited product scope proposed by the Commission.

Therefore, we cannot consider the draft proposal for a Regulation on the establishment of a Carbon Border Adjustment Mechanism, as proposed today, as an effective tool against carbon leakage in our sector.

Proposed improvements to the proposal

- For **aluminium, the CBAM cannot cover indirect emissions (both in the initial phase and after that) before the decarbonisation of the EU electricity sector has reached an advanced stage.** Indirect emissions do not correlate with indirect costs (see information sheet). The latter are the direct result of marginal pricing in EU electricity markets, **irrespective** of embedded emissions in the electricity consumed. This means that even low-carbon aluminium produced in Europe based on renewables is exposed to significant CO2 costs passed on in the power price. Therefore, including indirect emissions in the CBAM (and phasing out compensation for CO2 costs in

[4] Under EU ETS Free Allocation Rules (FAR) there are two product benchmarks set for the aluminium sector: one for electrolysis (1.514 tCO2/t Al in phase III) and one for the anode production (0.324 tCO2/tAnode in phase III). All the remaining segments of the aluminium value chain are covered by the heat and fuel consumption fall-back benchmarks (62.3 tCO2 /TJ and 56.1 tCO2/TJ in phase III respectively).

power prices) will only result in increased carbon leakage, since even low-carbon European producers would face significantly higher indirect CO2 costs than the equivalent CBAM charge placed on imports (even those produced from fossil fuels). As a result, **a CBAM covering scope 2 would paradoxically benefit carbon-intensive aluminium imports at the expense of low-carbon European production[5].**

Our request:

For aluminium, the CBAM cost should apply only to direct emissions, in line with the Commission proposal. ETS indirect compensation must remain until 2030 and beyond, as correctly recognised by the Commission in the ETS revision impact assessment[6]. Including indirect emissions and pricing them in the CBAM should be done only when the mismatch between ETS indirect costs and emissions is reduced to the minimum, as the national/regional/EU electricity grid decarbonises.

Furthermore, before – if at all - including scope 2 and pricing these emissions, the CBAM must be well tested and robust and ensure it delivers as intended as on the objective to serve as an instrument to protect against carbon leakage. This should be clarified in the Regulation.

- **Review mechanisms after the transition period to ensure the proper application of CBAM.** The CBAM proposal details a gradual phase-out of free allocation from 2026 to 2035. To ensure predictability, it is crucial that this is carried out with careful consideration of its effects. The proposal includes an assessment at the end of 2025 to consider the quality of the emissions data collected over the first three years. It is paramount that the phase-in of CBAM does not start until the data is of a quality comparable to that collected under the ETS. If it is not, the CBAM Regulation must mandate that the free allocation gradual phase out is pushed back until the Commission finds a way to ensure data quality and comparability with the existing European MRV standard for the ETS CBAM sectors. The Commission must also monitor whether CBAM actually protects against carbon leakage.

Our request:

We recommend evaluating the actual price effect of the CBAM on products at set intervals, with the possibility to halt further phase-in if the evaluation shows that adjustments to the scheme are necessary to achieve its objectives. This assessment must be carried out as early as possible before the gradual phase out of free allocation has started. Also, if after the initial transition phase there is clear evidence that the system is not effective, the CBAM should not be applicable to the products under the mechanism. If the assessment shows that CBAM does not comply with its purpose as a carbon leakage protection instrument, the application of the system to aluminium and the further phase-in of new sectors (and phase-out of free allocation) must be paused until the EU can introduce a reliable solution serving its intentions. If these prerequisites are not in place, CBAM will not represent the carbon leakage assurance industries require in the carbon transition period.

[5] Further, the CBAM impact assessment itself confirms that by including indirect emissions for commodities like Aluminium, the system would be more circumventable.

[6] See ETS Revision impact assessment p. 507 (14 July 2021): «*Even though fossil-fuelled power generation will likely shift from coal to gas, carbon costs will thus continue to be passed through to consumers to a significant extent. Moreover, these carbon costs will reflect increasing carbon prices due to the strengthened cap. Therefore, indirect carbon costs, although potentially declining, can be considered still relevant in the period from 2021 to 2030*».

