

Comments on draft EU ETS State Aid Guidelines

Polish Organisation of Oil Industry and Trade (POPiHN) views the compensation of indirect emissions costs as indispensable measure to protect the international competitiveness of European refineries. Draft Guidelines as well as Consultants report confirm the significant risk of carbon leakage due to indirect ETS costs in case of refineries that not only produce goods traded on the worldwide market with prices determined on stock exchanges, but have limited ability to pass-through indirect and direct carbon costs.

Proposed quantitative assessment uses free allocation methodology limited to indirect emission data only, which we view as methodologically correct. However, the proposed eligibility conditions to enter qualitative assessment (trade intensity x indirect emission intensity > 0,2 and carbon leakage risk rated at 'medium risk') is not consistent with the approach applied to the assessment of the risk of carbon leakage, which via free allocation remedies the risk. Just like in case of direct and indirect carbon leakage list for 2021-2030, a qualitative assessment should be considered for borderline sectors and sub-sectors with at least trade intensity x indirect emission intensity > 0,15 and in case of incomplete or missing data - at Prodcorn 8 level.

It is especially important for borderline cases such as NACE 20.14 – a strategic sector for multiple value chains throughout economy, located between the refined petroleum products sector (NACE 19.20) and the production of materials indispensable for the economy transformation, such as specialty chemicals and high value chemicals used to the production of insulation materials, lighter materials in automotive sector or advanced materials for renewable technologies.

It is worrying that the consultants understate fuel and electricity exchangeability factor. Certain products, including the most important high value chemicals under NACE 20.14, can be produced through both fuel- or electricity-driven processes. The exchangeability is used to set these

product benchmarks in order to avoid distortion between EU producers. Otherwise, installations interchangeably using heat or mechanical energy from electricity would be in a significantly worse situation than those using heat or mechanical energy from fuel combustion, even if the overall emission efficiency of both installations is at the same level.

As indirect emissions from electricity consumption are not eligible for free allocation, the share of indirect electricity emissions is subtracted from the calculated free allocation. Therefore for consistency reasons, all sectors with product benchmarks which face exchangeability should be eligible for full indirect cost compensation to avoid distortion between EU producers. The logic was followed during qualitative criteria setting for indirect compensation in phase III: for indirect compensation eligibility in case of a higher trade intensity, a lower cost criterion has been accepted for sectors where fuel/electricity exchangeability is a key factor. It is important to stress that moderate extension of the list of eligible sectors is unlikely to cause undue distortions of competition in the internal market. Indirect cost compensation schemes have been introduced in the majority of industrialized EU Member States, with economies that the sectors deemed to be at the risk of carbon leakage play an important role in. Additional governments, including Poland and Czech Republic, have also recognised the advantages and implement the indirect compensation schemes.

Data on refining sector confirms investment leakage phenomenon as new investment in refining capacities are taking place outside the EU. Global oil refining capacity is expected to increase by 15% over 2018-25, about 75% of new capacity additions will be in Asia Pacific and Middle East.¹ At the same time in recent years we can observe closing refineries in the EU. Since 2009, out of the 100 refineries operating in Europe, 18 mainstream refineries were closed. The 78 mainstream refineries operating in 2018 in the EU-28, Norway and Switzerland had a primary refining capacity of 662 million tonnes. This represents a decrease by some 95 million tonnes of primary refining capacity since 2010.² In the period from 2010 to 2017 oil and petroleum products imports increased from 920,1 Mtoe to 968,5Mtoe, and final consumption petroleum products in

¹ Bloomberg NFT 2019

² Fuels Europe Statistical Report 2019

⁴ EU Energy in Figures 2019

transport sector increased from 299,8 Mtoe to 303 Mtoe.⁴ This could mean that UE refinery production is being replaced by imports. It means carbon leakage.

