

## **Position paper on the draft of the EU ETS State Aid Guidelines 2021-2030**

### **Association of Chemical and Pharmaceutical Industry of the Slovak Republic**

EU ETS State Aid Guidelines will continue to play crucial role in carbon leakage protection which is becoming even more important in the context of increasing EU climate ambition while at the same time no similar steps are taken in other parts of the world. Such role is even more important due to the higher carbon price compared to phase 3 and in view of the development and uptake of low carbon technologies that will increase substantially the (direct and/or indirect) electricity consumption in many sectors. However, the presence of the State Aid itself (next to the free allocation of EU ETS allowances) is not sufficient, as its effectiveness is clearly dependent on how it will be set, including its individual parameters, and how appropriately it will complement other carbon leakage measures. As the Czech Republic has decided not to continue implementing the system of free allocation of EU ETS allowances for electricity generators in the 4<sup>th</sup> EU ETS trading period, **the following comments will only be focused on the draft rules for compensation of indirect carbon costs post 2021.**

Generally, we welcome that the Commission proposal stems from experiences and some methodologies used during the 3<sup>rd</sup> EU ETS trading period. Nevertheless, despite there are aspects of the proposal that we deem appropriate, we see urgent need to amend several parameters of the Commission proposal so that the compensation of indirect costs can become fit for purpose, i.e. will help to ensure sufficient protection of competitiveness of EU industrial sectors at risk of carbon leakage (and thus prevent carbon leakage), while, at the same time, not jeopardizing the motivation of beneficiaries to further invest in relevant environmental measures.

The following text contains our main concerns in terms of individual compensation parameters proposed by the Commission. All these points and recommendations need to be perceived in mutual relations.

#### **1) Sectoral eligibility**

In comparison with the current trading period, the number of sectors (NACE) eligible for compensation is proposed to be reduced almost by a half. However, to make the compensation effective, the industrial value chain of eligible sectors proposed must be taken into account both in terms of supplying sectors (e.g. raw material or energy inputs such as industrial gases which will be also very important for long term transformation of some sectors) and downstream processes/sectors that are at risk of carbon leakage due to electricity prices. Without this and due to further reduction of compensation proposed by the Commission (in aid intensity and benchmarks, see point 2 and 4 below), the compensation even for some sectors already proposed to be eligible for aid could cover less than 50 % of the actual indirect costs borne by the companies. This undermines significantly the effectiveness of the provisions to prevent the risk of carbon leakage. The

downstream processes or subsectors at risk of carbon leakage will also face increased costs of carbon, energy and material inputs which further reduces their competitiveness.

Furthermore, the proposed possibility for member states to exclude eligible sectors (paragraph 21) creates major legal uncertainty and may lead to unintended effects and distortions within the EU. Thus, it should not be retained in the final text.

## **2) Maximum level of aid intensity**

We welcome that the Commission is proposing to keep the State Aid intensity factor stable over the whole 4<sup>th</sup> trading period. However, there are several reasons why we are convinced that the percentual figure should be higher than 75 % (concretely 100 % of the benchmark) as a basic rule, instead of the proposed possibility for individual member states to compensate by intensity higher than 75 % in individual cases (see point 3).

The eligible sectors are facing high exposure of carbon leakage linked to indirect costs and are unable to pass through unilateral regulatory costs without genuine risk of losing market shares. This risk is even more relevant in the context of much higher carbon prices compared to those experienced in the recent past.

Furthermore, affordable and competitive electricity prices are essential to facilitate the transition to breakthrough technologies which will require even larger amounts of electricity.

Thus, the aid intensity factor needs to be set at 100 % of the benchmark because any factor reduction undermines the effectiveness of the carbon leakage provisions as long as there is no comparable climate legislation in competing countries. No one can say that this intensity would mean full compensation of indirect costs, as the aid will still be capped by the very strict benchmarks which are to be even updated in the middle of the period. It is clear that energy efficiency improvements are a must for industries with high energy costs in order to remain competitive.

*For example, in case of using fall back benchmarks, the compensation will be reduced by 20 % compared to the baseline electricity consumption. If the 75% aid intensity level would be set, the installations in fall back may receive compensation only for maximum of 60 % of their indirect costs (75 % of 80 %). This is absolutely not consistent with the aim to ensure sufficient carbon leakage protection.*

## **3) Possibility of MSs to compensate beyond the 75 % intensity**

As stated in point 2, we are convinced that the aid intensity must be kept at the level of 100 % of the benchmarks to make the compensation fit for purpose.

Nevertheless, if the default aid intensity is not increased to such level, introducing the possibility for member states to grant additional compensation beyond the default value is an important step to reduce indirect costs to eligible sectors. Then, the additional compensation should be set so that indirect costs are capped at no more than 0.5 % of the GVA (adequacy of using GVA is commented below). At the same time, this possibility should be open to all eligible sectors and not limited only to some of them.

