BE non-paper on partial free allocation for the export production of CBAM sectors

1 CONTEXT

On 15 March 2022, the ECOFIN Council adopted a general approach on the CBAM Regulation. Several member states, however, indicated that various aspects related to the CBAM proposal still needed to be clarified, mainly in the framework of the revision of the ETS Directive. Belgium was also one of those member states and expressed particular concern about the impact on export and downstream production. Several member states are not convinced by the Commission's substitution argument, which states that the negative impact of CBAM on exports will be compensated by increased production for the EU market, due to the higher price of imported products.

These concerns were partly reflected in a note presented by the French Presidency to the ECOFIN Council, which included the following paragraph:

> *2. b) The issue of limiting potential carbon leakage from exports calls for appropriate solutions that ensure economic efficiency, environmental integrity and compatibility with WTO rules.*

Belgium has previously indicated that partial free allocation for export production is currently, in the short term, the only solution that meets the three criteria, as *economic efficiency* also includes 'broad access for companies'.

This non-paper elaborates on the proposal of partial free allocation for export production of CBAM sectors and proposes that the future allocation of free allowances for CBAM sectors (= both the existing free allocation and a partial free allocation for export) based on the following formula:

Free allocation = benchmark * (AL-EP) * CLF * CSCF (* CBAM factor) + benchmark * EP * CLF (* EF) * CSCF

With:

AL:	Activity Level
CBAM factor:	Factor applied for phasing out existing free allocation
CLF:	Carbon Leakage Factor
CSCF:	Cross Sectoral Correction Factor
EP:	Production level destined for export
EF:	Export factor

2 PRACTICAL IMPLEMENTATION

2.1 Current rules for free allocation

Currently, CBAM sectors receive protection from carbon leakage through the system of free allocation within the EU ETS. The free allocation is calculated according to the following formula:

Existing free allocation = benchmark * AL * CLF * CSCF (* CBAM factor)

- The activity level (AL) of an installation: measure of production volume. This therefore includes production destined for the internal EFTA market as well as production destined for export.

- The relevant benchmarks: measure of the emission intensity of production, calculated on the basis of the 10% most efficient EU installations.
- The Carbon Leakage Factor (CLF): This factor estimates the risk of carbon leakage and is calculated based on the trading and emission intensity of the sectors. CBAM sectors (with the exception of electricity) have a high carbon leakage risk, which is why the current Directive foresees 100% of the free allocation until 2030, and this does not affect the free allocation any further.
- The Cross-Sectoral Correction Factor (CSCF): The total volume of allowances that can be allocated for free is capped at 43% of the total (i.e.: allocated for free + auctioned) ETS allowances, with an additional buffer of 3%. If the 43% + 3% threshold were to be exceeded by the first three criteria, all emission allowances allocated for free would be reduced *pro rata* by the CSCF. According to the European Commission, the CSCF will not have to be applied before 2030.
- In the proposal for revision of the ETS Directive, the Commission proposes to introduce a CBAM factor. This factor should result in the free allocation for CBAM sectors being phased out. In the Commission proposal, this factor is to be reduced by 10 percentage points per year between 2026 and 2035.

2.2 Additional allocation for export production CBAM sectors

2.2.1 Practical implementation

Export production is already protected at present through the existing free allocation, as production destined for export is also included in the criterion “activity level”. In order to avoid that production for export is compensated twice, which would be incompatible with WTO rules, a solution seems to be to separate the share of production for the internal European market from the share of production destined for export. For both aspects, separate rules on free allocation are being drawn up. The *existing free allocation* is therefore adjusted in the formula as follows:

Free allocation = *benchmark * (**AL-EP**) * CLF * CSCF (* CBAM factor)* + benchmark * EP * CLF (* EF) * CSCF

With some minor modifications, the formula for the existing free allocation can be adopted for a new type of partial free allocation for the export production of CBAM sectors (second part of the equation). Unlike the existing free allocation, this allocation would not be reduced by the CBAM factor.

The criterion "activity level" can be replaced by the criterion "**production for export**" (EP). As a result, installations under the ETS covered by CBAM would receive free allocation only for the production destined for export. The dynamic allocation rules now valid under the EU ETS can be applied to exports. This means that the allowances are allocated on the basis of the export production in a reference year (year to be decided). The allocation is then adjusted if necessary if the export production in a certain year changes by more than [15%][1] compared to the historical activity level (based on a rolling two-year average).

To obtain the free allocation, installations will have to report annually on export levels through export reports verified by independent verifiers, just as they do now on activity levels. This reporting has to be done on the basis of a specific export monitoring methodology plan (EMMP), which is prepared in the first instance for the period 2026-2030 and approved by the competent authorities. This EMMP should be established based on the following steps:

[1] This is the current rule in the existing free allocation. This can be changed specifically for exports.

- Version 1 shall be submitted to the competent authority by **31 December 20XX**: This "Backward looking EMMP" shall detail how the relevant data for the export production of reference year X will be measured and reported.
- Version 2 is submitted to the competent authority by **31 December 20XX**: The Backward-looking EMMP section is reworked based on the comments from the competent authority. In addition, a forward-looking EMMP that details how production levels destined for export will be monitored during the period 2026-2030 needs to be added.
- The competent authority aims to approve the EMMPs by **31 December 20XX**.

The competent authorities will provide the necessary templates, apply, and monitor the application of the allocation rules, possibly in cooperation with customs for a *post factum* control. These steps would lead to a certain additional administrative burden for both the companies and the competent authorities, but is limited due to the experience of ETS installations with the free allocation process.

