ERCST

European Roundtable on Climate Change and Sustainable Transition

2020

Response to the public consultation on the ‘draft guidelines on certain State Aid measures in the context of the system of greenhouse gas emissions trading post-2021.

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The European Roundtable on Climate Change and Sustainable Transition (ERCST) welcomes the opportunity to comment on the European Commission's **proposal for revised Guidelines on certain State aid measures in the context of the system for greenhouse gas emission allowance trading post-2021** (ETS Guidelines).

Indirect cost compensation was introduced in the EU ETS to address the risk of carbon leakage due to utilities passing their costs for purchasing EUAs on to their consumers. Electricity intensive industries would therefore face higher production costs, which would affect their bottom line.

Overall, ERCST sees a number of issues that need to be balanced in the state aid guidelines for indirect costs compensation:

- carbon leakage risk, which is the 'raison d'être for having indirect costs compensation schemes;
- risk of overcompensation and potential windfall profits;
- risk of internal market distortion within and between sectors;
- how to incentivise cost efficient decarbonization.

ERCST makes use of the following principles and criteria in assessing the guidelines:

- They must ensure effective carbon leakage protection for sectors that need it;
- The assessment of carbon leakage risk needs to be transparent and objective;
- Dynamic cost compensation is necessary;
- A mid-Phase review is desirable;
- Member State compensation schemes should be as similar as possible (in order to avoid market distortion);
- Some level of symmetry with free allocation rules is desirable, as both direct and indirect costs have similar impacts on competitiveness.

Overall, ERCST welcomes the draft state aid guidelines, which present a step in the right direction in terms of developing effective rules which successfully mitigate the risk of carbon leakage due to indirect costs and minimise the distortive effect of the internal market.

ERCST especially wants to highlight and express its support for the following developments:

1) The degressivity principle of the aid granted has been let loose. This is a welcome development as a flat and uniform decrease in aid intensity over the years *(which has been the approach during Phase 3)* is not the correct way to ensure the digressiveness of the aid given. ERCST has long argued that degressivity should be naturally introduced through increasing the time-sensitiveness of the key variables such as the benchmarks, the CO2 intensity factor and the output rate. This has been introduced to some extent for these variables, especially for the output rate, which now is determined by the installations' *actual output levels*, which is a welcome development.

2) The fact that fully renewable electricity contracts (as well as electricity generated by renewables that face an opportunity cost equivalent to the carbon price) are now explicitly covered in the guidelines, resolving the current perverse incentive where clean electricity consumption is penalised in some national schemes (e.g. Germany and Wallonia). This is a much-needed improvement and should be kept in the final guidelines.

3) The ex-post adjustment mechanism to ensure over-payments are repaid to state budgets is a positive evolution.

4) The enhanced transparency and reporting requirements can be supported as well. They set much needed minimum requirements, including an exhaustive list of data to be reported and published by the Member States, ensuring that civil society and researchers have access to information on how much compensation is being given, and to whom.

However, in ERCST's opinion, the draft guidelines include some issues that should be clarified and shortcomings that should be addressed:

1) The introduction of the possibility for Member States to grant additional support for some sectors facing particularly high indirect costs (as tbd% of GVA, after compensation has been given) can in principle be supported but should be unnecessary.

This clause to grant additional support highlights that the aid intensity factor of 75% is not 'fit for purpose' in terms of limiting the risk of carbon leakage. If cost intensity is the real indicator of risk for carbon leakage, then using the aid intensity variable both leads to under- and overcompensation.

As such, ERCST supports that this approach to limit indirect costs faced to a certain % of GVA should be the *default option* for indirect costs compensation. Moreover, a cost intensity variable should ideally also be used in determining the eligibility of sectors over the indirect emissions intensity variable currently used.

2) The draft guidelines leave room for some possibilities or options in the 'maximum aid formula' which should be clarified.

Firstly, the guidelines seem to include two options with regard to the product-specific electricity consumption efficiency benchmarks. The first option would be to keep the current methodology, basing the benchmark on the most electricity-efficient methods of production for the product, but updating these benchmarks both at the beginning and middle of Phase 4. While this approach would already be an improvement compared to Phase 3, the alternative proposed in the explanatory note is the preferred option for ERCST: it would align the methodology with the one used to determine the benchmarks for free allocation, as specified in Article 10a(2) of the EU ETS directive, and similarly extrapolate annual reduction rates for each benchmark based on past efficiency improvements.