- **Predictability of free allocation phase-out must be ensured.** The revision of the ETS Directive reduces industries' financial predictability and increases installations' CO2 costs. This is an issue both for industries that have invested long term and those that plan to invest in new climate friendly production facilities in Europe. Industrial activity is dependent on stable and predictable framework conditions ensuring their competitiveness in an uneven carbon constrained world. Reductions of free allocation due to ETS benchmarks, the increase of the LRF, tightening of the Market Stability Reserve (MSR), which will tighten the auction supply and lead to a price increase, and, on top, the threat of a high Cross Sectoral Correction Factor all represent considerable financial risks to European industries. CBAM introduces another element of risk, being that it is very difficult to assess beforehand whether it will work as a carbon leakage measure.

Our request:

CBAM must come on top of existing free allocation and be complementary to it. However, if CBAM is to replace free allocation, it is crucial that the included sectors have their general ETS risk exposure reduced. Phase-out of free allocation must therefore be based on ETS benchmarks alone, and not subjected to the Cross Sectoral Correction Factor (CSCF), so that CBAM industries are not exposed to a third mechanism to reduce free allocation.

- **In the draft Regulation, it is also unclear how the free allocation phase-out will be implemented for producers of aluminium products which fall under the CBAM, versus aluminium products falling outside the CBAM[7]. In fact, free allocation for aluminium is based on a NACE code covering the full value chain, while CBAM covers specific products under the EU Customs Code (e.g. CN).** The impact on the full value chain must therefore be carefully considered: What will happen to free allocation post 2030 for producers of aluminium products not under the CBAM?

Our request:

Before proceeding with any yearly reduction of free allocation, as proposed in the mirroring draft ETS Directive proposal part of the fit for 55% package, the impact of such reduction must be carefully considered across the aluminium value chain, and full free allowances auctioning should remain in place. For example, the status of alumina, a key input for the primary smelting process, is unclear.

- **More targeted support for CBAM sectors under the EU Innovation Fund:** It should be clarified how sectors under the CBAM producing products under the scope of the CBAM could benefit from more targeted support under the strengthened ETS Innovation Fund. Channelling the revenues from ETS auctions and CBAM to industry for them to invest in mitigating measures and climate friendly solutions will accelerate the climate transition. Also, the majority of emissions in the aluminium sector are indirect emissions. It is unclear whether investments aimed at reducing indirect emissions are eligible for support under the Innovation Fund (e.g. support for the additional costs involved in signing a RES PPA). If the idea is to support CBAM sectors via the Innovation Fund, it is crucial to ensure that the aluminium sector would actually be able to benefit from this provision.

[7] The current proposal only covers Aluminium products under CN Code7601, and from 7603 to 7609. Products from CN codes 7610 to 7616 as well as other important aluminium products outside chapter 76 are not included in the proposal.

Our request:

The proposed increase of capacity of the ETS Innovation Fund under the revised ETS proposal should be increased. If aluminium is subject to the CBAM, we suggest earmarking a share of the added revenue caused by auctioning of previously freely allocated quotas to abatement measures in CBAM sectors. Investments aimed at reducing indirect emission must be eligible for targeted support under the Innovation Fund.

- **More aluminium products should be included in the CBAM scope (Annex I).** In addition, finished products outside of CN Chapter 76 should be added, including products where the aluminium part is less than 100%. If the scope is too narrow, as it is in the current proposal, China or other trading parties will simply export products outside the existing scope in Annex I with no CO2 costs to the detriment of EU producers' competitiveness.

Our request:

More aluminium products should be added to the list in annex I of the draft Regulation. We stand ready to define which products should be added under the scope of the mechanism. This is because a CBAM which does not apply to final products jeopardises the downstream aluminium value chain, as it will be more attractive to produce the final product outside of the EU. Circumvention through adding value abroad to import under a tariff code outside of the CBAM must be avoided. By adding more downstream products to the scope, the possibility of carbon leakage for the manufacturing industry decreases significantly.

- **The devil is in the detail and the number of elements left to secondary legislation is significant:** The secondary legislation work will likely proceed in parallel to the negotiations on the Regulation. European Aluminium is therefore concerned about the broad spectrum of Commission delegated and implementing acts, which limit the productive interaction with industry, MEPs and Member States and hold too many uncertainties.