2.2.2 WHO compatibility

In addition, it must be ensured that the system is compatible with the rules of the World Trade Organisation. For this purpose, it must be avoided that the allowances allocated for export are higher in volume than the emission allowances that need to be surrendered. Since the benchmarks are set on the basis of the 10% most efficient installations in the European market, many producers (i.e. the 90% least efficient installations) will only receive partial compensation if these benchmarks are used. It should be noted, however, that the update of the benchmarks only partly follows the efficiency improvement of the 10% most efficient installations, as the benchmark update is limited by a minimum and maximum.

To further ensure WHO compatibility, two options can therefore be considered:

1. [Include a reduction factor, in order to reduce the allowances allocated for exports. In this proposal, the "**export factor**" (EF) is denoted by X.
2. If, based on the benchmarks, more allowances are allocated for free than the allowances that need to be surrendered for the production destined for export, the surplus can be deducted (retroactively, if necessary) from the allocated free allocation.
3. Other options may also be possible.]

Together, these elements lead to the following formula for the integral free allocation for an installation within CBAM sectors:

Free allocation = benchmark * (AL-EP) * CLF * CSCF (* CBAM factor) + benchmark * EP * CLF (* EF) * CSCF

With:

AL:	Activity level
CBAM factor:	Factor applied for phasing out existing free allocation
CLF:	Carbon Leakage Factor
CSCF:	Cross Sectoral Correction Factor
EP:	Production destined for export
EF:	Export factor

2.2.3 Entry into force of the proposal (if with export factor)

Currently, installations receive protection from carbon leakage through the existing free allocation, but this is being phased out. However, this phase-out is gradual, with installations still receiving 90% of their allocation in 2026, 80% in 2027 etc. under the proposed revision of the ETS Directive. If the CBAM

factor is higher than the export factor, it is not interesting for an installation to recieve the partial free allocation for export. After all, they receive a higher free allocation if the production intended for export counts under the "activity level" and is reduced by the CBAM factor. Therefore, the proposal for partial free allocation for exports would only take effect when the CBAM factor is lower than the export factor. If the CBAM factor were to equal the export factor at some point, a test phase could possibly be introduced.

Purely as an example, with an [initial] EP of 90%, the partial free allocation could take effect from 2027, with 2026 as the possible test year.

Year	**CBAM factor**
2026	90%
2027	80%
2028	70%
2029	60%
2030	50%
...	...

2.2.4 Quantity of partial free allocation

Based on rough estimates, it can be deduced what proportion of EU production in the various CBAM sectors is exported to non-EFTA countries. This gives an indication of the volume of free allocation that will not be phased out according to the CBAM factor.

Sector	EU exports to non-EFTA as part of total production[2]	Total volume of EU free allocation for exports (currently, with EF = 100%)[3]	Total volume of EU free allocation for partial allocation (if EF is used)
Iron and steel	19,05%	~ 21 million EUAs[4]	*Volumes in column three, further reduced by multiplication with the export factor X.*
Aluminium	30,75%	~ 2 million EUAs[5]	
Cement and clinker	6,46%	~ 6 million EUAs[6]	
Fertilisers	20,50%	~ 6 million EUAs[7]	

2.2.5 Link to CSCF

The total volume of allowances that can be allocated for free is currently limited to 43% of the total (i.e. allocated for free + auctioned) ETS allowances, with an additional buffer of 3%. If demand for free allocation exceeds availability, free allocation is limited via the application of the CSCF. The revision of the ETS Directive would not lead to an application of the CSCF before 2030, according to estimates by the European Commission.

Importantly, for the calculation of the CSCF, the amount available for free allocation (namely the 43%+3% of the ETS cap) is reduced based on:

1. the share of free allocation of CBAM sectors in the total free allocation that is foreseen;
2. the CBAM factor applied to the free allocation for CBAM sectors.

[2] Based on: https://finance-climact.fr/wp-content/uploads/2022/02/CBAM-Policy-Paper-07022022clean.pdf
[3] Based on: policy_ets_allowances_bm_curve_factsheets_en.pdf (europa.eu)
[4] On the basis of the current free allocation for benchmark "hot metal"
[5] On the basis of the current free allocation for benchmark "aluminium"
[6] On the basis of the current free allocation for benchmark "grey cement clinker"
[7] On the basis of the current free allocation for the benchmarks "ammonia", "nitric acid", "adipic acid"

In other words, the total volume of free allocation available in the Commission proposal decreases in line with the phasing out of free allocation for CBAM sectors. The phasing out of free allocation to CBAM sectors therefore does not increase the amount of free allocation available to non-CBAM sectors. In the Commission's proposal, these allowances are auctioned, with the revenues going to the EU Innovation Fund.

In this proposal, part of the free allocation originally foreseen for CBAM sectors would not be phased out, but would continue in the form of partial free allocation for exports. The total amount available for free allocation for all ETS installations would therefore only be reduced based on:

- CBAM factor
- the part production destined for EFTA countries (instead of the full share of free allocation for CBAM sectors in the total foreseen free allocation)
- If an export factor were to be applied, it would also have to be taken into account by multiplying the total amount available for free allocation that remains for export with the export factor.

Therefore, this proposal of partial free allocation has no impact on the application of the CSCF, but the proposal would be at the expense of part of the additional revenue for the EU Innovation Fund.[8]

2.2.6 Link with CBAM certificates

The partial free allocation for export does not create an advantage for European producers over importers on the European market. Consequently, this partial allocation free of charge cannot be seen as part of the free allocation that is deducted for the purpose of calculating the CBAM certificates as in Article 31(1) of the CBAM Regulation (general approach). For this purpose, Art. 31§1 CBAM Regulation can be amended during the trilogues. Another possibility is that partial free allocation is included in a separate article in the ETS Directive (e.g. a new Article 10e).

[8] See the Commission proposal: alignment with recital 30 and Article 10a(§1a) of the ETS Directive revision.