

EU ETS : INDIRECT COMPENSATION

OBSERVATIONS BY HCIA, THE HELLENIC CEMENT INDUSTRY ASSOCIATION

I. INTRODUCTION

HCIA, the Hellenic Cement Industry Association, hereby comments on the Draft “*Guidelines on certain State aid measures in the context of the system for greenhouse gas emission allowance trading post 2021*” (hereinafter the “Draft Guidelines”). The Draft Guidelines were accompanied by an Explanatory note and by a Consultant Report under the title “*Combined retrospective evaluation and prospective impact assessment support study on Emission Trading System (ETS) State Aid Guidelines*” (hereinafter the “Consultant Report”).

These documents were published by the European Commission following the submission, including by the cement sector, of a file arguing eligibility under the indirect compensation regime.

II. PROCEDURAL REMARK

As a preliminary remark, it is important to note that the Consultant Report refers to sector fiches which include the analysis per sector of the parameters to determine eligibility for indirect compensation. While the Consultant’s Report states on its page 18 and 26 that the 41 Sector Fiches are included in Annex to the Final Report, these fiches are not part of the consultant report that forms the basis for the public consultation.

The absence of these fiches makes it difficult for HCIA to provide meaningful and detailed input into the consultation as we do not have an insight into how the four main areas for analysis (market characteristics, profit margins, abatement potential and fuel and electricity substitutability) have been assessed.

We understand from discussions with the Commission services that these fiches will not be made publicly available until after the closing of the consultation period and that the Commission will carry out its own assessment of the eligibility criteria and compare these with the findings by the consultants.

III. INDIRECT COMPENSATION: RELEVANCE FOR THE CEMENT INDUSTRY

HCIA hereby reiterates a number of key characteristics for the sector which underline the importance to mitigate the impact of electricity costs on the overall cost structure for the industry.

- ✓ While the indirect emissions account for around 11% of total CO₂ emissions of the cement sector, the “cement, lime and plaster” sector has the highest share of energy costs in total production costs (see Annex I¹) and electricity costs in the EU represent more than 50% of total energy cost and this is higher than in other jurisdictions see (see Annex II²); we do acknowledge that the percentage of electricity costs in the

¹ Presentation DG Energy, European Commission, “Energy Prices and costs in Europe 2018”, presented at the Refining Forum, 25th April 2019.

² “Competitiveness of the European Cement and Lime Sectors”, Report by Ecorys and WIFO for the European Commission, December 2017.

overall production cost differs from Member State to Member State and understand that this element will be taken into account for determining the amount of aid for eligible sectors; we nevertheless find it relevant to point to the impact on the cost structure especially since the cement business is a low-margin business and this item is of direct relevance for the discussion on profit margins in the industry;

- ✓ The Draft Guidelines correctly state that there is a risk of carbon leakage “*either because production is transferred from the Union to other countries with lower ambition for emission reduction, or because Union products are replaced by more carbon-intensive products*”. In this respect, it is worth mentioning that a capacity build-up of 70 million tonnes is forecasted in areas bordering the European Union over the 2018-2025 period (see [Annex III](#)). While capacity build-up does not equal exports to Europe, this development needs to be considered in combination with a change in business model witnessed in the industry whereby clinker manufacturing (the most CO₂ intensive part of cement manufacturing) is done in areas bordering the EU and brought to grinding installations in Europe where clinker is ground into cement which is then further transported across Europe. CEMBUREAU points out that the consultant’s report, in identifying examples of carbon leakage actually happening, only provides to one case and that is the Gador plant from CEMEX in Spain³; this confirms that the cement sector is one of the sectors most at risk of carbon leakage ([Annex IV](#));
- ✓ The Draft Guidelines do refer to the Green Deal as the context in which indirect compensation needs to be considered. The decarbonisation of energy intensive sectors will entail an increasing demand in electricity, as set out in the Masterplan developed in the High-Level Group for energy intensive industries⁴. See the item below for more details about the cement sector.

IV. ELECTRIFICATION AND THE CEMENT INDUSTRY

For energy-intensive sectors, higher electricity demand and therefore cost is usually associated with the electrification of the sectors. In the cement sector, most of the CO₂ emissions (66% of total CO₂ emissions) are process-related.