Secondly, it is important to note that power prices are set at the margin, and that a marginal plant approach would be the ideal methodology to determine the CO2 emissions factor. The draft guidelines however keep the existing methodology of calculating the *average* CO2 factor in electricity generation by fossil fuels, stating lack of data availability. While the *intention* of the Commission to change this methodology during the mid-term review if the data is available, the Commission should not passively wait for this data to come but actively try to collect it. Moreover, if the marginal plant approach is adopted, this should not only take into account fossil fuels, as it is hard to product what the marginal plant might be in ten years' time.

Lastly, given the fast pace of decarbonisation of the power sector we are currently witnessing, and the increased levels of effort that are required to reach the EU's climate objectives, ERCST argues in favour of regularly revisiting the CO2 intensity factors.

5) The draft guidelines are to an extent incomplete, with key data such as the regional CO2 factors and the proposed GVA threshold to be eligible for additional compensation left blanc. Moreover, although the consultant's report has made public, which is to be encouraged and provides valuable information, the 'sectoral fiches' have not been published – this is a vital piece of information that should be made public to facilitate stakeholders to assess the appropriateness and adequacy of the guidelines.

6) While ERCST can support the introduction of some type of conditionality for aid granted, it is important that this conditionality should not punish those installations and companies that have already made large investments to reduce their (in)direct emissions, e.g. through energy efficiency investments.

As such, ERCST can definitely support the condition to carrying out energy audits mandatory, and to implement the audit recommendations as long as they are economically viable. The pay-back rate of 5 years can even be considered at the lower end, and could be made higher. This type of conditionally does not penalise any early movers, but seem to aim for the 'laggards', which is to be encouraged.

However, we do not see the logic to invest over 80% of the aid amount given, as stipulated by the third option, in projects to reduce emissions of the installation. Firstly, it seems counterintuitive that aid, which is given in the first place to alleviate the risk of carbon leakage to indirect costs, has to be reinvested. This condition implies that either the aid is deemed unnecessary in the first place, of that the risk of carbon leakage will not be alleviated.

As such, ERCST argues to focus the conditionality on energy efficiency improvements only, possibly making the requirements more ambitious than currently stated.

Some final comments:

1) The draft guidelines seem to have operationalised the concept of a ***genuine*** risk of carbon leakage, by making the eligibility criteria more stringent than the ones set out by the EU ETS directive to assess the risk of carbon leakage for industrial sectors. In ERCST's view, this indicates a move towards **a 'tiered' risk assessment of carbon leakage**. If this development is intentional, it should be carefully fleshed out and clarified by the Commission looking forward to the upcoming revision of the EU ETS directive.

Next to a 'tiered' risk assessment, ERCST also interprets the possibility to grant additional aid for those sectors facing high indirect costs compared to their GVA a step into the direction of **'tiered compensation' levels**. Similarly, as to what we said above, if this is indeed the intention of the Commission, this should be fleshed out carefully. In ERCST's view, a combination of tiered risk assessment and tiered compensation, if well designed and implemented, has the potential to make both direct and indirect costs compensation more targeted and balanced, limiting both the risk for over- and under-compensation.

2) There is a lack of clarity regarding the options Member States should use if they deem their state aid scheme too expensive – a risk which is set to increase with rising EUA prices. Industry needs clarity and predictability with regards to how this issue could be resolved – as is the case for free allocation. It would be beneficial if the guidelines were to include some recommendations, e.g. through advising a 'tiering' list for compensation.

3) The soft cap on state aid (25% of auction revenue) has limited use. It is not binding, and Member States can go beyond the 25% with minimal difficulties. In addition, it is skewed towards Member States with higher auction revenues and an emissions-intensive power sector, while placing more limits on countries with a less emissions-intensive power sector – especially those that are in the same region (for emission factors) with countries with a more emission intensive power sector.

5) Indirect cost compensation should not count towards Art 10(3) of the EU ETS Directive on use of auction revenues for selected climate and energy related purposes.