Our request:

It is crucial that the Commission works closely with industry experts in designing the related implementing legislation, especially during the transition period, where the reporting requirement on both scope 1 & 2 emissions will apply. Accurate data as well as evidence of potential circumvention practices and loopholes will be needed. The European Parliament and Member States' representatives in Council and national ministries should closely engage with aluminium producers to fully understand the consequences of the measure on the competitiveness and decarbonisation pathways of the industry in Europe and globally.

- **We need an export solution to recover from ETS costs in the EU:** In 2019, aluminium producers exported around 3 million tons of semi-finished products. This represents a value of around 10 billion EUR that will be at peril. There is the risk that the CBAM will make aluminium less attractive than other materials which do not fall under the scope of the CBAM, or for which Europe is less reliant on imports. Besides the negative economic impact, the EU's sustainability agenda is put in jeopardy as aluminium serves as a vital input for those EU's strategic industries serving the energy transition, ranging from renewable energy technologies and low-carbon mobility

to energy-efficient buildings and circular packaging applications. CBAM will increase tensions with our global trading partners and generate retaliation measures or complaints to the WTO.

Our request:

We need a solution to the reduced global competitiveness of exported products caused by higher ETS compliance costs. We suggest that exporters get refunded the ETS compliance costs each supplier faces above the benchmark level on their exported products, otherwise CBAM represents a major threat to European export industries. With regards to potential solutions, the legal opinion[8] of King & Spalding and NCTM concluded that two design options – which are functionally quite similar – could be considered to address exports within the context of an EU climate policy that imposes a regulatory burden on EU production.

The first option, referred to as the 'de facto export solutions option' involves an extension of the allocation of free allowances to EU production that is exported. The free allowances for exports would be taken from the pool of allowances for auctions and would remain in force until other countries take equivalent and effective steps to impose carbon costs on competing foreign production. Thus, even if the allocation of free allowances for production destined for EU consumption declines, the free allowances for export consumption would not.

The second option, referred to as the 'de jure export refund option' is a refund/credit for allowance obligations on exports. For products consumed within the EU, the allowances obligation applicable to domestically produced products would correspond to the GHG emissions in excess of the product-specific benchmark, with the equivalent obligation imposed on imports consumed within the EU through the application of the CBAM. This equivalent allowance would be refunded when products are exported.

CBAM must contain a mechanism that allows for rolling back the introduced measures if EU export products and businesses are severely impacted by retaliation measures. It should be subject to periodic reviews to ensure for alignment with global initiatives[9] to reduce carbon emissions.

- **Anti-circumvention measures need to be strengthened:** the Regulation's Chapter on anti-circumvention measures is weak. So far, we can make the following considerations:
    - **Chinese over-capacity and risk of source-shifting:** If the system is to be extended to cover indirect emissions, the risk of China redirecting its lowest CO2 aluminium to Europe while keeping its coal-based smelters for internal consumption remains, and there will be no benefit for global climate action.
    - **"Nominal re-direction" aluminium and subsidised over-capacity:** How would the EU expect to shield the CBAM system against nominal redirection of low-carbon aluminium, while respective volumes would simultaneously feed the domestic (e.g. Chinese) downstream industry (double-counting)? Moreover, how would the efficiency of the "economic signal" - i.e. the decarbonisation "incentive"- intended by the CBAM be safeguarded in real life, taking into consideration e.g. the total lack of transparency surrounding state subsidies[10] to the Chinese aluminium industry, which can easily offset the incremental cost impact of the CBAM on exports; said impact would in any event be negligible, as a result of cost absorption, particularly when compared to the tremendous cost increase faced by EU

[8] A full copy of the legal option can be accessed here.
[9] See « IMF Blog A Proposal to Scale Up Global Carbon Pricing », June 2021
[10] See OECD reports "Measuring distortions in international markets: the aluminium value chain" (January 2019) & on "Below-market finance" (May 2021)

producers for their entire output, if existing carbon leakage measures are phased out. These are all elements that must be clarified in the Regulation and in the implementation of the instrument moving forward.