Electrification efforts in the industry are in an early stage of research and development. The technologies under study are:

- **Plasma** is a fundamental state of matter that occurs when a gas is heated sufficiently to form an ionized gas. Temperatures between 3000 and 5000 °C can be obtained.
- **Electrical flow heaters** whereby heat is generated by running a current through a resistant element, which is usually protected by a shroud, and transferred to a gas flow through high-velocity convection. Maximum gas outlet temperatures of 1100–1200°C are quoted.
- **Microwave heating**
- **Resistive electrical heating**
- **Induction heating**.

Cemena and Vattenfall run a joint project ([CemZero](#)) with the aim to check the technical feasibility to electrify the cement production process. Different technologies have been tested, to be verified in larger scale tests.

³ p. 24 of the Consultant Report, footnote 11.

⁴ Masterplan for a competitive transformation of EU energy-intensive industries enabling a climate-neutral, circular economy by 2050, p. 39, mentioning an electricity demand for energy intensive industries between 2,980 TWh and 4,430 TWh.

Hydrogen combustion: providing the heat for the cement production process through combustion of hydrogen generated through electrolysis of water may be considered as an electrification of the production process. Hydrogen as a fuel is characterized by very wide flammability limits, high burning velocity and a quite high adiabatic flame temperature. The application of hydrogen as a fuel in a cement plant would require extensive testing and, most probably, modifications of kilns and the clinker burning process. Challenges of these are handling problems (e.g. risk of explosion), effects on heat transfer (temperature profile inside kiln, radiative characteristics) and possible impact on product quality.

An **increased electricity demand**, however, will result from the decarbonisation, efforts in the cement manufacturing process, including the development of carbon capture projects, the increased recourse to alternative fuels and for grinding of alternative raw materials or cements of higher fineness⁵.

- In the European Union, the cement industry now draws 46% on average of its fuel needs from alternative fuels to replace fossil fuels; this is an increase from 2% in 1990 and there are no technical impediments to increase to 95% -100%; the barriers are regulatory in nature (permitting public acceptance, no landfill ban on waste) but also the electricity cost plays a role which means that individual plants reaching high levels of fuel substitution are located in areas where electricity prices are relatively low;
- The cement industry is currently involved in demonstration and pilot carbon capture projects whereby the purification of the CO₂ stream from 25%-30% in a current kiln to 100% (required for capture) happens through membrane or calcium looping technologies or through amine adsorption. All of these processes require twice as much energy costs (50% of which is electricity cost) compared to current processes (6 GJ/t clinker instead of 3 GJ/t clinker). For CCS/CCU technology, an increase in power consumption at plant level is estimated between 50% and 120%⁶.
- Roughly speaking, 120 million tonnes of clinker, which is the current EU production, requires 3 GJ/t clinker thermal energy consumption. If we were to convert the thermal energy need in electrical energy demand, we would need 120 TWhr of electrical energy consumption for the current kilns. When the industry opts for CO₂ purifying amine solutions, the total energy demand would increase to 200-250 TWhr of electrical consumption for the production of 120 million tonnes of clinker.

For further investment in technologies or already existing business applications referred to above, companies include the cost of electricity in their return on investment calculation.

V. **RED-AMBER-GREEN (RAG) ANALYSIS TO DETERMINE THE RISK OF INDIRECT CARBON LEAKAGE**

HCIA was surprised to note a “medium-low” qualification under the Red-Amber-Green (RAG) assessment carried out by the consultants. While each of the criteria for the assessment have been discussed in detail in CEMBUREAU’s submission filed with the European Commission in April, we do wish to highlight a few core arguments for each of the criteria as the rating received does not correspond to our own assessment. This is precisely the reason why access

⁵ Ibidem, p. 138.

