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Revision of the state aid guidelines in the context of the EU ETS: discussion on the draft guidelines

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Background: process

- Revision of the guidelines from 2012
  - Legal basis = Reviewed ETS Directive (2018/410/EU)
    - Article 10a (6)
  - State aid measure under Article 107(3)(c) of the TFEU
  - DG COMP
- *Revision* process kicked-off in December 2018
  - Two consultations in 2019: targeted (sectors) and public
  - Draft guidelines were published on January 14
  - Now: eight-week public consultation – March 10 deadline
  - Adoption foreseen for mid-Q3 2020

Background: direct vs. indirect costs

- Similar effects on competitiveness
- Dealt with differently
  - Direct cost
    - Free allocation
    - Centralised EU approach
    - Full compensation (at benchmark level)
    - Based on carbon costs (direct+indirect)
  - Indirect cost
    - Cash
    - Fragmented and voluntary MS approach with EU ground rules
    - Compensation limited (at benchmark level)
    - Based on indirect costs only

Background: EU ETS directive (Art. 10a (6))

- MS ‘shall seek’ to use no more than 25% of auctioning revenues or must publish a report explaining why they exceeded that percentage
- Ex ante (sub-)sectoral benchmarks to be used for calculation of carbon leakage risk
  - Benchmarks based on electricity consumption per unit of production using most efficient available technologies and CO2 emissions of relevant EU electricity production mix
- EC to assess impacts of indirect cost compensation on internal market in annual ETS report
  - And ‘where appropriate’ recommend measures to limit such effects

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Background: indirect compensation in P3

Member State	Compensation paid for 2016 (€ million)	Auction revenues 2016 (€ million)	Percentage	Compensation paid for 2017 (€ million)	Auction revenues 2017 (€ million)	Percentage
Flanders	46.75	56.92	82.14%	31.72	76.14	41.67%
Wallonia	/	/	/	7.5	68.17	11%
Netherlands	53.59	142.61	37.58%	36.9	190.71	19.35%
Germany	288.72	850.39	33.95%	202.21	1,146.82	17.63%
UK	19	424.33	4.48%	17.16	566.48	3.03%
Spain	71.44	369.46	19.34%	66.64*	493.55	13.50%
France	135.15	234.68	57.59%	98.73	313.40	31.50%
Slovakia	10	65.05	15.37%	10	87.06	11.49%
Finland	37.91	71.22	53.22%	26.75	95.26	28.08%
Lithuania	1.04	11.5	8.70%	0.24	15.39	1.54%
Greece	12.4	148.05	8.38%	12.44	198.03	6.28%
Luxembourg	/	/	/	3.4	6.87	49.5%

Source: 2019 State of EU ETS Report (ERCST, I4CE, EcoAct, ICIS and Wegener Centre)

Background: ERCST work

- Work stream started when revision was kicked-off
- Three meetings organised in 2019: starting a discussion in Brussels on potential elements to be included in the revision
- Today, second meeting in 2020: focus on the draft guidelines and the response to the public consultation

Background: ERCST main criteria for assessing indirect cost compensation

- ***Effective*** carbon leakage protection for sectors that ***need*** it;
- ***Transparent*** assessment of leakage risk;
- ***Dynamic*** cost compensation;
- Need for mid-Phase ***review;***
- MS compensation ***as similar as possible*** (avoid market distortion);
- ***Symmetry*** with free allocation rules desirable.

Today: Five issues for discussion

1. What are the **objectives** of the State Aid Guidelines;
2. **Eligibility**: which sectors are to receive compensation;
3. **Aid intensity and degressivity**: how much state aid can beneficiaries receive;
4. **Conditionality**: conditions to be fulfilled by beneficiaries receiving state aid;
5. **Implications for future discussions** on carbon leakage measures.

1. Objectives of the State Aid Guidelines

Indirect cost compensation itself and the state aid guidelines have different goals – ERCST's interpretation always was as follows:

- Indirect cost compensation is meant to tackle carbon leakage concerns.
- State aid guidelines themselves are meant to *limit the aid* itself in order to address internal competition concerns / limit the risk of internal market distortions between Member States.