We can also observe increasing regulatory pressure on fossil based fuels and accompanied by increasing incentives for alternative fuels. In this context the following should be mentioned: planned amendment of energy taxation directive and alternative fuels directive, new regulations concerning emission standards for vehicles. There is already significant and accelerating increase in electric vehicles in EU. Therefore refineries' margins are shrinking and passing through of any additional costs seem very difficult. For the European refineries indirect compensation provides an instrument to manage transition risks as substantial financial resources are required to for example step up investment in low-carbon hydrogen, bio-methane and advanced biofuels. Oil companies are already redeploying capital to switch to "energy" companies that supply a range of fuels, electricity and other energy services (shift to electricity) or deepening integration with petrochemical operations.

POPiHN appreciates the proposal of stable level of 75% aid intensity throughout phase IV. However, since the calculation of maximum aid is based on the most recent production data and ambitious updated efficiency benchmarks, we would encourage to increase aid intensity level to 100% throughout entire ETS phase IV to ensure better protection. The European industry sectors with serious indirect risk of carbon leakage are going to be exposed to increasing indirect carbon costs while facing competitors from third countries. Alternatively, just like in current compensation scheme, the intensity factor could be set at the level of 100% at the beginning and reduced to 75% later.

Concerning increasing competition from non-EU refineries, as mentioned previously, investing in energy efficiency is a must. According to Salomon Associates energy savings in refining business is one of the key competitive advantages. Therefore there is no risk of less investment in efficiency improvements due to higher compensation level. Green New Deal requires unprecedented levels of investment, so the industry could use whatever it can get on financing the transformation, in particular given the planned increase the EU's greenhouse gas emission reductions target for 2030 to at least 50% and towards 55% compared with 1990. When it comes to CO₂ prices assumptions presented in the report, it seems, that 15 €/tone of CO₂ is not relevant

any more. Concerning more ambitious regulations in ETS phase IV, we should rather expect higher prices of CO₂ and thus take into consideration scenarios assuming 25 € or even 35 € CO₂ price as more realistic, with all its consequences provided in the report, including 300 mln and 400 mln € annual indirect costs respectively.

It is valuable to have energy audits or energy management systems as a condition for beneficiaries – these are already introduced in indirect cost compensation scheme in Poland. However, we are against the strict obligations imposed on beneficiaries to implement recommendations of audit reports, installing RES to cover at least 50% electricity consumption or invest in substantial (below the benchmark) reduction of direct emissions.

The condition to have aid invested in energy efficiency measures with the proposed [5 years] payback time should be challenged. Investments in energy efficiency improvements in energy intensive industries often take many years and are conducted in stages. Majority of investments have already been completed (low-hanging fruits) and it becomes more difficult to achieve the proposed payback time. As a possible option we recommend to introduce longer payback time to avoid discrimination against projects that generate substantial cash inflows in later years.

Moreover, the incentives to energy efficiency improvements are already present in sectors with already adopted ambitious product benchmarks reflecting the best performance in the sector (to be further updated for EU ETS phase IV). The use of recent production data and updated benchmarks replace aid degressivity and provide sufficient incentive for energy efficiency investments. However, the dynamic adjustment of aid (based on recent electricity consumption data) is likely to reduce the incentive to energy efficiency improvements in case of beneficiaries manufacturing products where fall-back electricity consumption efficiency benchmark is applied, as improving energy efficiency directly translate into an aid's decrease.

The condition to reduce carbon footprint of electricity consumption should take account of the specific characteristics of energy intensive industries. It is not always viable to install on-site renewable energy generation facility due to various weather-related or land limitations. The proposed threshold of 50% is also too high given absolute values of electricity volumes consumed

and intermittency issues given still prohibitive costs of sustainable energy storage solutions at scale required by industry.

The draft also proposes too ambitious indication of substantial reduction of direct emissions. Due to the methodology used in benchmarks update, they are reduced to the levels not achievable by the industry at large. It is important to stress that each subsequent emissions reduction achieved costs more and the increasing number of companies reach economic and technological limitations of production assets. Too ambitious benchmarks lose their motivational goal, as the companies not able to meet benchmarks are burdened with increasing direct emissions costs, tend to limit or simply end the production.

Emission factor at country level approach is maintained, which is appropriate as there are still great limitations to market coupling in the majority of Member States. Calculation methodology based on 'marginal plant approach' based on average of fossil fuel plants should remain unchanged until 2030, not only 2025.