Finally, it should be noted that undertaking specific assessment needs to consider the actual specificities of the sites. The GVA of companies is highly dependent on their structure, including the configuration of the production steps where the higher share of value added is generated. Hence, a site assessment would also be necessary where appropriate.

Furthermore, company-specific assessment on electricity consumption should not lead to unintended results in case energy efficiency measures that have already been implemented.

#### **4) Update of the fall back benchmarks**

The draft guidelines do not indicate the default value of the fall back benchmark. In phase 3, this was 80 % of the reference electricity consumption. Since this represents a major reduction of aid, it should not be reduced further, otherwise the state aid would be insufficient to achieve its objective of avoiding the risk of carbon leakage.

It should also be noted that the reference fall back benchmark in the free allocation rules for direct emissions is the process emissions benchmark, which is much higher than the electricity fall back benchmark (97% of historical process emissions) and most importantly has not been further reduced between phase 3 and phase 4.

#### **5) Regional emission factors**

As a matter of principle, the CO<sub>2</sub> emission factor must reflect the full indirect CO<sub>2</sub> burden, i.e. the actual CO<sub>2</sub> cost passed through into prices. The approach of using historical empirical data on the fossil emission factor in the relevant regional market should be maintained in order to ensure a consistent and stable framework. The calculation of the factors should be based on reliable and transparent sources in order to reflect the real costs faced by the industry.

#### **6) Conditionality**

Generally, there is an urgent need to respect the essence of the “compensation” measure. Therefore, the aid should not be conditional upon additional requirements as it aims at reimbursing the energy consuming sectors for the indirect costs passed on in their energy bill. The proposed conditionality on additional measures to be taken by the beneficiaries (i.e. investments in energy efficiency or emission reductions and carbon free power purchase agreement) requires additional expenditures and this would cause that the purpose of the compensation which is to reimburse incurred costs is lost as well as the proper carbon leakage protection effect.

As the eligible sectors are acknowledged as being at risk of carbon leakage (on the basis of market characteristics, profit margins and abatement potential), any missed reimbursement would create further conditions for the materialisation of such risk, leading to, inter alia, an increase in global emissions. The beneficiaries must have a right to invest their capital, including the money received through the compensation, to measures according to their actual needs as possibilities, and they should not be obliged by any rules to do some concrete steps. In this context, it is also necessary to add that energy efficiency improvements are a must for industries with high energy costs in order

to remain competitive. Compensation of indirect costs does not distort incentives for energy efficiency investments because it is still based on very strict benchmarks reflecting the best performance in the sector. Furthermore, the “incentive effect” is also preserved by the fact that the benchmarks will be updated during the phase 4, so that companies have further interest in improving performance, where technically possible.

Moreover, the proposed conditionality requirements are actually linked to the implementation and enforcement of other pieces of legislation (notably the Energy Efficiency Directive and the Renewable Energy Directive). However, member states retain the possibility of adopting different instruments to promote energy efficiency and renewables in order to achieve the targets set in such legislation. Therefore, the conditionality requirements would overlap and possibly collide with different national measures.

Finally, the three proposed conditionality requirements present specific crucial limitations:

- a) The energy efficiency investments with a payback period of 5 years do not reflect the reality of business decisions (e.g. in the steel sector), which are bound to a significantly shorter period. Furthermore, the draft text does not take into account early actions such as recent energy efficiency investments. We strongly disagree with any conditionality. If there is no political will to delete it, the only and possibly acceptable requirement in this sense would be that the beneficiaries should strive, according to their possibilities, to follow recommendations of the energy audits (i.e. without payback time requirement).
- b) The requirement to install an onsite renewable energy generation facility covering at least 50 % of the electricity needs absolutely does not match with the very large energy consumption of industrial sites and the physical limits of such on-site generation. Furthermore, the RES can never match with the typical non-stop production nature of the sites, as they are not able to ensure stable and permanent supply of enough energy needed. And moreover, in many plants it would not be possible to build up the required RES capacities due to their land capacities and requirements. This conditionality requirement is therefore not technically nor financially feasible, hence it cannot be achieved realistically by the eligible sectors.
- c) The requirement to invest at least 80 % of the received state aid into investments to reduce direct emissions of the installation is not consistent with the scope of the Guidelines which are targeting indirect costs. This requirement completely undermines the purpose of the compensation. Furthermore, the condition to ensure that the investment must lead to emission reduction well below the benchmark values does not take into account neither existence and availability of the technologies, nor the fact that investment in such technologies would require far more financial sources, including private sources, of which the 80 % of compensation would be negligible.