1. Objectives of the State Aid Guidelines

However, various objectives are mentioned throughout the documents:

- "**in order to prevent State aid from distorting competition in the internal market** and affecting trade between Member States…" *(Introduction to the draft communciation)*
- "the primary objective of State aid control … is to **ensure that State aid measures will result in a higher reduction of GHG emissions** that would occur without the aid and to ensure that the positive effects of the aid outweigh its negative effects in terms of distrotions of competition in the internal market" *(Introduction to the draft communication)*
- "the draft EU ETS State aid Guidelines **aim at reducing the carbon leakage risk** related to indirect ETS costs, and incentivising the modernisation of production processes" *(factsheet)*
- The purpose of the guidelines proposed for consultation is to **address the risk of carbon leakage due to indirect ETS costs while minimizing competition distortions** and maintaining the incentives for a cost-effective decarbonisation of the economy *(explanatory note + website)*

➔ ***How are these objectives to be balanced?***

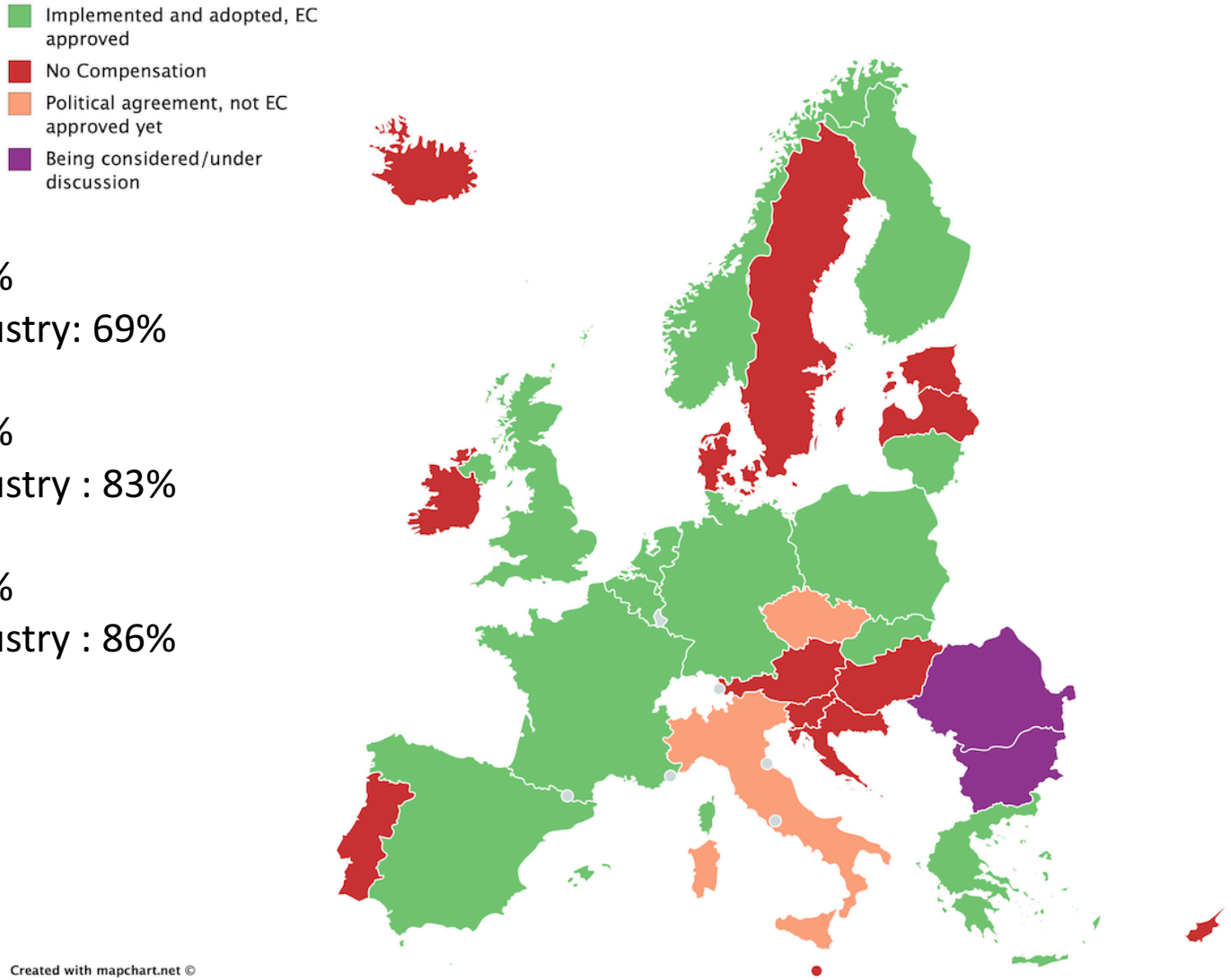
1. Objectives of the State Aid Guidelines