- **Cost absorption:** The efficiency of the CBAM, both as an "economic decarbonisation signal" to our trade partners and as a carbon (and investment) leakage measure, is highly doubtful, also because of the issue of cost absorption. Defined in very simple terms, this is the method that producers have for capturing all costs associated with manufacturing a particular product in their accounting books. Provided no circumvention occurs, the CBAM would inevitably apply only to the particular fragment of the third country operator's total production that is exported to the EU. In case this would amount to a smaller portion of their production (e.g. 5 or even 10% of their total output). Therefore:
    i. The incurred carbon cost through the CBAM levy would exclusively affect said volumes. Considering Chinese over-capacity and the high production volumes, the cost would therefore be easily absorbed and would not provide an incentive for decarbonising the "carbon intensive" production.
    ii. On the other hand, EU producers exposed to the full (direct and indirect) carbon cost would face a tremendous increase in their overall production cost, for their total output: e.g. if a primary aluminium producer in the EU was to bear the full indirect (pass-through) carbon cost (in case compensation was removed), they will face a 40-50% production cost increase on the total volumes produced.
    iii. consequentially, the expectation that the CBAM would level the playing field by effectively pushing third country producers to decarbonise and shielding global competitiveness of EU production, which is already among the most sustainable in the world, is erroneous. For any third country producer, incorporating this insignificant added cost in their overall production cost would have a negligible effect. This undermines the environmental objectives of the measure and compromises the aspired ambition to protect against carbon leakage.
- **Exemptions, verifications & possibility of individual assessments:** Allowing third parties the opportunity not to use their average country emissions but rather, for individual exporters to the EU, to use actual emissions per installation after 2026 as outlined in articles 3 and 7, will lead to market distortions. By allowing individual assessment, exporters to the EU can easily circumvent the system. While Europe may receive more low carbon product, this will not lead to a reduction in greenhouse gas emissions overall**, thus negating the carbon reduction objective of the CBAM.**
- **Review of the CBAM declaration:** Article 19 leaves discretion to the CBAM authority to review the CBAM declaration by stating that *"[…] the competent authority may review the CBAM declaration […]"*. This gives no guarantee about the accuracy of the information provided by the importer and runs the risk of creating an even more fragmented enforcement mechanism, also considering that there will be different competent authorities in charge of ensuring compliance with the Regulation. A more centralised system will be more effective in preventing circumvention.

Our request:

Anti-circumvention measures need to be strengthened and consider all the situations above. If the EU's ambition is to design a system capable of effectively reducing emissions, it is indispensable that resource shuffling is also considered as a motive for circumvention. Similarly, enforcement mechanisms should be strengthened. Penalties for attempts at circumvention should also include the option of withdrawing the import authorisation.

- **CBAM exemption for aluminium products under the Inward Processing Procedure (IPP):** Products subject to the IPP should be exempted from the CBAM and any CBAM declaration, as it is done today for anti-dumping duties: IPR products are exempted of anti-dumping tax when they are temporarily imported into Europe for further export.

Our request:

Aluminium products subject to the Inward Processing Procedure should be exempted from CBAM and any CBAM declaration.

Final remarks

Overall, the CBAM is highly complex and untested as a carbon leakage measure. It is unclear whether it will work as intended. As the EU's "new Carbon Leakage initiative" it must be balanced and give a higher degree of assurance that it will better protect European industries already exposed to international (and often unfair) competition, as long as there is no truly global level playing field on climate action. This requirement will be even more important now, in the build-up after the Covid-19 pandemic and with stepped-up 2030 ambitions, resulting in an even larger imbalance between Europe and the rest of the world.

European Aluminium stands ready to work with the European Commission, European Parliament, the Member States and other stakeholders to design a future-proof carbon leakage mechanism for aluminium.

For further information:

- Presentation at the European Economic and Social Committee (EESC) hearing: "*CBAM: an Unfit for 55 Measure for Aluminium" (*see also streaming of our intervention here) 16 September 2021
- European Aluminium Press release "*European Aluminium warns against unintended effects of aluminium inclusion in Commission's EU Carbon Border Adjustment Mechanism proposal*". 14 July 2021
- European Aluminium response to the EC Public Consultation questionnaire on the EU Carbon Border Adjustment Mechanism (CBAM), 27 October 2020
- European Aluminium our Non paper on excise duty tax design, February 2021

For further information, please contact:

Emanuele Manigrassi
Public Affairs Manager
P +32 2 775 63 97 / M +32 471 73 53 06

Sandro Starita
Director Environment, Health and Safety & Sustainability
P +32 2 775 63 61 / M +32 494 52 59 04

European Aluminium – Transparency Register 9224280267-20, Avenue de Tervueren, 168 – 1150 Brussels, Belgium