## Annex I

### NACE 20.14, NACE 20.16

#### **ETS State aid Guidelines – position paper**

Association of Chemical and Pharmaceutical Industry of the Slovak Republic supports current emission reduction targets of European Union, recognizing great importance of EU ETS as a tool in transition of European industry to carbon neutrality. It is essential to ensure that this unprecedented, common effort of entire European economy is appropriately distributed among sectors and supported by financial measures, letting European industry as the most exposed sector to keep its competitiveness in the global market. Compensation of indirect costs of electricity, together with the free allowances allocations are indispensable tools for minimizing carbon leakage risk of industry sector. It remains crucial to distinguish between direct and indirect risk of carbon leakage. However, whereas it is possible to easily quantify direct effect of the emission costs on production and industry competitiveness, there are methodological challenges in case of sectors with serious indirect risk of carbon leakage resulting from interdependencies between particular value chains across all the industry.

The new, quantitative criteria of indirect electricity costs compensation appear to be reasonable. Quantitative assessment assures structured policy approach towards all the industry sectors exposed to higher prices of electricity stemming from the EU ETS. At the same time, it is crucial to underline necessity of individual approach to qualitative eligibility criteria in reference to sectors exposed to indirect carbon costs with effects reaching far beyond the situation of particular sector.

**Petrochemical-related sectors** are not on the list in draft Guidelines, but substantially affect many other sectors in the strategic high-end value chains. Despite the fact that those sectors do not meet quantitative criteria proposed by the European Commission, they should be eligible under qualitative assessment as their absence on the list may result in far reaching negative consequences for low-carbon transformation of European industry at large. Sectors that fits into this group are those directly related to petrochemical production: **NACE 20.14: manufacture of other organic basic chemicals and NACE 20.16: production of plastics in primary forms which is strictly interdependent with petrochemical sector.**

According to the new methodology Indirect Carbon Leakage Indicator value moves NACE 20.14 sector to the borderline category. Moreover, due to the specificity of NACE 20.14, there are some considerable doubts if the values used in quantitative assessments reflect real situation of the sector.

Dependent on the company structure, reported GVA contributions for NACE 20.14 can contain data from many different products and processes as well as non-production personal and R&D costs or income from participations and investments. Due to the reporting phenomenon specific for NACE 20.14<sup>1</sup>, the reported GVA could be overstated (Eurostat allows that GVA of a site with multiple products can be reported under one NACE code). For many chemical sites 20.14 is the most important sector, as it is the biggest subsector of the chemical industry. As a consequence real Indirect Carbon Leakage Indicator in all likelihood exceeds 0,2.

At the same time Indirect Carbon Leakage Indicator for 20.16 is 0,246 higher than postulated > 0,2.

Objective risk of carbon leakage risk for all these codes have to be evaluated as high. The key arguments that constitutes this situation:

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<sup>1</sup> Eurostat GVA for NACE 20.14 is in any case not a fixed and stable figure but instead subject to retroactive statistical changes over time. Depending on the observed point in time and the nature and spread of margins of reported activities, the actual GVA value is changing and then leads to a different score of direct and indirect emission intensity in kg CO<sub>2</sub>/€ GVA making NACE 20.14 a borderline case that should be subject to a qualitative assessment.

- Unlike majority of the sectors exposed to carbon leakage risks not included in the proposal, petrochemicals are present in value chains of many other industry sectors. They serve as a raw material or semi-finished product used within the same company or in other entities from other industry sectors. The length of the products value chain and the degree of processing required may vary depending on particular product, nevertheless weakening of competitiveness of European petrochemical production will subsequently affect all related sectors. The main groups of high-volume organic compounds are: aliphatic compounds (ethylene, propylene), aromas (benzene, toluene, xylene), and oxygen compounds such as ethylene oxide, ethylene glycol, formaldehyde and methanol. Derivatives of these products can be found in clothing, household goods, car components, airplanes, computers, paints, solvents, cosmetics and pharmaceuticals. Many of these products enable the reduction of greenhouse gases in other sectors of the economy, e.g. insulation materials in construction, production of renewable energy installations, improvements of the energy efficiency in transport (composites that reduce the weight of vehicles).
- One of the biggest advantages of European petrochemical industry is high integration of crackers in the chemical value chains. Weakening this source of synergies decreases European petrochemical industry competitiveness and real GVA stemming from the manufacturing process.
- Petrochemical industry in Europe accounts for around half of ETS chemical industry emissions, so presents great potential of further electrification of its manufacturing processes. Electrification is a cornerstone in the long-term process of transformation of energy intensive industries in compliance with carbon neutrality goal. Higher prices of electricity will deter European industry from investments in electrification.
- Currently existing electrified manufacture facilities will become disadvantaged – while direct emission will be still receiving free allowances, indirect costs of electricity will not be compensated in any way.
- Excluding petrochemicals from Member States' indirect cost compensation will negatively affect competitiveness of the sector on global market due to higher costs of production. This argument becomes even stronger when we take into account recent big investments of petrochemical companies from other regions of the world including China and Arab Peninsula.
- Abovementioned tendency is also very actual for production of plastics in primary forms – along with big increase of world manufacturing capacity in last years, retaining current market share of European companies would be difficult even without EU ETS impact.