Internal market distortion

- Since compensating indirect costs is voluntary, risk for internal market distortions exists.
- The State Aid Guidelines introduce coherence between MS schemes by setting a cap on aid given and determine which sectors are eligible *(though MS can go beyond)*
- Distortion was a real concern in the beginning of Phase 3: only a handful of MS had schemes in place.
- This amount has increased steadily over the last few years, and continues to increase
  - 2017: 10 Schemes in place
  - Luxembourg and Wallonia (Belgium): 2018
  - Poland: 2019
  - Czech Republic and Italy: political agreement
  - Romania and Bulgaria: under discussion

1. Objectives of the State Aid Guidelines

Internal market distortion



- **2020 situation**
  - ETS Emissions: 73%
  - Energy use by industry: 69%
- **+ Italy & Czechia**
  - ETS Emissions: 85%
  - Energy use by industry : 83%
- **+ Romania & Bulgaria**
  - ETS Emissions: 89%
  - Energy use by industry : 86%

**2018 data*

1. Objectives of the State Aid Guidelines

Internal market distortion

Member State	Deviations from state aid guidelines?
Flanders	• No support for the first 1.000 MWH • Reference electricity consumption calculation does not take into account lowest year • EUA price calculated on basis of highest traded volumes in first quarter • **Conditionality**: join in agreement with government on Energy Efficiency • **Only 2 installations per beneficiary receive compensation**
Wallonia	• No support for the first 1.000 MWH • **Calculates % of electricity originating from ETS installations = additional variable limiting overall compensation given**
Netherlands	• No support for the first 1.000 MWH • **Conditionality**: join agreement with government on Energy Efficiency (covenant)
Germany	• No support for the first 1.000 MWh • **Uses actual electricity consumption + output levels for calculation** • **No aid for electricity supply contracts that do not include CO2 costs**
Finland	• No support for the first 1.000 MWH • **Maximum aid intensity is ½ of the maximum aid intensity allowed by the guidelines** • No compensation if the electricity purchased is not from a plant falling under the ETS and does not face an opportunity cost *(prove that it 'could' be sold on the market)*
United Kingdom	• Cost assessment **at company level rather than sector level** (5% of GVA) • Carbon costs = EU ETS and CPF costs taken together

1. Objectives of the State Aid Guidelines

Internal market distortion

- Increasingly less due to the voluntary nature of compensation but rather due to differences in national schemes?
- Only two options to fully alleviate internal market distortion
  - No compensation
  - Compensation at EU level

Other objectives

- Draft guidelines seem very much focused on ***limiting the aid*** itself: they often *go beyond* what was set in the EU ETS directive *(see later)*
  - e.g. definition of sectors deemed at ***genuine*** risk of carbon leakage

- *Other stated objectives seem to be included more implicitly:*
  - Reducing GHG emissions
  - Reaching the overall objectives of the European Green Deal
  - Public acceptability (?)

  ➔ **Captured in Conditionality?** *(see later)*

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2. Eligibility: which sectors can receive compensation?

- Article 10.b of the ETS directive reads:
  - Sectors with the product of trade exposure x CO2 intensity/GVA > 0,2 *"shall be deemed to be at risk of carbon leakage"*
  - Sectors with the product of trade exposure x CO2 intensity/GVA < 0,2 but > to 0,15 may be considered as exposed to carbon leakage as a result of a qualitative assessment.