⁶ European Cement Research Academy (ECRA), Technology Papers, p. 12.

to the sectoral fiches is indispensable as it would provide useful insights into the assessment made by the consultants based on our submission.

a. Market characteristic parameters

- ✓ Input prices have gone down at a slightly faster pace than output prices over 2012-2016, mostly driven by lower prices of energy/kg
- ✓ the domestic output price index decreased faster than the non-domestic index over 2014-2016 which suggests strong price competition;
- ✓ prices evolve more slowly than costs because of the limited pricing power of the industry in the EU (for these three points, see Annex VI);
- ✓ pricing power is constrained both by competition from third countries and by the fact that cement only represents 20% of the construction sector purchases even though more than 70% of cement is destined for the construction sector
- ✓ cost-pass through in the cement industry is limited due to the following factors:
 - (i) cement is a homogeneous product traded in both local and international markets, facing commodity pricing;
 - (ii) strong price elasticity, especially in markets bordering the EU;
 - (iii) long downward demand cycles hinder any price increase
 - (iv) destination markets are not likely to apply equivalent environmental measures to those in the EU on a sectoral level
- ✓ See Annex VII for excerpts from a PwC literature study done for CEMBUREAU on cost pass through in the cement sector also demonstrating that the industry will still be facing strong competitive pressure from non-EU countries by 2030.

b. Profit margin

- ✓ the added value in the cement industry decreased by 7.8% per year between 2008 and 2016, faster than the turnover which led to a margin deterioration (see Annex IV);
- ✓ gross operating rate decreased by 11% between 2008 and 2012 and has remained at the same level since;
- ✓ many cement companies are still operating at a return on capital employed below the cost of capital;
- ✓ investments in the cement sector have halved since 2009, falling from EUR 2.1 bn (2009) to EUR 944 million (2016)
- ✓ At a CO₂ price of EUR 25, the cement industry's EBITDA threatens to be wiped out completely especially when no compensation for indirect costs is foreseen⁷.
- ✓ see Annex VIII⁸ showing the decrease in profitability in the cement sector for selected countries pre-crisis / post-crisis

c. Abatement potential

⁷ Based on average production cost (ex factory, i.e. without transport costs) of EUR 55/t cement and a sales price of EUR 80 – EUR 85.

⁸ Report mentioned in footnote 2, p. 36.

- ✓ Efforts made to improve energy efficiency in the cement manufacturing process have already resulted in a very high energy efficiency of between 70% and 80%, depending on the moisture content of the raw materials⁹;
- ✓ The potential for a further decrease in electricity consumption through new techniques is limited given the unrealistically high cost of carbon required to reach break-even: by way of an example, reference is made in CEMBUREAU's submission to a EUR 385/t CO₂ carbon price for a preheater modification leading to a electricity consumption decrease of 5 KWh/t clinker; in addition, the pay-back time of more than 5 years is longer than the one anticipated by the European Commission in its para. 54(a) of Draft Guidelines when referring to the energy audit.

d. Fuel and electricity substitution

- ✓ The cement industry is increasingly moving away from fossil fuels: today, 46% of the industry's fuel needs are covered by alternative fuels taken from a variety of waste streams; while the shift from fossil fuels is not (yet) a massive shift to electrification, the need for electricity increases with a stronger recourse to alternative fuels.

Conclusion: given that there is no ability for the cement sector to pass on costs, the prospects for investment are worsening, further abatement potential is low (and even negative, due to increased electrification) and the industry is a price taker, the RAG analysis should have resulted in a higher ranking for the cement sector on the eligibility curve.

VI. SUGGESTIONS

VI.1. Proposal including medium (RAG rating) sectors, qualitative approach

A first option, taking into account the qualitative approach proposed by the Commission, would be to include those sectors and subsectors with a **medium risk** (RAG rating), according to the Commission Report, and meet any of the following two criteria, or the intensity trade is =0.2; or indirect emissions intensity is > 1

NACE Code	Sector	Trade Intensity	Indirect emissions intensity	or TI (UE)*IEI(UE)>0,2 or IEI>1		RAG rating
24.44	Copper production	0,35	0,71	0,251	YES	Medium
20.60	Manufacture of man-made fibres	0,44	0,64	0,281	YES	Low- medium
20.16	Manufacture of plastics in primary forms	0,36	0,69	0,247	YES	Medium
08.99	Other mining and quarrying n.e.c.	1,73	0,25	0,438	YES	Low- medium
20.11	Manufacture of industrial gases	0,06	15,09	0,905	YES	Low- medium
23.51	Manufacture of cement	0,10	1,33	0,134	YES	Low- medium

⁹ Evaluation of the energy performance of cement kilns in the context of co-processing, European Cement Research Academy (ECRA), Technical Report A 2016/1039, p. 3.