➔ 24 sectors – eligible

➔ 11 sectors – qualitative assessment

2. Eligibility: which sectors can receive compensation?

- Draft guidelines introduce additional criteria
  - Trade intensity of at least 20%, *and*
  - Indirect emission intensity of at least 1kg CO2/EUR

➔ 8 sectors – eligible

➔ 4 sectors – qualitative assessment

- Reason?
  - based on the assessment of the consultants that many of these sectors are not at (a high) risk of carbon leakage (?)
  - Should this be seen as the Commission implementing the term '**genuine**' in *'genuine* risk of carbon leakage' mentioned in Article 10a (6) and throughout the draft guidelines?

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2. Eligibility: which sectors can receive compensation?

- Only sectors for whom the compensation of indirect costs are a ’matter of survival’ seems to have made the list
- Limited resources available by MS to be shared by fewer sectors:
  - Could limit MS further limiting the sectoral scope or amount of aid given (e.g. Finland)

Some questions for discussion

- **Is it an issue that the state aid guidelines *go beyond the directive*?** *(though, this is of course not new for indirect costs compensation)*
- **Does this create inconsistencies?** *(e.g. definition of a sector deemed at risk of carbon leakage vs at ‘genuine’ risk of carbon leakage)*
- **Consequences for future carbon leakage discussions?** Are we going towards a ’tiered’ risk assessment of carbon leakage?

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2. Eligibility: which sectors can receive compensation?

- Possibility introduced for MS to *grant additional support* for some sectors with particularly high indirect costs (as ***tbd***% of GVA, after compensation has been given)
- Interesting addition, as it effectively introduces the possibility for a ***tiered approach*** to indirect costs compensation – **precedent**?
- Consultants' study shows that, depending on the GVA threshold, this could be applicable to a large number of sectors on the list– **knowing the threshold is essential**
- As this is an optional clause, there is of course a risk for increased market distortions between MS

2. Eligibility: which sectors can receive compensation?

- Some additional thoughts on the additional support option:
  - Eligibility is determined by ***indirect emission intensity*** while additional support beyond 75% would be based on ***cost intensity****;*
  - Cost intensity is expected to rise as EUA prices increase;
  - By including this option, the EC seems to indicate that the aid intensity variable is not 'fit for purpose' (?)
    - If cost intensity is the *real* indicator of risk for carbon leakage, then using the aid intensity variable both leads to under- and overcompensation.
    - Would it be better to design the entire compensation scheme with the objective to limit indirect costs to a certain % of the GVA?

2. Eligibility: which sectors can receive compensation?

- Some additional thoughts on the additional support option:
  - Other sectors that do not make the list *(based on the emission intensity critera of 1kg CO2/EUR)* do of course not get this additional compensation, even though their cost intensity levels can be pretty high as well *(see consultancy report)*
  - Moreover, this additional compensation is dynamic (as who receives it can change over time due to the EUA price) while eligibility for indirect costs compensation is static over Phase 4.

➔ This option shows signs of inconsitencies

3. Aid intensity, degressivity and dynamism

- Degressivity principle in Phase 3: maximum aid intensity rate that decreased over time (85% → 75% over Phase 3)
- **ERCST:** Not the right way to introduce degressivity of aid – degressivity should be naturally introduced through increasing the time-sensitiveness of the key variables
  - Benchmarks
  - CO_2 intensity factor
  - Output rate

3. Aid intensity, degressivity and dynamism

Formula

$$Amax_t = Ai_t * C_t * P_{t-1} * E * BO$$

$$Amax_t = Ai * C_t * P_{t-1} * E * AO_t$$

$Amax_t$ is the maximum aid intensity in year t
Ai_t is the aid intensity at year t, set at 75%
C_t is the applicable CO_2 emission factor (tCO_2 /MWh) (at year t);
P_{t-1} is the EUA forward price at year t-1 (EUR/tCO_2);
E is the applicable product-specific electricity consumption efficiency benchmark; and
AO is the actual output.