VI.2. Proposal including sectors that meet and go beyond a higher criterion of carbon leakage

There are precedents for applying exceptions by countries in the ETS Directive itself, which is referred to in the Communication draft on Guidelines on certain State aid measures post 2021:

1.2.2. Aid involved in the optional transitional free allocation for the modernization of the energy sector

Under Article 10c of the ETS Directive, Member States fulfilling certain conditions relating to the level of GDP per capita in comparison to the Union average, may derogate from the principle set out in the second subparagraph of Article 10a(1) of Directive 2003/87/EC that no free allocation is to be made in respect of any electricity production. Those Member States may give a transitional free allocation to installations for electricity generation for the modernization, diversification and sustainable transformation of the energy sector.

Articles 10.c and 10.d of the *ETS Directive* set out:

Article 10c “Option for transitional free allocation for the modernization of the energy sector”

- 1. By way of derogation from Article 10a(1) to (5), Member States which had in 2013 a GDP per capita at market prices (in euros) below 60 % of the Union average may give a transitional free allocation to installations for electricity generation for the modernization, diversification and sustainable transformation of the energy sector. The investments supported shall be consistent with the transition to a safe and sustainable low-carbon economy, the objectives of the Union's 2030 climate and energy policy framework, and reaching the long-term objectives expressed in the Paris Agreement. The derogation provided for in this paragraph shall end on 31 December 2030.*

Article 10d Modernization Fund

- 1. A fund to support investments proposed by the beneficiary Member States, including the financing of small-scale investment projects, to modernize energy systems and improve energy efficiency, in Member States with a GDP per capita at market prices below 60 % of the Union average in 2013 (the ‘Modernization Fund’), shall be established for the period from 2021 to 2030. The Modernization Fund shall be financed through the auctioning of allowances as set out in Article 10.*

Due to its historical generation characteristics, the electricity market is not uniform.

The markets for basic industrial products may also have heterogeneities due to their geographical location, access to maritime transport, the situation close to the borders of the EU or its manufacturing capabilities for specific products of greater international demand.

These two characteristics create unfair or unequal treatments in some of the geographic areas defined by the Commission

In addition, taking into account the regional specificity established in the guidelines and in line with the support that the Commission promulgates to the regions affected by the transition of its economic sectors, it is proposed to include those sectors that (for Spain or Iberia) meet and go beyond a higher criterion of carbon leakage. That is, the indicator is greater than 0.25 (compared to 0.2 established).

NACE Code		Sector		
23.51		Manufacture of cement		
Annex III Geographic areas	Indirect emissions intensity (IEI)	Trade intensity (TI)	TI (UE)*IEI(UE)>0,25	
Iberia (Spain, Portugal)	1.33	0.27	0.36	YES
Baltic (Lithuania, Latvia, Estonia)	1.33	0.49	0.65	YES
Nordic (Sweden, Finland)	1.33	0.37	0.49	YES
Czech Rep.-Slovakia	1.33	0.00	0.01	
Belgium	1.33	0.05	0.06	
Bulgaria	1.33	0.23	0.30	YES
Denmark	1.33	0.21	0.28	YES
Germany	1.33	0.04	0.06	
Ireland	1.33	0.00	0.00	
Greece	1.33	0.53	0.71	YES
France	1.33	0.05	0.07	
Croatia	1.33	0,57	0.76	YES
Italy	1.33	0.07	0.09	
Cyprus	1.33	125.61	167.07	YES
Luxembourg	1.33	97.80	130.08	YES
Hungary	1.33	0.32	0.43	YES
Malta	1.33	1.01	1.35	YES
Netherlands	1.33	4.07	5.41	YES
Austria	1.33	0.06	0.07	
Poland	1.33	0.02	0.02	

Romania	1.33	0.02	0.03	
Slovenia	1.33	91.23	121.33	YES
United Kingdom	1.33	0.02	0.03	

That means that cement sector in 17 Member States comply these criteria, representing a 30.8 % of the EU population and a 25.9 % of the EU cement market.