3. Aid intensity, degressivity and dynamism

- **Aid intensity**:
  - Draft guidelines keeps aid intensity stable at 75%
  - "the aid is proportionate and has sufficiently limited negative effect on competition and trade if it does not exceed 75% of the indirect emission costs incurred" *(draft guidelines)*
    - Shows again that the guidelines are aimed at *limiting the amount of aid given.*
    - ⇔ option for additional support based on cost intensity (% of GVA)

3. Aid intensity, degressivity and dynamism

- **CO2 intensity factors:**
  - Phase 3: static CO2 emissions factor, while it seemingly implied to change over time in the formula (C_t)
  - **Draft guidelines:**
    - Use of regional factors maintained where applicable
    - Mid-term review introduced
    - EC: Calculation method will change to marginal plant approach based on fossil fuels for mid-term review

➔ Good changes, but one mid-term review seems insufficient

3. Aid intensity, degressivity and dynamism

- **Benchmarks:**
  - Phase 3: static benchmark based on most electricity-efficient methods of production for the product
  - **Draft guidelines: two options**
    1. Benchmark based on most electricity-efficient methods of production for the product - Update at the beginning of Phase 4 + reviewed mid-term
    2. ”the Commission is considering aligning … with the methodology specified in Article 10a(2) of the EU ETS directive = extrapolate annual reduction rates for each benchmark based on past efficiency improvements

       = preferred option - increases dynamism of compensation + incentive for continuous EE improvements

3. Aid intensity, degressivity and dynamism

- **Output levels:**
  - Phase 3: Baseline output levels used, static
  - **Draft guidelines:**
    - Actual output levels will be used in the calculation
    - Most dynamic method possible

    = good development

4. Conditionality

- **Phase 3**: no conditionality
- **Draft guidelines:**
  - Energy audit mandatory for all beneficiaries *(under the EE directive already mandatory for large companies)*
  - One of three options to be fulfilled by beneficiaries:
    1. Implement audit recommendations; OR
    2. Reduce carbon footprint of electricity consumption (e.g. through on-site renewable energy generation covering 50% of electricity needs or a carbon-free PPA); OR
    3. Invest > 80% of the aid amount in projects to reduce the installation's emissions

4. Conditionality: some thoughts

1. Conditionality is not new:

- Both the Dutch and the Flemish scheme include a similar conditionality clause for beneficiaries to receive indirect costs compensation: participate in an (otherwise voluntary) energy efficiency agreement with the government
  - Carry out audits + implement recommendations
- Other MS have similar voluntary agreements with industry and/or national schemes in place to support investments towards energy efficiency improvements

4. Conditionality: some thoughts

2. What effect might the conditionality for energy efficiency improvements have?

- Dutch case: *"the link with the covenants provides hardly any additional incentive for companies to invest in energy efficiency … only a few companies started participating in the covenants as a result of the link. In some cases, however, the link prevents companies from canceling their participation."* *
  - Hard to judge whether this is case-specific or general.

➔ Does not seem like this will be a *stringent* condition; aimed at the 'laggards'?

**** Policy analysis of indirect costs compensation carried out for the Dutch Ministry for economic affairs***

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4. Conditionality: some thoughts

3. Investing 80% of aid amount given in projects to reduce emissions:

- Aimed at reducing direct emissions from installations
- Seems illogical, given the fact that this aid is given to alleviate the risk of carbon leakage due to *indirect* costs
  - Also, if the aid granted has to be reinvested, does it alleviate the risk of carbon leakage?
  - Short-term vs. long-term risk.
- Moreover, how would this option be assessed? How can the *additionality* of the investment be determined? Does it even have to be additional?

4. Conditionality: some thoughts

4. **Reducing the carbon footprint of electricity consumption:**
   - Commendable, but as the text is currently written, fulfilling this condition would exempt the beneficiary from implementing the audit recommendations;
   - 'energy efficiency first' principle?

5. Implications for future discussions on carbon leakage measures.

- In light of the European Green Deal, the European Commission is expected to publish a proposal for reviewing the EU ETS Directive by the summer of 2021.
- Many of the elements in the draft guidelines start from the methodology used for Free Allocation, but often go beyond *(more stringent)*:
  - More restrictive eligibility criteria;
  - Aid intensity of 75%;
  - Actual output levels used in the calculation;
  - Conditionality introduced;
  - Effectively introduces an (optional) tiered approach.
- A new concept seems to be introduced, that of 'genuine' carbon leakage = tiered risk assessment?

Will this impact the expected debate on Free Allocation?

To what extent does it set precedents?

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